

John Williams'
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Analysis Behind and Beyond Government Economic Reporting

COMMENTARY NUMBER 329
Inflation, Retail Sales, Trade Deficit and Debased Money

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Dollar Debasement Fears Mount

September Consumer Inflation: 1.1% (CPI-U), 8.5% (SGS)

**Retail Sales Gain Reflected Seasonal Distortions from Year-Ago Clunkers
More Than It Did a Happier Consumer**

August Trade Deficit Took 0.5% from Third-Quarter GDP

PLEASE NOTE: The next regular Commentary is scheduled for Tuesday, October 19th, following the release of the September Housing Starts and including analysis of September Industrial Production.

-- Best wishes to all, John Williams

And So It Begins. In an apparent effort to prop up the stock market, the Fed is sending out all sorts of signals that it is about to launch a round of "quantitative easing" -- a euphemism for Fed monetization of U.S. Treasury debt -- in an effort to expand money supply and to increase U.S. inflation. In short, the Fed openly is moving to debase the U.S. dollar.

While the Fed will find that it can debase the U.S. dollar much further, spiking inflation, its efforts to stimulate economic activity will continue to fall flat due to structural issues limiting consumer activity.

The more-sober markets have taken note of the promised inflation, with yields on the 30-Year Treasury Bonds rising in tandem with intensified selling of the U.S. dollar and buying of gold and silver.

Yet, raised on the false precepts that neither the dollar nor the budget deficit matters, Wall Street hypesters are touting the Fed's pending largesse to equity investors. Such efforts are consistent, perhaps, with former Federal Reserve Chairman Alan Greenspan's recent suggestion that the "most effective" economic stimulus would be a rallying stock market (see *USA Today*, September 27, 2010).

While a fundamentally strong stock market would be good news, a healthy market usually is based on solid underlying business. Unfortunately, except for the Fed's funny money, the underlying fundamentals for the economy and stocks just could not be much worse, as discussed in [*Special Commentary No. 383*](#).

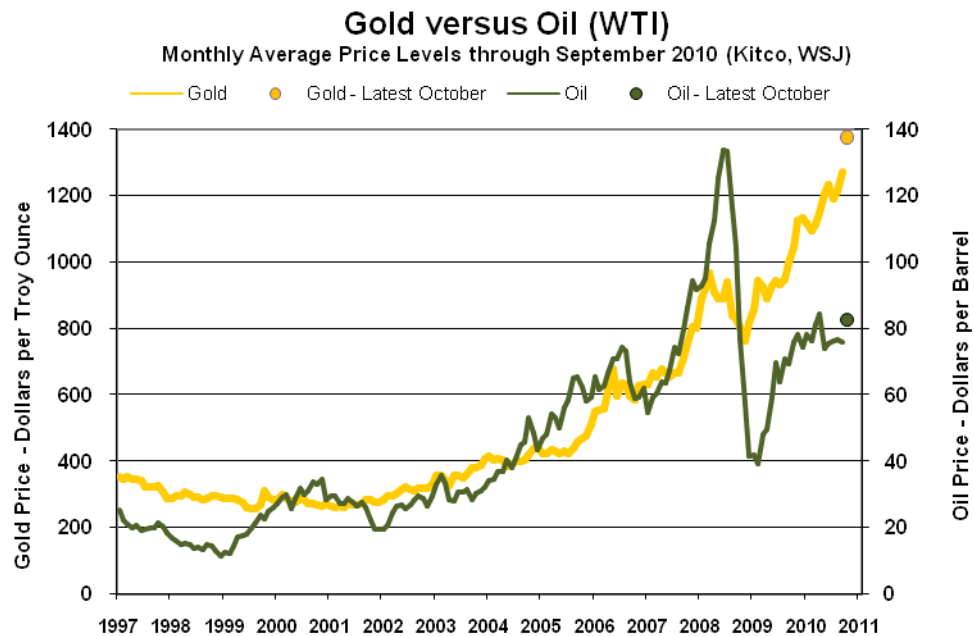
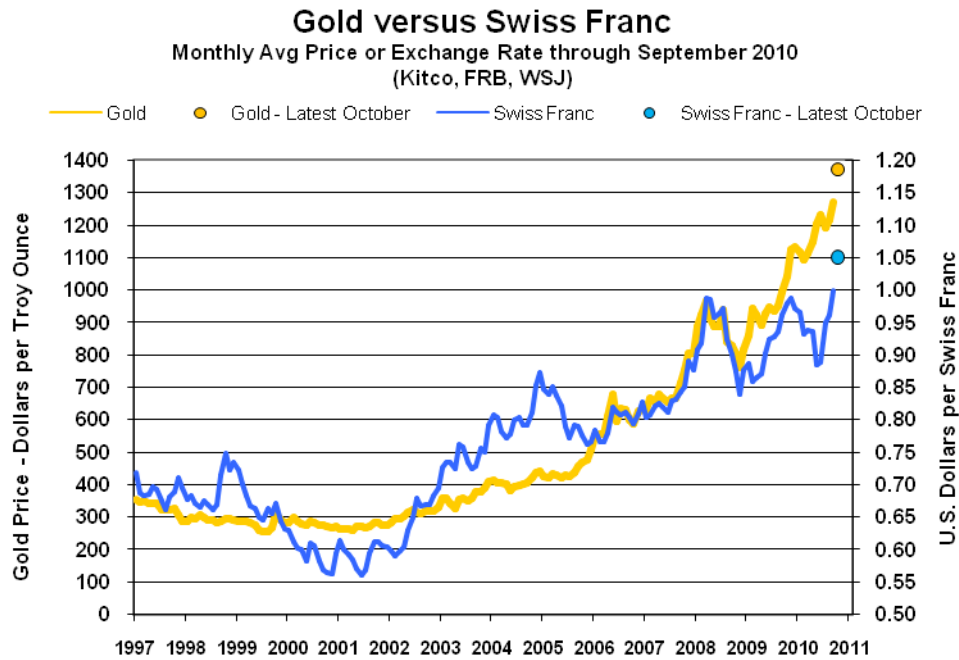
Euphoric Inflation Insanity. Buying U.S. stocks because the Fed says it will proactively debase the U.S. dollar is like sitting on the beach in order to get a great view of an incoming tsunami. Any pleasure so derived should be short-lived, when the terror of underlying reality quickly takes hold.

If one were to view movement in the price of gold as a surrogate for anticipated inflation, for example, the issues begin to come into focus. Consider that last night's (October 14th) respective S&P 500, Dow Jones Industrial Average and NASDAQ Composite closing levels were up by 7.5%, 10.8%, 12.1% from a year ago, but the price of gold was up by 29.6% in the same period. Relative to gold, which tends to hold its purchasing power over time -- albeit sometimes in an anticipatory manner -- the S&P 500, Dow Jones Industrial Average and NASDAQ Composite have declined respectively by 22.1%, 18.8% and 17.5% year-to-year. This is against the prospective inflation environment being discounted by the gold market.

While stock prices do tend to rise in an inflationary environment -- where revenues and profits are inflated -- rising stock prices do not always stay ahead of inflation. On a constant-dollar or real, inflation-adjusted basis, stocks go through bull and bear markets, just as they do otherwise. If prices do not stay ahead of inflation, investors lose value in terms of the purchasing power of their assets. The equity markets may rally in the upcoming inflation, but the systemic implications and current gold behavior suggest that the circumstance will not give investors a positive real return, as discussed in the [*Hyperinflation Special Report*](#).

Given the current systemic distortions and extreme irrationality in the equity markets, a severe and violent sell-off in stocks would not be a shock, and it could come with minimal, if any, warning. It also might be coincident with a U.S. dollar-selling panic.

There is particular risk of recent dollar selling -- which has been closing in on historic lows -- turning into an outright dollar-dumping panic, which not only would roil the domestic U.S. markets, but also would set the stage for a rapid acceleration of domestic consumer inflation. Irrespective of any near-term market volatility, gold and silver, as well as the stronger currencies, remain the best long-term liquid hedges against loss in purchasing power of the U.S. dollar.





Dollar Debasement Fears Spike Gold and Trigger Some Early Escape for the U.S. Dollar. As shown in the preceding graphs, all the Fed's rumblings about quantitative easing have had some impact in the area of U.S. dollar debasement against precious metals and most major currencies, while dollar-denominated commodity-based inflation -- driven by U.S. dollar weakness -- should begin showing up in higher U.S. consumer prices in the next several months. Such will reflect just monetarily-driven higher prices, not inflation driven higher by strong economic demand.

Although Mr. Bernanke's ongoing comments may be just be his jawboning phase, the Fed's actions will forced in the same direction soon enough, as discussed in [Special Commentary No. 383](#) and in the [Hyperinflation Special Report](#).

Third-Quarter GDP Reporting is Looking Flatter. As discussed below, real quarterly growth in third-quarter retail sales came in slightly to the plus-side in today's reporting, but the trade deficit was much worse than expected. Net of temporary census workers and pending benchmark revision, last week's payroll reporting left the quarterly employment levels about unchanged. Next week's housing starts and industrial production are the last major reports before the October 29th "advance" estimate of third-quarter GDP.

Where I have been giving fair odds to reporting of an outright quarterly contraction for the upcoming real GDP growth, such is now closer to "unchanged," given the retail sales report and the likelihood that the payroll benchmark revision will not be considered in the Bureau of Economic Analysis's (BEA) considerations at this time. I shall update the outlook after next week's reporting.

Where the BEA targets its "advance" estimate at the consensus guess, I would expect the current positive consensus to move more towards flat, as the later data come in. Where the GDP "advance" estimate will

be published in the week before the election, other than for market impact and political hype, it has minimal, if any, value. It rarely is a meaningful indicator of recent economic activity.

In general, the broad outlook for economic, systemic and financial-market stability is unchanged, again, as last reviewed in [Special Commentary No. 383](#).

Notes on Different Measures of the Consumer Price Index

The Consumer Price Index (CPI) is the broadest inflation measure published by U.S. Government, through the Bureau of Labor Statistics (BLS), Department of Labor:

*The **CPI-U (Consumer Price Index for All Urban Consumers)** is the monthly headline inflation number (seasonally adjusted) and is the broadest in its coverage, representing the buying patterns of all urban consumers. Its standard measure is not seasonally adjusted, and it never is revised on that basis except for outright errors.*

*The **CPI-W (CPI for Urban Wage Earners and Clerical Workers)** covers the more-narrow universe of urban wage earners and clerical workers and is used in determining cost of living adjustments in government programs such as Social Security. Otherwise its background is the same as the CPI-U.*

*The **C-CPI-U (Chain-Weighted CPI-U)** is an experimental measure, where the weighting of components is fully substitution based. It generally shows lower annual inflation rate than the CPI-U and CPI-W. The latter two measures once had fixed weightings -- so as to measure the cost of living of maintaining a constant standard of living -- but now are quasi-substitution-based.*

*The **SGS Alternative CPI-U Measures** are attempts at adjusting reported CPI-U inflation for the impact of methodological change of recent decades designed to move the concept of the CPI away from being a measure of the cost of living needed to maintain a constant standard of living.*

Softer-Than-Expected September CPI And No COLA Increase for Social Security. Although annual inflation in the CPI-W averaged 1.5% in the third-quarter -- the quarter's inflation is used in the annual cost-of-living-adjustment for Social Security payments -- there will be no adjustment this year, shy of an act of Congress, which apparently is being advertised before the election as up for consideration after the election. The problem remains that last year's CPI-W was lower in third-quarter 2009 than it was in third-quarter 2008. Although the inflation was negative, the COLA was unchanged -- not reduced -- and the COLA will not kick in again until the base period once more exceeds third-quarter 2008. That did not happen in 2010. In order for the COLA to increase Social Security payments next year, the CPI-W annual inflation for third-quarter 2011 would have to top 0.6%

CPI-U. The Bureau of Labor Statistics (BLS) reported this morning (October 15th) that the seasonally-adjusted September CPI-U rose for the month by 0.10% (up by a statistically-insignificant 0.06%,

unadjusted) +/- 0.12% (95% confidence interval, not seasonally adjusted), about 0.1 percentage point less-than-expected by consensus forecasters. Such followed a 0.25% gain (up 0.14% unadjusted) in August. Seasonally-adjusted, the annualized rate of inflation for third-quarter 2010 CPI-U was 1.47%, against the second-quarter's annualized contraction of 0.72%. With the annualized rates heavily influenced by seasonal-adjustment patterns, consumers experienced "deflation" in the second-quarter only if they lived seasonally-adjusted lives; otherwise, the experience was one of inflation, not deflation.

Unadjusted, September's year-to-year inflation was 1.14% +/- 0.20% (95% confidence interval) against a 1.15% annual increase in August.

Year-to-year inflation would increase or decrease in next month's October 2010 reporting, dependent on the seasonally-adjusted monthly change, versus the 0.21% adjusted monthly gain seen in October 2009. I use the adjusted change here, since that is how consensus expectations are expressed. To approximate the annual inflation rate for October 2010, the difference in October's headline monthly change (or forecast of same) versus the year-ago monthly change should be added to or subtracted directly from September 2010's reported annual inflation rate of 1.14%.

CPI-W. The narrower, seasonally-adjusted September CPI-W rose by 0.15% (up 0.05% unadjusted) for the month, following a gain of 0.35% (0.14% unadjusted) in August. Seasonally-adjusted, the annualized rate of CPI-W inflation for third-quarter 2010 was 1.76%, against the second-quarter's annualized contraction of 1.37%. Again, these numbers were distorted heavily by seasonal-adjustment patterns.

Unadjusted year-to-year CPI-W inflation rose by 1.41% in September, versus a 1.44% August increase.

C-CPI-U. The Chain-Weighted CPI-U -- the fully substitution-based series that gets touted by CPI opponents and inflation apologists as the replacement for the CPI-U -- is reported only on an unadjusted basis. C-CPI-U year-to-year inflation picked up to 0.94% in September 2010, versus a 0.90% gain in August.

Alternate Consumer Inflation Measures. Adjusted to pre-Clinton (1990) methodology, annual CPI inflation was roughly 4.4% in September 2010, down a notch from 4.5% in August, while the SGS-Alternate Consumer Inflation Measure, which reverses gimmicked changes to official CPI reporting methodologies back to 1980, was about 8.5% (8.48% for those using the extra digit) in September, versus 8.5% in August.

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

Gold and Silver Highs Adjusted for CPI-U/SGS Inflation. Despite yesterday's (October 14th) historic high gold price of \$1,373.25 per troy ounce (London afternoon fix) and multi-decade high silver price of

\$24.49 per troy ounce (London fix), gold and silver prices have yet to approach their historic high levels, adjusted for inflation. The earlier all-time high of \$850.00 (London afternoon fix, per Kitco.com) of January 21, 1980 would be \$2,387 per troy ounce, based on September 2010 CPI-U-adjusted dollars, and would be \$7,785 per troy ounce in terms of SGS-Alternate-CPI-adjusted dollars (all series not seasonally adjusted).

In like manner, the all-time high price for silver in January 1980 of \$49.45 per troy ounce (London afternoon fix, per silverinstitute.org) has not been hit since, including in terms of inflation-adjusted dollars. Based on September 2010 CPI-U inflation, the 1980 silver price peak would be \$139 per troy ounce and would be \$453 per troy ounce in terms of SGS-Alternate-CPI-adjusted dollars (again, all series not seasonally adjusted).

As shown on page 22 in the [Hyperinflation](#) report, over the decades, the price of gold has compensated for more than the loss of the purchasing power of the U.S. dollar as reflected by CPI-U inflation, while it has effectively fully compensated for the loss of purchasing power of the U.S. dollar based on the SGS-Alternate CPI.

Real Money Supply M3. The signal of the still unfolding double-dip recession, based on annual contraction in the real (inflation-adjusted) broad money supply (M3), most recently was discussed and graphed in [Commentary No. 328](#). The real contraction in September M3 (SGS-Ongoing) estimated for that *Commentary* was 5.1%. Based on today's CPI-U report and the latest estimate on the September SGS-Ongoing M3 Estimate, that annual contraction was 4.9%, narrower than August's 5.3% contraction, and May's post-World War II record annual decline of 7.9%.

The signal for a downturn or an intensified downturn is generated when annual growth in real M3 first turns negative in a given cycle; the signal is not dependent on the depth of the downturn or its duration. The current downturn signal was generated in December 2009. The broad economy tends to follow in downturn or intensification roughly six to nine months after the signal, as has appeared to happen in recent months, with what formally should become recognized as a double-dip recession.

September PPI Topped Consensus Expectations. Seasonally-adjusted inflation at the wholesale and production level rose month-to-month in September at twice the 0.2% expected monthly gain, with a broad pattern of stronger annual inflation. As reported yesterday (October 14th) by the Bureau of Labor Statistics (BLS), the regularly-volatile, seasonally-adjusted finished-goods producer price index (PPI) in September rose by 0.4% (up by 0.3% before seasonal adjustment) month-to-month, following August's gain of 0.4% (down by 0.1% unadjusted). Unadjusted and year-to-year, August's annual PPI inflation was 4.0%, on the upswing versus the annual inflation rate of 3.1% reported for August.

On a monthly basis, seasonally-adjusted September intermediate goods rose by 0.5% (up by 0.3% in August), with September crude goods declining by 0.5% (up by 2.3% in August). Year-to-year inflation in September intermediate goods was up by 5.6% (a 5.0% gain August), with September annual inflation in crude goods up by 20.3% (up by 18.3% in August).

Including Seasonal Adjustment Distortions, Reported Retail Sales Gain and Revisions Boosted Third-Quarter. As published on a seasonally-adjusted basis, before inflation adjustment, the reported 0.6% monthly retail sales gain in September was statistically indistinguishable from no growth. Yet, that gain and an upside revision to August's reporting were enough to push the relative quarter-to-quarter

change in real (inflation adjusted) sales from what had been shaping up as a quarter-to-quarter contraction, to a small gain, albeit much weaker than the quarterly growth reflected in the second-quarter's current reporting of real retail sales.

At work in the September reporting likely were severe seasonal factor distortions based on the unusual trading patterns of 2009, particularly including impact from last year's "cash for clunkers" program. Net of seasonal-factor adjustments, September 2010 retail sales declined by 4.7% for the month.

Nominal Retail Sales. Today's (October 15th) September 2010 retail sales report -- issued by the Census Bureau -- indicated a statistically-insignificant, seasonally-adjusted monthly gain of 0.62% (up 1.09% net of revisions) +/- 0.6% (95% confidence interval), versus a revised 0.71% (initially 0.42%) increase in August.

On a year-to-year basis, September 2010 retail sales were reported up by 7.34% from September 2009, versus a revised annual August gain of 4.07% (previously 3.64%). Annual changes, again, have been gyrating monthly due to year-ago comparisons ranging from a severe trough in activity to last year's cash-for-clunkers stimulus effects, while at the same time the Census Bureau has continued to play games with the monthly seasonal factors and revisions to year-ago data.

Real Retail Sales. Based on the September 2010 CPI-U reporting, inflation- and seasonally-adjusted monthly September retail sales increased by 0.52%, where before inflation adjustment the current number was up by 0.62%, versus a revised real monthly gain of 0.45% (was 0.16%) in August.

September real retail sales rose at a year-to-year pace of 5.97%, versus the upwardly revised 2.95% (previously 2.47%) annual gain reported for August.

On a quarter-to-quarter basis, real retail sales in second-quarter 2010 expanded at a 5.3% annualized pace, down from annualized growth of 6.6% in the first-quarter. Adjusted for inflation, seasonally-adjusted monthly retail sales in the third-quarter grew at an annualized pace of 0.9% (up a straight 0.23% quarter-to-quarter not annualized). The third-quarter's quarterly pace just as easily could have been a contraction, allowing for confidence intervals and seasonal-factor issues.

Since November 2008, monthly real retail sales (CPI-U deflated) have been fluctuating around an average of \$162.9 billion (the deflated September number was \$168.4 billion). The first graph below reflects the relatively volatile monthly levels of real retail sales, as reported.

Smoothed for the monthly volatility on a six-month moving-average basis, as shown in the second graph, the pattern of activity here has been one of bottom-bouncing in terms of the level of inflation-adjusted sales. The recent bounce from short-lived stimulus factors and warped-seasonals appears largely to have run its course, with the average close to rolling over, and with lower real sales levels still likely in the months ahead. There has been no change in underlying fundamentals that would support a sustainable turnaround in personal consumption or in general economic activity -- no recovery -- just general bottom-bouncing.

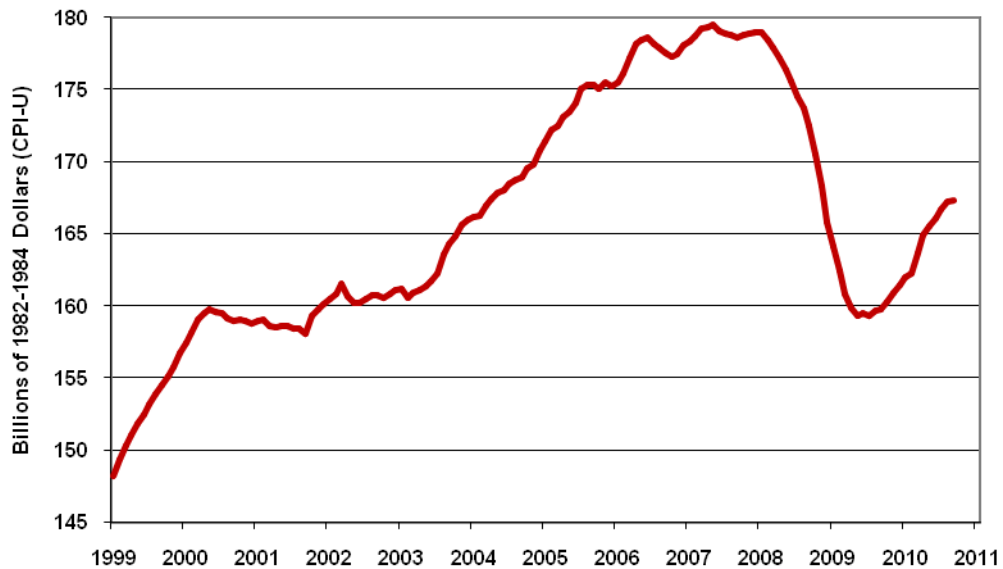
Inflation-Adjusted Retail Sales (Monthly Level)

Through September 2010, Seasonally-Adjusted (SGS, Census, BLS)



Inflation-Adjusted Retail Sales (6-Mo Moving Avg)

Through September 2010, Seasonally-Adjusted (SGS, Census, BLS)



Core Retail Sales. Assuming that the bulk of non-seasonal variability in food and gasoline sales is in pricing, instead of demand, "core" retail sales -- consistent with the Federal Reserve's predilection for

ignoring food and energy prices when "core" inflation is lower than full inflation -- are estimated using two approaches:

Version I: September versus August 2010 seasonally-adjusted retail sales -- net of total grocery store and gasoline station revenues -- gained by 0.7% versus the official aggregate gain of 0.6%.

Version II: September versus August 2010 seasonally-adjusted retail sales -- net of the monthly change in revenues for grocery stores and gas stations -- increased by 0.5% versus the aggregate gain of 0.6%.

August Trade Deficit Had Negative Implications for Third-Quarter GDP Growth. Widening well beyond consensus expectations, the August trade deficit -- the last reporting before the "advance" estimate of third-quarter GDP on October 29th -- was bad enough to reduce the upcoming estimate by roughly 0.5% annualized real (inflation-adjusted) growth from what it would have been otherwise (see below).

Nominal (Not Adjusted for Inflation) Trade Deficit. For August 2010, the Bureau of Economic Analysis (BEA) and the Census Bureau reported yesterday (October 14th) that the nominal seasonally-adjusted monthly trade deficit in goods and services widened to \$46.3 billion, versus a revised \$42.6 (previously \$42.8) billion in July, and widened sharply from the \$31.1 billion monthly deficit of August 2009.

Against July 2010, the August trade balance showed a small gain in exports but a larger gain in imports. The higher imports were not heavily influenced by oil. Unadjusted oil imports reflected lower physical volume but higher oil prices. Specifically, for the month of August 2010, the not-seasonally-adjusted average price of imported oil was \$73.47 per barrel, versus \$72.09 in July 2010 and \$64.78 in August 2009. In terms of not-seasonally-adjusted physical oil imports, August 2010 volume averaged 9.900 million barrels per day, versus 10.056 million in July 2010 and 8.673 million in August 2009.

Real (Inflation-Adjusted) Trade Deficit. A widening trade deficit directly reduces GDP growth and vice versa. As reported by the BEA, adjusted for seasonal factors and inflation (2005 chain-weighted dollars as used in reporting real GDP), the second-quarter goods deficit was an annualized of \$575.1 billion. Based on July and August reporting, the annualized third-quarter deficit is running at a pace of \$590.9 billion, a quarterly deterioration of about \$15 billion, or roughly 0.5% in annualized real GDP growth.

Week Ahead. Given the unfolding reality of an intensifying double-dip recession and more-serious inflation problems than generally are expected by the financial markets, risks to reporting will tend towards higher-than-expected inflation and weaker-than-expected economic reporting in the months ahead. Increasingly, previously unreported economic weakness is showing up in prior-period revisions.

Industrial Production (September 2010). Due for release on Monday, October 18th, September industrial production is expected to increase 0.3% for the month, per Briefing.com, following a 0.2% gain in August. Seasonal factor catch-up and weaker economic activity than viewed by consensus forecasters suggest some downside reporting risks against market expectations.

Residential Construction (September 2010). Due for release on Tuesday, October 19th, September Housing Starts generally should show further deterioration, although any monthly decline still may lack statistical significance.