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

COMMENTARY NUMBER 653
First Revision to Second-Quarter 2014 GDP

August 28, 2014

Economic Bluff and Bluster versus
Reality, Politics and Elections

Minimal Upside Revision to Second-Quarter GDP
Left Gimmicked Growth Even More Heavily Overstated

Underlying Reality Remains a
Severely Impaired Consumer and Economy

Monthly Economic Series to Turn Increasingly Negative

PLEASE NOTE: The next regular Commentary *is scheduled for Thursday, September 4th, covering the July trade deficit and construction spending, with a subsequent* Commentary *on September 5th, covering August employment and unemployment.*

Best wishes to all for a great Labor Day Weekend! — John Williams

OPENING COMMENTS AND EXECUTIVE SUMMARY

Actual Economic Activity Is in Downturn, but Positive GDP Reporting Likely Will Hold until the Election. Today's (August 28th) *Commentary* concentrates on the near-term outlook for the general economy and specific reporting tied to the second-estimate of second-quarter GDP. Likely economic reporting in the near future also is assessed, in the context of the nearing mid-term elections.

On top of the gimmicked changes in reporting methodologies that have created regular downside biases in inflation numbers and upside biases in data affecting the broadly popular, underlying monthly economic series, the GDP traditionally has been subject to special-purpose (usually election-related) political manipulations. Discussed previously, these manipulations have taken place over the last five decades and have involved both major political parties.

Despite the initial second-quarter 2014 GDP estimate coming in well above the ShadowStats expectation, and despite a small-upside, rather than sharp-downside first revision, the negative broad outlook for actual economic activity has not changed. Headline GDP reporting rarely reflects conditions in the real world (see the "corrected" GDP graphs in the *Opening Comments* and *2014 Hyperinflation Report—Great Economic Tumble – Second Installment*), but it still has serious impact on the financial markets, the consensus market outlook, and the level and nature of pontification by Washington politicians and central bankers.

Given the existing, significant upside biases already built into GDP reporting, an outright contraction in headline GDP—as was seen in first-quarter 2014—means the economy is in severe trouble. The GDP series, however, also is one where the flexibility of "assumptions" used by the Bureau of Economic Analysis (BEA) can prop up headline growth, for a quarter or two, if needed.

The headline second-quarter GDP estimate remained bloated by overly-optimistic guesses on the part of the BEA as to inventory building, auto sales, construction spending, economic impact of the Affordable Care Act, near-term performance of the trade deficit and swings in consumer utility usage tied to ongoing unseasonable weather patterns. Those areas still may have some downside revision impact, come the September 26th second revision (the final revision for the second-quarter until the July 2015 benchmarking), but the headline second-quarter number mostly likely will remain well within positive territory for now.

Third-Quarter GDP Contraction within Its Normal Revision Cycle. Nonetheless, near-term activity in key underlying economic series should be markedly weaker than consensus expectations in the next month or so. Those numbers, including the trade deficit, payroll employment, retail sales, industrial production and housing starts, not only should move market expectations towards recognition of a renewed economic downturn, but also should trigger the headline reporting of a much weaker-than-anticipated third-quarter GDP. Odds will be strong for an actual quarterly contraction by the second revision to third-quarter GDP, assuming a pullback in post-election political reporting.

Keeping GDP-Reporting Positive through the November Election. Before the mid-term election on November 4th, there will be two more GDP reports. Again, the second-revision to second-quarter 2014 GDP (September 26th) most likely will remain happily positive. Then, the first-estimate of third-quarter GDP will be released on October 30th, the Thursday before the election. One should not underestimate the ability of the BEA to bring in an initial, positive-growth estimate for the third-quarter GDP, irrespective of the underlying detail and even though subsequent revisions well might take that number negative.

I have found with ShadowStats that Main Street U.S.A. has a good sense of economic reality, a much-more-realistic outlook of what is happening than is suggested by bloated GDP reporting. Economic times generally are not good. The broad economy never recovered, and the average person still is under significant financial stress. When pocketbook issues are strongly negative, as they are now, they tend to impact elections heavily against incumbents.

Nonetheless, political surveying and analysis during the Clinton Administration found that the overstatement of economic growth could help to swing a tight election.

Headline Second Estimate—Gross Domestic Product (GDP). The second estimate of, first revision to second-quarter 2014 GDP showed a statistically-significant, real (inflation-adjusted), annualized, quarterly gain of 4.17%. The initial reporting had been for an increase of of 3.95%. That was against a benchmarked 2.11% contraction (-2.11%) [pre-benchmark drop of 2.93% (-2.93%)] in headline first-quarter 2014 GDP activity. All the reporting here, particularly of the GNP and GDI, is in the context of the annual GDP benchmark revisions of a month ago (see *Commentary No. 646*).

Year-to-year growth in real second-quarter 2014 GDP revised to 2.48% in the second estimate. That was against a first-quarter benchmarked growth of 1.89% (1.54% pre-benchmark). Year-to-year rates of change are graphed in the *Reporting Detail* section.

Implicit Price Deflator (IPD). The second estimate of second-quarter 2014 GDP inflation, or the implicit price deflator (IPD), was a revised annualized quarterly pace of 2.16%, at the highest level since third-quarter 2011. That followed benchmarked IPD inflation of 1.33% in first-quarter 2014. Year-to-year, second-quarter 2014 IPD inflation revised to 1.64%, versus a benchmarked 1.37% in first-quarter 2014.

For comparison, on a seasonally-adjusted, annualized quarter-to-quarter basis, CPI-U inflation published by the Bureau of Labor Statistics (BLS) was up by 3.03% in second-quarter 2014, at the highest level since second-quarter 2011. That followed inflation of 1.91% in first-quarter 2014. Not-seasonally-adjusted, on a year-to-year basis, second-quarter 2014 CPI-U inflation was 2.05%, up from 0.86% in first-quarter 2014.

The weaker the inflation rate used in deflating an economic series, the stronger will be the resulting inflation-adjusted growth.

Gross National Product (GNP). The first estimate of second-quarter 2014 real GNP growth was published today, along with the second estimate of second-quarter GDP growth. GNP is the broadest measure of U.S. economic activity, where GDP is GNP net of trade flows in factor income (interest and dividend payments). As a reporting gimmick aimed at boosting the headline reporting of economic growth for net-debtor nations such as Greece and the United States, international reporting standards were shifted some decades back to reporting headline GDP instead of GNP.

With only minor relative shifts in second-quarter versus first-quarter factor-income activity, the headline annualized quarterly-growth rate in real second-quarter 2014 GNP was 4.34% (versus 4.17% GDP), up from a benchmarked 2.81% contraction (-2.81%) in first-quarter 2014. Pre-benchmark, headline first-quarter growth had been a 3.61% contraction (-3.61%). Year-to-year change was 2.47% in second-quarter 2014, versus a benchmarked 1.86% in first-quarter 2014.

Gross Domestic Income (GDI). The first estimate of second-quarter 2014 real GDI growth was published today (August 28th) along with the second estimate of second-quarter GDP growth. GDI is the theoretical income-side equivalent of the consumption-side GDP estimate. The GDP and GDI are made to equal each other, every quarter, with the addition of a "statistical discrepancy" to the GDI-side of the equation, but the discrepancy just as easily could be added to the GDP number.

The headline annualized quarterly-growth rate in real second-quarter 2014 GDI also was 4.34% (versus 4.17% GDP), up from a benchmarked 0.44% contraction (-0.44%) in first-quarter 2014. Pre-benchmark, headline first-quarter growth had been a 2.61% contraction (-2.61%). Year-to-year change was 1.90% in second-quarter 2014, versus a benchmarked 1.49% in first-quarter 2014.

Suggestive of the ongoing deterioration the quality of the GDP-related statistics, irrespective of the recent benchmark revisions, the statistical discrepancy continued to deteriorate, in nominal terms (all negative) of $202.5 billion as of second-quarter 2014, versus $177.5 billion as of a revised first-quarter 2014, which had been $105.3 billion pre-benchmark.

Distribution of Headline GDP Growth. Despite the severely-limited significance of the following detail, it is included for those interested in the reported internal patterns of GDP growth, as guessed at by the BEA. The second estimate of the headline change in second-quarter 2014 GDP, was revised growth of 4.17% (previously 3.95%), following a benchmarked quarterly contraction of 2.11% (-2.11%) for the first-quarter 2014.

The annualized second-quarter growth rate is detailed in the following aggregation of contributed growth. Please note that the annualized growth number in each sub-category is the additive contribution to the aggregate, headline change in GDP, where 1.69% + 2.64% - 0.43% + 0.27% = 4.17%. Generally, with the exception of some reduction in inventory change, not one of the significant reporting issues evident in the first estimate was addressed in the second estimate.

- ***Consumer Spending Contributed an Unrevised 1.69% to Second-Quarter Growth; Contributed 0.83% to First-Quarter.*** Consumer-dependent personal consumption expenditure accounts for 68% of the GDP. Headline growth here still reflected surging sales of durable goods (contributed a revised 1.00%, previously 0.99%) including automobiles. Housing and utilities subtracted 0.42% (-0.42%), previously down by 0.41% (-0.41%), due to a reversal in difficult first-quarter weather conditions. Yet, auto sales remained overstated and the reversal of weather-generated electricity demand remained understated, significantly. The Affordable Care Act still should have been a much greater negative, and likely still gave a false reported boost to state-government spending.

- ***Business/Residential Investment Contributed a Revised 2.64% (Previously 2.57%) to Second-Quarter Growth; Subtracted 1.13% (-1.13%) from First-Quarter.*** Against the previous estimate, nonresidential fixed investment rose to a 1.03% contribution, versus an initial estimate of 0.68%, due to increased nonresidential construction and higher computer purchases. Hard, underlying data, however, do not support those revisions. A big plus was in inventories, despite a reduced contribution to the overall growth rate, plus 1.39% (revised lower from 1.66%). The inventory reduction still has some way to go in the next revision. This area is a regular BEA tool for spiking or offsetting headline growth. Net of inventories, final sales rose by a revised 2.48% (previously 2.29%) in second-quarter 2014, versus a contraction of 0.95% (-0.95%) in first-quarter 2014.

- ***Net Exports Subtracted a Revised 0.43% (-0.43%) [Previously 0.61% (-0.61%)] from Second-Quarter Growth; Subtracted 1.66% (-1.66%) from First-Quarter.*** Although the revision was in the same direction as the last monthly trade reporting, the initial widening of deficit never was accounted for properly. This area should have subtracted more than 1.0% from aggregate growth.

- ***Government Spending Contributed a Revised 0.27% (Previously 0.30%) to Second-Quarter Growth; Subtracted 0.15% (-0.15%) from First-Quarter.*** With minimal revisions, federal government spending remained a drag on government spending, but a surge in local government spending and investment pushed the aggregate category into positive territory.

Economic Reality. Even with the second estimate of second-quarter 2014 GDP headline growth of 4.17%, following a contraction of 2.11% (-2.11%) in first-quarter 2014, the general outlook as to economic reality has not been altered. The broad economy still is turning down anew, and a wide variety of monthly economic detail should confirm that in reporting of the next month or two. Accordingly, the gist of much of the following text is along the lines of other recent GDP commentaries, but the details and numbers have been updated for today's second reporting of aggregate second-quarter 2014 economic activity.

The GDP remains the most-worthless and the most-heavily modeled, massaged and politically-manipulated of government's economic series. It does not reflect properly or accurately the changes to the underlying fundamentals that drive the economy. Underlying real-world economic activity suggests that the broad economy began to turn down in 2006 and 2007, plunged into 2009, entered a protracted period of stagnation thereafter—never recovering—and then began to turn down anew in recent quarters (see *2014 Hyperinflation Report—The End Game Begins – First Installment Revised*, and *2014 Hyperinflation Report—Great Economic Tumble – Second Installment*). Irrespective of the reporting gimmicks introduced in the July 2013 and July 2014 GDP benchmark revisions, a consistent, fundamental pattern of historical activity is shown in the accompanying sets of "corrected" GDP graphs.

Please note that the pattern of activity shown for the "corrected" GDP series is much closer to the patterns shown in the graphs of monthly real median household income and other liquidity measures (see graphs in *Commentary No. 649*) and of economic series not otherwise reliant on understated inflation for their reported growth (see the second installment of the *Hyperinflation Report*). A sustainable business recovery could not have taken place since 2009, and a recovery will not be forthcoming until the consumer's structural income and liquidity problems are resolved.

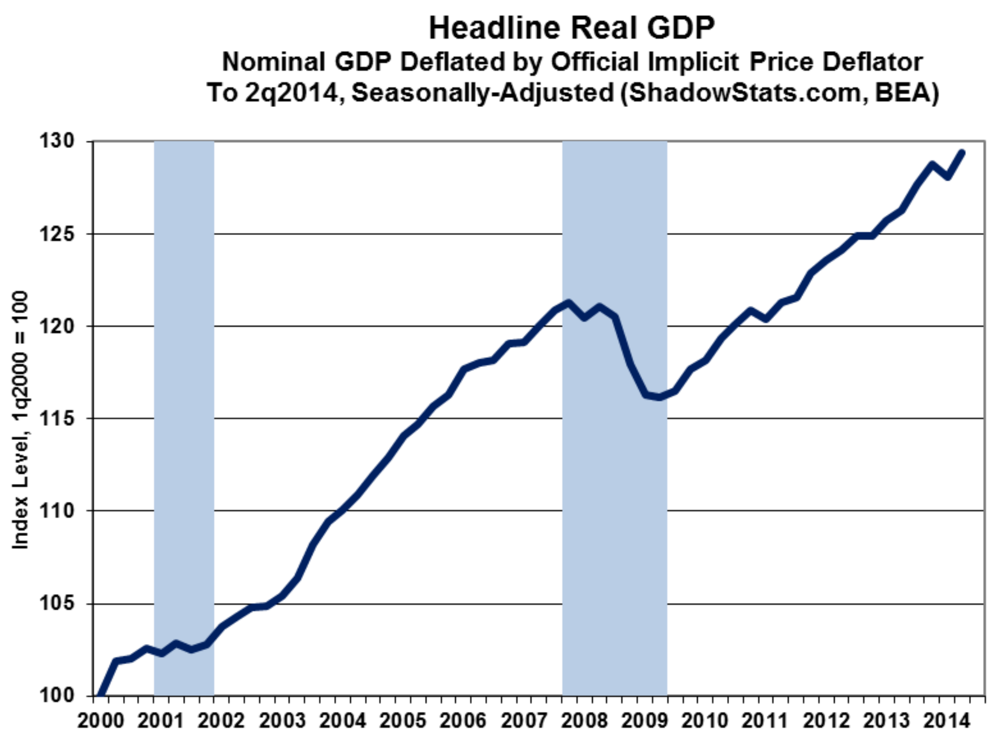
Official and Corrected GDP. As usually discussed in the *Commentaries* covering the quarterly GDP reporting and monthly revisions, the full economic recovery indicated by the official, real GDP numbers remains an illusion. It is a statistical illusion created by using too-low a rate of inflation in deflating (removing inflation effects) from the GDP series. The accompanying two sets of graphs tell that story, updated for the second estimate of second-quarter 2014 GDP.

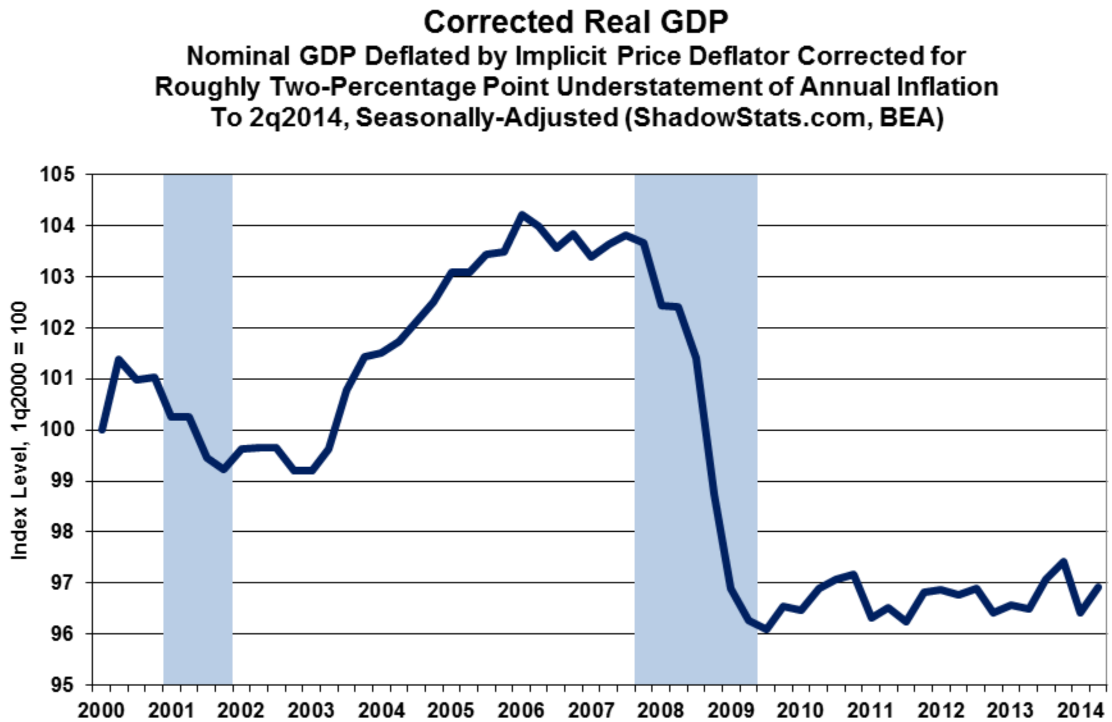
The first set of graphs (2000-to-date) is the one traditionally incorporated in the GDP *Commentaries*, and is expressed on an index base where first-quarter 2000 = 100.0. The second set updates the longer-term graphs (1970-to-date), expressed in billions of 2009 dollars, published in *2014 Hyperinflation Report—Great Economic Tumble – Second Installment*.

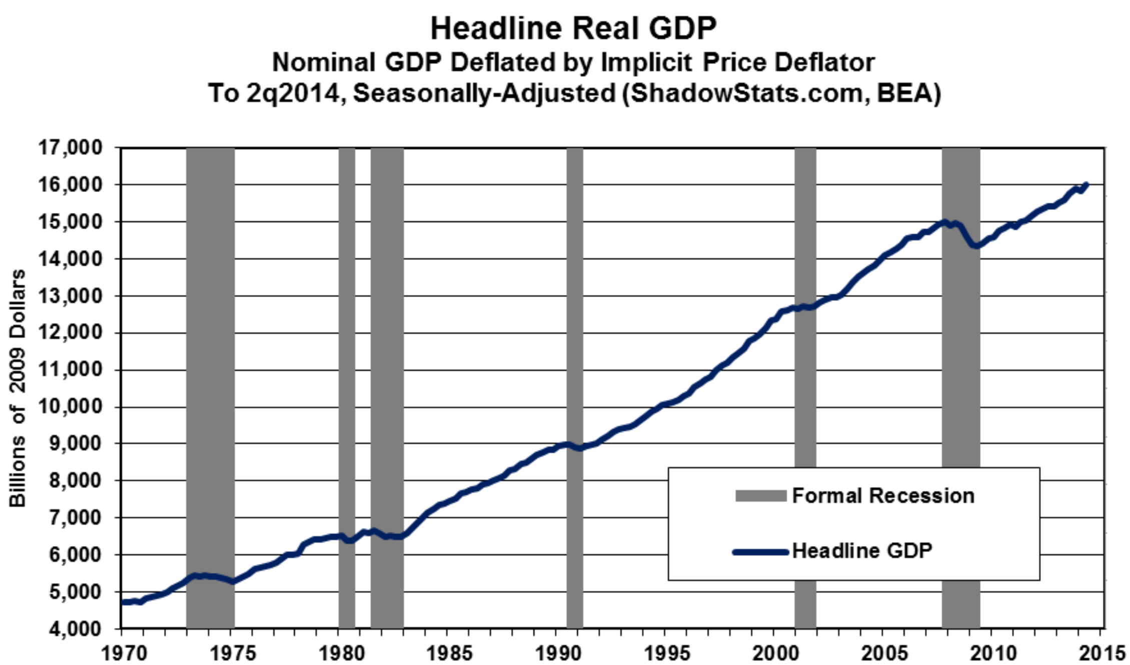
Shown in the first graph of official *Headline Real GDP*, GDP activity has been reported above pre-2007 recession levels—in full recovery—since second-quarter 2011, and headline GDP has shown sustained growth since (with a growth interruption in first-quarter 2014). Adjusted for official GDP inflation (the implicit price deflator), the level of first-quarter 2014 GDP currently stands at 6.7% above the pre-recession peak-GDP estimate of fourth-quarter 2007. In contrast, the "corrected" GDP version, in the second graph, shows second-quarter 2014 GDP activity at 7.0% below the pre-recession peak of first-quarter 2006.

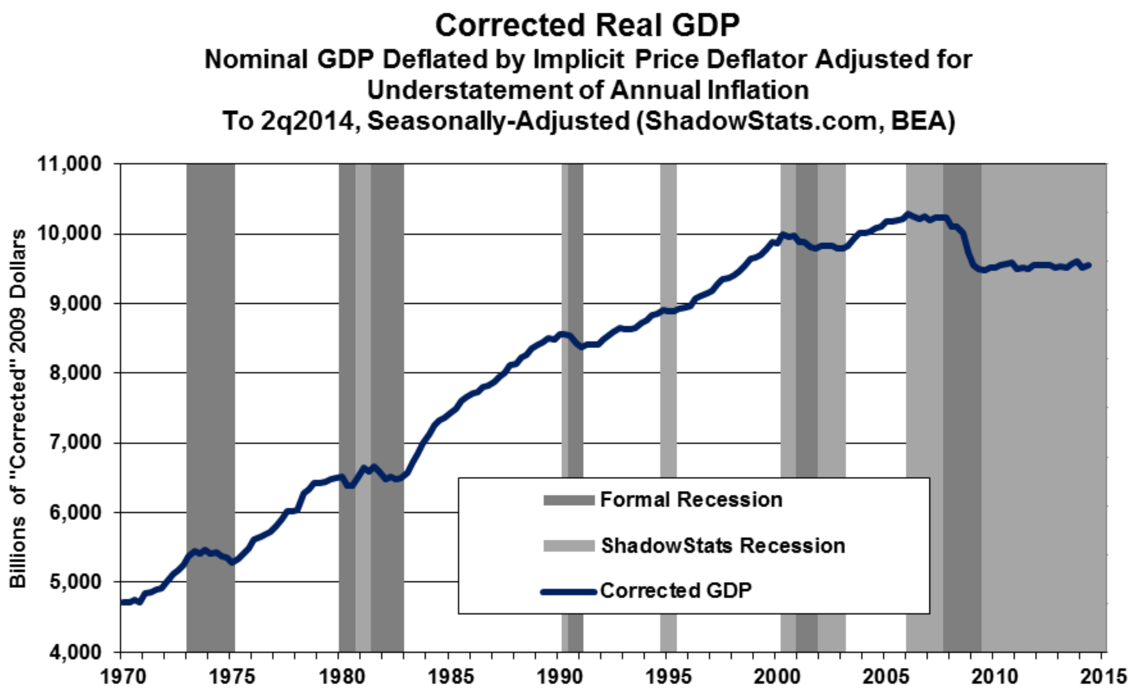
Further, as discussed in the second installment of the *Hyperinflation Report*, no other major economic series has shown a parallel pattern of official full economic recovery and meaningful expansion beyond, consistent with the GDP reporting. Either the GDP reporting is wrong, or all other major economic series are wrong. While the GDP is heavily modeled, imputed, theorized and gimmicked, it also encompasses reporting from those various major economic series and private surveys, which still attempt to survey real-world activity. Flaws in the GDP inflation methodologies and simplifying reporting assumptions have created the "recovery."

The second graph in each series plots the *Corrected Real GDP*, corrected for the understatement inherent in official inflation estimates (see *Public Commentary on Inflation Measurement*), with the deflation by the implicit price deflator (IPD) adjusted for understatement of roughly two-percentage points of annual inflation. The inflation understatement has resulted from hedonic-quality adjustments, as discussed in the *Hyperinflation Reports*. Both graphs in the first set are indexed to first-quarter 2000 = 100, and show official periods of recession as shaded areas.




Corrected Real GDP
Nominal GDP Deflated by Implicit Price Deflator Corrected for
Roughly Two-Percentage Point Understatement of Annual Inflation
To 2q2014, Seasonally-Adjusted (ShadowStats.com, BEA)
Index Level, 1q2000 = 100
105
104
103
102
101
100
99
98
97
96
95
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
2013
2014


Headline Real GDP
Nominal GDP Deflated by Implicit Price Deflator
To 2q2014, Seasonally-Adjusted (ShadowStats.com, BEA)
Billions of 2009 Dollars
17,000
16,000
15,000
14,000
13,000
12,000
11,000
10,000
9,000
8,000
7,000
6,000
5,000
4,000
1970
1975
1980
1985
1990
1995
2000
2005
2010
2015
Formal Recession
Headline GDP



The shaded areas in the "corrected" graph in this second set reflect official as well as ShadowStats-defined recessions, as discussed in detail in the second installment of the *Hyperinflation Report.*

[For further details on the second estimate of second-quarter 2014 GDP, see the* Reporting Detail *section.]

[Drill-down detail and customized graphic options for the headline GDP data will be available shortly to subscribers at ShadowStats affiliate* www.ExpliStats.com*.]

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HYPERINFLATION WATCH

Hyperinflation Outlook Summary. This *Summary* has been updated in the first two paragraphs of the "*Current Economic Issues ...*" section, with new text underlined. Otherwise, the *Summary* is unchanged from its previous version. 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 second estimate of second-quarter 2014 GDP growth came in at 4.17%, such still heavily overstated actual current economic activity and remained subject to some downside revisions. The "advance" estimate of third-quarter GDP on October 30th will be that last reporting before the midterm election. While third-quarter GDP should show a quarterly contraction within its standard revision cycle, one should not underestimate the ability of the Bureau of Economic Analysis to keep that final pre-election number in positive territory, in initial reporting.

Nonetheless, basic underlying economic series, such as the trade deficit, retail sales and industrial production, even payroll employment, should be showing enough of a downturn or weakness in headline activity during the same timeframe—the next several months—so as to provide consensus expectations with downside shocks. That increasingly should shift the popular outlook towards a "new recession," with negative shifts in the economic 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 covering 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 71.4% of effective net issuance of the federal debt to be held by the public in calendar-year 2014 (through August 13th). The pace of effective monetization has been 70.2% 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

GROSS DOMESTIC PRODUCT—GDP (Second-Quarter 2014, Second Estimate, First Revision)

Although Business Activity Is Turning Down, Positive GDP Reporting Likely Will Hold Until the Election. *[PLEASE NOTE: The text in this introductory section largely is repeated from today's* Opening Comments.*]* On top of the gimmicked changes in reporting methodologies that have created regular downside biases in inflation numbers and upside biases in data affecting the broadly popular, underlying monthly economic series, the GDP also has been subject, traditionally, to special-purpose (usually election-related) political manipulations. Discussed previously, these manipulations have taken place over the last five decades and have involved both major political parties.

Despite the initial second-quarter 2014 GDP estimate coming in well above the ShadowStats expectation, and despite a small-upside, rather than sharp-downside first revision, the negative broad outlook for actual economic activity has not changed. Headline GDP reporting rarely reflects conditions in the real world (see the "corrected" GDP graphs in the *Opening Comments* and *2014 Hyperinflation Report—Great Economic Tumble – Second Installment*), but it does have serious impact on the financial markets, the consensus market outlook, and the level and nature of pontification by Washington politicians and central bankers.

Given the existing significant upside biases already built into GDP reporting, an outright contraction in headline GDP—as was seen in first-quarter 2014—means the economy is in severe trouble. The GDP series, however, also is one where the flexibility of "assumptions" used by the Bureau of Economic Analysis (BEA) can prop up headline growth, for a quarter or two, if needed.

Today's (August 28th) estimate of headline second-quarter GDP remained bloated by overly-optimistic guesses on the part of the BEA as to inventory building, auto sales, construction spending, economic impact of the Affordable Care Act, near-term performance of the trade deficit and swings in consumer utility usage tied to ongoing unseasonable weather patterns. Those areas still may have some downside revision impact, come the September 26th second revision (the final revision for the second-quarter until the July 2015 benchmarking), but the headline second-quarter number mostly likely will remain well within positive territory for now.

Third-Quarter GDP Contraction within Its Normal Revision Cycle. Near-term activity in key underlying economic series, however, should be markedly weaker than consensus expectations in the next month or so. Those numbers, including the trade deficit, payroll employment, retail sales, industrial production and housing starts, not only should move market expectations towards recognition of a renewed economic downturn, but also should trigger the headline reporting of a much weaker-than-anticipated third-quarter GDP, which has good odds of being in actual quarterly contraction by its second revision. That assumes some post-election pullback in the politicized reporting.

Keeping GDP-Reporting Positive through the November Election. Before the mid-term election on November 4th, there will be two more GDP reports. Again, the second-revision to second-quarter 2014 GDP (September 26th) most likely will remain happily positive. Then, the first-estimate of third-quarter GDP will be released on October 30th, the Thursday before the election. One should not underestimate the ability, here, of the BEA to bring in an initial, positive-growth estimate for the third-quarter GDP, even though subsequent revisions might take that number negative.

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Most Worthless of Series. Otherwise, the GDP remains the most-worthless and the most-heavily modeled, massaged and politically-manipulated of government economic series. It does not reflect properly or accurately the changes to the underlying fundamentals that drive the economy. Underlying real-world economic activity suggests that the broad economy began to turn down in 2006 and 2007, plunged into 2009, entered a protracted period of stagnation thereafter—never recovering—and then began to turn down anew in recent quarters (see *2014 Hyperinflation Report—The End Game Begins – First Installment Revised*, and *2014 Hyperinflation Report—Great Economic Tumble – Second Installment*).

Notes on GDP-Related Nomenclature and Definitions

For purposes of clarity and the use of simplified language in the text of the GDP analysis, here are definitions of several key terms used related to GDP reporting:

Gross Domestic Product (GDP) *is the headline number and the most widely followed broad measure of U.S. economic activity. It is published quarterly by the Bureau of Economic Analysis (BEA), with two successive monthly revisions, and with an annual revision in the following July.*

Gross Domestic Income (GDI) *is the theoretical equivalent to the GDP, but it generally is not followed by the popular press. Where GDP reflects the consumption side of the economy and GDI reflects the offsetting income side. When the series estimates do not equal each other, which almost always is the case, since the series are surveyed separately, the difference is added to or subtracted from the GDI as a "statistical discrepancy." Although the BEA touts the GDP as the more accurate measure, the GDI is relatively free of the monthly political targeting the GDP goes through.*

Gross National Product (GNP) *is the broadest measure of the U.S. economy published by the BEA. Once the headline number, now it rarely is followed by the popular media. GDP is the GNP net of trade in factor income (interest and dividend payments). GNP growth usually is weaker than GDP growth for net-debtor nations. Games played with money flows between the United States and the rest of the world tend to mute that impact on the reporting of U.S. GDP growth.*

Real *(or* ***Constant Dollars****) means the data have been adjusted, or deflated, to reflect the effects of inflation.*

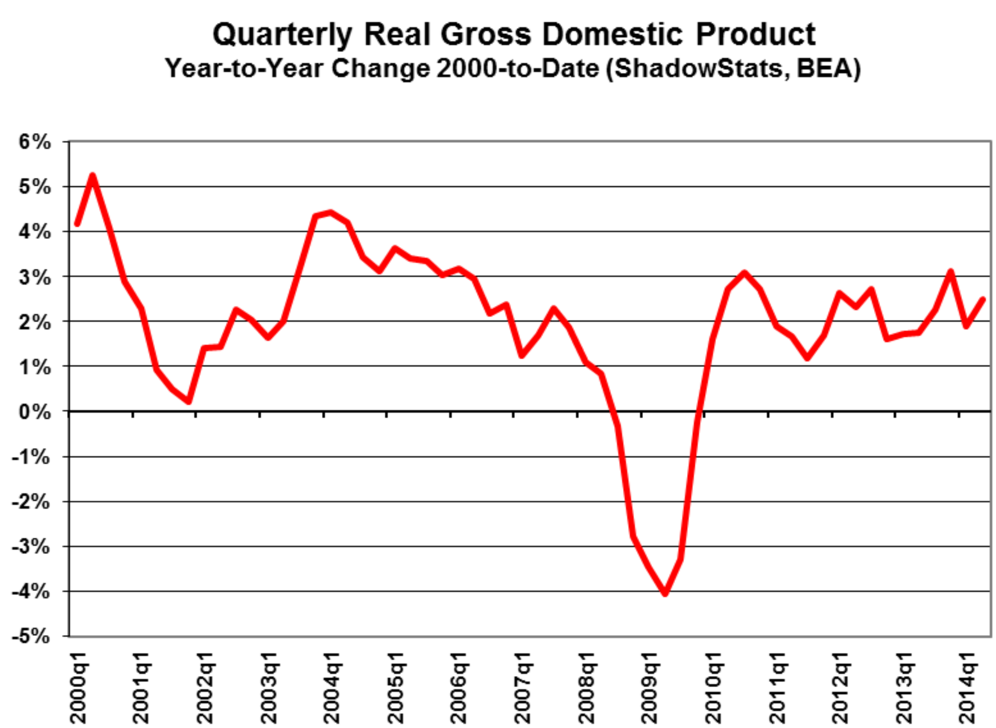
Nominal *(or* ***Current Dollars****) means growth or level has not been adjusted for inflation. This is the way a business normally records revenues or an individual views day-to-day income and expenses.*

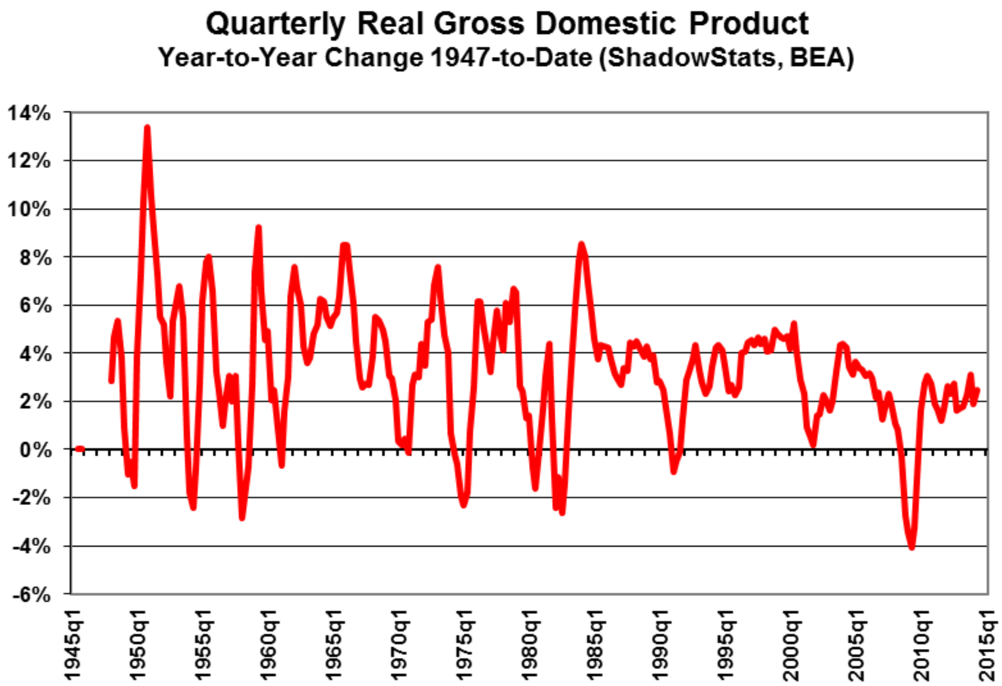
GDP Implicit Price Deflator (IPD) *is the inflation measure used to convert GDP data from nominal to real. The adjusted numbers are based on "Chained 2009 Dollars," as introduced with the 2013 comprehensive revisions, where 2009 is the base year for inflation. "Chained" refers to the substitution methodology which gimmicks the reported numbers so much that the aggregate of the deflated GDP sub-series missed adding to the theoretically-equivalent deflated total GDP series by $41.8 billion in "residual," as of the initial estimate of second-quarter 2013.*

Quarterly *growth, unless otherwise stated, is in terms of seasonally-adjusted, annualized quarter-to-quarter growth, i.e., the growth rate of one quarter over the prior quarter, raised to the fourth power, a compounded annual rate of growth. While some might annualize a quarterly growth rate by multiplying it by four, the BEA uses the compounding method, raising the quarterly growth rate to the fourth power. So a one percent quarterly growth rate annualizes to 1.01 x 1.01 x 1.01 x 1.01 = 1.0406 or 4.1%, instead of 4 x 1% = 4%.*

Annual *growth refers to the year-to-year change of the referenced period versus the same period the year before.*

Gross Domestic Product (GDP). Published this morning, August 28th, by the Bureau of Economic Analysis (BEA), the second estimate of, first revision to second-quarter 2014 GDP showed a statistically-significant, real (inflation-adjusted), annualized, quarterly gain of 4.17% +/- 3.5% (95% confidence interval). The initial reporting had been for a gain of 3.95%. That was against a benchmarked 2.11% contraction (-2.11%) [a pre-benchmark 2.93% drop (-2.93%)] in headline first-quarter 2014 GDP activity. The latest reporting remains in the context of the annual GDP benchmark revisions of a month ago (see *Commentary No. 646*). The distribution of the headline quarterly GDP growth rate by major components is detailed in the *Opening Comments*.





As shown in the two graphs preceding, year-to-year growth in real second-quarter 2014 GDP revised to 2.48% in the second estimate, from an initial estimate of 2.43%, versus benchmarked growth of 1.89% (1.54% pre-benchmark) in the first-quarter. The first graph shows current detail, from 2000-to-date, where the second graph shows the series in terms of its full quarterly history.

The latest quarterly year-to-year growth remained below the near-term peak of 3.13% seen in fourth-quarter 2013. The current-cycle trough in annual change was in second-quarter 2009, at a 4.09% pace of decline (-4.09%). That was the deepest year-to-year contraction for any quarterly GDP in the history of the series, which began with first-quarter 1947.

Implicit Price Deflator (IPD). The second estimate of second-quarter 2014 GDP inflation, or the implicit price deflator (IPD), was a revised annualized quarterly pace of 2.16% (previously 1.99%), at the highest level since third-quarter 2011. That followed benchmarked IPD inflation of 1.33% in first-quarter 2014. Year-to-year, second-quarter 2014 IPD inflation revised to 1.64% (previously 1.60%), versus a benchmarked 1.37% in first-quarter 2014.

For comparison, on a seasonally-adjusted, annualized quarter-to-quarter basis, CPI-U inflation published by the Bureau of Labor Statistics (BLS) was up by 3.03% in second-quarter 2014, at the highest level since second-quarter 2011. That followed inflation of 1.91% in first-quarter 2014. Not-seasonally-adjusted, on a year-to-year basis, second-quarter 2014 CPI-U inflation was 2.05%, up from 0.86% in first-quarter 2014.

The weaker the inflation rate used in deflating an economic series, the stronger will be the resulting inflation-adjusted growth.

Gross National Product (GNP). The first estimate of second-quarter 2014 real GNP growth was published today (August 28th) along with the second estimate of second-quarter GDP growth. The second-quarter detail was reported in the context of the annual benchmark revisions of a month ago, as discussed in *Commentary No. 646*.

GNP is the broadest measure of U.S. economic activity, where GDP is GNP net of trade flows in factor income (interest and dividend payments). As a reporting gimmick aimed at boosting the headline reporting of economic growth for net-debtor nations such as Greece and the United States, international reporting standards were shifted some decades back to reporting headline GDP instead of GNP.

With only minor relative shifts in second-quarter versus first-quarter factor-income activity, the headline annualized quarterly-growth rate in real second-quarter 2014 GNP was 4.34% (versus 4.17% GDP), up from a benchmarked 2.81% contraction (-2.81%) in first-quarter 2014. Pre-benchmark, headline first-quarter growth had been a 3.61% (-3.61%) contraction. Year-to-year change was 2.47% in second-quarter 2014, versus a benchmarked 1.86% in first-quarter 2014.

Gross Domestic Income (GDI). The first estimate of second-quarter 2014 real GDI growth was published today (August 28th) along with the second estimate of second-quarter GDP growth. The second-quarter detail was reported in the context of the annual benchmark revisions of a month ago, as discussed in *Commentary No. 646*.

GDI is the theoretical income-side equivalent of the consumption-side GDP estimate. The GDP and GDI are made to equal each other, every quarter, with the addition of a “statistical discrepancy” to the GDI-side of the equation, but the discrepancy just as easily could be added to the GDP number.

The headline annualized quarterly-growth rate in real second-quarter 2014 GDI was 4.34% (versus 4.17% GDP), up from a benchmarked 0.44% contraction (-0.44%) in first-quarter 2014. Pre-benchmark, headline first-quarter growth had been a 2.61% contraction (-2.61%). Year-to-year change was 1.90% in second-quarter 2014, versus a benchmarked 1.49% in first-quarter 2014.

Suggestive of the ongoing deterioration the quality of the GDP-related statistics, irrespective of the recent benchmark revisions, the statistical discrepancy continued to deteriorate, in nominal terms (all negative) of $202.5 billion as of second-quarter 2014, versus $177.5 billion as of a revised first-quarter 2014, which had been $105.3 billion pre-benchmark.

ShadowStats-Alternate GDP. The ShadowStats-Alternate GDP estimate for second-quarter 2014 GDP remains a 1.7% year-to-year contraction (-1.7%) versus a headline revised annual gain of 2.5% (previously 2.4%). That was against a ShadowStats 1.9% year-to-year contraction (-1.9%)—unaltered by the benchmarking games—and the benchmarked headline GDP gain of 1.9% (pre-benchmark 1.5%) in first-quarter 2014 (see the Alternate Data tab).

While annualized real quarterly growth is not estimated formally on an alternate basis, the headline 4.2% quarter-to-quarter gain for second-quarter 2014 likely was much weaker, flat-to-minus, net of all the regular reporting gimmicks. An actual quarterly contraction appears to have been a realistic possibility for the real GDP in most quarters since the official, second-quarter 2009 end to the 2007 recession.

Adjusted for understated inflation and other methodological changes (such as the inclusion of intellectual property, including software), the business downturn that began in 2006/2007 is ongoing; there has been no meaningful economic rebound. The "corrected" real GDP graph, and the longer-term "corrected" graph updated from *2014 Hyperinflation Report—Great Economic Tumble* – *Second Installment* (see the *Opening Comments* section) are based on the removal of the impact of hedonic quality adjustments that have reduced the reporting of official annual GDP inflation by roughly two-percentage points. It is not the same measure as the ShadowStats-Alternate GDP, which reflects reversing additional methodological distortions ("Pollyanna Creep") of recent decades.

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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 Trends. 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 strong bounce-back estimated by the Bureau of Economic Analysis (BEA) for headline second-quarter GDP still should face some downside revision, with a likely GDP contraction eventually seen 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:

Construction Spending (July 2014). The Commerce Department has scheduled release of July 2014 construction spending for Tuesday, September 2nd. The headline monthly changes, as usual, should not be statistically significant, while previous data will be subject to large and unstable revisions. Most frequently, the revisions are to the downside, irrespective of almost perpetually-positive market expectations for this series.

U.S. Trade Balance (July 2014). The Commerce Department and Bureau of Economic Analysis (BEA) will release their estimate of the July 2014 trade-balance on Thursday, September 4th. The early market consensus is for the July deficit to change little, versus June. The July trade deficit estimate and any revisions to June will have implications for the third-estimate of second-quarter GDP growth, due for release on September 26th, and for the advance estimate of third-quarter GDP on October 30th.

Irrespective of wherever the consensus outlook settles, look for the July deficit to widen versus June and very possibly for the June trade deficit (and the encompassing second-quarter deficit) to widen in revision. Trade deficit deterioration should be the norm, going forward, along with related, increasingly-negative effects of a deteriorating net-export account balance on aggregate GDP activity.

Employment/Unemployment (August 2014). The Bureau of Labor Statistics (BLS) will release its August 2014 labor data on Friday, September 5th. Given continuing indications of weakening broad economic activity, and the heavy, regular distortions in the headline reporting of monthly nonfarm payroll gains, almost anything is possible in the headline August reporting. Nonetheless, the system is due for some severely-negative surprises against the usual, overly-optimistic market expectations.

As published previously by ShadowStats-affiliate www.ExpliStats.com, in its extended analysis of the trends and biases built into the concurrent seasonal factor modeling of the July 2014 payroll employment, the implied built-in bias trend as of July, for August 2014, suggests a headline August jobs gain of 247,000 jobs. Where consensus forecasts tend to settle in around the trend number, market expectations currently seem to be running about 20,000 jobs below trend. Again, underlying economic reality would indicate a pending downside surprise to those expectations.

Separately, expectations appear to be for the August U.3 unemployment rate to ease a notch from the 6.2% level seen in July. Underlying economic reality and the fundamental drivers of economic activity would suggest a general increase in the U.3 rate, but the BLS's continuing purge of discouraged workers from the unemployment rolls and headline labor force could argue in favor of a lower rate. Separately, as discussed regularly in the employment/unemployment-related *Commentaries*, month-to-month comparisons of U.3 and related numbers are of no meaning, because of the standard, inconsistent reporting calculations that leave the monthly data not comparable.

If U.3 drops anew, there likely would be additional labor-force loss associated with those relative, but still-not-comparable headline numbers. The broader U.6 and ShadowStats unemployment measures would tend to hold, or increase anew, at their broader and higher respective levels. All the Labor Department numbers remain unsettled and could come in well outside general expectations.

