

# John Williams'

# Shadow Government Statistics

*Analysis Behind and Beyond Government Economic Reporting*

Number 47

November 14, 2008

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**Still-Intensifying U.S. Inflationary Recession**

**Systemic Solvency Crisis/Market Instability Not Contained**

**Obama Faces Same Limited Options as Bush**

**Hyperinflation Possible in 2009**

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## **OVERVIEW -- OPENING COMMENTS**

### **Relapse of Severe U.S. Dollar Woes Could Trigger Next Phase of Financial Crisis**

Despite extraordinary actions by the Federal Reserve, U.S. Treasury and other central banks and finance ministries, the global solvency crises, financial panics and market distortions and instabilities continue. While the collapse of a functional U.S. banking system has been avoided, so far, bank lending has not resumed meaningfully, and other weak links in the economy appear ready to break. Possible failures of the "Big-Three" U.S. automakers now are touted in the financial media. Where GM once boasted, "What is good for General Motors is good for America," a failure there would be the ultimate symbol of structural destruction that has sapped U.S. economic activity for decades.

Structural issues drove the economy into deep recession well before any crises exacerbations. With the economy in recession, oil prices down and the dollar stronger, deflation concerns abound. Yet, inflation ultimately is a monetary phenomenon, and the Fed's recent monetary incontinence promises much higher inflation ahead, regardless of near-term CPI gyrations from the pre-election plunge in gasoline prices.

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**Inflation/Deflation, Money Supply, U.S. Dollar, Price of Gold, G-20 Are Key Questions.** I have received a large number of questions from readers concerning inflationary and deflationary pressures, what is or is not happening to money supply, what is the outlook for the U.S. dollar and gold given significant recent relative counterintuitive gains and losses in those markets, among other issues. Those areas are discussed in the sections ahead, and further, related reader queries are invited.

This weekend's G-20 meeting, though called to address the global nature of the ongoing financial-system crisis, is not likely to generate any surprises, but one never knows. There is talk of coordinated fiscal stimulus, but, as discussed later, the U.S. has increasingly limited options in that area. There is talk of establishing global regulatory oversight of the financial services industry, but such would do little to improve the current circumstance, and it is not likely that the U.S. would yield any sovereignty over its domestic markets and financial institutions, at present. To the extent anything of substance is forthcoming, such will be addressed in a separate *Flash Update* or *Alert*, as usually would be the case for a significant economic or market development in the period between full newsletters.

With third-quarter GDP reported in contraction, and with consensus forecasters and the popular financial media talking recession, my claims of the economy being in a protracted, deep recession are among the least controversial of my analyses. Accordingly, this special double issue concentrates first on the solvency/financial crisis and the resulting monetary implications for inflation. Explored second are the nature, depth and prospects for the ongoing recession, with the downturn considered in historical context in this month's Reporting/Market Focus.

**General Outlook is Unchanged, Except for Hyperinflation Timing (2009).** With the financial markets unstable and the systemic-solvency crisis ongoing, my broad outlook has not

changed. The various markets are about as volatile and as dangerous as they can get. With extraordinary crosscurrents from the solvency crisis and various governmental and global central bank interventions in the markets and marketplace, volatility likely will continue, sometimes in directions that may seem irrational.

The gold and currency markets, in particular, have suffered extreme distortions, moving against strong fundamentals. As deleveraging pressures subside (timing unknown), the U.S. dollar should come under heavy selling pressure, once again, likely triggering a rebound in gold as well as some pick-up in oil prices. Over the longer term, U.S. equities, bonds and the greenback should suffer terribly, while gold and silver prices should boom.

The U.S. continues in a severe, inflationary recession that was well underway before the housing/ mortgage crisis attracted attention. Little can be done to stimulate near-term economic activity, to contain inflation or to provide a long-term prop to equity values. The government, however, does have the ability to support depositor safety, to prevent a collapse of the related financial services industry and to prevent a deflation in the prices of goods and services. Those government actions are underway, and the cost of systemic salvation is higher price inflation, despite plunging oil prices.

As broad money growth accelerates, inflation will increase. When heavy dollar selling begins anew, and dollar dumping leads to dumping of dollar-based assets held by foreign investors, the Fed will find itself in a circumstance where increasingly it will have to monetize accelerating Treasury debt supply. Under that combination of circumstances, I am moving ahead in time the possible onset of hyperinflation into 2009, from 2010 in the previously estimated range of 2010 to 2018, detailed in the *Hyperinflation Special Report* of April 2008.

In the severe structural downturn that has unfolded over decades, the U.S. economy cannot be turned

overnight with quick-fix stimulus packages that otherwise might help balance out a brief and shallow inventory recession (where production is cut in order to work-off an excess build-up in inventories). An economic fix requires structural change and time. What looms is a depression, which would become a great depression in the event of the disruption to normal commerce from a period of hyperinflation (see the Reporting/Market Focus section).

### **Obama Faces Same Fiscal Limitations as Bush.**

The Obama Administration will face the same fiscal constraints that the Bush Administration has faced but largely ignored. Presumably, if Bush could ignore the fiscal constraints, then so could Obama. As the U.S. government's effective long-term bankruptcy gains broader recognition, however, Uncle Sam increasingly will have difficulty selling its debt to anyone other than the Federal Reserve (see the *Hyperinflation Special Report* of April 8, 2008). Shy of what new debt can be foisted on a gullible public or severely pressured U.S. trading partners, there should be zero new funds available to pay for new government programs, expanded programs or fiscal stimulus.

Nonetheless, the political miscreants in Washington will continue to spend money they do not have and that they have no prospects of ever raising, at least until the financial markets start to say "no more." With the economy in a structural contraction, promised further fiscal stimulus will have increasingly short-lived positive impact on the economy, but increasingly dire consequences for the U.S. fiscal condition and the U.S. dollar.

Views expressed by President-Elect Obama have been heavily suggestive of a rapid push by his Administration for a more-expansive, more-controlling, more-intrusive and more-expensive central government. As a rule of thumb, forced redistributions of income and wealth, greater government control of production and commerce, and more-intrusive government programs such as nationalized health insurance tend to lead to a less

productive and less competitive society. Such programs limit economic growth and -- at the extreme -- ultimately condemn business activity to perpetual bottom-bouncing. Such programs not only would exacerbate the current structural downturn in the U.S. economy, but also would accelerate the timing on the eventual hyperinflation, given the deficit financing needs of same.

### **U.S. Dollar Strength a Temporary Artifact of Ongoing Solvency Crisis.**

As discussed in greater detail in the respective market or reporting sections, the sharp rise in the value of the U.S. dollar has been key to the decline in gold, silver and oil prices. The dollar's recent surge has been heavily affected by the dollar-holding needs of foreign investors in the process of deleveraging. That process is ongoing. At such time as the markets begin to stabilize, the pressures on the dollar likely will shift sharply to the sell side, which in turn should help to boost pricing both for precious metals, as well as for dollar-denominated oil.

### **Oil/Gasoline Price Declines Partially Pre-**

**Election Politics?** When national gasoline prices averaged above \$4.10 per gallon back in June and July -- with oil prices at record highs -- not only was the gasoline-consuming electorate feeling increasing cost-of-living discomfort, but the political implications for the incumbent Republican Party holding the White House were horrendous. Beyond the possibility of political deals that may have been struck within the global oil industry, a sudden and unfounded surge in buying of the U.S. dollar began (likely Treasury/Fed encouraged), which added significant downside pressure to oil prices. Those factors, combined with already weakening gasoline demand and normal seasonal price variation, brought gasoline prices down by about 45% to an average \$2.28 per gallon in the week including election day, back to price levels not seen since February 2007 (Department of Energy numbers).

With the election having gone against the Republicans, whatever political pressures were there to keep gasoline prices low, have vanished. Any new political pressures now will be coming from the Democrats, along with what had been promises of something along the lines of a windfall profits tax for U.S. oil corporations.

**Gasoline Prices Will Reduce Near-Term CPI Inflation.** Those arguing that the U.S. faces deflation, as opposed to inflation, in goods and services prices in the not-too-distant future -- an actual contraction annual CPI inflation -- anticipate contracting money growth and look at collapsing commodity prices hit by an unfolding, savage global recession. In fact, the October manufacturing purchasing managers survey showed a sharp decline in its price index into deflation territory.

Near-term CPI reporting likely will see two fairly strong, seasonally-adjusted monthly contractions in October and November, thanks to the recent collapse in gasoline prices, but that should be about the extent of the oil induced "deflation." As these particularly large declines are absorbed by the CPI, annual inflation will not come close to turning negative.

Aside from risks of a resurgence in oil prices -- discussed later -- possibly adding near-term upside pressures on energy prices, the long-term impacts of a weaker dollar and high oil prices still are working their way through the system, during the next six months or so.

As a separate and overriding issue, price inflation is a monetary phenomenon. Although broad money growth has slowed on an annual basis (to a level that still is highly inflationary) and contracted on a monthly basis, and although velocity may have slowed along with the solvency crisis, actions by the Federal Reserve and U.S. Treasury have put into play a surge in money growth that should become painfully evident in the next several months. As money growth resumes, so, too, will velocity accelerate, as

consumers again consider the implications of negative real interest rates.

**Federal Deficit and Debt Continue to Explode.** As discussed in more detail in the federal deficit section, gross U.S. federal debt at the end of October had increased by \$928 billion since the end of August, an increase of 10.2% in two months. The officially gimmicked federal deficit was \$169 billion in 2007, \$455 billion in 2008, and it appears to be headed to \$1.5 trillion in 2009. Such has contributed to the timing advance in the possible year of the hyperinflation onset.

**Risks of U.S. Default.** I keep receiving queries on a possible default on U.S. debt within the next year or so, as result of the explosive growth in federal debt. Such is not likely, unless foreign lenders start making not-so-unreasonable demands that the United States issue its debt in yen, pounds, euros, etc. While the government's gross debt level is exploding, the United States already had no prospects of ever honoring the obligations that were in place before the current crisis (see the *Hyperinflation Special Report* of April 8, 2008). Under such circumstances, most governments would opt to use the printing press to inflate their way out of debt, rather than to go through a formal debt default.

That is why the agencies that issue sovereign debt ratings usually will give a "AAA" rating, when debt is issued in the sovereign's currency, backed by the power of being able to create whatever currency is needed in order to meet the obligations.

If, however, the U.S. had to start covering new obligations in something other than the U.S. dollar, then the risk of formal default would become meaningful, and sovereign ratings on non-dollar U.S. Treasury debt easily could fall below investment grade.

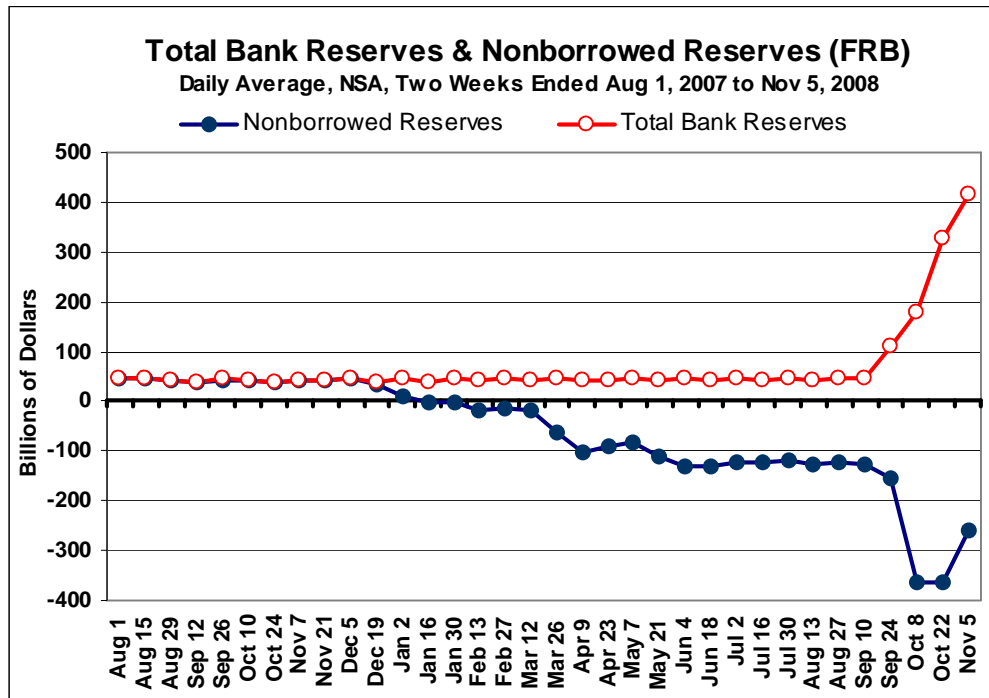
**Reserves and Monetary Base Surge, Broad Money Measure Still Lags.** As shown in the following graphs, total reserves of depository

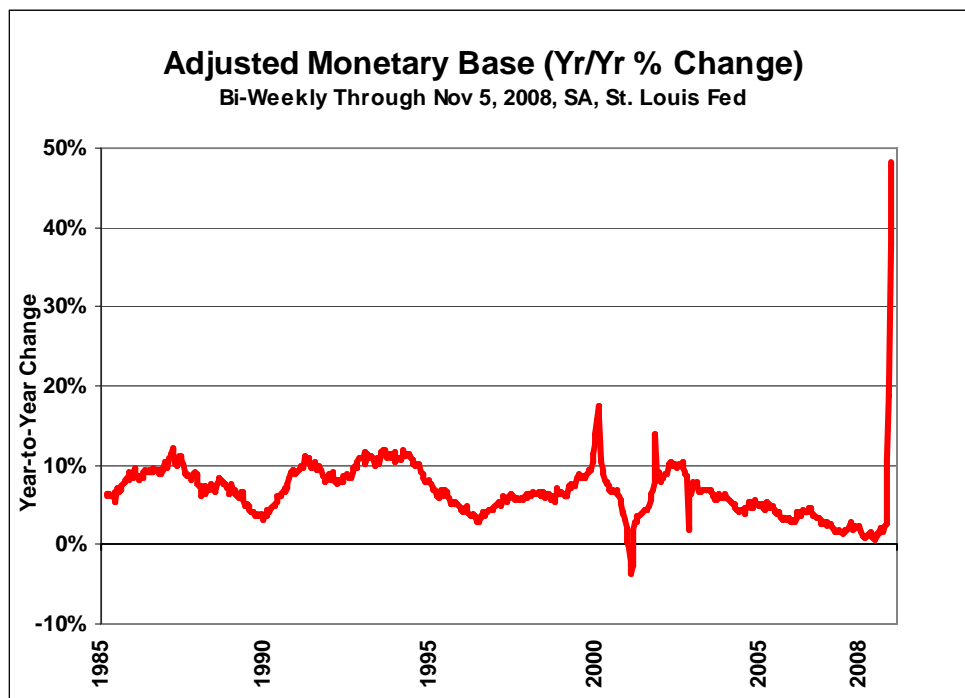
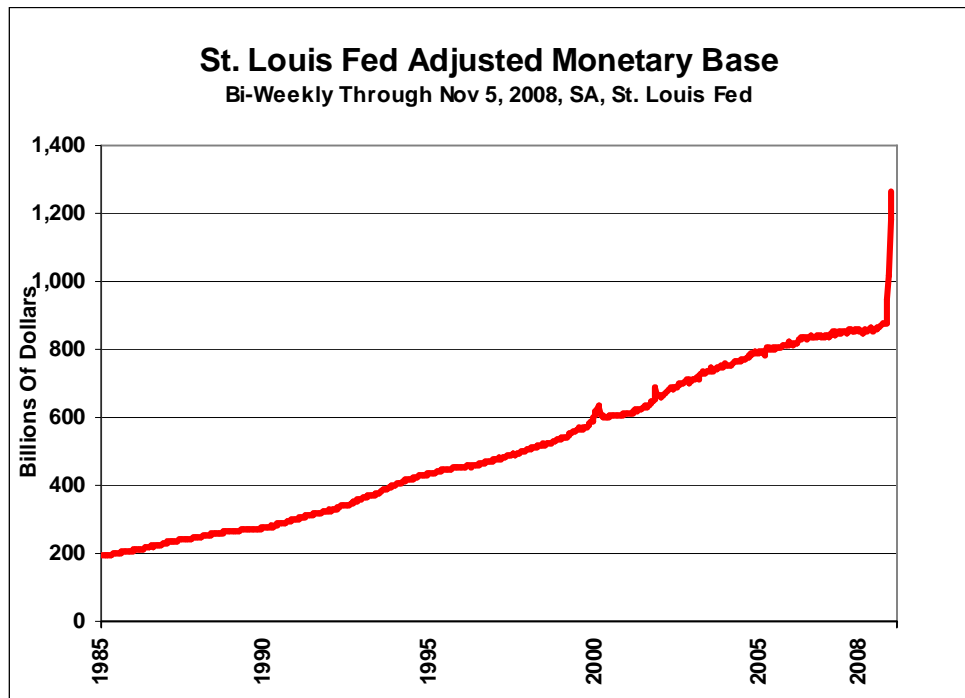
institutions (FRB, not seasonally adjusted) continued to surge, rising to \$415.7 billion in the two weeks ended November 5th, from \$327.6 billion in the prior two-week period, and from \$44.2 billion as recently as September 10th.

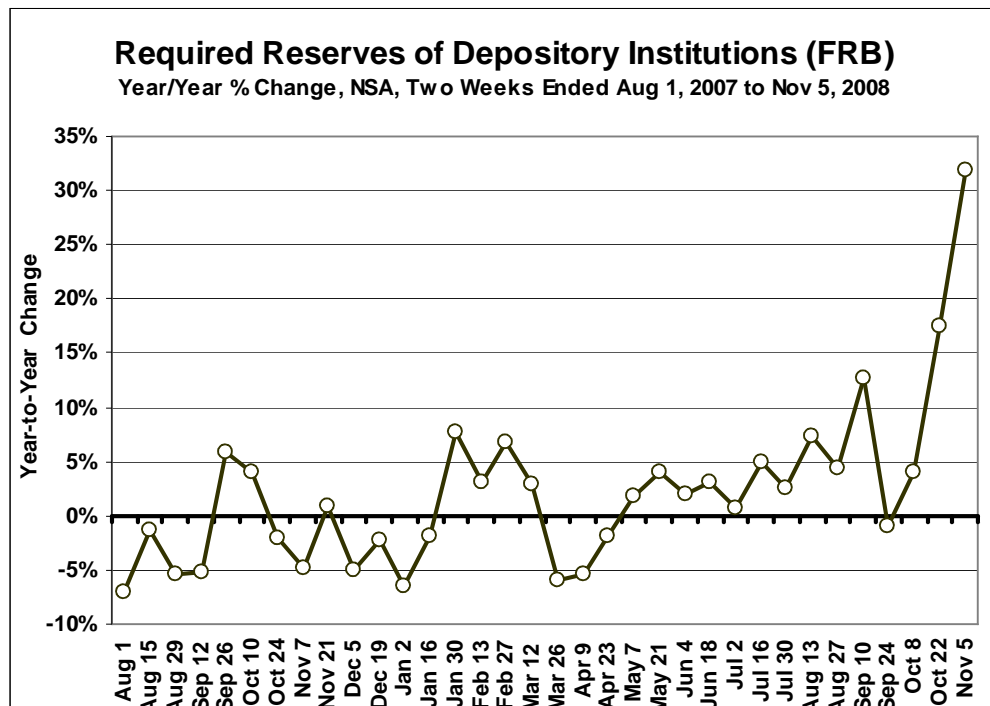
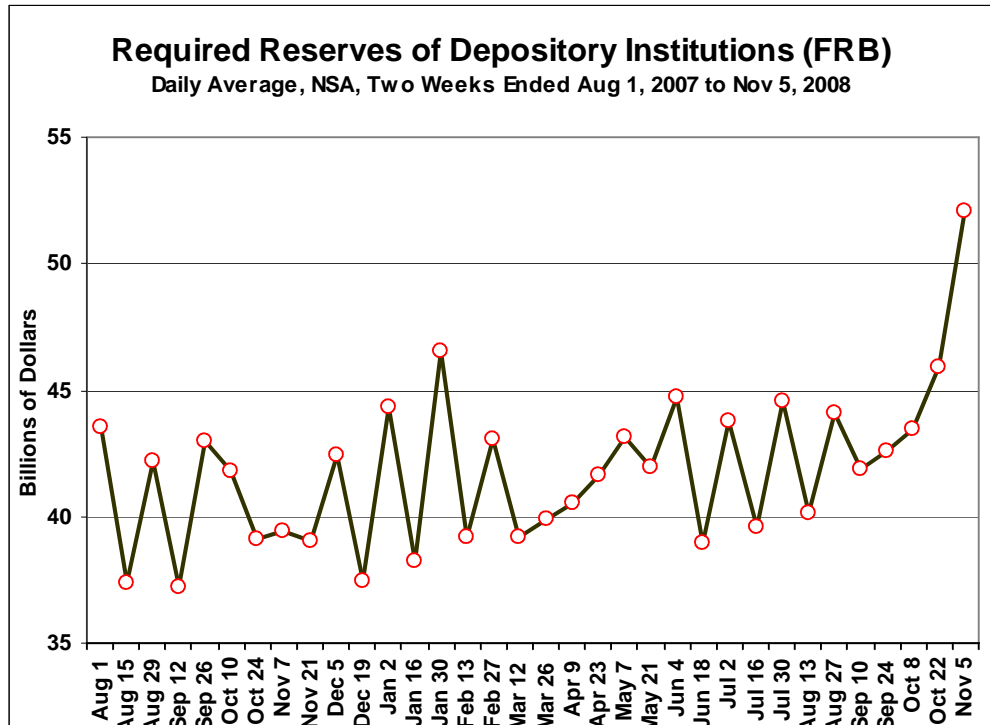
Where most of the growth has been in excess reserves, such suggests that the banks generally have not resumed normal lending. Of some significance, however, required reserves rose to \$52.1 billion in the latest period, up from \$45.9 billion in the prior period and from \$41.9 billion in the two weeks ended September 10th. The 31.9% annual growth in required reserves is at the fastest pace of the post-World War II era. This suggests

that the excess reserves have started entering the system, albeit slowly, even allowing for shifts in unreserved existing funds into accounts that have reserve requirements.

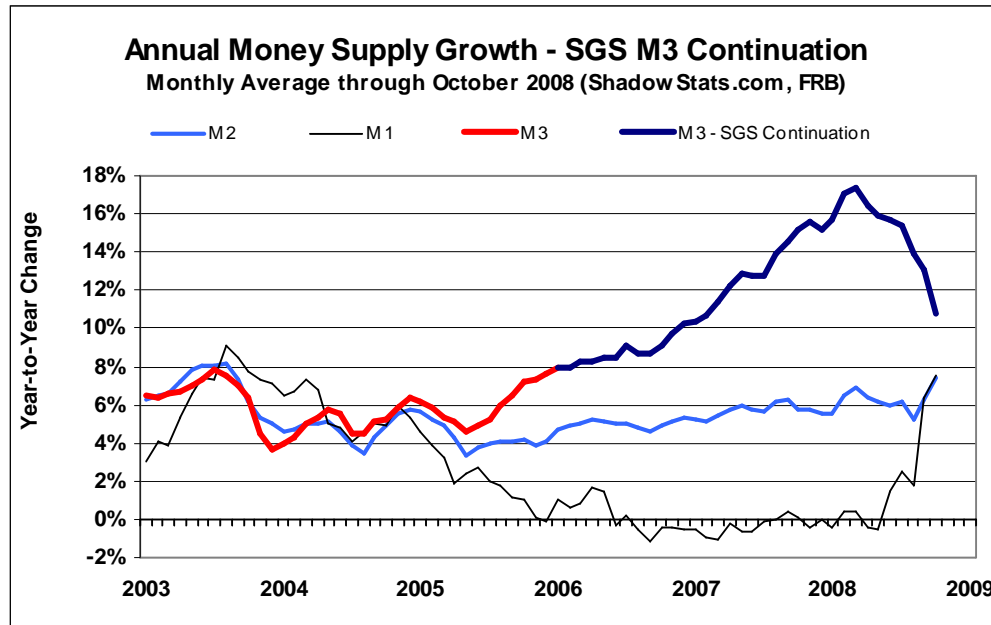
The seasonally-adjusted St. Louis Fed Monetary Base -- the traditional tool for adjusting money supply growth -- rose by 7.0% (annualizes to over 3200%) between the two-week periods ended October 22nd and November 5th. The monetary base basically includes the currency component of M1 and total bank reserves. Year-to-year growth for the latest two week period was 48.2%, up from 38.0% year-to-year in the prior period, due largely to surging reserves.











**Annual Broad Money Growth Slows, Contracts on Monthly Basis.** The monthly-average annual growth in the SGS-Ongoing M3 estimate for October was roughly 10.8%, still a highly inflationary level, and likely the trough in the current growth cycle. Monthly change was a contraction of 0.4%, the ninth such contraction since 2000. There are indications that the M3 components have started to pick-up in response to the recent extreme accommodation by the Federal Reserve. Details will be provided in *Flash Updates* as the information becomes available.

As discussed in the *Money Supply Special Report* of August 3, 2008, there is no perfect measure of money growth. Generally, the broader the measure (M3 being the broadest until discontinued by the Fed in 2006, still estimated by the SGS-Ongoing M3), the better it is as a predictor of inflation. Discontinued in 1998 by the Fed was a still-broader measure known as "L" for liquid assets. It contained individual holdings of Treasury bills. In the recent panic, the Treasury issued bills to help keep that market liquid, but that had the effect of drawing cash out of the system and out of the reported money supply. If "L" still were published, I estimate annual growth would have been about 15% in October.

Fed apologists offer assurances that the U.S. central bank will dry up excess liquidity when the crisis passes, with no net impact on money supply growth or inflation prospects. Assurances also are being put forth that the surge in government borrowing will be absorbed happily by the usual forced lenders, and that the Fed will not have to monetize Treasury debt further. Do not count on that! As to talk of declining money supply velocity in the current crisis, such has some merit, but as bank lending returns to normal (which it will, as it is forced by the Fed, the Treasury and Congress), so, too, will velocity likely accelerate anew in response to still negative real (inflation-adjusted) interest rates.

**Formal Recession Appears Near.** A week before the "advance" estimate of third-quarter GDP was released, the White House effectively warned that it would show a contraction, as would likely the fourth quarter. Such would be a recession terms of traditional definition. Whether that will happen, however, remains to be seen. Recent trade reporting could allow for the artificially small 0.3% third-quarter contraction to revise away.



As shown by almost all major economic indicators, the U.S. economy is in a deep and deteriorating structural recession, which could reach depression status in 2009. The nature of the structural problem and depth of the current downturn are addressed in historical perspective in the Reporting/Market Focus. Based on existing GDP, GDI and GDP reporting, the following quarters have shown inflation-adjusted quarterly contractions: 1Q07 (GNP/GDI), 4Q07 (GDP/GDI), 1Q08 (GDI), 3Q08 (GDP). Accordingly, in conjunction with the better quality underlying economic series, these patterns suggest that a formal recession could be timed from as early as fourth-quarter 2006.

Such timing would support my contention that the current downturn is but the second leg of a multiple-dip recession that began back in 2000. Given the recession's structural nature and the present fiscal limitations on the U.S. government, this contraction will be particularly protracted. Recovery is not yet within the nine-month horizon of the better leading indicators to economic activity.

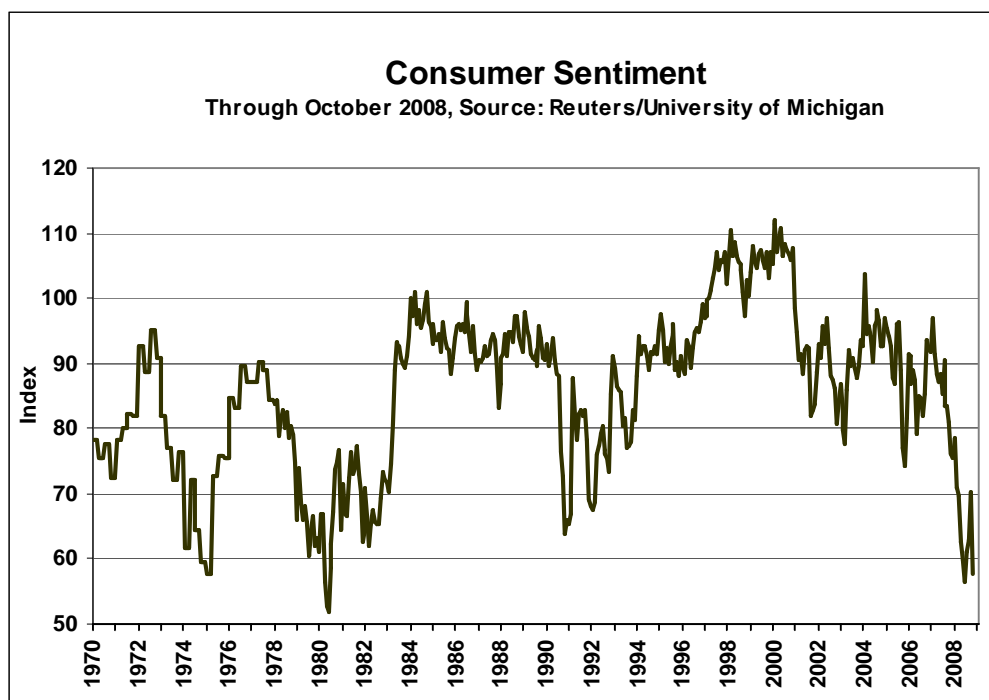
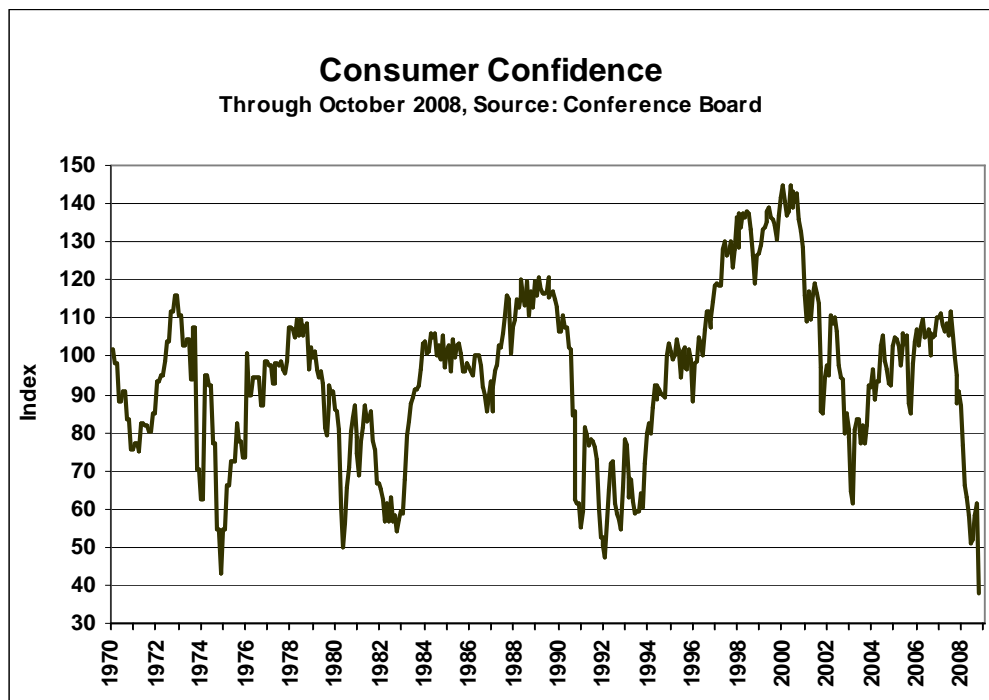
The following series of six graphs reflect the official recessions of 1969/70, 1973/5, 1980, 1981/2, 1990/1 and 2001 (see this month's

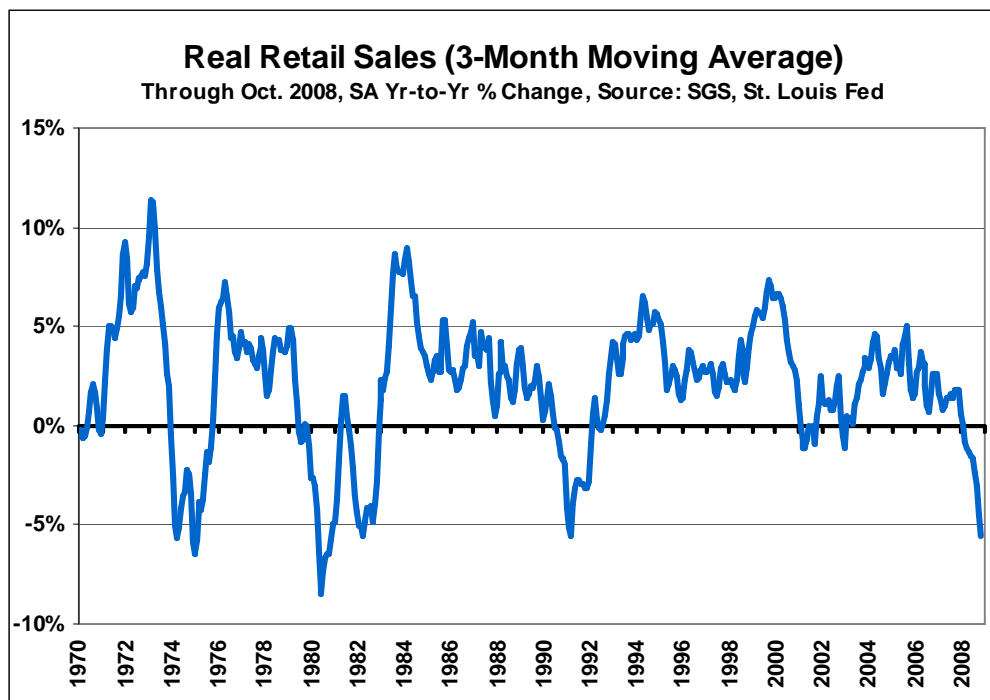
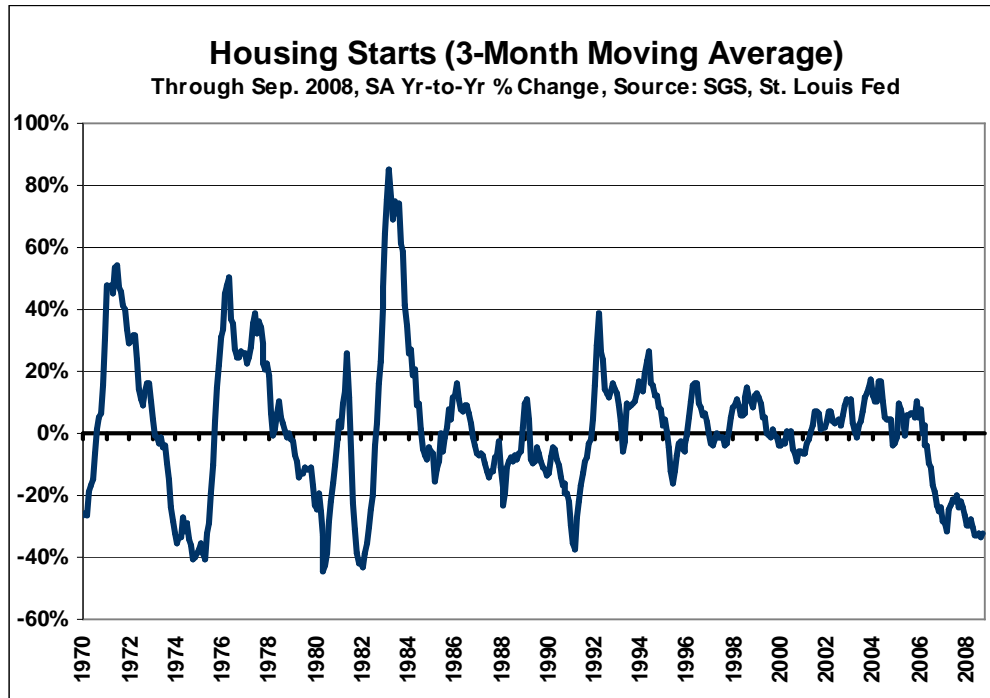
Reporting/Market Focus), as shown with the low readings or the depths of contraction never seen outside of official recessions. The less-severe downswings tend to coincide with unofficial downturns, also discussed in this month's Reporting/Market Focus.

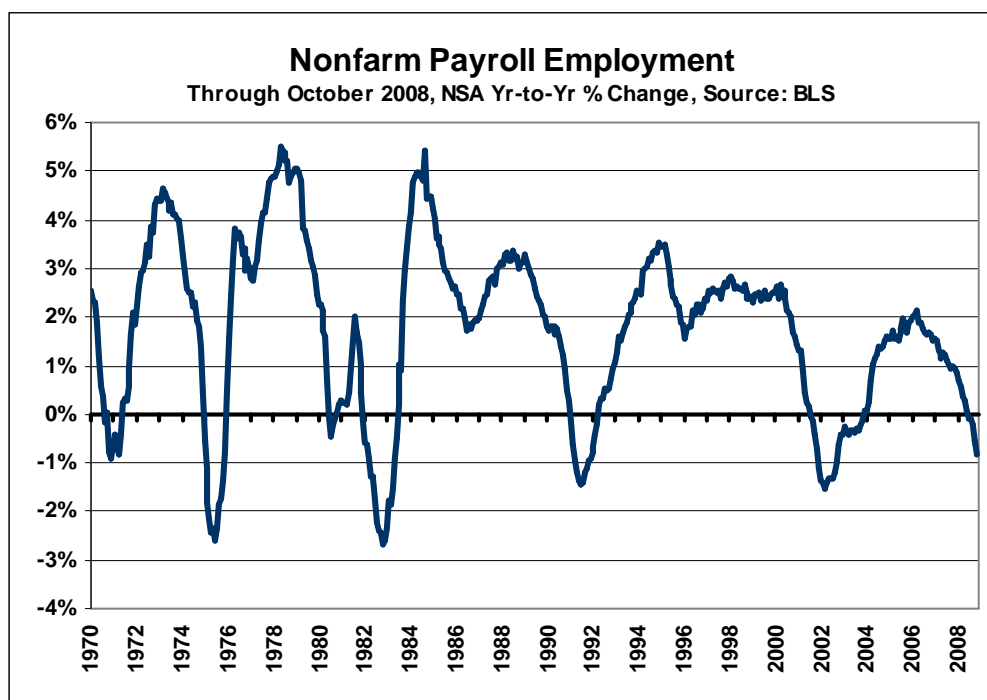
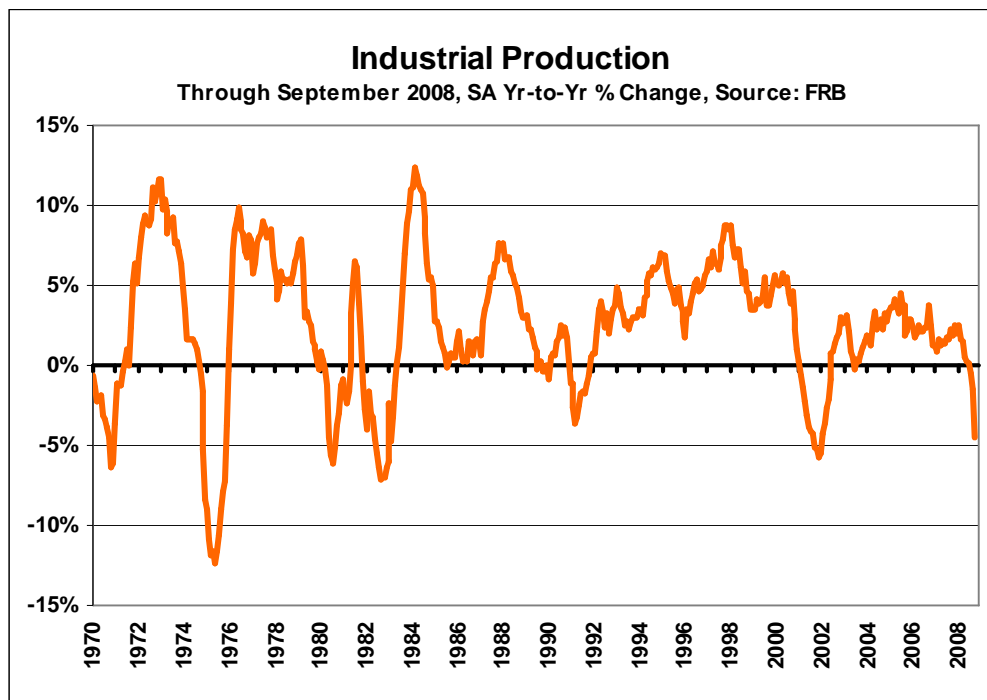
The consumer confidence and sentiment measures have shown extremely sharp downturns, and are consistent with the annual growth patterns seen in housing starts and retail sales, as well as the later pattern seen in payrolls. In like manner industrial production has mirrored the pattern of consumer demand.

In each series showing year-to-year change, the patterns show not only sharp year-to-year contraction in the last year or two, but the underlying numbers in each series also show successive quarter-to-quarter contractions. These patterns of sharp contractions never have been seen outside of periods of formal recessions.

The housing starts graph was adjusted to eliminate New York City paperwork distortions that artificially inflated June 2008 reporting. The retail sales graph includes October reporting, with an estimate of a seasonally adjusted 1.0% decline in the October CPI.



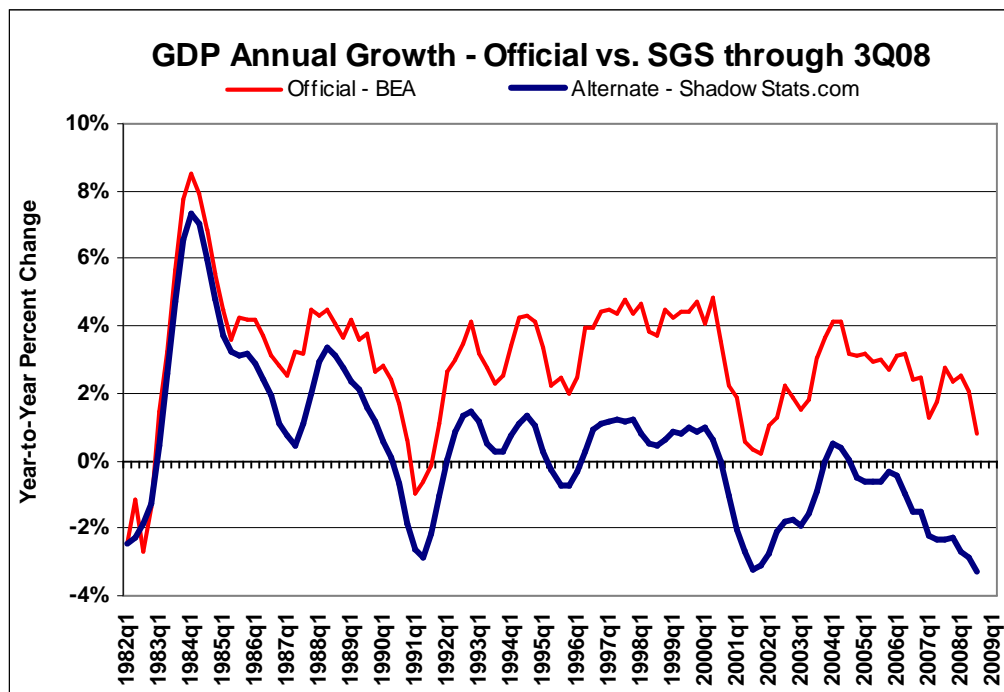




*PLEASE NOTE: A "General background note" provides a broad background paragraph on certain series or concepts. Where the language used in past and subsequent newsletters usually has been or will be identical, month-after-month, any text changes in these sections will be highlighted in bold italics upon 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.** This section updates the Shadow Government Statistics (SGS) alternate

measures of official GDP, unemployment and CPI 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 pre-Reagan-Era CPI and GDP and the pre-Clinton Era unemployment rate. Methodologies for the GDP and CPI series are discussed in the August 2006 SGS.



**GDP.** The alternate third-quarter 2008 GDP growth reflects the "advance" estimate, with many of the methodological gimmicks of recent decades removed. The alternate third-quarter inflation-adjusted annual growth rate (year-to-year, as opposed to the popularly-touted annualized

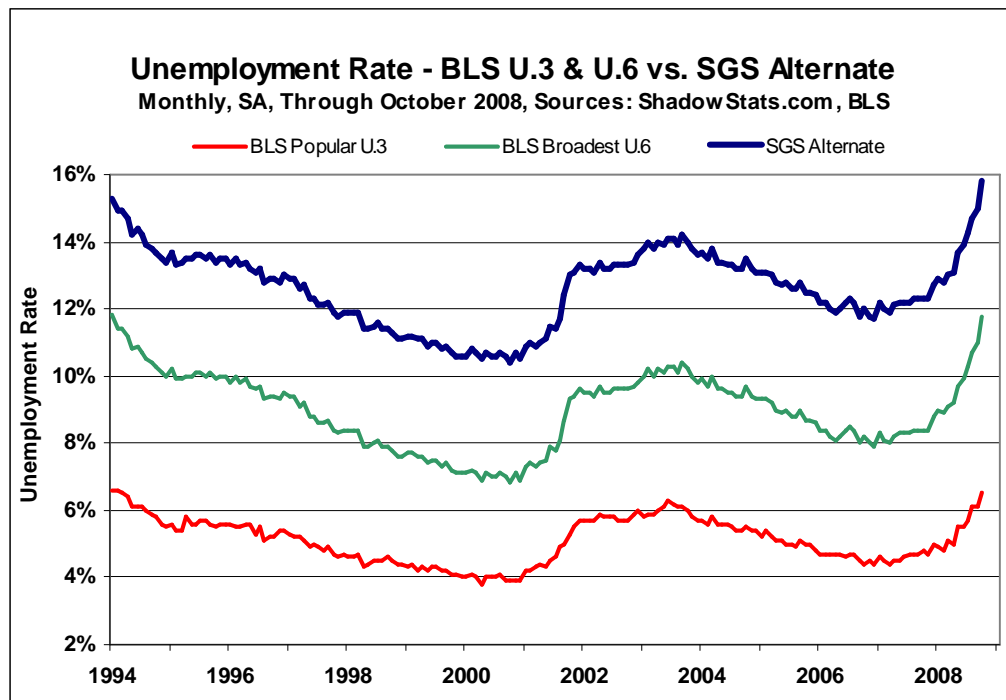
quarter-to-quarter rate) for GDP was a decline of roughly 3.3% versus the official year-to-year gain of 0.8%. The official, annualized real quarter-to-quarter change stands at a 0.3% contraction. While the quarterly growth number is popularly followed, its significant inaccuracies are expanded

to the fourth-power in reporting. The alternate measure safely would have shown an annualized quarterly contraction in the third quarter, likely in excess of two-percent.

*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](http://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, which are major indicators used by the National Bureau of Economic Research in determining the official timing of U.S. business cycles.



**Unemployment Rate.** Shown are two official seasonally-adjusted unemployment measures, U.3 and U.6, and the SGS-Alternate Unemployment Measure. The various measures moved sharply higher in October, reflecting the rapidly deteriorating labor-market conditions. They stood respectively at 6.5%, 11.8% and 15.8%, up from 6.1%, 11.0% and 15.0%.

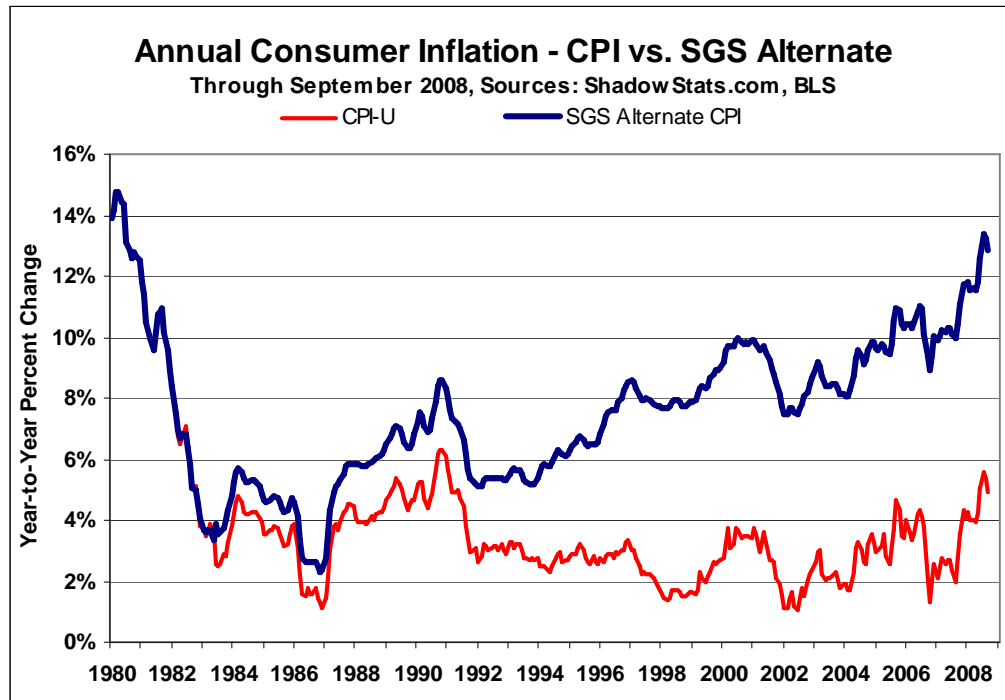
*General background note:* U.3 is the popularly followed unemployment rate published by the

Bureau of Labor Statistics (BLS), while U.6 is the broadest unemployment measure published by the BLS. U.6 is defined as total unemployed, plus all marginally attached workers, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all marginally attached workers. Marginally attached workers include the discouraged workers who survived redefinition during the Clinton Administration. The SGS-Alternate Unemployment Measure simply is U.6 adjusted for an estimate of the millions of

discouraged workers defined away during the Clinton Administration -- those who had been "discouraged" for more than one year.

*General background note:* Historical data on both the official and SGS-Alternate unemployment

series are available for download on the Alternate Data page of [www.shadowstats.com](http://www.shadowstats.com). The Alternate numbers are reported from the 1994 series redefinitions forward. It is planned to take the alternate series further back in time.



**CPI.** Absorbing a further sharp decline in energy prices, September's annual full inflation rates eased again, while "core" inflation largely held at August levels. Shy of October and November's pending inflation dips from the pre-election plunge in gasoline prices, annual inflation generally should rise well into 2009, with mounting inflationary pressures reflecting the ongoing flow-through impact of energy-cost damages to the general economy and upside inflation pressures from monetary growth in place before the recent systemic solvency crisis. Renewed and intensified money growth and dollar selling will spike the longer range inflation outlook further.

*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](http://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](http://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.



**Eight Levels of Consumer Inflation  
Annual Inflation for June to September 2008**

Measure		2008			
		Jun	Jul	Aug	Sep
I.1	Core PCE Deflator (r)	2.3%	2.5%	2.5%	2.4%
I.2	Core Chained-CPI-U	2.1%	2.2%	2.2%	2.2%
I.3	Core CPI-U	2.4%	2.5%	2.5%	2.5%
I.4	PCE Deflator (r)	4.1%	4.5%	4.5%	4.2%
I.5	Chained-CPI-U	4.2%	4.8%	4.7%	4.3%
I.6	CPI-U	5.0%	5.6%	5.4%	4.9%
I.7	Pre-Clinton CPI-U	8.3%	8.9%	8.7%	8.3%
I.8	SGS Alternate Consumer Inflation	12.6%	13.4%	13.2%	12.9%

(r) Revised.

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](http://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.

## MARKETS PERSPECTIVE

The following table shows still another snapshot of the protracted financial panic's roller coaster ride, where extreme volatility in prices has become the near-term norm for various markets. The systemic

### Closing Financial-Market Indicators as of November 13, 2008

<i>Indicator</i>	<i>4th-Quarter-to-Date November 13, 2008</i>				<i>3rd-Quarter 2008</i>			<i>Year-End 2007</i>	
	<i>Level</i>	<i>QTD</i>	<i>YTD</i>	<i>Yr/Yr</i>	<i>Level</i>	<i>YTD</i>	<i>Yr/Yr</i>	<i>Level</i>	<i>Yr/Yr</i>
<b><i>Equity Market</i></b>									
<b>DJIA</b>	<b>8,835.25</b>	-18.57%	-33.39%	-33.60%	<b>10,850.66</b>	-18.20%	-21.39%	<b>13,264.82</b>	6.43%
<b>S&amp;P 500</b>	<b>911.29</b>	-21.76%	-37.94%	-38.47%	<b>1,164.74</b>	-20.68%	-23.71%	<b>1,468.36</b>	3.53%
<b>DJ Wilshire 5000</b>	<b>9,120.05</b>	-23.20%	-38.46%	-39.00%	<b>11,875.40</b>	-19.87%	-22.70%	<b>14,819.60</b>	3.94%
<b>NASDAQ Comp</b>	<b>1,596.70</b>	-23.67%	-39.80%	-40.28%	<b>2,091.88</b>	-21.13%	-22.57%	<b>2,652.28</b>	9.81%
<b><i>Credit Market (1)</i></b>									
<b>Fed Funds Target</b>	<b>1.00%</b>	-100bp	-325bp	-350bp	<b>2.00%</b>	-225bp	-275bp	<b>4.25%</b>	-100bp
<b>3-Mo T-Bill</b>	<b>0.22%</b>	-70bp	-314bp	-328bp	<b>0.92%</b>	-244bp	-290bp	<b>3.36%</b>	-166bp
<b>2-Yr T-Note</b>	<b>1.24%</b>	-76bp	-181bp	-230bp	<b>2.00%</b>	-105bp	-197bp	<b>3.05%</b>	-177bp
<b>5-Yr T-Note</b>	<b>2.43%</b>	-55bp	-102bp	-141bp	<b>2.98%</b>	-47bp	-125bp	<b>3.45%</b>	-125bp
<b>10-Yr T-Note</b>	<b>3.84%</b>	-1bp	-20bp	-42bp	<b>3.85%</b>	-19bp	-74bp	<b>4.04%</b>	-67bp
<b>30-Yr T-Bond</b>	<b>4.34%</b>	3bp	-11bp	-27bp	<b>4.31%</b>	-14bp	-52bp	<b>4.45%</b>	-36bp
<b><i>Oil (2) US\$ per Barrel</i></b>									
<b>West Texas Int.</b>	<b>58.24</b>	-42.13%	-39.34%	-36.13%	<b>100.64</b>	4.82%	23.23%	<b>96.01</b>	57.24%
<b><i>Currencies/Dollar Indices (3) US\$/Unit</i></b>									
<b>Pound Sterling</b>	<b>1.4799</b>	-16.88%	-25.42%	-28.61%	<b>1.7804</b>	-10.28%	-12.68%	<b>1.9843</b>	1.31%
<b>Euro</b>	<b>1.2526</b>	-11.04%	-14.22%	-14.19%	<b>1.4081</b>	-3.57%	-0.97%	<b>1.4603</b>	10.65%
<b>Swiss Franc</b>	<b>0.8337</b>	-6.71%	-5.55%	-6.16%	<b>0.8937</b>	1.25%	4.32%	<b>0.8827</b>	7.64%
<b>Yen</b>	<b>1.0422</b>	10.41%	16.43%	14.97%	<b>0.0094</b>	5.45%	8.52%	<b>0.0090</b>	6.54%
<b>Canadian Dollar</b>	<b>0.8123</b>	-13.92%	-19.73%	-21.70%	<b>0.9437</b>	-6.75%	-6.02%	<b>1.0120</b>	17.92%
<b>Australian Dollar</b>	<b>0.6402</b>	-19.00%	-27.05%	-28.01%	<b>0.7904</b>	-9.94%	-10.74%	<b>0.8776</b>	11.31%
<b><i>Weighted Currency Units/US\$ (Jan. 1985 = 100)</i></b>									
<b>Financial (FWD)</b>	<b>55.77</b>	12.55%	18.01%	21.18%	<b>49.55</b>	4.85%	4.93%	<b>47.26</b>	-7.64%
Change US\$/FX	--	-11.15%	-15.26%	-17.48%	--	-4.62%	-4.70%	--	8.27%
<b>Trade (TWD)</b>	<b>60.24</b>	9.97%	14.26%	15.96%	<b>54.78</b>	3.91%	2.34%	<b>52.72</b>	-10.00%
Change US\$/FX	--	-9.06%	-12.48%	-13.76%	--	-3.76%	-2.28%	--	10.01%
<b><i>Precious Metals (4) US\$ per Troy Ounce</i></b>									
<b>Gold</b>	<b>713.50</b>	-19.33%	-14.42%	-11.28%	<b>884.50</b>	6.09%	19.04%	<b>833.75</b>	31.92%
<b>Silver</b>	<b>9.37</b>	-27.70%	-36.52%	-36.17%	<b>12.96</b>	-12.20%	-5.06%	<b>14.76</b>	14.41%

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

solvency crisis has continued to evolve, roiling investors' outlooks, triggering panicked market moves and flights-to-safety amidst heavy crosscurrents of distortions from forced portfolio liquidations of troubled entities, a general deleveraging of the system, and ongoing overt and covert official market interventions and manipulations. Daily stock market movements in the U.S. have gotten so volatile, that large one-day swings are yawned at, where once they would have been considered stock crashes.

Except against the yen, the U.S. dollar generally has rallied strongly in recent months, counter to underlying fundamentals. Buying of the greenback reflects strong demand for dollars as various global entities have been forced to deleverage their investment positions. Market hype as to the relatively better U.S. economic or financial-system conditions, versus the rest of the world, is nonsense. The dollar's strength should prove to be temporary. At such time as heavy U.S. dollar selling resumes, affected markets in precious metals and oil should see significant rallies.

*General background note:* The broad outlook is unchanged, with still-intensifying crises in systemic solvency and in a deepening inflationary recession. Over the long-term: U.S. equities will continue to suffer in a severe bear market; long-term U.S. Treasury yields will spike in response to inflation, eventual dollar dumping and mounting Treasury borrowing needs against a market with weakening demand; selling will intensify against the U.S. dollar, evolving into dollar dumping and dumping of dollar denominated assets; precious metals, particularly gold, will rally against mounting monetary and inflation pressures (likely higher oil prices), weakness in the dollar, and as safe-havens against increasing systemic instability. Holding gold and holding assets outside the U.S. dollar (such as in Swiss francs **and the Canadian dollar**) remain the best long-range hedge against all the real risks facing investors and the system.

**U.S. Equities** -- The equity markets have never been more unstable, with major indices down 33% to 40% year-to-year. Almost anything is possible, with underlying fundamentals remaining miserable. The ongoing nature of the systemic solvency crisis, a generally less-business-friendly Administration coming to power in about two months, and a severe and protracted inflationary recession that will mean heavy hits to corporate earnings, all weigh on the equity markets. Eventually, heavy dollar selling and increased flight from dollar-denominated assets should also drain liquidity from the domestic markets, hitting both stock and bond prices. Higher market interest rates generally act as an inhibitor to stock market exuberance.

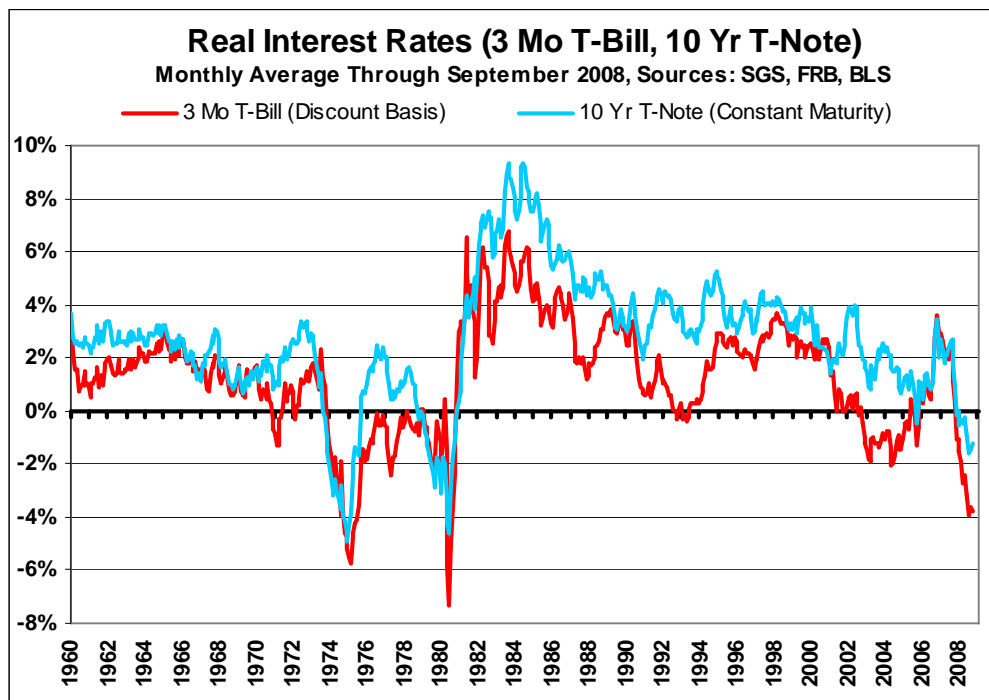
*General background note:* I contend that stocks already have turned down into what will prove to be a particularly protracted and savage bear market (see the *Hyperinflation Special Report*). As equities catch-up with the underlying economic, financial and systemic fundamentals, the downside adjustments to stock prices should be quite large over some years, eventually rivaling the 90% decline in equities seen in the 1929 crash and ensuing four years. The decline might have to be measured in real terms, as a hyperinflation eventually will kick in, with the Fed moving to liquefy the system and monetize federal debt. 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 well below today's levels, adjusted for inflation.

**U.S. Credit Market** -- Despite heavy borrowing by the U.S. Treasury, ongoing flight-to-safety issues for both individuals and institutions and ongoing foreign investment have kept Treasury yields unusually low. With the Fed having lowered the targeted federal funds rate to 1.00%, the U.S. central bank has moved within in striking range of 0%. Accordingly, there is little further downside potential for Fed easing, although the lower rates generally are ineffective in stimulating

current economic activity. The Fed, however, could be pushed into raising rates in defense of the U.S. dollar. At such time as intense selling of the greenback resumed, and if that threatened domestic liquidity, which it likely would, then the Fed would have little choice but to raise rates.

Net of inflation, Treasury yields remain negative, and negative real interest rates should remain the

case following the release of the October CPI (November 19th). The exception could be for the 30-year Treasury bond yield, which might briefly show a slightly positive real yield. At subscriber request, the following graph of real interest rates is shown. It plots monthly average 3-month Treasury bill and 10-year Treasury note yields less annual CPI-U inflation.



The common pattern to periods of negative real interest rates is that they generally have been seen during inflationary recessions, when the Fed has eased despite ongoing inflation problems. When inflation exceeds interest rates, it makes more sense for individuals to buy products instead of Treasuries, since products will increase more in value than a note or bond. This circumstance encourages individuals not to hold cash, which in turn tends to increase money supply velocity.

The continuing financial crisis remains likely to suppress yields in the near-term, given ongoing safe-haven issues. Aside from the recent safe-

haven effects, the forced investment in U.S. Treasuries of unwanted dollars held outside the United States generally has kept U.S. Treasury yields artificially low. Therein lies upside risk for Treasury yields at such time as dollar dumping becomes serious. Other upside pressures will come from the deteriorating fiscal and monetary (inflation) conditions.

The longer range outlook continues for long-term Treasury yields to back-up by at least several hundred basis points, approaching a more-normal spread in long-term Treasuries over inflation. With a normal spread and annual inflation at

4.9%, the yield on the 30-year Treasury bond should be over 8.00%, not around the current 4.35%. Irrespective of any near-term softness in annual inflation, still-higher inflation looms in 2009, with corresponding upside risk to long-term interest rates.

**U.S. Dollar** -- Well beyond any coordinated, massive covert intervention in the currency markets to support the U.S. dollar following the Bear Stearns failure in mid-March, and related jawboning, it appears that the evolution of the solvency crisis has created an artificial demand for the U.S. currency. Troubled institutions have had to acquire dollars in the deleveraging process, along with the forced liquidations of various financial instruments. This process, by its nature, will be limited in its timing, but it has not yet run its course.

In terms of underlying fundamentals for the U.S. dollar, little has changed: they remain abysmal and are deteriorating. Accordingly, as the global financial system begins to stabilize, heavy selling of the U.S. dollar should resume, with the long-term outlook for the dollar remaining for a massive sell-off, and with flight from the dollar eventually evolving into a flight to safety outside the dollar.

The U.S. dollar's portfolio of underlying fundamentals generally could not be worse, but there have been some changes. Relative to major trading partners, the U.S. economy is much weaker; interest rates are lower; inflation is higher; rising federal deficit and relative trade-balance conditions are horrendous; and relative political/systemic concerns are high.

What has changed on the plus side is that although U.S. rates are low, major trading partners tend to be moving their rates lower, too, in response to growing global recession concerns. While such narrows the interest rate spreads and can help the dollar, it would be much more powerful for the greenback if the narrowing were due to the U.S. raising interest rates. As to political change, there

appears to be some positive reaction from major U.S. trading partners to the U.S. President-Elect. How that evolves remains to be seen.

On the downside, whatever limited U.S. fiscal and monetary discipline existed is gone. The U.S. is moving quickly to debase its currency in a manner unprecedented for the world's reserve currency. The U.S. economy also is in much worse shape than previously recognized by the rest of the world, and it is relatively much worse off than its major trading partners.

*General background note:* The proximal trigger for a full dollar panic already may be in place, given the still-unfolding solvency/funding crisis and the Fed and Treasury's response to same, ***although dollar funding needs in the crisis likely will have to abate first.*** Otherwise it could come from a bad economic statistic, political missteps by the ***current or incoming*** Administration, negative trade or market developments outside the United States, or a terrorist attack or expansion of U.S. military activity. When the trigger is pulled, what likely will be broad selling pressure will turn to an outright panicked dumping of the greenback, which should overwhelm any short-lived central bank intervention and roil the domestic financial markets. 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, on top of an otherwise intensifying systemic and economic crisis.

As shown in the accompanying graph, the U.S. dollar has rallied strongly since the Bear Stearns bailout, now turning positive on a year-to-year basis. The latest data points shown for the financial- and trade-weighted indices are as of Thursday, November 13th.

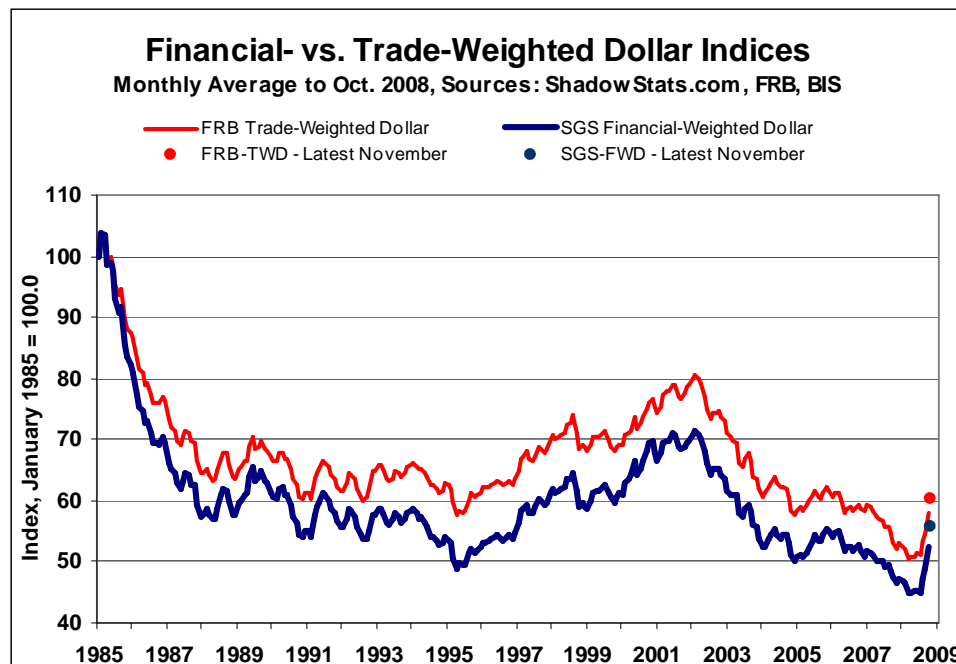
**U.S. Dollar Indices.** The Shadow Government Statistics' Financial-Weighted U.S. Dollar Index (FWD) is based on dollar exchange rates weighted for respective global currency trading volumes. For October 2008 the monthly FWD rose by 7.32% after a gain of 3.41% in September. The

October 2008 average index level of 52.48 (base month of January 1985 = 100.00) was up by 10.31% from October 2007, while September 2008 was up 0.64% from the year before. As of November 13th, the FWD stood at 55.77.

Also rallying in August was the Federal Reserve's Major Currency Trade-Weighted U.S. Dollar Index (TWD). The October 2008 average rose by 6.49% from September, which was up by 1.92% from August. The October 2008 index level of

57.87 (base month of January 1985 = 100.00) was up by 8.77% from October 2007, versus an annual 0.53% year-to-year decline in September. As of November 13th, the TWD closed at 60.24.

The differences in the two series can be accounted for largely by the much heavier weighting of the Canadian dollar in the TWD series.



*General background note:* Historical data on both dollar series are available for download on the Alternate Data page of [www.shadowstats.com](http://www.shadowstats.com). See the July 2005 SGS Newsletter for methodology.

**Gold and Silver** -- Beyond the related factors that have rallied the U.S. dollar, and any forced liquidations of gold to raise cash, there has been no underlying fundamental reason for the sharp decline in precious metals since the collapse that

began following the Bear Stearns bailout in mid-March. If anything, the fundamentals have gotten stronger for gold. While there likely was some direct manipulation of the market in precious metals, with the Fed and U.S. Treasury looking to kill the bullish sentiment for gold and silver -- at near-term highs in mid-March -- the faux turn in the U.S. dollar likely has been the major factor in the price declines of precious metals and oil.



For October (based on Kitco.com), the monthly average London gold afternoon fix was \$806.62 per troy ounce, down from \$829.93 in September. Silver averaged \$10.44 per troy ounce in October, down from \$12.37 in September. Gold has been pummeled, falling from its all-time high London afternoon fix of \$1,011.25 per troy ounce on March 17th, to \$713.50 as of November 13th (with intervening extreme volatility). In like manner, silver has plunged from its March 17th high of \$20.92 per troy ounce, to \$9.37 on November 13th.

When the dollar turns meaningfully to the downside, gold prices should rebound sharply and could regain \$1,000 fairly quickly. Gold not only serves as a hedge against currency debasement, as seen with the U.S. dollar, but also functions as a safe-haven investment.

Extreme near-term gold and silver price volatility likely will continue. Again, key to a rebound in prices is renewed weakness in the U.S. dollar. Upside price pressures otherwise should be in place from the broad ongoing debasement of the dollar by the Fed and Treasury, along with implications for much higher inflation ahead. Beyond the negative impact of forced liquidations, increasing global political, financial and systemic instabilities can trigger safe-haven rallies in the precious metals. Such may face offsets with bouts of profit taking and market distortions from intense overt and covert central bank interventions in the precious metals and currency markets, aimed at propping the greenback. Despite any central-bank machinations or intervention, the long-term upside potential for gold and silver remains explosive.

***Inflation-Adjusted Historic Gold and Silver Highs.*** Outside of the current period's March 17th high of \$1,011.25, the earlier all-time high of

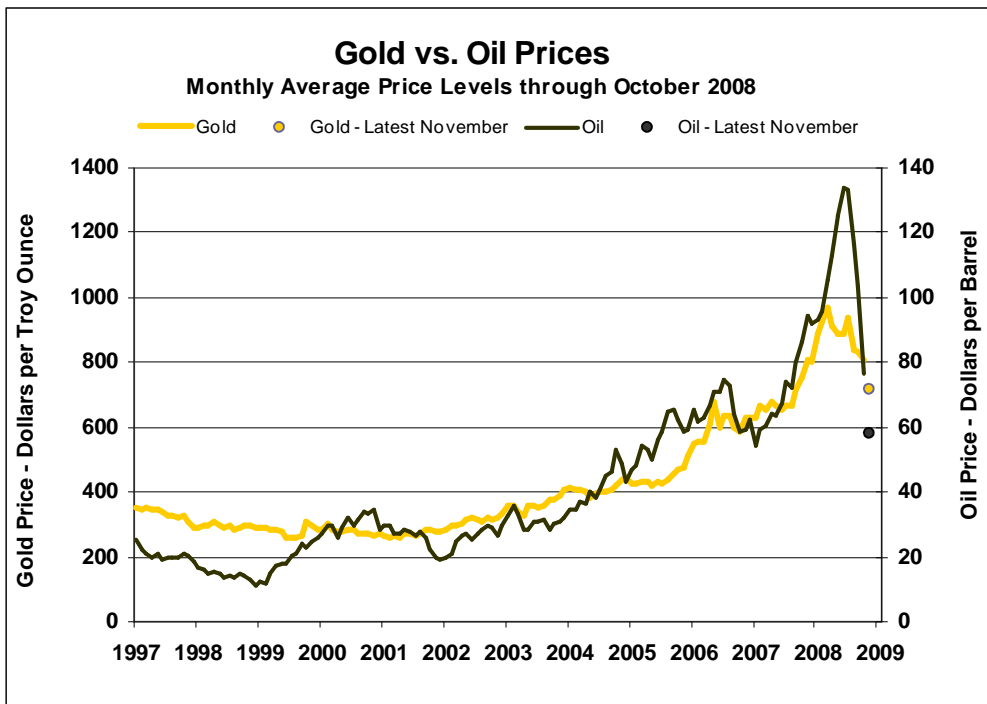
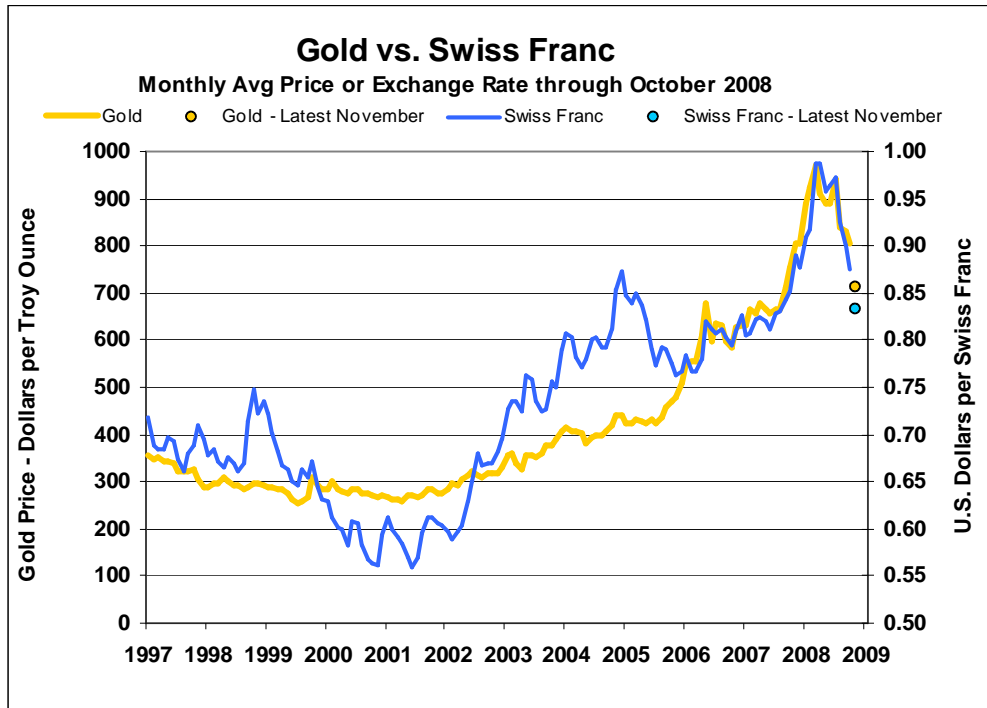
\$850.00 (London afternoon fix, per kitco.com) of January 21, 1980 still has not been hit in terms of inflation-adjusted dollars. Based on inflation through September 2008, the 1980 gold price peak would be \$2,390 per troy ounce, based on not-seasonally-adjusted-CPI-adjusted dollars, and would be \$6,763 per troy ounce in terms of SGS-Alternate-CPI-adjusted dollars.

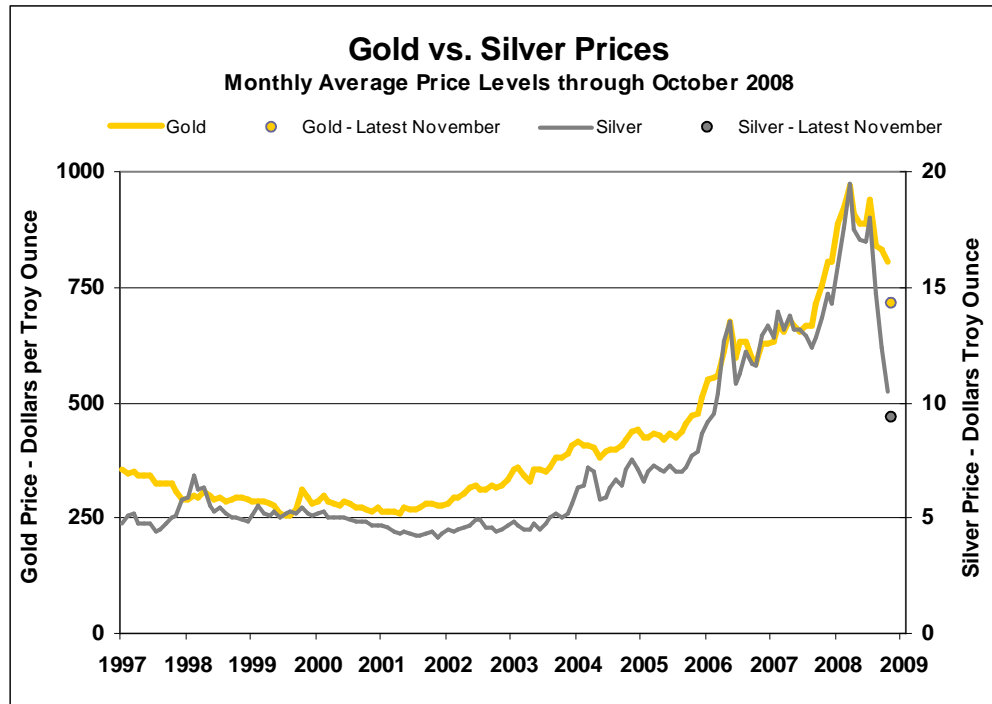
In like manner, the all-time high price for silver in January 1980 of \$49.45 (London afternoon fix, per silver institute.org) has not been hit since, including in terms of inflation-adjusted dollars. Based on inflation through September 2008, the 1980 silver price peak would be \$139 per troy ounce, based on not-seasonally-adjusted-CPI-adjusted dollars, and would be \$393 per troy ounce in terms of SGS-Alternate-CPI-adjusted dollars.

*General background note:* As discussed in the *Hyperinflation Special Report (April 2008)*, the eventual 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, Swiss franc and silver graphs show October monthly average price levels, as well as added points for closing prices on November 13th, with gold at \$713.50, silver at \$9.37, oil at \$58.24 and the Fed's published noon buying rate for the Swiss franc at \$0.8337. As current market distortions subside, all four measures should trade significantly higher in the months ahead, eventually breaking highs seen otherwise during the last year.







## REPORTING PERSPECTIVE

### The Big Three Market Movers

Most underlying economic fundamentals have deteriorated sharply in recent reporting, with a downside acceleration and catch-up seen in post-election payroll reporting. The election is over, so any short-term manipulations are likely to be financial-market oriented, aimed at pacifying the still highly unstable financial conditions. The apparent "concurrent seasonal factor bias" in headline reporting of payrolls continues and is assessed further in the Employment/Unemployment section.

The extraordinary drop in oil and gasoline prices will reduce the reported annual CPI inflation for October and probably November. Reporting patterns, again, are likely to reflect the rapid flow through of oil price swings to the downside, in contrast to the slow pick-up in reporting of energy-related costs when oil prices are rising. Those patterns tend to run counter to common experience.

Messrs. Bernanke and Paulson need a stable or relatively strong U.S. dollar in the evolving systemic solvency crisis, and such requires stronger economic data than commonly might be expected in the now widely accepted recession. With the financial crisis threatening national security, almost anything remains possible in the arena of data and market manipulations. Data manipulation is an extremely inexpensive and effective policy tool.

Absent manipulation, and against market expectations that have shifted sharply to the downside, most near-term economic reporting still should tend to surprise the markets on the downside. Market-moving reports, such as employment and GDP, however, still may show

massaged results that come in on the upside of expectations. With inflation expectations tanking along with oil prices, beyond the October CPI report, most inflation reporting should surprise expectations on the upside.

**Employment/Unemployment** -- As discussed and graphed in the Opening Comments, and as noted in the November 7th *Flash Update*, annual payroll contractions continued to show a pattern never seen outside of recession. Against a background of rapidly deepening recession and intensifying weakness in all other key employment/unemployment indicators, the Bureau of Labor Statistics (BLS) reported that the October seasonally-adjusted payroll levels plunged and that the unemployment rate soared, a picture much closer than usual to reality, but still something shy of it.

The pattern of revisions in the October report (released post-election) showed that pre-election reporting of job losses actually had been well shy of reality in initial estimates of August and September payrolls. Those happy headline numbers not only were relatively good news at the time for political incumbents, but also were taken positively by troubled financial markets that had been expecting something worse, each time.

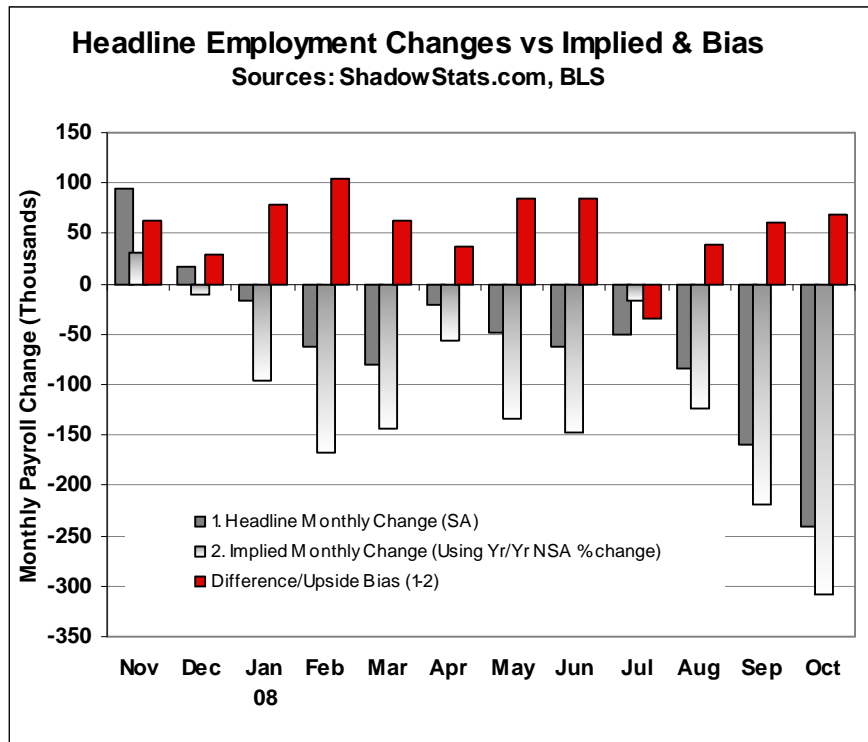
The initial reporting of jobs loss in August of 84,000 was revised to a 73,000 decline with the September report. In the October report, August's decline deepened in revision to 127,000. September's employment report -- the last before the election -- also showed a less severe than expected 159,000 drop in employment and an unchanged unemployment rate. Now, with October's reporting (the first since the election),

September's payroll data underwent extreme negative revision, to a 284,000 decline, while October showed a much larger than expected surge in unemployment. History would suggest this pattern is more a function of catch-up following political manipulation of the data, than it is of normal variation in monthly reporting. Also, as suggested by the ongoing upside concurrent seasonal bias, misreporting of the data continues.

The BLS also announced that its annual benchmark revision will adjust for an unbelievably low 29,000 jobs overstatement as of March 2008. The issues tied to the benchmarking process and

the related use of the gimmicked birth-death model will be reviewed in a later newsletter.

**Payroll Survey.** The BLS reported a statistically-significant, seasonally-adjusted jobs loss of 240,000 (down 419,000 net of revisions) +/- 129,000 for October, following a revised 284,000 (previously 159,000) jobs loss in September. Annual contraction (unadjusted) in total nonfarm payrolls continued to deepen, down 0.85% in October, versus a revised 0.52% (previously 0.43%) in September. The seasonally-adjusted series also contracted year-to-year, down by 0.78% in October, versus a 0.51% (previously 0.38%) contraction in September.



**Concurrent Seasonal Factor Bias.** The pattern of impossible biases (see the Reporting/Market Focus in *SGS Newsletter No. 43* of June 10, 2008) being built into the headline payroll employment changes intensified with October reporting. Instead of the headline jobs loss of 240,000, consistent application of seasonal-adjustment factors -- net of what we are calling the concurrent

seasonal adjustment bias -- would have shown a more-severe monthly jobs loss of about 308,000. This upside reporting bias has been seen in 11 of the last 12 months, with a rolling 12-month total upside headline-number bias of 678,000.

Examining the seven months of revised data, in place since the last benchmark revision, confirms

that an unusual upside reporting bias has been in play for the headline payroll numbers. In recent reporting, headline payrolls generally have come in slightly better than consensus expectations, helping the financial markets of the reporting day.

Before the standard two revisions that follow a headline release, the headline bias was positive in six out of the seven months, aggregating to 275,000. (In 11 out of the last 12 months, again the bias was positive, aggregating to 678,000.) After two revisions (non-benchmark), however, the seven months of data show now that three months ended up with negative biases, and four months had positive biases, aggregating to plus 44,000. The latter pattern is what should be typical for headline number reporting.

***Birth-Death/Bias Factor Adjustment.*** A minor element in October that added upside pressure to the payroll number was the monthly bias factor (birth-death model). Never designed to handle the downside pressures from a recession, the model added a 71,000 upside jobs bias to October 2008 (same amount as in October 2007), and followed a net upside bias of 42,000 jobs in September 2008. The process boosted financial-activities and construction jobs by 13,000 and 7,000, respectively, for the month. Although the adjustments are made to the unadjusted series, they flow through at roughly the same magnitude in the seasonally-adjusted series.

***Household Survey.*** The usually statistically-sounder household survey, which counts the number of people with jobs, as opposed to the payroll survey that counts the number of jobs (including multiple job holders), showed household employment fell by 297,000 in October, following a 222,000 loss in September.

The October 2008 seasonally-adjusted U.3 unemployment rate showed a statistically-significant increase to 6.50% +/- 0.23% from 6.12% in September. Unadjusted U.3 rose to 6.1% in October, versus 6.0% in September. The broader October U.6 unemployment rate jumped

to an adjusted 11.8% (11.1% unadjusted) from 11.0% (10.6% unadjusted) in September. Refigured for the bulk of the "discouraged workers" defined away during the Clinton Administration, actual unemployment, as estimated by the SGS-Alternate Unemployment Measure (graphed in the Alternate Realities section), rose to 15.8% in October, up from 15.0% in September.

In 1994, the BLS completely redesigned and redefined the unemployment series and all its measures, broad and narrow, so that the new series going forward could not be compared with the old series. I still am struggling to take my alternate measure back before 1994, where finding consistent and good data is a major problem. That said, the U.6 broad measure of 11.8% unemployment is the highest since the same reading in January 1994, where such was the first reading under the new definitions, during a period of unofficial recession.

***Employment Environment.*** The deterioration in October's employment environment continued in line with, but still shy of reality, per trends indicated by the better-quality employment-environment indicators: September help-wanted advertising remained at its historic low; new claims for unemployment insurance continued to surge sharply in terms of annual growth; and deepening, recession-level employment readings were seen in both the October manufacturing and nonmanufacturing purchasing managers survey. Since the employment and unemployment indicators tend to be coincident markers of broad economic activity, weaknesses in these numbers are signaling an ongoing recession in place.

***Next Release*** (December 5): Based on continuing deterioration in underlying economic activity, the November payroll survey should plunge by more than 300,000 jobs, along with a further spike in the unemployment rate. The Treasury/Fed's needs to continue to salve the markets, however, suggest that reporting likely will come in a little better

than consensus expectations in place in advance of the report.

**Gross Domestic Product (GDP)** -- As discussed in the Opening Comments and noted in the October 30th *Flash Update*, the Bush Administration signaled a week before the data release that not only would the "advance" estimate of third-quarter 2008 GDP growth show a contraction, but also that the fourth quarter likely would, too. Such would place in the U.S. economy in a formal recession based on traditional definition (see the Reporting/Market Focus).

The Bureau of Economic Analysis (BEA) estimated a 0.25% contraction +/- 3% (95% confidence interval) in the "advance" estimate of annualized real (inflation-adjusted) growth in third-quarter GDP. The number was statistically indistinguishable from average economic growth or a deep contraction, and it was against estimated second quarter real growth of 2.83%.

With the sharp reversal in current quarterly growth against the unbelievable annualized 4.8% growth reported for third-quarter 2007, year-to-year change slowed sharply, with annual third-quarter GDP growth slowing to 0.81%, from 2.05% in the second quarter. The SGS-Alternate GDP estimate is for an annual contraction of roughly 3.3% versus an annual (not annualized) contraction of 2.9% in the second quarter. Against reporting of underlying economic series, and annualized quarterly contraction in excess of 2% would have been more realistic than the 0.25% estimate. The SGS-Alternate GDP measure is graphed in the Alternate Realities section.

The difference between the reported 0.3% annualized Gross Domestic Product (GDP) and the consensus expectation of a 0.5% contraction was no more than statistical noise, yet the reported result most certainly was manufactured so as to allow the hysteresis on Wall Street and in Washington to spin their fairy tales of a "less-severe recession" in order to help draw the gullible

back into stocks, at least for a day or two before the election. Such followed earlier economic scare tactics aimed at the public to help sell the "bailout" package.

The 0.3% contraction was a plug number, as its calculation included significant "guesstimates." For example, the "advance" estimate was based on only two out of three highly volatile and suspect monthly trade reports. The BEA could have brought in the reported growth at a small plus, just easily as a small minus, but the credibility of perpetual GDP growth may have reached its limits and was abandoned publicly by the White House. The reported "advance" growth estimate usually is massaged so as to come in close to consensus, in this case a little bit better. Keep in mind that the 0.25% contraction is an annualized rate, only 0.06% (\$7.4 billion out of \$11,720.0 billion) quarter-to-quarter, a magnitude well within the scope of regular monthly revisions and statistical noise.

Against the heavy upside biases built into GDP reporting, the BEA also had to allow an inflation surge in order to get real GDP into contraction. The GDP implicit price deflator (GDP inflation rate) exploded to an annualized 18-year high of 4.09%, versus the multiple-year low of 1.26% used to keep second-quarter GDP growth in positive territory (the lower the GDP inflation rate used, the higher the reported real growth).

The BEA's GDP-like measures for third-quarter 2008, including Gross National Product (GNP), where GDP is GNP net of trade in factor income (interest and dividend payments), and Gross Domestic Income (GDI), which is the theoretical income-side equivalent to the GDP's consumption-side measure have not been estimated, yet, given the particular lack of significance associated with the "advance" estimate. The GDI and GDP, which have shown various quarterly contractions since the fourth-quarter of 2006, likely will be updated with the next GDP release.



*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** (November 25): Underlying economic fundamentals suggest that the "preliminary" estimate revision of third-quarter GDP should revise to show a deeper contraction, but the initial contraction reported was shallow enough to revise away and become a shallow economic expansion. The September trade deficit was reported with enough improvement to allow for the possibility of the third-quarter GDP growth to revise into positive territory. The BEA will bring in the revision wherever it chooses to, likely helping to meet perceived financial-market needs of the moment.

**Consumer Price Index (CPI)** -- As discussed in the October 16th *Flash Update*, September CPI inflation eased back again on both a monthly and annual basis, as the CPI continued to absorb the impact of an ongoing tumble in oil prices. Yet, monthly "core" inflation also eased (CPI-U core was up by 0.1% in September, 0.2% in August, and 0.3% in July) despite significant anecdotal evidence of surging non-energy and food inflation. As discussed in the Opening Comments, significant further hits on CPI inflation likely lie ahead in October and November reporting, thanks to the continued collapse in gasoline prices, but annual inflation will remain positive and likely rise in the months following.

**CPI-U.** The Bureau of Labor Statistics (BLS) reported seasonally-adjusted September CPI-U (I.6) eased by 0.03% (down by 0.14% unadjusted) +/- 0.12% for the month, versus a 0.14% (0.40% unadjusted) decline in August. Year-to-year or annual inflation in September backed off to 4.94% from 5.37% in August.

Annual inflation would increase in October 2008 reporting, dependent on the seasonally-adjusted monthly gain exceeding the 0.26% monthly increase seen in October 2007. The difference in growth would directly add to or subtract from September's annual inflation rate of 4.94%.

**CPI-W.** Annual inflation for the narrower CPI-W -- targeted at the wage-earners category where gasoline takes a bigger proportionate bite out of spending -- eased to 5.4% in September from 5.9% in August and 6.2% in July. The CPI-W is used for making the annual cost of living adjustments to Social Security payments, and the 2009 adjustment -- based on the July to September 2008 period -- was 5.8%, two-and-a-half times the 2.3% adjustment for 2008. Such is not good news for federal budget deficit, discussed elsewhere.

**C-CPI-U.** Year-to-year or annual inflation for the Chain Weighted CPI-U (I.5) -- the fully substitution-based series that increasingly gets touted by CPI opponents and inflation apologists as the replacement for the CPI-U -- eased to 4.34% in September from 4.70% in August.

#### ***Alternate Consumer Inflation Measures.***

Adjusted to pre-Clinton (1990) methodology (I.7), annual CPI growth declined to roughly 8.3% in September from 8.7% in August, while the SGS-Alternate Consumer Inflation Measure (I.8), which reverses gimmicked changes to official CPI reporting methodologies back to 1980, eased back to roughly 12.9% in September from 13.2% in August. The alternate numbers are not adjusted for any near-term manipulations of the data.

The eight levels of annual inflation, I.1 to I.8, are detailed in the table in the Alternate Realities section, along with the graph of SGS-Alternate Consumer Inflation.

**Next Release** (November 19): Annual October CPI inflation should decline, based on a continued collapse in oil and gasoline prices. Average gasoline prices in October were down roughly 20% from September, which would tend to knock



off roughly 1% from the not-seasonally-adjusted monthly CPI. The seasonally-adjusted effect should be less, though, given that gasoline prices tend to ease some at this time of year. Consensus expectations (briefing.com) of a monthly 0.8% drop in the adjusted CPI are not unreasonable. Longer-range impact from earlier dollar weakness and high oil prices, and high broad money growth

rates will tend to lead to upside CPI surprises in later months.

As to annual CPI inflation, any seasonally-adjusted monthly increase above or below the 0.26% monthly gain seen in October 2007 would directly add to or subtract from September 2008's annual inflation rate of 4.94%.

### Other Troubled Key Series

**Federal Deficit.** Rapid deterioration continues in the U.S. government's fiscal condition, partially as a result of the impact from the ongoing systemic solvency crisis. The 12-month rolling deficit through October 2008 -- the first month of fiscal 2009 -- rose to \$635.1 billion, up from the September's \$454.8 billion and from October 2007's \$169.1 billion.

In terms of fiscal-year 2008 (year-ended September 30th) the official federal deficit was \$454.8 billion, against official forecasts just three months ago of a \$389 billion deficit, and against a \$161.5 billion deficit in 2007. These are the officially-gimmicked numbers, not GAAP reporting, which will show a much larger deficit in statements due for release in mid-December. The GAAP-based deficit for fiscal-year 2007 topped \$4 trillion and likely will top that in the 2008 GAAP-based estimate.

Confirming that a recession was in place long before the solvency crisis came to a head, government revenues in 2008 fell by 15.3% versus 2007. The budget deficit outlook for the current 2009 fiscal year is for continued sharp deterioration, given the rapid decline in economic activity and prospects for further lost tax revenues, and given soaring government costs tied to the systemic bailout and promised new stimulus packages. Official reporting likely will show a 2009 federal budget deficit in excess of \$1.5

trillion. The downturn in revenues tied to the weak economy also has started to impact state and local government fiscal operations, as well, with serious funding problems already surfacing in a number of jurisdictions.

Viewing the change in the level of gross federal debt bypasses several of the regular reporting manipulations of the government's financial results and is a better indicator of actual net cash outlays by the federal government than is the official, gimmicked deficit reporting.

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

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

The continued, rapid rise in initial claims for unemployment insurance reflects the severe deterioration taking place in labor conditions. On a smoothed basis for the 17 weeks ended November 8th, annual growth hit 43.3%, up from 37.0% as of the 17 weeks ended October 11th, and up from 29.6% as of the 17 weeks ended

September 6th. 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 Veterans Day and Thanksgiving*). The Labor Department has demonstrated an inability to do such adjusting successfully. When the new claims series is viewed in terms of the year-to-year change in the 17-week (four-month) moving average, however, such generally is a fair indicator of current economic activity.

**Real Average Weekly Earnings** -- Reflecting impact from a further pullback in gasoline prices, September's seasonally-adjusted monthly real earnings were unchanged in September, following a 0.6% increase in August and a 0.6% decline in July. Annual change in September remained in deep contraction, holding at August's level of 2.5% year-to-year decline, following an annual contraction in July of 2.8%.

*General background note:* Gyration in the poor quality of reported CPI growth account for most month-to-month volatility in this series. Adjusting for the major upside biases built into the CPI-W inflation measure used in deflating the average weekly earnings, annual change in this series shows the average worker to be under severe financial stress in an ongoing structural recession (see the *Hyperinflation Special Report* of April 8, 2008, and this month's Reporting Focus).

**Retail Sales** -- As discussed and graphed in the Opening Comments, the pattern of monthly quarterly and annual contractions in real (inflation-adjusted) retail sales continued to deteriorate in September and October, and likely will deepen further in November, as the holiday shopping season kicks in. These growth patterns show weakness never seen outside of major recessions.

The Census Bureau reported this morning (November 14th) that seasonally-adjusted sales for the month of October fell by 2.77% (down 3.14% net of revisions) +/- 0.6% (95% confidence interval), versus a revised decline of 1.29% (previously 1.16%) in September. The decline was exacerbated by the fall in gasoline prices, but as indicated in October's "core" measure, it still was significant. On a year-to-year basis, October sales were negative for a second month, down by 4.11%, versus a revised 1.15% (previously 1.03%) annual decline in September.

**Real Retail Sales.** The reported monthly and annual declines in October retail sales also will show intensifying declines, net of inflation, despite a likely sharp monthly decline in the October CPI. Deflated by the September CPI-U, seasonally-adjusted real (inflation-adjusted) retail sales contracted by 1.26% for the month of September (down 1.29% before inflation adjustment), following a 0.31% decline in the month of August (down 0.45% before inflation adjustment). On a year-to-year basis, September retail sales fell by 5.81% (down 1.15% before inflation adjustment), versus a 3.66% decline in August (up by 1.50% before inflation adjustment).

The series now has suffered its fourth consecutive quarter-to-quarter real contraction (an annualized decline of 10.8% in the third quarter versus a 1.2% drop in the second quarter) and the third consecutive quarter of annual contraction (down 4.4% for the third quarter versus a 1.6% decline for the second quarter). The fourth quarter is off to an even worse start. Such ongoing negative growth patterns never have been seen outside of formal recessions.

**Core Retail Sales.** Consistent with the Federal Reserve's predilection for ignoring food and energy prices, "core" retail sales -- retail sales net of grocery store and gasoline station revenues -- fell by 1.65% in October (down 2.13% net of revisions), versus a revised 1.64% (was 1.47%) decline in September. Those numbers contrasted

with the official aggregate drop of 2.77% in October and the revised 1.29% decline in September. On an annual basis, October "core" retail sales fell by 5.95%, versus a revised 4.43% (was 4.26%) decline in September. The sharp declines shown in "core" retail sales are after a 12.7% decline in October gasoline station sales, tied to reduced gasoline prices.

**Next Release** (December 12): November retail sales should continue showing a pattern of deepening monthly and annual contractions, net of inflation. Odds favor a result somewhat weaker than likely consensus forecasts.

**Industrial Production** -- As discussed and graphed in the Opening Comments and detailed in the October 16th *Special Update*, the Federal Reserve reported a 2.8% monthly contraction in September industrial production, following a revised 1.0% (previously 1.1%) drop in August. September's weakness was attributable to a strike at Boeing and to oil and gas related shutdowns in the Gulf of Mexico region due to hurricanes. September year-to-year change plunged by 4.5%, after a 1.4% annual contraction in August. Adjusting for strike and hurricane impacts, however, third-quarter production still was down on both a quarterly and an annual basis.

Not adjusted for the special factors, following a 3.1% annualized quarter-to-quarter contraction reported in the second quarter, industrial production suffered its second consecutive quarterly downturn in the third quarter at an annualized 6.0% rate of decline. In conjunction with a 2.7% contraction in year-to-year growth for the third quarter, the series is showing growth patterns not seen outside of recessions.

**Next Release** (November 17): The October production numbers should not contract as sharply as in September, given the settlement of the Boeing strike and some resumption of curtailed oil and gas production in the Gulf of Mexico region. Nonetheless, production should be down both

month-to-month and year-to-year, and likely will be weaker than already soft consensus estimates.

**New Orders for Durable Goods** -- As discussed in the October 30th *Flash Update*, although the regularly-volatile new orders for durable goods reportedly rose by 0.8% in September, versus a 5.5% contraction in August, year-to-year change continued to decline in a recessionary pattern, down 2.4% from September 2007, versus August's 8.9% annual decline. In the third quarter, the series showed its second consecutive quarter of year-to-year contraction (down 4.7%) and its third consecutive quarter-to-quarter contraction, down at an annualized 14.3% from the second quarter. The annual and quarterly contractions are before any adjustment for inflation.

New orders for nondefense capital goods also rose by 0.8% for the month, versus a 7.7% contraction in August, and fell 6.7% year-to-year, following a 5.2% annual drop in August.

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

**Trade Balance** -- The trade deficit reportedly narrowed in September, still reflecting likely oil import shortfalls and continued paperwork flow distortions. The Census Bureau and the Bureau of Economic Analysis reported the seasonally-adjusted September trade deficit narrowed to \$56.5 billion from a largely unrevised \$59.1 billion in August. With continued games-playing in reported oil imports, these data (net of inflation) could be used to help revise third-quarter GDP into positive territory.

The latest report showed continuing, unusual volatility in import and export carryover (imports or exports included in the current month that actually took place in earlier periods, when they should have been reported), along with an unusually sharp and unseasonable decline in daily crude oil imports to 8,443 thousand barrels per

day, down 15.1% month-to-month, down 16.2% year-to-year. Separately, average imported oil prices were down 10.3% for the month to \$107.58 per barrel.

**Next Release** (December 11): The trade deficit for October likely will be softened by falling oil prices. Whatever gimmicking has been taking place with the reporting shows no sign of abating. Significant catch-up in the deficit understatement is long overdue.

**Consumer Confidence** -- As graphed and discussed in the Opening Comments, consumer confidence tumbled terribly in October, as the Messrs. Bernanke and Paulson's efforts to terrify the public on the economy and individual financial prospects bore fruit.

The Conference Board's Consumer Confidence measure suffered the largest percentage declines, ever, on both a monthly and annual basis, with confidence falling to its lowest level, ever. The Confidence measure fell by 38.1% for the month, following a 5.0% gain in September. Year-to-year October confidence fell by 60.1%, having been down by 38.3% in September.

The Reuters/University of Michigan's Consumer Sentiment measure dropped by 18.1% in October, following a 12.6% rise in September. Year-to-year, Sentiment declined by 28.8% in October, versus a 15.7% decline in September.

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

*General background note:* The Conference Board measure is seasonally adjusted, which can provide occasional, but significant distortion. The adjustment does not make much sense and is of suspect purpose, given that the Conference Board does not release the unadjusted number. The Reuters/Michigan survey is unadjusted. How does one seasonally-adjust peoples' attitudes? Also, beware the mid-month Consumer Sentiment release from Reuters/University of Michigan. The

sampling base is so small as to be virtually valueless in terms of statistical significance.

**Short-Term Credit Measures** -- Annual growth in both consumer credit and commercial borrowing has continued to slow, intensifying recessionary pressures and highlighting difficulties the Federal Reserve still is having in stabilizing solvency issues in the U.S. banking system. With direct intervention as a lender in the commercial paper market, and with heavy jawboning of banks to lend to credit-worthy customers, the Fed is pursuing increasingly desperate approaches to stimulate both commercial and consumer lending.

For seasonally-adjusted consumer credit, which includes credit cards and auto loans, but not mortgages, annual growth was reported at 3.7% in September, down from 3.9% in August and 5.0% in July.

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

In the current environment, where inflation-adjusted growth in income (see this month's Reporting/Market Focus) is not adequate to support meaningful growth in the personal consumption component of GDP, GDP growth only can come from temporary debt expansion or savings liquidation. Accordingly, stagnating growth and eventual contraction in consumer debt remains an ongoing constraint on economic activity.

Annual growth in commercial borrowing continued to fall off. Commercial paper outstanding showed a 16.2% year-to-year contraction in October, versus a 13.2% annual decline in September, and an 8.0% drop in August. Fed intervention should begin to boost the annual growth rate.



Annual growth in September commercial and industrial loans slowed to 13.3%, down from 15.2% in August and from 17.5% in July. Slowing growth in commercial lending should place a damper on broad business activity.

**Producer Price Index (PPI)** -- As discussed in the October 16th *Special Update*, the regularly volatile Producer Price Index (PPI) for finished goods contracted by a seasonally-adjusted 0.4% (0.1% unadjusted) in September, versus 0.9% (1.6% unadjusted) in August, as reported by the Bureau of Labor Statistics. The decline largely reflected the continued sharp decline in oil prices. Year-to-year PPI inflation in September eased to 8.7% from 9.6% in August.

On a monthly basis, seasonally-adjusted September intermediate goods fell by 1.2% (down 1.0% August), crude goods fell by 7.9% (down 11.9% August). Year-to-year inflation slowed but remained high, with September intermediate goods up by 15.4% (16.7% August) and September crude goods up by 26.0% (38.1% August).

**Next Release** (November 18): Allowing for the ongoing, regularly random volatility of the monthly price variations, PPI inflation reporting over the next six-to-nine months generally should favor upside surprises in official results, despite hits in October and November from the continued fall in oil prices.

### Better-Quality Numbers

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

#### *Economic Indicators*

**Purchasing Managers Survey: Manufacturing New Orders** -- The October purchasing managers manufacturing index (PMI) fell into official recession territory, even with the index reweightings that kept the aggregate index above 50.0 for a number of month's this year. The Institute for Supply Management (ISM) reweighted its key index so that the PMI would better match GDP results. While the effort was well intentioned, altering the data to match the extremely overstated GDP growth rates damaged the reporting quality of the PMI. Fortunately,

however, the more meaningful components of the index were not affected by the efforts to match the flawed government data.

The October PMI plunged to 38.9, down from 43.5 in September, to its lowest level since September 1982. While the ISM uses an index reading of 41.1 (now breached) as the break-point between recession in the broad economy and expansion, a reading below 50.0 means a contracting manufacturing sector. The 50.0 mark still has worked out as a solid, broad recession signal in my analyses that are unfettered by reliance on GDP data for a recession signal.

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

The October new orders index plummeted to 32.2, from 38.8 in September, and stood at its lowest reading since April 1980. The new orders have

been in actual contraction since December 2007. Distortions from the seasonal factors calculated by the Department of Commerce can be minimized by viewing the series using year-to-year change on a three-month moving average basis. On that basis, the October new orders index fell by 25.9%, following a 19.9% decline in September and 15.1% drop in August.

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

Also a significant measure, the manufacturing employment component fell to 34.6 in October from 41.8 in September.

**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 October services composite index fell to 44.4% in October, from 50.2 in September.

Both the services employment and prices paid components, however, have some meaning. Covering the real estate and banking industries, among others, the October employment component remained below 50.0, falling to 41.5 from 44.2 in September. The heavily hit prices-paid component for both indices is covered in the Inflation Indicators.

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

The seasonally-adjusted September help-wanted advertising index continued at its historic low level of 15, the same as in August, the lowest level seen since the index was first calculated at the end of President Harry Truman's term in office.

The September reading was down by 37.5% year-to-year, versus a 34.8% decline in August. The annual change in the three-month moving average as of September was a 36.1% decline, versus August's 33.8% contraction. Despite some of the historic weakness in the series being due to the loss of newspaper business to the Internet, and despite its looming abandonment by the Conference Board, the HWA remains a solid leading indicator to the broad economy and to the monthly employment report. It continues to signal severe deepening in the recession and ongoing deterioration in labor-market conditions.

Where the HWA series does not include a measure of on-line advertising, recent indices developed to measure Internet activity have serious definitional problems and still are too young to be meaningful indicators. That said, the Conference Board has reported that annual growth in its nascent on-line measure of help-wanted advertising has contracted on a year-to-year basis in each month from April through September 2008. Such cannot be a good sign for national employment or for broad economic activity.

**Housing Starts** -- As discussed in the Opening Comments and as graphed there net of the New York City paperwork distortions in June's reporting, housing starts continue to show a severe, deepening recession. The seasonally-adjusted September housing starts level was reported down by 6.3% for the month and down 31.1% year-to-year. August was down a revised 8.1% (previously down 6.2%) for the month, and down 34.8% (previously 33.1%) year-to-year. The latest numbers still show ongoing quarterly and annual contractions in housing activity never seen otherwise outside of recessions.

In home sales data, the seasonally-adjusted September new home sales rose by 2.7% +/- 14% (95% confidence interval), which was not statistically distinguishable from a loss, following a 12.6% (previously 11.5%) monthly decline in August. On a year-to-year basis, September new home sales dropped by 33.1%, following a 35.6% (previously 34.5%) decline in August. Reflecting the intensifying impact of foreclosure sales, existing home sales in September rose by 5.5% for the month, 1.4% year-to-year, while August fell by 2.2% for the month and by 10.7% year-to-year.

### ***Inflation Indicators***

**Money Supply** -- As graphed and discussed in the Opening Comments, significantly higher, broad money growth likely will result from recent Federal Reserve and U.S. Treasury actions, along with an increase in money velocity as bank lending and financial markets return to some semblance of normalcy (see the August 3rd *Money Supply Special Report* for a discussion of the practical measurement and analytical uses of money supply in assessing inflation prospects).

Annual growth in the seasonally-adjusted SGS-Ongoing M3 continued, but it is estimated to have slowed to 10.8% in October, down from 13.1% in September and off from its record-high 17.4% level in March. The slowing growth reflects serious difficulties the Fed has had in getting banks to resume normal commercial activity, although some positive impact has started to surface. With Fed actions working their way through the system, October's annual growth should be close to the trough of the current cycle, with sharply higher M3 growth likely by the end of November and into December.

Outside of the last several months, the prior historic high of 16.4% was seen in June of 1971, two months before President Nixon closed the gold window and imposed wage and price controls. While October's growth is well shy of

1971's high, the current environment still promises heavy upside inflation pressure well into 2009.

For October 2008, annual growth for monthly M1 surged to 7.6% from 6.4% in September. Annual M2 growth increased to 7.4% from 6.2% in September, and the SGS-Ongoing M3 estimate showed annual growth of roughly 10.8%, down from 13.1% in September.

In terms of seasonally-adjusted month-to-month change, October M1 rose by 1.3%, following a 4.3% increase in September; October M2 rose by 1.4% following a 1.3% gain in September; and October SGS-Ongoing M3 fell by 0.4%, following a 0.7% increase in September. Monthly money numbers do rise and fall, with the latest monthly M3 contraction the ninth such occurrence in the last eight years.

One benefit of continuing to estimate the broader M3 measure is that it helps to explain what is happening in the narrower measures. For example, the recent strength reported in M1 and M2 did not reflect the Fed's extreme attempts at systemic liquefaction, but rather a movement of funds out of M3 accounts into M1 and M2 accounts. As mentioned in the opening comments, a still-broader money measure than M3 likely would be showing rising annual growth.

*General background note:* Historical annual growth data and monthly levels for the money supply series, including the SGS-Ongoing M3 estimates, are available for download on the Alternate Data page of [www.shadowstats.com](http://www.shadowstats.com). See the August 2006 SGS Newsletter for methodology. The indicated M3 levels are our best estimate and are provided at specific subscriber request. Keep in mind that regular revisions in the related Fed series affect historical M3. Usually, annual growth rates hold, although levels may shift a little. We have not attempted, nor do we plan to recreate a revised historical series for an M3 monthly-average level going back in time; the published series can be linked to earlier historical data available from the St. Louis



Fed. The purpose of the SGS series was and is to provide monthly estimates of ongoing annual M3 growth. We are comfortable with those numbers and that our estimated monthly growth rates are reasonably close to what the Fed would be reporting, if it still reported M3.

**Purchasing Managers Surveys: Prices Paid Indices** -- Both of the October purchasing managers composite surveys prices-paid indices took large hits, reflecting the severe plunge in oil prices.

On the manufacturing side, the October price index showed declining prices, with the index dropping to 37.0, from 53.5 in September, and hitting the lowest reading since December 2001. On a three-month moving average basis, October's year-to-year change was a decline of 9.5%, versus a 17.1% gain in September and a 31.1% increase in August. 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 October prices diffusion index also dropped, but held in positive territory, falling to 53.4 from 70.0 in September. On a three-month moving-average basis, October's annual gain was 2.7%, down from 18.9% in September and from 26.2% in August.

*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** -- With the West Texas Intermediate (WTI) spot price closing at \$58.24 on November 13th, oil prices have plunged by 60.0% since the record-high closing price of \$145.66 on July 11,

2008, and have collapsed well below the \$90 per barrel that level that promised ongoing severe near-term inflation problems in the U.S. economy. October's monthly average spot price for WTI (St. Louis Fed) was \$76.65 per barrel, down 26.2% from September's \$103.90, and down 42.8% from June's \$133.93 historic-high average. For October 2008, the year-to-year change in price level was a decline of 11.2%, versus a 30.0% annual gain in September.

As discussed in the Opening Comments, the lower oil prices likely will result in monthly declines in the CPI for October and November, but the long-term impact from recent high oil prices still is working its way through the broad economy, and still will add upside pressures to general inflation (exclusive of the near-term energy measures) into the first half of 2009. Those pressures reflect costs ranging from transportation of goods and services, to material costs in the plastics, pharmaceutical, fertilizer, chemical industries, etc. These broad inflationary pressures will remain intact for a while, despite any near-term oil price gyrations.

Oil prices remain highly volatile and sensitive to minor surprises. While slowing U.S. and global economies reduces oil demand, recent OPEC activities have been and likely will continue to be aimed at offsetting such, with production cuts. Adding some upside pressure to prices, the U.S. interregnum offers risk of intensified global military and political tensions, and other supply and demand risks/issues. Other than the possible impact of pre-election politics, the recent strength in the U.S. dollar has been key to the oil price decline, much as dollar weakness had been key to the earlier oil-price surge. At such time as heavy dollar selling resumes -- and it will eventually -- look for oil prices to spike anew, moving back above the \$100 per barrel level and rekindling oil-price related inflation concerns.

## Reporting/Market Focus

### Economic and Systemic Crises in Historical Perspective

History does tend to repeat itself. Nonetheless, where current economic and financial conditions have a number of parallels in history, the underlying structural problems for the economy and unprecedented debt leverage in the financial system have started to unwind in what ultimately should be the greatest economic and financial calamity in U.S., if not global, history.

The historical list of U.S. economic contractions and their causes is an updated version of one published in *SGS Newsletter* (No. 36) of October 29, 2007, covering the post-Revolution history of the United States. Most major financial panics are mentioned, where they typically also were associated with business contractions. The notable official exception is the 1987 stock market crash, discussed later.

#### **Recession, Depression and Great Depression.**

*Please note: This definitional section has been lifted from the SGS Hyperinflation Special Report of April 8, 2008, with minor alterations.*

A couple of decades back, I tried to tie down the definitional differences between a recession, depression and a great depression with the Bureau of Economic Analysis (BEA), the National Bureau of Economic Research (NBER) and a number of private economists. I found that there was no consensus on the matter, so I set some definitions that the various parties (neither formally nor officially) thought were within reason.

If you plot the level of economic activity during a downturn, you will see something that looks like a bowl, with activity recessing on the downside and recovering on the upside. The term used to describe this bowl-shaped circumstance before World War II was "depression," while the downside portion of the cycle was called

"recession." Before World War II, all downturns simply were referred to as depressions. In the wake of the Great Depression of the 1930s, however, a euphemism was sought for future economic contractions so as to avoid evoking memories of that earlier, financially painful time.

Accordingly, a post-World War II downturn was called "recession." Officially, the worst post-World War II recession was from November 1973 through March 1975, with a peak-to-trough contraction of 5%. Such followed the Vietnam War, Nixon's floating of the U.S. dollar and the Oil Embargo. The double-dip recession in the early-1980s may have seen a combined contraction of roughly 6%. I contend that the current double-dip recession that began in late-2000 already has exceeded the 1980s double-dip as to depth, and that the current downleg already is rivaling the 1973/1975 contraction as to severity.

Here are the definitions:

**Recession:** Two or more consecutive quarters of contracting real (inflation-adjusted) GDP, where the downturn is not triggered by an exogenous factor such as a truckers' strike. The NBER, which is the official arbiter of when the United States economy is in recession, refines its timing calls on a monthly basis, through the use of economic series such as payroll employment and industrial production. It no longer relies on the two quarters of contracting GDP rule.

**Depression:** A recession, where the peak-to-trough contraction in real growth exceeds 10%.

**Great Depression:** A depression, where the peak-to-trough contraction in real growth exceeds 25%.

**Historical List of U.S. Economic Contractions.**

The main body of the following list/table represents about as close to an official or consensus picture that I can put together. The

second portion of the table shows the SGS-alternate version of recent economic history, with detail covered in the text following.

**United States of America - Economic Contractions, 1784 to Date  
By Administration, Duration, Depth and Causes**

**Pre-Constitution;** Timing/Duration: 1784 to 1789, 48 months; Peak-to-Trough Contraction: Severe; Nature: Structural/Liquidity. Background: Post-Revolution, no Constitution, no central authority, lack of sound money, excessive trade deficit.

**Jefferson;** Timing/Duration: 1807 to 1810, 24 months; Peak-to-Trough Contraction: 20%; Nature: Exogenous. Background: European war blocked shipments of goods to the U.S.

**Madison;** Timing/Duration: 1815 to 1821, 60 months; Peak-to-Trough Contraction: 15%; Nature: Structural/Liquidity. Background: Post-War of 1812. Debt excesses led to currency inflation, then debt/liquidity collapse and severe deflation.

**Van Buren;** Timing/Duration: 1837 to 1843, 60 months; Peak-to-Trough Contraction: 25%; Nature: Liquidity/Structural. Background: Excess debt and currency inflation fueled by speculative lending out of England. U.S. crop failure and English banking crisis led to debt/liquidity collapse.

**Polk;** Timing/Duration: 1847 to 1848, 12 months; Peak-to-Trough Contraction: 4%; Nature: Exogenous. Background: Post-Mexican War. Effect of severe European depression was offset partially by raised expectations from discovery of gold in California.

**Buchanan-I;** Timing/Duration: Jun 1857 to Dec 1858, 18 months; Peak-to-Trough Contraction: 12%; Nature: Liquidity. Background: Banking crisis and liquidity collapse.

**Buchanan-II;** Timing/Duration: Oct 1860 to June 1861, 8 months; Peak-to-Trough Contraction: 10%; Nature: Structural. Background: Tied to secession movement.

**Lincoln/A Johnson;** Timing/Duration: Apr 1865 to Dec 1867, 32 months; Peak-to-Trough Contraction: 13%; Nature: Structural/Liquidity. Background: Post-Civil War, retirement of greenbacks and English Panic.

**Grant-I;** Timing/Duration: June 1869 to Dec 1870, 18 months; Peak-to-Trough Contraction: 5%; Nature: Structural/Liquidity. Background: Secondary downturn following Civil War, "Black Friday" panic from Gould & Fiske's efforts to corner the gold market.

**Grant-II;** Timing/Duration: Oct 1873 to Mar 1879, 65 months; Peak-to-Trough Contraction: 15%; Nature: Liquidity/Structural. Background: Over-building of railroads, over-extension of debt, foreign funding collapse with Vienna Panic of 1873, collapse of savings banks, fear of currency debasement tied to elimination of silver backing.

**Arthur;** Timing/Duration: Mar 1882 to May 1885, 38 months; Peak-to-Trough Contraction: 12%; Nature: Liquidity. Background: French Panic of 1882, collapse of commodity prices, silver and stock panics of 1884.

**Cleveland-I;** Timing/Duration: Mar 1887 to Apr 1888, 13 months; Peak-to-Trough Contraction: 4%; Nature: Liquidity. Background: Government paid off debt, forcing reduction of circulating banknotes.

**B Harrison;** Timing/Duration: Jul 1890 to May 1891, 10 months; Peak-to-Trough Contraction: 3%; Nature: Liquidity. Background: Baring Panic in England, forced liquidation of foreign holdings of U.S. stocks.

**Cleveland-II;** Timing/Duration: Jan 1893 to Jun 1894, 17 months; Peak-to-Trough Contraction: 16%; Nature: Liquidity. Background: Failure of Reading Railroad triggered panic.

**Cleveland-III;** Timing/Duration: Dec 1895 to Jun 1897, 18 months; Peak-to-Trough Contraction: 15%; Nature: Liquidity/Inventory. Background: Lack of confidence in currency system.

**McKinley;** Timing/Duration: Jun 1899 to Dec 1900, 18 months; Peak-to-Trough Contraction: 4%; Nature: Liquidity. Background: German stock market panic of 1899.

**T Roosevelt-I;** Timing/Duration: Sep 1902 to Aug 1904, 23 months; Peak-to-Trough Contraction: 10%; Nature: Liquidity/Inventory. Background: Temporary layoffs, "Rich Man's Panic" of 1903/04.

**T Roosevelt-II;** Timing/Duration: May 1907 to Jun 1908, 13 months; Peak-to-Trough Contraction: 15%; Nature: Liquidity/Exogenous. Background: San Francisco earthquake and conflagration (1906), March 1907 panic and banking crisis.

**Taft;** Timing/Duration: Jan 1910 to Jan 1912, 24 months; Peak-to-Trough Contraction: 5%; Nature: Exogenous. Background: Increasing government regulation of railroads and trusts.

**Wilson-I;** Timing/Duration: Jan 1913 to Dec 1914, 23 months; Peak-to-Trough Contraction: 13%; Nature: Exogenous/Liquidity. Background: Collapse of foreign markets, loss of foreign liquidity as World War I broke out, U.S. stock market closed.

**Wilson-II;** Timing/Duration: Aug 1918 to Mar 1919, 7 months; Peak-to-Trough Contraction: 5%; Nature: Structural. Background: Post-World War I, overproduction of war goods, not enough jobs.

**Wilson-III;** Timing/Duration: Jan 1920 to Jul 1921, 18 months; Peak-to-Trough Contraction: 9%; Nature: Inventory/Liquidity. Background: Commodity inflation/deflation, sugar scandal.

**Harding;** Timing/Duration: May 1923 to Jul 1924, 14 months; Peak-to-Trough Contraction: 4%; Nature: Inventory. Background: Inventory-related lay-offs.

**Coolidge;** Timing/Duration: Oct 1926 to Nov 1927, 13 months; Peak-to-Trough Contraction: 2%; Nature: Inventory/Liquidity. Background: Real estate bust, bank failures, automobile over-production.

**Hoover;** Timing/Duration: Aug 1929 to Mar 1933, 43 months; Peak-to-Trough Contraction: 33%; Nature: Structural/Liquidity. Background: The Great Depression. Collapse of debt excesses from 1920s and liquidity crisis, extreme income variance, overbuilding, stock crash, banking collapse, industrial restructuring as long-term aftershock of Panama Canal construction and World War I end, permanent job losses.

**F Roosevelt-I;** Timing/Duration: May 1937 to Jun 1938, 13 months; Peak-to-Trough Contraction: 18%; Nature: Structural. Background: Second-dip of Great Depression.

**F Roosevelt-II;** Timing/Duration: Feb 1945 to Oct 1945, 8 months; Peak-to-Trough Contraction: 21%; Nature: Structural. Background: Post-World War II, start of conversion to peacetime economy.

**Truman;** Timing/Duration: Nov 1948 to Oct 1949, 11 months; Peak-to-Trough Contraction: 2%; Nature: Inventory. Background: Residual post-war reconversion, recoil from excess post-war production.

**Eisenhower-I;** Timing/Duration: Jul 1953 to May 1954, 10 months; Peak-to-Trough Contraction: 3%; Nature: Inventory. Background: Post-Korean War.

**Eisenhower-II;** Timing/Duration: Aug 1957 to Apr 1958, 8 months; Peak-to-Trough Contraction: 3%; Nature: Structural. Background: Delayed post-war downturn, ended with Sputnik.

**Eisenhower-III;** Timing/Duration: Apr 1960 to Feb 1961, 10 months; Peak-to-Trough Contraction: 1%; Nature: Inventory/Exogenous. Background: Dominated by 105-day steel strike.

**Nixon-I;** Timing/Duration: Dec 1969 to Nov 1970, 11 months; Peak-to-Trough Contraction: 1%; Nature: Inventory. Background: Cyclical blow-off of "Guns and Butter" era.

**Nixon-II;** Timing/Duration: Nov 1973 to Mar 1975, 16 months; Peak-to-Trough Contraction: 5%; Nature: Structural/Exogenous/Liquidity. Background: Post-Vietnam War, oil embargo, aftermath of wage and price controls, U.S. dollar flotation and closing of gold window.

**Carter;** Timing/Duration: Jan 1980 to Jul 1980, 6 months; Peak-to-Trough Contraction: 3%; Nature: Liquidity. Background: Disruption from credit card controls.

**Reagan;** Timing/Duration: Jul 1981 to Nov 1982, 16 months; Peak-to-Trough Contraction: 3%; Nature: Inventory. Background: Inflationary environment that led to high interest rates.

**Bush, Sr.;** Timing/Duration: Jul 1990 to Mar 1991, 8 months; Peak-to-Trough Contraction: 2%; Nature: Inventory/Exogenous. Background: Started with Iraq invading Kuwait and ended with Gulf War I, as consumer pulled back and then returned. (See SGS Version: Bush Sr.)



**Bush, Jr.;** Timing/Duration: Mar 2001 to Nov 2001, 8 months; Peak-to-Trough Contraction: Less than 1%; Nature: Liquidity. Background: Driven by collapse in stock-market bubble. (See SGS Version: Clinton-II.)

### **SGS-Alternate Version of the U.S. Economy Since 1981**

**Reagan-I;** Timing/Duration: Jul 1981 to Nov 1982, 16 months; Peak-to-Trough Contraction: 3%; Nature: Inventory. Background: Inflationary environment that led to high interest rates.

**Reagan-II;** Timing/Duration: 4th-Q 1986 to 3rd-Q 1987, 11 months; Peak-to-Trough Contraction: 1%; Nature: Structural/Liquidity. Background: See text following.

**Bush Sr.;** Timing/Duration: 4th-Q 1989 to 2nd-Q 1993, 42 months; Peak-to-Trough Contraction: 4%; Nature: Structural/Liquidity. Background: See text following.

**Clinton-I;** Timing/Duration: 1995, 9 months; Peak-to-Trough Contraction: 1%; Nature: Structural. Background: See text following.

**Clinton-II;** Timing/Duration: 3rd-Qtr 2000 to 3rd-Qtr 2003, 36 months; Peak-to-Trough Contraction: 4%; Nature: Liquidity/Structural. Background: See text following.

**Bush Jr.;** Timing/Duration: 4th-Qtr 2006 to Date, 24+ months; Peak-to-Trough Contraction: 6%+; Nature: Structural/Liquidity. Background: See text following.

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**Sources and Notes:** All estimates of timing and depth are approximate. GNP is used throughout for consistency; GDP is GNP net of international transactions in factor income (interest and dividends). Various sources have been combined.

*Peak-to-Trough:* Before 1857 - Business Cycles and Forecasting, Elmer C. Bratt (Bratt), 1940; 1857 and after - National Bureau of Economic Research (NBER) as published on their Web site (<http://www.nber.org/cycles.html/>); full period and SGS Version: [www.shadowstats.com](http://www.shadowstats.com).

*Duration in Months:* Before 1857 - Bratt; 1857 and after - NBER; full period and SGS Version: [www.shadowstats.com](http://www.shadowstats.com).

*Depth, Nature and Background:* Percentage change shown is the approximate peak-to-tough decline in economic activity as measured in constant-dollar GNP. 1784 to 1937 - Bratt; 1790 to 1987 - Ameritrust, Cleveland, Ohio (estimated as a percent variation from a projected economic trend line); 1867 to 1960 - A monetary History of the United States, 1867-1960, Milton Friedman and Anna Jacobson Schwartz, 1963; 1900 to 1995 - Albert Sindlinger, Sindlinger & Co., Wallingford, Pennsylvania; 1920 to 1993 - Center for International Business Cycle Research, Columbia Business School; 1929 to date - Bureau of Economic Analysis (BEA); full period and SGS Version: [www.shadowstats.com](http://www.shadowstats.com).

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**SGS-Alternative Analysis: Current Downturn Could Reach Depression Status in 2009.** The table details 37 official economic contractions in the United States since the American Revolution, excluding the current recession, which is not yet official. The total is 40 downturns, per the alternate SGS analysis, including the current recession.

Based on the earlier definitions, there has been one great depression (so named), in the 1930s, although the 25% decline in activity, during the 1837 to 1843 downturn, reached the lower threshold of the great depression definition. Most of the economic contractions before 1930s would be classified as depressions. All business downturns since World War II -- as officially reported -- have been recessions, so far.

The current economic contraction is beyond halfway towards being classified as a "depression," based on the SGS definitions and GDP accounting. Depression status likely will be attained by year-end 2009. As the Great War became World War I with the advent of World War II, so too may the Great Depression of the 1930s become Great Depression I. When the current crisis reaches its full, terrible potential, with an eventual hyperinflation that collapses normal commerce, it well may become known as Great Depression II. As with the two world wars, Great Depression II would have had its roots in Great Depression I. (See the *Hyperinflation Special Report* on [www.shadowstats.com](http://www.shadowstats.com)).

**Structural Changes and Liquidity Problems Dominate Economic History.** A review of the various downturns since 1784 makes a strong case for the repetitive nature of history. Major economic and financial market upheavals usually reflect a confluence of factors, often structural or liquidity-related in nature. In the latter case, an economic downturn already was well underway before the defining panic of a liquidity crisis. Indeed the underlying economic and liquidity problems usually were well in play before a panic,

which then would exacerbate the economic downturn, sometimes in a self-feeding cycle.

Leading up to the Great Depression, for example, the U.S. manufacturing sector had been in structural contraction as result of the loss of production after World War I and after the completion of the Panama Canal. The U.S. economy already was in contraction prior to the 1929 stock crash, but despite the structural downturn in the industrial sector, the financial markets were booming, with debt excess built upon debt excess leveraging stock prices to historic levels, with income variance at an historic high level that would not be exceeded until 1987.

It was the liquidity implosion that followed the stock-market and financial panic, and banking collapse, in combination with the structural change, that enabled the scope and depth of the Great Depression.

The present recession had its roots in a structural change dating back several decades, with the current contraction starting well in advance of the ongoing systemic-solvency and financial-market crises, which have exacerbated the downturn. The current financial crises, in turn have their roots back in the Great Depression.

**Structural Change Tied to Trade Losses.**

Starting with the explosive growth in the U.S. trade deficit in the 1970s, and the accelerating loss of the U.S. manufacturing base to offshore facilities that followed, the U.S. economy entered a long-term structural decline that continues today and that has provided the base for many of the U.S. economic difficulties since the 1980s.

At fault here are a variety of factors, ranging from the post-World War II success of the United States as the world's dominant economy and dynamo for global economic activity, to trade policies of recent decades that have been extremely detrimental to the U.S. economy and to those making a living in the United States.



In the post-World War II era through the early-1970s, when the United States ran regular trade surpluses, there were two markets for global manufacturers, the United States and the rest of the world. In the late-1960s and 1970s, before beginning my economic consulting business, I was active in a family company in the import and export trade, primarily importing chainsaws to the United States from what then was West Germany. Though overly simplified, the following comments reflect some personal perspectives of the time, as generally expressed in *SGS Newsletter* (No. 17) of March 15, 2006.

In the days of surplus, with the exception of food producers and companies such as Boeing and IBM, too few U.S. manufacturers ignored or did not take global markets seriously. More than adequate sales volume could be generated at home without undertaking the trouble of learning the languages and customs of potential foreign buyers, or having to produce low volume special products that met the particular needs of foreign markets.

In contrast, European manufacturers had to sell beyond their borders in order to gain economic scale. The rest of the world never did quite catch on to the U.S. consumers' addiction to disposable products and the concept of planned obsolescence, where automobiles, for example, became stylishly obsolete in three years. Instead, European manufacturers often had to provide a higher quality manufactured product for their customers than was available from U.S. manufacturers. Asian manufacturing at the time generally was noted for its low cost as well as generally low quality.

Not only did the competitors of many U.S. manufacturers dominate sales outside the United States, but also their often higher-quality products began to find broad markets within the United States, irrespective of higher prices and a near-perpetual weakening U.S. dollar. Eventually, quality improved for the lower cost Asian

products, which also led to significant market gains in the United States and the rest of the world.

Of course, much of the shift in U.S. manufacturing offshore resulted from careful long-term strategies by U.S. competitors to accomplish just that. "Long-term" here refers to decades, not to two-year election cycles or quarter-to-quarter profit reporting cycles common in U.S. political or business circles. In the late-1970s and early-1980s, Communist China eagerly was buying up as much as it could of available "antiquated" labor-intensive plant and equipment in the United States. China had the labor needed for it.

In a tragic 1989 explosion, the USS Iowa lost one of its large guns. At that time, the U.S. no longer had the machining capabilities to replace the gun, but China did.

As U.S. manufacturers began losing domestic market share to imported goods, a number sought lower-cost production offshore. Such was intensified by the effects of free-trade agreements that tended to shift manufacturing to under-employed, lower cost labor markets, such as Mexico. These shifts have been exacerbated up to present.

**The Problem with "Free Trade."** Aside from issues that "free trade" agreements entered into by the United States have been anything but, there is a basic flaw in the theory as to the benefits of free trade in today's real-world economies.

Assume two economies are at full employment, it is argued, and that there is no trade between two countries, where the first nation produces product A more efficiently than the other, and where second country is a more efficient producer of product B. If free trade is opened between the countries, then the first country will tend to end up making all the product A and the other country all the product B. In this simple system, open trade would result in more total production of A and B

than existed before, with everyone being better off.

In the real world, however, there is a problem with the underlying assumption that the involved economies are at full employment. Such rarely is the case, and it was not the case when the U.S., Canada and Mexico entered into the NAFTA agreement. When the involved trading partners do not have full employment, the advantage and the production tends to move to the low-cost producer.

As to NAFTA, the U.S. started the treaty in with roughly balanced trade, a small surplus with Mexico and a small deficit with Canada. Through August 2008, the combined U.S. trade deficit with Canada and Mexico was running close to an annual rate \$150 billion, reflecting a net loss of roughly 1.5 million jobs in the United States since the treaty went into effect on January 1, 1994.

Not so coincidentally, 1994 was the year the Clinton Administration's Bureau of Labor Statistics defined away millions of "discouraged" workers: unemployed individuals who had given up looking for work because there were no jobs to be had. Previously used in broader unemployment rates measures, the discouraged worker category was restricted to only those who had been "discouraged" for less than a year.

The effect of these "free trade" policies has been to redistribute the productive wealth of the United States to the rest of the world. While this may be a happy circumstance for the rest of the world, it is extremely painful financially for, and detrimental to the living standards of, the average individual in the United States.

Partially as a result of this debilitating circumstance, which has had some self-feeding influence on burdensome domestic union contracts, in conjunction with extremely poor long-term corporate management, and systemic problems that include overregulation by the U.S.

government, the Big Three auto makers purportedly teeter on the brink of bankruptcy.

**Crisis in 1987 and Lack of Real (Inflation-Adjusted) Income Growth.** With a confluence of factors ranging from accelerating dollar weakness, excessive debt and income variance levels, to a period of economic weakness, the issues came to a head with the stock-market crash and liquidity panic of 1987. Alan Greenspan was the new Fed chairman, at the time, and he decided to abandon any support of the U.S. dollar in favor of stabilizing and salvaging the domestic financial markets and financial services industry.

Gerald Corrigan of the New York Fed, the entity that handled the various financial markets for the Federal Reserve Board, led the initial charge. Though never officially confirmed, the New York Fed reportedly worked an arrangement with a major New York investment house to buy stock futures on the second day of the stock crash, with the effect of rallying the market and bringing it back to life. Out of this action evolved the present day President's Working Group on the Markets (a.k.a. Plunge Protection Team), which still is active in managing unstable or disorderly financial market conditions.

The Fed did everything it could to forestall a further day of reckoning that loomed because of ever-increasing trade and fiscal imbalances, along with an increasing dependence on foreign capital for the liquidity of the U.S. markets. Due to Greenspan papering over these issues for two decades, the basic problems intensified, remaining at uncontrollable levels. These issues now have collapsed the basic stability of the U.S. financial system and threaten the very existence of the U.S. dollar as the world's reserve currency.

As the structural economic changes have intensified, and what had been higher-paying production jobs disappeared, the average U.S. household has found it increasingly difficult to make ends meet. Real average weekly earnings today (government numbers using CPI-W) are

roughly 20% below where they were in 1970. Even as households moved from one-worker to two-or-more-worker families, and from one to two jobs per worker, the average household still could not stay ahead of inflation. Deteriorating real household incomes in recent years (using government inflation numbers) has continued, as seen in the government's annual poverty report and in annual income data reported by the Internal Revenue Service. The difference between growth in income and growth in consumption was made up in debt expansion, as directly fostered by Alan Greenspan's policies. Unconstrained debt growth, however, ultimately was and is unsustainable.

Without sustained growth in inflation-adjusted income, there cannot be sustained economic growth. Aware of that, Greenspan helped to fuel a stock-market bubble, which had the short-lived result of fueling wealth-effect consumption. When that bubble burst and helped to trigger the 2000 recession, he tried the same gimmick with home prices. Such enabled increased home equity lending, but the bubble burst there, and such helped cause the problems with mortgage backed securities to the surface, exacerbating the current downturn in business activity.

**Great Depression Liquidity Solutions Led to Current Liquidity Problems.** When the U.S. banking system collapsed in the early 1930s, the money supply followed, and that condition helped the depression of the time deteriorate into a deflationary great depression. The gold standard

of the day acted as a regulator of money supply and prevented the extreme government spending that President Franklin Roosevelt hoped to use as a tool to counter the depression. Such was a factor in Roosevelt's abandoning the domestic gold backing of the U.S. dollar and basing the U.S. financial system on a fiat currency and what I call the "debt standard," the full faith and credit of the U.S. government to pay its obligations with money that it creates.

It took 11 administrations following Roosevelt to push the debt standard to its limits, eventually taking on excessive obligations the government knew it never could honor. In the private sector, debt was leveraged upon debt in order to help sustain fundamentally unsustainable economic growth. It is the ultimate failure of the debt standard that has started to play out in the economy and markets of the last year or so. Unfortunately, there is nothing beyond the debt standard that can be used to revitalize the system. With there being little further the Fed can gimmick, aside from propping the functioning of the financial services industry, the long-delayed day of reckoning is nearing. As the great financial tempest slowly makes landfall, the impact of heavy gusts in its outer bands on the financial markets and economic activity, already has not been pretty. Ultimately, it is the hyperinflation and full debasement of the U.S. dollar that loom and threaten systemic survival. (See the *Hyperinflation Special Report* of April 8, 2008.

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*PLEASE NOTE: The next SGS Newsletter currently is targeted for the week of December 8th, following the release of the November employment/unemployment report. Intervening Flash Updates and Alerts will be posted in response to key economic and/or financial-market developments.*

*Earlier editions of the SGS writings and Special Reports referenced in the text can be found on the Archives tab at [www.shadowstats.com](http://www.shadowstats.com).*