

John Williams'

Shadow Government Statistics

Analysis Behind and Beyond Government Economic Reporting

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**Bernanke Orders Helicopter Deployment
As Fed Lending to Banks Tops Pre-1933 Bank Holiday**

Inflationary Recession Continues to Intensify

Weak Economy Does Not Mean Lower Gold Prices

Perils of Trying to Mimic Bad Government Data

OVERVIEW -- OPENING COMMENTS

Fed Saves the System -- Almost

But for systemic intervention and manipulations by the Federal Reserve, it appears we might be contemplating a collapsed U.S. banking system and a looming deflationary great depression that could have dwarfed the bad times of the 1930s. Such is the good news. The bad news is that with those same systemic interventions, the Fed is locking in a hyperinflationary great depression in the decade ahead, with the turmoil possibly breaking by 2010 or earlier.

I have contended for some time that the Fed will do everything in its power -- create whatever money/liquidity is necessary -- to prevent any portion of the financial system from collapsing. The Fed cannot allow any sector to fail, given

the heavy interrelationships and leverage built upon leverage within the broad U.S. financial markets and industry. Failure in one area quickly would implode the entire system.

The crisis containment process still is unfolding. For example, some current market concerns center on how or whether bailouts might be worked for major credit insurers. Despite market

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uncertainties, the Fed has little choice but to back the credit insurers with some form of overt or covert action, such as a hold-harmless arrangement with a major investor, absent viable independent investors/backers. The alternative of letting the major credit insurers fail or suffer significant ratings downgrades would place the stability of the already shaky banking system at risk.

Systemic vulnerabilities involving financial concerns outside the United States and other central banks only complicate the circumstance. No one has been through a crisis of the current magnitude for three-quarters of a century. Coming into the Great Depression the United States was on the gold standard and enjoyed fiscal and trade surpluses, which offered some meaningful policy options to the government. Today's environment has had the meaningful options fully depleted, leaving only gimmicks and the government's ability to print money.

Helicopter Ben Keeps the Banking System

Afloat. Federal Reserve Chairman Ben Bernanke picked up his various helicopter nicknames and references as the result of a November 21, 2002 speech he gave as a Fed Governor to the National Economists Club entitled "Deflation: Making Sure 'It' Doesn't Happen Here." The phrase that the now-Fed Chairman Bernanke likely wishes he had not used was a reference to "Milton Friedman's famous 'helicopter drop' of money."

What caused the deflation of the 1930s was the insolvency and collapse of the U.S. banking system, with a resulting implosion in the money supply. Attempting to counter concerns of another Great Depression-style deflation, Bernanke explained in his remarks: "I am confident that the Fed would take whatever means necessary to prevent significant deflation in the United States ..." As a quick point of clarification, Mr. Bernanke's current actions still are in the preventative phase. The money supply is not in collapse, and the Fed has not started dropping cash

from helicopters, yet, but the choppers are in the air and at the ready.

For anyone interested, the full text of then-Fed Governor Bernanke's remarks can be found at: <http://federalreserve.gov/boarddocs/speeches/2002/20021121/default.htm>. A sampling of other comments from Bernanke's pro-inflation remarks are included here as general background and will be discussed further detail in the upcoming *Hyperinflation Special Issue*:

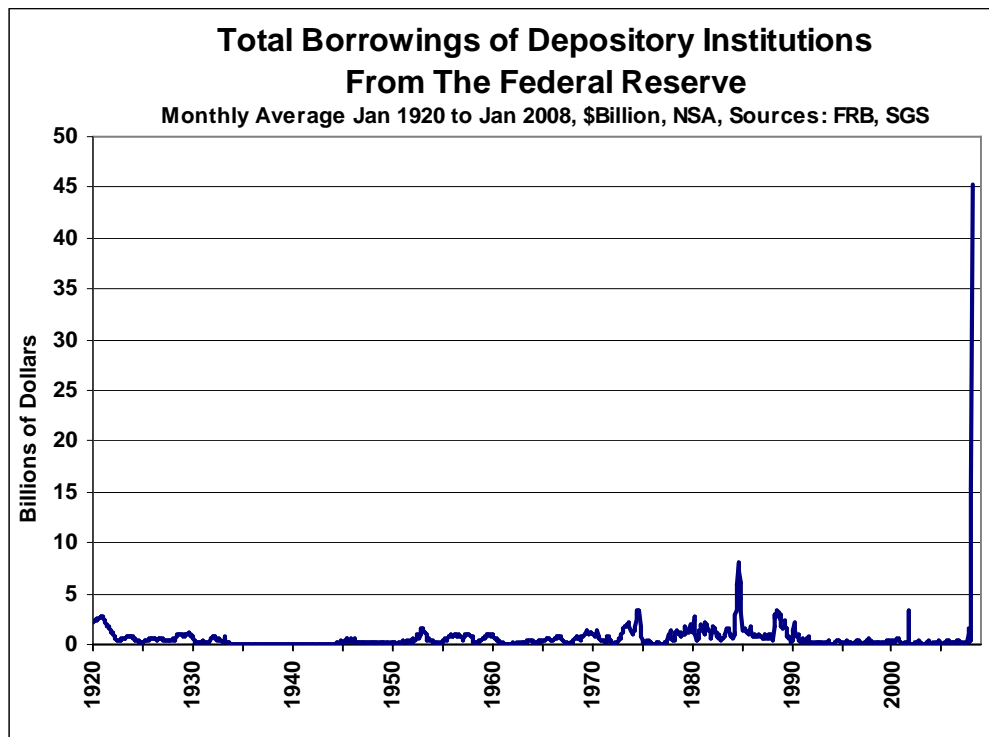
"Indeed, under a fiat (that is, paper) money system, a government (in practice, the central bank in cooperation with other agencies) should always be able to generate increased nominal spending and inflation, even when the short-term nominal interest rate is at zero."

"Like gold, U.S. dollars have value only to the extent that they are strictly limited in supply. But the U.S. government has a technology, called a printing press (or, today, its electronic equivalent), that allows it to produce as many U.S. dollars as it wishes at essentially no cost. By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so, the U.S. government can also reduce the value of a dollar in terms of goods and services, which is equivalent to raising the prices in dollars of those goods and services. We conclude that, under a paper-money system, a determined government can always generate higher spending and hence positive inflation."

Nonborrowed Reserves Turn Negative. Official fluff aside, the Federal Reserve's primary mission in recent decades has been and continues to be the solvency of the U.S. banking system. Economic growth and inflation containment are secondary concerns for the U.S. central bank, but they remain the factors put forth for public and financial-market consumption to help justify the Fed's activities and remain the topics around which Wall Street, White House and Federal Reserve spinmeisters weave their yarns.

As discussed in the February 5th *Flash Update*, nonborrowed reserves of U.S. depository institutions have turned negative for the first time since before the Great Depression (see Federal Reserve Statistical Release H.3 *Aggregate Reserves of Depository Institutions and the Monetary Base*). In January 2008, the U.S. banking system met its reserves only by borrowing an amount in excess of 100% of total reserves from the U.S. central bank. In December

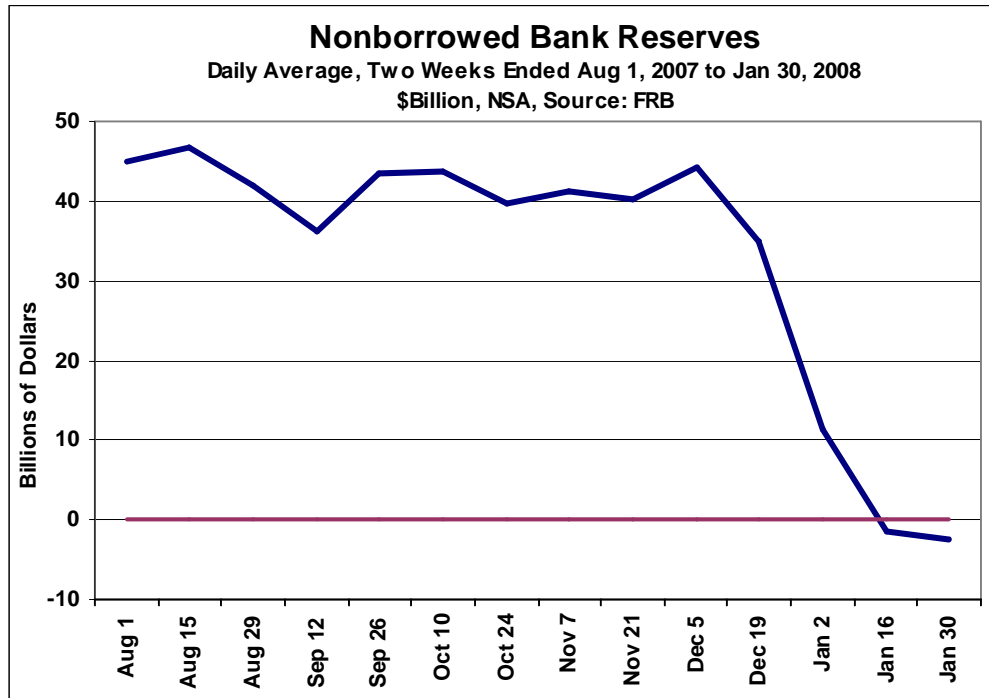
2007, total borrowings from the Fed topped 36% of total reserves, then the highest proportion seen since 46% in March 1933, when President Franklin Roosevelt declared a "bank holiday" and closed the banks. The ratio shown in the accompanying graph has been calculated using the historical depository institution borrowings and total reserve data available from the St. Louis Federal Reserve's database.



While the banking system remains intact, the crisis is far from over, and there is a price that will be paid for the Fed's activities in the not too distant future. Current Fed actions and the precedents being set are locking in an eventual hyperinflationary depression, as will be discussed later in the newsletter and the pending *Hyperinflation Special Report*.

Mr. Bernanke has vowed that the mistakes made by the Federal Reserve in the 1930s, whereby the banking system and the money supply collapsed

into a deepening, deflationary Great Depression, would not be repeated. The latest data on bank reserves suggest that something along the lines of an attempted non-repeat of 1933 is underway. Faced with a devil's choice, the Fed has acted in the last several months with a series of emergency actions to hold the banking system together and to prevent a debilitating implosion in the money supply. As suggested by Mr. Bernanke's current actions, the Fed appears ready to create whatever money is needed to prevent a collapse of any portion of the financial system.



Bank reserves deposited with the Federal Reserve and held in vault cash are the fractional backing for transactional bank deposits and, along with currency in circulation, form the base for the money supply. On a daily basis, depository institutions, such as banks, have to have adequate reserves on deposit with a Federal Reserve Bank. When one bank has excess reserves on deposit with the Fed, it usually will lend those funds overnight to a bank that is shy the requisite reserves. Such is the fed funds market, and the interest rate at which overnight funds are lent is the highly publicized fed funds rate that currently is targeted by the Federal Reserve's policy makers on the Federal Open Market Committee (FOMC).

If a bank is troubled -- such as having solvency issues -- and other banks are not willing to lend it reserves, the problem bank can go to the Federal Reserve's discount window and borrow the needed reserves, usually pledging high quality assets as collateral. The discount window's new Term Auction Facility (TAF), established in December, is a "temporary" term -- as opposed to overnight -- facility, and accepts a broad range of collateral, including mortgage backed securities.

Non-borrowed reserves simply are total reserves less total borrowings of depository institutions from the Fed, and those borrowings now exceed total reserves.

While there are a number of factors involved in the reporting of negative nonborrowed reserves, one has to wonder how functional the U.S. banking system would be at present without the TAF. The Fed described the TAF facility in its December 12th pronouncement as helping to "promote the efficient dissemination of liquidity when the unsecured interbank markets [fed funds] are under stress." In other words, the TAF was established because the fed funds market was not operating normally. As confirmed in its February 1st announcement, the Fed said it "intends to conduct biweekly TAF auctions as long as necessary to address elevated pressures in short-term funding markets."

The growing size of the TAF and recent extension of credit to smaller banks suggest that the solvency crisis for banks is spreading. In the February 1st announcement of two auctions (February 11th and 25th) totaling \$60 billion, the

Fed noted, "To facilitate participation by smaller institutions, the minimum bid size will be reduced to \$5 million, from \$10 million in the previous auctions."

Since the publication of the February 5th *Flash Update* on this topic, I have received a fair amount of communication from subscribers along with other commentaries published on the current circumstance. One prominent analyst suggested that there really was nothing wrong, just business as usual, but then went on to explain effectively how the system ceased functioning normally due to inter-bank solvency concerns, hence the set-up of the TAF. While TAF lending may supplant some Federal Reserve open market transactions and some inter-bank fed funds borrowing (areas not counted as borrowed reserves), those arenas continue to operate. Open market operations by the New York Fed do not appear to have changed radically. Without the TAF, however, the process of supplying banks with adequate short-term funding was and apparently remains dysfunctional, per the Fed's ongoing assessment.

The TAF seems to be working, at present. Reserve levels are where they are supposed to be, with fed funds trading reasonably close to target, but the underlying crisis that led to the emergency action also appears to be getting worse. How solvent the troubled banks are remains to be seen. With bank borrowings from the Fed exceeding total reserves, it suggests that the Fed's lending through its discount window is going beyond meeting reserve functions.

Recession Broke into the Open in 2007. While deterioration in the housing market and the current recession have been exacerbated by the liquidity/solvency crisis that surfaced in third-quarter 2007, the downturns were well underway before the Federal Reserve and the Administration began to panic, and well before consensus economists began talking about a recession possibility. Such is something of a traditional pattern, where broad recognition of recession generally does not follow until the

economic contraction has been underway for up to a year, and often where the recession onset can be blamed on some factor other than the real cause. Such was the case in 2001, when the September 11th terrorist attacks received initial blame for a recession that later was timed officially from March 2001. In like manner, the 1990/1991 recession supposedly began when Iraq invaded Kuwait.

Where the "1990/1991" recession was evident in the fourth-quarter 1989, and the "2001" recession was evident in third-quarter 2000, the current downturn was signaled in mid-2005 and evident in third-quarter 2006, although it is likely that the official beginning of the recession will be placed in late-2007. Another distortion common to recession reporting is that the downturn is declared over long before key data like employment and industrial production have begun to recover (see the Reporting/Market Focus of the October 2007 SGS newsletter). As a result, the current downturn really is little more than the second down-leg of a severe and protracted double-dip recession that began back in 2000. With neither traditional fiscal nor monetary stimulus available to help turn economic activity, the current circumstance is likely to evolve into a hyperinflationary depression (see December 2006 SGS and the pending *Hyperinflation Special Report*).

What has been at work here since before the 1990/1991 recession is the unfolding of a structural economic change. With the debilitating trade policies and trade deficits of recent decades savaging the domestic U.S. manufacturing base and relatively high-paying production jobs, the average U.S. family has found it increasingly difficult to make ends meet. With household incomes unable to keep up with inflation, families that once were supported by one wage earner now rely on multiple wage earners. Unless inflation-adjusted take-home pay sees sustained growth, there cannot be sustained economic growth. Temporary economic spikes can be generated through debt expansion or savings liquidation, but

those short-term measures -- encouraged by the Greenspan Fed -- largely have reached their limits.

With debt built upon debt and leverage built upon leverage, the current financial system is on the brink of implosion, but Mr. Bernanke is fighting hard to prevent any portion of the system from failing. He has the ability and willingness to create whatever amount of dollars is needed to bailout the system.

These actions, however, have moved the dollar towards the brink of the abyss. The extreme trade deficit suffered by the U.S. in recent decades has dumped excessive dollars on the rest of the world. Those holding the greenbacks, in turn, have provided massive liquidity to the U.S. financial markets, absorbing most of the net U.S. Treasury debt issuance of recent years. At risk with the eventual dumping of the dollar is the dumping of foreign held U.S. securities, which in turn would create a further, severe liquidity crisis in the U.S. markets, one the Fed likely would address by entering the markets and buying unwanted U.S. Treasuries. The dollar-selling trigger is at high risk of being pulled at any time, by a number of factors, including excessive accommodation by the Federal Reserve.

Hyperinflationary Depression. Also looming is the effective and ultimate bankruptcy of the U.S. government. With annual GAAP-based deficits running over \$4 trillion per year (see the December 2007 SGS Reporting/Market Focus), the government could raise taxes to 100% of wages, salaries and corporate profits, and it still would be in deficit. The current political machine in Washington keeps spending dollars it does not have and producing programs it cannot fund, in order to buy the support of a dumbed-down electorate. On the spending side, severe reductions are needed in Social Security and Medicare, but no one in power has the political courage to address the issues.

Rather than face outright bankruptcy and default on its obligations, the U.S. government likely will follow the precedent of other nations that have been faced with similar spending problems and rev up the currency printing presses, as described by Helicopter Ben. Such promises an eventual hyperinflation, where the largest bank note prior to the inflation (a \$100 bill for the United States) becomes worth more as functional wallpaper than as currency. While such a circumstance is likely within the next decade or so, Mr. Bernanke's current problems and limited options/solutions raise the risk of a hyperinflation as early as 2010. When it does hit, it likely will come quickly and with little warning. In conjunction with a deepening structural contraction the economy, such promises an eventual hyperinflationary depression.

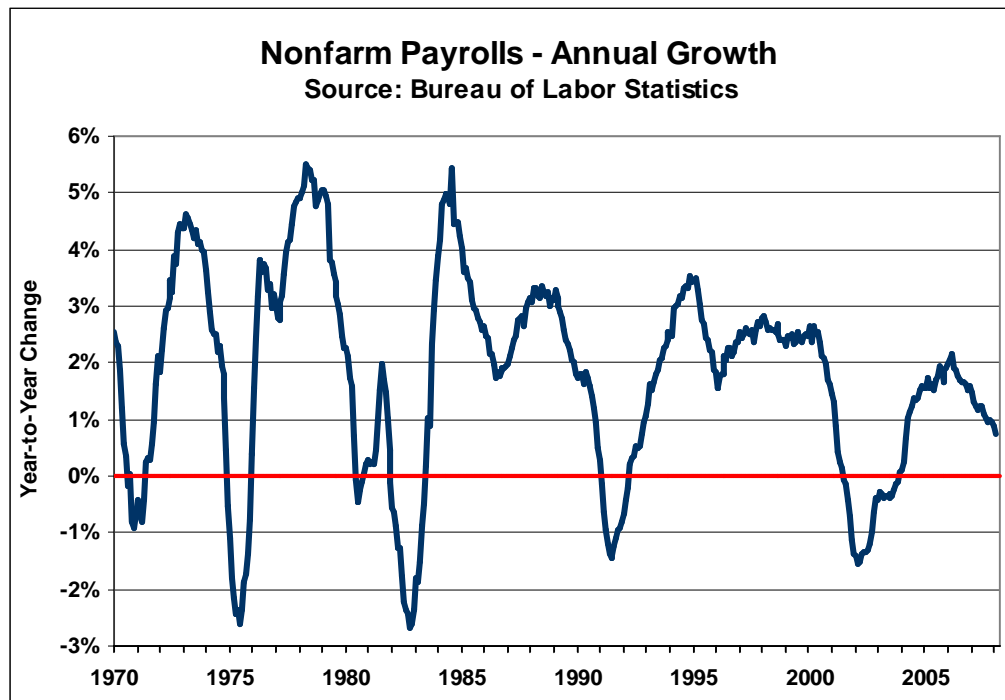
Current Data Already Show an Inflationary Recession. Nearly all key economic releases in the last month or so have confirmed or have been consistent with a deepening inflationary recession. Annualized fourth-quarter GDP growth, net of inflation, was statistically indistinguishable from a severe economic contraction. Inflation-adjusted December retail sales turned negative year-to-year, devastating an industry dependent on the holiday shopping season. Consumer conditions did not look promising in the tanking of annual change in consumer confidence, or in the continuing collapse of the housing data.

Fourth-quarter 2007 Industrial production showed an outright quarter-to-quarter contraction, while the highly volatile new orders for durable goods, after inflation adjustment, remained in year-to-year contraction on a six-month moving-average basis. The purchasing managers survey (old-style as per the table in the Purchasing Managers Survey section and the Reporting/Market Focus) signaled a second month of a contracting manufacturing sector.

In the employment sector, annual change in help-wanted advertising continued to collapse, new

claims for unemployment insurance soared, and both purchasing managers surveys showed declining employment. January payrolls contracted, but that likely was aimed at helping to justify the Fed's panicked rate cuts and could disappear with next month's revision. Nonetheless, the highly politicized payroll survey

suffered downward revisions, as expected, in its annual benchmark revisions (see Reporting/Market Focus). The updated annual growth in nonfarm payrolls is plotted in the accompany graph, and the current annual growth rate of 0.7% has never been seen in a downswing-phase outside of a recession.



On the inflation front, December CPI registered annual inflation of 4.1%, the highest December year-to-year inflation rate since 1990. Oil prices remain shy of \$100 per barrel but are extremely inflationary in the current \$90-plus per barrel trading environment. Further inflationary pressure is in the works as a result of recent dollar weakness, and dollar selling should intensify sharply.

Broad money growth, as measured by the SGS-Ongoing M3 estimate was 15.2% in January 2008. Other than the 15.4% growth seen in November 2007, current M3 growth is the highest since Nixon closed the gold window in August 1971. In a related area, the Bush Administration now projects a fiscal 2008 officially-gimmicked deficit of \$410 billion, up from \$163 billion in

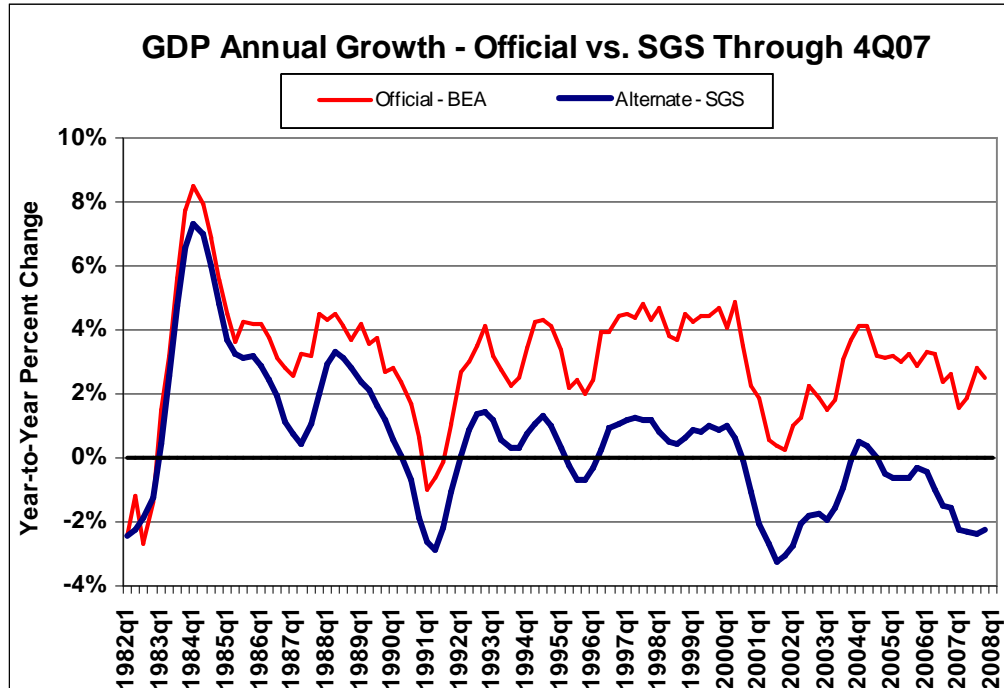
2007. That estimated widening assumes no recession, so the actual numbers, on the official basis, should be significantly worse.

Ongoing Market Instabilities. The current deteriorating economic fundamentals, combined with the still unfolding banking-system solvency/liquidity crisis create an unfortunate environment for the equity and credit markets. Stocks have entered what should prove to be a severe bear market. While the Fed's panicked accommodation of banks has lowered short-term rates, rising inflation fears and a looming flight from safety in the dollar offer upside risk to long-term interest rates. Indeed, risks remain high of significant and panicked dollar selling. These underlying fundamentals, however, all are heavily bullish for the gold market, irrespective of any

short-term central bank interventions in any of the markets.

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

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



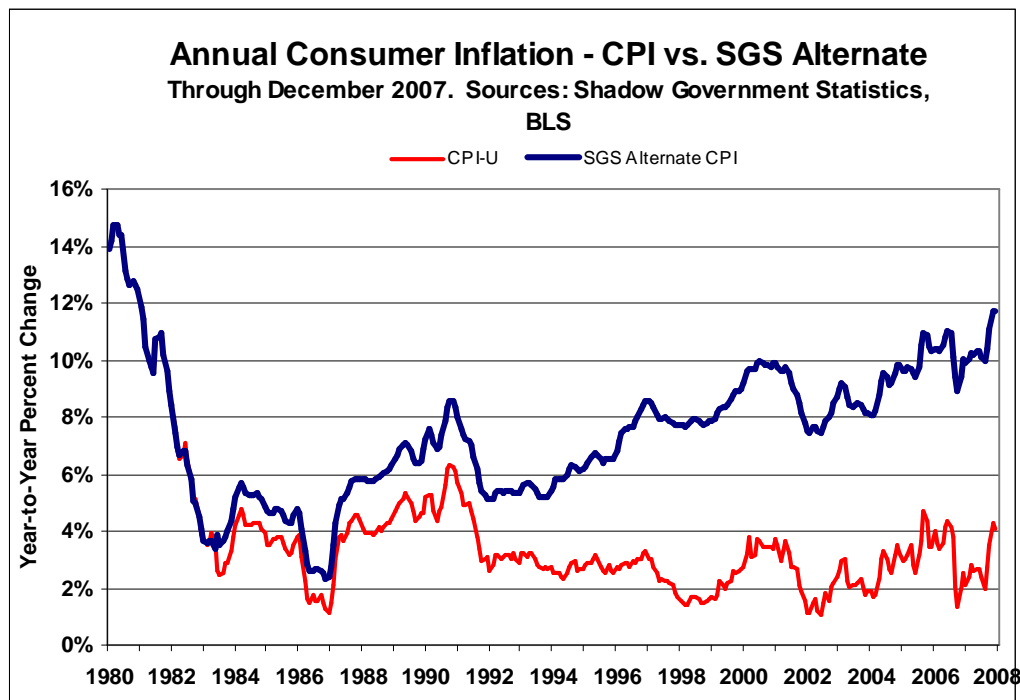
GDP. The alternate fourth-quarter 2007 GDP growth reflects the "advance" estimate, with many of the methodological gimmicks of recent decades removed. The alternate fourth-quarter inflation-adjusted annual growth rate (year-to-year, as opposed to the popularly-touted annualized quarter-to-quarter rate) for GDP was a decline of roughly 2.3% versus the official, slowing year-to-year gain of 2.5%.

General background note: Historical data on both the official and SGS-Alternate GDP series are available for download on the Alternate Data page of www.shadowstats.com. The Alternate GDP numbers tend to show deeper and more protracted recessions than have been reported formally or reflected in related official reporting. Nonetheless, the patterns shown in the alternate data are broadly consistent with the payroll employment and industrial production series (as

revised), which are major indicators used by the National Bureau of Economic Research in determining the official timing of U.S. business cycles.

CPI. The annual non-core annual inflation rates eased slightly in December, but should rise anew into 2008. The orchestrated malingerings of the so-called "core" inflation rates has started to crumble, as they did notched higher again in December. The PCE inflation measures appear to

have been understated so as to help keep real (inflation-adjusted) GDP growth from contracting in the fourth-quarter. Food and oil-related price pressures still have been reflected only minimally in much of the government's reporting of the non-core inflation, and in the impact on the broader economy. Visibly sharp increases in market prices, however, are making it increasingly difficult for the BLS to mask the mounting inflationary pressures, and the increasing impact of energy-cost damages in the general economy.



Eight Levels of Inflation
Annual Inflation for September to December 2007

Measure	2007			
	Sep	Oct	Nov	Dec
I.1 Core PCE Deflator	1.9%	2.0%	2.2%	2.2%
I.2 Core Chained-CPI-U	1.7%	1.8%	2.0%	2.1%
I.3 Core CPI-U	2.1%	2.2%	2.3%	2.4%
I.4 PCE Deflator	2.5%	3.0%	3.6%	3.5%
I.5 Chained-CPI-U	2.3%	3.0%	3.6%	3.4%
I.6 CPI-U	2.8%	3.5%	4.3%	4.1%
I.7 Pre-Clinton CPI-U	6.1%	6.9%	7.6%	7.4%
I.8 SGS Alternate Consumer Inflation	10.4%	11.1%	11.7%	11.7%

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

General background note: Historical data on both the official and SGS-Alternate CPI series are available for download on the Alternate Data page of www.shadowstats.com. The Alternate CPI numbers tend to show significantly higher inflation over time, generally reflecting the reversal of hedonic adjustments, geometric weighting and the use of a more traditional

approach to measuring housing costs, measures all consistent with the reporting methodology in place as of 1980. Available as a separate tab at the SGS homepage www.shadowstats.com is the SGS Inflation Calculator that calculates the impact of inflation between any two months, 1913 to date, based on both the official CPI-U and the SGS-Alternate CPI series.

MARKETS PERSPECTIVE

As shown in the accompanying table, U.S. stocks were up for 2007, but down in the fourth quarter and down since the beginning of 2008. Treasury yields generally have fallen as a result of the

Fed's recent panicked moves, while the dollar has sold off and oil and precious metals prices have soared.

Financial-Market Indicators at Year-End 2007 and January 31, 2008 Close

Indicator	First-Quarter 2008			Fourth-Quarter 2007			Third-Quarter 2007		
	To Date: 31 Jan 2008			Level	Qtr/Qtr	Yr/Yr	Level	Qtr/Qtr	Yr/Yr
Level	QTD/Qtr	Yr/Yr							
Equity Market									
DJIA	12,650.36	-4.63%	0.23%	13,264.82	-4.54%	6.43%	13,895.63	3.63%	18.98%
S&P 500	1,378.55	-6.11%	-4.15%	1,468.36	-3.82%	3.53%	1,526.75	1.56%	14.29%
Wilshire 5000	13,896.65	-6.23%	-4.09%	14,819.60	-3.53%	3.94%	15,362.02	1.00%	15.11%
NASDAQ Comp	2,389.86	-9.89%	-3.01%	2,652.28	-1.82%	9.81%	2,701.50	3.77%	19.62%
Credit Market(1)									
Fed Funds Target	3.00%	-125bp	-225bp	4.25%	-50bp	-100bp	4.75%	-50bp	-50bp
3-Mo T-Bill	1.96%	-140bp	-316bp	3.36%	-46bp	-166bp	3.82%	-100bp	-107bp
2-Yr T-Note	2.17%	-88bp	-288bp	3.05%	-92bp	-177bp	3.97%	-90bp	-75bp
5-Yr T-Note	2.82%	-63bp	-200bp	3.45%	-78bp	-125bp	4.23%	-69bp	-36bp
10-Yr T-Note	3.67%	-37bp	-116bp	4.04%	-55bp	-67bp	4.59%	-44bp	-5bp
30-Yr T-Bond	4.35%	-10bp	-58bp	4.45%	-38bp	-36bp	4.83%	-29bp	6bp
Oil(2)									
US\$ per Barrel									
West Texas Int.	91.76	-4.43%	57.80%	96.01	17.56%	57.24%	81.67	17.39%	29.80%
Currencies/Dollar Indices(3)									
US\$/Unit									
Pound Sterling	1.9895	0.26%	1.45%	1.9843	-2.68%	1.31%	2.0389	1.65%	8.94%
Euro	1.4841	1.63%	14.18%	1.4603	2.70%	10.65%	1.4219	5.17%	12.08%
Swiss Franc	0.9221	4.46%	14.98%	0.8827	3.02%	7.64%	0.8568	4.87%	7.13%
Yen	0.0094	4.66%	13.38%	0.0090	2.92%	6.54%	0.0087	7.32%	2.63%
Canadian Dollar	0.9982	-1.36%	17.71%	1.0120	0.79%	17.92%	1.0041	8.43%	12.06%
Australian Dlr	0.8968	2.19%	15.87%	0.8776	-0.89%	11.31%	0.8855	4.29%	18.68%
Weighted Currency Units/US\$									
Jan. 1985 = 100									
Financial (FWD)	46.41	-1.80%	-10.46%	47.26	-0.92%	-7.64%	47.70	-4.66%	-9.14%
Change US\$/FX	--	1.83%	11.68%	--	0.93%	8.27%	--	4.88%	10.06%
Trade (TWD)	51.96	-1.44%	-12.47%	52.72	-1.51%	-10.00%	53.53	-5.42%	-9.10%
Change US\$/FX	--	1.46%	14.25%	--	1.54%	10.01%	--	5.74%	10.01%
Precious Metals(4)									
US\$ per Troy Ounce									
Gold	923.25	10.73%	41.93%	833.75	12.21%	31.92%	743.00	14.22%	23.99%
Silver	16.74	13.41%	25.30%	14.76	8.13%	14.41%	13.65	8.85%	20.26%

bp: Basis point or 0.01%. (1) Treasuries are constant maturity yield, US Treasury.
 (2) Department of Energy. (3) Shadow Government Statistics, Federal Reserve Board
 (see Dollar Index Section for definitions). (4) London afternoon fix, Kitco.com.

In the week or so since the end of January, stocks declined another several percent, Treasury yields have bounced higher by 10 to 20 basis points, the U.S. dollar has gained a percent or two, and oil and precious metal prices are little changed.

Short-term trends aside, the rapidly deteriorating inflationary recession and broadening bank solvency crisis are terribly bearish for stocks, long-term Treasuries and the U.S. dollar in the year ahead. For gold, the general circumstances could not be much brighter. In this environment, all the markets are subject to extreme volatility and central bank intervention. In the end, however, the underlying fundamentals should prevail.

As a general strategy under the current circumstances, looking to preserve one's wealth and assets needs to be a primary concern, along with the liquidity and safety of investments.

U.S. Equities -- The inflationary recession is at hand, having gained reasonably broad recognition. Such has negative implications for general corporate revenues and profitability. In combination with the still unfolding solvency crisis and a looming tanking of the U.S. dollar, the outlook for stocks is as bleak as it gets. Stocks appear already to have entered what will become a severe bear market in 2008 and beyond.

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

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

U.S. Credit Market -- The apparent panic by the Fed in its effort to stabilize the banking system has knocked 125 basis points off the federal funds target rate in the last month. In turn, short-term treasury yields have dropped sharply with a meaningful increase in the positive slope of the yield curve.

In an environment of rising inflation, burgeoning federal deficit, soaring money growth and a weak dollar, long-term Treasury yields should be well above 7.50%, not at the 4.43% level as seen last Friday (February 8th). Other than for the 30-year Treasury bond, with a real (inflation-adjusted) yield of about 0.35%, all the other active Treasury issues have negative real yields.

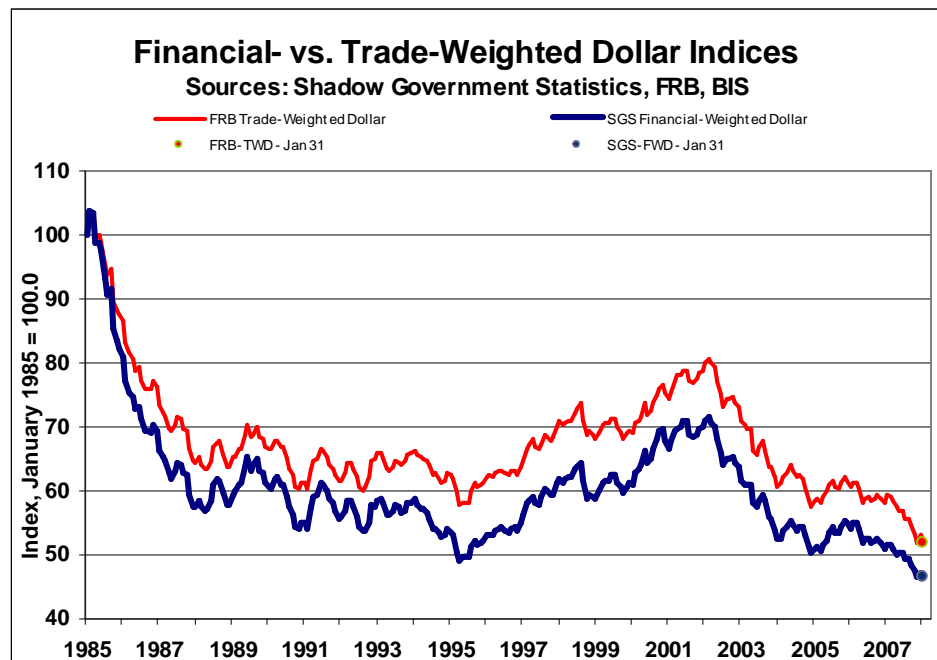
General background note: At such time as the flight from the dollar becomes a flight-to-safety out of the dollar, U.S. interest rates will be forced higher in a mounting liquidity squeeze resulting from foreign dumping of dollar denominated securities. Increasingly, those assets will have to be absorbed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

U.S. Dollar -- Dollar selling has been heavy in recent months, with intermittent periods of rebound and likely central intervention in the wake of the Fed's massive easings and related currency-market concerns. With the economic crisis gaining rapid recognition, and with the next round of bank solvency issues surfacing, U.S.

dollar selling pressures should intensify and become more sustained in year ahead, with flight from the dollar increasingly becoming a flight-to-safety outside the dollar. As currency volatility intensifies, so too should central bank intervention.

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

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



As shown in the preceding graph, the U.S. dollar continued to fall sharply in January 2008. The latest data points shown for financial- and trade-weighted indices are as of January 31st.

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

U.S. Dollar Indices. The Shadow Government Statistics' Financial-Weighted U.S. Dollar Index (FWD) is based on dollar exchange rates weighted for respective global currency trading volumes. For January 2008 the monthly FWD fell by 0.96%, after rising by 1.82% in December. The January 2008 average index level of 46.88 (base month of January 1985 = 100.00) was down by 9.33% from January 2007. December 2007 was down by 7.10% from December 2006. As of January 31st, the FWD stood at 46.41.

Also down in January was the Federal Reserve's Major Currency Trade-Weighted U.S. Dollar Index (TWD). The January 2008 average was down by 0.86% from December, which, in turn, had been up by 2.06% from November. The January 2008 index level of 52.57 (base month of January 1985 = 100.00) was down 11.30% from January 2007, while December 2007 was down 8.90% from December 2006. As of January 31st, the TWD closed at 51.96.

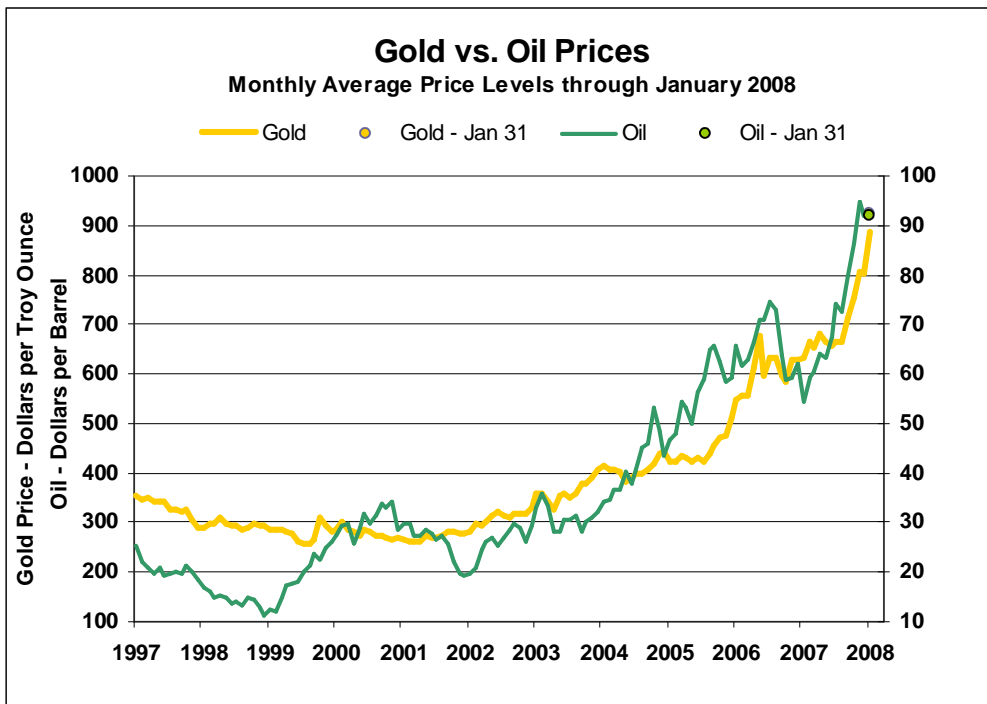
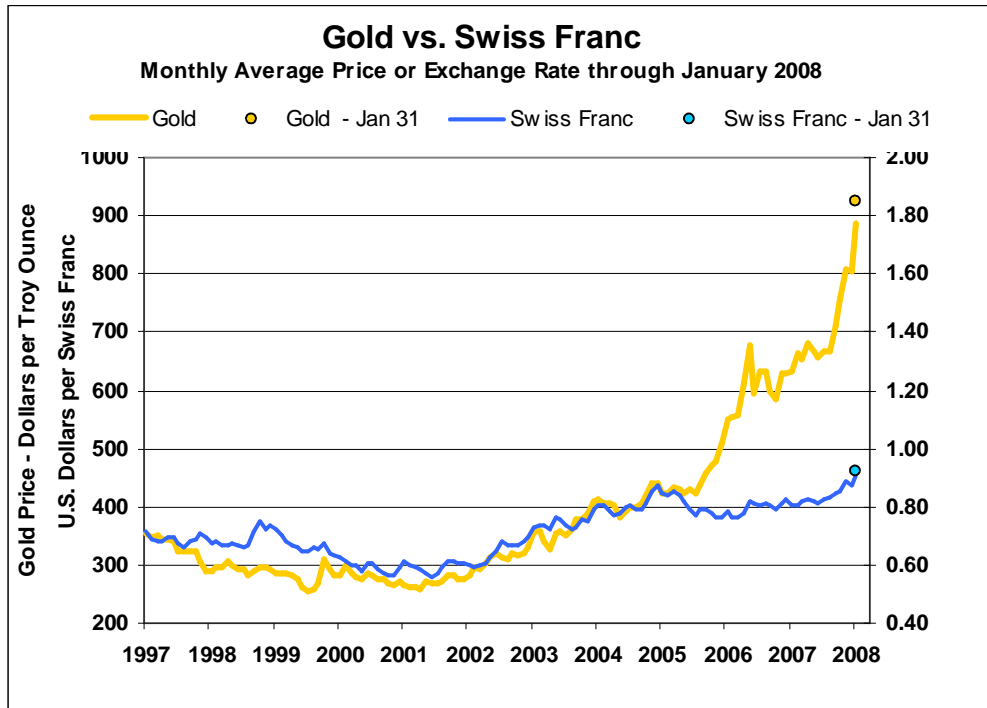
Gold -- Despite intermittent central intervention, the price of gold again is just shy of setting a new record high in current dollars. The London afternoon fix on Friday (February 8th) was \$916.25 per troy ounce, against the current record of \$923.25 set on January 31, 2008. The prior all-time high of \$850.00 (London afternoon fix) of January 21, 1980 still has not been hit in terms of inflation-adjusted dollars. Based on inflation through December 2007, the 1980 gold price peak would be \$2,294 per troy ounce, based on not-seasonally-adjusted CPI-adjusted dollars, and \$6,167 per troy ounce in terms of SGS-Alternate CPI adjusted dollars. The suggestion remains that the price of gold -- albeit at near a nominal high -- still faces some catch-up.

For January (based on Kitco.com), the monthly average London gold afternoon fix was \$887.75 versus \$803.20 in December. Silver averaged \$15.96 per troy ounce in January, up from \$14.30 per troy ounce in December.

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

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

The updated gold versus oil and Swiss franc graphs show the January averages as well as added points for closing prices on January 31st, with gold at \$923.25, oil at \$91.76 and the Fed's published noon buying rate for the Swiss franc at \$0.9221. Again, all three measures should trade significantly higher in the months ahead.



REPORTING PERSPECTIVE

The Big Three Market Movers

U.S. financial system stability and economic conditions continue to deteriorate rapidly, and, as a result, little can be trusted in current economic reporting. Mr. Bernanke still needs a stable U.S. currency, particularly under the circumstance of his capitulation to Wall Street pressures, and the Administration's political needs remain great. With financial circumstances on the brink of threatening national security, almost anything is possible in the arena of data and market manipulations.

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

Employment/Unemployment -- Current annual growth in payrolls is discussed and graphed in the Opening Comments, and the annual payroll benchmark revisions are reviewed in this month's Reporting/Market Focus. As discussed in the February 1st *Flash Update*, given the BLS's ability to report the monthly payroll change at any desired level, the reporting of a small contraction for January has to be viewed as a deliberate political move. Perhaps Treasury Secretary Paulson wanted to keep up the pressure on the FOMC, which seems to have had advance knowledge of the result in its statement announcing the last fed funds rate cut. It would be surprising, however, if the reported contraction survives next month's reporting and revisions.

Payroll Survey. The Bureau of Labor Statistics (BLS) reported a seasonally-adjusted jobs loss of 17,000 (a loss of 393,000 net of revisions and benchmark revisions) +/- 129,000 for January 2008, following a revised 82,000 (previously 18,000) jobs gain in December. The annual benchmark and other revisions knocked 376,000

jobs off the previously-reported seasonally-adjusted December 2007 payroll level. Annual growth in total nonfarm payrolls slowed to a recessionary 0.72% in January from a revised 0.89% (previously 0.92%) in December.

Bias Adjustment. One factor that may have affected the negative monthly result was a revamping of the bias factor (birth-death model), which was a net subtraction of 175,000 jobs in January 2007. At that time, the decline had been offset adequately by a change in seasonal adjustments. For January 2008, the bias factor was revised to subtraction of 378,000. The bias factor for February should swing by nearly 500,000 jobs to the upside, to perhaps a positive 100,000 bias, based on last February's pre-benchmark revision reporting.

Seasonal-Factor Gimmicks. Year-to-year growth should be virtually identical in both the seasonally-adjusted and unadjusted series, and applying the unadjusted annual change to the seasonally-adjusted year-ago numbers generates an adjusted January 2008 payroll level of 138.101 million versus the reported 138.102 million. That does not hold, however, with December, which should have been 138.201 million, instead of the reported 138.119 million. The difference is that seasonally-adjusted January payrolls, using consistent seasonals, would have shown a 100,000 jobs loss for January.

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 those of multiple job holders), went somewhat in the opposite direction of the payroll survey. Household employment was lower by 540,000 in January, but that really was a gain of 205,000, after removal of a 745,000 downward effect from population revisions.

The January 2008 seasonally-adjusted U.3 unemployment rate showed a statistically insignificant decline to 4.93% +/- 0.23% from 4.97% in December. The series also was revised for lowered population estimates. In an unusual divergence, the broader U.6 unemployment rose to an adjusted 9.0% in January, up from 8.8% in December. Adjusted for the "discouraged workers" defined away during the Clinton Administration, actual unemployment still is running about 12.5%.

Employment Environment. The small January employment decline was far short of the type of contraction suggested by the background of the better-quality employment-environment indicators, with collapsing December help-wanted advertising, surging new claims for unemployment insurance, and recession-level employment readings for the January purchasing managers surveys.

Next Release (March 7): Based on underlying economic activity, the February payroll survey also should show a month-to-month contraction, and the household survey should show a rebound in the unemployment rate. Nonetheless, given the political season and ongoing financial market distress, an upside revision in the January data, so as to show positive month-to-month change, is a fair bet. February reporting simply will be brought in as desired by the Administration.

Gross Domestic Product (GDP) -- The Bureau of Economic Analysis (BEA) reported annualized real (inflation-adjusted) growth in fourth-quarter 2007 GDP at 0.64% +/- 3%, which was statistically indistinguishable from a meaningful contraction. The reported growth was down from nonsensical growth of 4.91% for the third quarter. The BEA tries to target consensus forecasts (which were 1.2%) for the advance estimate, since the BEA has to guesstimate more than 90% of the underlying data. The reported result suggests the first-cut estimate actually was a contraction. Any number of bad assumptions currently in place, if altered slightly, would have

given that result. Annual growth reportedly slowed from 2.84% to 2.47%.

The GDP's implicit price deflator (inflation measure) rose at an annualized 2.56% in the fourth quarter versus a 1.04% rate in the third quarter. In contrast, annualized CPI inflation rose to 4.07% in the fourth quarter from 1.87% in the third quarter. Such suggests understated inflation was used in the fourth-quarter GDP estimate. Artificially-low inflation, when used in deflating the GDP, results in an overstatement of the inflation-adjusted GDP growth.

Adjusting for methodological distortions built into GDP reporting over time, the SGS-Alternate GDP measure suggests that economic reality is much weaker than officially reported. A fourth-quarter year-to-year contraction of roughly 2.3% would have been more in line with underlying fundamentals, past methodologies and the ongoing recession (see the graph in the Alternate Realities section of the Opening Comments). Such reflects some bottom bouncing with the annual contraction little changed from the SGS-Alternate GDP third-quarter estimate.

With the numbers too thin to generate alternate GDP measures at this time, the BEA will publish -- in conjunction with later revisions -- estimates of Gross National Product (GNP), where GDP is GNP net of trade in factor income (interest and dividend payments), and Gross Domestic Income (GDI), which is the theoretical income-side equivalent to the GDP's consumption-side measure.

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

Next Release (February 28th): Based on underlying fundamentals, the "preliminary"

estimate revision of annualized quarterly real GDP growth for the fourth quarter should show an actual quarterly contraction. Such, however, is highly unlikely in an election year. The best bet is for the revised growth rate to remain in positive territory.

Consumer Price Index (CPI) -- As discussed in the January 19th *Flash Update*, the Bureau of Labor Statistics (BLS) reported the seasonally-adjusted December CPI-U (I.6) up by 0.30% (minus 0.07% unadjusted) +/- 0.12% for the month, following November's 0.80% (0.59% unadjusted) gain. December's annual CPI inflation eased to 4.08% from November's 4.31%.

While the year-to-year December inflation of 4.1% (up from 2.5% in 2006) was the highest since 1990, the annual average 2007 CPI inflation dropped to 2.8% from 3.2% in 2006. The differences highlight some of the unusual volatility and reporting patterns seen in the last year.

Year-to-year annual inflation likely will resume its upturn with the January 2008 number, dependent on the seasonally-adjusted monthly gain exceeding the 0.17% monthly increase seen in January 2007. The difference will directly add to or subtract from December's annual inflation rate of 4.08%.

Annual inflation for the Chain Weighted CPI-U (C-CPI-U) (I.5) -- the substitution-based series

that increasingly gets touted by the manipulators and inflation apologists as the replacement for the CPI-U -- was 3.41% in December, down from 3.57% in November, but up from 2.36% in December 2006.

Adjusted to pre-Clinton (1990) methodology (I.7), annual CPI growth was about 7.4% in December, down from 7.6% in November, but up from up from 5.8% in December 2006. The SGS-Alternate Consumer Inflation Measure (I.8), which reverses gimmicked changes to official CPI reporting methodologies back to 1980, was roughly 11.7% in December, unchanged from November, and up from 10.0% in December 2006. The eight levels of annual inflation, I.1 to I.8, are detailed in the table in the Alternate Realities section, along with the graph of SGS-Alternate Consumer Inflation.

Next Release (February 20): If seasonally-adjusted monthly CPI inflation for January 2008 exceeds 0.17%, which it should, then annual CPI inflation will increase by the difference. Fundamental reporting risks generally favor an upside surprise to market expectations, but targeted manipulation still is of high risk given the deteriorating financial markets and the Fed's increasingly limited policy options. While some upside movement in core inflation has started to surface, a major uptick still is long overdue.

Other Troubled Key Series

Federal Deficit -- As discussed in the January 13th *Flash Update*, the officially gimmicked federal deficit deepened in the first three months of fiscal 2008. Surging outlays have widened the budget deficit to \$105.5 billion versus \$82.9 billion for the same period a year before. That puts the rolling 12-month deficit through December 2007 at \$187.9 billion versus \$211.8

billion in December 2006. The annual "improvement" in the deficit has narrowed to \$24 billion in December from \$49 billion in November and from \$85 billion at fiscal year-end (September 30th), and shortly it will turn to net deterioration.

Viewing the change in gross federal debt bypasses several of the regular reporting manipulations and is a better indicator of actual net cash outlays by the federal government than is the official, gimmicked deficit reporting. Gross federal debt stood at \$9.229 trillion at the end of December 2007, up \$80 billion for the month, up \$222 billion for the quarter and up \$549 billion from December 2006, which in turn was up \$510 billion from December 2005. As of January 31, 2008, the gross federal debt stood at \$9.238 trillion, up \$9 billion for the month, but it was up by \$620 billion from January 2007, which in turn was up by \$511 billion from January 2006.

Confirming what already is becoming apparent in the trend of the latest fiscal results, the Bush Administration now projects a gimmicked deficit of \$410 billion for fiscal 2008, up from \$163 billion in 2007. With no allowance for a recession in the assumptions underlying deficit the projections (the Administration forecasts real 2008 GDP growth at 2.7%), the final 2008 numbers should be much worse than the current Administration estimates.

The federal government's fiscal 2007 (year-ended September 30th) official accounting-gimmicked deficit narrowed to \$162.8 billion from \$248.2 billion in 2006. For fiscal year-end 2007, the gross federal debt stood at \$9.007 trillion, up by \$500 billion from 2006, which was up \$574 billion from 2005.

As discussed in the December 2007 SGS newsletter's Reporting/Market Focus, the GAAP-based deficit for fiscal-year 2007 topped \$4 trillion, on a consistent reporting basis. I am still in the process of getting clarification on some of the accounting changes used in the GAAP reporting, but the \$4 trillion number remains my best estimate at this time.

Of interest, as discussed in the January 13th *Flush Update*, was the January 10th Reuters story that, "Moody's Investors Service said on Thursday the United States' 'triple-A' government bond rating

could come under pressure in the very long-term if the Medicare and Social Security programs are not reformed." This appears to be the first time that the top rating given U.S. Treasuries has been threatened due to U.S. fiscal conditions.

Despite the bookkeeping games played by Administration and Congress, the gimmicked deficit should widen significantly in the months ahead, not only due to rapidly rising outlays, but also due to the intensifying recession and related tax receipt declines. While GDP growth estimates can be gimmicked, incoming tax receipts (based on consistently applied tax policies) remain an independent estimate of underlying economic reality and eventually will reflect the economy's mounting difficulties.

Initial Claims for Unemployment Insurance -- The trend in annual growth continued to deteriorate. On a smoothed basis for the 17 weeks ended February 2nd, annual growth rose to 5.8%, up from a revised 3.6% (was 3.4%) in the 17 weeks ended December 22nd. A rising growth trend in new claims is an economic negative.

General background note: More often than not, week-to-week volatility of the seasonally-adjusted weekly claims numbers is due to the Labor Department's efforts to seasonally adjust these numbers around holiday periods (*such as Martin Luther King's Birthday and the upcoming 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 -- December's seasonally-adjusted monthly real earnings rose by 0.1%, after dropping by a revised 0.5% (was down 0.4%) in November. Annual change in December deepened to a 0.9% contraction from the 0.8% decline 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 shows the average worker to be under severe financial stress in an ongoing structural recession.

Retail Sales -- As discussed in the January 15th *Flash Update*, the 2007 holiday shopping season was a bust. Where the seasonally-adjusted December retail sales number was reported down by 0.37% +/- 0.8% for the month, such was after downward revisions to November's reporting. Net of revisions, December was down by 0.73%, with November's previously reported gain of 1.22% now standing at 1.05%. The combined November/December retail sales gain of 0.7% was in contraction, net of official CPI-U reporting, with November CPI-U up by 0.8% and December CPI up by 0.3%.

The 4.08% gain reported in year-to-year December retail sales also was more than wiped out by the 4.12% (seasonally adjusted) annual CPI-U inflation. A year-to-year change in real (inflation-adjusted) retail sales below 1.8% (using the official CPI-U for deflation) signals recession, and a signal first was generated in this business cycle back in June 2006. An outright contraction in real year-to-year retail sales, as seen in December, is a recession.

Core Retail Sales. Net of grocery store and gasoline station sales, "core" retail sales for December was down by 0.36% (down 1.02% net of revisions), following a revised 0.29% gain in November (previously 0.78%), with reported gains in food prices offsetting reported lower gasoline prices.

An interesting pattern continued to unfold in the food and energy areas of retail sales, where implicit food and energy inflation reflected in the data were understated one month and then revised

upward the next month. This can be seen in the December non-core retail growth being down 0.4% versus down 0.7% net of revisions, with the December core being down 0.4% versus down 1.0% net of revisions. While retail sales keep getting revised, the CPI does not get revised from initial reporting (unless there is an outright error in calculation).

Next Release (February 13): Underlying fundamentals suggest a weaker showing than the expected unchanged January retail sales. The data most likely will be underwater after inflation adjustment, as well. Going forward, inflation-adjusted monthly and annual change should turn regularly negative.

Industrial Production -- As discussed in the January 19th *Flash Update*, seasonally-adjusted December industrial production was unchanged (plus 0.1% net of revisions), following a 0.3% gain in November and a 0.5% contraction in October. Production in the fourth quarter showed a seasonally-adjusted annualized contraction of 1.0% versus the third quarter. Year-to-year change eased to 1.6% in December from 2.2% in November.

Back in the days when GDP (or GNP) growth estimates had some meaning, a 1.0% annualized quarterly contraction in industrial production usually would be coincident with a quarterly contraction in GDP. Given current politics and methodological changes of the last two decades or so, reported GDP growth likely will remain in positive territory until after the Presidential election.

Next Release (February 15): Look for January industrial production to contract, despite consensus expectations for a small gain. Such would be consistent with the purchasing managers survey (old style) and recent weakness in new orders for durable goods. Monthly contractions in this series should become regular, with the erratic but generally slowing annual growth eventually turning negative.

New Orders for Durable Goods -- The usually volatile durable goods orders rose by 5.2% (5.5% net of revisions) in December, seasonally adjusted, after gaining 0.5% (previously 0.1%) in November. On a year-to-year basis, December's orders rose by 5.0% versus November's 0.1% contraction. Smoothed using a six-month moving average, annual growth (net of inflation) remained negative and a recession signal.

The closely followed nondefense capital goods new orders rose by 5.4% for the month in December, after a 5.3% gain in November. December's annual change was an increase of 7.4%, following November's 5.7% decline.

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

Trade Balance -- As noted in the January 13th *Flash Update*, the November trade report showed something of a surprise catch-up in recent underreporting. Though still well shy of reality, the seasonally-adjusted trade deficit widened to \$63.1 billion in November from \$57.8 billion in October, reflecting rising oil prices.

The value of imported oil still appears to be seriously understated in terms of pricing, despite the November gains. The average imported price for oil rose to \$79.65 per barrel in November, up from \$72.49 in October.

Next Release (February 14): Underlying reality favors further deterioration in the monthly trade deficit, but the government can play games with this series as long as it wants to play them. Contrary to underlying fundamentals, a narrowing of the December deficit is expected. That would help generate an upside revision to the fourth-quarter GDP estimate. On the other side, a significant deterioration could push the GDP into a contraction, in revision.

Consumer Confidence -- The monthly January consumer confidence measures were mixed in terms of monthly change but continued to show deepening contractions in annual change. For January 2008, the Conference Board Confidence measure sank by 3.0% for the month, after rising 3.2% (previously 0.9%) in December. January's year-to-year change was down by 20.2%, sinking from December's 17.6% annual decline.

The University of Michigan Sentiment measure was up by 3.8% in January, following a 0.8% decline in December. January's year-to-year decline also deepened, down by 19.1% versus December's 17.7% drop. These lagging, not leading, indicators tend to reflect the tone of the popular financial media and are fully consistent with a deteriorating inflationary 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 Michigan survey is unadjusted. How does one seasonally-adjust peoples' attitudes? Also, beware the mid-month Consumer Sentiment release from the University of Michigan. Its sampling base is so small as to be virtually valueless in terms of statistical significance.

Short-Term Credit Measures -- Patterns of annual growth in commercial borrowing continue to reflect pressures from the bank solvency crisis, with the sharply declining annual growth for commercial paper outstanding being offset partially by growth in commercial and industrial bank loans. Consumer credit numbers show slightly slowing annual growth, albeit against upwardly revised annual growth rates.

For seasonally-adjusted consumer credit, which includes credit cards and auto loans, but not mortgages, annual growth was reported at 5.5% in December against an upwardly revised 5.6% in November (previously 5.2%) and 5.7%

(previously 5.4%) 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 in consumer debt expansion remains an ongoing constraint on economic growth. The continuing large revisions in the consumer credit series confirm the Fed's inability to track bank activities accurately on a timely basis. Similar issues are evident in the Fed's quarterly flow-of-funds accounting for the banking system.

Commercial borrowing growth varied sharply, once more. Annual change in January commercial paper outstanding showed a 6.2% contraction, which narrowed from a 10.1% decline in December and a 4.5% decline in November. In contrast, annual growth in December commercial and industrial loans rose by 20.2%, after a 19.1% (previously 21.8%) gain in November and 18.4% (previously 18.5%) gain in October. The relative instability in commercial paper continues, with resultant credit difficulties placing a major dent in

broad business activity and continuing to disrupt banking system stability.

Producer Price Index (PPI) -- The seasonally-adjusted December finished goods PPI declined by 0.1% (down 0.4% unadjusted) after increasing by 3.2% (1.6% unadjusted) in November. Annual PPI inflation for December eased to 6.3% from November's 7.2%. Seasonally-adjusted intermediate and crude goods eased by 0.2% and rose by 1.0%, respectively for December, after increasing by 3.7% and 8.7% in November.

Next Release (February 26): On February 22nd, revisions to relative importance and seasonal factors will be published, restating history back through 2003. Nonetheless, allowing for the regular random volatility of the monthly price variations, PPI inflation reporting over the next six-to-nine months generally should favor official results coming in above market expectations, as the effects of oil prices increasingly permeate the broad economy. As with the CPI, the core PPI inflation rate still is long overdue for a meaningfully upside move, but such still may be further delayed by the ongoing financial-market needs of the battered Federal Reserve.

Better-Quality Numbers

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

Economic Indicators

Purchasing Managers Survey: Manufacturing New Orders -- As discussed in this month's Reporting/Market Focus, the Institute for Supply

Management (ISM) has impaired slightly the quality of its composite indices by altering component weightings so as to better mimic the heavily politicized and otherwise heavily upside-biased reporting of official GDP growth of "recent years." Nonetheless, the individual ISM components maintain their integrity, aside from distortions introduced by the annual seasonal-adjustment revisions calculated by the U.S. Department of Commerce, which also were just published. The problems created by government's seasonal-adjustment factors largely can be overcome by assessing the data using three-month moving averages.

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.

**Impact of Methodological Change and
Seasonal Adjustment Revisions on the ISM's
Purchasing Managers Survey (Manufacturing)**

	Dec 2007	Jan 2008
Current Reporting	48.4	50.7
Without Reweighting	48.4	50.9
Without Revised SA	48.0	49.9
Without Reweighting and Revised SA	47.7	49.7

Alternate index readings were calculated using weightings and seasonal-adjustment factors published by the ISM. Readings below 50.0 indicate a contracting manufacturing sector and traditionally would signal a recession.

As shown in the table above, but for the reweightings and seasonal-factor revisions, the overall January ISM manufacturing index would have indicated a contracting manufacturing sector for a second consecutive month. As reported, however, the January 2008 index rose into positive territory, at 50.7, up from a revised 48.4 (was 47.7) in December. Even with the alterations to the series, an accelerating decline in the broad indices remains a good bet in the next several months, based on general weakness in the overall industrial production and durable goods order series.

The revamped December new orders index remained in contraction for January at 49.5, against 46.9 (previously 45.7) in December. Seasonal-factor distortions 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 fell by 3.8% on an annual basis versus a 1.7% 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, the new orders measure breached its fail-safe point in mid-2005, generating a signal of pending recession.

Also of significance, the manufacturing employment component moved deeper into recession territory at 47.1 in January, down from 48.7 (previously 48.0) in December.

Service Sector Index. Also revamped as to structure and seasonal factors, the service-sector ISM index now has a composite index, which incorporates business activity as a component. Despite all the excitement in the financial press of the January index signaling recession, the series still 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, and such has not been altered by the reweightings.

With that as background, the first reporting of the services sector composite index was at 44.6 for January 2008. The ISM did not publish a December number for comparison, but the indicated formulation suggests that December would have been 53.2. The previously dominant "business activity" measure dropped to 41.9 in January from 54.4 (revised from 53.9) in December.

Both the services employment and prices paid components, however, have some meaning. With the covered industries including real estate and banking, the January employment component plunged to 43.9 from 51.8 (previously 52.1) in December. The prices paid component is covered in the Inflation Indicators.

Help-Wanted Advertising Index (HWA) -- The Conference Board's seasonally-adjusted December help-wanted advertising index bottom-bounced, rising to 22 from the historic low of 21 reported in November. Year-to-year change, however, continued to plummet, down 33.3% in December, versus a 27.6% decline in November. Despite some of the historic weakness in the series due to the loss of newspaper business to the Internet, the HWA is a solid leading indicator to the broad economy and to the monthly employment report, and it still is indicative of a severe deepening in an ongoing recession.

Where the series does not include a measure of on-line advertising, recent indices developed to measure Internet activity have serious definitional problems and still are too young to be meaningful indicators. That said, the Conference Board has reported that its on-line measure of help-wanted advertising fell in January with significant slowdown in annual growth.

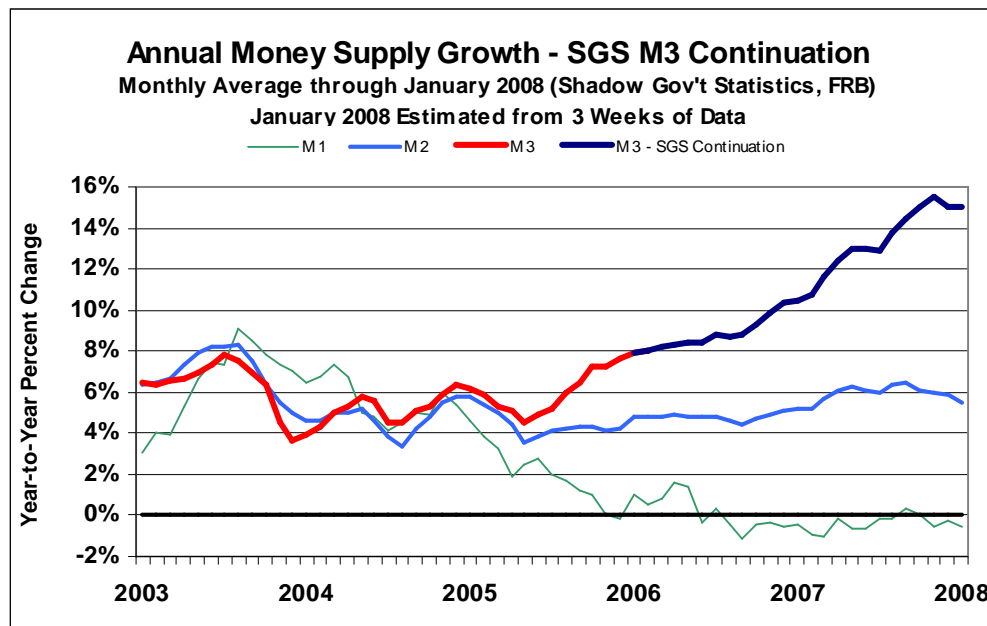
Housing Starts -- The housing numbers continue to collapse, showing an ongoing and deepening recession. December's seasonally-adjusted housing starts plunged by 14.2% (down 15.2% net of revisions) +/- 10% (95% confidence interval) for the month, after a 7.9% (previously 3.7%) decline in November. December's level was down 38.2% from the year before, which is near the trough of the current recession but still shy of the 48.6% annual decline seen at the trough of the 1990/1991 recession.

Also confirming the housing industry problems, December building permits were down 8.1% (7.3% net of revisions) for the month, 34.4% year-to-year, while new home sales fell 4.7% (6.6% net of revisions) for the month and 40.7% for the year. December existing home sales sank 2.2% for the month and were down 22.0% year-to-year.

Inflation Indicators

Money Supply -- The Federal Reserve's recent benchmark revisions to M2 (back into the 1990s) and other components of M3 lowered current reported dollar levels by about 0.3%, but did not alter significantly the reported or estimated annual growth patterns. Based on four weeks of data for January 2008, the SGS-Ongoing M3 of annual growth is estimated at 15.2% for the month, up from 15.0% in December.

M3 Growth Surge Update. Aside from the recent surge in annual M3 growth, the estimated January 2008 growth rate is the highest since 15.8% seen in August 1971 (Nixon's closing of the gold window); the all-time high annual growth rate for the reported series was 16.4% in June 1971. The current pace of broad-money growth continues to have disturbing inflationary implications.



Following up on subscriber questions and comments on the January 13th *Flash Update* as to how broad money supply is growing so much faster than the monetary base, indeed part of the issue -- as pointed out by one subscriber -- is that there are no reserve requirements for banks on nonpersonal time deposits and eurocurrency liabilities, which have grown rapidly.

Several subscribers asked how dollars that already are created and get paid to foreign creditors, add to the money supply when they get recycled through other central banks to the Fed and back into the U.S. system. The dollars disappear from the U.S. system as they are paid out and eventually end up held by other central banks. Initially the Fed adapts and adjusts as necessary to maintain the existing money supply. How and when the dollars are reintroduced to the U.S. system, and whether or not they add to the money supply then is a function of how the Fed handles the foreign central banks' interests and whether it chooses to neutralize the impact of the reintroduced funds.

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

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

Feb 06	10.303	Aug 06	10.746	Feb 07	11.430	Aug 07	12.224
Mar	10.362	Sep	10.855	Mar	11.566	Sep	12.417
Apr	10.429	Oct	10.990	Apr	11.728	Oct	12.643
May	10.502	Nov	11.102	May	11.868	Nov	12.817
Jun	10.562	Dec	11.227	Jun	11.933	Dec	12.909
Jul	10.643	Jan 07	11.315	Jul	12.012	Jan 08	13.030(p)

(r)Reflects Federal Reserve Benchmark revisions to underlying series.

(p)Preliminary estimate based on three weeks worth of data.

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

Based on roughly four weeks of data for January 2008, annual change for monthly M1 appears to have contracted by 0.9% after a 0.21% decline in December. January M2 annual growth appears to have softened to 5.6% from 5.85% in December.

Purchasing Managers Surveys: Prices Paid Indices -- The January 2008 prices paid indices were strong for the purchasing managers surveys, rallying sharply in the manufacturing sector and easing slightly -- but staying historically high -- for the services sector. The indices reflect upside inflation pressures from a variety of factors, including high oil prices, and signal broad inflation problems ahead.

On the manufacturing side, the January price index jumped to 76.0 from 68.0 in December. On a three-month moving average basis, January's 37.3% year-to-year gain was up from December's 34.1%. 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 came in at 70.7, down slightly from December's 71.5 (previously 72.7). On a three-month moving-average basis, however, January's annual gain

increased to 26.9%, up from a 25.5% increase 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 above 50.0 indicates rising prices.

Oil Prices -- For the last couple of months or so, oil prices have fluctuated around \$90 per barrel, still shy of the \$100 per barrel mark, a psychological price barrier that has not been meaningfully broken. For January 2008, the monthly-average West Texas Intermediate spot price (St. Louis Fed) rose 0.8% to \$92.50 from December's \$91.73, which was down 3.1% from November's record high monthly average of \$94.62 per barrel. Against last year's average, January's level was up by 68.9%, compared with December's 47.9% and November's 59.4%. These levels of growth continue to suggest disastrous news still is in the offing for official CPI, PPI and GDP annual inflation reporting.

As of Friday, February 8th, West Texas Intermediate closed at \$91.78 per barrel, spot,

little changed from \$91.76 at the end of January. Oil price movement remains highly volatile, but generally should trend higher and set new record highs in the months ahead, despite growing recognition of a U.S. and possible global recession. Irrespective of how high oil prices may go, or how much they may fall back in short-lived profit taking, current prices are well above levels that will help trigger debilitating U.S. inflation. Regardless of any near-term price swings, meaningful upside risks to oil prices remain in place, both from the still-unfolding dollar catastrophe and ongoing OPEC rumblings, as well as from ever-volatile Middle Eastern and related global political tensions, and other supply and demand issues.

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

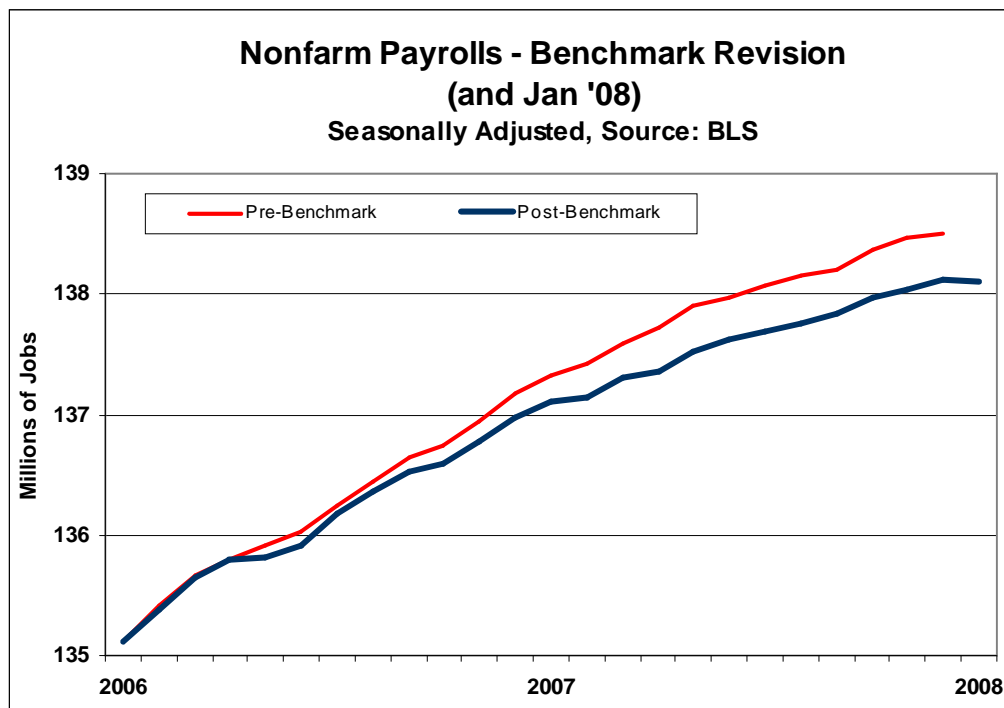
Reporting/Market Focus

Payroll Employment Benchmark Revision

Perils of Mimicking Poor-Quality Government Numbers (ISM and ADP Data)

Historical Payrolls and Employment Growth Revised Downward. As shown in the accompanying graphs, benchmark revisions to the payroll employment series of the Bureau of Labor

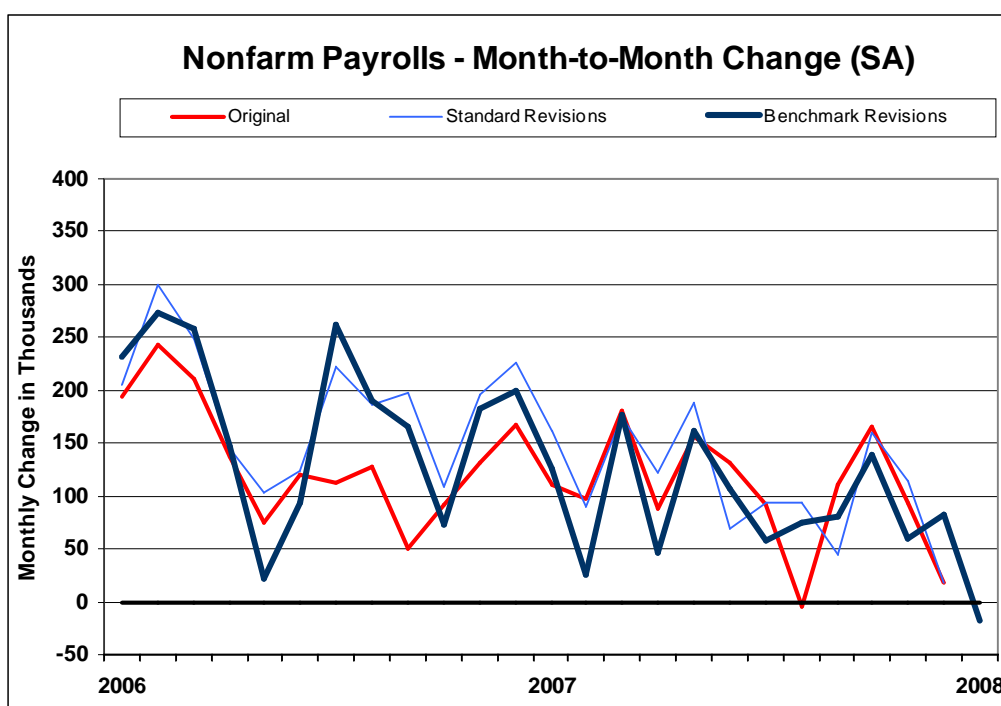
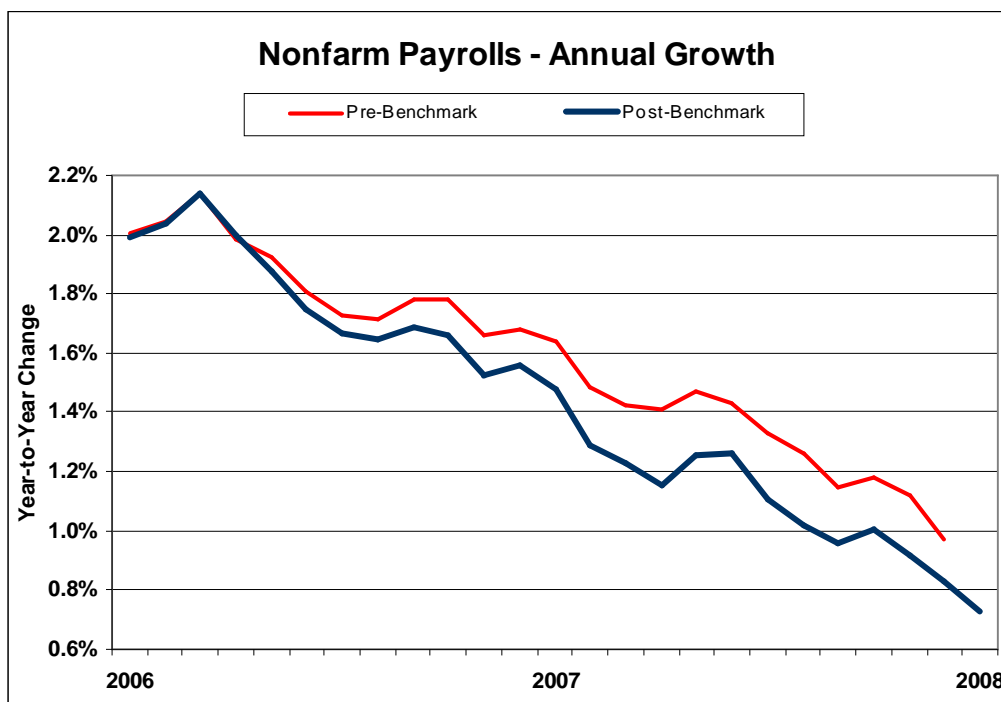
Statistics (BLS) showed meaningful downside revisions both in terms of employment level and of year-to-year growth.



With the not-seasonally-adjusted March 2007 payroll survey benchmarked against state unemployment insurance filings of the time, the BLS estimated that March 2007 payrolls had been overstated by 293,000 jobs, which translated into a 284,000 downside revision to the seasonally-adjusted March number. By November 2007, such meant a 440,000 downside revision in the adjusted numbers. December should have been even worse, but as discussed in this month's

employment section, the December number may have been altered so as to keep the month-to-month payroll decline in January 2008 to a minimum.

Annual growth now appears to have slowed more sharply than previously reported, slipping to 0.72% as of January 2008. Growth that low, in a downtrend, has always been tied to a coincident recession.



The third graph shows some of the variability in the month-to-month payroll gain that is so heavily followed by the financial markets. Aside from the historical month-to-month numbers averaging a little less than previously reported (95,000 instead of 111,000 in 2007), the revision patterns showed a

tendency for initial reporting (an average of 103,000 in 2007) to be revised upward in the standard two months of revision that follow initial release, exclusive of the benchmark revisions. In general, the BLS estimates a 95% confidence

interval around the seasonally-adjusted monthly change of +/- 129,000 jobs.

With the exception of the benchmark revision one year ago, most recent benchmark revisions have been to the downside, and most have been significant, regardless of direction. The process highlights some of the basic weaknesses in the accuracy of the regular payroll surveying and reporting, and it should raise issues for those in the private sector attempting to make use of the numbers.

ADP, ISM and Efforts at Mimicking

Government Data. There was a time -- a couple decades back -- where it may have made sense for private sector publishers of economic data to attempt to link the reporting of their series to popularly followed government statistics. If an indicator such as the purchasing managers survey proved to be a good predictor of broad economic activity, as measured by the GNP/GDP, then economists and analysts would come to rely heavily on the significance of the numbers.

In recent decades, however, some government economic data have been gutted of economic significance thanks to methodological changes that have structured upside biases into the GDP and employment data, and downside biases into inflation reporting. Accordingly, private enterprises attempting to mimic today's government reporting, unwittingly may be distorting and biasing their own otherwise very good and valuable data. Such enterprises can put out meaningful reports that have the respect of the markets, without having to tie themselves too closely to tainted government data. Two recent cases come to mind: Automatic Data Processing, Inc. (ADP) and the Institute for Supply Management (ISM).

Relatively new to the economic reporting field is ADP, a company that processes a very large number of company payrolls. Their unique database has enabled the creation of ADP's National Employment Report. Given the quality of the company's data, the high level of technical and economic skill behind the data analysis, and

presumed political neutrality, significant trends should be signaled by the ADP data with a higher accuracy than often are available from the government's monthly survey.

The issue is that ADP adjusted the reporting of their monthly data in an early effort to mimic the monthly payroll change as reported by the government. Although this move appears to have been quite popular with financial traders, who always look for an edge in anticipating a key market-moving statistic such as the monthly payroll survey change, there can be problems trying to use high quality data to imitate a highly volatile number that is subject to political massaging, birth-death models, etc.

Consider that the government's monthly payroll gain comes within a +/- 129,000 range 95% of the time, and lies outside that range one time in twenty. If one used 100,000 as a base in 2007 (the average initial jobs gain reported by the BLS in 2007 was 103,000), a range from minus 9,000 to plus 229,000 easily covered all the initial reportings. One could expect results in a given month that would show something close to a random number in that range. If the numbers were random, they are by nature unpredictable. Yet, markets can respond if the monthly change is 10,000 more or less than consensus estimates. When consensus forecasts come close to the actual number, one has to wonder how random the government's monthly reporting process is in reality.

The ISM has been publishing its purchasing managers survey of manufacturing activity for some years, and the survey has been recognized broadly as a reliable indicator of economic activity. Of particular value is the new orders component of the manufacturing survey, which I have used regularly as a leading indicator of significant economic change. It was one of the first indicators to send out a warning signal in advance of the current economic downturn and has been a much more accurate indicator of current economic activity than official GDP reporting.

On January 18, 2008, the Institute for Supply Management (ISM) announced a reformulation of its purchasing managers index (PMI), where, "The new formula more closely predicts the GDP for the past several years." The ISM explained further that, "In late 2006, ISM asked a group of supply management professionals, educators and leading economists to study the relationship between the PMI Index and GDP (gross domestic product). After extensive study, the revised formula was determined to more closely predict GDP. While the impact of the change is marginal, it does provide a more precise measure than the previous formula."

Therein lies the problem. The ISM recognized a disconnection between the results of its surveys and the ever-rosy recent performance of the GDP. The reaction was to change the ISM series, assuming the GDP was correct. Yet the problem was with the quality of the government's GDP reporting, not the ISM's high-quality survey.

Basically the weightings of new orders and production, which had been 30% and 25%, respectively, were changed to the 20% weighting now applied to all series, including employment, supplier deliveries and inventories. Not surprising, the best leading indicator was downgraded because it failed to perform in predicting politically-rigged results of the GDP.

While the reweightings do not alter the broad picture significantly, in conjunction with the new seasonal factors introduced in January, they did prevent the January 2008 index from falling below 50.0 and signaling a contracting manufacturing

sector. Such would have happened otherwise, without the reformulated changes (see the Purchasing Managers Survey section in the Better Quality Numbers segment for a detailed table).

Fortunately, the individual series, such as new orders, will continue to be published as usual, along the regular once-per-year revamping of seasonal factors, as determined by the Commerce Department.

As to GDP, the annualized quarterly real (inflation-adjusted) growth rate come with a 95% confidence interval of +/- 3%. Yet, consensus forecasts often come extremely close to the "advance" or initial estimate. There is nothing random about the reporting of the carefully structured GDP estimates.

Upcoming Reporting/Market Focus for February:

Illegal Immigration's Impact on the Economy and Economic Reporting

This reporting focus has been pushed back one month to accommodate the analysis of the payroll benchmark revisions and related issues for economic reporting out of the private sector. The number of undocumented aliens in the United States appears to be underestimated, severely, and the impact of the current circumstance will be explored as it affects U.S. economic activity, inflation, living standards, long-range federal fiscal performance and reporting of same, among other issues.

PLEASE NOTE: Earlier editions of the SGS newsletter referenced in the text, can be found on the Archives tab at www.shadowstats.com.

The February 2008 "Shadow Government Statistics" newsletter is targeted for posting around March 3rd. The Hyperinflation Special Issue should be posted in approximately two weeks.

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