

# John Williams'

# Shadow Government Statistics

*Analysis Behind and Beyond Government Economic Reporting*

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This is the third section of this Issue.

To view all of the Newsletter, please visit <http://www.shadowstats.com/article/359>

## REPORTING PERSPECTIVE

### The Big Three Market Movers

Most underlying economic fundamentals have continued to deteriorate in recent reporting, yet, key headline statistics -- specifically strong GDP and low "core" CPI -- increasingly have shown market-pacifying results, which is highly suggestive of political/financial-market oriented manipulation.

Messrs. Bernanke and Paulson need a stable U.S. currency, particularly with the exploding systemic solvency crisis. How could their "bailout" prevent a debilitating recession, when, in reality, one already has been underway for some time. The Administration's political needs remain great, and with the financial crisis threatening national security, almost anything remains possible in the arena of data and market manipulations. Data manipulation remains an extremely inexpensive and effective policy tool.

Absent manipulations, and against market expectations that keep shifting relative to underlying reality, most near-term economic reporting should tend to surprise the markets on

the downside, while most inflation reporting should surprise expectations on the upside. Watch out, though, for the key headline numbers, at least until after the November election.

**Employment/Unemployment** -- As discussed in the September 5th *Flash Update* and graphed in the Opening Comments, the August monthly employment report again showed an intensifying recession, with increasing payroll losses and rising unemployment. Monthly, quarterly and annual payroll contractions continued, patterns never seen outside of recessions. Once again, though, the reported deterioration appears to have been shy of reality, with payroll revisions pushing greater weakness into prior history.

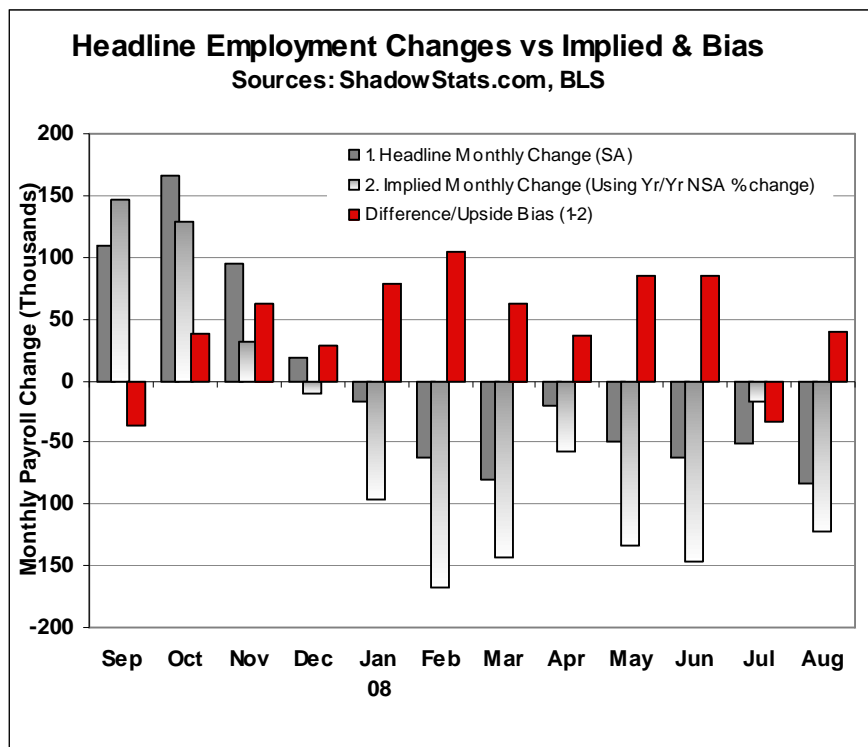
**Payroll Survey.** The Bureau of Labor Statistics (BLS) reported a statistically-insignificant, seasonally-adjusted jobs loss of 84,000 (down 142,000 net of revisions) +/- 129,000 for August, following a revised 60,000 (previously 51,000) jobs loss in July. Annual change (unadjusted) in total nonfarm payrolls continued to be negative,

down 0.29% in August, versus a revised 0.15% (previously 0.13%) contraction in July. The seasonally-adjusted series also remained negative year-to-year, down 0.21% in August, versus a revised 0.09% (previously 0.05%) decline in July.

**Concurrent Seasonal Factor Bias.** The pattern of impossible biases (see the Reporting/Market Focus in the June 10, 2008 *SGS Newsletter*) being built into the headline payroll employment changes resurfaced with the August reporting. Instead of the headline jobs loss of 84,000, consistent application of seasonal-adjustment factors -- net of what we are calling the concurrent seasonal adjustment bias -- would have shown a more-severe monthly jobs loss of about 123,000.

Despite last month's pattern reversal, the upside reporting bias has been seen in 10 of the last 12 months, as plotted in the graph on the next page.

**Birth-Death/Bias Factor Adjustment.** Another element that added upside pressure to the monthly payroll numbers was the monthly bias factor (birth-death model). Never designed to handle the downside pressures from a recession, the model added a 125,000 jobs bias to August 2008 (versus the prior August's 102,000 upside bias), and following a net upside bias of 4,000 jobs in July 2008.



**Household Survey.** The usually 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 multiple job holders), showed household employment fell by 342,000 in August, following a 72,000 decline in July.

The August 2008 seasonally-adjusted U.3 unemployment rate showed a statistically-significant increase to 6.05% +/- 0.23% from 5.68% in July. Unadjusted, U.3 increased to 6.1% in August, versus 6.0% in July. The broader U.6 unemployment rate jumped to an adjusted 10.7% (10.7% unadjusted) from 10.3% (10.8% unadjusted) in July. Refigured for the bulk of the "discouraged workers" defined away during the

Clinton Administration, actual unemployment, as estimated by the SGS-Alternate Unemployment measure, rose to 14.7% in August, up from 14.3% in July.

**Employment Environment.** The deterioration in August's employment environment continued in line with, but still shy of reality, per trends indicated by the better-quality employment-environment indicators: July help-wanted advertising fell again to its historic low; new claims for unemployment insurance continued to surge sharply in terms of annual growth; and recession-level employment readings were seen in both the August manufacturing and nonmanufacturing purchasing managers survey. In combination, these factors suggest that an ongoing jobs loss running in excess of 100,000 jobs per month would be closer to reality than the officially-reported changes. Since the employment and unemployment indicators tend to be coincident markers of broad economic activity, weaknesses in these numbers are signaling an ongoing recession in place.

**Next Release** (October 3): Based on continuing deterioration in underlying economic activity, the September payroll survey should show deepening month-to-month and annual contractions, with monthly jobs loss topping 100,000, while the household survey should show a further rise in the unemployment rate (barring political massaging). The unfortunate reality remains, however, that these numbers can be brought in at whatever level is desired by the Administration or the Federal Reserve, and risk of political distortion remains extremely high. With market expectations for roughly a 90,000 jobs loss, something a little more positive than that would be a fair bet.

**Gross Domestic Product (GDP)** -- As noted in the September 12th *Flash Update* and the September 26th *Alert*, the recent negative revisions to the "improving" trade deficit, helped to trigger some downward revision in the "final" estimate of second-quarter GDP growth. Also contributing to the weaker report, released by the

Bureau of Economic Analysis (BEA), were downward revisions to the largely guesstimated services-sector component of personal consumption expenditure.

Though revised in an appropriate direction, the GDP reporting nonsense continued, with the "final" estimate revision for the second-quarter 2008 showing annualized real (inflation-adjusted) growth of 2.83% +/- 3%, down from the "preliminary" estimate of 3.28%, but still up from the "advance" estimate of 1.89%, and up from the first quarter's 0.87%. Year-to-year growth revised to 2.05%, from the "preliminary" 2.17% and "advance" 1.82% estimates, and it still was down from the first quarter's 2.54%. The SGS-Alternate GDP estimate of annual change remained a contraction of roughly 2.9%.

The numbers also reflected a downward revision in the second-quarter inflation rate for the GDP deflator to 1.26%, versus the "preliminary" 1.33% and "advance" 1.11%, and against 2.56% in the first quarter. The weaker the GDP deflator, the stronger is the reported, inflation-adjusted growth.

The BEA's GDP-like measures for second-quarter 2008, including Gross National Product (GNP), where GDP is GNP net of trade in factor income (interest and dividend payments), and Gross Domestic Income (GDI), which is the theoretical income-side equivalent to the GDP's consumption-side measure have been estimated. Annualized real growth in second-quarter GNP revised to 2.10% from initial reporting of 2.58%, after negligible growth of 0.09% in the first quarter. Annualized real growth in second-quarter GDI revised to 0.46% from initial reporting of 0.47%, after two consecutive quarterly contractions in fourth-quarter 2007 (down 0.79%) and first-quarter 2008 (down 0.13%).

Adjusting for methodological distortions and gimmicks built into GDP reporting over time, the SGS-Alternate GDP measure suggests that economic reality was much weaker than officially reported. A second-quarter year-to-year

contraction of roughly 2.9% 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). Such reflects some bottom-bouncing with the annual contraction somewhat greater than the SGS-Alternate GDP first-quarter estimate of a 2.7% annual decline.

*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** (October 30): The "advance" estimate of third-quarter GDP growth just has to show a quarter-to-quarter gain in order to keep formal recession talk out of the popular media until after the November election, which is less than one week later. Accordingly, look for reporting of positive growth, irrespective of the reporting patterns in underlying economic fundamentals that show deepening quarterly contractions.

**Consumer Price Index (CPI)** -- As discussed in the September 16th *Flash Update*, Reported consumer inflation eased back on both a monthly and annual basis, as the CPI absorbed the impact of a sharp decline in oil prices. The 0.1% seasonally adjusted monthly decline in August CPI-U reflected a 7.4% unadjusted decline in gasoline prices. Such compared with a monthly 5.9% decline estimated from Department of Energy (DOE) data. The difference would have resulted in an unchanged CPI. September gasoline prices (DOE) appear to have flattened, virtually unchanged versus August, as was the case in 2007.

Outside of the 5.6% annual CPI-U inflation reported for July, the 5.4% annual inflation for August still was at a 17-year high. Annual inflation for the narrower CPI-W -- targeted at the

wage-earners category where gasoline takes a bigger proportionate bite out of spending -- eased to 5.9% in August, from 6.2% in July. The CPI-W is used for making the annual cost of living adjustments to Social Security payments. The 2009 adjustment -- based on the July to September 2008 period -- remains a strong bet to top 5%, more than double last year's 2.3% adjustment for 2008. Such is not good news for federal budget deficit projections.

**CPI-U.** The Bureau of Labor Statistics (BLS) reported that the seasonally-adjusted August CPI-U (I.6) declined by 0.14% (0.40% unadjusted) +/- 0.12% for the month, versus a 0.82% (0.53% unadjusted) gain in July. Year-to-year or annual inflation in August eased to 5.37%, from 5.60% in July.

Annual inflation would increase in September 2008 reporting, dependent on the seasonally-adjusted monthly gain exceeding the 0.37% monthly increase seen in September 2007. The difference in growth would directly add to or subtract from August's annual inflation rate of 5.37%.

**C-CPI-U.** Year-to-Year or annual inflation for the Chain Weighted CPI-U -- the fully substitution-based series that increasingly gets touted by CPI opponents and inflation apologists as the replacement for the CPI-U (I.5) -- eased to 4.70% in August from 4.76% in July.

***Alternate Consumer Inflation Measures.***

Adjusted to pre-Clinton (1990) methodology (I.7), annual CPI growth declined to roughly 8.7% in August from 8.9% in July, while the SGS-Alternate Consumer Inflation Measure (I.8), which reverses gimmicked changes to official CPI reporting methodologies back to 1980, eased back to roughly 13.2% in August from 13.4% in July.

The alternate numbers are not adjusted for any near-term manipulations of the data.

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** (October 16): Annual September CPI inflation should rise a little, based on more-stable energy prices, a weaker dollar and from the

effects of higher broad money growth. Any seasonally-adjusted monthly increase exceeding the 0.37% monthly gain seen in September 2007 would directly add to August's annual inflation rate of 5.37%. Where underlying fundamentals favor an upside surprise to market expectations, targeted manipulation remains of very high risk.

### Other Troubled Key Series

**Federal Deficit** -- As discussed in the Opening Comments, the fiscal deterioration of the U.S. government is accelerating, due to surging government outlays, funding for handling the systemic solvency crisis and otherwise uncontained spending in conjunction with recession-strangled tax revenues. Excluding significant war costs in its July 28th mid-session review, the Office of Management and Budget estimated that the fiscal-year 2008 (year-ended September 30, 2008) budget deficit would total \$389 (previously \$410) billion dollars, up from \$162 billion in 2007, and that the deficit for fiscal-year 2009 would hit \$482 billion. The budget forecasts do not reflect a recession.

Evidence continues to mount of weaker-than-anticipated federal tax collections as a partial result of recession, where for the first 11 months of fiscal 2008, federal receipts were down 1.4% from the same period in 2007. Personal income taxes were down by 2.7%, corporate income taxes fell by 14.6%. Comparative total outlays were up by 7.0%.

With no allowance for recession or a solvency crisis bailout in the assumptions underlying the deficit projections, the final 2008 numbers should be worse than currently estimated, while the 2009 deficit estimate should see significant further deterioration. Where GDP growth estimates can be gimmicked, incoming tax receipts (based on

consistently applied tax policies) remain an independent estimate of underlying economic reality and have started to reflect the economy's mounting problems.

The rolling 12-month deficit through August 2008 stood at \$370.5 billion versus \$218.2 billion in August 2007, compared with the rolling 12-month deficit through July 2008 of \$365.5 billion versus \$165.8 billion in July 2007.

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.

Gross federal debt stood at \$9.849 trillion at September 25, 2008, up \$204 billion for the month and up \$842 billion from September 2007, which in turn was up \$501 billion from September 2006. Considering that September is a tax collection month (these numbers are not final), such increases are extraordinary. As of the end of August 2008, gross federal debt stood at \$9.646 trillion, up \$61 billion for the month, and up \$640 billion from August 2007, which in turn was up \$491 billion from August 2006.

*General background note:* The federal government's fiscal 2007 official, accounting-gimmicked deficit narrowed to \$162 billion from \$248 billion in 2006. Yet 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. As discussed in the December 2007 SGS Newsletter's Reporting/Market Focus, the GAAP-based deficit for fiscal-year 2007 topped \$4 trillion, which still remains my best estimate.

#### **Initial Claims for Unemployment Insurance --**

The rapid deterioration in the trend of annual change has continued to intensify. On a smoothed basis for the 17 weeks ended September 20th, annual growth hit 32.1%, up from 22.9% as of the 17 weeks ended August 2nd. A rising growth trend in new claims is an economic negative.

*General background note:* 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 (*such as Columbus Day*). 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 --** Reflecting a pullback in gasoline prices, July's seasonally-adjusted monthly real earnings rose by 0.6% in August, after a 0.5% decline in July and 0.9% decline in June. Annual change in August remained in sharp contraction, down 2.5% year-to-year, following annual contractions of 2.8% and 2.5% respectively in July and June.

*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

(see the *Hyperinflation Special Report* of April 8, 2008, *and this month's Reporting Focus*).

**Retail Sales --** As discussed and graphed in the Opening Comments, and as detailed in the September 12th *Flash Update*, August retail sales showed a deepening economic contraction. The Census Bureau reported that seasonally-adjusted August retail sales fell for the month by 0.27% (down by 0.90% net of revisions) +/- 0.6% (95% confidence interval), following a revised 0.49% (previously 0.12%) decline in July. On a year-to-year basis, August retail sales growth softened to 1.56% from a revised July gain of 2.12% (previously 2.63%).

**Real Retail Sales.** Deflated by the August CPI-U, seasonally-adjusted real (inflation-adjusted) retail sales contracted by 0.13% for the month of August (down 0.27% before inflation adjustment), following a 1.30% decline in the month of July (down 0.49% before inflation adjustment). On a year-to-year basis, August retail sales fell by 3.60% (up 1.56% before inflation adjustment), versus a 3.23% decline in July (up by 2.62% before inflation adjustment). The series is set for its fifth consecutive quarter-to-quarter real contraction and the third consecutive quarter of annual contraction. Such ongoing negative growth patterns never have been seen outside of formal recessions.

**Core Retail Sales.** Consistent with the Federal Reserve's predilection for ignoring food and energy prices, "core" retail sales -- retail sales net of grocery store and gasoline station revenues -- fell by 0.06% (down 0.70% net of revisions) in August, versus a revised 0.73% (was 0.33%) decline in July. Those numbers contrasted with the official aggregate drop of 0.27% in August and the revised 0.49% decline in July. On an annual basis, August "core" retail sales fell by 1.73% versus a revised July decline of 1.06% (previously down by 0.53%).

**Next Release** (October 15): September retail sales likely will continue to disappoint market expectations. Any monthly gains should be due to inflation, with sharp contractions likely continuing in the monthly, quarterly and annual growth rates.

**Industrial Production** -- As discussed and graphed in the Opening Comments and detailed in the September 16th *Flash Update*, the Federal Reserve reported a 1.1% (1.3% net of revisions) monthly contraction in August industrial production, following a revised 0.1% (previously 0.2%) gain in July. Weakness was attributed to the auto sector, with a 0.1 percentage point of decline estimated due to oil production shutdown due to Hurricane Gustav. August year-to-year change plunged by 1.5%, after a 0.4% annual contraction in July.

Following a 3.1% annualized quarter-to-quarter contraction in the second quarter, industrial production is set for a likely second consecutive quarterly downturn in the third quarter. In conjunction with likely contracting annual growth for the third quarter, the series is showing growth patterns not seen outside of recessions.

**Next Release** (October 16): The September production numbers should continue the pattern of ongoing monthly and annual contractions. Reported growth likely will be weaker than consensus estimates.

**New Orders for Durable Goods** -- As discussed in the September 26th *Alert*, seasonally-adjusted new orders for consumer goods contracted by 4.5% (4.9% net of revisions) for the month of August, following a revised 0.8% (previously 1.3%) monthly gain in July for this regularly volatile series. Annual change continued in contraction, with August orders down 8.1% year-to-year, following a 2.2% annual contraction in July.

Such sets up third-quarter 2008 for both a quarterly and annual contraction, even before inflation adjustment. This protracted pattern of

quarterly (four consecutive quarters) and annual (two consecutive quarters) contractions is common to reporting during formal recessions and suggests that the current economic downturn is intensifying.

New orders for nondefense capital goods fell by 7.5% for the month, and slumped by 35.5% year-to-year, following a monthly gain of 3.5% and annual decline of 6.6% in July.

*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** -- The Bureau of Economic Analysis and Census Bureau reported that the seasonally-adjusted monthly trade deficit for July widened to \$62.2 billion from a revised \$58.8 (previously \$56.8) billion in June. Other major revisions were published on the services sector, showing deeper than previously reported deficits going back to January. Those revisions helped to take some steam out of the reported second-quarter GDP and suggest a future downward revision to first-quarter GDP in next year's annual GDP restatement.

The latest reporting also showed a rising level of import carryover (imports included in the current month that actually took place in earlier periods, when they should have been reported), with July carryover at \$2.2 billion up from \$0.2 (previously \$1.4 billion) in June. Given also that physical oil import volume showed an unusually large and unseasonal surge in average barrels per day (bpd), the evidence for an understatement of oil imports in recent months continued to mount. July 2008 showed 11.033 million bpd of imports versus 9.918 million bpd in June; the same numbers in 2007 were 10.018 million bpd in July versus 10.735 million bpd in June.

**Next Release** (October 10): The trade balance for August likely will be happy enough on a relative basis to help assure a positive "advance" third-

quarter GDP estimate, despite some catch-up in the most recent reporting.

**Consumer Confidence** -- August consumer confidence measures jumped, but year-to-year contractions remained deep in recession territory. The Conference Board's Consumer Confidence measure rose by 9.6% for the month, following a 1.8% gain in July, and the Reuters/University of Michigan's Consumer Sentiment measure rose 2.9% in August, after an 8.5% jump in July.

Where August Consumer Confidence was down by 46.1% year-to-year, such followed the largest annual decline in history in July, down by 53.6% year-to-year. On a three-month moving-average basis, the August annual decline was 50.5% versus 50.6% in July. August Consumer Sentiment fell year-to-year by 24.5% (30.3% three-month moving average) versus an annual decline in July of 32.3% (32.8% three-month moving average), also near a record decline.

In September reporting, only Sentiment has been published, so far, surging 11.6% for the month, but down 15.7% (23.4% three-month moving average) year-to-year. Neither the September Confidence nor Sentiment measure will reflect much, if any, impact of the public recognition of the financial crisis. Accordingly, the next round of confidence readings can be expected to take a hit.

*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 Reuters/Michigan survey is unadjusted. How does one seasonally-adjust peoples' attitudes? Also, beware the mid-month Consumer Sentiment release from Reuters/University of Michigan. The sampling base is so small as to be virtually valueless in terms of statistical significance.

**Short-Term Credit Measures** -- Annual growth in both consumer credit and commercial borrowing has continued to slow, intensifying recession pressures and highlighting ongoing difficulties the Federal Reserve has had in stabilizing solvency issues in the U.S. banking system. While a sharp monthly decline in commercial paper has been seen so far in September, such is against similar contractions last year. Accordingly, the decline in annual change for commercial paper outstanding has started to become less negative, while growth in commercial and industrial bank loans has continued to slow.

For seasonally-adjusted consumer credit, which includes credit cards and auto loans, but not mortgages, annual growth was reported at 5.0% in July, down from a revised 5.4% (was 5.6%) in June and 5.4% (previously 5.5%) in May.

As reported by the Fed (Flow of Funds September 2008), home mortgage loan growth slowed from a seasonally-adjusted annualized growth rate of 6.1% in fourth-quarter 2007, to 3.3% and 1.4% respectively in the first and second quarters of 2008. The data, however, are of questionable quality.

In the current environment, where inflation-adjusted growth in income (see this month's Reporting/Market Focus on income variance) 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 and eventual contraction in consumer debt remains an ongoing constraint on economic activity.

Annual growth in commercial borrowing is mixed, given the sharp year-ago contractions in commercial paper outstanding. Though down more than 4% for the month of September (as of the 24th), commercial paper outstanding showed a 9.1% year-to-year contraction, versus a 7.8%



annual downturn in August and a 20.8% contraction in July.

Annual growth in August commercial and industrial loans slowed to 15.5% in August, from 17.9% in July and from 19.0% in June. September lending appears likely to show a further slowdown in annual growth into perhaps the 12% to 13% range. Slowing growth in commercial lending should place a damper on broad business activity.

**Producer Price Index (PPI)** -- As discussed in the September 12th *Flash Update*, The regularly volatile Producer Price Index (PPI) for finished goods contracted by a seasonally-adjusted 0.9% (1.6% unadjusted) in August, as reported by the Bureau of Labor Statistics. The decline was due largely to the recent sharp decline in oil prices. The August decline was against a reported adjusted increase of 1.2% (1.4% unadjusted) in

July. Since the August monthly price swing pattern was about the same as last year, the annual rate of PPI inflation slowed only by 0.2 percentage points, to 9.6%, from 9.8% in July.

On a monthly basis, seasonally-adjusted August intermediate goods fell by 1.0% (up 2.7% July), crude goods fell by 11.9% (up 4.2% July). Year-to-year inflation, remained high, but still shy of a real-world experience, with August intermediate goods up by 16.7% (16.6% July) and with August crude goods up by 38.1% (51.2% July).

**Next Release** (October 15th): Allowing for the ongoing, regularly random volatility of the monthly price variations, PPI inflation reporting over the next six-to-nine months generally should favor upside surprises in official results, thanks in particular to what should be the increasingly broad-based impact of higher oil prices.

### 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** -- The August purchasing managers manufacturing index (PMI) was reported in contraction, and but for the reformulation of the PMI back in January, the June and July index readings also would have been below 50.0, signaling a contracting manufacturing sector and a recession. The Institute for Supply Management (ISM) reweighted its key index so that the PMI would better match GDP results. While the effort

was well intentioned, altering the data to match the extremely overstated GDP growth rates damaged the reporting quality of the PMI. Fortunately, however, the more meaningful components of the index were not affected by the efforts to match the flawed government data.

The August PMI eased to 49.9, just below the borderline growth-contraction reading of 50.0 reported in July, and down from 50.2 in June. The May reading of 49.6 had been the fourth consecutive monthly recession reading. While the ISM uses an index reading of 41.1 (in its recently reformulated index) as the break-point between recession in the broad economy and expansion, a reading below 50.0 means a contracting manufacturing sector. The 50.0 mark works out still as a solid broad recession signal in my analyses that are unfettered by reliance on GDP data for a recession signal.

The various components of the ISM composite indices are diffusion indices, which are calculated as the percent of positive responses from the ISM survey plus one-half of the neutral or unchanged responses. Hence, a reading below 50.0 indicates a contracting series.

The August new orders index showed continuing contraction (holding below 50.0), rising to 48.3 from 45.0 in July. The new orders have been in actual contraction since December 2007. Distortions from the seasonal factors calculated by the Department of Commerce can be minimized by viewing the series using year-to-year change on a three-month moving average basis. On that basis, the August new orders index fell by 15.1%, following July's 17.1% decline.

The new orders component of the purchasing managers survey is a particularly valuable indicator of economic activity. The measure gradually has notched lower from its peak annual growth of 35.5% in April of 2004. As an SGS early-warning indicator of a major economic shift, new orders breached its fail-safe point in mid-2005, signaling pending recession.

Also a significant measure, the manufacturing employment component fell to 49.7 in August from 51.9 in July.

**Service Sector Composite Index.** This series 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. With that as background, the August services composite index rose to 50.6 from 49.5 in July.

Both the services employment and prices paid components, however, have some meaning. Covering the real estate and banking industries, among others, August employment component remained below 50.0, at 45.4, versus 47.1 in July. The still-high prices paid component for both indices is covered in the Inflation Indicators.

**Help-Wanted Advertising Index -- (Newspapers and On-Line) -- *Please Note:*** The Conference Board has ceased issuing press releases on its help-wanted advertising in newspapers series, but the monthly data still are available for some undetermined period of time, upon request.

The seasonally-adjusted July help-wanted advertising index sank again to its historic low of 17, from 18 in June, and against a reading of 17 in May. The May reading had been the lowest level seen since the index was first calculated at the end of President Harry Truman's term in office.

The July reading was down by 32.0% year-to-year, versus a 30.7% decline in June. The annual change in the three-month moving average as of July was a 33.3% decline, versus June's 35.4% contraction. Despite some of the historic weakness in the series being due to the loss of newspaper business to the Internet, and despite its looming abandonment by the Conference Board, the HWA remains a solid leading indicator to the broad economy and to the monthly employment report. It continues to signal severe deepening in the recession and ongoing deterioration in labor-market conditions.

Where the HWA series does not include a measure of on-line advertising, 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 has reported that annual growth in its nascent on-line measure of help-wanted advertising has contracted on a year-to-year basis in each month from April through August 2008. Such likely is not a good sign for national employment or for broad economic activity.

**Housing Starts --** The consistency of the government's residential construction measures was compromised in June reporting, seriously distorted by changes in New York City construction codes that triggered a surge in paperwork activity. Where the distortions appear

largely limited to June and possibly July, I am ignoring the June data at present.

Seasonally-adjusted August housing starts were reported down by 6.2% for the month (possibly overstated) and down 33.1% year-to-year. July had been down by 30.4% (possibly understated). The latest numbers still show ongoing quarterly and annual contractions in housing activity never seen otherwise outside of recessions.

In home sales data, the seasonally-adjusted August new home sales fell by 11.5% +/- 14% (95% confidence interval), which was not statistically distinguishable from a gain. The August contraction followed an also statistically insignificant 4.0% July gain. On a year-to-year basis, August new home sales dropped by 34.5%, following a 34.7% decline in July. Increasingly reflecting the impact of foreclosures, existing home sales in August fell by 2.2%, after reflecting a 3.5% gain in July. Year-to-year sales fell by 10.7% in August, following a 12.8% annual decline in July.

Net of increasing stress in the reporting of the data, the housing market remains in a severe and protracted recession.

### ***Inflation Indicators***

**Money Supply** -- The impact of the systemic solvency crisis is discussed in the Opening Comments. See the August 3rd *Money Supply Special Report* for a discussion of the practical measurement and analytical uses of money supply in assessing inflation prospects.

Annual growth in the seasonally-adjusted SGS-Ongoing M3 is estimated to have slowed further, to 14.0% in August, following estimated annual growth of 15.4% in July, off from a record-high 17.4% in March. I noted in the August 13th *SGS Newsletter* that, "The continued slowing in annual growth in June and July (the monthly data continue to expand) appears tied to the still-intensifying problems in the banking system, and well may foreshadow near-term systemic jolts and still-further liquidity expansion by the Fed." With the continued slowing of annual growth in August, such now appears to have been the case.

Outside of the last several months, the prior historic high of 16.4% was seen in June of 1971, two months before President Nixon closed the gold window and imposed wage and price controls. While August's growth remains shy of 1971's high, it still promises heavy upside inflation pressure into first-half 2009. Still reflecting the unfolding systemic liquidity problems, September annual M3 growth could slow to near 13%, before rebounding sharply with October's numbers (see Opening Comments).

For August 2008, annual growth for monthly M1 eased to 1.6% from 2.4% in July, continuing its general a positive swing from a 0.6% contraction in May, ending two years of flat-to-minus annual growth. August's annual M2 growth eased to 5.4% from 6.3% in July. The relative pick-up in M1 growth appears to be due to funds shifting from accounts in the broader M2 and M3 measures (particularly institutional money funds and large time deposits) into M1 checking accounts and currency. Such may have reflected early increased wariness of the part of large depositors.

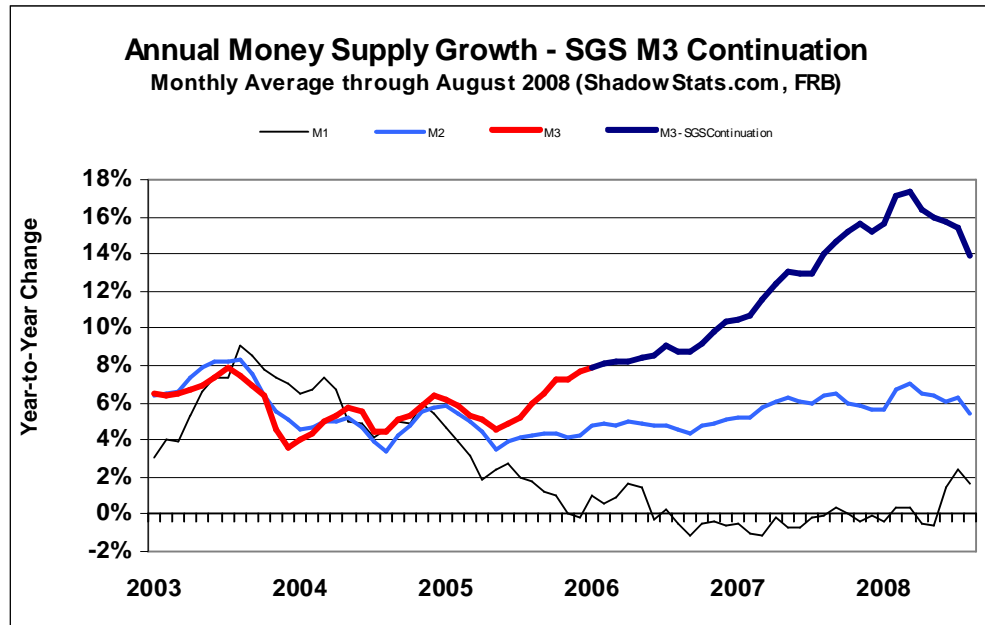
**Shadow Government Statistics Ongoing M3\***  
**Estimated Seasonally-Adjusted Monthly Average, \$ Trillions**

Feb 06	10.311	Oct	10.979	Jun	11.950	Feb	13.390
Mar	10.364	Nov	11.094	Jul	12.055	Mar	13.575
Apr	10.425	Dec	11.226	Aug	12.261	Apr	13.646
May	10.504	Jan 07	11.314	Sep	12.443	May	13.764
Jun	10.575	Feb	11.436	Oct	12.651	Jun	13.836
Jul	10.672	Mar	11.563	Nov	12.823	Jul	13.907
Aug	10.755	Apr	11.720	Dec	12.931	Aug (p)	13.973
Sep	10.852	May	11.872	Jan 08	13.088		

(\*) Available electronically on the Alternate Data tab of [www.shadowstats.com](http://www.shadowstats.com). (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 even when the Fed published the series. The most meaningful way to view the data is in terms of year-to-year change.

*General background note:* Historical annual growth data and **monthly levels** for the money supply series, including the SGS-Ongoing M3 estimates, are available for download on the Alternate Data page of [www.shadowstats.com](http://www.shadowstats.com). See the August 2006 SGS Newsletter for methodology. The indicated M3 levels 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 published series can be linked to earlier historical data available from the St. Louis Fed.*** 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.



**Purchasing Managers Surveys: Prices Paid Indices** -- Both of the August purchasing managers composite surveys prices-paid indices remained extremely high, though off the peaks seen in June, due to a sharp decline in oil prices. Nonetheless, the indices continued to reflect strong upside inflation pressures from a variety of factors, including still generally high oil prices and a weaker U.S. dollar. They continued to signal broad inflation problems ahead.

On the manufacturing side, the August price index eased to 77.0 from 88.5 in July. On a three-month moving average basis, however, August's year-to-year gain was 31.1% versus 30.9% in July. 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 August prices diffusion index also dropped, falling to 72.9 from 80.8 in July, but on a three-month moving-average basis, August's annual gain was 26.2% versus 25.5% in July.

*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** -- Extreme price volatility has been the recent norm for oil trading, but the general outlook for inflation continues to be strongly on the upside, despite any relative near-term oil-price softness. The economy still suffers from oil priced in excess of \$105 per barrel, where severe inflation damage already was ingrained in the system when oil broke above the \$90 per barrel. Other than for some month-to-month volatility, \$90 oil is not deflationary for the U.S. economy over the longer term. Implications for inflation and real GDP growth remain extremely ominous for the balance of 2008 and into 2009.

After exploding to a record-high closing spot price of \$145.66 for West Texas Intermediate (WTI) on July 11, 2008, the price of oil plunged to the \$90 dollar range early in September, before recovering to around the \$107 area as we go to press. One could make the case that the oil price decline was aided by some official intervention in the oil or



related currency markets, aimed at lowering gasoline prices in advance of the U.S. presidential election in November. I would be extremely surprised if we have seen the near-term peak in oil. Oil-supply, global-political and dollar stability-issues continue to promise ongoing oil price volatility but likely with still higher prices ahead.

August's monthly average spot price for WTI (St. Louis Fed) was \$116.61 per barrel, and September's average should be close to \$105. Despite the heavy oil selling in late-July, July's monthly average spot price was \$133.44 per barrel, down just 0.4% from June's \$133.93 historic-high average. For September 2008, the year-to-year increase in price level should be about 31%, down from 61.1% in August, 79.9% in July and 98.5% in June.

The oil market, again, remains highly volatile and sensitive to minor surprises. Despite a deepening U.S. recession and increasing indications of a global recession, oil prices have rallied recently in response to increasing global resistance to holding U.S. dollars. Regardless of any continued extreme

short-term price movements, meaningful upside risks to oil prices remain in place over the longer term. In particular, pressures continue from the slowly unfolding U.S. dollar catastrophe, irrespective of any near-term dollar strength. Further pressures come from ongoing OPEC needs, increasingly volatile global military and political tensions, and other supply and demand risks/issues.

*General background note:* Though a reversal in questionable seasonal factors has helped to resume spiking basic annual CPI inflation in the United States, energy inflation measures still remain well shy of reality. The gimmicked "core" inflation measures -- net of changes in food and energy prices -- also should be increasing, but, somehow, the oil-related costs just do not seem to get into the government's inflation reporting. This is despite high oil prices continuing to work 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 gyrations.