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Analysis Behind and Beyond Government Economic Reporting

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Section Three of Four

REPORTING PERSPECTIVE

The Big Three Market Movers

Underlying economic fundamentals have continued showing unusually sharp deterioration in recent reporting, with a downside acceleration and ongoing catch-up seen particularly in post-election payroll reporting. With election pressures gone, and with the markets acknowledging a bad recession, reporting pressures could shift to the downside for a short while, reflecting ongoing catch-up, and the need for the incoming Obama Administration to sell its stimulus package. Such also could be used to set a low base against which future Obama-generated activity can be measured. Suggestions here of possible of games-playing with the numbers have nothing to do with Mr. Obama, per se. It comes only from the historical precedent of such happening in nearly all post-Truman administrations, and from the preponderance of Clinton Administration people showing up in Washington. The Clinton Administration was the most masterful of all in controlling its reported data.

In the other direction, Messrs. Bernanke and Paulson /Geithner need a stable or relatively strong U.S. dollar in the still-evolving systemic solvency crisis, and such requires contained inflation numbers and stronger economic data than might be expected in the now recognized recession. With the financial crisis remaining a threat to national security, almost anything remains possible in the arena of data and market manipulations. Data manipulation is an extremely inexpensive and effective policy tool, but its use presumably depends to certain degree on perceived financial market vulnerability.

Absent manipulation, and against market expectations that are shifting sharply to the downside, most near-term economic reporting still should tend to surprise the markets on the downside. With inflation expectations having tanked along with oil prices, beyond the pending December CPI report, most inflation reporting should surprise expectations on the upside.

Employment/Unemployment -- As discussed in the December 5th *Flash Update*, and as explored and graphed in the Opening Comments, payroll employment likely is sinking faster than has been reported by the Bureau of Labor Statistics (BLS) and shortly should be showing the sharpest annual percentage decline in annual employment change since the shutdown of war production at the end of World War II and the Great Depression. Such a pace of tumbling already may be in place, but it is not showing, due at least partially to the Concurrent Seasonal Factor Bias (CSFB) discussed below.

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As bad as the headline November jobs numbers appeared to have been, the data indicated that consistent reporting would have shown an even bleaker picture. Perhaps someone in the incoming Congress or Administration might raise a question with the BLS as to the nature of the increasingly obvious positive biases built into the monthly headline payroll numbers. The problem is evidenced by ongoing massive revisions to prior history (exceeding the 95% statistical confidence interval for monthly change), after the markets have absorbed much happier headline numbers published in the months before, as well as by the consistent, overly positive nature of the headline jobs numbers confirmed by the CSFB.

For example, the pre-election headline estimate of September payrolls was a decline of 159,000 +/- 129,000, but the CSFB suggested the reporting should have been a decline of about 219,000. In the first post-election revision, September's decline deepened to 284,000; in the second revision, it dropped to a decline of 403,000. October's headline jobs loss was 240,000, while the CSFB suggested it should have been about 308,000. October's jobs loss revised to 320,000 in the first revision. The headline November jobs loss was 533,000, but the CSFB suggested it should have been a loss of about 873,000.

Payroll Survey. The BLS reported a statistically-significant, seasonally-adjusted jobs loss of 533,000 (down 732,000 net of revisions) +/- 129,000 for November, following a revised 320,000 (previously 240,000) jobs loss in October. Annual contraction (unadjusted) in total nonfarm payrolls continued to deepen, down 1.47% in November, versus a revised 0.79% (previously 0.85%) decline in October. The seasonally-adjusted series also contracted year-to-year, down by 1.35% in November, versus a decline of 0.93% (previously) 0.78% in October.

Concurrent Seasonal Factor Bias. The pattern of impossible biases (see the Reporting/Market Focus in *SGS Newsletter No. 43* of June 10, 2008) being built into the headline monthly payroll employment changes intensified sharply with November reporting. Instead of the headline jobs loss of 533,000, consistent application of seasonal-adjustment factors -- net of what I call the concurrent seasonal adjustment bias -- would have shown a more-severe monthly jobs loss of about 873,000. This upside reporting bias has been seen in 11 of the last 12 months, with a rolling 12-month total upside headline-number bias of 955,000.

Birth-Death/Bias Factor Adjustment. A minor element that added upside pressure to the latest payroll number was the monthly bias factor (birth-death model). Never designed to handle the downside pressures from a recession, the model added a 30,000 upside jobs bias to November 2008 (versus an upside bias of 17,000 in November 2007), and followed a net upside bias of 71,000 jobs in October 2008. The process boosted financial-activities by 5,000, but subtracted 7,000 from construction. The largest benefactor was the trade, transportation and utilities sector, which picked up an extra 17,000 jobs. Although the adjustments are made to the unadjusted series, they flow through at roughly the same magnitude in the seasonally-adjusted series.

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 673,000 in November, following a 297,000 decline in October.

The November 2008 seasonally-adjusted U.3 unemployment rate showed a statistically-insignificant increase to 6.68% +/- 0.23% from 6.50% in October. Unadjusted U.3 rose to 6.5% in November, versus 6.1% in October. The broader November U.6 unemployment rate jumped to an adjusted 12.5% (12.2% unadjusted) from 11.8% (11.1% unadjusted) in October.

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During the Clinton Administration, "discouraged workers" -- those had given up looking for a job because there were no jobs to be had -- were redefined so as to be counted only if they had been "discouraged" for less than a year. This time qualification defined away the bulk of the discouraged workers. Adding them back into the total unemployed, actual unemployment, as estimated by the SGS-Alternate Unemployment Measure (graphed in the Alternate Realities section), rose to 16.5% in November from 15.8% in October.

Note of Caution. Keep in mind that any comments in the popular media as to historical comparisons of current unemployment data to 1994, are going against the first month published in most of the current series. Accordingly, any reference to the "worst level since 1994," could well be against a much earlier period, if only the data were comparable.

Comparisons of current reporting with data before 1994 are not valid. In 1994, the BLS completely redesigned and redefined the unemployment series and all its measures, broad and narrow, so that the new series going forward could not be compared with the old series. I still am struggling to take my alternate measure back before 1994, where finding consistent and good data is a major problem. That said, the U.6 broad measure of 12.5% unemployment was the highest since before January 1994.

Employment Environment. The broad deterioration in November's employment environment broadly was in line with the better-quality employment-environment indicators: October/November help-wanted advertising levels were at an historic low; new claims for unemployment insurance continued to surge sharply in terms of annual growth; and deepening, recession-level employment readings continued in both the December/November manufacturing and November nonmanufacturing purchasing managers survey. Since the employment and unemployment indicators tend to be coincident markers of broad economic activity, weaknesses in these numbers are signaling an ongoing and deepening recession in place.

Next Release (January 9th): Based on continuing deterioration in underlying economic activity, the December payroll survey should plunge again, by more than 400,000 jobs, along with a further spike in the unemployment rate. Consensus expectations (briefing.com) are for a decline of about 475,000, with a 0.3 percentage point increase in the unemployment rate. While not unreasonable, the expected weak results likely still are shy of reality.

Gross Domestic Product (GDP) -- As discussed in the December 23rd *Flash Update*, the Bureau of Economic Analysis's (BEA) "final" estimate revision (it gets revised again in July 2009) of real (inflation-adjusted) annualized growth in the third-quarter GDP remained a statistically insignificant contraction of 0.51% +/- 3% (95% confidence interval), unchanged from the "preliminary" estimate, but deeper than the "advance" estimate of a 0.25% annualized decline. That calculation, however, reflected a combination of an upward revision to nominal (not adjusted for inflation) annualized growth of 3.57%, from a preliminary 3.35%, and an offsetting upwards revision to GDP inflation (implicit price deflator) to 4.11% from a preliminary 3.88%.

The third quarter's contraction of 0.51% was against a second quarter growth rate of 2.83%. In terms of year-to-year change, the third quarter's annual growth revised to 0.75% (previously 0.74%), against second quarter annual growth of 2.05%. The SGS-Alternate GDP estimate remained an annual contraction of roughly 3.3% versus an annual (not annualized) contraction of 2.9% in the second quarter. Against reporting of underlying economic series, an annualized quarterly contraction in excess of 2% for the third quarter would have been more realistic than the 0.51% estimate.

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The BEA's GDP-like measures for third-quarter 2008 also were revised in the latest reporting: 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.

GNP. Third-quarter GNP contracted at an annualized rate of 0.17% (previously 0.43%), versus a 2.10% gain in the second quarter. Year-to-year change was 0.83% (previously 0.77%) in the third-quarter, versus 2.43%, in the second.

GDI. Third-quarter GNP contracted at an annualized rate of 0.57% (previously 0.56%), versus a 0.46% gain in the second quarter, but the current contraction was the third quarterly contraction in the last four quarters. Year-to-year change was a contraction of 0.45% (previously 0.43%) in the third quarter, following a 0.30% annual gain in the second.

4th-Quarter GDP. Looking to the "advance" estimate of fourth-quarter GDP on January 30, 2009 -- the first estimate due to be published by the incoming Obama Administration (although the bulk of the data will be prepared under the Bush Administration) -- some forecasts being floated in the markets are for a 5% annualized real contraction. Such is not an unreasonable number and even might be desirable as a political tool in helping to sell the promised massive stimulus package. Any contraction deeper than an annualized 3% would turn year-to-year GDP change negative, a reality already indicated by most of the better underlying economic series.

Less-negative numbers then would tend to be reported in the post-stimulus period. In order to get a real 5% annualized contraction in fourth-quarter 2008, though, nominal growth likely would have to turn negative as well, a characteristic of only the deepest historical downturns.

Given the recent collapse in energy prices, the fourth-quarter GDP implicit price deflator's inflation rate should be lower than the 4.11% used in the third quarter. (GDP inflation subtracted from nominal GDP growth yields real GDP growth.) The importation of lower-priced oil in the fourth-quarter should work as an inflation booster (imports are subtracted from economic activity, which reverses the inflation impact in the GDP), offsetting some of the impact of lower prices of consumed gasoline, etc., so the annualized pace of slowing GDP inflation should not be quite as severe as seen in the CPI. Even so, nominal GDP growth could see its sharpest annualized decline since the Eisenhower Administration.

Next Release (January 30): Underlying economic fundamentals suggest that the "advance" estimate of fourth-quarter 2008 GDP should show a deeper annualized contraction than was reported in the third quarter. Whatever is reported likely will be near the consensus estimate of the time, as that often is targeted in the "advance" reporting by the BEA. As discussed above, look for annual real GDP change to turn negative, as well as for a possible quarterly contraction in nominal GDP.

Consumer Price Index (CPI) -- As discussed in the December 16th *Flash Update*, the sharp hits in November's reported monthly and annual inflation rates were about as expected, due to the continued collapse in oil-related prices, particularly in gasoline. With oil and gasoline prices perhaps near a bottom, however, annual CPI inflation likely is near a bottom, too, and not likely to turn negative in a formal deflation.

CPI-U. The Bureau of Labor Statistics (BLS) reported seasonally-adjusted November CPI-U (I.6) declined by 1.68% (down by 1.92% unadjusted) +/- 0.12% for the month, versus a 0.96% drop (down by 1.01% unadjusted) in October. Year-to-year or annual inflation in November fell to 1.07% in November, from 3.66% in October, still remaining in positive territory. For those of you interested in exploring

the various facets of official CPI-U reporting, I continue to refer you to cpiwatch.com, a site prepared by one of my SGS colleagues.

Annual inflation would increase or decrease in December 2008 reporting, dependent on the seasonally-adjusted monthly change versus the 0.36% monthly increase seen in December 2007. The difference in growth would directly add to or subtract from November's annual inflation rate of 1.07%.

With average monthly gasoline prices dropping by roughly another $0.19 per gallon in December (per the Department of Energy), the seasonally adjusted CPI could fall by roughly 0.9%, with annual inflation turning negative by 0.2% to 0.3%. Albeit minimal and likely fleeting, such would represent formal deflation, the first outright decline in the CPI-U since a 0.4% drop in August 1955. Of course, if the CPI today were calculated the same way it was back then, annual inflation December still would be near 8%, instead of showing a fractional decline (see the Alternate Data Section).

C-CPI-U. Year-to-year or annual inflation for the Chain Weighted CPI-U (I.5) -- the fully substitution-based series that increasingly gets touted by CPI opponents and inflation apologists as the replacement for the CPI-U -- also eased sharply, to 0.69% in November, from 3.28% in October. Yet the PCE deflator, which usually tracks the C-CPI closely, slowed only to 1.4%.

Alternate Consumer Inflation Measures. Adjusted to pre-Clinton (1990) methodology (I.7), annual CPI growth eased to roughly 4.4% in November from 6.9% in October, while the SGS-Alternate Consumer Inflation Measure (I.8), which reverses gimmicked changes to official CPI reporting methodologies back to 1980, dropped back to roughly 9.3% in November from 11.6% in October. 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 (January 16): The December CPI likely will contract by roughly 0.9% for the month, due primarily to the continued fall in oil and gasoline prices. As discussed above, a formal small annual deflation appears a fair bet, but such should be considered in the context of methodological revisions in the last several decades that have tended to reduce the level of reported CPI inflation.

Annual inflation would increase or decrease in December 2008 reporting, dependent on the seasonally-adjusted monthly change versus the 0.36% monthly increase seen in December 2007. The difference in growth would directly add to or subtract from November's annual inflation rate of 1.07%.

Longer-range impact from renewed dollar weakness, a likely bottoming in oil prices and rising broad money growth will tend to generate some upside CPI surprises in early 2009.

Other Troubled Key Series

Federal Deficit. The federal budget deficit deteriorated sharply in fiscal-year 2008 (year-ended September 30th) and has exploded in the first two months of fiscal-year 2009. As discussed in the Reporting/Market Focus section, unsustainable GAAP-based federal deficits and federal obligation levels also have worsened markedly.

The official 2008 federal deficit was $454.8 billion, against a $161.8 billion deficit in 2007. These are the officially-gimmicked numbers (counting Social Security revenues, but not liabilities, not fully counting the costs of the Iraq War, etc.), using a variation on cash-based accounting, not GAAP reporting. The 2008 GAAP-based deficit (counting unfunded Social Security and Medicare liabilities, etc.), using accrual accounting, was $5.1 trillion, up from $1.2 trillion ($4 trillion-plus, using consistent annual assumptions and accounting) in 2007.

Significantly, the $700 billion financial system bailout package was not enacted until fiscal-year 2009 and thus was not reflected in any of the 2008 numbers. For October and November 2008 -- the first two months of the new fiscal year -- the official deficit more than doubled to $401.6 billion, from $154.1 billion in the same period of fiscal 2008.

Near-term fiscal results reflect the impact of the ongoing solvency crisis and the deepening recession. The 12-month rolling deficit through November 2008 rose to $701.3 billion, up from October's $635.1 billion, and September's $454.8 billion. The 12-month rolling deficit through November 2007 was just $194.2 billion. The fiscal problems likely are going to be exacerbated in the next several months, with the incoming Administration promising to boost government spending significantly, in an effort to stimulate economic activity.

For fiscal 2008, recession-impaired tax revenues fell by 1.7% from 2007, that decline deepened to 3.1% for the 12-month rolling results through November. The downturn in tax revenues tied to the deepening recession also has started to impact state and local government fiscal operations, with serious funding problems surfacing in a number of jurisdictions.

Viewing the change in the level of gross federal debt bypasses several of the regular reporting manipulations of the government's financial results 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 $10.553 trillion at December 30, 2008, down by $128 billion for the month, but up by $1.324 trillion from December 31, 2007, which in turn was up $549 billion from December 2006. Gross federal debt stood at $10.661 trillion at November 30, 2008, up by $86.1 billion for the month and up $1.512 trillion from November 2007, which in turn was up $516 billion from November 2006.

With mounting solvency crisis impact, gross federal debt stood at $10.574 trillion at October 31, 2008, up by an extraordinary $549 billion for the month and up $1.495 trillion from October 2007, which in turn was up $495 billion from October 2006. As of the end of September 2008, the close of the government's fiscal year, gross federal debt stood at $10.025 trillion, up $379 billion for the month and up by $1.017 trillion from September 2007, which in turn was up $501 billion from September 2006.

Initial Claims for Unemployment Insurance -- The ongoing rapid rise in initial claims for unemployment insurance continues to reflect the severe deterioration in labor market conditions. On a smoothed basis for the 17 weeks ended December 27th, annual growth hit 52.1%, up from 46.2% as of the 17 weeks ended November 29th, and up from 39.4% as of the 17 weeks ended October 25th. 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 Christmas -- with a meaningless 98,000 plunge in claims for the December 27th week -- and New Year's 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 primarily the benefit of sharply declining gasoline prices, November's seasonally-adjusted monthly real earnings surged by 2.3% for the month, following a 1.6% monthly increase in October. Annual change in November, accordingly, turned to the plus side, up by 2.2% from the year before. Such followed a 0.8% annual decline in October.

General background note: Gyrations 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 still 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 the last newsletter's Reporting Focus).

Retail Sales -- As discussed and graphed in the Opening Comments and discussed in the December 12th *Flash Update*, the Census Bureau reported that seasonally-adjusted sales for the month of November -- the opening month of the holiday shopping season -- fell by 1.76% (by 2.21% net of revisions) +/- 0.6% (95% confidence interval), versus a revised decline of 2.95% (previously 2.77%) in October. The declines, once again, were exacerbated by a fall in gasoline prices, but as indicated in November's "core" measure, they still were significant. The extreme volatility in monthly gasoline prices has been enough to affect levels of consumption. Based on Department of Energy reporting, average gasoline prices in November were down by roughly 30%, versus a not-seasonally-adjusted decline in gasoline station sales of 23.6%, and a seasonally-adjusted 14.7% drop.

On a year-to-year basis, November retail sales (before inflation adjustment) were negative for a third month, down by 7.41%, versus a revised 4.63% (previously 4.11%) decline in October.

Real Retail Sales. Real (inflation-adjusted) November retail sales fell by 0.08% on a monthly basis, versus a 2.01% contraction in October, deflated using the CPI-U. Annual real retail sales fell by 8.33% in November versus 8.00% in October, while the annual contractions on a three-month moving-average basis were 7.47% and 5.99%, respectively, in November and October.

The inflation-adjusted retail sales series tends to lead activity in the broad economy. The patterns of declining monthly, quarterly and annual real retail sales remain consistent with a deepening recession and are not yielding any hint or sign of a pending economic bottom or upturn.

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 0.30% (down 0.81% net of revisions) in November, following a revised 1.82% (previously 1.65%) decline in October. Those numbers contrasted with the official aggregate drop of 1.76% in November and the revised 2.95% in October. On an annual basis, November "core" retail sales fell by 6.92%, versus a revised 6.53% (was 5.95%) decline in October.

Next Release (January 14): December retail sales should continue showing a pattern of deepening monthly and annual contractions, net of inflation. Odds favor a nominal result somewhat weaker than likely consensus forecasts.

Industrial Production -- As discussed and graphed in the Opening Comments and detailed in the December 16th *Flash Update*, the Federal Reserve reported that seasonally-adjusted November industrial production fell by 0.6% (down 1.1% net of revisions) for the month, after a revised 1.5% (previously 1.3%) gain in October. The year-to-year decline in November production

was 5.5%, following a revised 4.5% (was 4.0%) drop in October. Consistent with the still-deepening recession, fourth-quarter 2008 production is on track for roughly a 10% annualized quarterly contraction, following an 8.9% contraction in the third quarter.

With the December manufacturing purchasing managers survey showing a sharp monthly drop in production activity, to the lowest index reading ever (since January 1948), a further sharp decline in the Fed's production measure likely will follow.

Next Release (January 16): December production should show sharply deepening month-to-month and year-to-year declines.

New Orders for Durable Goods -- The regularly-volatile new orders for durable goods continued plunging on both a month-to-month and year-to-year basis in November. November's seasonally-adjusted monthly decline of 1.0% (3.2% net of revisions) followed a revised drop of 8.4% (previously 6.2%). Year-to-year change continued to decline in a pattern confirming a deepening a severe recession. Before any accounting for inflation, November's new orders were down 17.6% from November 2006, against October's revised 12.9% (previously 10.6%) decline from October 2007. Following an annualized third-quarter contraction of 8.1%, new orders in the fourth quarter were falling at a still-preliminary pace of roughly 37%.

The widely followed new orders for nondefense capital goods fell by 0.8% for the month of November, after a revised 6.5% (previously 3.6%) decline in October. Year-to-year, orders fell by 20.8%, following a 13.2% (previously 11.3%) annual drop in October.

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 12th *Flash* Update, the seasonally-adjusted October trade deficit widened to $57.2 billion from a revised $56.6 billion (previously $56.5 billion) in September, reflecting a sharper decline reported in exports than in imports.

Unusual in the data was a renewed surge in the physical volume of October oil imports, which was suggestive of catch-up reporting. Prior data had helped to limit the scope of the reported third-quarter GDP contraction. Seasonally-unadjusted October oil entered the U.S. at a pace of 10.5 million barrels per day, up from 8.4 million in September, contrasted with last year's respective October and September import rates of 10.2 million and 10.1 million. The reported average price for imported oil dropped to $92.02 per barrel in October, from $107.58 in September, helping to offset in total dollars the gain in physical oil imports.

Next Release (January 13): Any further deterioration in the trade deficit for November likely will be softened further by sharply falling oil prices. It will be interesting to see if there is any further post-election catch-up in reporting. If there is, then the reported November deficit likely will be worse than consensus estimates.

Consumer Confidence -- Extremely volatile, but still showing an economy in deepening trouble, the December consumer confidence numbers were mixed, after flattening in November and collapsing in October. The Conference Board's December Consumer Confidence measure fell by 15.0% for the month, to an all-time low reading (lowest since the Lyndon Johnson Administration), after rebounding 15.2% in November from a 36.8% plunge in October. Year-to-year change for the three-month moving average deepened to a decline of 55.6%, from a drop of 48.7% in November and a 47.1% decline in October.

The Reuters/University of Michigan's Consumer Sentiment measure rose by 8.7% for the month of

December, after declining by 4.0% in November and dropping by 18.1% in October. Year-to-year change in the Sentiment three-month moving average eased to a decline of 25.6% in December, following a 23.8% fall in November and a 22.9% drop in October.

These lagging, not leading indicators confirm that the economy has been in a deepening recession.

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 recessionary pressures and highlighting difficulties the Federal Reserve has had in stabilizing the solvency issues in the U.S. banking system. With direct intervention as a lender in the commercial paper market, and with heavy jawboning of banks to lend to credit-worthy customers, the Fed has pushed to stimulate both commercial and consumer lending. Early indications in the money data of improving conditions in lending post-date the numbers available here.

For seasonally-adjusted consumer credit, which includes credit cards and auto loans, but not mortgages, annual growth was reported at 3.1% in October, down from 3.5% (previously 3.7%) in September, and down from 3.8% (previously 3.9%) 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 and eventual contraction in consumer debt remains an ongoing constraint on economic activity.

Annual contraction in commercial paper outstanding has narrowed minimally, with the Fed's proactive involvement in the market. Commercial paper outstanding showed a 13.1% year-to-year contraction in November, following a 16.2% year-to-year contraction in October and a 13.2% annual decline in September.

Annual growth in November commercial and industrial loans slowed to 13.3%, down from 15.1% in October and versus 13.2% in September. Slowing growth in commercial lending tends to dampen broad business activity.

Producer Price Index (PPI) -- As discussed in the December 12th *Flash Update*, the regularly volatile Producer Price Index (PPI) for finished goods absorbed another severe hit from the recent collapse in oil prices, contracting by a seasonally-adjusted 2.2% (2.9% unadjusted) in November, versus a 2.8% (2.6% unadjusted) decline in October, as reported by the Bureau of Labor Statistics. Going against a 2.6% monthly spike in the November PPI of last year, the current November's PPI year-to-year inflation fell to 0.4% from 5.2% in October.

If the monthly PPI should decline by 1% or more in December's reporting, a year-to-year deflation number would be likely for the series. Since 1980, the finished goods PPI has shown formal deflation (year-to-year decline) in 1986, 1994, 1997/1998 and 2001/2002, without the CPI ever following suit. Those declines and related index volatility often were tied to large swings in oil prices.

On a monthly basis, seasonally-adjusted November intermediate goods fell by 4.3% (down 3.9% October), crude goods fell by 12.5% (down

18.6% October). Year-to-year inflation slowed sharply, with November intermediate goods up by 2.6% (10.2% October) and November crude goods down by 19.4% (down by 1.4% October).

Next Release (January 16): 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, despite another monthly hit in December, with annual PPI possibly turning negative in December as a result of the impact from lower 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 December manufacturing purchasing managers survey took a further big hit, to 32.4, down from 36.2 in November, and down from 38.9 in October. Key December components indices for new orders and production hit their lowest levels ever, pre-January 1948. The November nonmanufacturing purchasing managers survey also took a big hit. Both series have fallen deep into recession territory (32.4 for December manufacturing, 37.3 for November nonmanufacturing).

The Institute for Supply Management (ISM) designates a reading of 41.1or below in its aggregate indices as signaling recession. The ISM reweighted its key index last January so that the manufacturing index 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 index. Fortunately, however, the more meaningful components of the index were not affected by the efforts to match the flawed government data.

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, which is the reading I use as a signal for contracting economic activity.

The December new orders index plummeted to 22.7 in December from 27.9 in October, and stood at its lowest reading ever. 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 December new orders index plunged by 45.6%, following a 37.8% decline in November and a 25.9% drop in October.

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 29.9 in December, the lowest reading since November 1982, down from 34.2 in November and from 34.6 in October.

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 November services composite index fell to 37.3, from 44.4 in October, and from 50.2 in September.

Both the services employment and prices paid components, however, have some meaning. Covering the real estate and banking industries, among others, the November employment component tumbled to 31.3, from 41.5 in October, and from 44.2 in September. The heavily hit prices-paid components for both indices are covered in the Inflation Indicators.

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

The seasonally-adjusted November help-wanted advertising index continued at its historic low level of 14, the same as in October, down from the prior historic low of 15 in September. These readings are at the lowest level seen since the index was first calculated during the Truman Administration, in January 1951.

The November reading was down by 33.3% year-to-year, versus a 36.4% decline in October, as the series continued to bottom-bounce. The annual change in the three-month moving average as of November was a 35.8% decline, versus October's 36.2% 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 November 2008, with a year-to-year 15.0% decline in new on-line ads. Such cannot be a good sign for national employment or for broad economic activity.

Housing Starts -- As discussed in the December 16th *Flash Update* and in the Opening Comments, and as graphed there net of the New York City paperwork distortions in June's reporting, housing starts continued to show a severe, deepening recession. The Census Bureau reported that seasonally-adjusted November housing starts fell by 18.9% (down 21.0% net of revisions) +/- 10.5% (95% confidence interval), a statistically-significant decline for the month. Such followed a revised 6.4% (previously 4.5%) decline in October. On a year-to-year basis, starts were down by 47.0%, after a revised 39.5% (previously 38.0%) drop in October.

November building permits showed a similar pattern, down 15.6% (13.0% net of revisions) for the month, following October's revised 9.3% (previously 12.0%) decline. Permits fell by 48.1% year-to-year in November, after an annual drop of 38.2% (previously 40.1%) in October.

In home sales data, the seasonally-adjusted November new home sales fell by 2.9% (down by

6.0% net of revisions) +/- 14% (95% confidence interval), which was not statistically distinguishable from a monthly gain, following a 5.2% (previously 5.3%) monthly decline in October. On a year-to-year basis, November new home sales dropped by 35.3%, following a 42.0% (previously 40.1%) decline in October. Even reflecting the intensifying upside pressures from the impact of foreclosure sales, existing home sales in November still fell by 8.6% (9.8% net of revisions) for the month, and declined 10.6% year-to-year. October monthly sales were down a revised 4.5% (previously 3.1%).

Inflation Indicators

Money Supply -- As discussed and graphed in the Opening Comments and the December 31st *Flash Update*, annual growth in the seasonally-adjusted December 2008 monthly averages for M1, M2 and SGS-Ongoing M3 money measures appears to have spiked. Based on the latest three-plus weeks of reporting of M2 and non-M2 components of M3, annual M3 growth appears to have bottomed in November at 8.9%, with a rebound to an estimated 10.4% in December.

Slowly beginning to absorb the extreme liquefaction of the system by the Fed, December M1 annual growth is estimated at 16.3%, following 11.5% growth in November and 7.6% growth in October. December M2 annual growth is estimate at 9.5%, after November's growth of 7.6% and October's growth of 7.4%. December annual growth in the SGS-Ongoing M3 is estimated at 10.4%, after an 8.9% gain in November, and a 10.7% gain in October. Respective monthly gains reported or estimated in the seasonally-adjusted monthly average for October, November and December are 1.3%, 3.4% and 4.3% for M1, 1.4%, 0.7% and 4.3% for M2, and contractions of 0.4% and 0.3%, and a gain of 2.3% for M3. These data will be updated in the weeks ahead as more information becomes available.

Annual growth in the seasonally-adjusted SGS-Ongoing M3 continued has slowed from its record-high 17.4% level in March 2008. The slowing growth reflected serious difficulties the Fed had in getting banks to resume normal commercial activity, although some positive impact now has begun to surface. With Fed actions working their way into the system, not only should significantly higher broad money growth result, but also money velocity should increase as bank lending and financial markets return to some semblance of normalcy, and as consumers begin to pull cash out from underneath their mattresses (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).

Outside of the strong growth seen early in 2008, 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 December's growth likely was shy of 1971's high, the current environment still promises much stronger broad money growth in the months ahead and heavy upside inflation pressure well into 2009.

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. 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 -- Prices paid in both the December manufacturing and November nonmanufacturing surveys have plummeted, showing extreme declines in inflationary pressures, thanks primarily to the severe plunge in oil prices.

On the manufacturing side, the December prices paid index dropped to a 60-year low (since June 1949) of 18.0, from 25.5 in November, and from 37.0 in October. On a three-month moving average basis, December's year-to-year change was a collapse of 59.4%, versus a November annual decline of 38.8% and an October annual decline of 9.5%. 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 also dropped, falling to 36.6, from 53.4 in October, and from 70.0 in September. On a three-month moving-average basis, November's annual decline was 21.9%, versus October's annual gain of 2.7%, and September's annual gain of 18.9%.

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 below 50.0 indicates falling prices.

Oil Prices -- The ongoing collapse in oil prices has been the primary factor behind the drop in reported annual CPI inflation. There are some suggestions, however, that the plunge in oil prices may have about run its course, what with the U.S. election out of the way, with global political tensions returning to their normal inflated states, and with the U.S. dollar coming under some renewed selling pressures.

With the West Texas Intermediate (WTI) spot price closing at $44.60 per barrel on December 31st, oil prices have plunged by 69.4% since the record-high closing price of $145.66 on July 11, 2008, and have collapsed well below the $90 per barrel that level that promised ongoing severe near-term inflation problems in the U.S. economy. December's monthly average spot price for WTI (St. Louis Fed) was $41.36 per barrel, down 28.0% from November's $57.44, which was down by 25.1% from October's $76.65 per barrel. The December average was down 69.1% from June's $133.93 historic-high average. For December 2008, the year-to-year change in price level was a decline of 54.9%, versus a decline of 39.3% in November.

In terms of annual average for WTI, however, 2008 still set an historic high of $99.60 per barrel, up by 37.6% from $72.36 in 2007, which, in turn, was up by 9.5% from $66.10 in 2006.

As discussed in the Opening Comments, the continued drop in oil and gasoline prices has hammered reported CPI-U inflation sharply in October and November, and it will hit December, as well, triggering perhaps a brief period of official, albeit minor, year-to-year CPI-U deflation. There still remains in play, however, the long-term impact from recent high oil prices that still is working its way through the broad economy, and still will add upside pressures to general inflation (exclusive of the near-term energy measures) into the first half of 2009.

There also should be some lag in the full impact of drop in oil prices flowing through to the CPI, irrespective of overly optimistic reporting out of the Bureau of Labor Statistics. A number of firms (such as airlines) hedged their energy costs by buying oil futures, locking in their costs and protecting themselves from the negative impact of potentially still higher oil prices. Such activity is standard and good business practice. Any higher costs now locked in, still were done presumably at levels that were acceptable to the involved businesses, although they now are being worked

off. On the other hand, any oil prices locked in now could be of great benefit going forward, slowing the growth in future energy-related inflation costs, should oil prices go higher, as I believe they will.

Beyond immediate fuel costs, oil-related costs impact industries ranging from the transportation of goods and services, to material costs in the plastics, pharmaceutical, fertilizer, chemical industries, etc. These broad inflationary pressures will remain intact for a while, despite any near-term oil price gyrations.

Oil prices remain highly volatile and sensitive to minor surprises. While slowing U.S. and global economies reduce oil demand, OPEC activities have been and likely will continue to be aimed at offsetting such, with production cuts. Adding some upside pressure to prices are intensified global military and political tensions, and other supply and demand risks/issues. Of greatest long-term impact, however, is the U.S. dollar, where oil is denominated in same. At such time as heavy dollar selling resumes -- and it may be starting -- look for oil prices to spike anew, moving back above the $100 per barrel level and rekindling oil-price related inflation concerns.

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