

John Williams'

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REPORTING PERSPECTIVE

The Big Three Market Movers

As discussed in the *Flash Update* of February 3rd, underlying economic fundamentals have been in freefall, but such will not continue indefinitely. Some bottom-bouncing would be normal in the reporting of the months ahead. Such already has been seen in the January purchasing managers manufacturing survey and January retail sales reports. The January industrial production estimate, in particular, is vulnerable to some bottom bouncing. Such does not necessarily mean looming economic recovery, rather some bottom-bouncing as the broad economy hits a low-activity plateau, before rolling down hill again -- albeit with occasional bumps -- in a further downleg of a multiple-dip recession/depression.

With political pressures intense on getting the Obama stimulus package enacted, and with the Administration touting near-depression-like conditions, reporting pressures, or at least the hype, have shifted temporarily to the downside for economic reporting, although anecdotal evidence suggests that most numbers have been coming in weak of their own accord. Any weakness

recognized now could be used to set as low a base as possible, against which future "Obama-generated" activity will be measured.

Political hype indeed has exaggerated some negative conditions, although economic reality is not too far behind catching up with the hype. Consider references to jobs losses or employment drops as being the worst ever, or worst since the Great Depression. While such is true for a purely physical count, it is not so on a percentage basis, where the total number of employed after World War II was roughly a quarter to a third of today's level. Accordingly, as shown in the payroll employment graph in the Opening Comments, the "worst since" references most appropriately should be applied to the double-dip recession of the early 1980s, and shortly will be applied to the 1973/1975 recession, or before, as has happened already to other series, such as retail sales.

In the other direction, Messrs. Bernanke and Geithner need to maintain 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 have shifted 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, going forward, most inflation reporting should surprise expectations on the upside.

Employment/Unemployment -- As discussed in the January 6th *Flash Update*, and as explored and graphed in the Opening Comments section, beyond the impact of the annual benchmark revisions, payroll employment continued to sink faster than initially reported by the Bureau of Labor Statistics (BLS). Sharp downside revisions continued to prior months, and the Concurrent Seasonal Factor Bias (CSFB) continued to show major ongoing distortions to the headline reporting of payrolls, as detailed in the graph in the Opening Comments section and as discussed below. Nonetheless, the year-to-year percentage decline in January 2009 payrolls tumbled further, now rivaling the employment-contraction trough seen in the double-dip recession of the early 1980s.

As to the annual benchmark revision (see the Reporting/Market Focus for further detail), it was worse than had been advertised, with unadjusted payrolls for the benchmark month of March 2008 being revised lower by 89,000, instead of the initial estimate of a 21,000 downward adjustment to payrolls.

Payroll Survey. The BLS reported a statistically-significant, seasonally-adjusted jobs loss of

598,000 (down 909,000 net of revisions) +/- 129,000 for January 2009, following a revised 577,000 (previously 524,000) jobs loss in December. Annual contraction (unadjusted) in total nonfarm payrolls continued to deepen, down 2.58% in January -- the weakest since a 2.67% decline in October 1982 -- versus a revised 2.11% (was 2.03%) annual contraction in December. The seasonally-adjusted series also contracted year-to-year, down by 2.53% in January, versus a revised 2.15% (was 1.88%) contraction in December. Notice the narrowing in of the differences in revision of the annual growth rate on both a seasonal adjusted and unadjusted basis.

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 continued with January 2009 reporting. Instead of the headline jobs loss of 598,000, 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 716,000. 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 1,185,000. A worksheet on this is available upon request.

As discussed in the opening comments, looking at reported history after the benchmark revision, the SGS CSFB estimate at the time of the publication of the headline number has turned out to have suggested a significantly more realistic estimate of monthly payroll changes than did the BLS's headline number.

Birth-Death/Bias Factor Adjustment. An element that may have intensified the reported January jobs loss was the monthly bias factor (birth-death model). Never designed to handle the downside pressures from a recession, the model adds a fairly consistent upside bias to the payroll levels each year, but with a seasonal distribution that has one month of negative bias: January. The

downside adjustment to unadjusted January 2009 payrolls was 356,000, versus a subtraction from employment of 378,000 in January 2008. The impact on the adjusted monthly level supposedly is neutered by seasonal adjustments.

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), went through further regular revisions in the latest reporting, in order to adjust for new population estimates.

Accordingly, with reported December 2008 and January 2009 employment levels not comparable, the BLS did not report the usual month-to-month changes in key data. The BLS, however, estimated that net of the population changes, household employment would have dropped by 832,000 in January, versus a decline of 806,000 in December.

The January 2009 seasonally-adjusted U.3 unemployment rate showed another statistically-significant increase, to 7.56% +/- 0.23% from 7.19% in December (old population basis). Unadjusted U.3 rose to 8.5% in January from 7.1% in December. The broader January U.6 unemployment rate jumped to an adjusted 13.9% (15.4% unadjusted) from a revised 13.5% (13.5% unadjusted) in December.

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, rose to about 18.0% in January, from 17.5% in December.

Note of Caution. *General background note:* 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.

General background note: 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 **13.9%** unemployment was the highest since before January 1994.

Employment Environment. The continued broad deterioration in January's employment environment broadly was in line with deterioration in the better-quality employment-environment indicators: December newspaper help-wanted advertising was at an historic low, with a deepening annual fall-off in January online help-wanted advertising (Conference Board); new claims for unemployment insurance have continued to surge sharply, setting a 33-year high in annual growth; and employment readings continued in the deepest recession territories for both the January manufacturing and nonmanufacturing purchasing managers survey. Since the employment and unemployment indicators tend to be coincident markers of broad economic activity, weaknesses in these series are signaling an ongoing and deepening recession in place.

Next Release (March 6th): With continuing deterioration in underlying economic activity, the February payroll survey should plunge again, by more than 400,000 jobs, along with a further spike in the unemployment rate. A 400,000 jobs loss in February would sink the annual contraction in payroll employment to its lowest level since 1958.

Gross Domestic Product (GDP) -- As discussed in the January 30th *Flash Update*, official GDP reporting showed a traditional recession to be in place as of fourth-quarter 2008. Given the heavy upside growth biases built into official GDP reporting, such almost was a shock. Not only did the real (adjusted for inflation) fourth-quarter GDP contract for the second consecutive quarter, but also year-to-year change turned negative. In the 2001 recession -- the prior formal downturn recognized by recession arbiter National Bureau of Economic Research (NBER) -- three consecutive quarterly contractions and year-to-year declining growth did not appear in the Bureau of Economic Analysis' (BEA) reporting until the ensuing benchmark revisions of 2002. In subsequent revisions, however, both the 2001 annual and consecutive quarterly contractions disappeared. The NBER called the current recession just after the November 2008 election as having started in December 2007.

Real GNP Weakest Since First-Quarter 1982.

The BEA's "advance" estimate of real annualized growth in the fourth-quarter 2008 GDP was a statistically significant decline of 3.80% +/- 3% (95% confidence interval), reflecting a deepening pace of contraction versus the 0.51% downturn reported in the third quarter. In terms of year-to-year change, the fourth quarter turned negative, down by 0.18%, versus the third quarter's annual gain of 0.75%.

As usual, the data published for the GDP are of little meaning -- other than for political or financial market purposes -- given the paucity of hard numbers available for the fourth quarter at the time of estimate (i.e. only two months of trade data), and given the heavily rigged nature of GDP reporting in general. Consider, for example, that Personal Consumption Expenditure (PCE), which represents roughly 71% of GDP -- improved from an annualized contraction of 3.8% in the third quarter, to 3.5% in the fourth, while the annualized contraction in seasonally-adjusted real retail sales sank from an 11.1% downturn in the third quarter to a 17.1% contraction in the fourth.

Key series such as housing, industrial production and new orders for durable goods all are showing annualized quarterly percent declines in excess of 10%.

Based on earlier reporting methodologies and removal of some reporting gimmicks, the SGS-Alternate GDP estimate for the fourth quarter was an annual (not annualized) contraction of roughly 4.1% versus a 3.3% contraction in the third quarter, against official respective estimates of a 0.2% decline and 0.7% gain. Against reporting of underlying economic series, an annualized quarterly contraction in excess of 7% for the fourth quarter would have been more realistic than the published 3.8% estimate.

The BEA's GDP-like measures for fourth-quarter 2008; 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 income-side equivalent of the GDP's consumption estimate; likely will not be published until the second revision in March, due to the lack of hard data available for the advance estimate, and given that the numbers are annual and more heavily relied on than partial-year data.

Nominal GDP Growth Plunged. Thanks to a small annualized contraction in the fourth quarter GDP's inflation rate (implicit price deflator) of 0.26%, versus an inflation gain of 3.88% in the third quarter, nominal GDP contracted at a faster pace than real GDP. Nominal GDP is not adjusted for inflation and reflects sales and revenues the way a company would book them for accounting purposes (except they usually would not be annualized). On that basis, fourth-quarter nominal GDP dropped at a seasonally-adjusted annualized pace of 4.05%, the sharpest decline since first-quarter 1958. Such was against at 3.35% annualized gain in third-quarter 2008. On a year-to-year basis nominal growth in fourth-quarter GDP softened to 1.66% (weakest since first-quarter 1961), from 3.31% in the third quarter.

Next Release (February 27): Underlying economic fundamentals suggest that the "preliminary" revision estimate of fourth-quarter 2008 GDP should show a deeper annualized contraction than first estimated. All other factors aside, the December trade deficit release (released subsequent to the "advance" GDP estimate), was enough worse than expected to deepen the annualized fourth-quarter real GDP contraction from 3.8% to 4.2% or more. In any event, the GDP revision likely will come in close to consensus estimates of the week before the release.

Consumer Price Index (CPI) -- As discussed in the January 16th *Flash Update*, the Bureau of Labor Statistics (BLS) reported that December's annual CPI-U (CPI for All Urban Consumers) inflation held in positive territory, avoiding a possible shallow but brief bout with official deflation. Given the Fed's strong desire to avoid a formal deflation, the year-end CPI-U inflation coming in minimally above zero had to be somewhat suspect, where other measures turned negative year-to-year. The CPI for Urban Wage Earners and Clerical Workers (CPI-W) and the substitution-based Chain-Weighted-CPI-U (C-CPI-U) both contracted 0.5% year-to-year. Using the SGS-Alternate CPI measures, however, annual deflation still was not on the horizon.

Nearly all of the recent slowing/decline in reported annual inflation has been tied to collapsing oil and related gasoline prices. Of significance, retail gasoline prices turned higher in January 2009, with the monthly average monthly price for all grades of gasoline averaging 8.3% higher than in December (based on Department of Energy reporting).

The greatest threat for resurgent inflation, however, is the renewed growth evident in the broad money supply (SGS-Ongoing Estimate of M3), as discussed in the Opening Comments. Significantly higher inflation looms later in 2009,

despite the accelerating collapse in business activity.

CPI-U. The BLS reported that the seasonally-adjusted December CPI-U (I.7) declined by 0.74% (down by 1.03% unadjusted) +/- 0.12% (95% confidence interval not seasonally adjusted) for the month, versus a decline of 1.68% (down by 1.92% unadjusted) in November. Year-to-year or annual inflation in December softened to 0.09% +/- 0.20% (95% confidence interval) from 1.07% in November, remaining minimally in positive territory. For those 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 January 2009 reporting, dependent on the seasonally-adjusted monthly change versus the 0.39% monthly increase seen in January 2008.

The difference in growth would directly add to or subtract from December's annual inflation rate of 0.09%. With seasonal factors boosting the January reporting, an upside movement in annual inflation is possible. Shy of a further significant collapse in oil prices, annual CPI-U should be at or very near its trough for the current cycle.

CPI-W. The BLS reported that the narrower, seasonally-adjusted December CPI-W (I.8) declined by 0.91% (down by 1.20% unadjusted) for the month, versus a decline of 2.13% (down by 2.30% unadjusted) in November. Year-to-year or annual inflation in December turned negative, to a decline of 0.47%, versus a 0.68% gain in November.

C-CPI-U. Year-to-year or annual inflation for Chain Weighted CPI-U (I.6) -- the fully substitution-based series that increasingly gets touted by CPI opponents and inflation apologists as the replacement for the CPI-U -- turned negative in December, to a 0.54% decline, following to 0.69% gain in November.

Alternate Consumer Inflation Measures.

Adjusted to pre-Clinton (1990) methodology (I.9), annual CPI growth eased to roughly 3.4% in December, down from 4.4% in November, while the SGS-Alternate Consumer Inflation Measure (I.10), which reverses gimmicked changes to official CPI reporting methodologies back to 1980, dropped back to roughly 7.8% in December, from 9.3% in November. The alternate numbers are not adjusted for any near-term manipulations of the data.

Annual Averages. The 2008 annual average inflation rate for the CPI-U was an 18-year high of 3.84%, versus 2.85% in 2007. The 2008 annual average inflation rate for the CPI-W was 4.09%, versus 2.88% in 2007. The 2008 annual average inflation rate for the SGS-Alternate Consumer Inflation Measure (1980 methodologies) was a 28-year high of roughly 11.6%, versus 10.5% in 2007.

Next Release (February 20): The January CPI likely will show a small increase for the month, due partially to some uptick in gasoline prices and to seasonal adjustments.

Annual inflation would increase or decrease in January 2009 reporting, dependent on the seasonally-adjusted monthly change versus the 0.39% monthly increase seen in January 2008.

The difference in growth would directly add to or subtract from December's annual inflation rate of 0.09%. Consensus estimates are around 0.3% for the seasonally-adjusted month-to-month change at the moment (Briefing.com), which would take annual CPI-U inflation to around zero. Given some slight upside reporting risk to the CPI, and given what may be a defining desire by the Fed to prevent "deflation," annual CPI growth has a fair shot of staying minimally on the plus-side of zero in January reporting. If there were a formal small annual deflation, 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.

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

Other Troubled Key Series

Federal Deficit. Fiscal conditions continue to deteriorate as "solutions" to the financial system's solvency crisis and the deepening recession take their respective tolls. The 12-month rolling deficit through January 2009 rose to \$934.8 billion, up from December's \$833.2 billion, November's \$701.3 billion, October's \$635.1 billion and September's \$454.8 billion. In contrast, the 12-month rolling deficit through January 2008 was just \$208.3 billion.

Fiscal stresses are going to be exacerbated in the next year or two as the Obama Administration's economic stimulus package gets enacted. In line with the discussion in the January 9th *Flash*

Update, the 2009 official budget deficit is highly likely to top \$2 trillion, with commensurate funding in excess of that required by the U.S. Treasury.

General background note: 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.

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 \$10.632 trillion at January 31, 2009, down by \$68 billion for the month, but up by \$1.394 trillion from January 31, 2008, which in turn was up \$620 billion from January 2007. Gross federal debt stood at \$10.700 trillion at December 30, 2008, up by \$39 billion for the month, but up by \$1.471 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.

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 continued to reflect the severe deterioration in labor market conditions, where a rising growth trend in new claims is an economic negative. On a smoothed basis for the 17 weeks ended February 7th, annual growth hit 59.8%, its highest level since August 1975 (the 1980s double-dip recession's peak growth was 59.4%; historical peak growth (March 1975) was 78.8%). The February 7th growth rate was up from 52.4% annual growth as of the 17 weeks ended January 3rd, and up from 48.2% in the 17 weeks ended December 6th.

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 Martin Luther King's Birthday and Presidents' 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 a continued decline in gasoline prices, December's seasonally-adjusted monthly real earnings increased by 0.6% for the month, following a revised 2.6% (was 2.3%) monthly increase in November. Annual change in December rose to 2.9%, versus 2.3% (previously 2.2%) in November.

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 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).

Retail Sales -- As discussed and graphed in the Opening Comments and as discussed in the January 14th, 16th and February 12th *Flash Updates*, the Census Bureau reported that seasonally-adjusted retail sales for the month of January 2009 rose by 1.05% (0.41% net of revisions) +/- 0.6% (95% confidence interval). Such was after the month-to-month sales decline for December 2008 -- the selling climax of the holiday season -- was revised to 3.04%, having been reported initially to have fallen by 2.66%. On a year-to-year basis, January retail sales plunged by 9.70%, versus a revised 10.47% (previously a 9.81%) collapse in December. The

increasingly consistent pattern of current headline reporting being boosted by downward revisions to prior reporting continued, as also has been seen in nonfarm payroll reporting.

The January retail sales results reflected the bottom-bouncing suggested in the *Flash Update* of February 3rd. Economic series usually do not collapse in perpetual freefall, but can bottom-bounce when they hit a low-level plateau of activity. Annual growth patterns, however, tend to remain deep in recession territory, before the next down-leg in activity begins.

Core Retail Sales. Consistent with the Federal Reserve's predilection for ignoring food and energy prices when core inflation is lower than full inflation, "core" retail sales -- retail sales net of grocery store and gasoline station revenues -- rose by 0.70% (down 0.01% net of revisions) in January, following a revised 1.73% (previously 1.39%) decline in December. Those numbers contrasted with the official aggregate increase of 1.05% in January and the revised 3.04% decline in December. On an annual basis, January "core" retail sales fell by 7.75%, versus a revised 8.68% (was 7.88%) decline in December.

Real Retail Sales. With several months of falling gasoline prices having exacerbated recently reported monthly and annual retail sales declines, an upturn in January 2009 gasoline prices helped with the monthly January gain. As will be detailed following January CPI-U reporting next Friday (February 20th), the monthly change in real (inflation-adjusted) retail sales should hold in positive territory, but the severe annual contraction in real retail sales should have held near December's severe decline and cycle low.

Real December retail sales -- as revised with the January reporting -- fell by 2.32 (previously 1.94%) on a monthly basis, following a revised 0.69% (previously 0.45%) decline in November, deflated using the CPI-U. Year-to-year real retail sales fell by a revised 10.39% (previously 9.09%)

in December, versus a 9.35% (previously 9.11%) contraction in November, the steepest annual decline since 1952.

On a three-month moving-average basis, the December and November declines were 9.39% (previously 8.88%) and 8.00% (previously 7.87%), respectively. The December annual decline in the moving-average was the deepest in the history of the two most recent historical retail series, making the results the worst of the post-World War II era. The annualized real contraction for fourth-quarter 2008 retail sales was 18.0%, following an 11.1% annualized contraction in the third quarter.

A depression is defined (SGS) as a recession where peak-to-trough contraction exceeds 10%, a level currently exceeded in annualized terms by both third- and fourth-quarter 2008 real retail sales.

The inflation-adjusted retail sales series tends to lead activity in the broad economy. The pattern of declining annual real retail sales remains consistent with a severely deepening recession, and continues not to yield any sign of a pending economic upturn despite this month's nominal bottom-bouncing.

Next Release (March 12): February retail sales should continue showing a pattern of deepening annual contraction, though there may be some continued month-to-month bottom-bouncing.

Industrial Production -- As discussed and graphed in the Opening Comments and detailed in the January 16th *Flash Update*, the Federal Reserve reported that seasonally-adjusted December industrial production fell by 2.0% (down 2.4% net of revisions) for the month, after a revised 1.3% (previously 0.6%) decline in November. The year-to-year decline in December fell to a contraction of 7.8%, the weakest showing since September 1975. Such followed November's revised 5.9% (previously 5.5%) drop. Consistent with the still-deepening recession,

fourth-quarter 2008 production showed an annualized quarterly contraction of 11.5%, following an 8.9% contraction in the third quarter.

A depression is defined (SGS) as a recession where peak-to-trough contraction exceeds 10%, a level currently exceeded in annualized terms by fourth-quarter industrial production.

Next Release (February 18): January production should continue to show sharply deepening year-to-year decline, although some monthly bottom-bouncing at a low-activity plateau is possible in the next several reports, as suggested by the latest purchasing managers manufacturing survey.

New Orders for Durable Goods -- As discussed in the *Flash Update* of January 30th, the regularly-volatile new orders for durable goods continued collapsing on both a month-to-month and year-to-year basis in December, per the Census Bureau. December's seasonally-adjusted monthly decline of 2.6% (5.4% net of revisions) followed a revised drop of 3.7% (previously 1.0%) in November. Before any accounting for inflation, December's new orders were down 19.7% from December 2007, against November's revised 19.1% (previously 17.6%) tumble from November 2007. Following an annualized third-quarter contraction of 8.1%, new orders in the fourth quarter fell at an annualized pace of 43.3%. Adjusted for inflation the series have shown even sharper contractions.

A depression is defined (SGS) as a recession where peak-to-trough contraction exceeds 10%, a level currently exceeded in annualized terms by real new orders for durable goods.

The widely followed new orders for nondefense capital goods also fell, down by 5.9% for the month of December, after a revised 4.6% (previously 0.8%) decline in November. Year-to-year, orders fell by 24.0%, following a 22.5% (previously 20.8%) annual drop in November.

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 February 12th *Flash Update*, the Bureau of Economic Analysis and the Census Bureau reported that the seasonally-adjusted monthly trade deficit for December narrowed slightly from revised November numbers, but it was worse than expected by large enough margin, in conjunction with surging oil import volume, to suggest a negative revision to fourth-quarter GDP. Certain annual data are discussed in the Opening Comments.

The seasonally-adjusted December 2008 deficit in goods and services trade was reported at \$39.9 billion, narrowed from a revised \$41.6 billion (previously \$40.4 billion) in November, which in turn had shrunk sharply from a revised \$57.2 billion (previously \$56.7 billion) in October. The seasonally-adjusted monthly deficits were revised back to January 2008. The reported "improvements" in the December and November deficits (most of the November improvement) were due to catch-up reporting of collapsing oil prices. That process now has run the bulk of its course.

For all of 2008, the total deficit on a balance of payments basis narrowed to \$677.1 billion, from \$700.3 billion in 2007. The reported improvement was due to a purported increase in the "services" surplus, which is little more than a guesstimate. The "goods" deficit actually widened minimally for the year.

On the oil front, the average price of imported oil declined to \$49.93 per barrel in December, down from \$66.72 in November. Continuing to show extreme non-seasonal volatility, crude oil imports jumped to 10.3 million barrels per day, up from 8.7 million in November. For the year, physical volume dropped 2.7%, from 3.69 billion barrels in 2007 to 3.59 billion barrels in 2008.

Reporting of this series has been troubled during the last year, with suggestions of possible irregularities in import paperwork flows. Significant revisions to 2008 data in the months ahead would tend to trigger downside revisions in previously reported GDP growth rates, which are due for annual revision around July 2009.

Next Release (March 13): With oil prices near bottoming out in the trade reporting, the January trade deficit likely will reverse recent reporting trends, showing a net deterioration.

Consumer Confidence -- Showing some relative stability, but still showing an economy in deepening trouble, the January consumer confidence numbers again were mixed. The Conference Board's January 2009 Consumer Confidence measure fell by 2.3% for the month, to a new historic low (lowest since the Lyndon Johnson Administration), after tumbling a revised 13.7% (was 15.0%) in December. Year-to-year change for the three-month moving average was a decline of 54.5%, versus a 55.4% (previously 55.6%) in December.

The Reuters/University of Michigan's Consumer Sentiment measure rose by 1.8% for the month of January, following an 8.7% increase in December. Year-to-year change in the Sentiment three-month moving average was down by 23.22% versus a decline of 25.6% in December.

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 slowed sharply, reflecting both tight credit and impaired business conditions. Despite direct intervention as a lender in the commercial paper market, and heavy jawboning of banks to lend to credit-worthy customers, the Fed's push to stimulate both commercial and consumer lending has not turned lending to the upside. Early indications in the money data of somewhat improving conditions in lending, however, continue.

For seasonally-adjusted consumer credit, which includes credit cards and auto loans, but not mortgages, annual growth was reported 1.7% in December, down from 2.2% in November and down from 3.2% in October.

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 monthly contractions in consumer debt are an ongoing drag on economic activity.

Annual contraction in commercial paper outstanding has varied, with the Fed's proactive involvement in the market. Commercial paper outstanding showed a 16.3% year-to-year contraction in January, follow a 6.8% decline in December and a 13.1% contraction in November.

Annual growth in January commercial and industrial loans slowed sharply to 8.3%, down from 10.6% in December and down from 14.1% in November. Slowing growth in commercial lending not only tends to dampen broad business activity, but also can signal an economic downturn.

Producer Price Index (PPI) -- As discussed in the January 16th *Flash Update*, the regularly volatile Producer Price Index (PPI) for finished goods turned negative year-to-year in December, as it absorbed still another severe hit from the recent collapse in oil prices. As reported by the Bureau of Labor Statistics (BLS), the December PPI declined by a seasonally-adjusted 1.9% (1.9% unadjusted) versus a 2.2% (2.9% unadjusted) drop in November. December PPI year-to-year inflation contracted by 0.9% -- formal deflation -- following a 0.4% gain in November. 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 December intermediate goods fell by 4.2% (down

4.3% November), crude goods fell by 5.3% (down 12.5% November). Year-to-year inflation declined, with December intermediate goods down 1.7% (up by 2.6% November) and December crude goods down by 25.0% (down by 19.4% November).

Next Release (February 19): With the hemorrhaging in oil prices stopped, expectations have shifted tenuously to a small monthly gain for January's PPI. Allowing for the ongoing, regularly random volatility of the monthly price variations, anything is possible. A monthly gain of more than 1.2% would be needed to narrow the year-to-year decline in the finished goods annual inflation rate. A monthly gain of more than 2.1% would be needed to push annual change into positive territory. PPI inflation reporting over the next six-to-nine months generally should favor upside surprises in official results.

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 January 2009 manufacturing purchasing managers survey did some bottom bouncing, with the overall index rising to 35.6 from a revised 32.9 (was 32.4). The composite measure held deep in recession territory, despite the annual benchmark revisions by the Commerce Department. The revisions were of little

substance, other than showing a weaker start to 2008 than previously had been indicated. Key December components indices for new orders and production that hit their lowest levels ever, pre-January 1948, rebounded in January 2009, again, though, remaining deep in recession territory.

The Institute for Supply Management (ISM) designates a reading of 41.1 or below in its aggregate indices as signaling recession. The ISM reweighted its key in January 2008 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, although most are affected by the Commerce Department's attempts at seasonal adjustment.

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 January new orders index rebounded to 33.2 from a revised 23.1 (was 22.7) in December. 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 January new orders index plunged by 43.5%, following an unrevised 45.6% decline in December.

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 held at 29.9 in January 2009, the same reading as the unrevised initial December reporting, which was the lowest reading since November 1982.

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 January 2009 purchasing managers non-manufacturing (or services) composite index rose to 42.9 from 40.1 in December.

Both the services employment and prices paid components, however, have some meaning. Covering the real estate and banking industries,

among others, the January employment component eased to 34.4 from 34.5 in December. The bottom-bouncing 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.

As discussed in the February 3rd *Flash Update*, December help-wanted advertising (Conference Board, newspapers) sank to a new historic low, along with indications of a sharp annual fall-off in January online help-wanted advertising (Conference Board, online).

The seasonally-adjusted December help-wanted advertising index sank to a new historic low level of 13, down from the prior low of 14 in November. This reading is at the lowest level seen since the index was first calculated during the Truman Administration, in January 1951.

The December reading was down by 40.9% year-to-year, versus a 33.3% decline in November, as the series took a renewed hit. The annual change in the three-month moving average as of December was a 36.9% decline, versus a 35.8% decline in November. 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.

The Conference Board also reported that annual growth in its nascent on-line measure of help-wanted advertising has been in contraction since April 2008. While the online series is too limited

historically to be used in formal forecasting, the deteriorating year-to-year decline of 39.1% for new help-wanted ads in January 2009 cannot be a good sign. Since help-wanted advertising is a leading indicator to the employment report, the signals were negative for both January and February payroll reporting.

Housing Starts -- As discussed in the January 23rd *Flash Update* and in the Opening Comments, and as graphed there net of the New York City paperwork distortions in June's reporting, the Census Bureau reported that seasonally-adjusted December housing starts contracted by 15.5% +/- 11.3% (95% confidence interval) month-to-month and by 45.0% year-to-year. Such contrasted with November's revised monthly decline of 15.1% (previously 18.9%) and annual contraction of 44.8% (previously 47.0%). The current pace of annual contraction is on a par with the trough declines seen in the series during the major post-World War II recessions.

On an annualized quarter-to-quarter basis, fourth-quarter 2008 housing starts plunged by 68.5%, following 38.6% contraction in the third quarter. A depression is defined (SGS) as a recession where peak-to-trough contraction exceeds 10%, a level currently exceeded in annualized terms by both third- and fourth-quarter housing starts.

Seasonally-adjusted December building permits showed a similar pattern, down 10.7% (10.9% net of revision) +/- 1.9% (95% confidence interval) for the month, following November's revised 15.8% (was 15.6%). Permits fell by 50.6% year-to-year in December, after an annual drop of 48.2% (previously 48.1%) in November.

In home sales data, the seasonally-adjusted December new home sales fell by 14.7% (18.7% net of revisions) +/- 14% (95% confidence interval), which statistically was not much distinguishable from a monthly gain, following a revised 4.4% (was 2.9%) contraction in November. On a year-to-year basis, December

new home sales dropped by 44.8%, following a 38.3% (previously 35.3%) decline in November.

Heavily impacted by soaring foreclosure sales, existing home sales in December rose by 6.5% month-to-month, after declining a revised 9.4% (was 8.6%) in November. December sales were down 3.5% for the year, after an 11.4% (previously 10.6%) decline in November. Legal and political efforts to slow the pace of foreclosures could impact January reporting negatively.

Inflation Indicators

Money Supply -- As discussed and graphed in the Opening Comments and the January 16th and 23rd *Flash Updates*, after bottoming in November, broad money supply continued to grow in December and January. Although the general patterns did not change, recent annual growth estimates on the SGS-Ongoing M3 have been upped slightly, thanks to historical benchmark revisions made to key components by the Federal Reserve Board.

With full reporting in place for the month of January, annual growth was somewhat lower than in December for M1 and higher for M2 and the SGS-Alternate Measure of M3. For January 2009, annual M3 growth picked up to roughly 12.0%, from 11.4% in December, and from a near-term trough of 9.8% in November.

Annual growth for M2, in January, also increased, rising to 10.4% in January from 9.9% in December. Thanks to some shift from demand deposits (M1) to savings accounts (M2), annual M1 growth in January slowed to 15.1% from 17.0% in December.

Respective monthly changes reported or estimated in the seasonally-adjusted monthly averages for December and January are an increase of 4.7% and a decline of 1.3% for M1, increases of 2.3%

and 1.1% for M2, and increases of 2.3% and about 1.6% for M3.

Per the Opening Comments, given the extreme systemic liquefaction by the Fed, annual broad money growth has started to pick-up. The pace could be expected to rise sharply, particularly if the Federal Reserve begins to monetize the government debt issued to support the promised Obama stimulus package.

Annual M3 growth in the months ahead easily could overtake the historic strong growth seen early in 2008. Prior to February 2008, the historic high of 16.4% had been in June of 1971, two months before President Nixon closed the gold window and imposed wage and price controls. While current growth is shy of 1971's high, the current environment 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 January

manufacturing and nonmanufacturing surveys rebounded from December's lows, although they still continued to indicate falling prices in the aftermath of collapsing oil prices.

On the manufacturing side, the January prices paid index jumped to 29.0 from a 60-year low (since June 1949) of 18.0 reported in December. On a three-month moving average basis, January's year-to-year change was a collapse of 65.7% versus a 59.4% decline in December. 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 January prices diffusion index also rebounded, rising to 42.5 from 36.1 in December. On a three-month moving-average basis, January's annual decline was 46.8%, versus a decline of 40.4% in December.

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 -- Oil prices in January actually rose versus December, based on monthly average price level. Where the recent collapse in oil prices was the primary factor behind the slowdown in reported annual CPI inflation the last several months, the bottoming out in oil prices also should be accompanied by some bottoming out in the annual CPI inflation rate. Risks to the downside for the U.S. dollar, combined with supply and geopolitical risks, even offer some upside risk to oil prices, and to related short-term inflation swings.

With continued extreme volatility, the West Texas Intermediate (WTI) spot price closed at \$37.51 per barrel on February 13th. WTI spot has risen by 21.7% from its recent low close of \$30.81 on

December 22nd. The latest spot price, however, still is down by 74.2% since the record-high closing price of \$145.66 on July 11, 2008.

With an apparent bottoming in pricing, January's monthly average spot price for WTI (St. Louis Fed) was \$41.74 per barrel, up 1.8% from December's \$41.02. The January average was down 68.8% from June's \$133.93 historic-high average. For January 2009, the year-to-year change in price level was a decline of 54.9%, versus a decline of 55.3% in December.

Higher oil prices already are being reflected in an upturn in retail gasoline prices. 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. This is due both to the long lead time

inherent in some price impact, as well to the impact of oil futures contracts. Used as traditional hedges against unusual price swings, these instruments can keep energy costs relatively high or low, depending on the timing, nature and duration of the open contracts.

Oil prices remain highly volatile and sensitive to minor surprises. While sharp declines in U.S. and global economic activity reduce oil demand, OPEC activities have been and likely will continue to be aimed at offsetting such, with production cuts. Also 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 that is just a matter of time -- look for oil prices to spike anew, moving back above the \$90 per barrel level, rekindling oil-price related inflation concerns.