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

COMMENTARY NUMBER 666
September Industrial Production

October 16, 2014

Third-Quarter Production Growth Slowed Sharply

Falling Auto Production in September More than Offset by
Defense Industry Output, Oil and Gas Production and Weather-Related Utility Surge

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PLEASE NOTE: The next regular Commentary *is planned for tomorrow, Friday, October 17th, covering September Housing Starts.*

Best wishes to all — John Williams

OPENING COMMENTS AND EXECUTIVE SUMMARY

Third-Quarter Growth Continued to Slow. The image of an economic boom—suggested by headline second-quarter real GDP growth of 4.6%—increasingly has faltered, proving to be an illusion created by overly-optimistic assumptions in an environment of extremely limited reporting quality. Underlying second-quarter economic detail never supported the "boom" numbers. Underlying third-quarter reporting detail, so far, has shown sharply-slowing growth relative to the second-quarter, and it should not come close to supporting market expectations of headline 3.0%-plus third-quarter 2014 GDP growth.

Nonetheless, the October 30th "advance" third-quarter GDP estimate will be the last major economic release before the November 4th election. The initial estimate of such a heavily-politicized series more likely than not will be politically-correct, not functionally-correct.

These issues, along with a summary of key September reporting to-date, will be reviewed in tomorrow's (October 17th) *Commentary No. 667*, with a more-comprehensive review of September and third-quarter 2014 data to be published with next week's October 22nd *Commentary No. 668*, which also will cover headline CPI inflation and real retail sales and earnings for September.

Increasing Market Instabilities. Day-to-day financial news remains dominated by financial-market and political-system turmoil and instabilities. The outlooks for the political, financial and economic systems, and for the financial markets have not changed from the discussion in the October 10th *Commentary No. 664*, which reviewed domestic and global financial, economic and systemic circumstances, and updated the *Hyperinflation Outlook Summary*. It remains the suggested reading for the current circumstance.

ShadowStats will address breaking news and developing issues as appropriate.

Today's relatively brief missive focuses on the September 2014 industrial production detail, where the headline numbers generally were somewhat stronger than market expectations.

Industrial Production—September 2014—Relative Gain in September Boosted by Downside August Revision. Headline September 2014 industrial production rose by 1.0%. In this highly-volatile and frequently- and heavily-revised series, the headline September number received a relative boost from a downside revision in August 2014 production to a 0.2% (-0.2%) contraction, from what previously had been a 0.1% (-0.1%) monthly decline. At an annualized quarterly pace, third-quarter growth slowed to 3.2%, from 5.5% in the second quarter, a pattern more significant in terms of relative shift and leveraged-inventory implications, than in magnitude, for this series that is tied to less than 45% of current GDP reporting.

Industrial Production—Headline Detail. Headline seasonally-adjusted, September 2014 industrial production rose by 1.01% month-to-month. Net of prior-period revisions, the monthly gain was 0.92%. The September headline was against a revised decline of 0.17% (-0.17%) in August, and a revised 0.23% gain in July.

Reflecting still-softer automobile sales (inventory adjustment), auto manufacturing fell by 1.1% in September, following a 5.4% decline in August and a 7.6% gain in July. The headline manufacturing sector, however, saw more-than-offsetting September gains in defense-industry and in business-equipment production. Oil and gas drilling/production continued to boost the mining sector, while unseasonable air-conditioning usage spiked production of electricity at utilities.

By major industry group, the headline September 2014 gain of 1.0% [August 2014 revised decline of 0.2% (-0.2%)] in aggregate production was composed of a September gain of 0.5% [August revised decline of 0.5% (-0.5%)] in manufacturing; a 1.8% September gain [August revised gain of 0.3%] in mining; and a 3.9% September gain [August revised gain of 1.2%] in utilities.

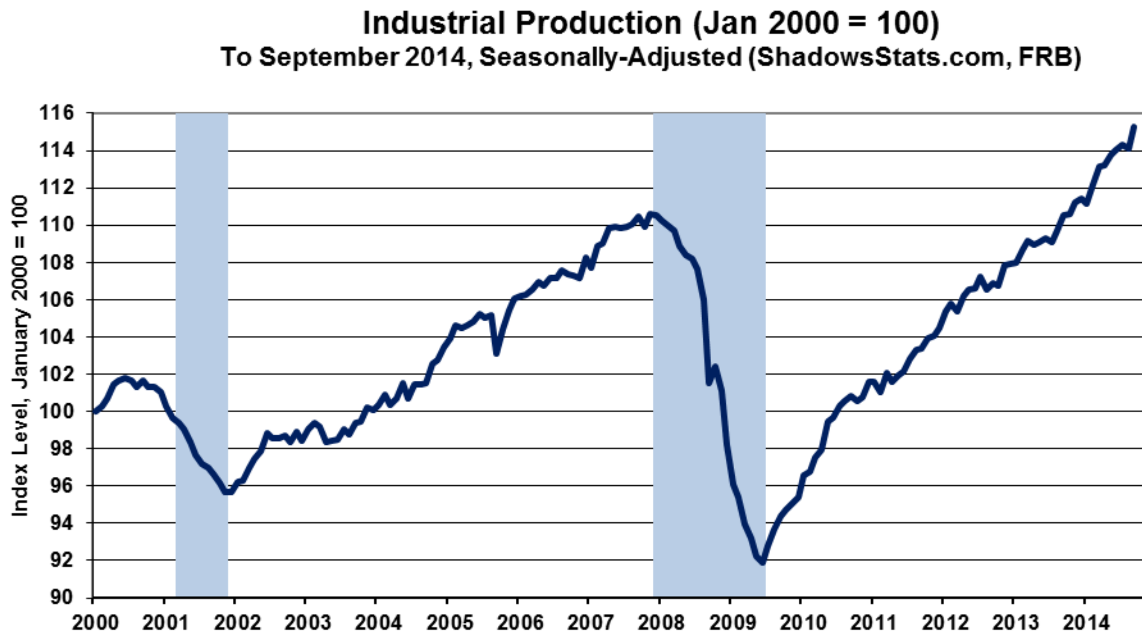
Year-to-year growth in September 2014 production was 4.30%, off a revised, four-month low of 4.02% in August and versus a revised 4.78% in July.

Production Graphs—Corrected and Otherwise. Graphs of the industrial production level and year-to-year change are in the *Reporting Detail* section. The two graphs that follow here address issues tied to

reporting quality and the overstatement of headline growth that results from using too-low an estimate of inflation in deflating economic series.

Hedonic quality adjustments to inflation understate the inflation used in deflating some components of the index 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*]).

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 simply provides 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, 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/downturn in third-quarter 2013, and some uptrend in fourth-quarter 2013 and into a renewed period of topping-out and a September gain in 2014.

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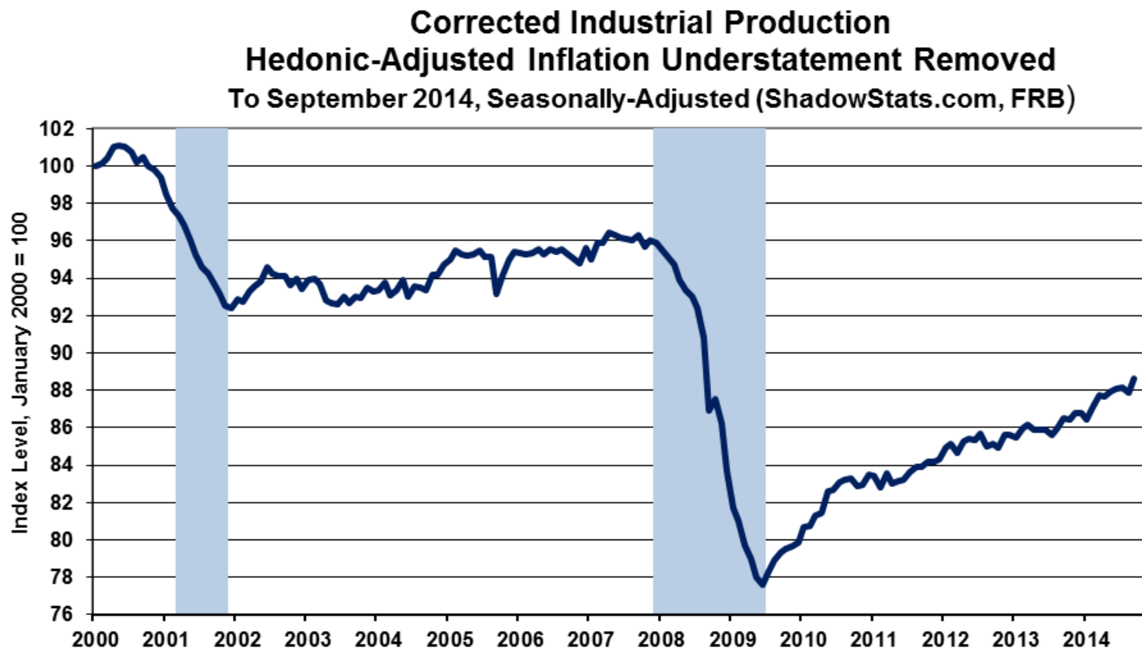

[For further details on September Industrial production, see the **Reporting Detail** *section. Also, various drill-down detail and graphics options on the headline reporting are available to ShadowStats subscribers at our affiliate:* **www.ExpliStats.com***]*

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HYPERINFLATION WATCH

Hyperinflation Outlook Summary. Except for minor language adjustments, the following *Summary* was updated most recently in *Commentary No. 664* of October 10th. If this section is being read for the first time, reading it in the context of the *Opening Comments* of *No. 664* (linked above), is suggested. The prior version of the *Summary* is found in *Commentary No. 661*.

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 *Commentary No. 661*. The two *2014*

Hyperinflation Report installments remain the primary background material for the hyperinflation and economic analyses and forecasts.

Primary Summary. Current fiscal conditions show the effective long-term insolvency of the U.S. government, a circumstance that usually would be met by unfettered monetization of the national debt and obligations, leading to an eventual hyperinflation. The 2008 Panic and near-collapse of the financial system, and official (U.S. government and Federal Reserve) response to same, pulled the elements of the eventual hyperinflation crisis into the 2014 period. The primary and basic summary of the broad outlook and the story of how and why this fiscal, financial and economic 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 and recent developments.

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, despite sharp recent rallies in the U.S. dollar's exchange and related heavy selling in the gold and silver markets.

Current relative U.S. economic strength versus major U.S. trading partners is seriously over-estimated, with a crash back to recognition of realistic domestic-economic circumstances likely to be accompanied by a crash in the U.S. dollar versus major currencies, such as the euro, yen, pound, Swiss franc, Canadian dollar and Australian dollar; related rallies in precious metals and oil; and related sell-offs in the domestic stock and bond markets.

Current Economic Issues versus Underlying U.S. Dollar Fundamentals. U.S. economic activity is turning down anew. The headline contraction in first-quarter 2014 GDP was the reality; the headline second-quarter GDP boom was the aberration. Such should become increasingly and painfully obvious to the financial markets in the domestic economic reporting of the weeks and months ahead.

New reporting of relatively hard annual numbers from 2013 showed ongoing economic contraction, with no trend towards sustainable economic growth (see *Commentary No. 656*). Also, as discussed in the *Opening Comments* section of *Commentary No. 664*, real business activity—net of all the happy assumptions and modeling used by the Bureau of Economic Analysis in putting the GDP growth estimates together—is flat-to-minus.

Despite any short-term pre-election fluff, those basic underlying, increasingly negative economic conditions will show up in various series, such as the trade deficit, retail sales, industrial production and payroll employment, providing consensus expectations with downside shocks. In turn, that should shift the popular outlook quite rapidly towards a "new recession," with negative shifts in the economic consensus increasingly disrupting the already-disintegrating stability in the financial markets.

As financial-market expectations increasingly shift towards renewed or deepening recession, that circumstance, in confluence with other fundamental issues, specifically 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 and ongoing "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.

Accordingly, some speculation already has begun to circulate as to an added round of Federal Reserve quantitative easing, QE4. That would be a major factor behind crashing the dollar and boosting the price of gold. The Fed has strung out its options for propping up the system as much as it could, with continual, negative impact on the U.S. economy. The easing to date, however, appears to have been a prop to the equity markets (see *Commentary No. 663*). In the event of QE4, any resulting renewed boost to U.S. equities likely would be a fleeting illusion, at least in terms of real value (purchasing power of the dollar). Such gains would tend to be losses, with the stocks valued in terms of Swiss francs, for example, or valued against what would be a rapidly-increasing pace of domestic U.S. inflation.

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 should combine against the U.S. dollar, likely in the very-near future. That said, recent faux market perceptions of domestic economic, financial-system and monetary tranquility have boosted the U.S. dollar's strength significantly in global trading and have contributed to savaging the prices of precious metals. Again, such should not prevail in the context of underlying reality. The actual fundamental problems threatening the U.S. dollar could not be worse. The broad outlook has not changed. The key issues 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 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 has continued to run in the $6-trillion-plus range for annual shortfall—and should have done so again in the just-completed fiscal-2014—while those in Washington continue to increase spending and to take on new, unfunded liabilities. The history and issues here are explored in the first installment of the *Hyperinflation Report*, as previously linked.

- ***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.*** Despite the "tapering" of the Fed's asset purchases, the current pace of the Fed's monetization is at 58.9% of effective net

issuance of the federal debt to be held by the public in calendar-year 2014 (through October 8th). The pace of effective monetization has been 66.0% since the January 2013 expansion of QE3.

- ***Mounting domestic and global crises of confidence in a dysfunctional U.S. government.*** The relative positive rating by the public of the U.S. President tends to be an indicative measure of this circumstance, with a meaningful correlation with the foreign-exchange-rate strength of the U.S. dollar. The weaker the rating, the weaker tends to be the U.S. dollar. Positive ratings for both the President and Congress are at historic lows and still are sinking.

- ***Mounting global political pressures contrary to U.S. interests.*** Downside pressures on the U.S. currency generally are mounting, in the context of global political and military developments contrary to U.S. strategic, financial and economic interests. Current conditions include the situation in Ukraine versus Russia and the extremely-volatile circumstances in the Middle East.

- ***Spreading global efforts to dislodge the U.S. dollar from its primary reserve-currency status.*** Active efforts or comments against the U.S. dollar have been seen with Russia, China, France and India, along with some rumblings in OPEC and elsewhere.

When the selling pressure breaks massively against the U.S. currency, the renewed and intensifying weakness in the 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. These circumstances will trigger the early stages of a hyperinflation.

Both the renewed dollar weakness and the resulting inflation spike 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 (September 2014)

Relative Gain in September Production Was Boosted by Downside August Revision. Headline September 2014 industrial production rose by 1.0%. In this highly-volatile and frequently- and heavily-revised series, the headline gain received a relative boost from a downside revision in August 2014 production to a 0.2% (-0.2%) contraction, from what previously had been a 0.1% (-0.1%) monthly

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decline. At an annualized quarterly pace, third-quarter growth slowed to 3.2%, from 5.5% in the second quarter, a pattern more significant in terms of relative shift and leveraged-inventory implications, than in magnitude, for this series that is related to less than 45% of current GDP reporting.

Industrial Production—September 2014. The Federal Reserve Board released its first estimate of seasonally-adjusted, September 2014 industrial production this morning (October 16th). Headline monthly production rose by 1.01%. Net of prior-period revisions, the monthly gain was 0.92%.

The September headline gain was against a revised decline of 0.17% (-0.17%), previously a drop of 0.10% (-0.10%), in August, a revised 0.23% (previously a 0.22%, initially a 0.44%) gain in July, and a revised gain of 0.28% (previously 0.32%, 0.38% and initially 0.22%) in June.

Reflecting still-softer automobile sales (inventory adjustment), auto manufacturing fell by 1.1% in September, following a 5.4% decline in August and a 7.6% gain in July. The headline manufacturing sector, however, saw more-than-offsetting September gains in defense-industry and in business equipment production. Oil and gas drilling/production continued to boost the mining sector, while unseasonable air-conditioning usage spiked production of electricity at utilities.

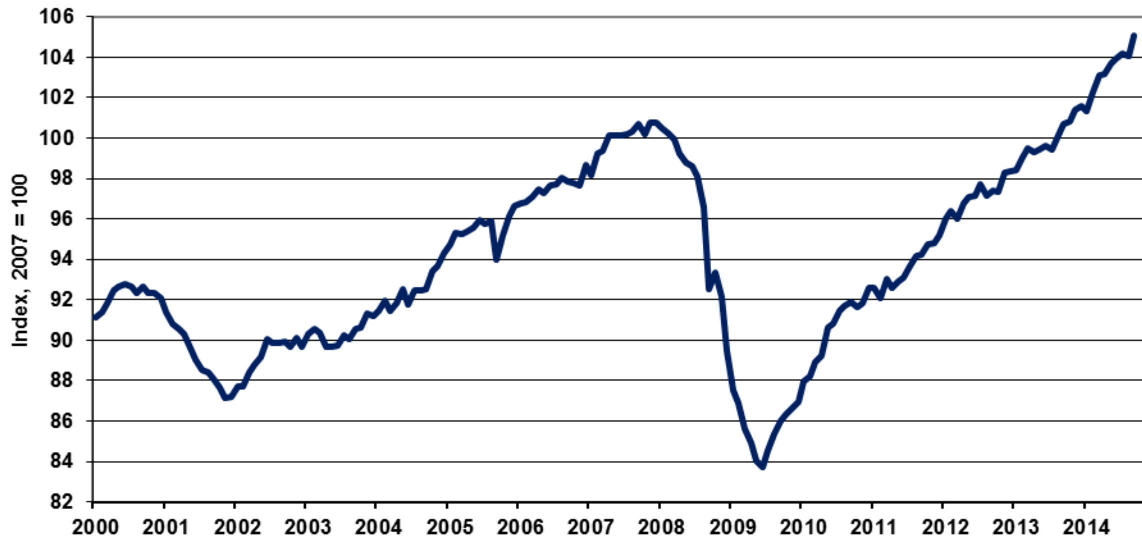
By major industry group, the headline September 2014 gain of 1.0% [August 2014 revised decline of 0.2% (-0.2%), previously down by 0.1% (-0.1%)] in aggregate production was composed of a September gain of 0.5% [August revised decline of 0.5% (-0.5%), previously down by 0.4% (-0.4%)] in manufacturing; a 1.8% September gain [August revised gain of 0.3%, previously up by 0.5%] in mining; and a 3.9% September gain [August revised gain of 1.2%, previously up by 1.0%] in utilities.

Year-to-year growth in September 2014 production was 4.30%, off a revised, four-month low of 4.02% (previously 4.12%), versus a revised 4.78% (previously 4.80%, initially 4.97%) in July and a revised 4.36% (previously 4.40%, 4.34%, and initially 4.32%) in June.

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 only at the onset of recessions, bounced higher into mid-2014 and headed lower again in the more-recent reporting. 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 2014 reporting, pulling back some in August, but surging anew in September. Corrected for the understatement of inflation used in deflating portions of the industrial production index (see the *Opening Comments* section), however, the series has shown more of a pattern of stagnation with a slow upside trend, since 2009, topping out into 2012, some uptrend in fourth-quarter 2013 and into a renewed period of topping-out and a September gain in 2014. The series remains well shy of a formal recovery.



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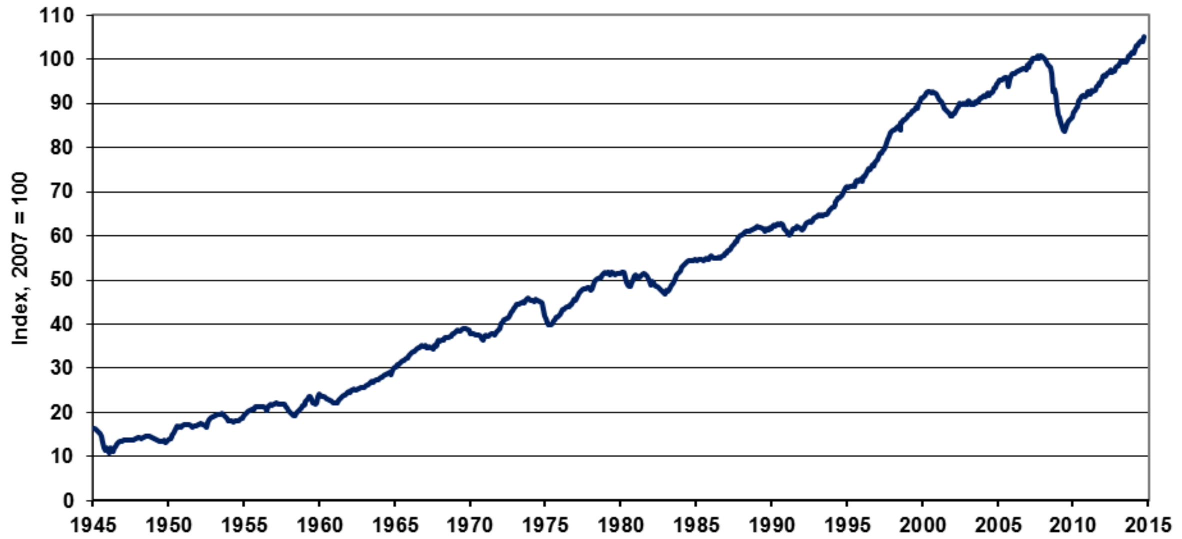

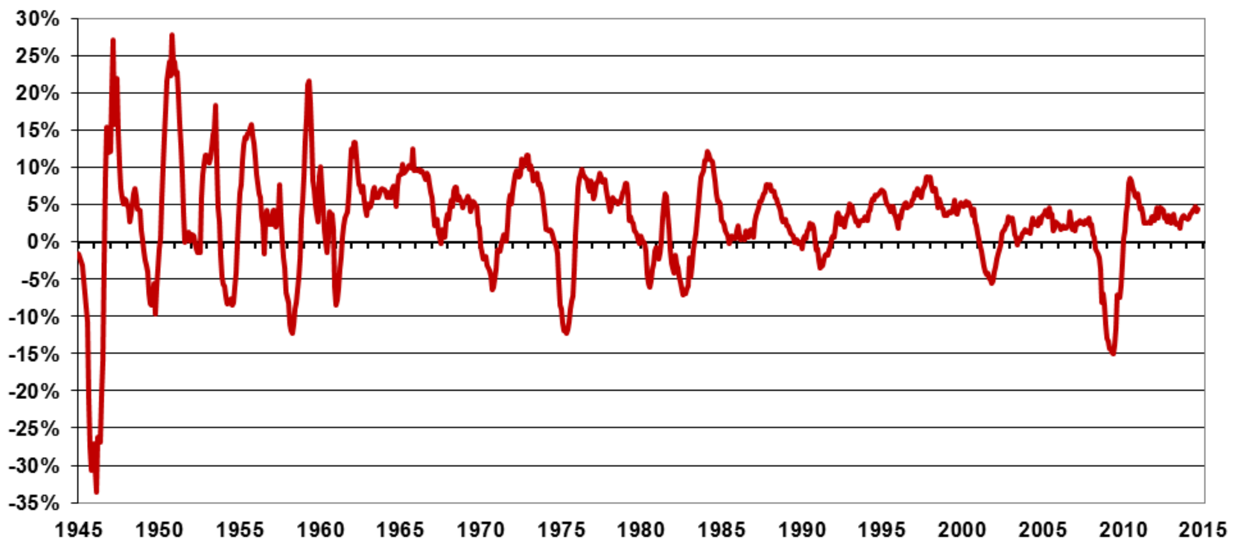

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WEEK AHEAD

Against Overly-Optimistic Expectations, Pending Economic Releases Should Be Much Weaker; Inflation Releases Should Be Increasingly Stronger. Although having shifted some 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 increasingly should be hammered, though, by ongoing, downside corrective revisions and by an accelerating pace of downturn in broad-based headline economic activity.

Longer-Range Reporting Trends. The process of downside shifting in economic-growth expectations has been sporadic, but the underlying fundamentals remain extraordinarily negative. Other than for nonsense-growth in the headline second-quarter GDP (see *Commentary No. 662*), renewed weakness has been, and increasingly will be seen in the headline reporting of other major economic series (see *2014 Hyperinflation Report—Great Economic Tumble – Second Installment*), particularly subsequent to the November 4th election. Indeed, 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 consumer inflation trend remains likely to continue, as seen in recent months (August 2014 excepted). 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. Such excludes any near-term efforts to push oil prices lower as an informal financial sanction against Russia.

The dollar faces eventual pummeling from the weakening economy, continuing perceptions of needed, ongoing quantitative easing, 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 prospective, significantly-weakened dollar, reporting in the year ahead generally should reflect much higher-than-expected U.S. inflation, across the board.

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.

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PENDING RELEASE:

Residential Construction—Housing Starts (September 2014). The Census Bureau plans the release of September 2014 residential construction detail, including housing starts, tomorrow, Friday, October 17th. As discussed in *Commentary No. 660* on the August version of this wild-man series of monthly economic detail, the headline reporting simply is worthless. Month-to-month volatility is extreme, and the headline numbers rarely come close to being statistically significant. Consensus expectations appear to be for a large, though likely not-statistically-significant, monthly increase.

In the violent headline swings seen regularly in the reporting of this series, month-to-month change likely will continue a pattern of statistical-insignificance, with ongoing stagnation and renewed downturn and/or downside revisions as seen in the six-month moving-average of the series. This series also 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 discussed in *Opening Comments* section of *Commentary No. 665*, 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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