

John Williams'

Shadow Government Statistics

Analysis Behind and Beyond Government Economic Reporting

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**Stimulus and Bailout Packages Will Not Reverse the Structural Depression or
Resolve the Deepening Systemic-Solvency Crisis**

Fed Monetization of Stimulus-Related Debt Would Spike Inflation

Cumulative 4.7 Million Jobs Lost to Trade Deficit

U.S. Dollar Fundamentals Remain Bleak versus Rest of World

OVERVIEW -- OPENING COMMENTS

"Worst Economy Since..." Moves to Mid-1970s and Earlier

It may be hard for the federal government to offer \$787 billion dollars in stimulus without having a noticeably positive impact on economic activity, but it can be done. Despite prior hype on employment, annual growth in inflation-adjusted retail sales is the first major economic measure to trigger a legitimate "worst since the Great Depression" comparison. The economic contraction now is severe enough to consume the stimulus without affected business activity ever breaking above water. Also, too little of the stimulus package addresses the structural issues driving the downturn. Even if the structural problems were addressed, fundamental recovery

would be measured in years, at best. Further, the systemic-solvency crisis is deepening again, with bailout exposures opening up to almost unlimited costs. That situation increasingly looks like it will involve the nationalization of major banks.

The financial markets remain incredibly volatile, unstable and dangerous. Gold has rallied not

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only from mounting flight-to-safety concerns, but also with a touch of renewed inflation fear. Those betting on the relative safety of the U.S. Treasuries and U.S. dollar underestimate the relative depths and severity of the economic and systemic-solvency crises in the United States versus the rest of the world.

Also underestimated is the upside inflation risk in the United States. The costs to the system of the stimulus and bailout packages will be inflation, with risks of high inflation moving to hyperinflation as early as the end of this year.

Structural Depression Largely Untouched by Stimulus and Bailout Packages. As discussed in greater detail in *Shadow Government Statistics Newsletters Nos. 47 and 48* (incorporated here by reference), the deepening economic contraction currently roiling regular commerce and business activity in the United States fundamentally is structural in nature, and it is not subject to an easy or quick fix. The cures being offered by the government should have only limited positive impact on the economy, but they do offer the promise of much higher inflation. They also significantly increase the risk of triggering a U.S. hyperinflation -- such was inevitable, based on extreme pre-crisis fiscal abuses -- as early as the end of this year. My best estimate on U.S. hyperinflation timing remains in the period of late-2009 to 2014.

The current crisis has developed and evolved during the last four decades, as trade and economic policies -- counter to the interests of much of the U.S. citizenry -- have resulted in the significant loss of high paying domestic production or technical jobs, where production operations have been lost to offshore competition, or simply moved offshore.

Direct impact of this circumstance has been seen in deteriorating U.S. household income, net of taxes and inflation. Using the government's numbers, real (inflation-adjusted) average weekly earnings (Bureau of Labor Statistics) in December

2008 were down 14% from the October 1972 high. Average weekly earnings never regained their pre-1973/1975 recession high. Partially as a result, households that once tended to have one breadwinner, now tend to have multiple breadwinners, out of necessity. Even so, the latest poverty survey published by the Census Bureau showed that real household income (average and median) in 2007 still had not regained its pre-2001 recession highs.

The numbers are much worse if the SGS-Alternate Consumer Inflation estimates are used for deflating the income measures. The SGS measure is an attempt to reflect the rate of inflation inherent in maintaining a constant standard of living, as reflected in earlier CPI reporting methodologies. In the real world, average household income has not kept up with the cost of maintaining a constant standard of living, and that shortfall has been met in recent decades, at least partially, by consumers taking on increasing levels of debt.

Indeed, without growth in inflation-adjusted income, real economic growth cannot be sustained, other than through temporary measures such as debt expansion. Aware of this circumstance, former Federal Reserve Chairman Alan Greenspan *et al* did their best to keep the economy growing in recent decades by encouraging unsustainable debt growth, with a resultant economic growth effectively borrowed from the future. The current downturn is akin to something of a payback period.

What I refer to as the "debt standard" was created during the Franklin Roosevelt Administration as replacement for the gold standard. Its expansion through the decades has led to excessive use of debt by government, industry and individuals. In recent years, creative derivative and structured financial instruments have allowed for even greater leverage, building debt excess upon debt excess.

Now, as the debt excesses begin to implode, the federal government, and unusually large segments of local and state governments and the commercial and private sector, face financial distress and possible insolvency. Fallout has been seen in the rapidly intensifying economic contraction.

The current recession, however, began before the solvency/liquidity issues came to a head and was itself instrumental in triggering the systemic liquidity crisis. The systemic liquidity crisis, in turn, has severely exacerbated the economic contraction. Neither President Obama's stimulus package or Messrs. Geithner and Bernanke's still-evolving systemic bailout program will turn the economy fundamentally or provide any lasting prop for the equity market. What these packages do promise is an ongoing effort to maintain a functioning system of depository institutions, and higher -- much higher -- inflation.

Intensifying Economic Pain Prior to 2010 Mid-Term Election. The "American Recovery and Reinvestment Act of 2009" awaits Mr. Obama's signature. The process that generated the legislation reflected Washington at its worst, with the dominant Democrats pushing through a package that received limited public airing and virtually no Republican support. Given the likelihood that the package will do little to relieve the financial suffering of the electorate before next year's mid-term election, perhaps the Republicans in Congress are hoping to use such a circumstance to regain seats in Congress. Both parties and related special interests are playing politics as usual with an economic crisis that is dangerous enough to threaten national security.

Given the long lead time of a number the package's stimuli, and the limited patience of the U.S. populace, however, refinements to the stimulus package or even an Obama Stimulus II may be a fair shot before the 2010 election. Indeed, while the U.S. economic downturn is unusually deep, and government stimulus efforts should help some, the relative positive impact on economic activity likely will not be noticeable, in

aggregate, as the positive impact could be swallowed and masked by the severity of the current downturn. Last year's Bush stimulus package suffered a similar fate, before the downturn intensified. The current stimulus package, however, already has had the undesirable effect of shifting global market focus to the faltering fiscal condition of the U.S. government.

In terms of historical comparisons, it also is worth keeping in mind that what brought the U.S. out of the Great Depression was the outbreak of war in Europe, and military orders received by U.S. manufacturers, not the various social and spending programs introduced by the Roosevelt Administration (see the Reporting/Market Focus Section).

While Mr. Obama -- in both his campaign rhetoric and comments as President -- has expressed some understanding of the nature of the structural downturn, his package was limited in addressing such issues. For example, rebuilding the nation's infrastructure -- usually viewed as a government (though not always federal) function -- indeed would stimulate activity and create new jobs, at least for a while.

Yet, in an early version of the bill, there also was a "Buy American" clause for items such as steel for bridges, an area of clear stimulus for the flagging U.S. steel industry. Foreign complaints threatened under the World Trade Organization (WTO) treaty, however, caused the Administration effectively to scrap that concept, opening the potential of shifting part of the U.S. tax-payer funded stimulus to a U.S. trading partner. The anti-U.S. nature of the WTO is an example of the trade policies of recent decades that have helped to neuter a fair portion of a once much mightier U.S. industrial base.

Other than to suggest that the private sector and the marketplace usually do a much better job than Uncle Sam in running or determining a viable business, I am not going to get into the relative merits, or lack of same, of the federal government

intervening in the private sector. Such applies to the government stepping in to salvage or control existing private enterprise such as the banking and automotive industries; as well as to the federal government trying to establish new industry that otherwise already is nascent in the private sector.

If high paying production jobs are gone, the development of new industries and new jobs in fields such as alternate energy and healthcare information is a natural counterpoint. The stimulus funding here, however, is stretched out over time, with the bulk of the outlays in 2011 and beyond.

As new industries develop, though, there is not much to prevent work or production from being outsourced to cheaper labor environments offshore. Such will remain an ongoing structural issue. Irrespective of the lack of desirability of trade conflicts, the U.S. economic problems ultimately come down to trade considerations in terms of the simple economic self-interest of many in the United States. Increasingly, trade matters could be pushed to the fore, particularly if there is an Obama Stimulus II.

Tax cuts almost always are a plus, but their impact pretty much disappears after 2010. I am not going to get into non-stimulus, political-agenda issues and other gimmicks that were added into the package often because public debate of controversial matters could be dodged easily.

Based on the Congressional Budget Office (CBO) assessment of the final \$787 billion stimulus package, only \$584 billion will be spent before the 2010 election, \$185 billion before September 30, 2009 and \$399 billion in fiscal 2010.

Traditionally, fiscal stimulus has a six- to nine-month lead time versus economic activity, so little economic gain from the package is likely before fourth-quarter 2009.

The CBO's estimates of economic impact from the package, measured fourth-quarter over fourth-quarter, are an addition of 1.4 to 3.8 percentage

points in annual real GDP growth in 2009, 1.1 to 3.3 percentage points in 2010. In terms of civilian employment, fourth-quarter 2009 purportedly could see a cumulative improvement of 0.8 to 2.3 million jobs, fourth-quarter 2010 could see a cumulative improvement of 1.2 to 3.6 million jobs, relative to where employment would have been without the stimulus. The CBO's estimates, however, tend to be overly optimistic. In the current circumstance, for example, the CBO projects employment growth and broad-based economic recovery in 2010, even without the stimulus bill.

Economic Activity Continues to Sink, Despite Occasional Bottom-Bouncing. The broad economy pretty much continued in freefall in the latest round of economic reporting, in terms of annual pace of decline, although there was some bottom-bouncing in the monthly retail sales number for January. There may be other short-term monthly bottom-bouncing in series such as industrial production. What is at work here is the natural result of the bottom falling out of a market. Activity rarely falls to zero, but it often will bounce along a plateau of low-level activity, before plunging anew. In such circumstances, the year-to-year change usually continues to deepen or temporarily stalls at a low level.

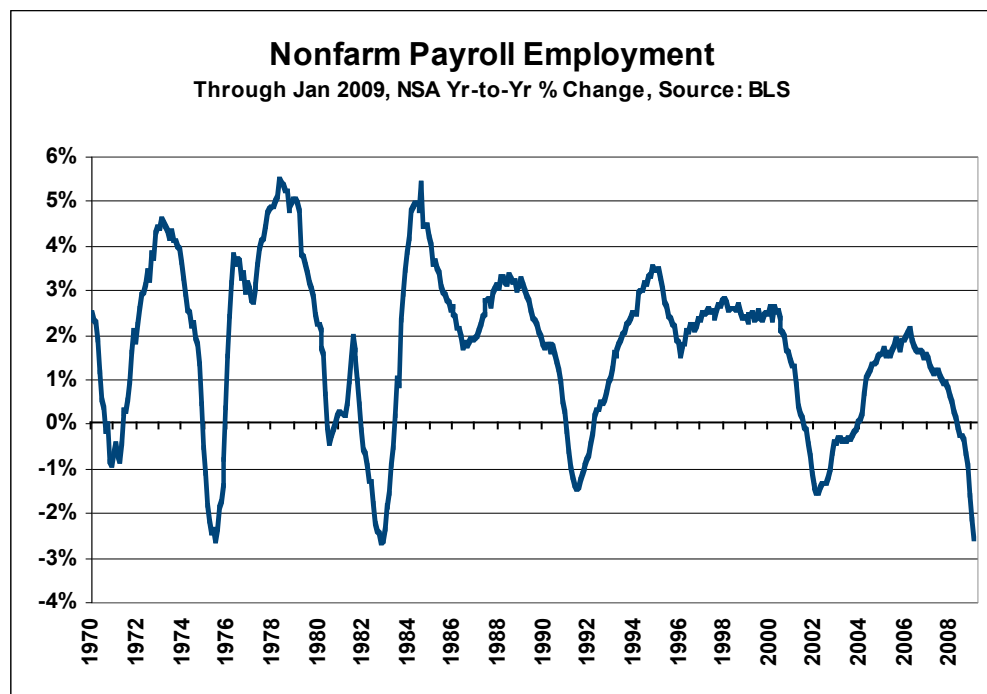
Record Merchandise Trade Deficit in 2008 -- Cumulative 4.7 Million Jobs Lost. The U.S. trade deficit, as reflected in the Net Exports account of GDP, is a net subtraction from total U.S. economic activity, where U.S. exports reflect domestic production (a plus), and U.S. imports reflect lost domestic production (a minus). Based on average annual nominal (not adjusted for inflation) GDP of \$14,280.7 billion dollars, net exports of a negative \$665.1 billion dollars, and average annual civilian employment of 145.362 million, GDP (net of net exports) per employed individual works out to about \$102,800. The implied jobs lost to the trade deficit on that basis is a cumulative 6.5 million, but recalculation based on inflation-adjusted activity -- a more appropriate

measure given oil prices -- works out at 4.7 million.

As noted in the Trade Deficit comments in the Reporting Perspective section, for all of 2008, the total deficit on a balance of payments basis narrowed to \$677.1 billion, from \$700.3 billion in 2007. The reported improvement, however, was due to a purported increase in the "services" surplus, which is little more than a guesstimate.

The "goods" deficit actually widened minimally for the year, to \$799.9 billion in 2008, from \$794.5 billion in 2007. For the year, the largest trade deficit was with China, at \$266.3 billion in 2008, up from \$256.2 billion in 2007.

Encompassing the second and third worst deficit accounts, the trade deficit with NAFTA partners Canada and Mexico narrowed to \$138.6 billion in 2008, from \$142.8 billion in 2007. The deficit with Canada increased to \$74.2 billion in 2008, from \$68.2 billion in 2007, while the deficit with Mexico shrank to \$64.4 billion in 2008, from \$74.6 billion in 2007. The deficit with Japan also shrank, down to \$72.7 billion in 2008 versus \$82.8 billion in 2007. Among OPEC members (including Ecuador in both 2007 and 2008), the U.S. trade deficit soared to \$175.6 billion in 2008, versus \$127.4 billion in 2007, basically reflecting the significantly higher annual average import oil price in 2008 (\$95.23 per barrel in 2008, versus \$64.28 in 2007).



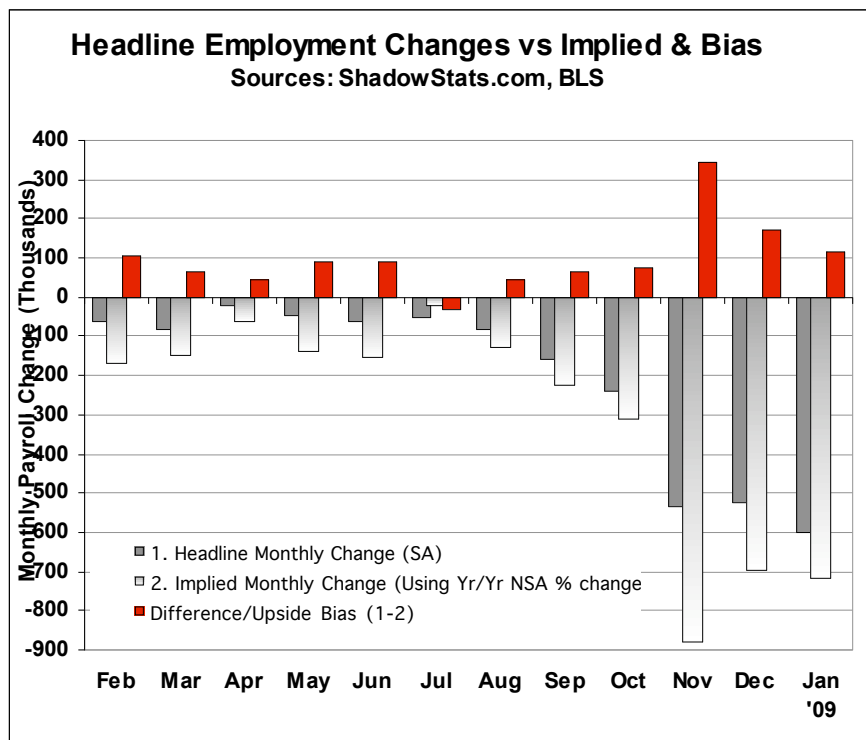
Nonfarm Payroll Losses Much Worse than Headline Reporting (593K Headline versus 1,680K Revised). As discussed in the Employment/Unemployment comments in the Reporting Perspective section, the January 2009 headline payroll contraction, reported at a loss of 598,000 for the month, likely was shy of reality,

once again. As reported, though, and as shown in the preceding graph of annual growth in nonfarm payrolls, January 2009 payroll employment was down by 2.6% against January 2008, the steepest decline since the depths of the double-dip recession in the early 1980s. A similar jobs loss in February 2009 would push the annual rate of

decline to its lowest level since the 1957/1958 recession, which was a delayed post-Korean War slowdown.

The next graph shows what I call the Concurrent Seasonal Factor Bias, which appears to be built into the current monthly reporting of payrolls (see the Reporting/Market Focus in *SGS Newsletter No. 43*). Over the period of a year, seasonally-adjusted and unadjusted payroll series should equal each other, with the seasonal factors simply redistributing jobs over time to neutralize the

effects of patterns of regular change seen in reporting during the holiday shopping season, the school year, etc. An issue with the payroll series, however, is that the seasonal factors are recalculated each month, as the series develops, which has highlighted and made possible an unusual reporting pattern. Where year-to-year change is an alternate way of eliminating seasonal effects in data, the year-to-year change in the monthly seasonally-adjusted and unadjusted series should be reasonably close, but they are not.



In 11 of the last 12 months, and in 20 of the last 22 months in which I have tracked this particular issue, applying the year-to-year change in unadjusted payroll numbers to the seasonally-adjusted payroll numbers has suggested that reality has been significantly weaker than indicated by the headline payroll numbers as reported by the BLS. The headline numbers are what drive the financial markets. Although the

numbers are revised in the next two months of reporting, and in the annual benchmark revisions, the markets rarely take note of revisions, concentrating instead on the latest headline report.

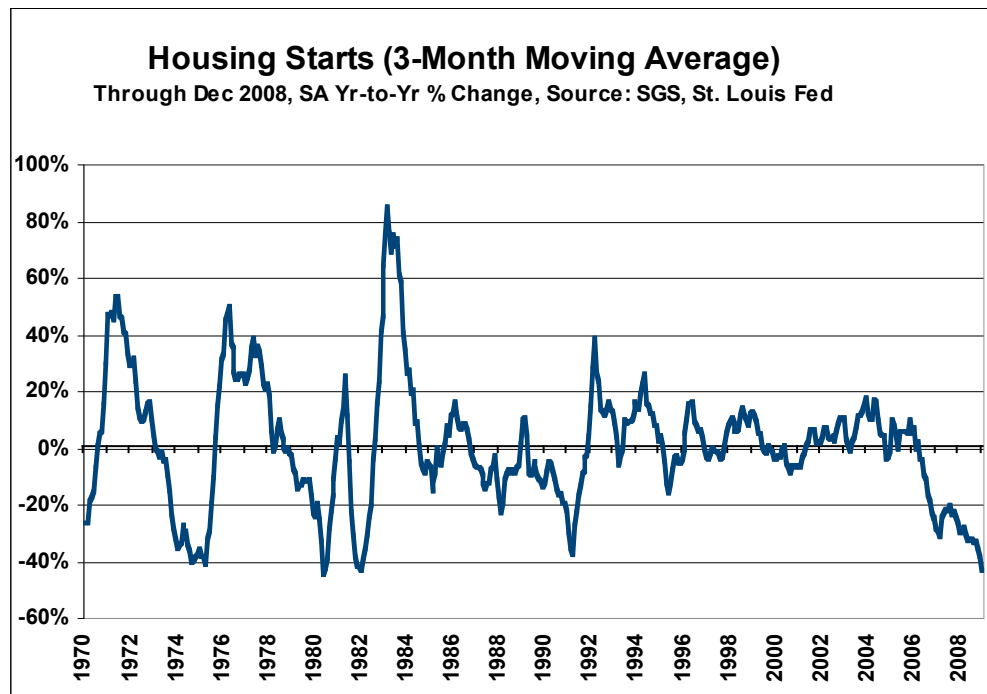
The difference is that if only the headline numbers were tallied, there was a cumulative jobs loss of 593,000 in the 20 months ended November 2008 (December 2008 and January 2009 still are subject

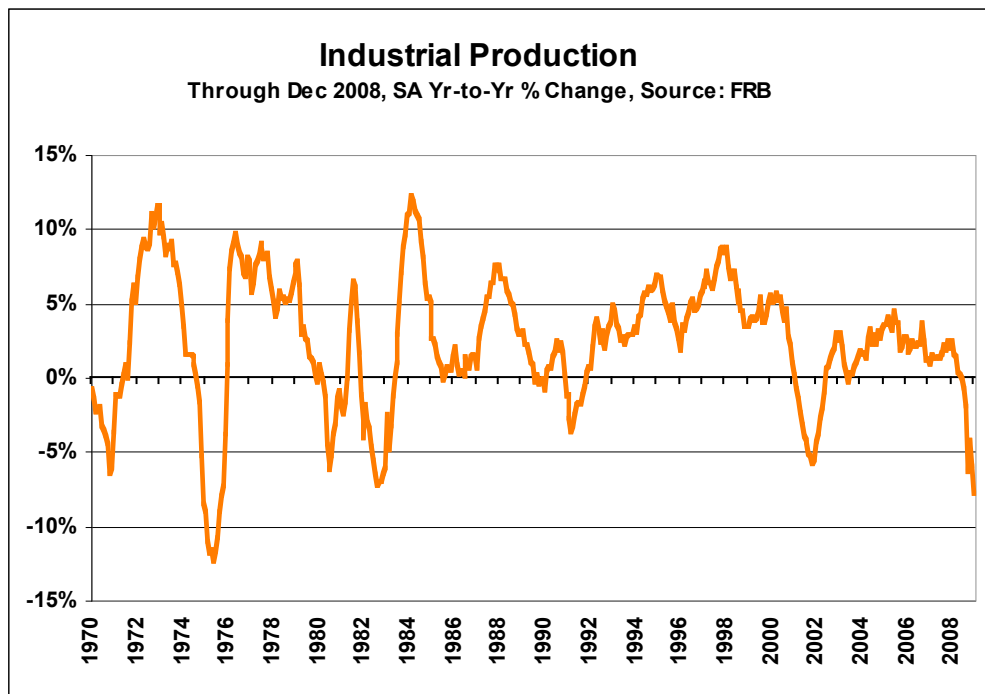
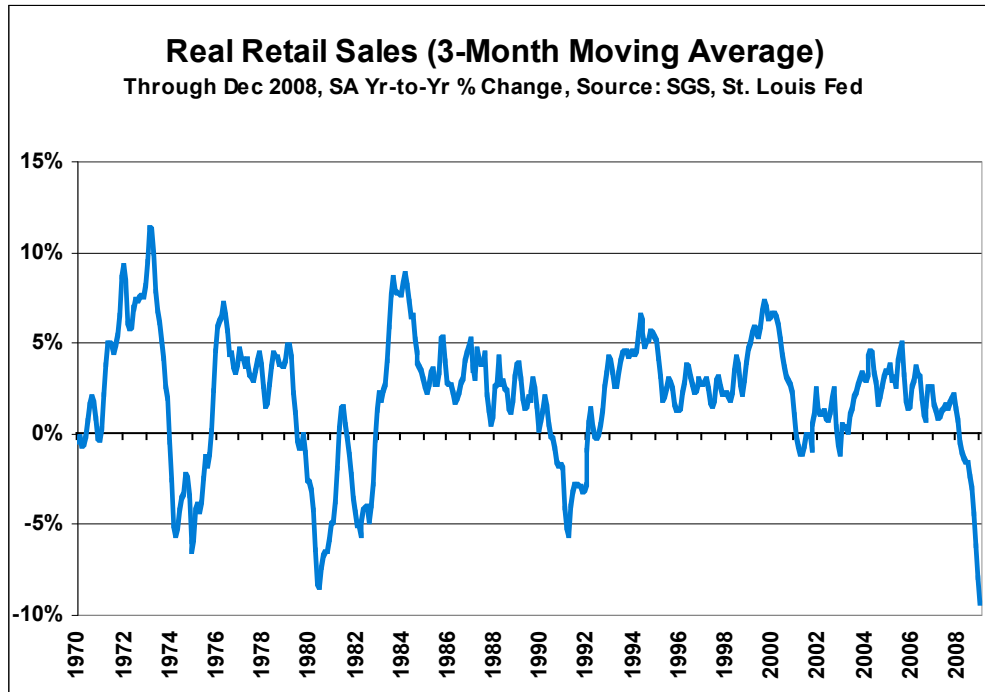
to monthly revisions). The SGS estimates made based on the same data published with the headline numbers totaled 1,840,000. In terms of later BLS revisions, total jobs lost in the same period were 1,343,000 before, and 1,680,000 after, the latest benchmark revision.

"Weakest Since .." Estimates Move Back in Time. As shown in the following graphs, annual growth rates in key economic series have continued to tumble. The three-month moving average of the annual decline in housing starts now stands at a contraction of 43.0%, the weakest showing since the double-dip 1980's recession.

With the annual contraction in the three-month moving average of real retail sales now at 9.4%, it has hit the lowest level of growth in the history of the two historical series that are combined in order to track the numbers back into the late-1940s. Aside from any distortions around World War II, this likely is the weakest showing since the Great Depression.

With annual contraction in industrial production at 7.8%, such is the weakest showing since the 1973/1975 recession.





As discussed in the Reporting Perspective, a depression is defined (SGS) as a recession where peak-to-trough contraction in inflation-adjusted economic activity exceeds 10%. That level of contraction currently is exceeded in annualized terms by fourth-quarter 2008 real retail sales,

industrial production, new orders for durable goods and housing starts.

Bailout Package Falters as Treasury and Fed Promise More Cash. Treasury Secretary Geithner put forth his latest version of the

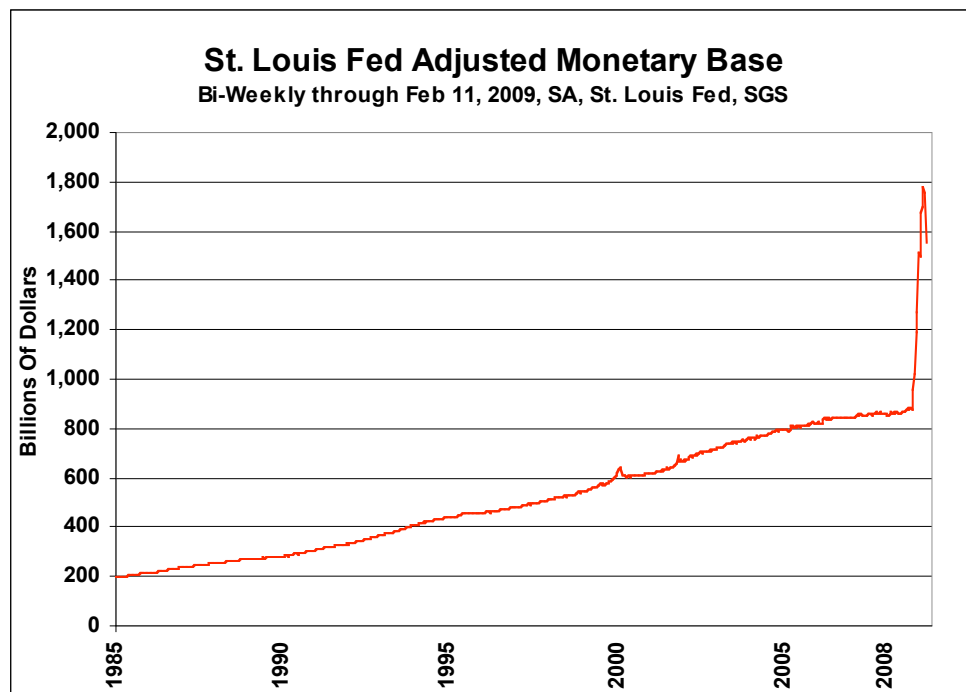
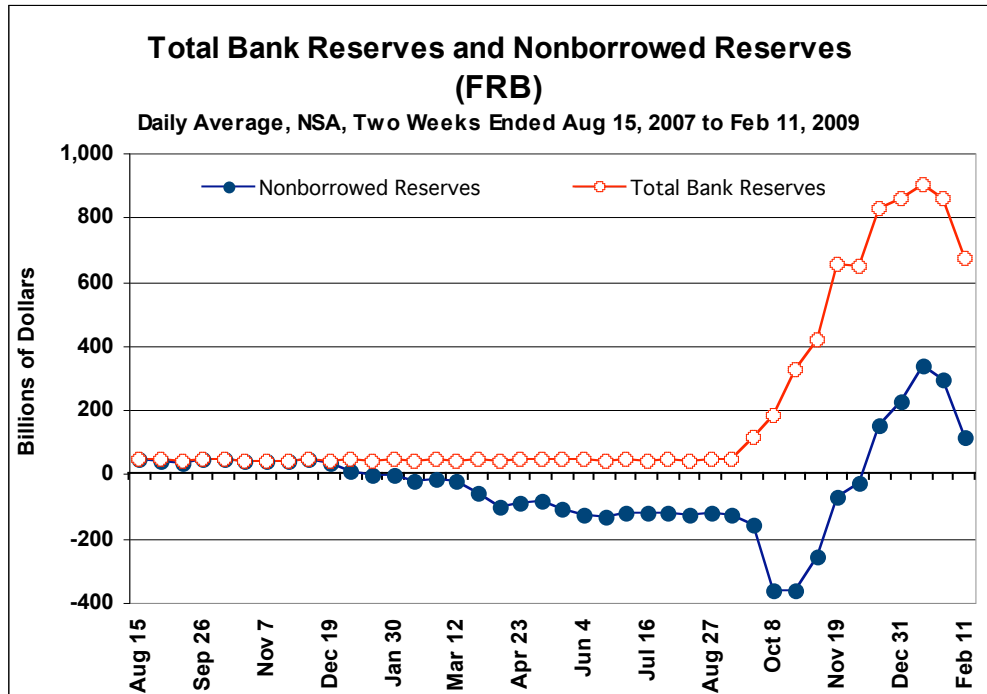
financial system bailout, promising adequate capital for banks, new stress tests to see which banks are worthy of saving, a public-private investment fund to buy bad assets from troubled banks, extensions of FDIC guarantees, and greater political oversight of banks receiving federal money. With no details provided beyond the usual huffing, puffing and wishful thinking, the stock market tanked in response.

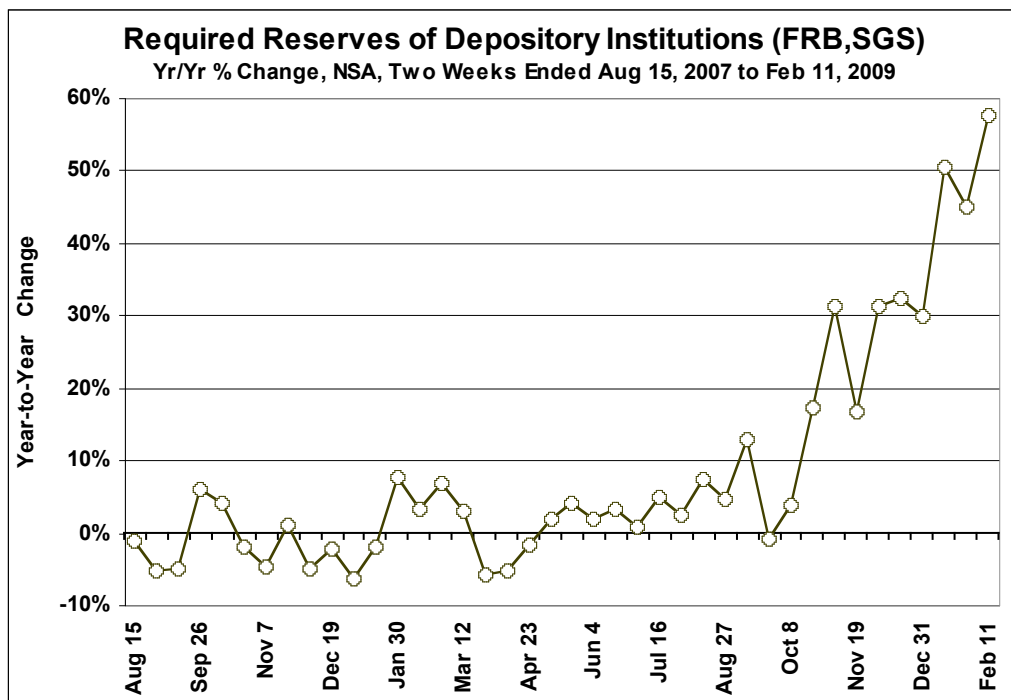
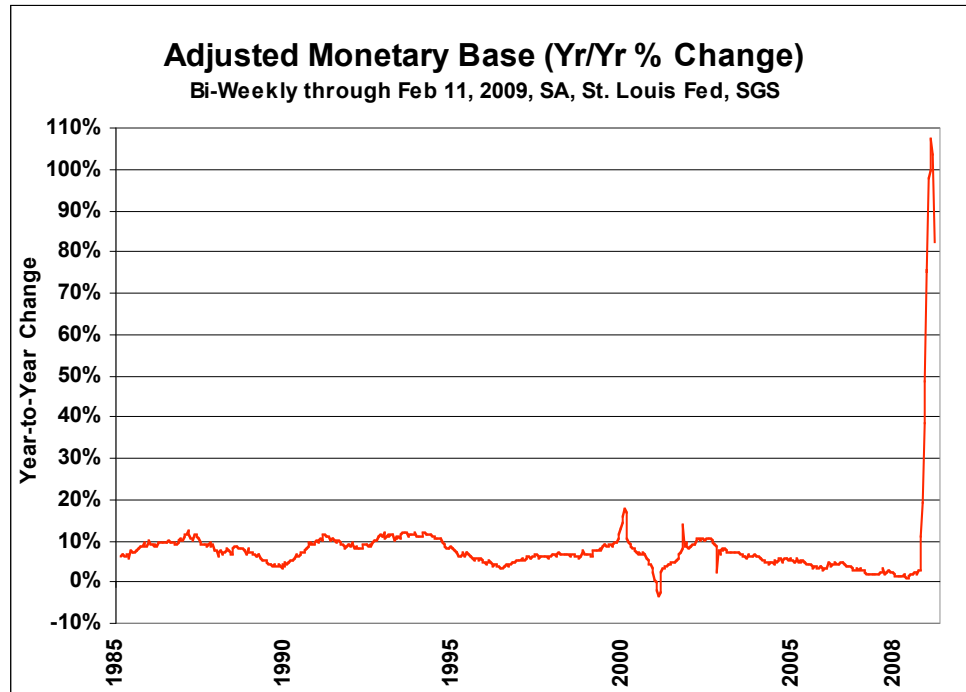
Although the depository system has been salvaged, at least temporarily, the banking system itself remains effectively insolvent, with both the Fed and the Treasury throwing around new trillion-dollar promises as though a trillion dollars is nothing anymore (it quickly would become so in a hyperinflation). Despite some signs of systemic stability, as evidenced by renewed growth in broad money supply, there also are possible signs again of increasing stress (see M3 comments that follow). The depths of the economic and systemic solvency crisis are so severe, the Fed and the Treasury likely are not going to be able to stabilize the banking system without eventual nationalization of at least some of the larger banks. However it unfolds, Messrs. Bernanke and Geithner will create and spend whatever money they have to in order to prevent a systemic collapse, and they will do so until such point as they may have destroyed the purchasing power of the U.S. dollar.

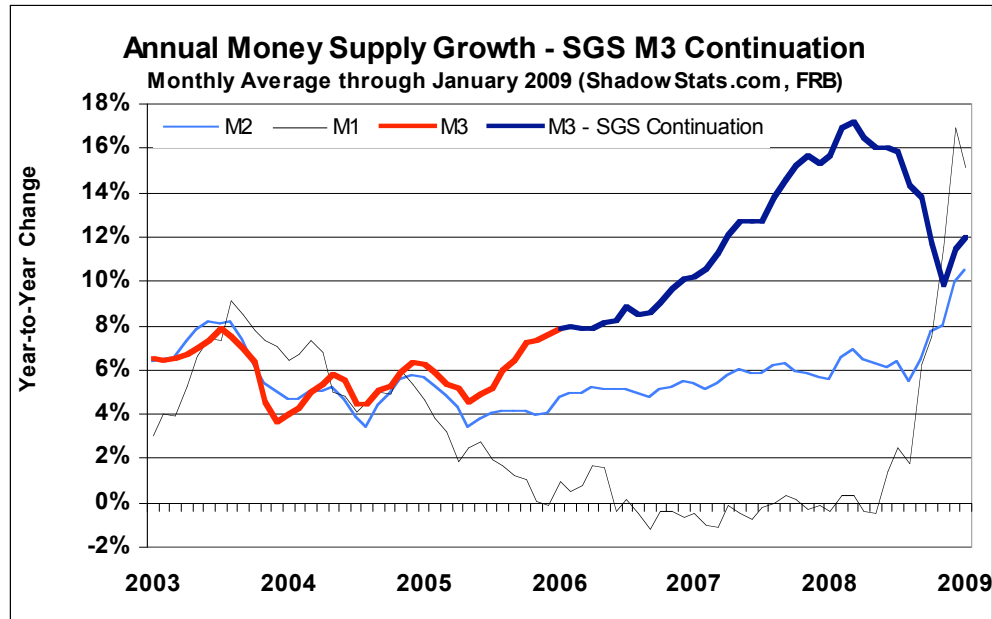
Annual Monetary Base Growth Slows to 81.9% but Required Reserves Jump 57.7%. Friday's (February 13th) release of bank reserves data showed the annual growth in the St. Louis Fed's Adjusted Monetary Base easing to 81.9% in the two weeks ended February 11th, versus 103.3% in the two weeks ended January 28th, and a record 107.2% in the two weeks ended January 14th. The slowing growth entirely was due to declining excess reserves, where banks had been parking funds they might otherwise have been lending. If those funds have been shifted into the regular stream of commerce, such is positive news for systemic stability.

Of greater significance to the broader money measures, however, annual growth in required reserves (seasonally-unadjusted) surged to 57.7% in the latest two weeks, up from 45.0% in the prior period and versus 50.4% in the period before that. This record post-World War II annual growth suggests ongoing growth in depository accounts.

The following four graphs are updated for the latest detail in terms of bank reserves and the monetary base (basically currency plus bank reserves). Again, the most significant development is in the continued surge in required reserves growth.







January Annual M3 Growth at 12.0%. As shown above, the annual growth in the SGS-Ongoing M3 measure for January 2009 is estimated at 12.0%, up from 11.4% in December and from the near-term growth trough of 9.8% in November. In the latest reporting (week ended February 2nd), however, weekly declines in seasonally-adjusted M2 and large time deposits largely offset a gain in institutional money funds. While weekly growth patterns vary sharply, any continued faltering of growth in the published M3 components could be a signal of renewed and intensified stress in the banking system. The reserve changes discussed earlier (two weeks ended February 11th), however, suggest increasing broad money growth ahead. Detail will continue in *Flash Updates* as developments warrant.

The downtick in January's annual M1 growth just reflects a shifting of funds from checking accounts (M1) to savings accounts (M2).

Inflation Remains the Concern. Mr. Bernanke is dedicated to debasing the U.S. dollar, in order to create inflation and to avoid deflation (he outlined

such plans as a Federal Reserve Governor in 2002). The broad money supply has started to grow again, annual growth in required reserves at depository institutions is soaring, and the velocity of money likely is rising again, all suggestive of double-digit consumer inflation later in 2009.

Yet, with some early suggestion of a possible renewed stall in the growth of the broader money measures, the systemic solvency crisis may be intensifying again, frustrating Fed efforts to get more cash into the system. Ahead lies an opportunity for the Fed, with heavy Treasury fundings needed to cover the stimulus package and an otherwise recession-driven deterioration in the federal government's fiscal condition. With likely light foreign and domestic demand for the Treasury securities, Federal Reserve monetization of that debt would be a reasonably easy option for Mr. Bernanke to help reignite inflationary pressures. The Fed mentioned the possibility of such purchases in its most recent FOMC statement.

All factors considered, the estimated timing for the onset of the hyperinflationary great depression

discussed in the *Hyperinflation Special Report* of April 8, 2008 remains in a range of late-2009 to 2014.

Over the shorter term, volatile oil prices still will move the CPI. With both oil and gasoline prices having bottomed in December -- at least temporarily -- the January 2009 CPI likely will show a seasonally-adjusted monthly increase and likely will hold around zero on a year-to-year basis, not showing any further significant softening relative to December. Any renewed strength in oil prices would start to boost short-term consumer inflation concerns, anew.

U.S. Dollar Fundamentals Weak -- U.S. Generally Worse Off than Rest of World.

Despite ongoing strength in the U.S. dollar, I remain extremely bearish on the U.S. currency over the long haul. As discussed later, the underlying fundamentals remain terrible, and despite recent market hype of relatively stronger fundamentals in the U.S. versus its major European trading partners, the reverse is more accurate.

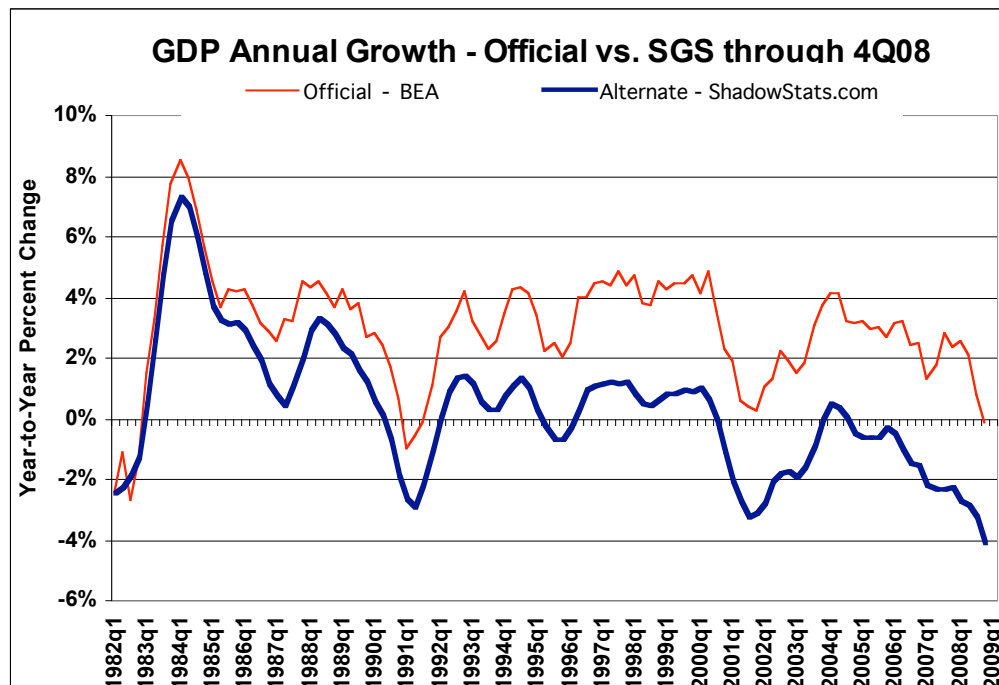
The deepening economic contraction and systemic solvency crisis in the U.S. are much worse than are the related problems among the United States' major trading partners, particularly against the backdrop of an effective U.S. bankruptcy that was in place before the current crises broke (see the Reporting/Market Focus of prior *SGS Newsletter No. 48*).

The U.S. dollar ultimately faces a massive selloff, along with dumping of foreign held dollar-denominated assets. The timing of this remains open, but it could break at any time, with little warning. It also could linger in the offing for months. At such time as the greenback comes under heavy selling pressure, U.S. dollar-denominated commodities, particularly oil, will suffer upside dollar pricing pressures as a result of the dollar weakness.

Over the long-term, the broad outlook is little changed. The markets remain highly volatile and dangerous. As to the equity and credit markets, extremely difficult times still lie ahead, with impaired corporate revenues and profits (and the economy) worse than current expectations, and with long-term interest rates likely to move much higher. Rates should rise as financial-panic pressures subside and funds flow out of U.S. Treasuries in response to ongoing dollar debasement (inflation). Also, over the long-term, the U.S. dollar should suffer significant selling, with resulting upside pressure on domestic long-term interest rates. Over the long-term, both gold and silver should rally sharply, in response to the greenback's eventual problems as well as to mounting flight-to-safety issues.

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.

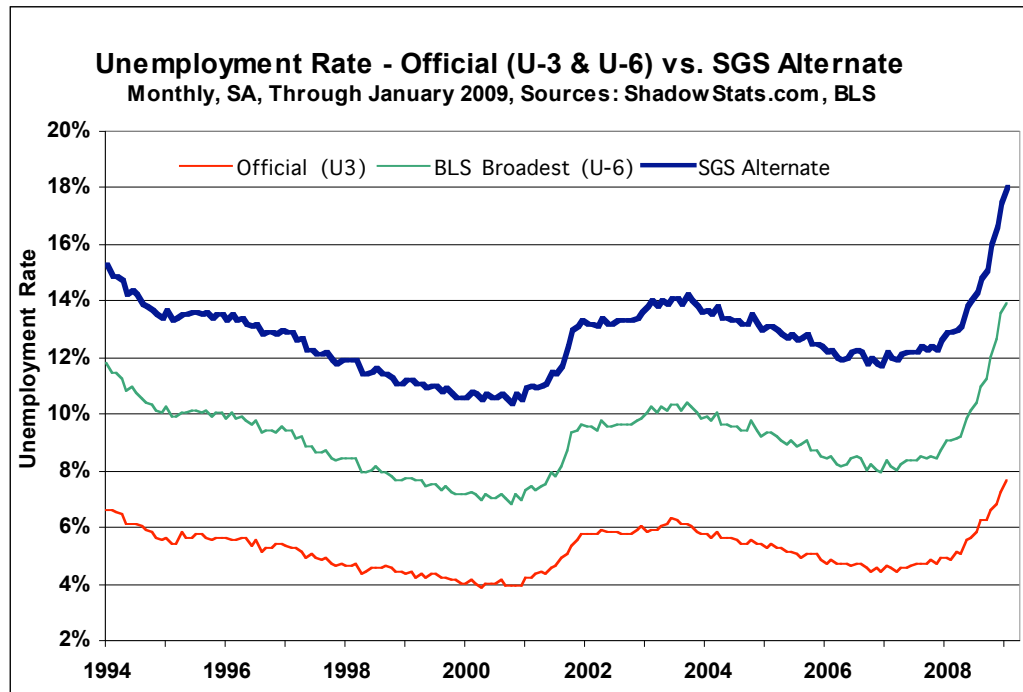


GDP. The alternate fourth-quarter 2008 GDP growth reflects the "advance" estimate, with many of the methodological gimmicks of recent decades removed. The alternate fourth-quarter inflation-adjusted annual growth rate (year-to-year, as opposed to the popularly-touted annualized quarter-to-quarter rate) for GDP was a decline of roughly 4.1% versus the official year-to-year contraction of 0.2%. The official, annualized real quarter-to-quarter change stands at a 3.8% 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 fourth quarter of more than seven-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. 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 again in January, reflecting continued rapid deterioration in labor-market conditions. The January rates stood respectively at 7.6%, 13.9% and 18.0%, up from 7.2%, 13.5% and 17.5% in December.



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. The Alternate numbers are reported from the 1994 series redefinitions forward. It is planned to take the alternate series further back in time.

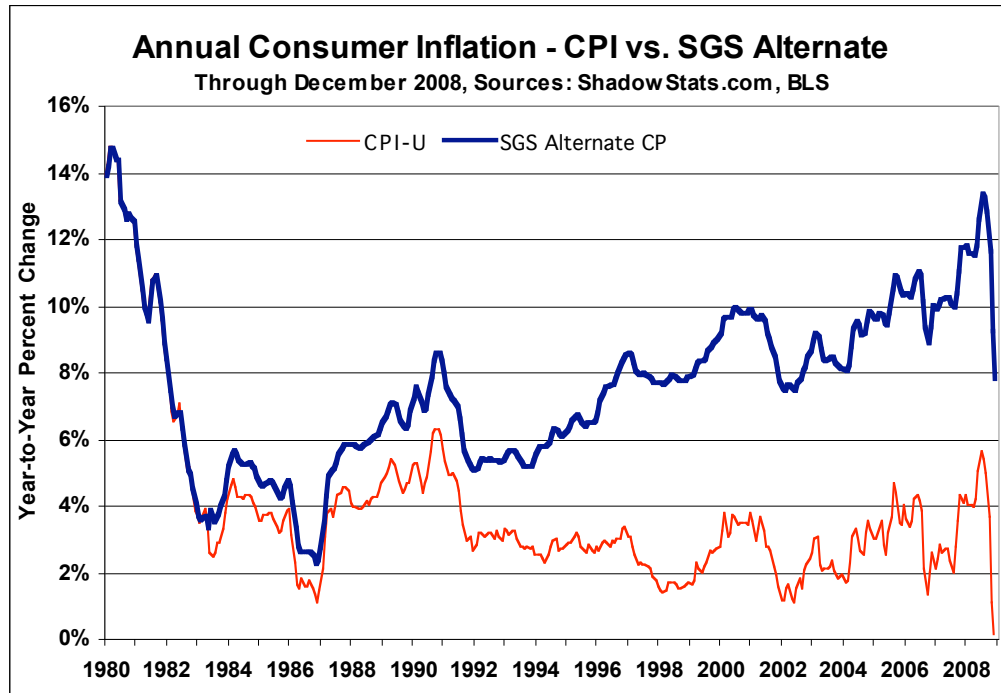
CPI. Once again absorbing sharp declines in energy prices, December's annual full inflation rates eased sharply, while "core" inflation continued to soften as well. Curiously, the PCE Deflator (I.5 in the accompanying table), which tends to track closely with the C-CPI-U (I.6), again showed annual inflation holding well above the C-CPI. Such remains suggestive of conflicting issues in handling the energy cost decline in the government's various inflation measures.

With oil and gasoline prices moving higher in January, the December annual inflation rates should be at or near the trough of the current cycle. Spiking broad money growth threatens much higher inflation ahead this year, with risk of a sharp dollar decline and oil price spike offering near-term upside risk.

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

reversal of hedonic adjustments, geometric weighting and the use of a more traditional approach to measuring housing costs, measures all consistent with the reporting methodology in place as of 1980. Available as a separate tab at the SGS

homepage www.shadowstats.com is the SGS Inflation Calculator that calculates the impact of inflation between any two months, 1913 to date, based on both the official CPI-U and the SGS-Alternate CPI series.



Please Note: At Subscriber request, we have expanded the consumer inflation list to 10 ten indices, adding the CPI-W (urban wage earners and clerical workers), which tracks the more popularly followed CPI-U closely, but which is more heavily weighted toward the basic necessities of living. Accordingly, the I.1 to I.10 numbering scale has been changed to reflect the additions.

**Ten Levels of Consumer Inflation
Annual Inflation for September to December 2008**

Measure		Sep	Oct	Nov	Dec
I.1	Core PCE Deflator (BEA)	2.3%	2.0%	1.9%	1.7%
I.2	Core Chained-CPI-U (BLS)	2.2%	1.9%	1.6%	1.3%
I.3	Core CPI-U (BLS)	2.5%	2.2%	2.0%	1.8%
I.4	Core CPI-W (BLS)	2.4%	2.1%	2.0%	1.7%
I.5	PCE Deflator (BEA)	4.1%	3.2%	1.4%	0.6%
I.6	Chained-CPI-U (BLS)	4.3%	3.3%	0.7%	-0.5%
I.7	CPI-U (BLS)	4.9%	3.7%	1.0%	0.1%
I.8	CPI-W (BLS)	5.4%	3.8%	0.7%	-0.5%
I.9	Pre-Clinton CPI-U (SGS)	8.3%	6.9%	4.4%	3.4%
I.10	SGS Alternate Consumer Inflation	12.9%	11.6%	9.3%	7.8%

Sources: SGS, BLS (Bureau of Labor Statistics), BEA (Bureau of Economic Analysis).

Notes: I.1 to I.4 reflect the core inflation rates, respectively, of the substitution-based personal consumption expenditure (PCE) deflator, the substitution-based Chained-CPI-U, and the geometrically-weighted CPI-U and CPI-W. I.5 to I.8 are the same measures, as standardly reported, with energy and food inflation included. The CPI-U (I.7) "all urban consumers" is the measure popularly followed by the financial press, when the media are not hyping core inflation. The CPI-W (I.8) "urban wage earners and clerical workers" is a narrower measure, more heavily weighted in basics such as gasoline, and used in calculating cost-of-living adjustments for items such as Social Security Payments. I.9 is the CPI-U with the effects of geometric weighting (Pre-Clinton Era as estimated by SGS) reversed. This is the top series in the CPI graph on the SGS home page www.shadowstats.com. I.10 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

Extreme market volatility continues in unusually unstable economic and systemic crises. Despite some faux flight-to-quality in the U.S. dollar, the precious metals have gained the most recently as deteriorating

Closing Financial-Market Indicators at February 13, 2009

<i>Indicator</i>	<i>1st-Qtr 2009 to Date (Feb 13)</i>			<i>Year-End 2008/4th-Qtr</i>			<i>Year-End 2007</i>	
	<i>Level</i>	<i>QTD/YTD</i>	<i>Yr/Yr</i>	<i>Level</i>	<i>Qtr/Qtr</i>	<i>Yr/Yr</i>	<i>Level</i>	<i>Yr/Yr</i>
<i>Equity Market</i>								
DJIA	7,850.41	-10.55%	-37.46%	8,776.39	-19.12%	-33.84%	13,264.82	6.43%
S&P 500	826.84	-8.46%	-39.52%	903.25	-22.45%	-38.49%	1,468.36	3.53%
DJ Wilshire 5000	8,385.74	-7.72%	-39.42%	9,087.17	-23.48%	-38.68%	14,819.60	3.94%
NASDAQ Comp	1,534.36	-2.71%	-35.37%	1,577.03	-24.61%	-40.54%	2,652.28	9.81%
<i>Credit Market (1)</i>								
Fed Funds (2)	0.00%	0bp	-300bp	0.00%	-200bp	-425bp	4.25%	-100bp
3-Mo T-Bill	0.29%	18bp	-199bp	0.11%	-87bp	-325bp	3.36%	-166bp
2-Yr T-Note	0.97%	21bp	-94bp	0.76%	-124bp	-229bp	3.05%	-177bp
5-Yr T-Note	1.88%	33bp	-83bp	1.55%	-143bp	-190bp	3.45%	-125bp
10-Yr T-Note	2.89%	64bp	-81bp	2.25%	-160bp	-179bp	4.04%	-67bp
30-Yr T-Bond	3.68%	99bp	-84bp	2.69%	-162bp	-176bp	4.45%	-36bp
<i>Oil (3) US\$ per Barrel</i>								
West Texas Int.	37.51	-15.90%	-59.58%	44.60	-55.68%	-53.55%	96.01	57.24%
<i>Currencies/Dollar Indices (4) US\$/Unit</i>								
Pound Sterling	1.4401	-1.49%	-26.59%	1.4619	-17.89%	-26.33%	1.9843	1.31%
Euro	1.2888	-7.41%	-11.59%	1.3919	-1.15%	-4.68%	1.4603	10.65%
Swiss Franc	0.8616	-8.04%	-4.58%	0.9369	4.83%	6.14%	0.8827	7.64%
Yen	0.0109	1.28%	10.39%	0.0110	16.68%	23.04%	0.0090	6.54%
Canadian Dollar	0.8097	-0.89%	-19.09%	0.8170	-13.43%	-19.27%	1.0120	17.92%
Australian Dollar	0.6580	-5.77%	-26.35%	0.6983	-11.65%	-20.43%	0.8776	11.31%
<i>Weighted Currency Units/US\$ (Jan. 1985 = 100)</i>								
Financial (FWD)	54.95	4.69%	16.91%	52.49	5.93%	11.07%	47.26	-7.64%
Change US\$/FX	--	-4.48%	-14.47%	--	-5.60%	-9.96%	--	8.27%
Trade (TWD)	59.31	3.78%	12.69%	57.15	4.33%	8.40%	52.72	-10.00%
Change US\$/FX	--	-3.64%	-11.26%	--	-4.15%	-7.75%	--	10.01%
<i>Precious Metals (5) US\$ per Troy Ounce</i>								
Gold	935.50	7.56%	4.06%	869.75	-1.67%	4.32%	833.75	31.92%
Silver	13.37	23.91%	-21.26%	10.79	-16.74%	-26.90%	14.76	14.41%

bp: Basis point or 0.01%. (1) Treasuries are constant-maturity yield, U.S. Treasury. (2) Current Fed Funds target is 0.00% to 0.25%. (3) Department of Energy. (4) Shadow Government Statistics, *Wall Street Journal*, Federal Reserve Board (see Dollar Index Section for definitions). (5) London fix (afternoon for gold), Kitco.com.

global conditions have intensified a flight-to-safety move in the long-term stores of wealth. Almost anything can happen in the current circumstance. While the text below may be somewhat repetitive with the last newsletter, my general thinking has not changed.

I continue to argue that investors should be looking at the long-term and at preserving their wealth and assets in what eventually will become a hyperinflationary great depression. With severe economic, inflation and currency displacements ahead in the United States, those who can ride out the turmoil eventually should see tremendous investment opportunities. As to preserving capital and assets for someone in a U.S. dollar-denominated environment, holding some assets in physical gold (and some silver), and holding some assets outside the dollar (i.e. the Swiss franc, Canadian dollar) in high-quality, liquid assets, remain the best long-range hedges against all the real risks facing investors and the system.

Again, this is for the long haul. Short-term conditions still can show extreme volatility in the U.S. dollar and precious metals, as seen in the last year. Putting aside risks of political instabilities tied to the economic turmoil or any short-term liquidity concerns, real estate also remains a prime long-term hedge against the severe currency debasement that lies ahead.

With the ongoing crises in systemic solvency and in a severely contracting economy with inflation problems, the long-term outlook holds: 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 (and likely higher oil prices from a weakening dollar), weakness in the dollar,

and as safe-haven hedges against increasing systemic and global political instability.

U.S. Equities -- The downside movement in equities generally has continued in what has proven to be a particularly savage bear market. It likely is far from over, with a downside potential still of roughly an 80% loss from current levels, which would bring total losses from last year's record closing prices -- peak-to-trough -- into the 90% range as seen in the 1929 to 1933 period (see note below). This outlook is over the longer term, and is in the context of ongoing extreme volatility, including likely intervening sharp rallies.

Feeding the ongoing bear market is an economy in deepening recession/depression with no sustainable recovery in sight. Even with the big stimulus package, the economy faces at best some bottom-bouncing before its next downleg, but more likely, the bottom-bouncing will not be strong enough to show any net economic gain. Also, with eventual heavy dollar selling, renewed inflation and mounting issues as to the long-term quality of U.S. Treasuries, long-term interest rates eventually will rise sharply.

General background note: Equities have begun to catch-up with the underlying economic, financial and systemic fundamentals, but the aggregate downside adjustments to stock prices still should be quite large over a number of years, eventually rivaling the total 90% decline in equities seen in the 1929 crash and ensuing four years. The current decline might have to be measured in real terms, however, 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 (see the *Hyperinflation Special Report* of April 8, 2008).

U.S. Credit Market -- With the targeted fed funds rate at 0.00% to 0.25%, the Fed has pushed short-

term interest rates as low as they can go. U.S. Treasury yields, in general, already are at or near historic lows, but are not sustainable at those levels, except that the Fed may move to monetize long-term debt issues in an effort maintain those low yields artificially. Such monetization, which appears increasingly likely, would accelerate broad money growth and intensify inflation pressures -- conditions also desired by the Fed, temporarily. Eventually, inflation and resulting dollar weakness would drive longer term rates much higher, assuming regular market forces remained in play. Further boosting yields would be mounting concerns as to U.S. government solvency.

If inflation rises strongly in the year ahead, as I expect (but not at hyperinflationary levels), it would tend to support double-digit long-term yields, again, assuming normal market forces are allowed to play out.

U.S. Dollar -- Those touting the U.S. dollar and U.S. Treasuries as bastions of safety in an increasingly insolvent world severely overestimate relative U.S. economic and systemic stability. Quite to the contrary, the world's largest economy is tumbling into the deepest post-World War II downturn, with no end in sight. Further, the world's largest financial system likely is largely insolvent, and may not be salvageable shy of significant nationalization of key firms. The solutions offered to these crises just add significant further unfunded liabilities to total U.S. government obligations that were at \$65 trillion pre-crises. At more than four times U.S. GDP, and at a level greater than total global GDP, that debt means the U.S. government faces eventual insolvency, which most likely will be covered by the currency printing presses. The resulting hyperinflation will lead to a full debasement of the U.S. dollar and an overhaul of the global currency system.

Central bankers have a pretty good sense of what lies ahead for the U.S. currency, and no one can be particularly happy with heavy holdings of the

greenback. Luo Ping, a director-general of the China Banking Regulatory Commission was cited by the *Financial Times* (FT.com, "China to stick with US bonds," February 11, 2009) as bemoaning the lack of options as to holding dollars and U.S. Treasuries:

"We hate you guys [United States]. Once you start issuing \$1 trillion-\$2 trillion ... we know the dollar is going to depreciate, so we hate you guys but there is nothing much we can do."

I would not bet against the Chinese central bank finding other options. In a related area, any demand on the U.S. to issue its debt denominated in something other than dollars would place severe strains on the U.S. dollar as well as on the United States' sovereign credit rating.

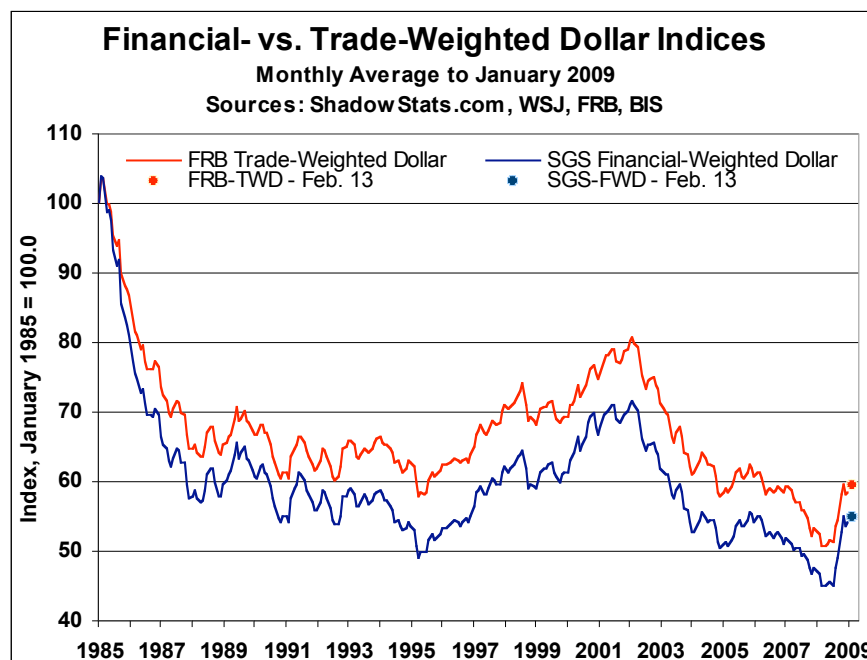
General background note: The long-term outlook for the dollar remains for a massive sell-off, with flight from the dollar eventually evolving into a flight to safety outside the dollar. The U.S. dollar's portfolio of underlying fundamentals generally could not be much worse. Relative to major trading partners, the U.S. economy is much weaker; interest rates are lower; inflation has been and will be higher; fiscal and monetary conditions are worse in the extreme; relative trade-balance conditions are horrendous; and relative political/systemic concerns are high, although the Obama Administration likely will enjoy some grace period with markets.

General background note: The proximal trigger for a full dollar panic already may be in place, given the Fed and Treasury's responses to the ongoing systemic solvency crisis. Otherwise it could come from a particularly bad economic statistic, political missteps by the 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 into an outright panicked dumping of the greenback, which should overwhelm any short-lived central bank intervention and roil the

domestic financial markets, further. 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 ongoing systemic and intensifying economic crisis.

As shown in the accompanying graph, the strength in the U.S. dollar, since the market distortions and

interventions following the Bear Stearns crisis, has continued amidst ongoing volatility. The financial- and trade-weighted indices bounced back a little in January, and have strengthened further as of the U.S. market close on February 13th.



Please Note: As of January 1, 2009, the Federal Reserve ceased publishing its daily noon exchange rates on a timely basis. Where the daily rate or monthly average for a currency or index used in the newsletter or indices has been based on Federal Reserve reporting, such will continue when possible. Otherwise, the exchange rate or index will be based on daily rates published in the Wall Street Journal. When full Federal Reserve data are available, the monthly indices will be updated to reflect same in the regular postings on the Alternate Data tab at www.shadowstats.com.

U.S. Dollar Indices. The Shadow Government Statistics' Financial-Weighted U.S. Dollar Index (FWD) is based on dollar exchange rates weighted for respective global currency trading volumes. For January 2009 the FWD gained 0.92% for the month after a 2.41% decline in December 2008. The January 2009 monthly average index level of 53.90 (base month of January 1985 = 100.00) was up by 14.98% from January 2008, up from December's 12.8% annual gain. As of February 13th, the FWD stood at 54.95.

Also rebounding in January 2009 was the Federal Reserve's Major Currency Trade-Weighted U.S. Dollar Index (TWD). The January average rose by 0.41% for the month, following a 2.47% decline in December. The January 2009 index level of 58.30 (base month of January 1985 = 100.00) was up by 10.88% from January 2008, versus an annual 9.49% increase in December. As of February 13th, the TWD closed at 59.31.

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. See the July 2005 SGS Newsletter for methodology.

Gold and Silver -- Gold and silver have benefited in recent weeks from safe-haven flight as well as increasing concern as to the prospects for the purchasing power of the U.S. dollar. With increasing global financial and political instability, and with the long-range inflation and dollar problems for the United States, as discussed earlier, the long-range outlook for the precious metals could not be better. In the short-term, however, extreme price volatility continues as a fair risk, as seen during the last year.

Falling from its all-time high London afternoon fix of \$1,011.25 per troy ounce on March 17, 2008, amidst extreme volatility, gold hit a subsequent bottom of \$712.50 in October. It closed February 13th at \$935.50. In like manner, silver plunged from its March 17, 2008 high of \$20.92 per troy ounce, hitting a subsequent low close of to \$8.88 in October. It closed on February 13th at \$13.37.

For January 2009 (per Kitco.com for both and silver prices), the monthly average London gold afternoon fix was \$858.68 per troy ounce, up from \$816.09 in December. Silver averaged \$11.29 per

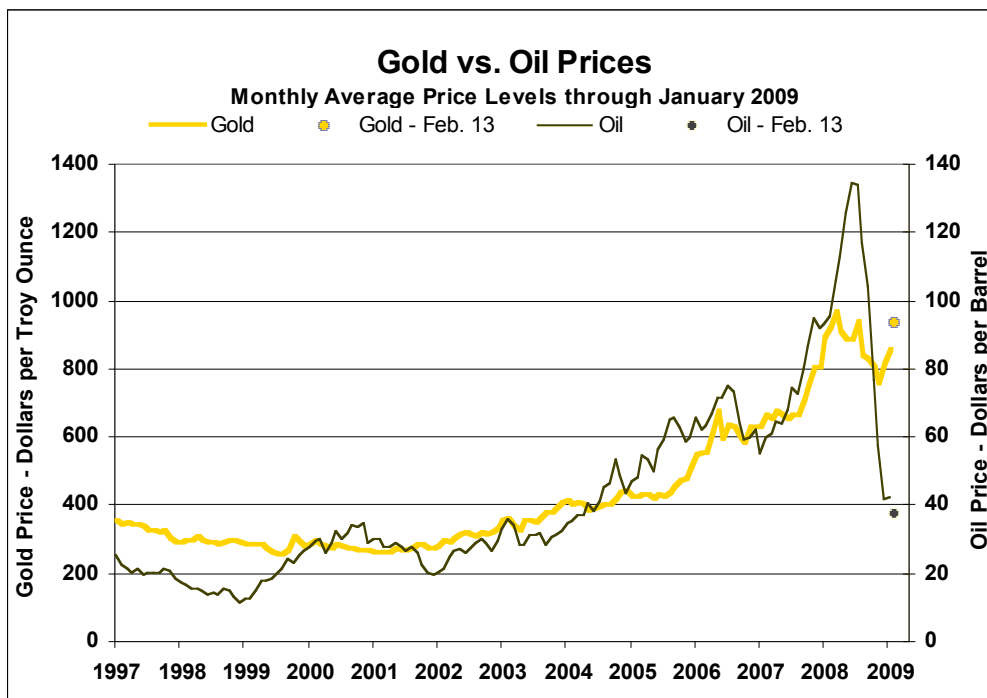
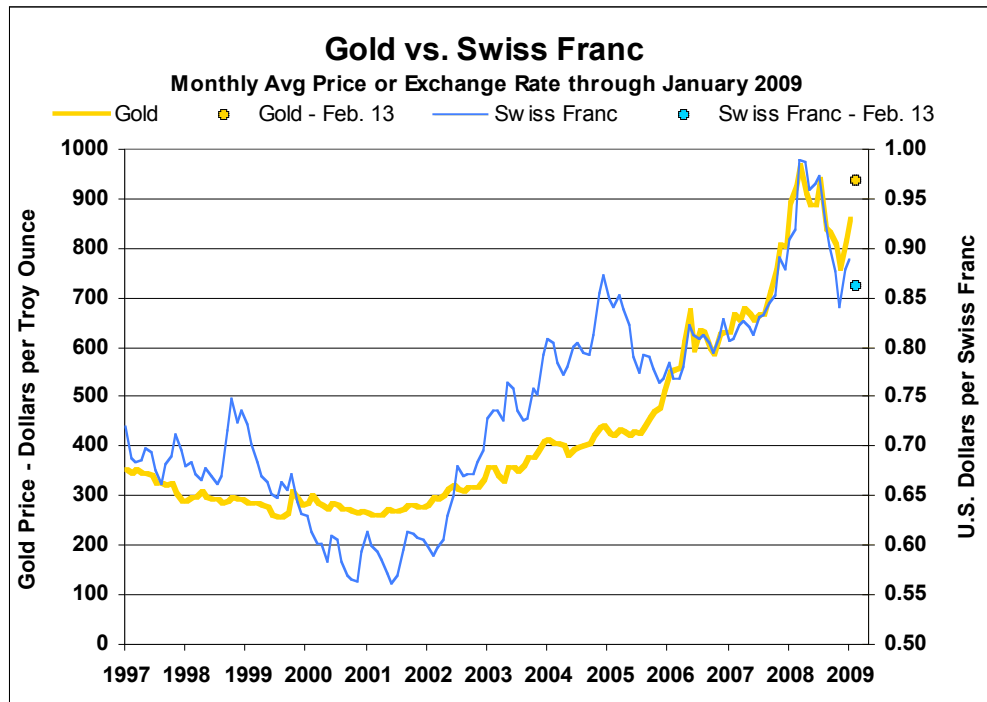
troy ounce in January, up from \$10.29 in December.

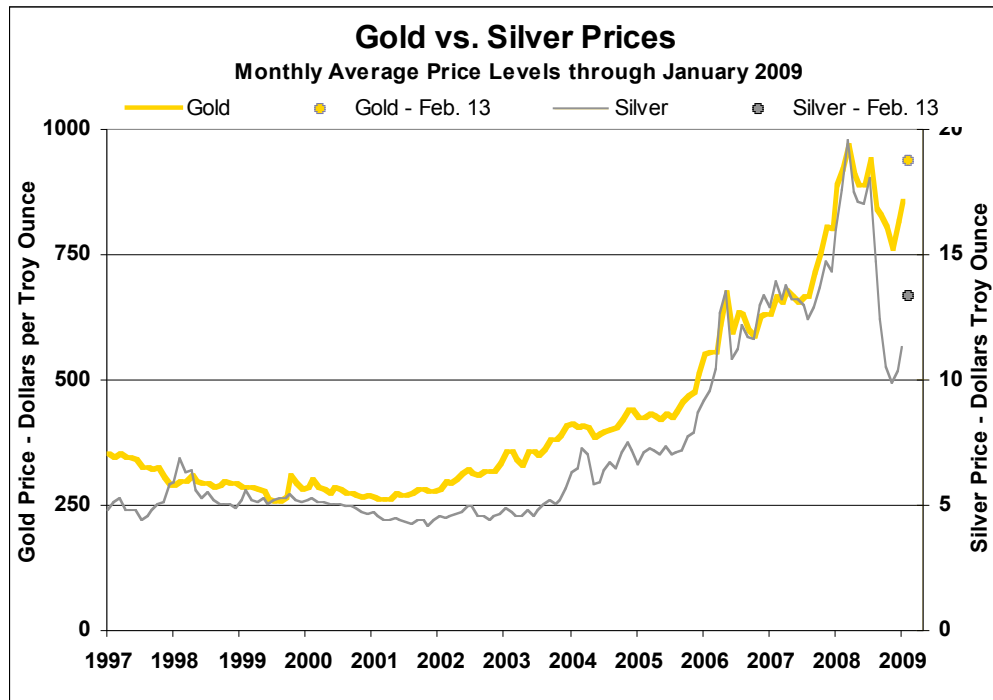
Inflation-Adjusted Historic Gold and Silver Highs. Even with the March 17, 2008 historic high of \$1,011.25, the prior all-time high of \$850.00 (London afternoon fix, per kitco.com) of January 21, 1980 still has not been hit in terms of inflation-adjusted dollars. Based on inflation through December 2008, the 1980 gold price peak would be \$2,297 per troy ounce, based on not-seasonally-adjusted-CPI-adjusted dollars, and would be \$6,650 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 November 2008, the 1980 silver price peak would be \$134 per troy ounce, based on not-seasonally-adjusted-CPI-adjusted dollars, and would be \$387 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 January monthly average price levels, as well as added points for closing prices at February 13th, with gold at \$935.50, silver at \$13.37, oil at \$37.51 and the *Wall Street Journal's* closing rate for the Swiss franc at \$0.8616. As current market distortions subside, all four measures should trade significantly higher in the months ahead, eventually breaking the highs seen otherwise during 2008.





REPORTING PERSPECTIVE

The Big Three Market Movers

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

With political pressures intense on getting the Obama stimulus package enacted, and with the Administration touting near-depression-like conditions, reporting pressures, or at least the hype, have shifted temporarily to the downside for economic reporting, although anecdotal evidence suggests that most numbers have been coming in weak of their own accord. Any weakness recognized now could be used to set as low a base as possible, against which future "Obama-generated" activity will be measured.

Political hype indeed has exaggerated some negative conditions, although economic reality is not too far behind catching up with the hype. Consider references to jobs losses or employment drops as being the worst ever, or worst since the Great Depression. While such is true for a purely physical count, it is not so on a percentage basis, where the total number of employed after World War II was roughly a quarter to a third of today's level. Accordingly, as shown in the payroll employment graph in the Opening Comments, the

"worst since" references most appropriately should be applied to the double-dip recession of the early 1980s, and shortly will be applied to the 1973/1975 recession, or before, as has happened already to other series, such as retail sales.

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

Absent manipulation, and against market expectations that have shifted sharply to the downside, most near-term economic reporting still should tend to surprise the markets on the downside. With inflation expectations having tanked along with oil prices, going forward, most inflation reporting should surprise expectations on the upside.

Employment/Unemployment -- As discussed in the January 6th *Flash Update*, and as explored and graphed in the Opening Comments section, beyond the impact of the annual benchmark revisions, payroll employment continued to sink faster than initially reported by the Bureau of Labor Statistics (BLS). Sharp downside revisions continued to prior months, and the Concurrent Seasonal Factor Bias (CSFB) continued to show major ongoing distortions to the headline reporting

of payrolls, as detailed in the graph in the Opening Comments section and as discussed below.

Nonetheless, the year-to-year percentage decline in January 2009 payrolls tumbled further, now rivaling the employment-contraction trough seen in the double-dip recession of the early 1980s.

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

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

Concurrent Seasonal Factor Bias. The pattern of impossible biases (see the Reporting/Market Focus in *SGS Newsletter No. 43* of June 10, 2008) being built into the headline monthly payroll employment continued with January 2009 reporting. Instead of the headline jobs loss of 598,000, consistent application of seasonal-adjustment factors -- net of what I call the concurrent seasonal adjustment bias -- would have shown a more-severe monthly jobs loss of about 716,000. This upside reporting bias has been seen in 11 of the last 12 months, with a rolling 12-month total upside headline-number bias of 1,185,000. A worksheet on this is available upon request.

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

Birth-Death/Bias Factor Adjustment. An element that may have intensified the reported January jobs loss was the monthly bias factor (birth-death model). Never designed to handle the downside pressures from a recession, the model adds a fairly consistent upside bias to the payroll levels each year, but with a seasonal distribution that has one month of negative bias: January. The downside adjustment to unadjusted January 2009 payrolls was 356,000, versus a subtraction from employment of 378,000 in January 2008. The impact on the adjusted monthly level supposedly is neutered by seasonal adjustments.

Household Survey. The usually statistically-sounder household survey, which counts the number of people with jobs, as opposed to the payroll survey that counts the number of jobs (including multiple job holders), went through further regular revisions in the latest reporting, in order to adjust for new population estimates.

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

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

(15.4% unadjusted) from a revised 13.5% (13.5% unadjusted) in December.

During the Clinton Administration, "discouraged workers" -- those had given up looking for a job because there were no jobs to be had -- were redefined so as to be counted only if they had been "discouraged" for less than a year. This time qualification defined away the bulk of the discouraged workers. Adding them back into the total unemployed, actual unemployment, as estimated by the SGS-Alternate Unemployment Measure, rose to about 18.0% in January, from 17.5% in December.

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

General background note: Comparisons of current reporting with data before 1994 are not valid. In 1994, the BLS completely redesigned and redefined the unemployment series and all its measures, broad and narrow, so that the new series going forward could not be compared with the old series. I still am struggling to take my alternate measure back before 1994, where finding consistent and good data is a major problem. That said, the U.6 broad measure of **13.9%** unemployment was the highest since before January 1994.

Employment Environment. The continued broad deterioration in January's employment environment broadly was in line with deterioration in the better-quality employment-environment indicators: December newspaper help-wanted advertising was at an historic low, with a deepening annual fall-off in January online help-wanted advertising (Conference Board); new claims for unemployment insurance have continued to surge sharply, setting a 33-year high

in annual growth; and employment readings continued in the deepest recession territories for both the January manufacturing and nonmanufacturing purchasing managers survey. Since the employment and unemployment indicators tend to be coincident markers of broad economic activity, weaknesses in these series are signaling an ongoing and deepening recession in place.

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

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

Real GNP Weakest Since First-Quarter 1982. The BEA's "advance" estimate of real annualized growth in the fourth-quarter 2008 GDP was a statistically significant decline of 3.80% +/- 3% (95% confidence interval), reflecting a deepening pace of contraction versus the 0.51% downturn reported in the third quarter. In terms of year-to-

year change, the fourth quarter turned negative, down by 0.18%, versus the third quarter's annual gain of 0.75%.

As usual, the data published for the GDP are of little meaning -- other than for political or financial market purposes -- given the paucity of hard numbers available for the fourth quarter at the time of estimate (i.e. only two months of trade data), and given the heavily rigged nature of GDP reporting in general. Consider, for example, that Personal Consumption Expenditure (PCE), which represents roughly 71% of GDP -- improved from an annualized contraction of 3.8% in the third quarter, to 3.5% in the fourth, while the annualized contraction in seasonally-adjusted real retail sales sank from an 11.1% downturn in the third quarter to a 17.1% contraction in the fourth. Key series such as housing, industrial production and new orders for durable goods all are showing annualized quarterly percent declines in excess of 10%.

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

The BEA's GDP-like measures for fourth-quarter 2008; Gross National Product (GNP), where GDP is GNP net of trade in factor income (interest and dividend payments); and Gross Domestic Income (GDI), which is the income-side equivalent of the GDP's consumption estimate; likely will not be published until the second revision in March, due to the lack of hard data available for the advance estimate, and given that the numbers are annual and more heavily relied on than partial-year data.

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

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

Consumer Price Index (CPI) -- As discussed in the January 16th *Flash Update*, the Bureau of Labor Statistics (BLS) reported that December's annual CPI-U (CPI for All Urban Consumers) inflation held in positive territory, avoiding a possible shallow but brief bout with official deflation. Given the Fed's strong desire to avoid a formal deflation, the year-end CPI-U inflation coming in minimally above zero had to be somewhat suspect, where other measures turned negative year-to-year. The CPI for Urban Wage Earners and Clerical Workers (CPI-W) and the substitution-based Chain-Weighted-CPI-U (C-CPI-U) both contracted 0.5% year-to-year. Using

the SGS-Alternate CPI measures, however, annual deflation still was not on the horizon.

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

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

CPI-U. The BLS reported that the seasonally-adjusted December CPI-U (I.7) declined by 0.74% (down by 1.03% unadjusted) +/- 0.12% (95% confidence interval not seasonally adjusted) for the month, versus a decline of 1.68% (down by 1.92% unadjusted) in November. Year-to-year or annual inflation in December softened to 0.09% +/- 0.20% (95% confidence interval) from 1.07% in November, remaining minimally in positive territory. For those interested in exploring the various facets of official CPI-U reporting, I continue to refer you to CPIwatch.com, a site prepared by one of my SGS colleagues.

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

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

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

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

Alternate Consumer Inflation Measures.

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

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

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

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

0.39% monthly increase seen in January 2008.

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

shot of staying minimally on the plus-side of zero in January reporting. If there were a formal small annual deflation, such should be considered in the context of methodological revisions in the last several decades that have tended to reduce the level of reported CPI inflation.

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

Other Troubled Key Series

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

Fiscal stresses are going to be exacerbated in the next year or two as the Obama Administration's economic stimulus package gets enacted. In line with the discussion in the January 9th *Flash Update*, the 2009 official budget deficit is highly likely to top \$2 trillion, with commensurate funding in excess of that required by the U.S. Treasury.

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

from \$1.2 trillion (\$4 trillion-plus, using consistent annual assumptions and accounting) in 2007.

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

Gross federal debt stood at \$10.632 trillion at January 31, 2009, down by \$68 billion for the month, but up by \$1.394 trillion from January 31, 2008, which in turn was up \$620 billion from January 2007. Gross federal debt stood at \$10.700 trillion at December 30, 2008, up by \$39 billion for the month, but up by \$1.471 trillion from December 31, 2007, which in turn was up \$549 billion from December 2006. Gross federal debt stood at \$10.661 trillion at November 30, 2008, up by \$86.1 billion for the month and up \$1.512 trillion from November 2007, which in turn was up \$516 billion from November 2006.

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

Initial Claims for Unemployment Insurance --

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

General background note: More often than not, week-to-week volatility of the seasonally-adjusted weekly claims numbers is due to the Labor Department's efforts to seasonally adjust these numbers around holiday periods (*such as Martin Luther King's Birthday and Presidents' Day*). The Labor Department has demonstrated an inability to do such adjusting successfully. When the new claims series is viewed in terms of the year-to-year change in the 17-week (four-month) moving average, however, such generally is a fair indicator of current economic activity.

Real Average Weekly Earnings -- Reflecting primarily the benefit of a continued decline in gasoline prices, December's seasonally-adjusted monthly real earnings increased by 0.6% for the month, following a revised 2.6% (was 2.3%) monthly increase in November. Annual change in December rose to 2.9%, versus 2.3% (previously 2.2%) in November.

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

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

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

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

Real Retail Sales. With several months of falling gasoline prices having exacerbated recently reported monthly and annual retail sales declines, an upturn in January 2009 gasoline prices helped

with the monthly January gain. As will be detailed following January CPI-U reporting next Friday (February 20th), the monthly change in real (inflation-adjusted) retail sales should hold in positive territory, but the severe annual contraction in real retail sales should have held near December's severe decline and cycle low.

Real December retail sales -- as revised with the January reporting -- fell by 2.32 (previously 1.94%) on a monthly basis, following a revised 0.69% (previously 0.45%) decline in November, deflated using the CPI-U. Year-to-year real retail sales fell by a revised 10.39% (previously 9.09%) in December, versus a 9.35% (previously 9.11%) contraction in November, the steepest annual decline since 1952.

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

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

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

Next Release (March 12): February retail sales should continue showing a pattern of deepening

annual contraction, though there may be some continued month-to-month bottom-bouncing.

Industrial Production -- As discussed and graphed in the Opening Comments and detailed in the January 16th *Flash Update*, the Federal Reserve reported that seasonally-adjusted December industrial production fell by 2.0% (down 2.4% net of revisions) for the month, after a revised 1.3% (previously 0.6%) decline in November. The year-to-year decline in December fell to a contraction of 7.8%, the weakest showing since September 1975. Such followed November's revised 5.9% (previously 5.5%) drop. Consistent with the still-deepening recession, fourth-quarter 2008 production showed an annualized quarterly contraction of 11.5%, following an 8.9% contraction in the third quarter.

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

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

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

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

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

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

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

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

For all of 2008, the total deficit on a balance of payments basis narrowed to \$677.1 billion, from \$700.3 billion in 2007. The reported improvement was due to a purported increase in the "services"

surplus, which is little more than a guesstimate. The "goods" deficit actually widened minimally for the year.

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

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

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

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

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

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

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

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

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

In the current environment, where inflation-adjusted growth in income is not adequate to support meaningful growth in the personal consumption component of GDP, GDP growth only can come from temporary debt expansion or savings liquidation. Accordingly, stagnating growth and monthly contractions in consumer debt are an ongoing drag on economic activity.

Annual contraction in commercial paper outstanding has varied, with the Fed's proactive involvement in the market. Commercial paper

outstanding showed a 16.3% year-to-year contraction in January, follow a 6.8% decline in December and a 13.1% contraction in November.

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

Producer Price Index (PPI) -- As discussed in the January 16th *Flash Update*, the regularly volatile Producer Price Index (PPI) for finished goods turned negative year-to-year in December, as it absorbed still another severe hit from the recent collapse in oil prices. As reported by the Bureau of Labor Statistics (BLS), the December PPI declined by a seasonally-adjusted 1.9% (1.9% unadjusted) versus a 2.2% (2.9% unadjusted) drop in November. December PPI year-to-year inflation contracted by 0.9% -- formal deflation -- following a 0.4% gain in November. Since 1980, the finished goods PPI has shown formal deflation (year-to-year decline) in 1986, 1994, 1997/1998 and 2001/2002, without the CPI ever following suit. Those declines and related index volatility often were tied to large swings in oil prices.

On a monthly basis, seasonally-adjusted December intermediate goods fell by 4.2% (down 4.3% November), crude goods fell by 5.3% (down 12.5% November). Year-to-year inflation declined, with December intermediate goods down 1.7% (up by 2.6% November) and December crude goods down by 25.0% (down by 19.4% November).

Next Release (February 19): With the hemorrhaging in oil prices stopped, expectations have shifted tenuously to a small monthly gain for January's PPI. Allowing for the ongoing, regularly random volatility of the monthly price variations, anything is possible. A monthly gain of more than 1.2% would be needed to narrow the year-to-year decline in the finished goods annual

inflation rate. A monthly gain of more than 2.1% would be needed to push annual change into positive territory. PPI inflation reporting over the

next six-to-nine months generally should favor upside surprises in official results.

Better-Quality Numbers

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

Economic Indicators

Purchasing Managers Survey: Manufacturing New Orders -- The January 2009 manufacturing purchasing managers survey did some bottom bouncing, with the overall index rising to 35.6 from a revised 32.9 (was 32.4). The composite measure held deep in recession territory, despite the annual benchmark revisions by the Commerce Department. The revisions were of little substance, other than showing a weaker start to 2008 than previously had been indicated. Key December components indices for new orders and production that hit their lowest levels ever, pre-January 1948, rebounded in January 2009, again, though, remaining deep in recession territory.

The Institute for Supply Management (ISM) designates a reading of 41.1 or below in its aggregate indices as signaling recession. The ISM reweighted its key in January 2008 so that the manufacturing index would better match GDP results. While the effort was well intentioned, altering the data to match the extremely overstated GDP growth rates damaged the reporting quality of the index. Fortunately, however, the more meaningful components of the index were not

affected by the efforts to match the flawed government data, although most are affected by the Commerce Department's attempts at seasonal adjustment.

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

The January new orders index rebounded to 33.2 from a revised 23.1 (was 22.7) in December. The new orders have been in actual contraction since December 2007. Distortions from the seasonal factors calculated by the Department of Commerce can be minimized by viewing the series using year-to-year change on a three-month moving average basis. On that basis, the January new orders index plunged by 43.5%, following an unrevised 45.6% decline in December.

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

Also a significant measure, the manufacturing employment component held at 29.9 in January 2009, the same reading as the unrevised initial December reporting, which was the lowest reading since November 1982.

Service Sector Composite Index. This series does not have much meaning related to overall business activity, since new order activity at law firms, dentists, hospitals or fast-food restaurants has little obvious relationship to broad economic activity. With that as background, the January 2009 purchasing managers non-manufacturing (or services) composite index rose to 42.9 from 40.1 in December.

Both the services employment and prices paid components, however, have some meaning. Covering the real estate and banking industries, among others, the January employment component eased to 34.4 from 34.5 in December. The bottom-bouncing prices-paid components for both indices are covered in the Inflation Indicators.

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

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

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

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

weakness in the series being due to the loss of newspaper business to the Internet, and despite its looming abandonment by the Conference Board, the HWA remains a solid leading indicator to the broad economy and to the monthly employment report. It continues to signal severe deepening in the recession and ongoing deterioration in labor-market conditions.

The Conference Board also reported that annual growth in its nascent on-line measure of help-wanted advertising has been in contraction since April 2008. While the online series is too limited historically to be used in formal forecasting, the deteriorating year-to-year decline of 39.1% for new help-wanted ads in January 2009 cannot be a good sign. Since help-wanted advertising is a leading indicator to the employment report, the signals were negative for both January and February payroll reporting.

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

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

Seasonally-adjusted December building permits showed a similar pattern, down 10.7% (10.9% net of revision) +/- 1.9% (95% confidence interval)

for the month, following November's revised 15.8% (was 15.6%). Permits fell by 50.6% year-to-year in December, after an annual drop of 48.2% (previously 48.1%) in November.

In home sales data, the seasonally-adjusted December new home sales fell by 14.7% (18.7% net of revisions) +/- 14% (95% confidence interval), which statistically was not much distinguishable from a monthly gain, following a revised 4.4% (was 2.9%) contraction in November. On a year-to-year basis, December new home sales dropped by 44.8%, following a 38.3% (previously 35.3%) decline in November.

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

Inflation Indicators

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

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

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

Respective monthly changes reported or estimated in the seasonally-adjusted monthly averages for December and January are an increase of 4.7% and a decline of 1.3% for M1, increases of 2.3% and 1.1% for M2, and increases of 2.3% and about 1.6% for M3.

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

Annual M3 growth in the months ahead easily could overtake the historic strong growth seen early in 2008. Prior to February 2008, the historic high of 16.4% had been in June of 1971, two months before President Nixon closed the gold window and imposed wage and price controls. While current growth is shy of 1971's high, the current environment promises much stronger broad money growth in the months ahead and heavy upside inflation pressure well into 2009.

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

back in time; the published series can be linked to earlier historical data available from the St. Louis Fed. The purpose of the SGS series was and is to provide monthly estimates of ongoing annual M3 growth. We are comfortable with those numbers and that our estimated monthly growth rates are reasonably close to what the Fed would be reporting, if it still reported M3.

Purchasing Managers Surveys: Prices Paid

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

On the manufacturing side, the January prices paid index jumped to 29.0 from a 60-year low (since June 1949) of 18.0 reported in December. On a three-month moving average basis, January's year-to-year change was a collapse of 65.7% versus a 59.4% decline in December. The manufacturing price indicator is not seasonally adjusted and, therefore, is generally the better indicator of pricing activity.

On the non-manufacturing side, the seasonally-adjusted January prices diffusion index also rebounded, rising to 42.5 from 36.1 in December. On a three-month moving-average basis, January's annual decline was 46.8%, versus a decline of 40.4% in December.

General background note: Published by the Institute for Supply Management (ISM), the prices paid components of the purchasing managers surveys are reliable leading indicators of inflationary pressure. The measures are diffusion indices, where a reading below 50.0 indicates falling prices.

Oil Prices -- Oil prices in January actually rose versus December, based on monthly average price level. Where the recent collapse in oil prices was the primary factor behind the slowdown in reported annual CPI inflation the last several months, the bottoming out in oil prices also should

be accompanied by some bottoming out in the annual CPI inflation rate. Risks to the downside for the U.S. dollar, combined with supply and geopolitical risks, even offer some upside risk to oil prices, and to related short-term inflation swings.

With continued extreme volatility, the West Texas Intermediate (WTI) spot price closed at \$37.51 per barrel on February 13th. WTI spot has risen by 21.7% from its recent low close of \$30.81 on December 22nd. The latest spot price, however, still is down by 74.2% since the record-high closing price of \$145.66 on July 11, 2008.

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

Higher oil prices already are being reflected in an upturn in retail gasoline prices. Beyond immediate fuel costs, oil-related costs impact industries ranging from the transportation of goods and services, to material costs in the plastics, pharmaceutical, fertilizer, chemical industries, etc. These broad inflationary pressures will remain intact for a while, despite any near-term oil price gyrations. This is due both to the long lead time inherent in some price impact, as well to the impact of oil futures contracts. Used as traditional hedges against unusual price swings, these instruments can keep energy costs relatively high or low, depending on the timing, nature and duration of the open contracts.

Oil prices remain highly volatile and sensitive to minor surprises. While sharp declines in U.S. and global economic activity reduce oil demand, OPEC activities have been and likely will continue to be aimed at offsetting such, with production cuts. Also adding some upside pressure to prices are intensified global military

and political tensions, and other supply and demand risks/issues. Of greatest long-term impact, however, is the U.S. dollar, where oil is denominated in same. At such time as heavy

dollar selling resumes -- and that is just a matter of time -- look for oil prices to spike anew, moving back above the \$90 per barrel level, rekindling oil-price related inflation concerns.

Reporting/Market Focus

January 2009 Benchmark Revision to Nonfarm Payrolls

Great Depression Indicators (1930s)

This Reporting/Market Focus is split into two sections. The first shows some detail of the annual benchmark revision to nonfarm payrolls. The second relates to the Great Depression, a popular topic in the current economic debate. Several measures of the downturn are plotted, so as to help establish a little bit of perspective on that troubled time.

Payroll Benchmark:

Historically Weaker Economic Activity

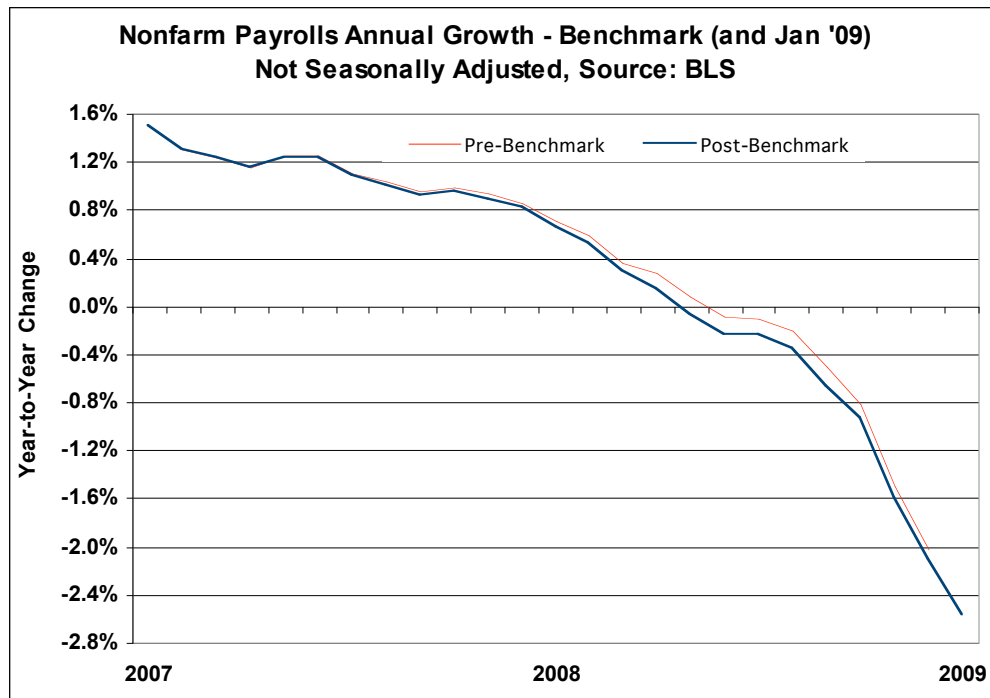
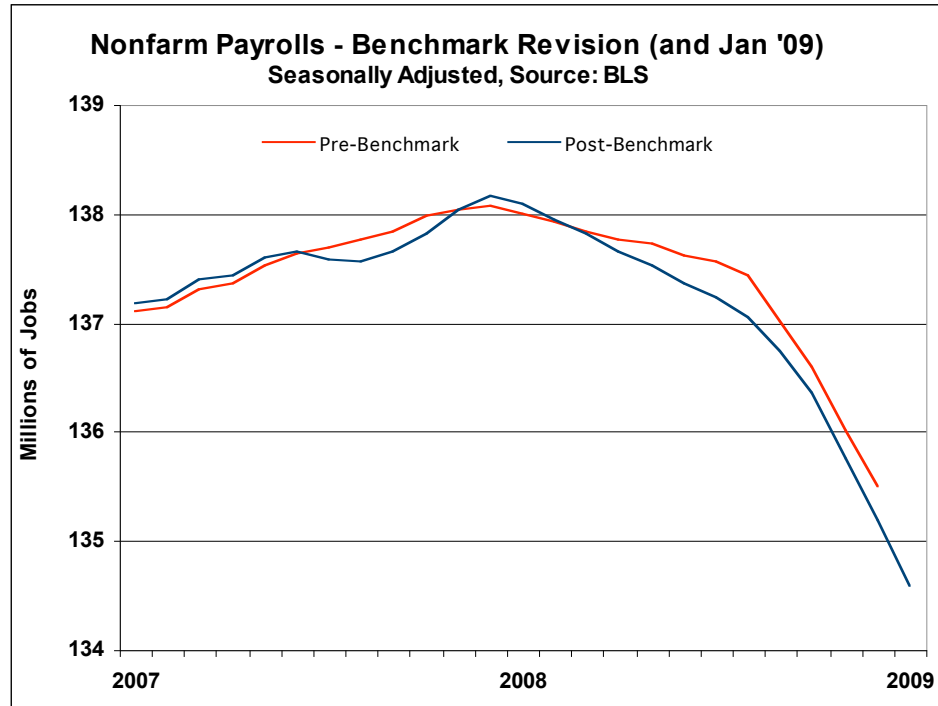
With the release of January payroll report, the Bureau of Labor Statistics (BLS) publishes its annual benchmark revision, where payroll employment estimates are compared with state employment tax filings as of the prior March (in the current instance, March 2008).

In general, the benchmark revision was worse than had been advertised, with unadjusted payrolls for the benchmark month of March 2008 being revised lower by 89,000, instead of the initial estimate of a 21,000 downward adjustment.

As noted in the *Flash Update* of February 6th, on a seasonally-adjusted basis, the benchmarking translated into a downward adjustment in payroll levels in excess of 200,000 for each month from May 2008 on. The effect was to suggest weaker growth patterns in place before the 2008 election.

The annualized quarter-to-quarter contraction in seasonally-adjusted payrolls deepened to 1.3% in the second quarter of 2008, versus the earlier estimate of 0.6%; the annualized quarter-to-quarter contraction deepened to 1.5% in the third quarter, versus the earlier estimate of 1.1%; but the annualized quarter-to-quarter contraction narrowed to 3.6% in the fourth quarter, versus the earlier estimate of 3.7%.

The graphs on the following page plot the old and revised series (including January 2009) for payroll levels (seasonally adjusted) as well as for annual change (not seasonally adjusted). In both instances the current economic downturn now stands a little deeper than it had in previous reporting.



Great Depression:

Money Supply and Consumer Prices Rebounded Following Abandonment of Domestic Gold Standard

The following four graphs show activity surrounding the Great Depression, as it related to broad money growth, consumer inflation, GDP and industrial production. The money supply estimates are from Milton Friedman and Anna Jacobson Schwartz's "A Monetary History of the United States, 1867-1960." The measure there is as broad as it existed, and it eventually ties into early estimates of M2 and M3, where M3, in more recent years, was generally the broadest money supply measure followed until its abandonment by the Fed in March 2006 (see the *SGS Money Supply Special Report* of August 8, 2008).

The following background is as published in the Reporting/Market Focus of *SGS Newsletter No. 47*, where various U.S. economic contractions were detailed by sitting the President at the time of onset:

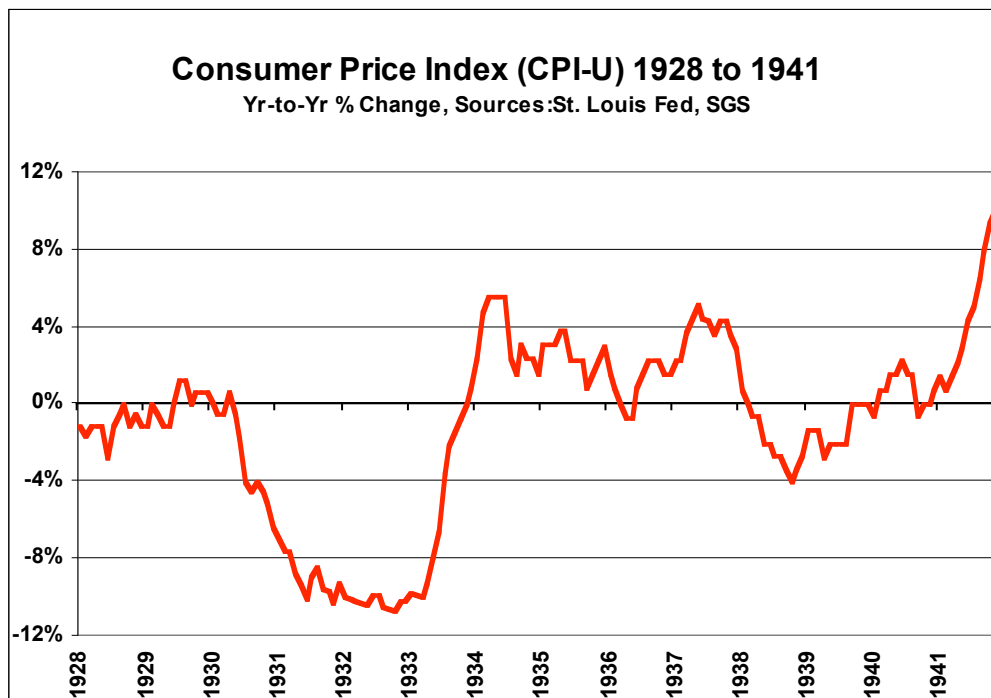
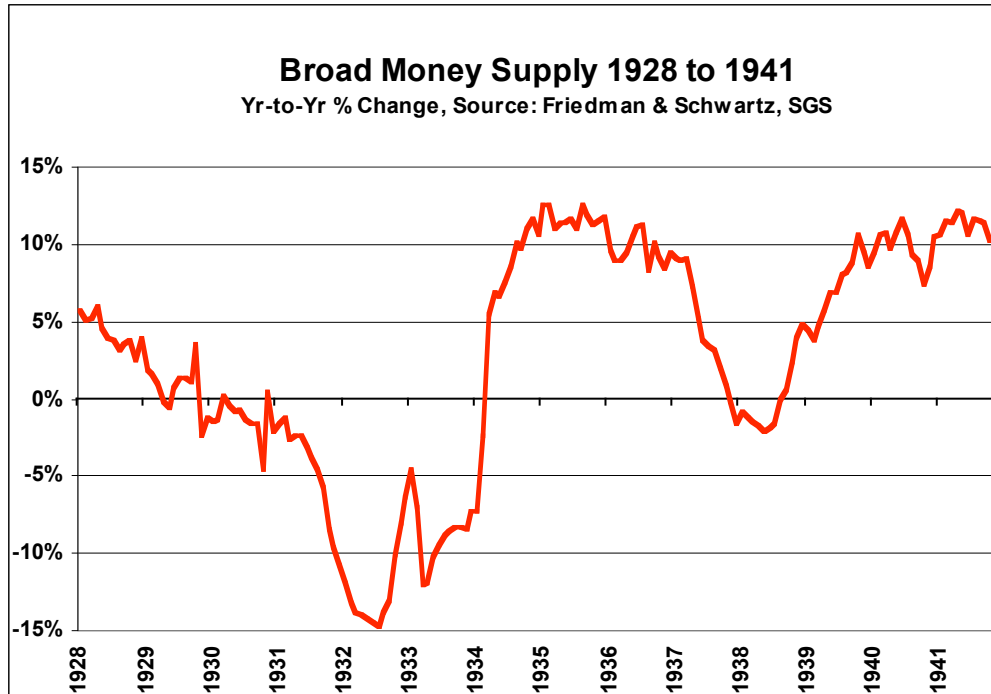
Hoover; Timing/Duration: Aug 1929 to Mar 1933, 43 months; Peak-to-Trough Contraction: 33%; Nature: Structural/Liquidity. Background: The Great Depression. Collapse of debt excesses from 1920s and liquidity crisis, extreme income variance, overbuilding, stock crash, banking collapse, industrial restructuring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

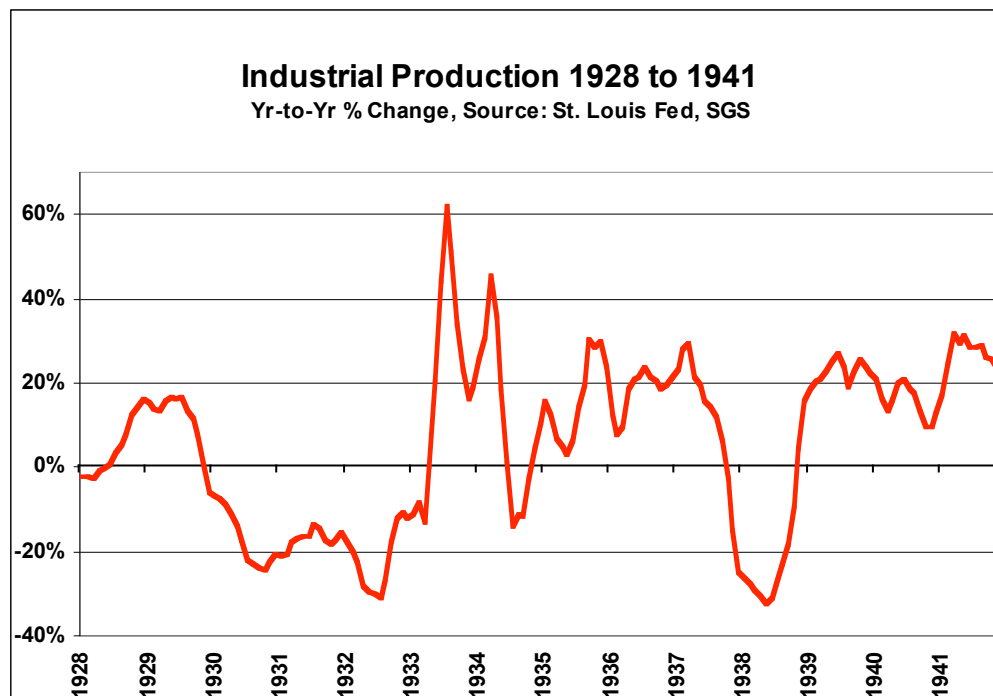
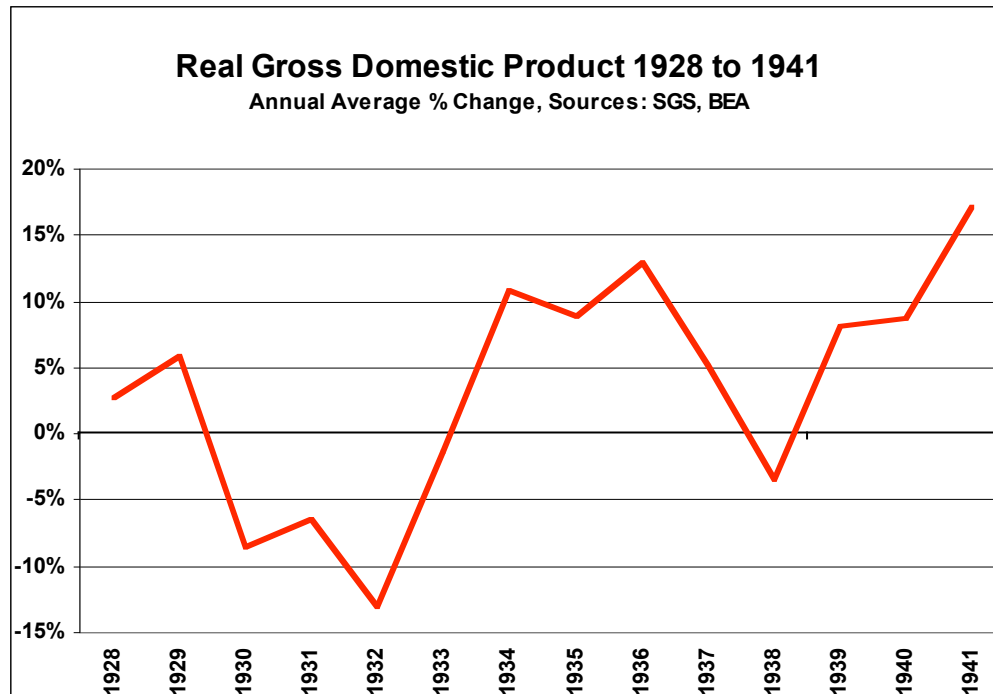
F Roosevelt-I; Timing/Duration: May 1937 to Jun 1938, 13 months; Peak-to-Trough Contraction: 18%; Nature: Structural. Background: Second-dip of Great Depression.

As shown in the GDP and industrial production graphs, the Great Depression was a double-dip downturn, encompassing the more severe 1929 to 1933 contraction and the 1937 to 1938 downturn. It was the war in Europe and surging defense orders from Britain that eventually ended the depression.

Of particular interest in the current monetary debate is what happened with the money supply. As the banks collapsed into 1933 and deposits were lost, the money supply collapsed along with sharp deflation in consumer prices. It was the fear of a similar banking collapse and loss of deposits (despite limited deposit insurance) that Mr. Bernanke was trying to avoid as the current crisis broke. The depository end of the current system appears to be stable, at the moment.

One reason Roosevelt abandoned the gold standard in 1933 was that it imposed discipline on the money supply. Once gold was abandoned, the government moved to the "debt standard" and spent a great deal of money; the money supply expanded and consumer prices rose anew.





PLEASE NOTE: The next SGS Newsletter currently is targeted for early March, likely post-February payroll reporting. 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.