John Williams'
Shadow Government Statistics
Analysis Behind and Beyond Government Economic Reporting

COMMENTARY NUMBER 650
July 2014 Industrial Production, Producer Price Index (PPI)

August 18, 2014

Production Report Showed Somewhat Weaker Second-Quarter Activity
Amidst Unusual Revision Patterns

Construction Inflation Surged in the July

PLEASE NOTE: The next regular Commentary *is scheduled for tomorrow, Tuesday August 19th, covering the July consumer price index (CPI), real retail sales and earnings, and housing starts.*

Best wishes to all — John Williams

OPENING COMMENTS AND EXECUTIVE SUMMARY

Downside Second-Quarter Revisions and Weaker Third-Quarter Economic Reporting Should Become the Trend. Friday's (August 15th) reporting of 0.4% headline production growth in July topped market expectations, but such was in the context of some unusual downside revisions to second-quarter 2014 activity.

On a seasonally-adjusted basis, surging July automobile production ran counter to weakening auto sales. In theory, the seasonal adjustments should have accounted for normal variations in production and sales activity tied to the shift to a new model year for autos. The divergent production and sales trends eventually will be resolved in the handling of inventories. All of the data are of poor quality, and downside revisions to both inventories and production levels are likely in the months ahead, as are downside revisions to automobile sales.

The irregularly-volatile July PPI generally was in line with the market consensus, showing as minimal a positive monthly headline inflation rate as possible. While not too much should be read into this recently recreated series, there may be an unfolding story in rising construction inflation.

Headline reporting for the bulk of the remaining, major July economic series—initial indicators of third-quarter 2014 economic activity and inflation—will be published tomorrow (see the *Week Ahead* section). Increasingly, headline reporting generally should disappoint market expectations, confirming a continuing decline in broad, headline economic activity that took root in first-quarter 2014. In turn, general market expectations should move towards renewed economic contraction. A summary assessment of initial July economic reporting and related early implications for third-quarter GDP estimation and for second-quarter GDP revisions is planned for tomorrow's (August 19th) *Commentary No. 651*.

The balance of today's relatively brief missive concentrates on the details of the July industrial production and producer price index data.

Industrial Production—July 2014—Strong July Amidst Unusual Revisions. Headline July 2014 production rose by 0.4% for the month, and headline June production rose by an upwardly revised 0.4%, from what initially had been 0.2% monthly growth. The news, though, was not quite as good as the headlines appeared. The revised boost in June growth was not due to an upside revision in June activity, but rather to a downside revision in May activity. April and June production levels effectively were unrevised, but May activity revised lower, taking the overall level of second-quarter activity down a notch. Implications for the GDP are for some minimal downside revisions to the initial estimate of second-quarter 2014 growth. That will be discussed in tomorrow's (August 19th) *Commentary No. 651*. Affected areas include not only manufacturing, but also suggestions of downside revisions to an already-contracting trend in utility usage among homeowners.

On the surface, headline July production was strong, heavily affected by surging automobile production. With auto sales faltering, however, significant issues arise as to what really is happening to inventories and to consumer demand. Again, this will be discussed in *Commentary No. 651*. In the weeks and months ahead, look for weakness in new reporting and for downside revisions to the data in hand.

Industrial Production—July 2014. Headline, seasonally-adjusted, July 2014 industrial production rose by 0.4% (0.44% at the second decimal point) on a month-to-month basis. Net of prior-period revisions, the July gain was 0.46%.

In the context of the unusual pattern of prior-period revisions, the July reporting was against a revised 0.38% (previously 0.22%) gain in June. Again, June was not revised higher; May simply was revised lower. Accordingly, the June gain was against a revised 0.34% (previously 0.47%) monthly gain in May.

Given the unusual nature of the May revision, the usual comparisons of monthly changes that follow are not meaningful. The headline 0.4% July production gain (revised June 0.4% gain) was composed of a July 1.0% gain (revised June gain of 0.3%) in manufacturing; a 0.3% July gain (a revised June gain of 1.3%) in mining; and a 3.4% July decline (-3.4%) [revised June 0.7% decline (-0.7%)] in utilities.

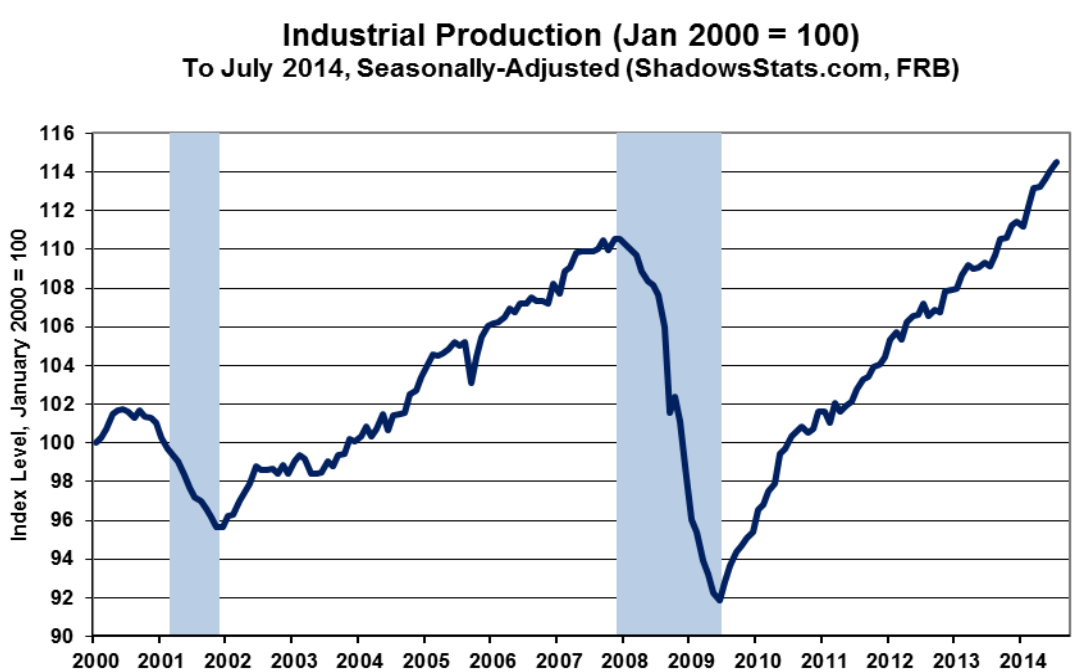
Year-to-year growth in July production increased to 4.97%, from a revised 4.34% in June, and a revised 4.15% (previously 4.30%) in May.

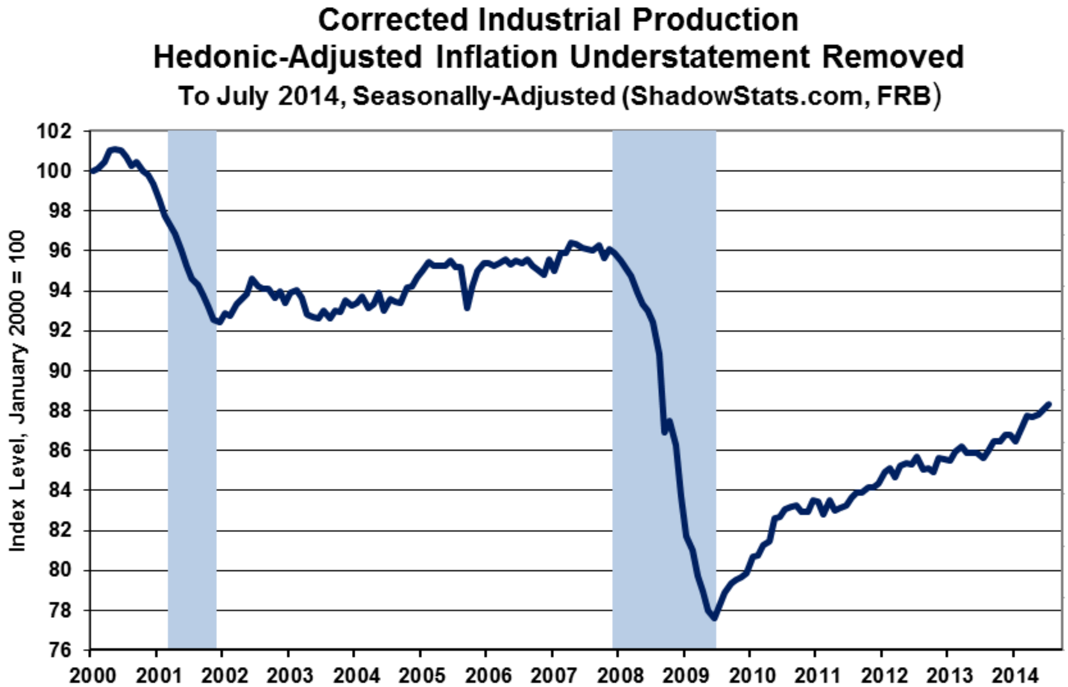
Production Graphs. Official production levels have moved higher since the June 2009 trough, setting a new series high, with the July 2014 reporting. Corrected for the understatement of inflation used in deflating portions of the industrial production index, however, the series has shown more of a pattern of stagnation with a slow upside trend, since 2009, topping out into 2012, with a renewed upside move into a recent, protracted period of inventory build-up. A further topping out pattern should develop as excess inventories are worked off.

Updated graphs of industrial production activity follow, including an index of the headline production level, and production index as corrected for the understatement of the inflation used in deflating certain components of industrial production. The regular graphs of short- and long-term headline industrial production activity, both in terms of official level and reported year-to-year change, are found in the *Reporting Detail* section. Drill-down and various graphics options for the official headline data also are available at ShadowStats-affiliate www.ExpliStats.com.

Corrected Industrial Production. Hedonic quality adjustments to inflation understate the inflation used in deflating some components of industrial production. That has the effect of overstating the resulting inflation-adjusted growth in the headline industrial production series (see *Public Comment on Inflation* and the discussion in *Chapter 9* of *2014 Hyperinflation Report—Great Economic Tumble*).

Again, the two following graphs address that issue. The first reflects official industrial production reporting, indexed to January 2000 = 100, instead of the Fed's formal index that is set at 2007 = 100. The 2000 indexing is used simply to provide for some consistency in this series of revamped graphics; it does not affect the appearance of the graph or reported growth rates. The second graph is a version of the first that has been corrected for the understatement of the inflation rate used in deflating the production index, with estimated hedonic-inflation adjustments backed-out of the official industrial-production deflator.





The "corrected" graph does show some growth in the period following the official June 2009 near-term trough in production activity. Yet, that upturn has been far shy of the full recovery and the renewed expansion reported in official GDP estimation. Unlike the headline-production data and the headline GDP, corrected production levels have not recovered pre-recession highs. Instead, corrected production entered a period of protracted low-level stagnation in 2012, with quarterly contractions in third-quarter 2012, second-quarter 2013, with stagnation in third-quarter 2013, and some upturn in the fourth-quarter 2013 and into 2014.

Producer Price Index (PPI)—July 2014—Construction Inflation Spiked. The recently-designed and redefined PPI showed a minimal 0.09% increase in headline wholesale inflation for July, which was within the general scope of market expectations for this highly volatile, unstable and questionable series. The aggregate gain reflected "unchanged" goods inflation, depressed by downside seasonal adjustments to energy inflation offsetting rising food prices, with the minimal 0.09% monthly inflation gain coming in on the services side. Not headlined, but of concern to anyone looking at construction spending numbers in real terms, adjusted for changing costs, "final demand construction" inflation jumped by a seasonally-adjusted 0.5% for the month of July 2014, up by 3.3% year-to-year.

As of January 2014, the traditional headline monthly measure of wholesale inflation in "finished goods," was redefined and replaced by a headline monthly measure of wholesale "total final demand," composed of "final demand goods" (basically the old "finished goods" series), "final demand services" which tends to cap the goods inflation when oil prices are an issue, and "final demand construction."

"Final demand services" largely reflects problematic and questionable surveying of intermediate or quasi-wholesale profit margins in the services area, a "soft" measure of inflation, at best. The relatively "hard" measure of goods inflation remains in place, but more often than not, its reporting is dominated in the aggregate headline inflation number by the guesstimated services inflation. There is not enough history available on the new series (just five years of post-2008-panic data) to establish any meaningful predictive relationship to general inflation, while the goods sector relationship has been established for many years.

July 2014 Headline PPI Detail. The seasonally-adjusted, month-to-month, headline producer price index (PPI) for July 2014 "total final demand" inflation increased by 0.09%, following a 0.36% monthly gain in June. The aggregate impact of the various seasonal adjustments on the headline monthly gain was nil. On a not-seasonally-adjusted basis—all annual growth rates are unadjusted—year-to-year headline PPI inflation was 1.74% in July 2014, versus 1.92% in June 2014, and against 1.96% in July 2013.

In terms of the three major subcategories for June 2014 "final demand" PPI, headline monthly "final demand goods" inflation was unchanged, "final demand services" inflation was up by 0.09%, and "final demand construction" inflation was up by 0.45%.

Final Demand Goods. Running somewhat in parallel with the old "finished goods" PPI series, headline monthly "final demand goods" inflation in July was unchanged, following a 0.52% gain in June, with an aggregate nil impact on the July reading from underlying seasonal-factor adjustments. Year-to-year inflation was 2.04% in July 2014, versus 2.13% in June 2014, and against 1.80% in July 2013. Headline monthly changes by major components for July final demand goods:

- "Foods" inflation was up by 0.41% in July, versus a June contraction of 0.24% (-0.24%), boosted by seasonal adjustments.
- "Energy" inflation fell by 0.58% (-0.58%) in July, following a 2.06% gain in June, with the July reading depressed by seasonal adjustments.
- "Less foods and energy" ('core' goods) inflation rose by 0.18% in July, versus a headline monthly gain of 0.09% in June. Seasonal adjustments enhanced the July gain.

Final Demand Services. Headline monthly "final demand services" inflation rose by 0.09% in July, following a 0.28% gain in June. As with the goods inflation, the impact on the July services inflation reading from underlying aggregated seasonal-factor adjustments was nil. Year-to-year unadjusted inflation was 1.58% in July 2014, following 1.87 % in June 2014, and against 1.99% in July 2013. The headline monthly changes by major components for June final demand services inflation:

- "Services less trade, transportation and warehousing" inflation was unchanged, versus a gain of 0.28% in June, with negative impact from seasonal adjustments.
- "Transportation and warehousing" inflation rose by 0.51% in July, following a 0.34% gain in June. Seasonal adjustments enhanced the July gain.
- "Trade" inflation was up by 0.18% month-to-month in July, for the second month, with the gain also boosted by seasonal adjustments.

Final Demand Construction. Although a fully self-contained subsection of the Final Demand PPI, "final demand construction" inflation receives no formal headline coverage, although there are headline numbers published. Headline monthly construction inflation jumped by 0.45% in July 2014, versus a

0.09% gain in June. The effective impact of seasonal factors on the headline number was nil. On an unadjusted basis, year-to-year inflation was 3.26% in July 2014, effectively the same as the 3.27% in June 2014, but up from 1.70% inflation in July 2013.

[For further details on July industrial production and PPI, see the* Reporting Detail *section. Drill-down and various graphics options for the headline production data are available at ShadowStats-affiliate www.ExpliStats.com.]

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HYPERINFLATION WATCH

Hyperinflation Outlook Summary. *[UNREVISED from prior* Commentary No. 649.*]* The long-standing hyperinflation and economic outlooks were updated with the publication of *2014 Hyperinflation Report—The End Game Begins – First Installment Revised*, on April 2nd, and publication of *2014 Hyperinflation Report—Great Economic Tumble – Second Installment*, on April 8th, along with ongoing updates in the regular *Commentaries*, including a review in *Commentary No. 639*.

Primary Summary. The primary and basic summary of the broad outlook and the story of how and why this crisis has unfolded and developed over the years—particularly in the last decade—is found in the *Opening Comments* and *Overview and Executive Summary* of that *First Installment Revised* (linked above). The following section summarizes the underlying current circumstance.

Consistent with the above *Special Commentaries*, the unfolding economic circumstance, in confluence with other fundamental issues, should place mounting and massive selling pressure on the U.S. dollar, as well as potentially resurrect elements of the 2008-Panic. Physical gold and silver, and holding assets outside the U.S. dollar, remain the primary hedges against the pending total loss of U.S. dollar purchasing power.

***Current Economic Issues versus Underlying U.S. Dollar Fundamentals*.** U.S. economic activity has turned down anew, with headline first-quarter 2014 GDP having contracted at an annualized real pace of 2.11% (-2.11%), following 3.50% fourth-quarter 2013 growth, per the July 30th GDP benchmark revisions. Although the initial headline second-quarter 2014 GDP growth came in at 3.95%, such was overstated heavily and subject to major downside revisions. By the time the now-unfolding headline third-quarter 2014 GDP growth is reported in contraction, the second-quarter GDP growth estimate should have revised to close to flat, if not worse. Consensus expectations still face downside shocks in the months ahead, moving the popular outlook towards a "new recession," with the shifts in the consensus likely to disrupt stability in the financial markets.

As financial-market expectations increasingly shift towards renewed or deepening recession, that circumstance, in confluence with other fundamental issues, should place mounting and massive selling pressures on the U.S. dollar, as well as potentially resurrect elements of the 2008-Panic.

Unexpected economic weakness intensifies the known stresses on an already-impaired banking system, hence a perceived need for expanded, not reduced, quantitative easing. The highly touted "tapering" by the FOMC is pre-conditioned by a continued flow of "happy" economic news. Banking-system and other systemic (*i.e.* U.S. Treasury) liquidity needs likely still will be provided, as needed, by the Fed, under the ongoing political cover of a weakening economy—a renewed, deepening contraction in business activity.

Unexpected economic weakness also savages projections of headline, cash-based, federal-budget deficits (particularly the 10-year versions) as well as projected funding needs for the U.S. Treasury. Current fiscal "good news" is from cash-based, not GAAP-based accounting projections, and comparative year-ago cash numbers are distorted against U.S. Treasury and government activity operating *sub rosa*, in order to avoid the limits of a constraining debt ceiling.

All these crises will combine against the U.S. dollar, likely in the very-near future.

In general, summary, the fundamental issues threatening the U.S. dollar could not be worse. They include, but are not limited to:

- A severely damaged U.S. economy, which never recovered post-2008 and is turning down anew. The circumstance includes a sharply widening trade deficit, as reflected in headline first- and second-quarter reporting, as well as ongoing severe, structural-liquidity constraints on the consumer, which are preventing a normal economic rebound in the traditional, personal-consumption-driven U.S. economy.

- U.S. government unwillingness to address its long-term solvency issues. Those controlling the U.S. government have demonstrated not only a lack of will to address long-term U.S. solvency issues, but also the current political impossibility of doing so. Any current fiscal "good news" comes from cash-based, not GAAP-based accounting projections. The GAAP-based version continues to run in the $6-trillion-plus range for annual shortfall, while those in Washington continue to increase spending and to take on new, unfunded liabilities.

- Monetary malfeasance by the Federal Reserve, as seen in central bank efforts to provide liquidity to a troubled banking system, and also to the U.S. Treasury. The current pace of the Fed's monetization is at 73.4% of effective net issuance of the federal debt to be held by the public in calendar-year 2014 (through August 6th), 70.7% since the January 2013 expansion of QE3.

- Mounting domestic and global crises of confidence in a dysfunctional U.S. government, where the relative positive rating by the public of the U.S. President tends to have a meaningful correlation with the foreign-exchange-rate strength of the U.S. dollar. Positive ratings for both the President and Congress are pushing, if not at, historic lows.

- Mounting global political pressures contrary to U.S. interests. Downside pressures on the U.S. currency generally are increasing, in the context of global political and military developments that have been contrary to U.S. strategic, financial and economic interests.

- Spreading global efforts to dislodge the U.S. dollar from its primary reserve-currency status.

Renewed and intensifying weakness in the U.S. dollar will place upside pressure on oil prices and other commodities, boosting domestic inflation and inflation fears. Domestic willingness to hold U.S. dollars will tend to move in parallel with global willingness, or lack of willingness, to do the same. Both dollar weakness and the resulting higher inflation should boost the prices of gold and silver, where physical holding of those key precious metals remains the ultimate hedge against the pending inflation and financial crises.

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REPORTING DETAIL

INDEX OF INDUSTRIAL PRODUCTION (July 2014)

Stronger Production Was Somewhat Out of Context. Headline July 2014 production rose by 0.4% for the month, and headline June production rose by an upwardly revised 0.4%, from what initially had been 0.2% monthly growth. The revised boost in June growth, however, was not due to an upside revision in June activity, but due to a downside revision in May activity, instead. April and June production levels were unrevised, but May activity revised lower, taking the overall level of second-quarter activity down a notch. Implications for the GDP are for some minimal downside revisions to the initial estimate of second-quarter 2014 growth. That will be discussed in tomorrow's (August 19th) *Commentary No. 651.* Affected areas include not only manufacturing, but also suggestions of downside revisions to an already-contracting trend in utility usage among homeowners.

On the surface, headline July production was strong, reflecting surging automobile production. With auto sales faltering, however, significant issues arise as to what really is happening to inventories and to consumer demand. In the weeks and months ahead, look for weakness in new reporting and for downside revisions to the data in hand (again, see tomorrow's *Commentary No. 651*).

Industrial Production—July 2014. The Federal Reserve Board released its first estimate of seasonally-adjusted, July 2014 industrial production on Friday, August 15th. Headline monthly production rose by 0.4% (0.44% at the second decimal point). Net of prior-period revisions, the July gain was 0.46%.

In the context of the unusual pattern of prior-period revisions discussed earlier, the July reporting was against a revised 0.38% (previously 0.22%) gain in June. Again, June was not revised higher; May simply was revised lower. Accordingly, the revised June gain was against a revised 0.34% (previously 0.47%, initially 0.59%) monthly gain in May.

Given the unusual nature of the May revision, the usual comparisons of monthly changes that follow are not meaningful. The headline 0.4% July production gain (revised June 0.4% gain, previously 0.2%) was composed of a July 1.0% gain (revised June gain of 0.3%, previously 0.1%) in manufacturing; a 0.3% July gain (a revised June gain of 1.3%, previously 0.8%) in mining; and a 3.4% July decline (-3.4%) [revised June 0.7% decline (-0.7%), previously a decline of 0.3% (-0.3%)] in utilities.

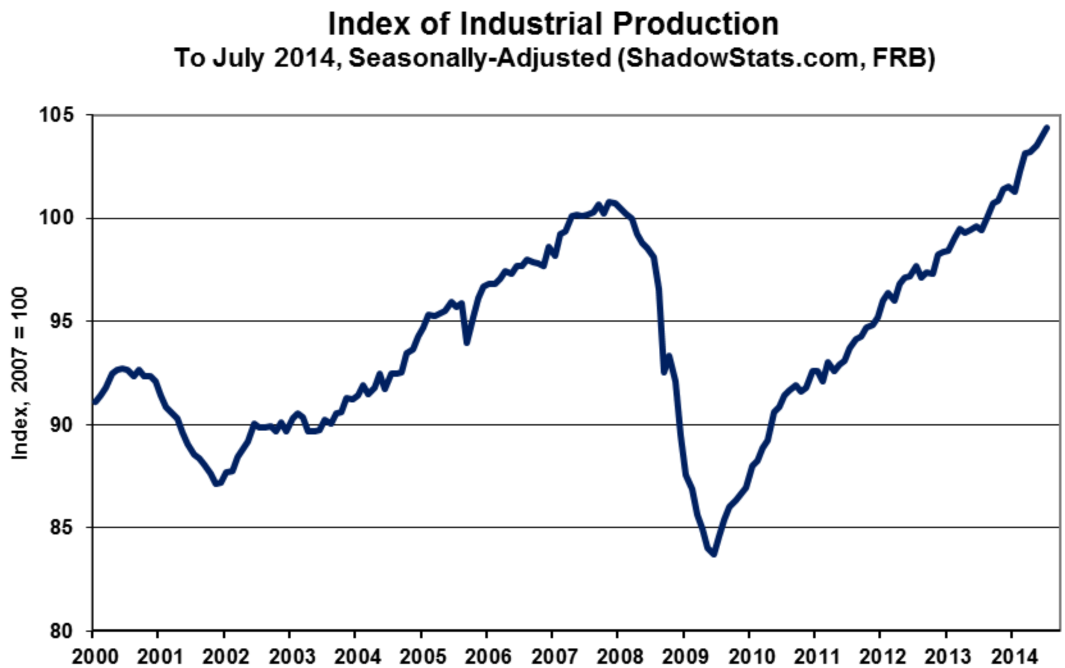
Year-to-year growth in July production increased to 4.97%, from a revised 4.34% (previously 4.32%) in June, and a revised 4.15% (previously 4.30%, initially 4.27%) in May.

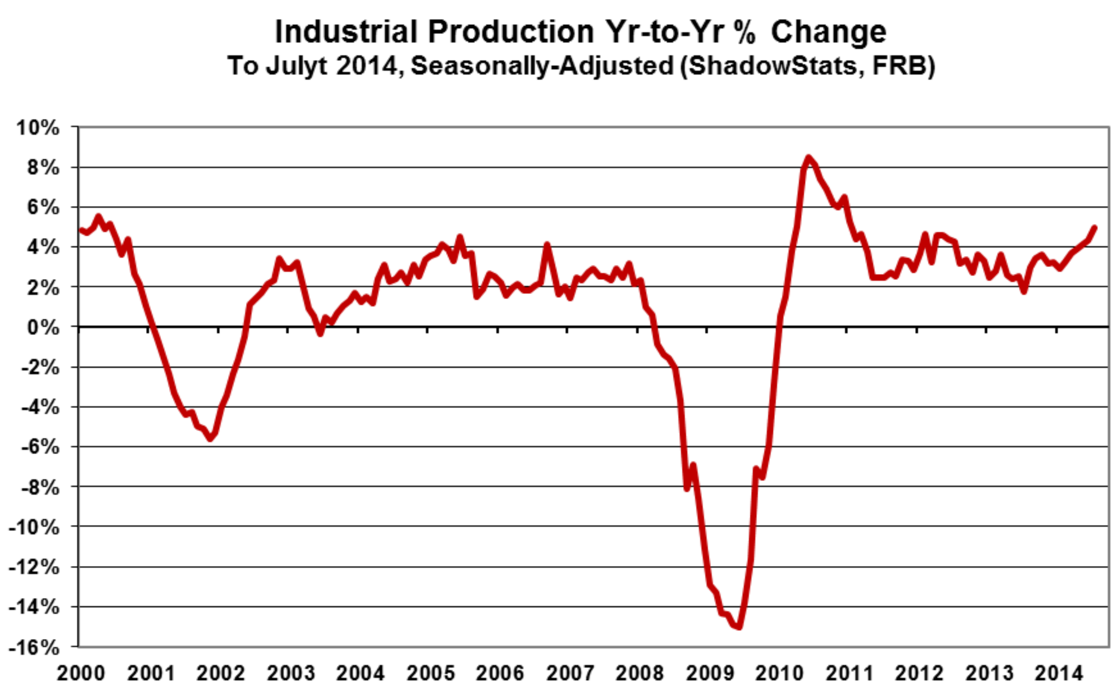
Production Graphs. The following two sets of graphs reflect headline industrial production activity. The first graph in the first set shows the monthly level of the production index, while the second graph shows the year-to-year percentage change in the same series for recent historical detail, beginning January 2000. The second set of graphs shows the same data in historical context since World War II.

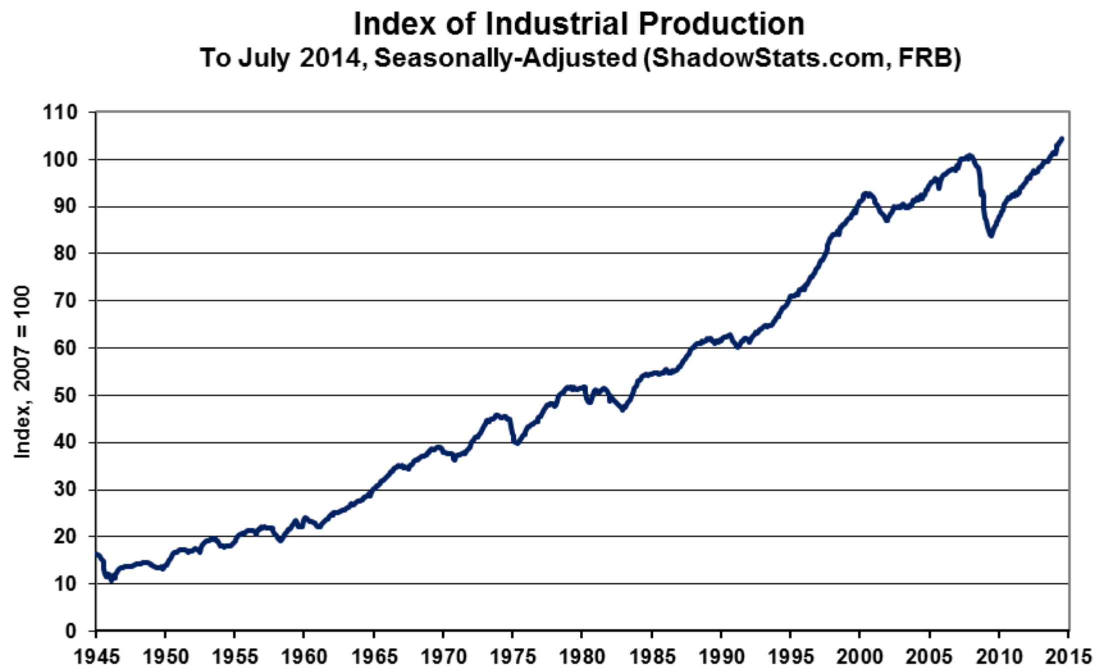
Shown more clearly in the first set of graphs, the pattern of year-to-year activity dipped anew in late-2013 to levels usually seen at the onset of recessions, although more-recent annual growth has come back some. Annual growth remains well off the recent relative peak for the series, which was 8.49% in June 2010, going against the official June 2009 trough of the economic collapse. Indeed, as shown in the second set of graphs, the year-to-year contraction of 15.06% in June 2009, at the end of second-quarter 2009, was the steepest annual decline in production since the shutdown of war-time production following World War II.

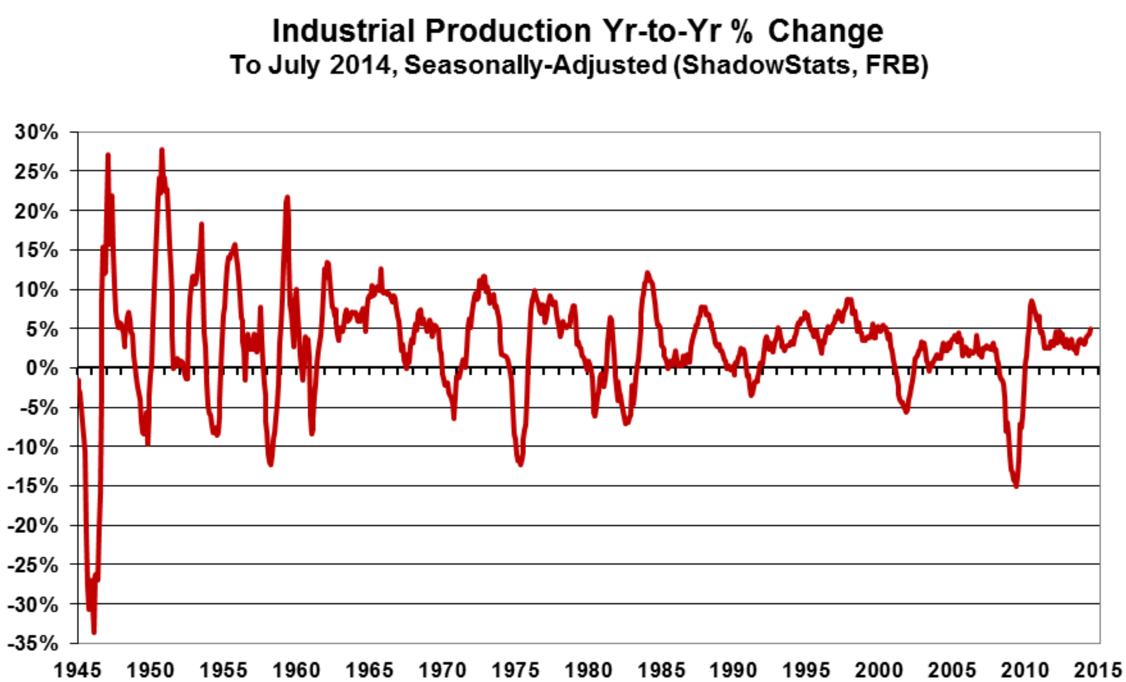
Official production levels have moved higher since the June 2009 trough, setting a new series high, with July's reporting. Corrected for the understatement of inflation used in deflating portions of the industrial production index, however, the series has shown more of a pattern of stagnation with a slow upside trend, since 2009, topping out into 2012, with a renewed upside trend into a recent, protracted period of inventory build-up.

The corrected production series is discussed and graphed in the *Opening Comments* section.


Index of Industrial Production
To July 2014, Seasonally-Adjusted (ShadowStats.com, FRB)
Index, 2007 = 100
105
100
95
90
85
80
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014


Industrial Production Yr-to-Yr % Change
To Julyt 2014, Seasonally-Adjusted (ShadowStats, FRB)
10%
8%
6%
4%
2%
0%
-2%
-4%
-6%
-8%
-10%
-12%
-14%
-16%
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014


Index of Industrial Production
To July 2014, Seasonally-Adjusted (ShadowStats.com, FRB)
Index, 2007 = 100
110
100
90
80
70
60
50
40
30
20
10
0
1945
1950
1955
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015


Industrial Production Yr-to-Yr % Change
To July 2014, Seasonally-Adjusted (ShadowStats, FRB)
30%
25%
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
-25%
-30%
-35%
1945
1950
1955
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015

PRODUCER PRICE INDEX—PPI (July 2014)

Watch Out for Rising Construction Costs. The recently-designed and redefined PPI showed a minimal 0.1% (0.09% at the second decimal point) increase in headline wholesale inflation for July, which was within the general scope of market expectations for this highly volatile, unstable and questionable series. The aggregate gain reflected "unchanged" goods inflation, depressed by downside seasonal adjustments to energy inflation offsetting rising food prices, with a minimal 0.09% monthly inflation gain on the services side. Not headlined, but of potential import to construction spending numbers in real terms, adjusted for changing costs, "final demand construction" inflation jumped by a seasonally-adjusted 0.5% in the month of July, up by 3.3% year-to-year.

Discussed in *Commentary No. 591*, a new producer price index (PPI)—effective with January 2014 reporting—replaced the traditional headline monthly measure of wholesale inflation in "finished goods," with a headline monthly measure of wholesale "total final demand," composed of "final demand goods" (basically the old "finished goods" series), "final demand services" which tends to cap the goods inflation when oil prices are an issue, and "final demand construction."

In the new structure of the PPI series, "final demand services" largely reflects problematic and questionable surveying of intermediate or quasi-wholesale profit margins in the services area. To the extent that profit margins shrink in the services sector, one could argue that the resulting lowered estimation of inflation actually is a precursor to higher inflation, as firms move to raise prices in an effort to regain more-normal margins. The new PPI series is an interesting concept, but likely limited as to its aggregate predictive ability versus general consumer inflation. There is not enough history available on the new series (just five years of post-2008-panic data) to establish any meaningful predictive relationship to general inflation, while the goods sector relationship has been established for many years.

July 2014 Headline PPI Detail. The Bureau of Labor Statistics (BLS) reported, Friday, August 15th, that the seasonally-adjusted, month-to-month, headline producer price index (PPI) for July 2014 "total final demand" increased by 0.09%, following a 0.36% monthly gain in June. The aggregate impact of the various seasonal adjustments on the headline monthly gain was nil. On a not-seasonally-adjusted basis—all annual growth rates are unadjusted—year-to-year headline PPI inflation was 1.74% in July 2014, versus 1.92% in June 2014, and against 1.96% in July 2013.

In terms of the three major subcategories for June 2014 "final demand" PPI, headline monthly "final demand goods" inflation was unchanged, "final demand services" inflation was up by 0.09%, and "final demand construction" inflation was up by 0.45%.

Final Demand Goods. Running somewhat in parallel with the old "finished goods" PPI series, headline monthly "final demand goods" inflation in July was unchanged, following a 0.52% gain in June, with an aggregate nil impact on the July reading from underlying seasonal-factor adjustments. Year-to-year inflation was 2.04% in July 2014, versus 2.13% in June 2014, and against 1.80% in July 2013. Headline monthly changes by major components for July final demand goods:

- "Foods" inflation was up by 0.41% in July, versus a June contraction of 0.24% (-0.24%), boosted by seasonal adjustments.

- "Energy" inflation fell by 0.58% (-0.58%) in July, following a 2.06% gain in June, with the July reading depressed by seasonal adjustments.
- "Less foods and energy" ('core' goods) inflation rose by 0.18% in July, versus a headline monthly gain of 0.09% in June. Seasonal adjustments enhanced the July gain.

Final Demand Services. Headline monthly "final demand services" inflation rose by 0.09% in July, following a 0.28% gain in June. As with the goods inflation, the impact on the July services inflation reading from underlying seasonal-factor adjustments was nil. Year-to-year unadjusted inflation was 1.58% in July 2014, following 1.87 % in June 2014, and against 1.99% in July 2013. The headline monthly changes by major components for June final demand services inflation:

- "Services less trade, transportation and warehousing" inflation was unchanged, versus a gain of 0.28% in June, with negative impact from seasonal adjustments.
- "Transportation and warehousing" inflation rose by 0.51% in July, following a 0.34% gain in June. Seasonal adjustments enhanced the July gain.
- "Trade" inflation was up by 0.18% month-to-month in July for the second month, with the gain also boosted by seasonal adjustments.

Final Demand Construction. Although a fully self-contained subsection of the Final Demand PPI, "final demand construction" inflation receives no formal headline coverage, although there are headline numbers published. Headline monthly construction inflation rose by 0.45% in July 2014, versus a 0.09% gain in June. The effective impact of seasonal factors on the headline number was nil. On an unadjusted basis, year-to-year inflation was 3.26% in July 2014, effectively the same as the 3.27% in June 2014, but up from 1.70% inflation in July 2013.

WEEK AHEAD

Against Overly-Optimistic Expectations, Pending Economic Releases Should Be Much Weaker; Inflation Releases Should Be Increasingly Stronger. Although shifting to the downside, again, amidst wide fluctuations, market expectations for business activity generally remain overly optimistic, well above any potential, underlying economic reality. Market outlooks should be hammered, though, by ongoing, downside corrective revisions and by an accelerating pace of downturn in headline economic activity.

Longer-Range Reporting. The initial stages of the process shifting economic-growth expectations to the downside already have been seen in the recent headline reporting of many major economic series (see *2014 Hyperinflation Report—Great Economic Tumble – Second Installment*), including the sharp pace of economic decline seen in real first-quarter 2014 GDP, which largely survived the GDP benchmark revisions. The initial strong bounce-back guessed at by the Bureau of Economic Analysis (BEA), for headline second-quarter GDP, should prove to be fleeting, both with looming downside revisions, and with a likely GDP contraction in third-quarter 2014.

Indeed, weakening, underlying economic fundamentals indicate still further deterioration in business activity. Accordingly, weaker-than-consensus economic reporting should remain the general trend until the unfolding "new" recession receives broad recognition, which likely would follow the next reporting of a headline contraction in real GDP growth.

A generally stronger inflation trend remains likely to continue, as seen in recent months. Beyond the spread of earlier oil-based inflation pressures into the broad economy, upside pressure on oil-related prices should continue and be rekindled from the intensifying impact of global political instabilities and a likely near-term weakening of the U.S. dollar in the currency markets. Again, food inflation also is picking up, partially due to supply issues. The dollar faces pummeling from the weakening economy, continuing QE3, the ongoing U.S. fiscal-crisis debacle, and deteriorating U.S. and global political conditions (see *Hyperinflation 2014—The End Game Begins (Updated) – First Installment*). Particularly in tandem with a weakened dollar, reporting in the year ahead generally should reflect much higher-than-expected U.S. inflation in a broad range of areas.

A Note on Reporting-Quality Issues and Systemic-Reporting Biases. Significant reporting-quality problems remain with most major economic series. Ongoing headline reporting issues are tied largely to systemic distortions of seasonal adjustments. The data instabilities were induced by the still-evolving economic turmoil of the last eight years, which has been without precedent in the post-World War II era of modern economic reporting. These impaired reporting methodologies provide particularly unstable headline economic results, when concurrent seasonal adjustments are used (as with retail sales, durable goods orders, employment, and unemployment data). These issues have thrown into question the statistical-significance of the headline month-to-month reporting for many popular economic series.

PENDING RELEASES:

Consumer Price Index—CPI (July 2014). The July 2014 CPI is scheduled for release tomorrow, Tuesday, August 19th, by the Bureau of Labor Statistics (BLS). The headline CPI-U is a fair bet to show an inflation gain that would top market expectations for a minimal monthly headline gain of 0.1%, or so. The reporting also will be reflected in estimates of July real retail sales and real average weekly earnings.

Average gasoline prices fell month-to-month in July 2014 by 2.1%, on a not-seasonally-adjusted basis, per the Department of Energy. Although BLS seasonal adjustments to gasoline prices should be positive in the July CPI, they will not be enough to turn gasoline prices into a positive contributor to the monthly headline July consumer inflation. In July 2013, an unadjusted monthly decline of 0.4% in gasoline prices was turned into a 0.8% gain, after the BLS seasonal adjustments. A similar treatment to the July 2014 numbers still would leave adjusted gasoline inflation as a net subtraction to the adjusted headline monthly CPI-U.

Higher food and "core" (net of food and energy) inflation, however, should more than offset the softer energy number, leading to a small headline gain in the CPI.

Year-to-year, CPI-U inflation would increase or decrease in July 2014 reporting, dependent on the seasonally-adjusted monthly change, versus an adjusted 0.17% gain in the monthly inflation reported for July 2013. The adjusted change is used here, since that is how consensus expectations are expressed. To approximate the year-to-year, or annual, unadjusted inflation rate for July 2014, the difference in July's headline monthly change (or forecast of same), versus the year-ago monthly change, should be added to or subtracted directly from the June 2014 annual inflation rate of 2.07%. If, for example, the headline July CPI-U gained by a near-consensus 0.1% month-to-month, then annual inflation would hold around 2.0%.

Residential Construction—Housing Starts (July 2014). Also tomorrow, Tuesday, August 19th, the Census Bureau plans the release of July 2014 housing starts detail. Despite extreme monthly volatility seen regularly in the reporting of this series, and despite near-perpetual wishful upside market expectations for housing starts—also seen in the current circumstance—month-to-month change likely will continue a pattern of statistical-insignificance, with ongoing stagnation and renewed downturn and/or downside revisions. As usual, this series is subject to extremely-large prior-period revisions.

In the wake of a 75% collapse in aggregate activity from 2006 through 2008, and of an ensuing five-year pattern of housing starts stagnation at historically low levels, little has changed. As was discussed in the *Consumer Liquidity* section of prior *Commentary No. 649*, there remains no chance of a near-term, sustainable turnaround in the housing market, unless there is a fundamental upturn in consumer and banking-liquidity conditions. That has not happened and does not appear to be in the offing.

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