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

SPECIAL COMMENTARY NUMBER 333
Updated Outlook: U.S. Economy, Inflation, Markets, Liquidity and Systemic Stability

November 10, 2010

Economic and Systemic-Stability Crises Continue

Promised Fed Actions Pummel Dollar versus Major Currencies and Precious Metals
As Global Markets Anticipate Higher U.S. Inflation

Fed Policies Will Trigger Inflation but Not Recovery

Hyperinflationary Great Depression Looms
Irrespective of Shifting Political Environment

September Trade Deficit Should Have Little Impact on GDP Revision

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PLEASE NOTE: This Special Commentary *focuses on updating the outlook for the U.S. economy, inflation, financial markets and systemic liquidity and stability (update to* No. 323*), and it includes details of today's (November 10th) September Trade Balance. Due to the timing of upcoming travel, the next regular* Commentary *will be on Wednesday, November 17th, following release of the October CPI and Residential Construction numbers. It will include assessments of the October reports on Retail Sales (to be released on Monday, November 15th) and Industrial Production and the PPI (to be released on Tuesday, November 16th).*

-- Best wishes to all, John Williams

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SUMMARY OUTLOOK

Fed Moves Preemptively to Debase U.S. Dollar. In announcing the effective monetization of U.S. Treasury funding needs through mid-2011, the Federal Reserve not only has begun a process from which it will be increasingly difficult to withdraw, but also has begun a process that likely will have to be accelerated in the months ahead, in response to mounting U.S. fiscal and systemic-solvency problems intensified by a still-unexpected "double-dip" recession, as well as in response to intensifying selling and dumping of the U.S. dollar and dollar-denominated paper assets in the global markets.

Such locks-in one of the underlying prerequisites for the U.S. economic environment to evolve into an unthinkable hyperinflationary great depression. The U.S. government effectively is bankrupt and remains extremely likely to resolve this ultimate sovereign insolvency by printing money to meet its obligations. As global pressures force the Fed into further Treasury debt monetization, as global confidence in the world's reserve currency evaporates, risks remain particularly high of a U.S. hyperinflation beginning to unfold in the first-half of 2011, along with severe economic, social and political consequences that will follow. The outside timing for this manmade financial catastrophe remains 2014.

What the Fed has done is in line with the prior *Special Commentary No. 323* and *Hyperinflation Special Report*, referenced here for broad background. The general outlook is not changed; again, certain elements have just started locking into place.

The U.S. central bank will succeed in creating consumer inflation, but it will be the worst sort of inflation, inflation that is driven by monetary policy distortions instead of by booming economic demand -- inflation combined with declining business activity. Given the Fed's recent jawboning of the now-announced Treasury debt monetization policy, the inflation process already has started. U.S. dollar weakness in response to the Fed's jawboning helped to spike oil and gasoline prices, which, in turn, will help to fuel somewhat stronger inflation reporting as early as next week (see *Week Ahead*).

Not only are Mr. Bernanke's actions unlikely to stimulate domestic economic activity, but, as seen with the dollar weakness and soaring gasoline prices in 2008, the unfolding "inflation creation" likely will exacerbate the current downturn in U.S. business activity, where liquidity-strapped consumers likely will be forced to ration other consumption in order to pay for necessary gasoline.

Rest of the World Protests. Heavy selling of the U.S. dollar against most major currencies and heavy buying of gold and silver followed the Fed's action, clearly signaling that the global investment community believed that the Fed would succeed in debasing the U.S. dollar and creating U.S. inflation. Prices and exchange rates have been volatile coming into tomorrow's G20 meeting. Irrespective of near-term swings, however, including central bank intervention, precious metals and the stronger major currencies should continue to do well, over the long haul, against the U.S. dollar, preserving the purchasing power that otherwise will be lost in a debased U.S. currency.

Consider in the following graphs that the "Latest November" prices were about even with the indicated October averages before the Fed's announcement. The "Latest November" points are the prices as I am putting this *Commentary* to bed and effectively represent net market actions post-FOMC announcement, versus the October averages.

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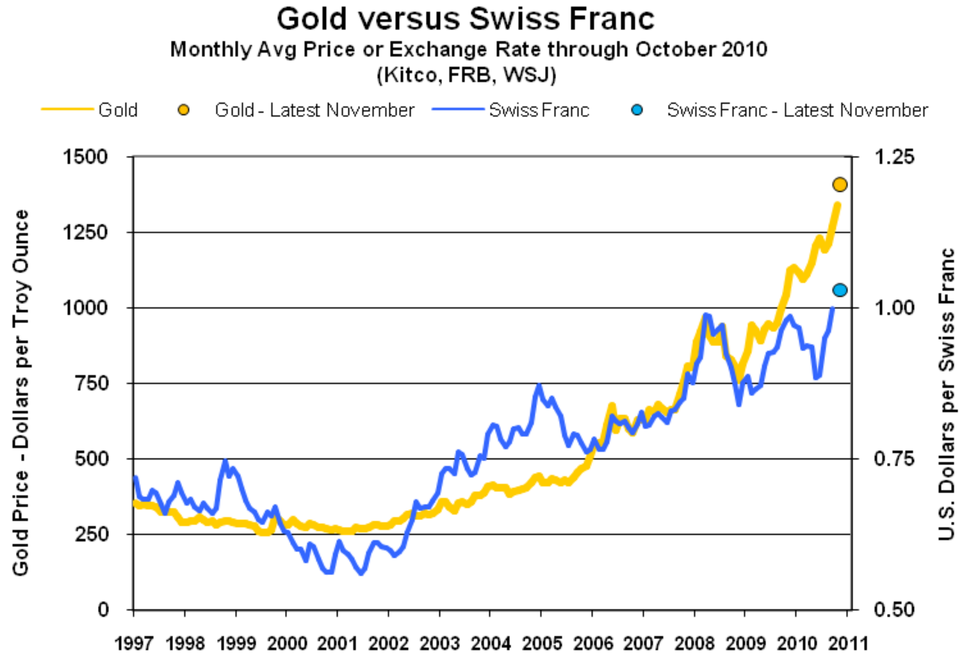

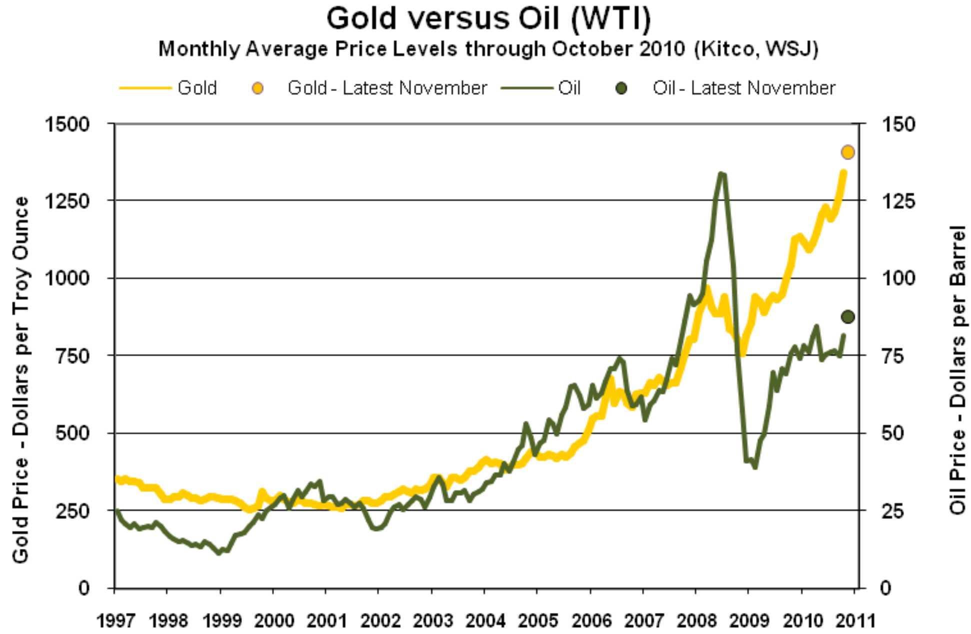

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Beyond precious-metal- and currency-market reactions, severe criticism of the Fed's action came quickly from major trading partners and global political rivals, including Germany, China and Russia, as well as from a number of politicians in the United States. Consider the following from China's Dagong credit rating agency, which downgraded the United States' sovereign rating from AA to A+, with a negative outlook. Dagong noted that the downgrade reflected the United States' "deteriorating debt repayment capability and drastic decline of the government's intention of debt repayment.

"The serious defects in the United States economic development and management model will lead to the long-term recession of its national economy, fundamentally lowering the national solvency. The new round of quantitative easing monetary policy adopted by the Federal Reserve has brought about an obvious trend of depreciation of the U.S. dollar, and the continuation and deepening of credit crisis in the U.S. Such a move entirely encroaches on the interests of the creditors, indicating the decline of the U.S. government's intention of debt repayment. Analysis shows that the crisis confronting the U.S. cannot be ultimately resolved through currency depreciation. On the contrary, it is likely that an overall crisis might be triggered by the U.S. government's policy to continuously depreciate the U.S. dollar against the will of creditors."

As an aside, while creditors may not like it, the U.S. always has the ability to repay its debts by printing the needed currency.

Does A Solvency Crisis Still Terrorize the Fed? Everything is just fine and dandy, if you believe the shills for Wall Street. The economic and financial crises of the last several years have been contained and stabilized. The economy is growing, albeit still somewhat slowly, but business activity is in an upswing. The Administration and the Federal Reserve tell pretty much the same story, but with a caveat, which has

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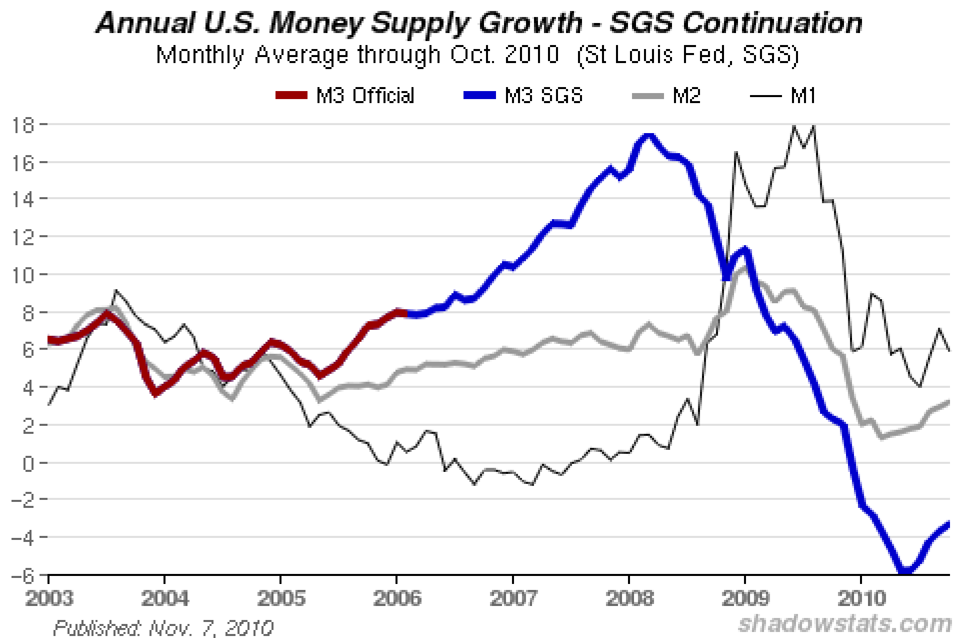
been intensified in the post-mid-term election period, that unemployment is too high and still needs to be brought down. The Fed also frets that inflation is too low.

Yet, as just discussed, the Fed's ability to stimulate inflation usually is not tied to commensurate growth in the economy, and Mr. Bernanke is a good enough economist to know that. He also was painfully aware of the global criticism his actions would draw. So, why did the Federal Open Market Committee announce on November 3rd that it would monetize nearly one trillion dollars of U.S. Treasury debt ($600 billion new buying and $250 to $300 billion in reinvested mortgage-backed securities), buying enough U.S. Treasury notes through mid-2011 to cover the total anticipated borrowing needs of the U.S. government for the same period?

Perhaps the Fed did not want to worry about there being enough foreign investment to fund the government's operations? More likely, the action was aimed at trying to front-run an intensifying systemic liquidity crisis that has been smoldering for the last couple of years -- never extinguished -- and that has been reignited in an economic environment of continued downturn and turmoil.



As shown in the above graph, the SGS-Ongoing M3 Measure continues to show year-to-year contraction (down 3.4% in October), although the pace of decline has narrowed, as the broad money measure has seen slow month-to-month growth recently, against monthly contractions a year ago. Nonetheless, the indication here remains one of ongoing systemic instability, particularly in the banking system.

Please note the following graphs on the monetary base. Broad money did not grow in response to the surge in excess bank reserves from prior "quantitative easing," largely because the banks did not lend the money into the normal stream of commerce, which would have spiked the money supply. Also the bulk of prior "quantitative easing" was in the purchase of mortgage-backed securities.

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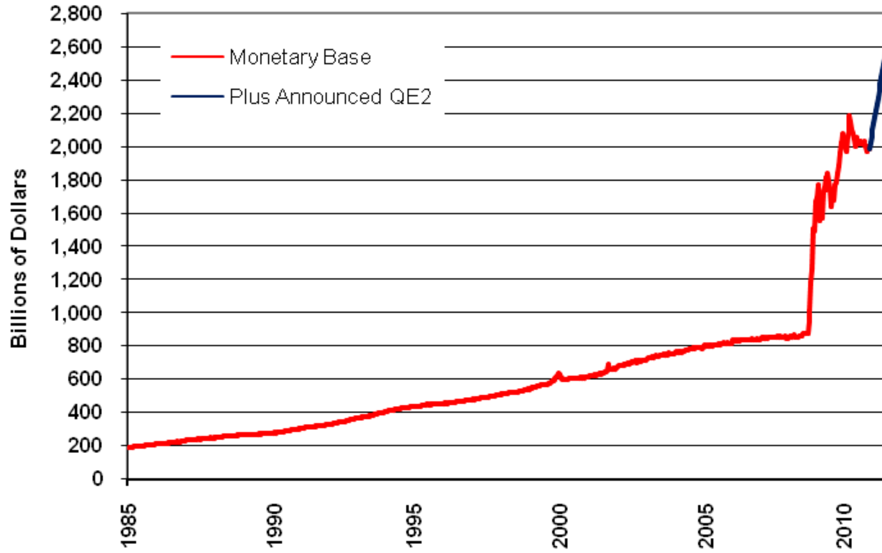

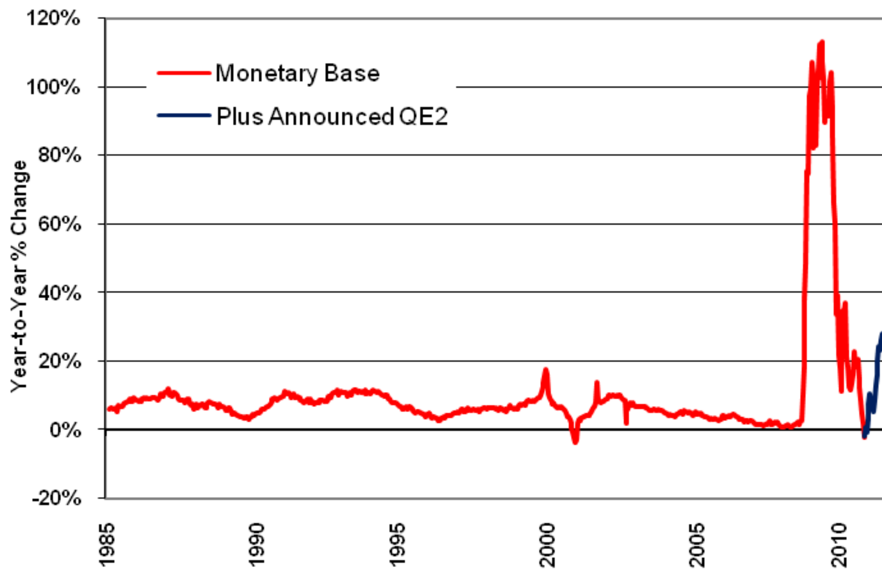

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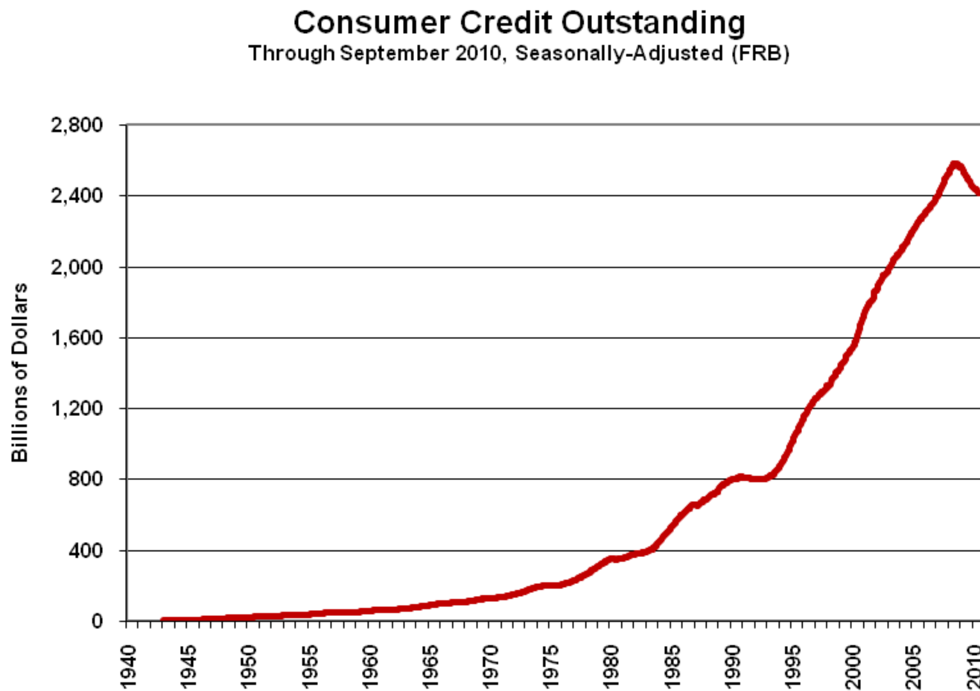
The monetary base is not a money supply measure, *per se*; it consists of bank reserves (not counted in any money supply measures) and currency in circulation (in money supply M1). It still is, in theory, the Fed's primary tool for adjusting the money supply.

The graphs show roughly what the monetary base would look like by mid-2011, given the promised stimulus. While there is no guarantee that banks will increase their lending -- part of the restraint still seems to be balance-sheet issues with certain banks -- the nature of the Fed buying so much in the way of Treasuries from banks or otherwise should be enough to have some minimal flow-through to the money supply.

As shown in the following graphs, bank lending to consumers and businesses remains abysmal, although the monthly declines have flattened out in the latest monthly reporting. In the area of commercial paper outstanding, after short-lived small bumps, both the aggregate (shown) and nonfinancial outstandings again have turned down.



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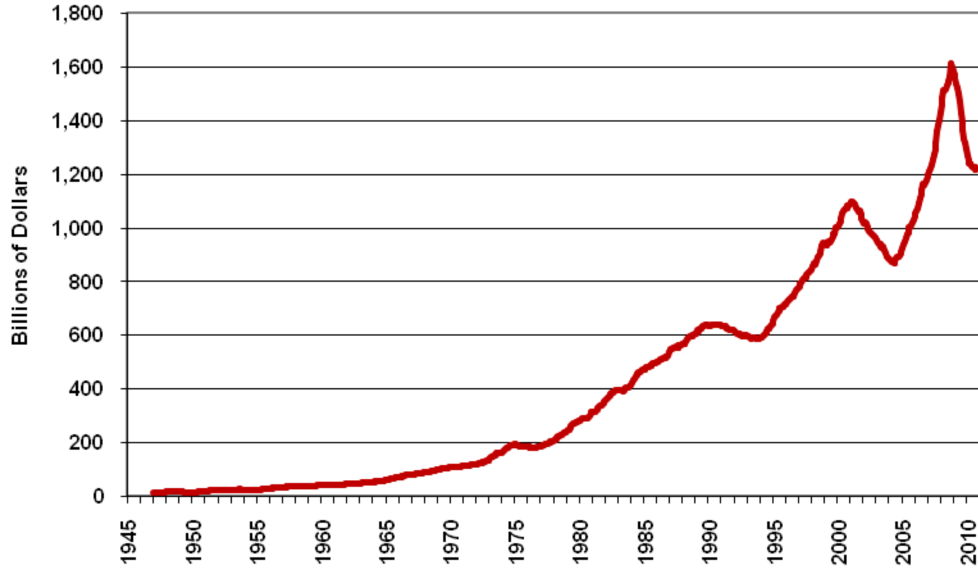

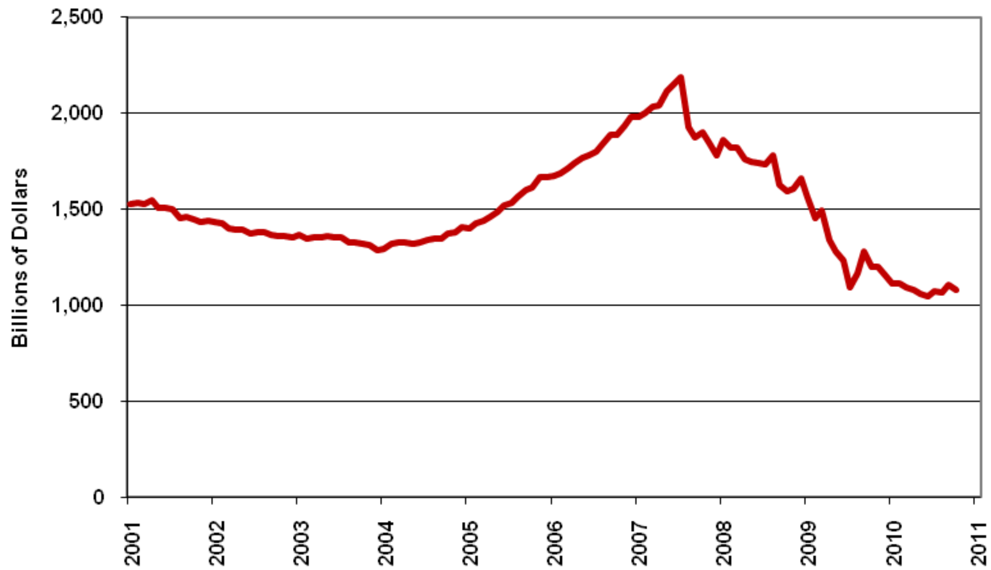

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The Fed's primary function -- as a private corporation owned by commercial banks -- is to protect the banking system. Supporting economic growth and containing inflation are secondary concerns, but the renewed economic threat now also can shatter the fragile appearance of banking-system stability. Indeed, the banking system is far from stable, which is one reason lending is down and likely is the primary reason the Fed has launched its new program.

Mid-Term Election Shifts Control of Congress But Not the Outlook for Hyperinflation. Also last week, the U.S. mid-term elections changed the composition of Congress. While the actual federal deficit and economic structural problems are likely to get a good airing, particularly before the House, little is likely to change that could alter the course of the government's effective bankruptcy or the short-range prospects of the structurally impaired economy, where the latter issue requires a major overhaul of U.S. trade policy.

Most who talk about "balancing" the budget are talking about the cash-based-accounting budget, which Bill Clinton was able to get into a reported "surplus." The actual deficit, based on GAAP-based accounting, including the annual change in the net present value of the unfunded liabilities for Social Security and Medicare, however, did not show a surplus during the Clinton Administration. Currently running in the $4 to $5 trillion range, the actual deficit is uncontainable from a practical standpoint. Taxes cannot be raised enough to offset it, and every penny of spending could be cut, except for the "entitlement" programs and the federal government still would be in deficit.

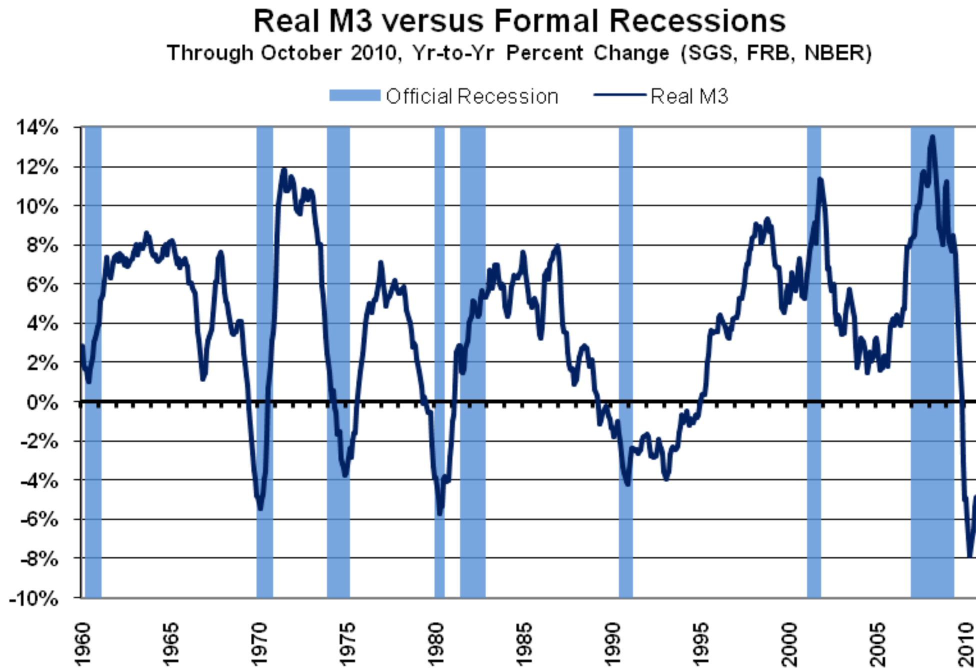
Accordingly, meaningful resolution of the actual deficit problem means severe slashing of the Social Security and Medicare programs, in addition to whatever other government costs can be slashed. Even with the shift in Congress, I do not see any political chance of the types of cuts needed being made in Social Security and Medicare. Further detail on this, again, is covered in the *Hyperinflation Special Report*.

U.S. Economy Still Faces Double-Dip Recession. The longest and deepest economic contraction of the post-World War II era, the 2007 to 2009 U.S. recession, is far from over. The downturn in the U.S. economy is re-intensifying, with no near-term stability or recovery on the forecast horizon. After an initial plunge, broad-based business activity bottom-bounced at a low-level plateau for more than year. Shy of short-lived bumps in activity from stimulus measures, there has been no meaningful recovery. Nonetheless, with the National Bureau of Economic Research (NBER) having called an end to the recession in June 2009, the current downturn eventually will be recognized as a double-dip recession

Reflecting an intense real (inflation-adjusted) annual contraction in broad systemic liquidity (SGS-Ongoing M3 estimate), the economy has started to contract anew, as reflected in the accompanying graph. As discussed in numerous *Commentaries* this year (see *Commentaries No. 323 and 328*, for example), declining year-to-year change in real (inflation-adjusted) M3 signals a pending economic downturn or pending intensification of an existing economic contraction, with contracting broad liquidity invariably constraining broad economic activity. The signal is generated when real M3 first turns negative year-to-year, which occurred in December 2009 in the current economic cycle. The signal is not generated by,

nor dependent on, either the length or the depth of the M3 downturn. The downside shift in business activity usually follows within six to nine months. Due to the NBER's current business cycle timing, the current downturn will be classified as a double-dip recession.

The following updated graph plots annual real M3 growth versus periods of recession formally recognized by the NBER. It includes an approximate annual real contraction in the SGS Ongoing-M3 Estimate as of October 2010. The inflation-adjusted October M3 estimate used here is an annual contraction of roughly 4.6%, versus a 4.9% contraction in September.



Structural problems tied to lack of real consumer income growth -- and worsened now by the credit-intensified contraction in consumer liquidity -- pushed the economy into recession by early 2007, almost a year before the officially-clocked onset of December 2007. Such helped to trigger the credit collapse, which exacerbated the unfolding downtown and threatened systemic collapse. Despite extraordinary efforts to prevent a failure of the banking system, the structural consumer liquidity issues have not been addressed. Until they are, sustainable growth in U.S. business activity will be lacking.

The current double-dip contraction likely will meet my definition of depression (a greater than 10% real decline in peak-to-trough activity). In response to a likely hyperinflation, the current circumstance would evolve into a great depression (a greater than 25% real decline in peak-to-trough activity). Ongoing contractions in the world's largest economy have sharply negative implications for global economic growth, but the hyperinflation risk for the United States likely will not spread to the more-stable major U.S. trading partners.

U.S. Financial Markets. The domestic equity market have shown some initial euphoric insanity in response to the Fed's promised activity, but the stock market is not recognizing an ongoing systemic solvency crisis, yet. The domestic equity and credit markets also both should be hit eventually by the looming U.S. dollar selling panic, which would encompass the selling of U.S. dollar-denominated stocks as well as credit instruments.

In the ongoing dollar debasement process, markets likely will be highly unstable and volatile, particularly when central banks try to affect activity. Looking at the longer term, though, strategies aimed at preserving wealth and assets continue to make sense. For those who have their assets denominated in U.S. dollars, physical gold and silver remain primary hedges, as do stronger currencies such as the Canadian and Australian dollars and the Swiss franc, which recently having hit or broken parity with the U.S. dollar. Holding assets outside the U.S. also likely will have some benefits.

LATEST ECONOMIC REPORTING

September Trade Deficit Should Have Negligible Impact on Third-Quarter GDP Revision. Back in the realm of day-to-day economic reporting, the September trade deficit, though slightly narrower than expected before inflation adjustment, widened minimally in the context of the inflation-adjusted level for the third-quarter deficit. Correspondingly, the impact of today's report on the November 23rd revision to the third-quarter GDP estimate could go slightly in either direction.

Nominal (Not Adjusted for Inflation) Trade Deficit. For September 2010, the Bureau of Economic Analysis (BEA) and the Census Bureau reported today (November 10th) that the nominal seasonally-adjusted monthly trade deficit in goods and services narrowed to $44.0 billion, versus a revised $46.5 (previously $46.3) billion in August, and widened sharply from the $35.2 billion monthly deficit of September 2009.

Against August 2010, the September trade balance showed a small gain in exports and a small decline in imports. The lower imports partially were influenced by oil activity. Unadjusted oil imports reflected both lower physical volume and lower prices. Specifically, for the month of September 2010, the not-seasonally-adjusted average price of imported oil was $72.36 per barrel, down from $73.47 in August 2010, but up from $68.17 in September 2009. In terms of not-seasonally-adjusted physical oil imports, September 2010 volume averaged 9.656 million barrels per day, versus 9.900 million in August 2010 and 9.540 million in September 2009.

Real (Inflation-Adjusted) Trade Deficit. A widening trade deficit directly reduces GDP growth and vice versa. As reported by the BEA with the September number, adjusted for seasonal factors and inflation (2005 chain-weighted dollars as used in reporting real GDP), the second-quarter goods deficit was at a revised annualized pace of $575.7 (previously $575.1) billion. Based on full third-quarter reporting, the annualized third-quarter deficit was running at a pace of $596.1 billion ($590.9 billion was the initial estimate based on just July and August reporting, but revised detail would take that July and August estimate to $594.5 billion). What portion, if any, of the inflation-adjusted trade data revisions will make it into the pending GDP revision is an open question.

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Week Ahead. Given the unfolding reality of an intensifying double-dip recession and more-serious inflation problems than generally are expected by the financial markets, risks to reporting will tend towards higher-than-expected inflation and weaker-than-expected economic reporting in the months ahead. Increasingly, previously unreported economic weakness will show up in prior-period revisions.

Retail Sales (October 2010). October retail sales are due for release on Monday, November 15th, with the consensus looking for a 0.7% seasonally-adjusted monthly gain (Briefing.com), versus a 0.6% monthly increase in September. A downside reporting surprise is a fair bet.

Industrial Production (October 2010). October industrial production, due for release on Tuesday, November 16th, is expected to show a 0.3% monthly gain (Briefing.com), versus a 0.2% monthly contraction in September. Again, a downside reporting surprise is a fair bet.

Producer Price Index -- PPI (October 2010). The October PPI is due for release on Tuesday, November 16th, with higher oil prices expected to push monthly wholesale inflation higher than September's 0.4% gain. The series is somewhat randomly volatile, but higher inflation is likely here, on both a monthly and annual basis, reflecting early "success" in the Fed's efforts to debase the U.S. dollar.

Consumer Price Index -- CPI (October 2010). Due for release on Wednesday, November 17th, the October CPI is expected to start showing some pick-up in seasonally-adjusted monthly consumer inflation. The consensus estimate for the monthly CPI-U gain is 0.3%, up from a 0.1% gain in September, per Briefing.com. Such is supported partially by a combination of a 3.5% monthly jump in not-seasonally-adjusted gasoline prices and seasonal factors that will tend to exacerbate same. The pick-up in consumer inflation also reflects an early victory for Mr. Bernanke's desired inflation creation (dollar debasement), based on distortions in monetary policy, or jawboning of same. Reporting risk is to the upside of expectations.

Year-to-year inflation would increase or decrease the October 2010 CPI-U reporting, dependent on the seasonally-adjusted monthly change, versus the 0.21% adjusted monthly gain seen in October 2009. I use the adjusted change here, since that is how consensus expectations are expressed. To approximate the annual inflation rate for October 2010, the difference in October's headline monthly change (or forecast of same) versus the year-ago monthly change should be added to or subtracted directly from September 2010's reported annual inflation rate of 1.14%. So a consensus result of a 0.3% monthly increase would move annual inflation to something over 1.2%.

Residential Construction -- Housing Starts (October 2010). October housing starts are due for release on Wednesday, November 17th. They should remain near historic lows, with any monthly change likely not to be statistically meaningful.

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