

John Williams'

Shadow Government Statistics

Analysis Behind and Beyond Government Economic Reporting

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Actual 2007 Federal Deficit Topped \$4.0 Trillion

Fed Allows Strongest Money Growth in 36 Years

Inflationary Recession Intensifies Sharply

System Continues Faltering as Central Banks Juggle Gimmicks

Dollar and Gold Breathers Are Proving Short-Lived

OVERVIEW -- OPENING COMMENTS

Solvency Crisis Intensifies as System Careens Towards Economic and Financial Disaster

Pushing the system ever nearer to the brink of the ultimate liquidity crisis, the Fed's December 11th easing, albeit minimal, played to the Wall Street speculators, not to the increasingly troubled global community holding large quantities of a rapidly-debasing U.S. dollar. Those not-so-happy dollar owners can see the U.S. economy sinking quickly into an inflationary recession, with the U.S. banking system facing a solvency crisis and the U.S. central bank playing games with itself. Such portends very difficult times for the greenback and the U.S. financial markets in 2008. The gold and silver markets, however, will be primary beneficiaries of these troubles.

Aside from the fantasy numbers published for

the third-quarter GDP, most reporting of the last month showed troubled business activity, consistent with a deepening recession. While similar data in the month ahead may be used to push the Fed into further easing, equally obvious deterioration on the inflation front may help to offset those pressures. While there is little that the U.S. central bank can do to fight recession or inflation, it still has the option of refraining from

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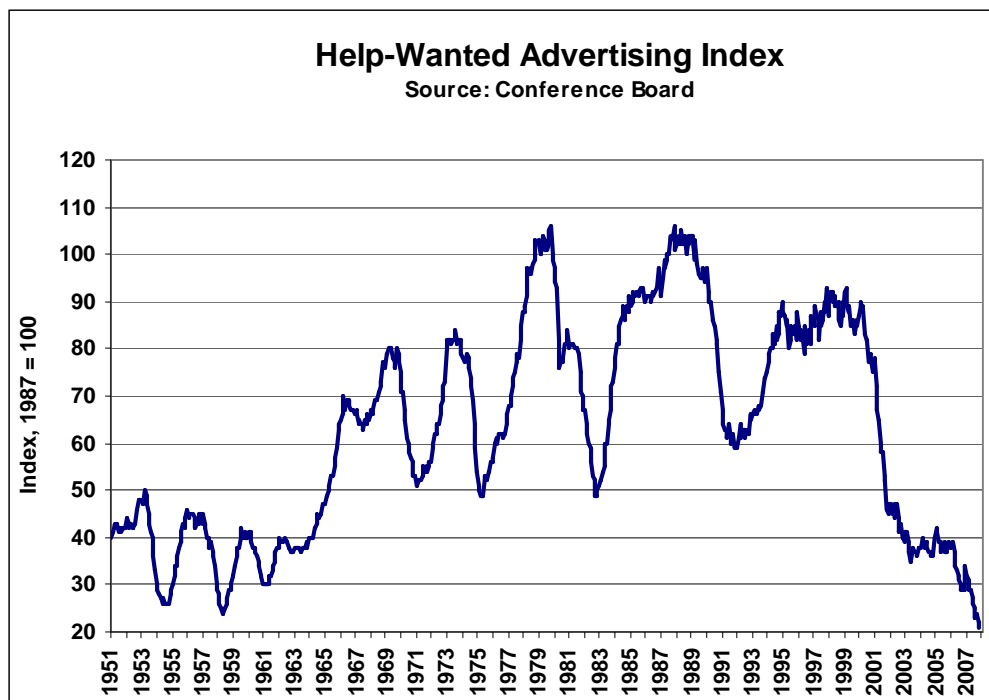
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further rate cuts in an effort to forestall some of the looming dollar dumping.

Recession Signs Abound. In addition to a couple of consensus economists moving into the recession camp (an occurrence that usually follows the onset of recession by at least six-to-nine months), most economic reports are showing a downturn, as discussed in the various sections.

Not only did annual growth in nonfarm payrolls slow to its cycle low, but new claims for unemployment insurance are rising sharply, the purchasing managers surveys are showing sharp drops in their employment indices, and help-wanted advertising for November collapsed to the lowest level in history, as shown in the accompanying graph.



As discussed later, even allowing for the impact of Internet help-wanted services, the current weakness foreshadows what should become a regular decline in monthly payroll reporting, if reporting were honest.

While recessions rarely hit all regions and industries at the same time, the November industrial production measure suggested a recession-like contraction for the fourth quarter, while the industrial production diffusion indices indicate that most industries have been in recession since mid-2006.

Ongoing weaknesses in housing activity, durable goods orders, consumer confidence measures and real average weekly income all tend to confirm a downturn. Retail sales should join the group in December.

Real Treasury Yields Turn Negative with Soaring Inflation. With November annual CPI surging to 4.31%, no one at present can beat inflation by buying an active-maturity Treasury security. The 30-year Treasury bond constant maturity yield was 4.45% (real interest rate of 0.14%) on December 31st, and all

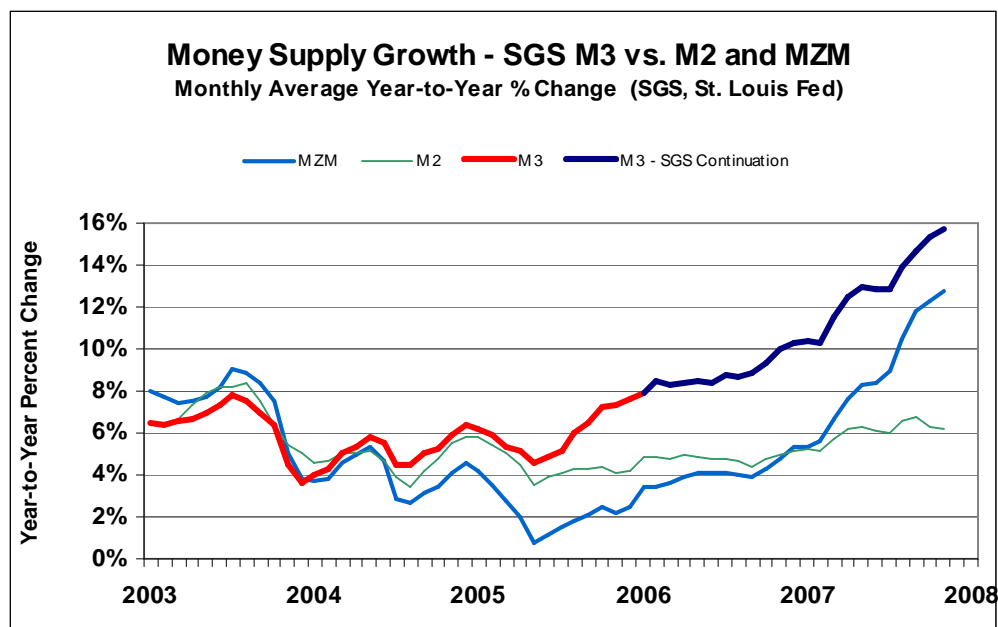
other maturities were under water in terms of the real or inflation-adjusted yield, using the official inflation numbers. Not only did CPI inflation surge, but annual November PPI jumped to 7.2%.

With oil pushing \$100 per barrel, with U.S. dollar selling picking up anew, with the SGS-Ongoing M3 growth at a 36-year high of 15.7%, and with federal deficit widening in 2008 (see the deficit section) and spinning out of control on a GAAP-basis (see this month's Reporting/Market Focus), the outlook for any near-term containment of inflationary pressures is bleak.

Fed's Spiking of Money Supply Growth Can Include a Variety of Options. The most common question I have been asked in recent months is, "Where is the broad money supply growth coming from, where the Fed does not seem to be adding lasting reserves to the system?" The answer partially is in still-growing foreign investment in U.S. Treasury securities.

The Federal Reserve has control over the nation's money supply. In terms of spiking broad money growth, the U.S. central bank can take action to inject funds directly into the system, or it can do so on the behalf of others, or sit passively by as others act. By not sterilizing or offsetting the impact of foreign held dollars going into U.S. Treasuries, the Fed is setting a policy of inflating money growth just much as if it were injecting the funds itself.

Treasuries held by the Fed for other central banks stood at \$1.196 trillion in October 2007, up 7.5% from the year before. Per U.S. Treasury surveying, U.S. Treasuries held by foreign investors stood at \$2.310 trillion in October, up 12.4% from the year before. Of some interest, Asian holdings of Treasuries fell for the year, Japan down 26.3%, South Korea down 22.4%, Taiwan down 7.4% and China down 4.1%. Saving the day, and more than accounting for the annual gain, was a 381% surge (\$235 billion) in investment out of the United Kingdom, which could reflect investment from any number of global sources.



Also at work in the broader money measures has been cash flowing out of M2 accounts to M3 accounts, such as large time deposits and institutional money funds. One money measure that has gained popularity in the official absence of M3 reporting is Money Zero Maturity (MZM), calculated by the St. Louis Federal Reserve. MZM includes only cash accounts that have no maturity considerations, and is M2 less small time deposits plus institutional money funds. Like the SGS-Ongoing M3 estimate, MZM has shown a rapid pick-up in annual growth. For the month of November 2007, M2 stood at \$7.4 trillion, up 6.2% from the year before, MZM stood at \$8.1 trillion, up 12.8%; SGS-Ongoing M3 stood at \$11.1 trillion, up 15.7%. Early indications for December, however, suggest some possible minor slowing of M3 growth.

Get Used to Amounts Expressed in Quadrillions of Dollars, as Solvency Crisis Deepens. When leverage is built upon leverage, eventually some large numbers can result. In publishing its six-month and triennial survey of global outstanding derivatives, the Bank for International Settlements (BIS) showed the June 2007 balance at \$516.4 trillion, up by 39.8% from June 2006. With the total notional amount of derivatives outstanding in the global markets now at \$0.5 quadrillion, the risks of systemic liquidity implosion are well beyond anything ever seen before. Of course, these estimates are from before the onset of the financial-system solvency crisis.

Central bank behavior in the last month, with the creation of special lending operations and extraordinarily large year-end cash infusions into the system, suggests a level of central bank distress and systemic problems that go beyond current marketplace perceptions. In the United States, renewed problems with commercial paper and soaring discount window borrowings show little improvement in circumstances over the last quarter. With economic fundamentals faltering rapidly, and with nature of troubled assets likely to expand rapidly, some major shocks to the system could loom early in 2008.

PLEASE NOTE: A "General background note" provides a broad background paragraph on certain series or concepts. Where the language used in past and subsequent newsletters usually has been or will be identical, month-after-month, any text changes in these sections will be highlighted in bold italics upon first usage. This is designed so that regular readers may avoid re-reading material they have seen before, but where they will have the material available for reference, if so desired.

General background note: The U.S. economy is in a protracted and deepening structural recession that will prove to be the second leg of a double-dip recession, which began in 2000/2001. The current downleg was signaled in mid-2005 by a series of leading indicators used for that purpose by SGS. With neither traditional fiscal nor monetary stimulus available to help turn economic activity, the current circumstance is likely to evolve into a hyperinflationary depression (see December 2006 SGS).

Continuing Market Instabilities. Unsettled bank solvency issues that likely will intensify in the New Year, and rapidly deteriorating inflationary recession conditions, promise a difficult year ahead for the U.S. equity and credit markets. Ahead likely are a major bear market in stocks, a sharp spike in long-term interest rates, heavy selling of the U.S. dollar, and a strong rally in the price of gold.

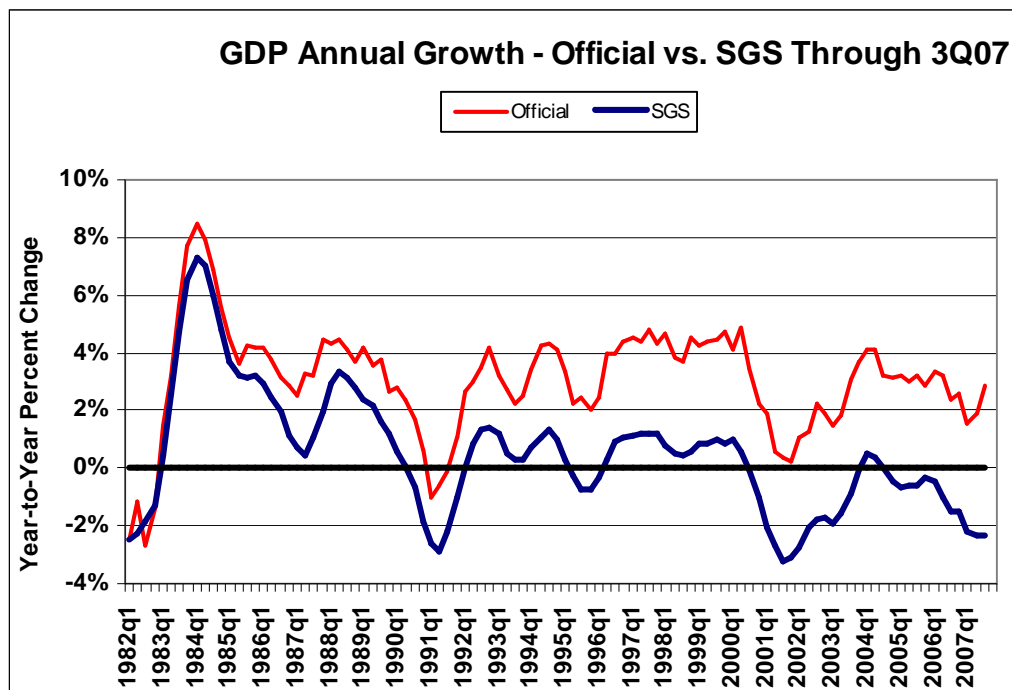
As U.S. dollar selling and dumping intensify in the year ahead, the greenback's weakening position will reflect not only movement out of the U.S. currency, but also an unusual flight-to-safety out of the U.S. dollar. This is the circumstance that Mr. Bernanke should fear and should be fighting to prevent. Such

eventually will force the Fed to increase rapidly its monetization of U.S. debt and to begin its unavoidable journey down the path towards hyperinflation.

Alternate Realities. *General background note:* This section updates the Shadow Government Statistics (SGS) alternate measures of official CPI and GDP reporting. When a government economic measure does not match common public experience, it has little use outside of academia or the spin-doctoring rooms of the Federal Reserve, White House and Wall Street. In these alternate measures, the effects of gimmicked methodological changes have been removed from the official series so as to reflect more accurately the common public experience, as embodied by the post-World War II CPI and the pre-Reagan-Era GDP. The methodologies for the series are discussed in the August 2006 SGS (see Archives page at www.shadowstats.com).

GDP. The alternate third-quarter GDP growth reflects the "final" estimate revision, with many of the methodological gimmicks of recent decades removed. The alternate third-quarter inflation-adjusted annual growth rate (year-to-year, as opposed to the popularly-touted annualized quarter-to-quarter rate) for GDP was a decline of roughly 2.4% versus the official, rising year-to-year gain of 2.8%.

General background note: Historical data on both the official and SGS-Alternate GDP series are available for download on the Alternate Data page of www.shadowstats.com. The Alternate GDP numbers tend to show deeper and more protracted recessions than have been reported formally or reflected in related official reporting. Nonetheless, the patterns shown in the alternate data are broadly consistent with the payroll employment and industrial production series (as revised), which are major indicators used by the National Bureau of Economic Research in determining the official timing of U.S. business cycles.



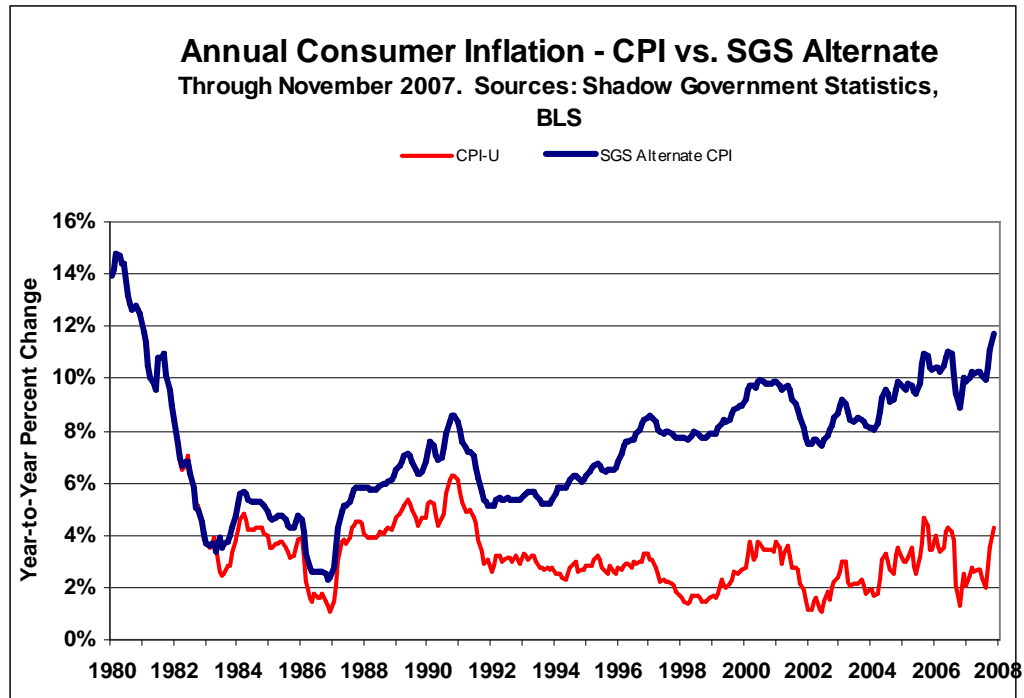
CPI. The annual non-core annual inflation rates spiked again in November and should continue rising into 2008. While the so-called "core" inflation rates continued their orchestrated malingering, they did notch slightly higher, and most PCE inflation measures were revised higher for recent prior periods. Food and oil-related price pressures continue as problems, due primarily to supply issues, but those pressures still have been reflected only minimally in much of the government's reporting of the non-core inflation, so far. Continued sharp increases in market prices, however, make it increasingly difficult for the BLS to mask the mounting inflationary pressures, and some spreading of the energy-cost damages has started to surface in the broad reporting.

Eight Levels of Inflation
Annual Inflation for August to November 2007

Measure	2007			
	Aug	Sep	Oct	Nov
I.1 Core PCE Deflator	1.9%r	1.9%r	2.0%r	2.2%
I.2 Core Chained-CPI-U	1.7%	1.7%	1.8%	2.0%
I.3 Core CPI-U	2.1%	2.1%	2.2%	2.3%
I.4 PCE Deflator	1.8%	2.5%r	3.0%r	3.6%
I.5 Chained-CPI-U	1.8%	2.3%	3.0%	3.6%
I.6 CPI-U	2.0%	2.8%	3.5%	4.3%
I.7 Pre-Clinton CPI-U	5.4%	6.1%	6.9%	7.6%
I.8 SGS Alternate Consumer Inflation	9.9%	10.4%	11.1%	11.7%

(r) Revised.

Notes: I.1 to I.3 reflect the core inflation rates, respectively, of the substitution-based personal consumption expenditure (PCE) deflator, the Chained-CPI-U and the geometrically-weighted CPI-U. I.4 to I.6 are the same measures with energy and food inflation included. The CPI-U (I.6) is the measure popularly followed by the financial press, when the media are not hyping core inflation. I.7 is the CPI-U with the effects of geometric weighting (Pre-Clinton Era as estimated by SGS) reversed. This is the top series in the CPI graph on the SGS home page www.shadowstats.com. I.8 reflects the SGS Alternate Consumer Inflation measure, which reverses the methodological gimmicks of the last 25 years or so, plus an adjustment for the portion of Clinton-Era geometric weighting that is not otherwise accounted for in BLS historic bookkeeping.



General background note: Historical data on both the official and SGS-Alternate CPI series are available for download on the Alternate Data page of www.shadowstats.com. The Alternate CPI numbers tend to show significantly higher inflation over time, generally reflecting the reversal of hedonic adjustments, geometric weighting and the use of a more traditional approach to measuring housing costs, measures all consistent with the reporting methodology in place as of 1980. Available as a separate tab at the SGS homepage www.shadowstats.com is the SGS Inflation Calculator that calculates the impact of inflation between any two months, 1913 to date, based on both the official CPI-U and the SGS-Alternate CPI series.

MARKETS PERSPECTIVE

U.S. stocks were down in the fourth quarter, but up for the year. Treasury yields were lower for the quarter and the year. Such was despite weakness in the dollar, strength in gold and higher oil prices over the same periods. While the formal quarterly and annual financial market review and look at the year ahead will follow in the January newsletter, current financial market conditions remain volatile, in an ongoing state of extreme agitation.

The U.S. economy is in a deepening, severe and sustained structural inflationary recession, saddled with an impotent Fed and a federal government that remains fiscally bankrupt in all but name. At the same time, the banking system is going through a major solvency crisis, largely due to poorly conceived structured financial instruments, which fundamentally were flawed in their modeling. The crisis tied to low quality mortgages should spread to into a wide variety of other instruments in the year ahead.

The central banks, particularly the Federal Reserve, are trying to appease the equity market speculators at the same time that efforts are being made to keep major financial institutions from failing. The Fed's task is complicated further by the risk of a major drain on U.S. financial market liquidity resulting from a major run on the dollar.

While the Fed has the wherewithal to prevent the collapse of the banking system, such does not necessarily flow through to the propping of the equity markets or the U.S. dollar. It would be surprising if 2008 does not see massive, global dumping of the U.S. dollar, with attendant large sell-offs in equities and Treasuries, along with a sharp spike in the prices of precious metals. Movements to reduce the U.S. dollar's reserve-currency status, and use in pricing of key commodities such as oil, likely will gain significant momentum in year ahead, intensifying the other dollar-related problems.

U.S. Equities -- The inflationary recession is gaining recognition rapidly, with negative implications for broad corporate revenues and profitability. In combination with the still unfolding solvency crisis and the still pending tanking of the U.S. dollar, the outlook for stocks is bleak, and the recent softness seen in equity prices likely will evolve into a ferocious bear market during the year ahead.

General background note: As the equity markets catch up with the underlying economic and looming financial fundamentals, the downside adjustments to stock prices should be quite large, eventually rivaling the 90% decline in equities seen in the 1929 crash and ensuing several years. The decline might have to be measured in real terms (net of inflation), as a hyperinflation eventually will kick in as the Fed moves to liquefy the system. Stocks do tend to follow inflation, since revenues and earnings get denominated in inflated dollars. Hence with a hyperinflation, a DJIA of 100,000 or 100,000,000 could be expected, but such still would be below today's levels, adjusted for inflation.

General background note: The approaching financial maelstrom already has come over the horizon and is **hovering near** landfall. When it hits, those investors who have taken shelter in cash, gold and outside the U.S. dollar will be the ones with the wealth and assets available to take advantage of the extraordinary investment opportunities that should follow.

U.S. Credit Market -- Key to the U.S. credit markets remains the global attitude towards the U.S. dollar. For the last quarter or two, U.S. Treasury yields have been depressed by both an ongoing influx of foreign-held dollars into Treasuries, along with the safe-haven effect that traditionally has boosted Treasury prices at times of financial-market or political turmoil.

These circumstances have led to a continued depression of Treasury yields. as discussed earlier, with the constant-maturity yield on a 30-year Treasury bond at 4.45% as of December 31st, and the latest annual CPI inflation at 4.31%, the real (inflation-adjusted) yield is about 0.1% on the long bond, and negative for all the active issues of shorter maturity.

Under current circumstances, the 30-Year Treasury bond normally would be yielding about 7.50%. At such time as the flight from the dollar becomes a flight-to-safety out of the dollar, U.S. interest rates will be forced higher in a mounting liquidity squeeze resulting from foreign dumping of dollar denominated securities. Increasingly, those assets will have to be absorbed in the U.S. markets, spiking treasury yields. With higher inflation down the road, long-term yields could be expected to rise by more than 300 basis points (3.00%) in the year ahead -- with a sharply steepening, positively-sloped yield curve -- despite a deepening recession and any further Federal Reserve accommodation.

U.S. Dollar -- Despite heavy dollar selling in November, the dollar regained its footing some in December, likely in conjunction with manipulation tied to both overt and covert central bank intervention in the gold market that was aimed at suppressing the gold price rally. Both gold and the dollar resumed their fundamentally-driven trends (gold higher, dollar lower) in the last week or so.

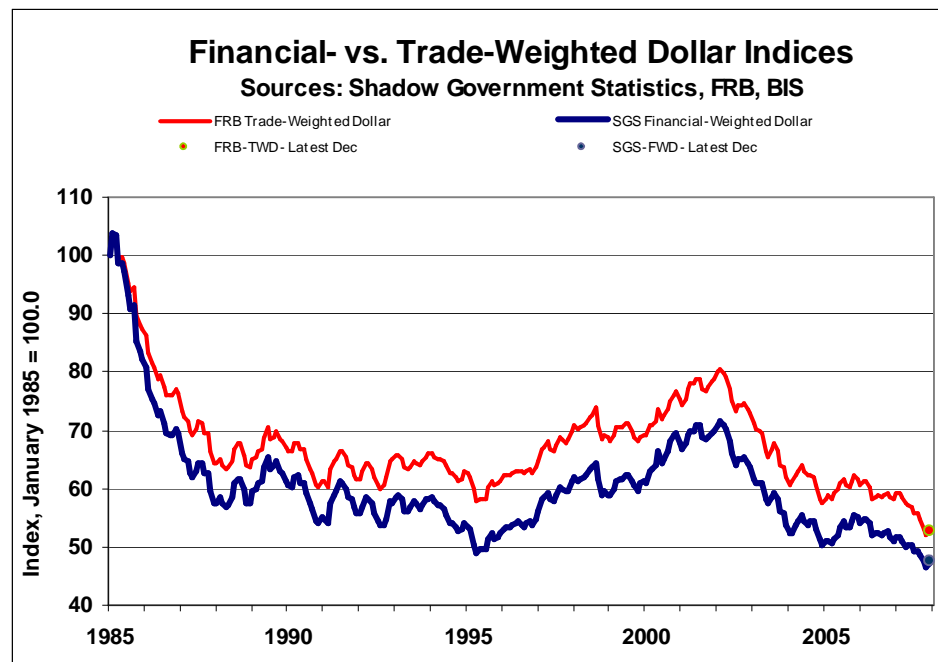
With the economic crisis gaining rapid recognition, and with the next round of bank solvency issues likely to surface in the New Year, U.S. dollar selling pressures should intensify and become more sustained in the post-year-end period. The flight from the dollar increasingly should become a flight-to-safety outside the dollar. Accordingly, the Swiss franc likely will be one of the better performing currencies, but weakness in the U.S. currency should remain broadly based against the major Western currencies, with particularly heavy dollar selling in the months ahead, despite any near-term swings induced by central bank intervention.

Potentially exacerbating the circumstance is a mounting move out of the dollar by major Asian economies, as well as the mounting pressures within OPEC to abandon the U.S. currency as the pricing mechanism for oil. The U.S. markets remain particularly vulnerable, at the moment, to "surprises" from those countries that are not so friendly to the United States, or even from those who simply would like to avoid large losses on the dollars they hold. The more the Fed eases, the greater will be the shift out of the U.S. dollar.

Beyond further easing by the Federal Reserve rate or further negative news out of the solvency/funding crisis, the proximal trigger for a full dollar panic could come from a bad economic statistic (some numbers, such as the trade deficit, appear to be massaged in a dollar-friendly manner), political missteps by the Administration, negative trade or market developments in Asia, or a terrorist attack or expansion of U.S. military activity in the Middle-East. When the trigger is pulled, the broad selling pressure should be strong enough to overwhelm short-lived central bank intervention.

General background note: In terms of underlying fundamentals that tend to drive currency trading, the dollar's portfolio could not be worse. Relative to major trading partners, the U.S. economy is much weaker, interest rates are lower and anticipated possibly to go lower still, inflation is higher, fiscal and trade-balance conditions are abysmal, and relative political concerns are rising sharply at the same time. The President's approval rating commonly has moved currency trading in the past, and, despite any near-term bouncing, it remains lower than has been seen for any other U.S. President in the post-World War II era. Relative political stability issues are compounded by the presence of a Congress that is hostile to the President, and that is rated even lower by the American people than is the President. Generally, the greater the magnitude of the dollar selling, the greater will be the ultimate inflation pressure and liquidity squeeze in the U.S. capital markets.

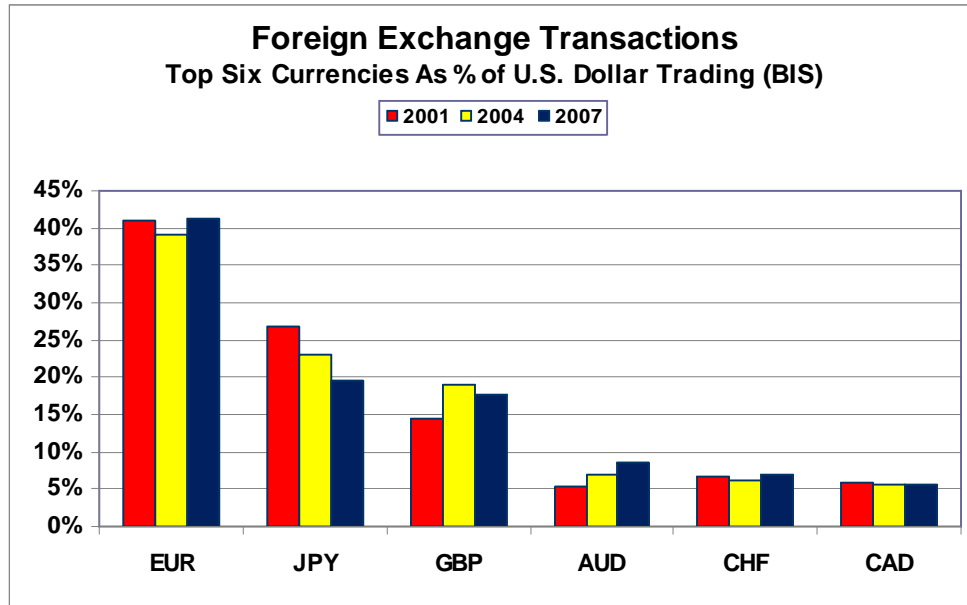
As shown in the following graph, the U.S. dollar continued to fall sharply in November, but bounced back in December. On a monthly basis, through November, the U.S. currency set new lows regularly on both a financial- and trade-weighted basis. The added latest December data points are as of December 31st.



General background note: Historical data on both dollar series are available for download on the Alternate Data page of www.shadowstats.com. See the July 2005 SGS for methodology.

U.S. Dollar Indices. The Shadow Government Statistics' Financial-Weighted U.S. Dollar Index (FWD) is based on dollar exchange rates weighted for respective global currency trading volumes. The series has been re-weighted for November 2007 and going forward, using the latest (April 2007) triennial survey of currency trading as published by the BIS. The earlier FWD levels have not been changed, and the November level was set consistent with the month-to-month change indicated by the October and November data on a reweighted basis.

Based on average daily foreign exchange market turnover in April 2007, the BIS estimates that 86.3% of all global currency transactions involved the U.S. dollar; such was down from 88.8% in April 2001. Of all U.S. dollar trading, 76.4% was accounted for by the top six currencies, used in the SGS Financial-Weighted U.S. Dollar Index (weighted as a percent of the top-six total): Euro/EUR (41.36%), Yen/JPY (19.55%), British Pound/GBP (17.77%), Australian Dollar/AUD (8.62%), Swiss Franc/CHF (7.04%) and the Canadian Dollar/CAD (5.66%). In April 2001, the top six currencies accounted for 81.4% of U.S. dollar trading.



The respective weightings of the six major currencies in U.S. dollar trading are plotted in the above graph. Of some interest is the general downtrend in the weighting of the yen, with irregular gains in the weightings of the euro, pound and Swiss franc, and the steady rise in the relative weighting of the Australian dollar.

For December 2007, the monthly FWD rose by 1.82%, after a decline of 2.09% in November and a decline of 2.29% in October. The December 2007 average index level of 47.33 (base month of January 1985 = 100.00) was down by 7.10% from December 2006. November 2007 was down by 10.15% from November 2006, with October down 9.58% from October 2006. The index again set a new historic monthly-average low in November of 46.49. The November 2007 average would have been 46.45 using the prior weighting scheme. While the U.S. currency showed a bounce in December, it again has come under selling pressure in the last week. The FWD stood at 47.42 as of December 31st.

Also setting a successive new all-time monthly-average low in November, and bouncing in December, was the Federal Reserve's Major Currency Trade-Weighted U.S. Dollar Index (TWD). In December, it rose by 2.06% from November, which was down 2.34% from October. The December 2007 index level of 53.03 (base month of January 1985 = 100.00) was down 8.90% from December 2006, following November's 11.39% decline. As of December 31st, the TWD closed at 52.79.

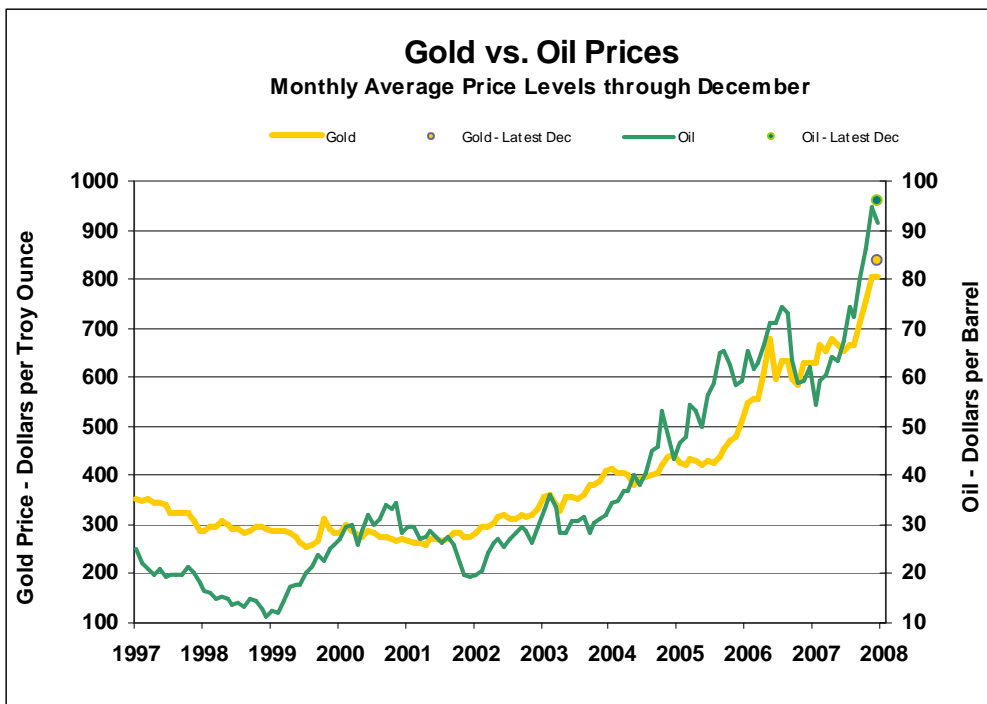
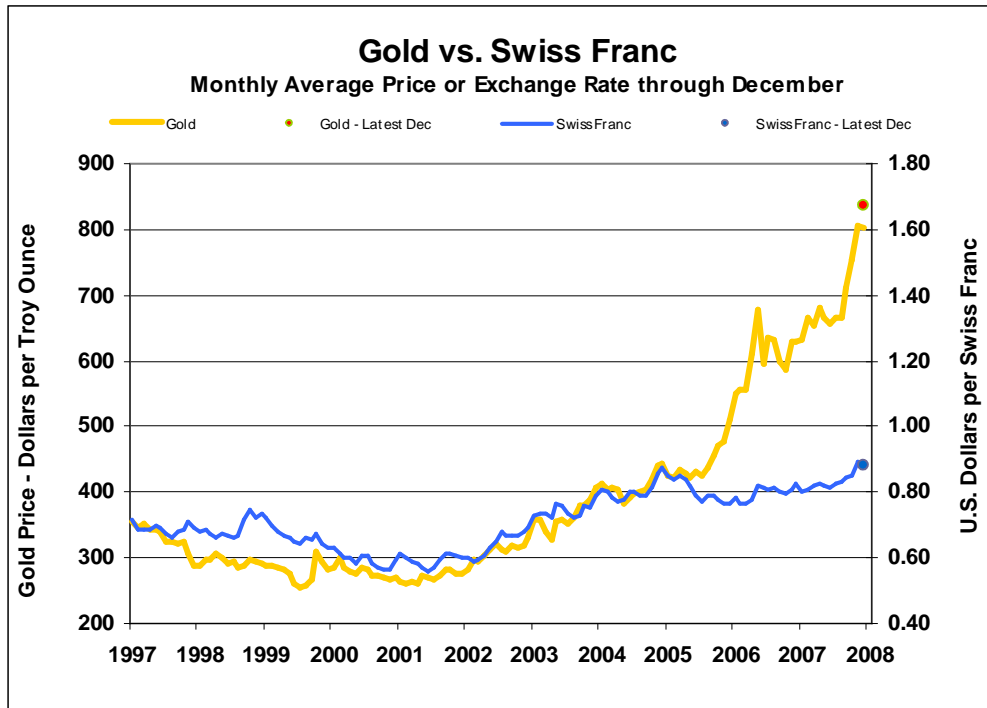
Gold -- As unexpectedly high November inflation numbers were published in mid-December, gold sold off, which was highly suggestive of some covert central bank intervention, in addition to some overt central bank selling of gold. Once again, however, the gold price is on the rise, with the current market closing in on the historic highs. On November 8th, the London afternoon gold fix was set a 27-year high \$841.10 per troy ounce, within striking distance of the all-time high of \$850.00 (London afternoon fix) of January 21, 1980. In terms of today's dollars (November 2007), the 1980 gold price peak would be \$2,296 per troy ounce, based on CPI adjusted dollars, and \$6,078 per troy ounce in terms of SGS-Alternate CPI adjusted dollars. The suggestion remains that the price of gold still faces some catch-up.

As estimated (based on Kitco.com) for December, the monthly average London gold afternoon fix was \$803.20, versus November's record high of \$806.25 per troy ounce, and up from \$754.60 per troy ounce in October. Silver averaged \$14.30 per troy ounce (estimated) in December, versus \$14.70 per troy ounce in November and \$13.67 per troy ounce in October.

While gold price volatility likely will continue, given the combination of rising inflation, weak dollar and increasing global instabilities, it would be very surprising if the price of gold does not break well above \$1,000 per troy ounce in the year ahead. Of some risk here, again, remains the possibility of intensified covert or overt central bank intervention in tandem with intensified intervention aimed at muting the effects of dollar selling. Despite any central-bank machinations or intervention, the upside potential for the precious metals remains explosive.

General background note: As discussed in the Hyperinflation Series (see the December 2006 to March 2007 SGSs), the eventual complete collapse of the U.S. dollar -- the world's reserve currency -- will force the creation of a new international currency system. Gold likely will be structured into any replacement system, in an effort by those organizing the new currency structure to gain public acceptance.

The updated gold versus oil and Swiss franc graphs show November and estimated December averages as well as added points for closing prices on December 31st. As of Monday's closing prices, gold was at \$836.50 (London morning fix) and oil at \$96.01 (Friday, December 28th), while the Fed's published noon buying rate had the Swiss franc at \$0.8827. Again, all three measures should trade significantly higher in the months ahead.



REPORTING PERSPECTIVE

The Big Three Market Movers

Rapidly deteriorating systemic and economic conditions are rattling the markets and are leaving the U.S. central bank with increasingly limited policy options. Having provided minimal easing at the last FOMC meeting, Mr. Bernanke still needs a stable U.S. currency and as much support as possible from upcoming economic data. The worse-than-expected November inflation numbers removed some of the easing pressure from the Fed, but if December payrolls show an outright contraction, which they could, then the pressure on the Fed will surge anew for massive accommodation.

Other than daily manipulation, the U.S. dollar largely is beyond the Fed's control, but that is not the case for upcoming economic reporting. Accordingly, near-term rigging of key U.S. economic data, such as jobs growth, is at high risk, with a likely massaging to the upside for economic reporting. Nonetheless, the reality of an inflationary recession will continue to dominate honest economic reporting.

From the standpoint of party politics and the rapidly nearing primary season, the continued bottom-bouncing of the President's positive rating generates added pressure on the government's statistical agencies to add in happy biases to the economic numbers. Where statistical games are being played for both the perceived political needs of the Administration and the increasingly heavy financial-market needs of a severely constrained Federal Reserve, the need for rigged numbers continues to border on what might be considered as national security issues.

Absent manipulation, and against lagging and increasingly realistic market expectations, most near-term economic reporting still should tend to surprise the markets on the downside, while most inflation reporting still should surprise expectations on the upside.

Employment/Unemployment -- As discussed in the December 7th Flash Update, the November jobs report was heavily manipulated to bring in the reported 94,000 gain in nonfarm payrolls, as opposed to an outright contraction. The reported gain was statistically indistinguishable from a monthly contraction. Even though slightly stronger than consensus estimates, the data -- particularly on close examination -- were extraordinarily weak. Beyond the gimmicks discussed below, the Bureau of Labor Statistics (BLS) simply can report any jobs number it desires. For example, during the Clinton Administration, the seasonally-adjusted monthly jobs were set to political needs (a target of 250,000 jobs per month at the time), and the BLS just backed into all the other numbers needed to support that.

Payroll Survey. Using its full suite of identifiable estimation gimmicks, the BLS reported seasonally-adjusted November payrolls up by 94,000 (46,000 net of revisions) +/- 129,000, following October's revised 170,000 gain (previously 166,000). Unadjusted year-to-year payroll growth fell in November to 1.04%, versus October's revised 1.17% (previously 1.18%). The decline in November annual growth to 1.0% has historic parallels seen only during recessions.

Seasonal-Factor Gimmicks. As discussed regularly in prior newsletters, the monthly seasonal factors are readjusted each month as needed, and the BLS can generate any desired result. Consistently adjusted and

unadjusted annual growth rates suggest that November otherwise would have been reported with just a 26,000 payroll gain. Separately, seasonal factor manipulation also is evident in the downward revision to the October payroll levels. Adjusted, October was revised lower by 48,000 jobs, but unadjusted, October's downward revision was just 8,000. The seasonal readjustments allowed for reporting a net extra 40,000 seasonally-adjusted jobs in November, while the reported October gain increased to 170,000 jobs, thanks to still-earlier period data adjustments.

Unusual Bias Adjustments. November's upside bias add-factor (from the birth-death model) was 51,000, versus 103,000 in October. Aside from those 51,000 plug-number jobs not being valid, the bias was increased from 36,000 in November 2006, an unusually large adjustment, where the change in bias normally is plus or minus a couple of thousand for the same month in successive years.

Household Survey. The statistically-sounder household survey, which counts the number of people with jobs, as opposed to the payroll survey that counts the number of jobs (including those of multiple job holders), showed seasonally-adjusted November employment soaring by 696,000, after a 250,000 decline in October. The seasonally-adjusted November U.3 unemployment rate was reported at 4.66% +/- 0.23%, down from the 4.73% in October, while unadjusted U.3 rose to 4.5% in November from 4.4% in October. The broader, adjusted November U.6 rate held at 8.4% for the fourth straight month, while unadjusted November U.6 was 8.1%, against 7.9% in October. Net of the "discouraged workers" defined out of existence during the Clinton Administration, the actual unemployment rate continued to run around 12%.

One note of caution, the seasonally-adjusted unemployment rate (as popularly followed) will be subject to revisions at the adjusted level for the last five years, along with the December data due on January 4th.

The reported November employment gain ran counter to the background of the better employment-environment indicators, with collapsing October and November help-wanted advertising, surging new claims for unemployment insurance, and sharp deterioration to recession-level and near-recession-level employment readings, respectively, for the manufacturing and non-manufacturing November purchasing managers surveys. These labor-market indicators remain consistent with what should be declining payrolls and a rising unemployment rate.

Last year, the December bias factor was an add of 64,000, following November's 36,000. With November 2007 revised to 51,000, the relative change in the December 2007 bias could be small, but it still would place some upside pressure on December's payroll results.

Next Release (January 4): Based on underlying economic activity, the December payroll survey should show a month-to-month contraction, despite expectations for a gain of roughly 70,000 jobs. The household survey also should show a sharp jump in the unemployment rate, beyond the expected 0.1% gain, again subject to annual seasonal-adjustment revisions. Given, however, the simplistic spin in the U.S. financial markets that a recession means Fed easing, and given the Fed's still-indicated reluctance to ease further, data massaging could keep the December results in positive territory and strong enough to help give the U.S. central bank some breathing room.

Gross Domestic Product (GDP) -- The Bureau of Economic Analysis (BEA) reported its "final" estimate revision of annualized real (inflation-adjusted) growth for the third quarter of 2007 at 4.91% +/- 3%, versus the "preliminary" estimate of 4.92% and the "advance" estimate of 3.90%, and up from the 3.82%

reported for the second quarter. From the standpoint of year-to-year growth, real GDP grew by 2.84% in the third quarter, versus prior estimates of 2.85% and 2.59%, and up from 1.89% in the second quarter. The latest revision reflected little more than statistical noise.

In its "final" form, the GDP's implicit price deflator (inflation measure) rose at an annualized 1.04% rate in the third quarter, down from the second quarter's 2.64%. Artificially-low inflation, used in deflating the GDP, results in overstatement of the inflation-adjusted GDP growth.

If the government's report on broad economic growth were accurate, then the economy would be booming and enjoying low inflation, not suffering an inflationary recession. Anecdotal evidence and better quality data, however, suggest that Main Street U.S.A. is seeing inflation and a recession, not an economic boom with contained inflation.

Adjusting for methodological distortions built into GDP reporting over time, the SGS-Alternate GDP measure also suggests that economic reality is much weaker than officially reported. A third-quarter annual contraction of roughly 2.4%, little changed from second-quarter performance, would have been more in line with underlying fundamentals, past methodologies and the ongoing recession (see the graph in the Alternate Realities section of the Opening Comments).

The also BEA has published its estimates of two broad alternate GDP measures for the third quarter. Gross National Product (GNP) is the first, where GDP is GNP net of trade in factor income (interest and dividend payments), and Gross Domestic Income (GDI) is the second, which is the theoretical equivalent to the GDP.

Reflecting the unusual gamesmanship in recent trade reporting, the annualized real growth in third-quarter GNP surged to 5.81%, from 4.01% in the second quarter, and was up 3.24% on a year-to-year basis.

As noted in the December 28th *Flash Update*, though, the GDI for the third quarter showed annualized real growth of just 1.46%. Again, the GDP and GDI should be equal to each other, with the GDP based on consumption and inventory change, and GDI based on income and net saving. Thanks to a fortuitous and highly unusual swing in the "statistical discrepancy" between the two series, from a negative \$40.8 billion in the second quarter to a positive \$74.8 billion in the third, the GDP was able to show its amazing and heavily suspect growth.

General background note: Although the GDP report is the government's broadest estimate of U.S. economic activity, it is also the least meaningful and most heavily massaged of all major government economic series. Published by the BEA, it primarily has become a tool for economic propaganda.

Next Release (January 30): Based on underlying fundamentals, the "advance" estimate of annualized quarterly real GDP growth for the fourth quarter should be in contraction, but such a showing remains unlikely in an election year. Nonetheless, consensus expectations appear to be moving to below 2% growth, a sharp slowing from the third quarter's nonsensical boom. As usual, the BEA is likely to target the consensus forecast for its advance estimate. As a result, the chances of a reported contraction at the first release are close to nil. Only the spinmeisters on Wall Street, at the Fed, and in the White House, and the targeted severely gullible, however, will believe or purport to believe that there is no recession.

Consumer Price Index (CPI) -- As discussed in the December 15th *Flash* Update, the Bureau of Labor Statistics (BLS) reported the seasonally-adjusted November CPI-U (I.6) up by 0.80% (0.59% unadjusted) +/- 0.12% for the month, following October's 0.29% (0.21% unadjusted) increase. November's annual CPI inflation surged to 4.31%, up from 3.54% in October, from 2.76% in September and 1.97% in August.

The increase in annual inflation likely will continue in December 2007. Such is dependent on the seasonally-adjusted monthly gain exceeding 0.45%, the amount of monthly increase seen in December 2006. The difference between December 2007 monthly reporting and the prior year's 0.45% will directly add to or subtract from November's annual inflation rate of 4.31%.

Annualized year-to-date inflation through the first 11 months of the year was 4.2% adjusted, 4.5% unadjusted. In theory, the adjusted and unadjusted numbers should be the same for the full year. Despite minimal catch-up in accounting for both CPI-U and PPI energy and food inflation, and a minor increase in reporting of so-called "core" inflation, core inflation continues to appear to be closely managed, staying conveniently "contained" for the needs of the Federal Reserve.

Annual inflation for the Chain Weighted CPI-U (C-CPI-U) (I.5) -- the substitution-based series that increasingly gets touted by the manipulators and inflation apologists as the replacement for the CPI-U -- was 3.57% in November, up from 2.99% in October, and up from 2.31% in September.

Adjusted to pre-Clinton (1990) methodology (I.7), annual CPI growth was about 7.6% in November, up from 6.9% in October and 6.1% in September, while the SGS-Alternate Consumer Inflation Measure (I.8), which reverses gimmicked changes to official CPI reporting methodologies back to 1980, was roughly 11.7% in November, up from 11.1% in October and 10.4% in September. The eight levels of annual inflation, I.1 to I.8, are detailed in the table in the Alternate Realities section, along with the graph of SGS-Alternate Consumer Inflation.

Next Release (January 16): Assuming monthly inflation for December in excess of 0.45%, annual CPI will continue its upturn and likely will continue rising into 2008. Fundamental reporting risks generally favor an upside surprise to market expectations, but targeted manipulation is of high risk, with the Fed increasingly facing no-win policy options. Significant upside movement in core inflation remains long overdue and is highly suspect by its absence.

Other Troubled Key Series

Federal Deficit -- The federal government's fiscal 2007 (year-ended September 30th) official accounting-gimmicked deficit narrowed to \$162.8 billion from \$248.2 billion in 2006. Yet, as discussed in this month's Reporting/Market Focus, the GAAP-based deficit for fiscal-year 2007 was reported at \$1.2 trillion, down from \$4.6 trillion in 2006, with total federal debt/obligations rising to \$59.8 trillion in 2007 from \$58.6 trillion the year before. The deficit "improvement" was due primarily to one-time changes in actuarial assumptions and accounting that otherwise were not reported on a consistent basis. On a consistent reporting basis, the GAAP-based deficit for 2007 topped \$4 trillion.

Net of accounting for unfunded Social Security and Medicare Obligations, the 2007 GAAP deficit was \$275.5 billion versus the officially gimmicked number of \$162.8 billion; the same numbers for 2006 were \$449.5 billion versus \$248.2. On this basis, total federal government debt/obligations were \$14.7 trillion in 2007, up from \$14.1 trillion in 2006. Those numbers contrast with gross federal debt of \$9.0 trillion in 2007 versus \$8.5 trillion in 2006.

Although it lacks the accrual accounting of the GAAP numbers, viewing the change in gross federal debt bypasses several of the regular reporting manipulations and is a better indicator of actual net cash outlays by the federal government than is the official, gimmicked deficit reporting. For fiscal year-end 2007, the gross federal debt stood at \$9.007 trillion, up by \$500 billion from 2006, which was up \$574 billion from 2005. For those who like to ignore the government's obligations to Social Security, etc., for cash borrowed from payroll taxes and used in covering general expenses, the federal debt held by the public was \$5.0 trillion in 2007, up by \$206 billion from 2006, which in turn was up by \$242 billion from 2005.

In terms of official reporting, though, the deficit is on the rise again early in fiscal 2008. The 12 month rolling, accounting-gimmicked federal deficit for November 2007 was \$194.2 billion, widening sharply from \$169.1 billion in October, and \$162.8 billion in September, but still down versus \$242.8 billion in the 12 months ended November 2006. Nonetheless, the annual "improvement" seen in the differential between the 2007 and 2006 numbers narrowed to \$49 billion in November from \$81 billion in October.

Gross federal debt totaled \$9.149 trillion as of November 30, 2007, up \$70 billion from October and up \$516 billion from November 2006, which in turn was up by \$540 billion from November 2005. Gross federal debt in October 2007 was up \$495 billion from October 2006, which in turn was up by \$557 billion from October 2005.

The Administration and Congress have been playing bookkeeping games for years and continue to do so. Even so, the gimmicked deficit should continue widening in the months ahead, as government finances begin to suffer from tax revenue losses due to the intensifying recession and relative tax receipt declines after the expiration of recent corporate tax incentives. While GDP growth estimates can be gimmicked, incoming tax receipts (based on consistently applied tax policies) remain an independent estimate of underlying economic reality and eventually will reflect the economy's mounting difficulties.

Initial Claims for Unemployment Insurance -- The trend in annual growth has continued to deteriorate. On a smoothed basis for the 17 weeks ended December 22nd, annual growth rose to 3.4%, up from 2.1% in the 17 weeks ended November 17th. An increasing growth trend in new claims is an economic negative.

More often than not, week-to-week volatility of the seasonally-adjusted weekly claims numbers is due to the Labor Department's efforts to seasonally adjust these numbers around holiday periods, as seen with the weeks that included Columbus Day, Veteran's Day and Thanksgiving and as will be seen with the upcoming Christmas and New Year's reporting. The Labor Department has demonstrated an inability to do such adjusting successfully. When the new claims series is viewed in terms of the year-to-year change in the 17-week (four-month) moving average, however, such generally is a fair indicator of current economic activity.

Real Average Weekly Earnings -- November's seasonally-adjusted monthly real earnings fell by 0.4% versus a 0.3% (previously 0.2%) a decline October. Annual change in November deepened to 0.8% contraction from the 0.5% decline in October.

General background note: Gyration in the poor quality of reported CPI growth account for most month-to-month volatility in this series. Adjusting for the major upside biases built into the CPI-W inflation measure used in deflating the average weekly earnings, annual change in this series shows the average worker to be under severe financial stress in an ongoing structural recession.

Retail Sales -- Seasonally-adjusted November retail sales was reported as up by 1.22% (1.44% net of revisions) +/- 0.8%, after increasing by 0.23% (previously 0.16%) in October. Year-to-year growth was reported at 6.27% for November versus 4.98% (previously 5.15%) for October.

Anecdotal evidence suggests that holiday shopping was unusually soft. Yet, helped by the Census Bureau's inability to adjust adequately for seasonal variations due to an early Thanksgiving, some retail sales appear to have been drawn from December into November reporting. If such were the case, December retail sales either should be particularly weak, or they will be strong only on the back of downward revisions to prior November reporting.

As discussed in the December 13th *Flash Update*, also helping the monthly reported November retail sales gain was surging inflation (including some upward revision to past history). Adjusted for CPI inflation, the November retail sales gain was up by 0.4% for the month, up 2.0% on a year-to-year basis.

General background note: Real (inflation-adjusted) year-to-year growth in retail sales below 1.8% (using the official CPI-U for deflation) signals recession, and a signal first was generated in this business cycle back in June 2006.

Core Retail sales. As discussed last month, if the Fed and Wall Street hypesters are going to tout "core" inflation, net of food and energy, at least they should be consistent and go to town over "core" retail sales, net of gasoline station and grocery store sales, which vary primarily based on those otherwise "meaningless" energy and food prices.

November's "core" retail sales rose by 0.78% (0.63% net of revisions), following October's 0.05% monthly increase (previously unchanged).

Next Release (January 15): Where the retail sales series appears to be one series used in trying to assuage market nervousness, such places upside risk on positive massaging of the monthly data, particularly for a

report due related to the peak of the holiday shopping season. Nonetheless, there appears to be enough market recognition of reduced holiday season activity to allow for a relatively weak December report in conjunction with any revisions to the November data. Going forward, inflation-adjusted monthly and annual gains should turn regularly negative.

Industrial Production -- As noted in the December 15th *Flash Update*, November's industrial production showed a recession, despite the reported seasonally-adjusted monthly gain of 0.3%. Such followed a revised contraction of 0.7% (previously 0.5%) in October. Annual growth in November jumped to 2.15% from October's 1.43% (previously 1.80%). Creating the mirage of growth, here, is a revisions game.

The November index is below July's. Based on two out of three months in place for the fourth quarter, the current quarter appears headed for an annualized 1.6% quarter-to-quarter contraction, an unusual change outside of a recession. Historically, such contractions often coincided with a GDP contraction, but that was back in the days when the federal government was willing to recognize a recession.

Separately, the Federal Reserve publishes diffusion indices on the percentage of industries that are growing or contracting. As with the diffusion indices used in the purchasing managers survey, readings of 50.0 and above are viewed as in positive territory. Against the prior month, prior three months and prior six months, the November indices respectively were 40.4, 43.6 and 51.2, suggesting that the majority of industries have been in recession for the last quarter. A look at the time series for these indices, however, would support a contention that much of the economy has been in recession since mid-2006.

Next Release (January 16): Look for December industrial production to decline anew and for a quarterly contraction, consistent with an ongoing recession. Eventually, monthly contractions in this series should become regular, with the erratic but generally slowing annual growth turning negative.

New Orders for Durable Goods -- For November, the usually volatile durable goods orders rose by 0.1%, seasonally adjusted, after having fallen an unrevised 0.4% in October. On a year-to-year basis, November's orders fell by 0.3% versus October's 3.0% gain. Both November and October growth rates continued the pattern of annual contraction, after inflation adjustment, deepening the recession signal coming out of this series.

The closely followed nondefense capital goods new orders rose by 3.8% for the month in November, after falling by 2.5% in October. November's annual change was an increase of 5.6%, following October's 0.1% decline.

General background note: Durable goods orders lost its status as a solid leading economic indicator when the semi-conductor industry stopped reporting new orders in 2002.

Trade Balance -- As discussed in the December 15th *Flash Update*, the trade numbers continue to be targeted for manipulation, with minimal change being used as an inexpensive tool to impact the currency markets in favor of the U.S. dollar. As reported, the seasonally-adjusted monthly trade deficit for October widened to \$57.8 billion from September's \$57.1 billion (previously \$56.5 billion). The revisions were based on a little catch-up in the regular overstatement of the guesstimated surplus in services trade. While these new numbers indicate the GDP has been weaker than previously reported, related GDP revisions will not be seen until next July's annual downward revisions to prior GDP growth reports.

The importation of oil still appears to be seriously understated in terms of both pricing and physical volume, although minor catch-up was shown in October.

Next Release (January 11): Underlying reality favors renewed, severe deterioration in the monthly trade deficit, but the government can play games with this series as long as it wants to play them. Reality continues to suggest negative reporting risk; financial-market manipulation continues to dominate the positive reporting risk.

Consumer Confidence -- Although the monthly December consumer confidence measures fluttered after taking big hits in November, annual change continued sinking deeper into recession territory. In December, the Conference Board Confidence measure rose by 0.9%, after dropping 7.8% in November and 4.3% in October. December year-to-year change was down by 19.5%.

The University of Michigan Sentiment measure was down by 0.8% in December, on top of declines of 5.9% and 3.0% in November and October. December year-to-year change was down by 17.7%.

These lagging, not leading, indicators tend to reflect the tone of the popular financial media and are showing that the inflationary recession is ongoing and deteriorating sharply.

General background note: The Conference Board measure is seasonally adjusted, which can provide occasional, but significant distortion. The adjustment does not make much sense and is of suspect purpose, given that the Conference Board does not release the unadjusted number. The Michigan survey is unadjusted. How does one seasonally-adjust peoples' attitudes? Also, beware the mid-month Consumer Sentiment release from the University of Michigan. Its sampling base is so small as to be virtually valueless in terms of statistical significance.

Short-Term Credit Measures -- Patterns of annual growth in commercial borrowing have continues to reflect pressures from the bank solvency crisis, with the still-declining annual growth for commercial paper outstanding being countered partially by growth in commercial and industrial bank loans. Consumer credit numbers continue to show no impact.

For seasonally-adjusted consumer credit, which includes credit cards and auto loans, but not mortgages, annual growth was reported at 5.4% in October against an upwardly revised 5.3% in September (previously 5.1%) and 5.4% in August. In the current environment, where inflation-adjusted growth in income is not adequate to support meaningful growth in the personal consumption component of GDP, GDP growth only can come from temporary debt expansion or savings liquidation. Accordingly, stagnating growth in consumer debt expansion keeps an ongoing constraint on economic growth.

As an aside, the continued revisions in the consumer credit series reflect the Fed's inability to track bank activities accurately on a timely basis. Similar issues can be seen in the Fed's quarterly flow-of-founds accounting for the banking system.

Commercial borrowing growth varied sharply, again, with annual change in November commercial paper outstanding dropping by 4.5%, after October's 0.7% gain and September's 0.8% decline. In contrast, annual growth in November commercial and industrial loans continued rose at an annual rate of 21.8%,

up from 18.5% in October and following a 16.9% gain in September. The relative stability seen in October commercial paper started to fall apart anew in November, with the crisis deepening in December. These credit difficulties are placing a major dent in broad business activity.

Producer Price Index (PPI) -- The seasonally-adjusted November finished goods PPI jumped by 3.2% (1.6% unadjusted), following October's severely understated 0.1% (0.1% unadjusted) increase. Annual PPI inflation for November increased to 7.2% from October's 6.1% and September's 4.4%. Seasonally-adjusted intermediate and crude goods rose by 3.7% and 8.7%, respectively for the November, after increasing by 0.1% and 2.4% in October. The so-called "core" rate for finished goods rose to 0.4% from 0.0% in October, still well shy of reality.

Next Release (January 15): Allowing for the regular random volatility of the monthly price variations, PPI inflation reporting over the next six-to-nine months generally should come in above market expectations, as the effects of rapidly rising oil and food prices continue to permeate the broad economy. As with the CPI, the core PPI inflation rate still is long overdue for a meaningfully upside move, but such may be further delayed by the financial-market needs of the battered Federal Reserve.

Better-Quality Numbers

General background note: The following numbers are generally good-quality leading indicators of economic activity and inflation that offer an alternative to the politically-hyped numbers when the economy really is not so perfect. In some instances, using a three-month moving average improves the quality of the economic signal and is so noted in the text.

Economic Indicators

Purchasing Managers Survey: Manufacturing New Orders -- Still maintaining its general trend toward showing a recession in manufacturing, the overall November ISM manufacturing index eased to 50.8 from 50.9 in October, with the November employment index collapsing to a contraction level of 47.8 from 52.0 in October. An accelerating decline in the broad series remains a good bet in the next several months, based on continued deterioration in the overall industrial production and durable goods order series. An outright contraction reading in the broad index (below 50.0) is possible as early as the release of the December on January 2nd (today).

The November new orders index inched higher to 52.6 from 52.5 in October. Seasonal-factor distortions, which have been present, usually are overcome by viewing the series using year-to-year change on a three-month moving average basis. On that basis, the November new orders index was up by 1.6% on annual basis versus a 0.2% gain in October.

General background note: Published by the Institute for Supply Management (ISM), the new orders component of the purchasing managers survey is a particularly valuable indicator of economic activity. The index is a diffusion index, where a reading below 50.0 indicates contracting new orders. The index gradually has notched lower from its peak annual growth of 42.6% in April of 2004. As an SGS early warning indicator of a major economic shift, the new orders measure breached its fail-safe point in mid-2005, generating a signal of pending recession.

Service Sector Index. The service-sector ISM index does not have much meaning related to overall business activity, since new order activity at law firms, dentists, hospitals or fast-food restaurants has little obvious relationship to broad economic activity. That said, the overall November services sector index dropped to 54.1 from 55.8 in October. Both the services employment and prices paid components, however, have some meaning. The November employment component eased to 50.8 from 51.8 in October. The surging prices paid component is covered in the Inflation Indicators.

Help-Wanted Advertising Index (HWA) -- As graphed and discussed in the Opening Comments, as well as noted in the December 28th *Flash Update*, the Conference Board's seasonally-adjusted November help-wanted advertising index continued to plunge, dropping to 21 from a revised 22 (previously 23) in October, and from 24 in December. The index had hit a near-term peak of 34 in December 2006. The series is a leading indicator to the broad economy and to the monthly employment report.

The November reading was the lowest since the series was started at the end of President Harry Truman's term in office. Part of the historical decline in recent years has been due to the loss of newspaper advertising to the Internet, but such impact has been relatively small over the last year. November's reading was down 27.6% from the year before, indicative of a severe deepening in the ongoing recession,

The series does not include a measure of on-line advertising, and recent indices developed to measure Internet activity have serious definitional problems and still are too young to be meaningful indicators. That said, the Conference Board also reported that its on-line measure of help-wanted advertising also fell in November, down by 2.1% from October.

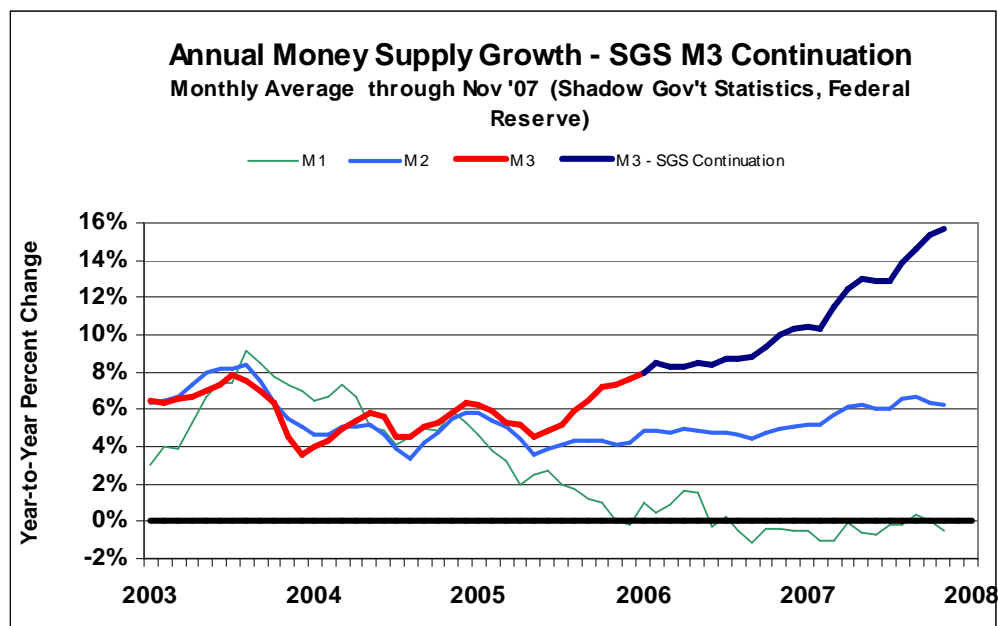
Housing Starts -- The housing numbers generally show an ongoing and deepening recession. November's seasonally-adjusted housing starts fell by 3.7% +/- 10% (95% confidence interval) for the month, after an increase of 4.2% (previously 3.0%) in October. November's level was down 24.2% from the year before.

Confirming the housing industry problems, the November building permits were down 1.5% for the month, 24.6% year-to-year, while new home sales fell 9.0% (11.1% net of revisions) for the month and were down 34.4% for the year. November existing home sales gained 0.4% (0.6% net of revisions) for the month but fell 20.0% year-to-year.

Inflation Indicators

Money Supply -- Questions as to what is generating strong growth in the broad money supply are addressed in this month's Opening Comments, along with a plot of M2, MZM and M3. Aside from shifts in cash from M2 accounts to M3 accounts, the Fed is not sterilizing massive amounts of dollars from outside the United States that still are flowing into U.S. Treasuries, with the direct Fed policy effect of liquefying the system.

As discussed in the December 15th *Flash Update*, the SGS-Ongoing M3 estimate of annual growth for November rose to 15.7% from 15.3% in October. The November growth rate was the highest since 16.1% in July 1971; the all-time high annual growth rate for the reported series was 16.4% in June 1971. Although early reporting (17 days) for the developing current December average suggests a possible slight slowing of annual growth for the month, the current pace of broad-money growth continues to have disturbing inflationary implications.



The bulk of the monthly increase in November's SGS-Ongoing M3 continued to come from the Fed's reported series on M2, large time deposits and institutional money funds. The pace of annual growth in November reflected a continued deceleration in the pace of increase. Keep in mind that the SGS numbers reflect year-to-year changes and may not necessarily mirror not-seasonally-adjusted week-to-week activity by the Fed.

General background note: Historical annual growth data for the money supply series, including the SGS Ongoing M3 estimates, are available for download on the Alternate Data page of www.shadowstats.com. See the August 2006 SGS for methodology. The indicated M3 levels below are our best estimate and are provided at specific subscriber request. Keep in mind that regular revisions in the related Fed series affect historical M3. Usually, annual growth rates hold, although levels may shift a little. We have not attempted, nor do we plan to recreate a revised historical series for an M3 monthly-average level going back in time. The purpose of the SGS series was and is to provide monthly estimates of ongoing annual M3 growth. We are comfortable with those numbers and that our estimated monthly growth rates are reasonably close to what the Fed would be reporting, if it still reported M3. With those caveats on the table, here are the monthly-average levels for M3:

Shadow Government Statistics Ongoing M3
(Estimated seasonally-adjusted monthly average, \$ Trillions)

Feb 06	10.349	Aug 06	10.748	Feb 07	11.415	Aug 07	12.239
Mar	10.365	Sep	10.865	Mar	11.559	Sep	12.457
Apr	10.435	Oct	10.999	Apr	11.732r	Oct	12.686
May	10.508	Nov	11.111	May	11.872	Nov	12.856p
Jun	10.564	Dec	11.227	Jun	11.925		
Jul	10.642	Jan 07	11.313	Jul	12.011		

(r)Revised. (p)Preliminary.

NOTE OF CAUTION: The estimates of monthly levels best are used for comparisons with other dollar amounts, such as nominal GDP. While the estimates are based on seasonally-adjusted Federal Reserve data, great significance cannot be read into the month-to-month changes, as was the case when the Fed published the series. The most meaningful way to view the data is in terms of year-to-year change.

Based on November reporting, annual change for monthly M1 contracted by 0.50% after a 0.07% gain in October. November M2 annual growth softened to 6.21% from 6.32% in October.

Purchasing Managers Surveys: Prices Paid Indices -- The November prices paid indices rallied sharply for purchasing managers surveys, reflecting upside inflation pressures from a variety of factors, including high oil prices, and signaling broader inflation problems ahead.

On the manufacturing side, the November price index jumped to 67.5 from 63.0 in October. On a three-month moving average basis, November's 17.3% gain was up sharply from October's 2.2%. The manufacturing price indicator is not seasonally adjusted and, therefore, is generally the better indicator of pricing activity.

On the non-manufacturing side, the seasonally-adjusted November prices diffusion index soared to 76.5 from October's 63.5. On a three-month moving-average basis November's annual change jumped to a 22.7% gain, up from a 3.0% increase in October.

General background note: Published by the Institute for Supply Management (ISM), the prices paid components of the purchasing managers surveys are reliable leading indicators of inflationary pressure. The measures are diffusion indices, where a reading above 50.0 indicates rising prices.

Oil Prices – For the last month or so, oil prices have fluctuated shy of the \$100 per barrel mark, a psychological price barrier that could fall at any time. For November, the monthly-average West Texas Intermediate spot price (St. Louis Fed) jumped 9.8% from October to a record high monthly average of \$94.62 per barrel. Against last year's average, November's level was up by 59.4%, compared with October's 46.4% gain. A preliminary estimate of December's average price level is \$91.52, down 3.3% from November, but up 47.6% from the year before. These levels of growth suggest disastrous news should continue to be in the offing for official CPI, PPI and GDP annual inflation reporting.

As of Friday, December 28th, West Texas Intermediate closed at \$96.01 per barrel, spot. Oil price movement remains highly volatile, but broadly continues trending higher, and likely will set further record highs in the months ahead. Irrespective of how high oil prices may go, or how much they may fall back in short-lived profit taking, current prices are well above levels that will help trigger debilitating U.S. inflation. Regardless of any near-term price swings, meaningful upside risks to oil prices remain in place, both from the unfolding dollar catastrophe and continued OPEC rumblings, as well as from ever-volatile Middle Eastern and related global political tensions, and other supply and demand issues.

Regardless of cause, high oil prices have spiked and will continue to spike basic inflation. Even the gimmicked "core" inflation measures -- net of changes in food and energy prices -- are beginning to inch higher, despite heavy political massaging of this data. The historically high oil prices still are working their way through all levels of U.S. economic activity, ranging from transportation and energy costs, to material costs in the plastics, pharmaceutical, fertilizer, chemical industries, etc. These broad inflationary pressures will remain intact despite any near-term oil price swings, and "core" inflation eventually should catch-up with full inflation reporting .

Reporting/Market Focus

GAAP Financial Statements of the U.S. Government for Fiscal Year 2007

On December 17th, The U.S. Treasury released the annual Financial Statements of the United States Government for fiscal year 2007 (year-ended September 30th), prepared using generally accepted accounting principles (GAAP), audited by the General Accountability Office (GAO) and signed off on by Treasury Secretary Paulson.

The statements still show that the federal government's fiscal woes continue to careen wildly out of control. Based on my estimate of the 2007 GAAP-based deficit exceeding \$4.0 trillion (see discussion below), the term "out of control" is not used loosely. If the government were to raise taxes so as to seize 100% of all wages, salaries and corporate profits, it still would be showing an annual deficit using GAAP accounting on a consistent basis.

Separately, the GAO still refuses to express an opinion on the financial statements, with three government agencies out of 24 earning GAO disclaimers: Department of Defense, Department of Homeland Security and Department of State, which accounted for 25% of net costs in 2007. The GAO referenced "serious financial management problems at the Department of Defense." With the exception of a qualified opinion on the statements for the Department of Agriculture, the opinions on all other agency statements were unqualified.

The results summarized in the following table show the various deficit/debt/obligation measures. The official GAAP-based deficit, including the annual change in the net present value of unfunded liabilities for Social Security and Medicare narrowed to \$1.2 trillion in 2007 from \$4.6 trillion in 2006. Much of the reported reduction in the deficit, however, was due to a one-time legislative-related accounting change in Medicare Part B that likely will be reversed, and, in any event, needs to be viewed on a consistent year-to-year accounting basis. Further, other one-time actuarial assumption and accounting changes need to be reported on a consistent basis for annual results to be comparable. Similar circumstances in 2004 had the reported deficit at \$11.0 trillion, which was \$3.4 trillion (SGS estimate) net of one-time changes to the Medicare system.

My final estimate for the actual 2007 GAAP-based deficit, and basis for same, will be published in the next several weeks, as research still is necessary to work through significant obfuscation. On a consistent year-to-year basis, I currently estimate the 2007 deficit will exceed \$4.0 trillion, meaningfully. Separately, as the numbers stand, total 2007 federal obligations of \$59.8 trillion represent 520% of U.S. GDP.

As noted in the *Flash Update* of December 18th, one example of the involved accounting issues is seen in Note 22 of the financial statements on Medicare, under "SMI Part B Physician Update Factor:"

"The projected Part B expenditure growth reflected in the accompanying 2007 Statement of Social Insurance is significantly reduced as a result of the structure of physician payment updates under current law. In the absence of legislation, this structure would result in multiple years of significant reductions in physician payments, totaling an estimated 41 percent over the next 9 years. Reductions of this magnitude are not feasible and are very unlikely to occur fully in practice. For example, Congress has overridden scheduled negative updates for each of the last 5 years in practice. However, since these reductions are

required in the future under the current-law payment system, they are reflected in the accompanying 2007 State of Social Insurance as required under GAAP. *Consequently, the projected actuarial present values of Part B expenditure shown in the accompanying 2007 Statement of Social Insurance is likely understated* [my emphasis]."

Since this was handled differently in last year's accounting, the change reduced the reported relative deficit. The difference would be \$4.4 trillion, per the government, if physician payment updates were set at zero.

With Social Security and Medicare liabilities ignored, the GAAP deficits for 2007 and 2006 were \$275.5 billion and \$449.5 billion, respectively. Those numbers contrast with the otherwise formal and accounting-gimmicked cash-based deficits of \$168.8 billion (2007) and \$248.2 billion (2006). Here, too, changes in actuarial assumptions reduced net costs for the Department of Veterans Affairs from \$113.8 billion in 2006 to \$59.4 billion in 2007. Consistent year-to-year reporting is needed in order to have consistent year-to-year comparisons of the results.

U.S. Government - Alternate Fiscal Deficit and Debt Reported by U.S. Treasury

Dollars are either billions or trillions, as indicated.

Sources: U.S. Treasury, Shadow Government Statistics.

Fiscal Year (1)	Formal Cash- Based Deficit (\$Bil)	GAAP Ex-SS Etc. Deficit (\$Bil)	GAAP With SS Etc. Deficit (\$Tril)	GAAP Federal Negative Net Worth (\$Tril)	Gross Federal Debt (\$Tril)	Total Federal Obilga- tions(2) (GAAP) (\$Tril)
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2007	\$162.8	\$275.5	\$1.2(3)	\$54.3	\$9.0	\$59.8
2006	248.2	449.5	4.6	53.1	8.5	58.2
2005	318.5	760.2(r)	3.5	48.5	7.9	53.3
2004	412.3	615.6	11.0(4)	45.0	7.4	49.5
2003	374.8	667.6	3.0	34.0	6.8	39.1
2002	157.8	364.5	1.5	31.0	6.2	35.4

(1)Fiscal year ended September 30th.(2)Revised to include gross federal debt, not just "public" debt.(3)On a consistent reporting basis, net of one-time changes in actuarial assumptions and accounting, SGS estimates that the GAAP-based deficit for 2007 topped \$4 trillion. (4)SGS estimates \$3.4 trillion, excluding one-time unfunded setup costs of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 (enacted December 2003). (r)Revised.

Link to the statements: <http://fms.treas.gov/fr/07frusg/07frusg.pdf>

Upcoming Reporting/Market Focus for January:

Illegal Immigration's Impact on the Economy and Economic Reporting

The number of undocumented aliens in the United States appears to be underestimated, severely. The impact of the current circumstance will be explored in terms of its impact on and implications for U.S. economic activity, inflation, living standards, long-range federal fiscal performance and reporting of same, among other issues.

PLEASE NOTE: The January 2008 "Shadow Government Statistics" newsletter will be a special year-end review and year-ahead assessment, currently is targeted for the week of January 28th. It should be accompanied the Hyperinflation Special Issue.

OCCASIONALLY, BRIEF UPDATES ARE COMMUNICATED DIRECTLY BY E-MAIL. IF YOU ARE NOT RECEIVING E-MAIL COMMUNICATIONS FROM US, PLEASE LET US KNOW at johnwilliams@shadowstats.com or by using the "Feedback" option on www.shadowstats.com.