

John Williams'

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Analysis Behind and Beyond Government Economic Reporting

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REPORTING PERSPECTIVE

The Big Three Market Movers

The economy remains in a severe and still-deepening recession. Most upcoming economic releases should tend to confirm same, particularly when viewed in terms of comparative year-to-year economic activity. Some bottom-bouncing in the better-quality data is inevitable, but such will reflect the distortions of severe and protracted economic activity on reporting, not herald the onset of an economic recovery.

In contrast, President Obama and Federal Reserve Chairman Bernanke need evidence of economic recovery, to salve their criticized actions, to keep budget deficit projections contained (at least until nationalized healthcare can be legislated), to pacify foreign investors and to excite the regular financial hypesters on Wall Street and in the popular media. Those needs also require contained inflation numbers.

With the systemic solvency 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 a certain degree on perceived financial-market vulnerability.

Absent manipulation, and against market expectations that once again seem to be firming on recovery hopes, most near-term economic reporting should tend to surprise the markets on the downside. With inflationary expectations still in the basement, inflation reporting should begin to surprise expectations on the upside, going forward.

Employment/Unemployment -- As discussed in the July 2nd *Flash Update*, and as explored and graphed in the Opening Comments section, payrolls continued to sink monthly, quarterly and annually, in line with an unfolding depression. Also, as separately explored in the Reporting/Market Focus, broad unemployment rates have risen to depression or near-depression levels for a number of major states.

June Employment Reporting Showed Ongoing Economic Deterioration. The Bureau of Labor Statistics (BLS) released ongoing indications of deteriorating U.S. employment/unemployment conditions in June, with a worse-than-expected

467,000 drop in June payrolls, but a narrower-than-expected rise in unemployment to 9.5%. Net of the Concurrent Seasonal Factor Bias (discussed below) and net of distortions built into the reporting by the Birth-Death Model (discussed below), the June jobs loss likely exceeded 700,000. Yet, before getting into the details of June's report, a variety of special considerations are detailed, as directly related to the reporting of employment conditions as well as to broader implications for economic reporting in general.

As discussed in the opening comments, a number of statistical distortions have been introduced to the system by the unfolding depression, itself. For example, the bankruptcies of Chrysler and General Motors may end up falsely boosting apparent employment conditions in July's reporting.

Birth-Death Model Gives Faulty Upside Boost to Payroll Reporting During Recessions. The Birth-Death Model used by the BLS to adjust for employment changes due to jobs gained or lost by new business creations and failures is structured on a non-recession environment. As a result, it spuriously adds upside monthly biases into the payroll employment reports during economic downturns, enough, perhaps to spike current reported annual payroll growth by more than 2.5 million jobs. This system was introduced in the early 2000s to upgrade the "bias adjustment" system created in the mid-1980s.

In the wake of underestimated payroll growth coming out of the 1980 to 1982 double-dip recession, the BLS introduced upside bias adjustments to its monthly payroll employment reporting. Blaming its inability to catch jobs created in the formation of new companies, the BLS began adding 120,000 to 160,000 jobs to each month's seasonally-adjusted report, with the monthly bias level recast every quarter or so. Bad estimates made of payroll growth, in theory, would be corrected in the next year's benchmark revisions.

The system was not designed to accommodate recessions, but the benchmark revisions tended to show a pattern of fairly consistent overstatement with the annual revisions, regardless of the business cycle. During the reporting cycle covering the 1990 to 1991 recession, a particularly large downward benchmark revision in previously reported payrolls levels was blamed partially on the BLS assuming that companies that had stopped reporting during the recession still were in business, with proportionate payroll employment attributed to them by the BLS. The problem was that much of the non-reporting reflected companies going out of business.

Amidst growing public criticism, the BLS moved to justify the bias factors with the introduction of a "Birth-Death Model." The BLS continued to assign proportionate employment and trends consistent within industry groups to non-reporting companies. It justified not counting jobs losses from business deaths, assuming that they were offset by gains from business creations. The net difference between business births and deaths and related employment changes were estimated based on an average sampling of the prior five years of data.

The bulk of that modeling was based on periods of economic growth. In recessions, however, more jobs tend to be lost with failed companies than are gained with generally smaller start-up firms. As a result, the average net birth-death adjustment should be a contraction, during a recession, not a positive monthly bias factor. At present, the seasonally-adjusted payroll change starts with an average 75,000-plus upside bias -- more than 900,000 per year -- before any of the regular monthly sampling of payroll employment is added in. In the present economic downturn, a monthly net loss (with a requisite required net negative bias) of 75,000 jobs from the birth-death impact per month likely would be more appropriate. Such an estimate could be quite conservative, with the 1,800,000 annual swing suggested by the reversal of a 75,000 upside bias to a downside bias, most

likely topping 2.5 million. No one can tell for sure, since the numbers available from the BLS just are not that meaningful. Future benchmark revisions eventually should show a more realistic picture.

Although the published monthly biases are added to the unadjusted numbers, seasonal adjustments have been changed over time to move the monthly impact towards the average seasonally-adjusted 76,000 bias. Had this not happened, monthly changes would be more clearly skewed by the biases, as was evident during the early days of the Birth-Death Model's use.

Impact of Protracted Economic Contraction on Employment Reporting. As the severe economic contraction rolls into multiple years, various areas of reporting have been or will be affected that could be misinterpreted as signs of economic improvement or that might not be showing the full extent of deteriorating conditions.

- *Discouraged Workers.* Discouraged workers are those who meet all the qualifications for being unemployed, except they have not looked for work in the last four weeks, because there are no jobs to be had where they live. In 1994, this definition was amended to limit discouraged workers to only those who had looked for work in the last year (as opposed to no duration limitation in prior reporting). Accordingly, anyone who has been discouraged now for more than a year -- since June 2008 or before -- has disappeared from the rolls of the government's "alternative measures of labor underutilization." The SGS-Alternate Unemployment measure adds in an estimate for those no longer included in the government's broader reporting.

- *Ongoing Claims for Unemployment Insurance.* Benefits eventually expire, and while the numbers may gyrate with changing government programs, a decline in ongoing unemployment benefits is not an economic positive in the current circumstance. See the Opening Comments and the New Claims

section for detail on developing distortions in new claims for unemployment insurance.

- *Furloughed Workers.* As seen recently for many State of California employees, for example, an increasingly common circumstance is for employees to be forced to take off days without pay. Such does not impact payroll employment reporting, but it is measured in the broader unemployment measure, U.6, in the category of "total employed part time for economic reasons."

- *Year-to-Year Change.* As year-to-year numbers shift to assessment against collapsing economic numbers a year ago, year-to-year percent changes will start to show a pattern of plateauing at extremely negative levels. Such is not a sign of pending economic rebound so much as it is an artifact of protracted economic contraction.

- *Seasonal Adjustments.* The extreme economic disruption has altered a variety of traditional seasonal patterns, with a resulting cautionary note that seasonally-adjusted data may be skewed unusually, as seen recently with irregular auto production schedules. Year-to-year comparisons may help to mitigate such distortions, but not fully.

June Reporting Showed Minimal Revisions. The June employment/unemployment reporting showed minimal prior-period revisions, but it may have been subject to unusual seasonal-factor distortions, given the impact of the severe recession, the normal sharp swings in employment tied to the end of the school year, and the BLS's inability to adequately adjust for same.

- *Payroll Survey.* The BLS reported a statistically-significant, seasonally-adjusted jobs loss of 467,000 (down 459,000 net of revisions) +/- 129,000 (95% confidence interval) for June 2009, following a revised 322,000 (previously 345,000) jobs loss in May.

From peak-to-current (the peak month was December 2007; the current month of June also is the short-lived trough of the current cycle), payroll

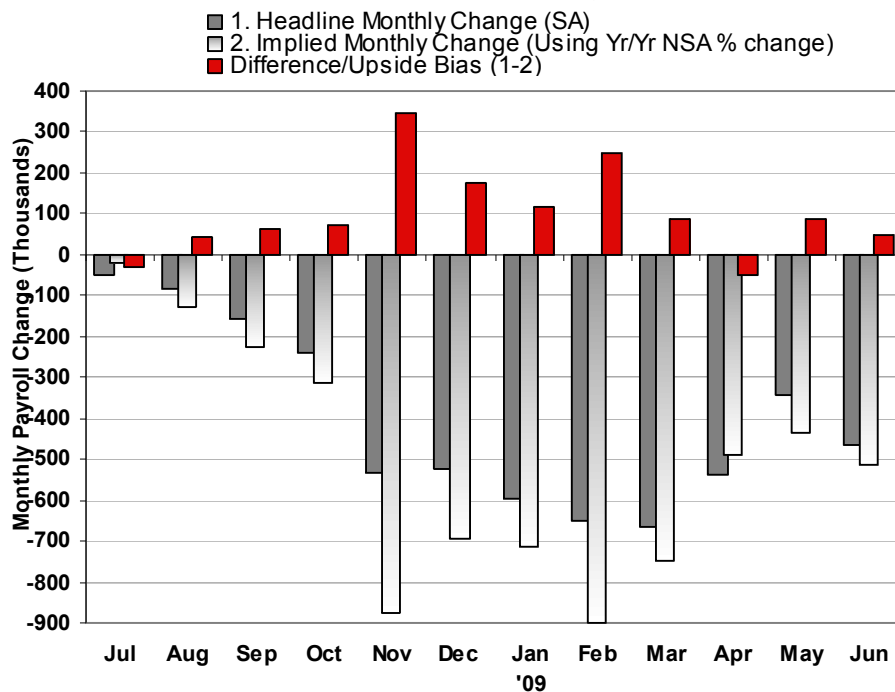
employment has declined by a seasonally-adjusted 6,460,000 jobs, or by 4.7%. Year-to-year contraction (unadjusted) in total nonfarm payrolls continued to deepen, down 4.22% in June versus a revised 3.96% (was 4.00%) in May. On a quarter-to-quarter basis, annualized contraction in payrolls was down 4.6% in the second quarter, versus an annualized 5.9% decline in the first quarter, not a meaningful improvement.

The unadjusted annual decline in June payrolls was the deepest since a similar decline at the trough of the 1958 recession, but still shy of the 4.9% trough seen in the 1949 downturn. When the 1949 annual low growth is broken, possibly next month, the annual percentage contraction in payrolls will be the most severe since the production shutdown following World War II.

- *Concurrent Seasonal Factor Bias*. The pattern of impossible biases being built into the headline monthly payroll employment continued, with an upside bias of 46,000 jobs in June 2009 reporting (see the accompanying graph). Instead of the headline jobs loss of 467,000, consistent application of seasonal-adjustment factors -- net of what I call the concurrent seasonal factor bias (CSFB) -- would have shown a more-severe monthly jobs loss of about 513,000. This pattern has generated an upside reporting bias seen in 10 of the last 12 months, with a rolling 12-month total upside headline-number bias of 1,210,000. A worksheet on this is available upon request. (See *SGS Newsletter No. 50*, for further background.)

Headline Employment Changes vs Implied & Bias

Sources: ShadowStats.com, BLS



- *Birth-Death/Bias Factor Adjustment*. As discussed in the prior Birth-Death Model section,

the biases from this process tend to overstate monthly jobs gains. Never designed to handle the

downside pressures from a recession, the model adds a fairly consistent upside bias to the payroll levels each year, currently averaging about 76,000 jobs per month. The unadjusted June 2009 bias was 185,000, up from 165,000 the year before, but down from 220,000 in May.

- *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 June employment fell by 374,000, after falling by a reported 437,000 in May. At work here continue to be poor quality seasonal adjustments.

The June 2009 seasonally-adjusted U.3 unemployment rate showed a statistically-insignificant increase, to 9.51% +/- 0.23%, from 9.36% in May. Unadjusted U.3 rose to 9.7% in June, from 9.1% in May. The broader June U.6 unemployment rate rose to an adjusted 16.5% (16.8% unadjusted), from 16.4% (15.9% unadjusted) in May. The less-than-proportionate seasonally-adjusted increase in the U.6 measure, versus the U.3 measure, again reflected seasonal factor distortions.

During the Clinton Administration, "discouraged workers" -- those who 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 long-term discouraged workers. Adding them back into the total unemployed -- unemployment in line with common experience -- as estimated by the SGS-Alternate Unemployment Measure, rose to about 20.6% in June, versus 20.5% in May. See the Alternative Reality section and the Alternate Data ab at www.shadowstats.com for graphs and more detail.

Next Release (August 7): The underlying fundamentals and better quality series suggest greater payroll contraction and a higher unemployment rate for July, versus June. Yet,

seasonal-factor distortions from collapsing economic activity may tend to mitigate those pressures misleadingly, as has been seen with new claims for unemployment insurance. At the moment, I caution about possible positive surprises to July reporting. The issue will be refined and addressed again before that data are released. Be particularly cautious if Administration or Fed officials begin touting an economic recovery the week before the employment release.

Gross Domestic Product (GDP) -- As discussed in the June 25th *Flash Update*, the "final estimate" revision to first-quarter 2009 gross domestic product (GDP) was no such thing. On July 31st, the Bureau of Economic Analysis (BEA) will revamp GDP history going back to 1929. The pending revisions are discussed below.

Less-Negative Inventory and Trade Changes Gave GDP Minimal Relative Boost. The BEA reported the "final" estimate revision of first-quarter 2009 GDP showed an annualized quarterly real (inflation-adjusted) contraction of 5.49% +/- 3% (95% confidence interval), narrowed minimally from the "preliminary" estimate of a 5.72% contraction and the "advance" estimate of a 6.14% contraction. Year-to-year change revised to a decline of 2.45%, from the "preliminary" 2.51% and the "advance" 2.62% contractions. The latest first-quarter contraction rate followed a reported annualized decline of 6.34% in fourth-quarter 2008 and a 0.51% contraction in the third quarter. In terms of year-to-year change, the fourth-quarter saw a contraction of 0.84%, following a gain of 0.75% in the third quarter. The first quarter's annual contraction was the deepest since the third quarter of 1982, while the third-consecutive quarterly contraction was the longest string of consecutive quarterly declines since the 1973 to 1975 recession.

The minimal revisions to the data included another increase (less-negative change) in business inventories. Higher than expected inventories often are unwanted and usually lead to production cutbacks and lower future GDP growth, although,

once again, the changes and revisions here were not that large. Also the net export account was less negative in revision, despite recent trade data revisions that showed a weaker, not stronger, trade circumstance. Recent downside revisions to key indicators of economic activity generally should be reflected in the upcoming benchmark revisions.

The first-quarter GDP inflation rate (GDP deflator) eased back, again, in revision to an annualized 2.77%, from the "preliminary" 2.80% and the 2.85% in initial reporting. Such contrasted with a 0.61% increase in the fourth quarter and a 3.88% inflation rate in the third quarter.

Based on removal of the effects of some reporting gimmicks and unfortunate methodological changes of recent decades, the SGS-Alternate GDP estimate for first-quarter 2009 is for an annual (not annualized) contraction of roughly 5.1% versus a 4.1% contraction in the fourth quarter, against official respective annual estimated declines of 2.5% and 0.8%. Against reporting of underlying economic series, the annualized quarterly contraction likely was in excess of 8% for the first quarter. Nonetheless, GDP reporting remains virtually worthless and is little more than political propaganda. See the Alternative Realities section and the Alternate Data tab at www.shadowstats.com for graphs and more detail.

Nominal GDP Also Showed Minor Upside Revision. The annualized decline in nominal GDP -- GDP not adjusted for inflation, reflective of the way companies book actual sales volume -- revised to 2.87%, versus the "preliminary" 3.08% and "advance" 3.47% declines. Such followed a 5.77% annualized contraction in the fourth quarter (the relative improvement reflected higher inflation -- see deflator comments above). As noted in prior commentary, for the first time since the severe impact of a steel strike in 1957 and 1958, nominal GDP declined quarter-to-quarter for a second consecutive quarter. Year-to-year change in nominal GDP turned negative in the first quarter, down a revised 0.38%, versus earlier estimated contractions of 0.43% (preliminary) and 0.53%

(advance). This was the first annual contraction since second-quarter 1958. Annual growth in fourth-quarter 2008 was a positive 1.21%.

GDP-Like Measures Revised. Estimates of the BEA's GDP-like measures for first-quarter 2009, Gross National Product (GNP) and Gross Domestic Income (GDI), also were revised. GNP is the broadest measure of U.S. economic activity (GNP is GDP plus trade in factor income, or interest and dividend payments). First-quarter GNP was reported showing a revised annualized real quarterly contraction of 5.62% (was 5.72%), still deepening slightly versus the fourth-quarter estimate of a 5.59% contraction. Year-to-year, first-quarter GNP declined by a revised 2.38% (was 2.42%), versus a 0.93% contraction in the fourth quarter.

GDI is the income-side equivalent of the GDP's consumption estimate. As estimated in last month's reporting, reflecting a sharp reversal in "statistical discrepancy," first-quarter GDI was reported showing an annualized real quarterly contraction of 3.64%, versus a fourth-quarter estimated contraction of 7.78%. Today's reporting and revision reflected something of a reversal in other trends, showing a deeper 4.31% annualized quarterly contraction in the first quarter. Year-to-year, first-quarter GDI declined by 3.11% (previously down 2.94%), versus a 2.16% contraction in the fourth quarter.

Pending Grand-Benchmark Revisions of Gross Domestic Product and National Income Accounts. A number of changes loom in the grand-benchmark revisions of the national income accounts, due for release on July 31st, along with the "advance" estimate of second-quarter 2009 GDP growth.

Beyond restating the inflation-adjusted numbers for a base year of 2005, instead of 2000, and beyond renaming the three GDP estimates "advance," "second" and "third," instead of "advance," "preliminary" and "final," there will be significant revisions to previously reported economic activity.

The revisions will come from both better information (benchmark revisions to key series such as retail sales, industrial production and the trade balance) as well as new methodologies intended to improve reporting quality.

Generally, weaker than previously reported relative economic activity should surface in the "corrected" data, showing declining quarterly real GDP that is more coincident with the official recession call by the National Bureau of Economic Research (NBER), which dates the onset of the downturn to December 2007. At present, reported GDP began contracting in third-quarter 2008.

The level of the GDP in 2002 should be upped by about 2%, based on already-announced revisions, but again, the relative annual and quarterly changes in the last several years should be weaker than previously reported. Assuming historical benchmarking patterns are repeated, otherwise, the methodological changes will tend to increase the relative strength and size of earlier historical GDP data back to 1929.

Of particular interest is the nature and impact of changes being made to the measurement of prices affecting GDP. Separately, if changes to income accounting perform as advertised, then the large statistical discrepancy between the GDP and GDI should narrow sharply. We shall see. Rather than getting into the minutiae of the changes now, I'll cover them as they impact GDP reporting, in a special report that will follow as soon after the benchmark revisions as practicable.

Next Release (July 31): Underlying economic fundamentals suggest that the pending second-quarter GDP will reflect a narrower quarterly contraction, but a deeper annual contraction, than will be reported for the revised first-quarter estimate. Generally, with revisions, the recession should appear to have been more serious than previously indicated, and the recession should become demonstrably the most severe economic downturn of the post-World War II era.

Consumer Price Index (CPI) -- As discussed in the July 15th *Flash Update*, the slight upside reporting surprise (0.7% gain versus 0.6% consensus per Briefing.com) in the June CPI was not enough to reverse the slide in the declining year-to-year change in the CPI-U, but it slowed it. There were quirks in the reporting. The downward trend in the annual decline in the Chain-Weighted CPI-U (C-CPI-U) actually reversed, so that the C-CPI-U now shows less-negative annual inflation than the CPI-U. Also, unusual distortions in the monthly seasonal adjustments suggest the seasonally-adjusted CPI-U should have risen by 0.8% instead of the reported 0.7%.

Irrespective of unusual number crunching in the latest reporting, ongoing shifts in oil prices promise higher reported inflation in the months ahead. While rebounding oil prices have pulled back some in July, and gasoline prices have backed off their late-June highs, such also happened last year. Oil hit a record-high closing price of \$145.66 on July 11, 2008 (West Texas Intermediate spot closing price), and the ensuing price collapse has muted inflation reporting ever since. Although oil is off its recent near-term highs, it likely does not face the relative magnitude of losses seen in the last half of 2008. With heavy selling pressure on the U.S. dollar still in the offing, a general upside pressure on dollar-denominated oil prices also should be seen in the months ahead. As a result, stronger relative year-to-year performance in oil prices and related energy costs would tend to spike year-to-year inflation measures. Where the regular seasonal adjustments that have reduced the impact of rising gasoline prices in recent months largely washed out in June, they will spike monthly inflation in the next several months, even in the absence of significant gasoline price increases.

CPI-U. The Bureau of Labor Statistics (BLS) reported this morning (July 15th) that the seasonally-adjusted June CPI-U (Consumer Price Index for All Urban Consumers) (I.7) rose by 0.74% (up by 0.86% unadjusted) +/- 0.12% (95% confidence interval not seasonally adjusted) for the

month, versus a gain of 0.10% (up by 0.29% unadjusted) in May. Unadjusted year-to-year inflation declined further (formal deflation), down by 1.43% +/- 0.20% (95% confidence interval) in June, versus a 1.28% contraction in May. Seasonally-adjusted, annualized, quarter-to-quarter change in the CPI-U rose to 3.3% in the second quarter, from 2.2% in the first quarter. The annualized seasonally-adjusted inflation rate for the month-to-month gain in June was 9.3%.

The reported June CPI-U year-to-year decline was largest since January 1950. I estimate, however, that CPI reporting methods used in 1950 would generate a reported current inflation rate of roughly 6% (see Alternate Consumer Inflation Measures below).

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 July 2009 reporting, dependent on the seasonally-adjusted monthly change, versus the 0.72% adjusted monthly increase seen in July 2008. I use the adjusted change here, since that is how consensus expectations are expressed. The difference in growth would directly add to or subtract from June's annual inflation rate of negative 1.43%. Annual CPI-U should be near or at its trough for the current cycle, with accelerating upticks in annual inflation likely starting in the next month or two.

CPI-W. The BLS reported that the narrower, seasonally-adjusted June CPI-W (CPI for Urban Wage Earners and Clerical Workers) (I.8) rose by 0.92% (1.05% unadjusted), following a 0.13% (0.41% unadjusted) increase in May. Year-to-year, CPI-W inflation declined by 1.98% in June, following a 1.89% decline in May.

C-CPI-U. Year-to-year or annual inflation for the Chain Weighted CPI-U (I.7) -- the fully

substitution-based series that gets touted by CPI opponents and inflation apologists as the replacement for the CPI-U -- fell by 1.26% in June, versus a 1.38% decline in May. The narrowing of the annual negative inflation rate and a less-negative annual inflation rate than shown in the CPI-U suggest reporting problems within the various CPI series.

Alternative Consumer Inflation Measures.

Adjusted to pre-Clinton (1990) methodology (I.9), annual CPI growth eased to roughly 1.9% in June versus 2.0% in May, while the SGS-Alternate Consumer Inflation Measure (I.10), which reverses gimmicked changes to official CPI reporting methodologies back to 1980, held even or softened slightly at about 6.1% (6.05% for those using the extra digit), versus 6.1% (6.15% with a rounding difference to the first decimal point) in May. See the Alternative Reality section, and the Alternate Data tab and Inflation Calculator at www.shadowstats.com, for graphs and data. The alternative numbers are not adjusted for any near-term manipulations of the data.

The SGS-Alternate Consumer Inflation Measure adjusts on an additive basis for the cumulative impact on the annual inflation rate of various methodological changes made by the BLS. Over the decades, the BLS has altered the meaning of the CPI from being a measure of the cost of living needed to maintain a constant standard of living, to something that no longer reflects the constant-standard-of-living concept. Roughly five percentage points of the additive SGS adjustment reflect the BLS's formal estimate of the impact of methodological changes; roughly two percentage points reflect changes by the BLS, where estimated impact has not been published by the BLS.

Next Release (August 14): Given the sharp reversal in seasonal factors that now will spike energy inflation sharply, and given rising relative year-to-year comparisons against last year's collapsing oil prices, July CPI inflation and monthly inflation the next several months likely will offer upside

surprises to consensus expectations. Longer-range impact from likely intensified dollar weakness, a likely continued upswing in oil prices and rising broad money growth should tend to generate upside CPI pressures well into 2010.

Annual inflation would increase or decrease in July 2009 reporting, dependent on the seasonally-

adjusted monthly change, versus the 0.72% adjusted monthly increase seen in July 2008. The difference in growth would directly add to or subtract from March's annual inflation rate of negative 0.38%.

Other Troubled Key Series

Federal Deficit. As discussed in the Opening Comments and in the July 14th *Flash Update*, the pace of growth in both federal debt and the gimmicked federal deficit has continued to accelerate, with prospects for both remaining bleak. Rapidly increasing market reluctance to hold U.S. Treasuries eventually will pummel the U.S. dollar and force heavy Fed monetization (overt or covert) of the Treasury's soaring obligations, along with dire consequences for broad money growth and domestic inflation.

On the deficit front, the recession continued to take its toll on federal tax revenues, which were down by 17.1% in June 2009 versus June 2008, following a 5.7% annual contraction for May. For the nine months fiscal year-to-date, revenues for 2009 were down by 17.9% from the year before.

Understated by accounting gimmicks used to mute the impact of the banking bailout program, the 12-month moving deficit through June 2009 was \$1,255.2 billion, versus \$1,127.3 billion in May and \$1,103.6 billion in April. Those numbers contrasted with 12-month rolling deficits for June, May and April 2008, respectively, of \$309.2 billion, \$332.5 billion and \$334.2 billion.

Accounting changes introduced in April reduced the reporting of outlays for the government's banking bailout program and continue on an ongoing basis. Before restatement for the new accounting gimmicks, April's 12-month moving

deficit was \$1,278.6 billion, instead of the now-estimated \$1,103.6 billion.

Viewing the change in the level of gross federal debt bypasses most of the regular reporting manipulations of the government's financial results and provides a better indicator of actual net cash outlays by the federal government than is the official, gimmicked deficit reporting. Gross federal debt stood at \$11.545 trillion as of June 30, 2009, up by \$224 billion for the month, and up by \$2,053 billion from June 2008, which in turn was up by \$634 billion from June 2007. Gross federal debt stood at \$11.322 trillion as of May 31, 2009, up by \$83 billion for the month, and up by \$1,933 billion from May 2008, which in turn was up by \$560 billion from May 2007. As of the end of September 2008, the close of the government's last 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.

Fiscal stresses are going to remain severe in the next several years, given the Obama Administration's budget and economic stimulus package boosts to government outlays, and given the sharp hit on tax receipts from the continuing, severe recession.

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 2009 official budget deficit easily should top \$2 trillion, with commensurate funding in excess of that required by the U.S. Treasury.

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. The 2009 GAAP-Based deficit likely will top \$9 trillion (more than 60% of annual U.S. GDP).

Initial Claims for Unemployment Insurance --

As discussed in the Opening Comments under depression-related distortions to economic data, initial claims for unemployment insurance having taken a heavy hit in recent weeks, due to unusual seasonal factor distortions. First was the regular disruptive impact of the July 4th holiday, for which the Department of Labor (DOL) has not been able to adjust adequately in its seasonal factors. The second problem was reported by Jeannine Aversa of the Associated Press on July 16th ("Jobless claims drop, but clouded by auto shutdowns") and largely confirmed by a DOL spokesperson. There was a distortion in seasonal factors from the regular automotive industry shutdown for retooling production lines for the next year's models. With production schedules in a largely bankrupt industry not following regular patterns, the DOL reporting model dutifully knocked off a large number of new claims that usually would have arisen from the shutdown process.

A rising growth trend in new claims is an economic negative; a downside trend is an economic positive. On a smoothed basis for the 17 weeks ended July 11th, annual growth was 65.1%, down from 67.3% the prior week, and down from the recent peak growth rate of 77.0% in the May 9th week. A year ago (July 12, 2008) claims were up 19.3%.

While the series had been topping out near its historically worst level, the recent decline seems overdone and likely will be countered by some large catch-up swings in the month ahead. Of

significance, the problem time period encompassed the survey period for both the payroll and household employment surveys. Accordingly, the July employment data may have some unusually happy, but unwarranted, reporting.

Real Average Weekly Earnings -- Reflecting lower weekly hours and higher CPI-W inflation, June's seasonally-adjusted real earnings fell by 1.2% for the month, after being unchanged in May. Annual growth in June was 2.6%, versus 2.8% in May. Recent positive annual growth has been due to the annual collapse in gasoline prices and resulting negative year-to-year inflation.

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 a deepening structural recession/depression.

Retail Sales -- As discussed and graphed in the Opening Comments and as discussed in the July 14th and 15th *Flash Updates*, the Census Bureau reported seasonally-adjusted June retail sales with a borderline-statistically-significant monthly increase of 0.6% (0.65% to the second decimal point, 0.63% net of revisions) +/- 0.6% (95% confidence interval). Such followed a revised 0.47% (previously 0.46%) monthly gain in May. On a year-to-year basis, June retail sales fell by 8.99%, versus a revised 9.75% (previously 9.56%) plunge in May. With monthly volatility smoothed by a three-month moving average, the nominal (not-adjusted for inflation) June year-to-year contraction of 9.6% remained close to its nadir for post-World War II reporting.

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 0.26% (0.23% net of revisions in June, following a revised 0.04% (previously 0.15%) increase in May. Those numbers contrasted with the official aggregate gain of 0.65% in June and a gain of 0.47% in May.

Real Retail Sales. Inflation- and seasonally-adjusted June retail sales declined by 0.09% (up by 0.65% before inflation adjustment) for the month, versus a revised 0.37% (previously 0.36%) gain in May (up by 0.47% before inflation adjustment). Year-to-year, June real retail sales fell 7.89% (8.99% before inflation adjustment), versus a revised 8.83% (previously 8.63%) decline in May, which was a drop of 9.75% before inflation adjustment. In terms of annualized quarter-to-quarter real growth (the same basis as headline GDP reporting), second-quarter retail sales fell at a 3.0% pace, little changed from the first quarter's annualized contraction of 3.1%.

Smoothed for monthly volatility on a three-month moving-average basis, the June and May real annual declines were 8.73% and 9.13%, respectively. Since December 2008, annual decline in the moving average has held around 9%, a record low for the two historical retail series of the post-World War II era. The pattern here of annual growth leveling off at an historically low level is being repeated in other series, such as housing starts. Such reflects the effects of a protracted period of economic decline, not a turnaround in economic activity.

Next Release (August 13): Any increase reported for July retail sales, once again, should be due to inflation. Accordingly, look for continued month-to-month and year-to-year contractions net of inflation.

Industrial Production -- As discussed and graphed in the Opening Comments and detailed in the July 15th *Flash Update*, the Federal Reserve reported that seasonally-adjusted June industrial production fell by 0.4% for the month, after a revised 1.2% (previously 1.1%) decline in May.

Year-to-year contraction in activity deepened to 13.6% in June from the revised 13.5% (was 13.4%) tumble in May. Such set a new record low for annual production growth since the shutdown of war-time production that followed World War II.

With annual change down 13.6% and with a peak-to-trough (June is the short-lived current trough) contraction at 15.1%, the industrial sector of the economy (including manufacturing, mining and utilities) continued in depression. A depression is defined (SGS) as a recession where the peak-to-trough economic contraction exceeds 10%. In terms of annualized quarter-to-quarter growth (the same basis as headline GDP reporting), second-quarter industrial production fell by 11.6%, a narrower pace of decline than the first quarter's annualized contraction of 19.1%, but still within formal depression territory.

As previously noted, since the index of industrial production was introduced in 1919, there have been four down cycles worse than what has been seen so far in the current downturn. In each instance, the trough reflected an annual decline somewhat in excess of 30%. Those four cycles were: (1) the post-war production shut-down following World War II; (2) and (3) the double dip of the Great Depression; (4) the post-World War I and post-Panama Canal production shutdowns in the early 1920s.

Next Release (August 14): July production may be spiked by poor-quality seasonal factors, warped by auto industry disruptions. Unusually cool weather could tend to offset such distortions to a certain extent. Beyond near-term monthly volatility, annual growth should continue at or close to historic lows.

New Orders for Durable Goods -- As discussed in the June 25th *Flash Update*, the general pattern of downside revisions to prior reporting by the Census Bureau continued in May. The regularly-volatile new orders for durable goods rose by 1.8% (up 1.5% net of revisions) month-to-month in May. The May data followed a revised 1.8% (previously

1.9%) monthly increase in April. In terms of year-to-year change, before any accounting for inflation, May's new orders were down by 24.5%, following April's revised annual decline of 26.9% (previously 26.6%). Adjusted for inflation the series would have shown even sharper contractions. Year-to-year change in the series has been holding at a 25% decline, plus or minus a percent or two, since February, having pushed into great depression territory, per SGS definition of a greater than 25% peak-to-trough decline in economic activity.

The widely followed new orders for nondefense capital goods rebounded in May with a 10.0% (8.8% net of revisions) monthly gain, after falling by a revised 2.9% (was 2.0% in April). Year-to-year, May orders were down by 28.6%, versus a revised April annual decline of 36.2% (previously down by 35.5%).

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 July 10th *Flash Update*, the Census Bureau and Bureau of Economic Analysis reported that the seasonally-adjusted May trade deficit narrowed to \$26.0 billion from a revised \$28.8 (was \$29.2) billion in April. Exports picked up, while imports eased, despite rising oil prices. Stronger exports suggest strengthening economies abroad, while falling imports suggest weakening demand at home. At work here may be unusual disruptions to merchandise flows from the auto industry's reorganization. Also, as was seen in 2008 reporting, significant distortions from less than timely paperwork flows likely is affecting results, again. An import transaction is tallied as of the month that the paperwork makes it into the trade data reporting, not when the import actually occurs. While revisions are made regularly for one month back in time, last year's reporting showed significant lags (more than one month) that caused a large negative revision to 2008 reporting. The reported deficit narrowing should be a boost to the

initial reporting of the pending second-quarter GDP estimate.

Next Release (August 12): The June trade deficit should deteriorate, assuming oil imports reflect some catch-up in monthly paperwork flows.

Consumer Confidence -- Consumer confidence is easily swayed by the tone of the popular media towards the state of economy and the financial markets, and it has been highly volatile in recent reporting. Despite the recent happy spins put on a variety of economic stories, the June consumer confidence numbers were mixed. The Conference Board's June 2009 Consumer Confidence measure fell by 10.0% for the month, after a 34.3% jump in May. Year-to-year change for the three-month moving average was a decline of 15.7% versus a 34.4% decline in May.

The Reuters/University of Michigan's Consumer Sentiment measure, however, rose by 3.1% in June, following a 5.5% increase in May. Year-to-year change in the Sentiment three-month moving average was up by 14.3% in June, versus a 0.4% decline in May.

Keep in mind that annual comparisons here are against extremely weak readings the year before, tied to soaring gasoline prices. As renewed economic and inflation concerns get aired before the public, and as the stock market's luster fades anew, the confidence numbers are likely to tumble sharply, again, in the months ahead.

These lagging, not leading indicators still confirm that the economy has been in 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 -- As discussed and graphed (consumer credit) in the Opening Comments, annual contractions in both consumer credit and commercial borrowing have continued to deteriorate, reflecting both tight credit and increasingly impaired business conditions. Despite direct intervention as a lender in the commercial paper market, and supposed heavy jawboning of banks to lend to credit-worthy customers, the Fed's push to stimulate both commercial and consumer lending has not been able to turn year-to-year lending trends back into positive territory. Such also is reflected in the slowing broad money growth. Although often used as lagging indicators of economic activity, the various credit measures also have leading relationships to broad economic activity.

For seasonally-adjusted consumer credit outstanding, which includes credit cards and auto loans, but not mortgages, annual change was a 1.8% contraction in May, the weakest showing in the post-World War II period, except for a 1.9% annual contraction in November 1991. That earlier record-low growth likely will be broken with June's reporting. The annual contraction in consumer credit was a decline of 1.4% in April, following a minimal, less than 0.1%, contraction in March.

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, contracting annual growth in consumer debt is a severe drag on economic activity.

Annual contraction in commercial paper outstanding has continued to deepen, down 29.4%

in June, versus a 27.2% contraction in May and a 24.1% contraction in April.

Annual change in June commercial and industrial loans also has turned negative for the first time in this recession, down by 3.1% in June, following a 0.7% drop in May and a gain of 0.8% in April. Annual contraction in commercial lending not only tends to dampen broad business activity, but also signals a deepening economic downturn.

Producer Price Index (PPI) -- As discussed in the July 14th *Flash Update*, consistent with upturns in the June purchasing managers surveys' prices-paid indices, the June producer prices rose sharply for the month, while a pattern of softening gains and deepening declines in annual price changes reversed for the first time since last July. As reported by the BLS, the regularly-volatile, seasonally-adjusted producer price index (PPI) rose in June by 1.8% (1.9% before seasonal adjustment), following a gain of 0.2% (0.5% before seasonal adjustment) in May. The so-called "core" inflation rate -- net of food and energy costs -- also spiked, up by 0.5% for the month, versus a 0.1% contraction in May. Year-to-year, what had been an intensifying contraction in PPI inflation began to reverse, with June prices down by 4.6% from the year before, versus an annual decline of 5.0% in May.

On a monthly basis, seasonally-adjusted June intermediate goods rose by 1.9% (up by 0.3% in May), with crude goods up by 4.6% (up by 3.6% in May). The decline in year-to-year inflation held even or narrowed slightly, with June intermediate goods down by 12.5% (down by 12.5% in May) and June crude goods down by 40.0% (down by 41.1% in May).

Next Release (August 18): Despite some softening of oil prices in July, the July PPI still should see some further rebound. Over the next six-to-nine months, generally, early seasonal-factor reversals and then increasingly positive year-to-year changes should favor upside surprises in official reporting.

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 June 2009 manufacturing purchasing managers survey showed an uptrend, while still signaling recession. While the overall index rose to 44.8 in June from 42.8 in May, it held 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 series 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. (Consider that the GDP did not show its first contraction until third-quarter 2008, where the NBER timed the recession from December 2007.) 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 (a.k.a. recession).

That said, the June new orders index rebounded to 49.2, from 46.5 in May. New orders have been in actual contraction (below 50.0) 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 June new orders index rose by 2.2%, following a 1.8% decline in May.

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 was 36.5 in June, up from 32.3 in May, still deep in recession territory, as counted by the ISM.

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 June 2009 purchasing managers non-manufacturing (or services) composite index rose to 47.0, from 44.0 in May.

Both the services employment and prices paid components, however, have some meaning. Covering the real estate and banking industries, among others, the June employment component rose to 39.8 from 36.1 in May. The surging 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 June 30th *Flash Update*, May newspaper help-wanted advertising (Conference Board) returned to its record-low reading of 10, following an upside revision from 10 to 11 in the April index (March remained at its 58-year low reading of 10). May was down by 42.6% year-to-year change on a three-month moving average basis, with the revised annual decline in for April at 43.1%.

Despite some of the historic weakness in the newspaper series being due to the loss of ads to the Internet, and despite its looming abandonment by the Conference Board, the newspaper index 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 nascent online surveys are telling a similar story.

Indeed, a similar annual fall-off pattern was seen again in the Conference Board's online help-wanted advertising measure for June, down 36.5% year-to-year, versus a 36.6% annual decline in new online help-wanted ads in May.

Housing Starts -- As discussed in the Opening Comments, and as graphed there net of the New York City paperwork distortions in year-ago June 2008 data, the Census Bureau reported that seasonally-adjusted June housing starts rose by 3.6% (up 9.4% net of revisions) +/- 13.6% (95% confidence interval) month-to-month and fell by 46.0% year-to-year (such is closer to a 40.1% decline, adjusting for the inconsistent numbers published in June 2008). Such contrasted with May's revised monthly decline of 17.3% (previously 14.4%) and annual contraction of

42.1% (previously 45.2%). The current 44.8% pace of annual contraction on a three-month moving-average basis is down from 47.3%, and reflects some bottom bouncing along a plateau of historically-low growth.

Seasonally-adjusted June building permits rose by 3.6% for the month +/- 4.8% (95% confidence interval) for the month, following May's unrevised 4.0% gain. Permits fell by 52.0% year-to-year in June (down roughly 42.4% net of the distortions in June 2008 reporting), after an annual drop of 47.0% in May.

As discussed in the June 25th *Flash Update*, weakness in May home sales paralleled activity with housing starts. The Census Bureau and HUD reported May new home sales down by a statistically insignificant 0.6% (down by 2.8% net of revisions) +/- 21% (95% confidence interval) for the month, following a revised 2.7% (previously 0.3%) increase in April. May homes sales declined by 32.8% year-to-year, following a revised 35.5% (previously 34.0%) decline in April.

The National Association of Realtors (NAR) estimated that 33% of existing home sales in May (down from 45% in April and down from somewhat more than 50% in March) were distressed (in foreclosure). Such still makes the reported 2.4% monthly gain and 3.6% annual decline in the May sales difficult to assess related to underlying economic activity. There is no easy way to estimate what portion of the foreclosed properties would have otherwise translated into normal home sales, had the forced sales not been present in the market. Safely, the net annual pace of decline would have been much steeper. The NAR also noted a significant problem with pending home sales not closing, due to appraisals coming in too low to support needed financing.

Inflation Indicators

Money Supply -- As suggested in the July 10th *Flash Update*, and as discussed and graphed in the Opening Comments, the annual growth in the monthly average SGS-Ongoing M3 Estimate slowed anew in June, though monthly change appears to have remained minimally positive. Year-to-year growth in June was about 6.4%, down from 7.1% in May, which was higher than the 6.8% seen in April. On a seasonally-adjusted monthly basis, M3 was estimated to have notched higher by 0.1%, after a 1.1% gain in May.

In the narrower monetary aggregates, annual growth in June M1 rose to a record (highest in modern reporting since 1959) 18.4%, from 15.4% in May. Such likely reflected the intensification of the systemic solvency crisis and some flight to cash. Month-to-month, seasonally-adjusted M1 rose by 3.3%, following a 0.2% increase in May.

As an aside, in response to numerous questions arising from articles on the Internet, the monetary base is not part of M1 and can exceed M1 in size, as it has recently. The monetary base includes currency, which is part of M1, and bank reserves. Required reserves reflect a portion of depository accounts, but the extreme level of excess reserves has no relationship to depository accounts and is the reason for the monetary base's unusually large size relative to M1. Sweeps of M1 accounts are included in components of M3.

Annual growth in June M2 rose to 9.0%, from 8.8% in May. Month-to-month, seasonally-adjusted M2 rose by 0.3%, following a 0.8% increase in May.

The series went through massive revisions by the Federal Reserve, again, in the most recent month, but the general patterns of seasonally-adjusted money growth remain intact.

Per the Opening Comments, despite recent, extreme systemic liquefaction by the Fed, annual broad money growth has not picked-up. Broad money would be expected to rise sharply,

particularly if Federal Reserve monetization of Treasury debt were to increase sharply, as is likely.

Once accelerating, annual M3 growth in the months ahead easily could overtake the historic strong growth seen early in 2008. Prior to the recent peak annual growth of 17.4% seen in March 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 well 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 2010.

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 indices in the June manufacturing and nonmanufacturing surveys both broke out of deflationary readings.

On the manufacturing side, the June prices-paid index rose to 50.0 (a reading below 50.0 indicates contraction) from 43.5 in May. On a three-month

moving average basis, June's year-to-year change was a decline of 52.3% versus a 58.2% drop in May. 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 June prices diffusion index jumped to 53.7, from 46.9 in May. On a three-month moving-average basis, June's annual decline was 38.8%, versus a decline of 42.4% in May.

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 generally have trended higher in recent months, despite some pullback in July. Where the collapse in oil prices since last July was the primary factor behind the slowdown in reported annual CPI inflation, the recent bottoming and rebound of oil prices appears to triggered some bottoming in the annual CPI inflation rate.

West Texas Intermediate (WTI) spot price closed at \$63.56 per barrel on July 17th, which was up by 104.5% from its recent low close of \$30.81 on December 22, 2008. The latest spot price, however, still is down by 56.4% since the record-high closing price of \$145.66 seen just over one year ago, on July 11, 2008.

June's monthly average spot price for WTI (St. Louis Fed) was \$69.68 per barrel, up 17.8% from May's \$59.16. The June average was down 48.0% from the record high monthly average of \$133.93 the year before. For May 2009, the year-to-year change in price level was a decline of 52.8%.

Higher oil prices have been reflected in an upturn in retail gasoline prices, which has stalled in July. 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.

Oil prices remain highly volatile and sensitive to minor surprises. While sharp declines in U.S. and global economic activity have reduced oil demand, OPEC activities have been and likely will continue to be aimed at offsetting such, with production cuts or enforcement of same. Also adding upside pressure to prices are intensifying Middle East political tensions, and other supply and demand risks/issues. Of greatest long-term impact, however, remains the U.S. dollar, where oil is denominated in same. As discussed previously and as reiterated the Opening Comments, Mr. Bernanke's efforts at debasing the U.S. dollar likely eventually will fuel massive selling of the dollar in the currency markets. At such time as heavy dollar selling intensifies -- and that is just a matter of time -- look for oil prices to spike further, moving back well above the \$90 per barrel level, and significantly rekindling oil-price related inflation concerns.