

John Williams'
Shadow Government Statistics
Analysis Behind and Beyond Government Economic Reporting

COMMENTARY NUMBER 331

Third-Quarter GDP, Quantitative-Easing Games, Homes Sales, New Orders

October 29, 2010

Third-Quarter GDP Growth Statistically Indistinguishable from Zero

Official Economic Activity Is Virtually Flat Other Than for Inventory Building

**Fed Will Be Forced to Monetize Treasury Debt
Irrespective of Current Jawboning, Games Playing and Hand Wringing**

October Employment Data Likely Will Disappoint Market Expectations

PLEASE NOTE: The next regular Commentary is scheduled for Friday, November 5th, following the release of the October's payroll employment and unemployment data. Intervening Commentaries will be published as needed to address unusual market or other circumstances.

-- Best wishes to all, John Williams

Systemic Conditions Will Force Federal Reserve Monetization of Treasury Debt. As noted by then-Federal Reserve Governor Ben Bernanke in his infamous "helicopter" speech of November 21, 2002:

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

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

While the above is lifted from the [*Hyperinflation Special Report*](#) (page 22), it may be somewhat revealing as to the now-Fed Chairman's thinking. Consider the comment: *By increasing the number of U.S. dollars in circulation, or even by credibly threatening to do so....*

Much of what has been seen recently in terms of pending "quantitative easing" (monetization of Treasury debt) by the Fed has been nothing more than jawboning, posing a "credible threat." Such has had some of its desired impact on the markets, weakening the U.S. dollar and spiking the price of gold along with boosting inflationary expectations. Now, however, the markets are expecting the Fed actually to do something other than further rumination.

I am not going to guess at what the Fed is going to do next week. The games-playing and market manipulation here has gotten so clever that it just might backfire, with too little monetization possibly crashing stocks, or too much monetization boosting gold and crashing the U.S. dollar and stocks.

What is not yet widely recognized is that the Fed will have to monetize Treasury debt soon enough, regardless of any action taken or not taken next week by the U.S. central bank to rearrange the proverbial deck chairs on the Titanic. Monetization will be forced in an effort to prevent a systemic collapse, as discussed variously in the [*Hyperinflation Special Report*](#) and in [*Special Commentary No. 323*](#), as the unexpectedly weak U.S. economy spikes the federal deficit, impairs Treasury fundings and the combination of factors pushes the U.S. dollar into a likely selling panic.

The general outlook described in *No. 323* is unchanged. The economic outlook will be reviewed and updated in the *Commentary* addressing the October labor market conditions.

Notes on GDP-Related Nomenclature and Definitions

For purposes of clarity and the use of simplified language in the text of the GDP analysis, here are definitions of several key terms used related to GDP reporting:

Gross Domestic Product (GDP) is the headline number and the most widely followed broad measure of U.S. economic activity. It is published quarterly by the Bureau of Economic Analysis (BEA), with two successive monthly revisions, and with an annual revision in the following July.

Gross Domestic Income (GDI) is the theoretical equivalent to the GDP, but it generally is not followed by the popular press. Where GDP reflects the consumption side of the economy and GDI reflects the offsetting income

side. When the series estimates do not equal each other, which almost always is the case, since the series are surveyed separately, the difference is added to or subtracted from the GDI as a "statistical discrepancy." Although the BEA touts the GDP as the more accurate measure, the GDI is relatively free of the monthly political targeting the GDP goes through.

Gross National Product (GNP) is the broadest measure of the U.S. economy published by the BEA. Once the headline number, now it rarely is followed by the popular media. GDP is the GNP net of trade in factor income (interest and dividend payments). GNP growth usually is weaker than GDP growth for net-debtor nations. Games played with money flows between the United States and the rest of the world tend to mute that impact on the reporting of U.S. GDP growth.

Real (or Constant Dollars) means the data have been adjusted, or deflated, to reflect the effects of inflation.

Nominal (or Current Dollars) means growth or level has not been adjusted for inflation. This is the way a business normally records revenues or an individual views day-to-day income and expenses.

GDP Implicit Price Deflator (IPD) is the inflation measure used to convert GDP data from nominal to real. The adjusted numbers are based on "Chained 2005 Dollars," at present, where the 2005 is the base year for inflation, and "chained" refers to the methodology which gimmicks the reported numbers so much that the total of the deflated GDP sub-series misses the total of the deflated total GDP series by nearly \$40 billion in "residual" as of second-quarter 2010.

Quarterly growth, unless otherwise stated, is in terms of seasonally-adjusted, annualized quarter-to-quarter growth, i.e., the growth rate of one quarter over the prior quarter, raised to the fourth power, a compounded annual rate of growth. While some might annualize a quarterly growth rate by multiplying it by four, the BEA uses the compounding method, raising the quarterly growth rate to the fourth power. So a one percent quarterly growth rate annualizes to $1.01 \times 1.01 \times 1.01 \times 1.01 = 1.0406$ or 4.1%, instead of $4 \times 1\% = 4\%$.

Annual growth refers to the year-to-year change of the referenced period versus the same period the year before.

Third-Quarter GDP Growth Matched Late-Consensus Outlook. The consensus forecast for annualized real growth in third-quarter GDP softened from 2.4% last week, to 2.0% this week, per Briefing.com. Missing significant data for its initial estimation and placing unwarranted faith in consensus estimates, the Bureau of Economic Analysis (BEA) tends to target its "advance" reporting of GDP at the consensus estimate, which it hit in today's (October 29th) reporting. Accordingly, the pre-election report showed the GDP growing at a faster (albeit minimally faster) pace than in the quarter before, with a number that in theory should not rock the financial markets.

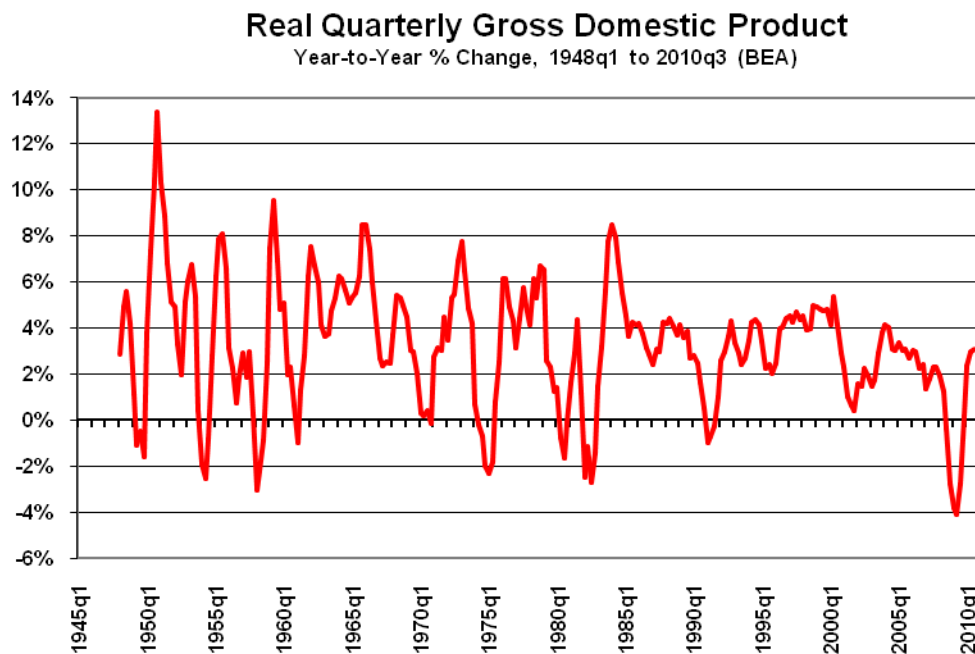
Inventory Building Accounted for 72% of Third Quarter Growth, 63% of 2010 Year-to-Date GDP Gains. Despite underlying reporting that showed slowing consumption, contracting orders and slowing production in the third-quarter, reported inventory build-up continued to surge, generating the bulk of the estimated broad economic growth in the third-quarter. Of the 2.01% "advance" estimate of third-quarter growth, 1.44% was due to inventory building, leaving final sales (GDP net of inventories) at an annualized 0.57% growth rate. If the quarterly GDP growth were viewed in terms of just quarter-to-quarter change -- the way the rest of the world tends to report GDP -- that non-annualized quarterly

growth rate in final sales would round to 0.1%, which is minimal growth, virtually flat, by most any standards.

For the year-to-date, of the 2.48% annualized growth estimated for the first three quarters of 2010, 63% of the reported growth was in inventories, leaving annualized final sales year-to-date 2010 at an annualized growth rate of 0.92%. With continued weak consumption, the official GDP reporting at some point should begin to reflect liquidation of unwanted inventories -- perhaps in the current fourth-quarter -- with a resumption of the reporting of regular quarterly contractions in broad economic activity.

GDP -- The Detail. The "advance" estimate of third-quarter 2010 Gross Domestic Product (GDP) showed a statistically-insignificant annualized real growth rate of 2.01% +/- 3% (95% confidence interval), up from an estimated 1.72% in the second-quarter. The year-to-year change in real third-quarter GDP notched higher to 3.11% from 3.00% in the second quarter.

The following graph shows the annual percent change in inflation-adjusted quarterly GDP for the history of the series. The record annual contraction for the series was 4.11%, seen in second-quarter 2009.



The GDP implicit price deflator was estimated at an annualized pace of 2.17% inflation for third-quarter 2010, up from 1.96% in the second-quarter. In contrast, annualized seasonally-adjusted quarterly inflation for the CPI-U in the third quarter spiked to 1.47%, following a 0.72% contraction in the second-quarter. The lower the inflation rate used in deflating the GDP, the stronger is the inflation-adjusted number and vice versa.

The SGS Alternate-GDP estimate for third-quarter 2010 was an approximate annual contraction of 1.4% versus the official estimate of a 3.1% gain, more-negative than the alternate 1.3% annual contraction (3.0% official gain) estimated in the second-quarter (see the [Alternate Data](#) tab). While annualized real quarterly growth is not estimated formally on an alternative basis, a flat-to-minus quarter-to-quarter change would have been realistic for the second-quarter. The recent relative upturn in annual change reflects the bottom-bouncing at low levels of activity seen for much of the last year in key underlying economic series, not an economic recovery. As discussed in [Commentary No. 328](#), an intensified downturn, now in the form of a double-dip recession, continues to unfold.

GNP and GDI (see *Notes on GDP-Related Nomenclature and Definitions Sidebar*). The initial reporting of third-quarter GNP and GDI will not be until November 23rd, because -- as with the GDP -- data are so heavily guesstimated at this point in reporting, the BEA recognizes GNP and GDI detail largely would be meaningless.

Durable Goods Orders Spiked Again by Airplane Orders. The Census Bureau reported Wednesday (October 27th) that the regularly volatile, seasonally-adjusted new orders for durable goods rose by 3.3% (up by 4.1% before prior-period revisions) month-to-month in September 2010, after a revised 1.0% (previously 1.3%) decline in August. Unadjusted, year-to-year change in September new orders was a gain of 12.7%, up from a revised 12.8% (previously 12.1%) annual increase reported for August.

One of the larger factors accounting for the irregular volatility in this series is commercial airplane orders, and such orders accounted for more than the total gain in the durable goods accounting. While the aircraft orders are good news in terms of long-range economic activity, the nature of multi-year delivery schedules does not impact the broad economy immediately. Net of the increase in orders for nondefense aircraft and parts, new orders for durable goods declined by 0.1% in September.

Widely followed nondefense capital goods surged by 8.6% (up 11.8% before prior-period revisions) in September. Net of airplanes, though, orders were down by 1.3%. In August, orders gained a revised 1.0% for the month (previously a contraction of 0.9%). For September, the unadjusted year-to-year change in the series was 27.0%, versus a revised 23.9% (previously 22.6%) gain in August.

Home Sales Remain Seriously Impaired, With Higher Foreclosures in September. The residential sales environment remains abysmal at the moment, as shown in industry reporting and as suggested by anecdotal evidence. Even in this morning's GDP report, residential investment tanked. Boosted by expiring home-buyer tax credits, purchases of new homes had contributed 0.6 percentage points to the 1.7% GDP growth rate reported in the second-quarter, but third-quarter residential activity drained 0.8 percentage points of growth from the third-quarter GDP.

With a liquidity crisis in play for many potential home buyers, in conjunction with low consumer confidence, home sales still hold no near-term prospects of helping to boost broad economic activity. Instead, they likely will continue sapping strength from the economy, further impairing residential construction and new orders for durable goods, which usually benefit from home sales activity (appliance sales, etc.) in more-positive times.

Wednesday's (October 27th) reporting of September new home sales (counted based on contract signings, Census Bureau) showed a statistically meaningless monthly gain of 6.6% +/- 19.8% (95% confidence interval) from August. August showed a revised 1.1% monthly gain (previously unchanged). The year-

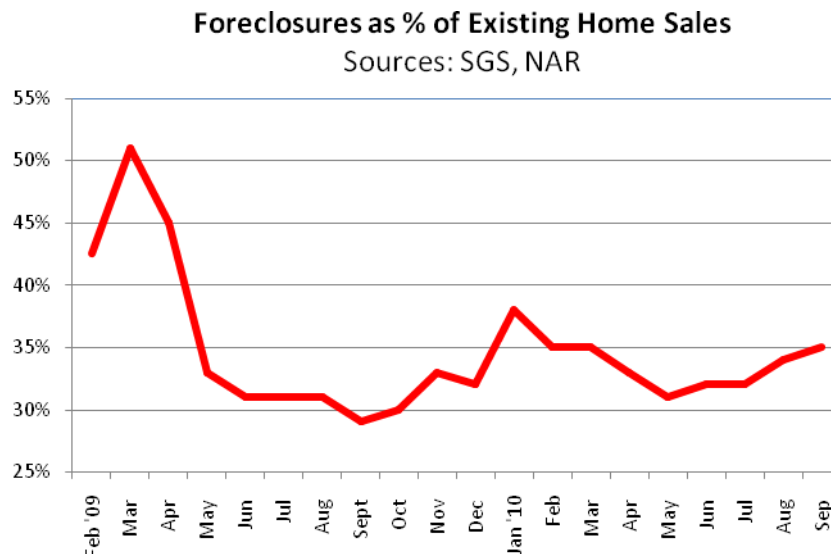
to-year decline in the new home sales series in September 2010 narrowed to 21.5% from a 28.9% decline in August.

Monday's (October 25th) release of September existing home sales (counted based on actual closings, National Association of Realtors [NAR]) showed a 10.0% gain in activity from August (up 9.7% before prior period revisions), but still at historically-low levels. August gained a revised 7.3% (previously 7.6%) versus July. On a year-to-year basis, sales were down by 19.1% in September versus a revised 28.8% (previously 29.0%) annual decline in August.

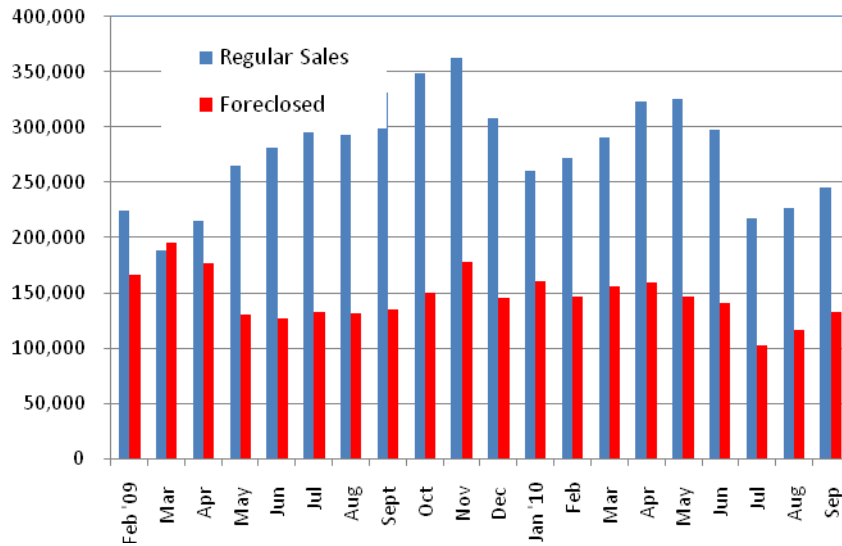
Foreclosure activity remained a major distorting factor for home sales, with "distressed" activity accounting for 35% of existing sales in the NAR's September reporting, up from 34% in August. Such is despite some press of certain financial institutions putting foreclosures on temporary hold, in response to mounting legal issues.

Separately, the Census Bureau acknowledges that a portion of new home sales also is from foreclosure activity but offers no estimates as to the scope of the issue. Some in the construction trade have difficulty competing with the pricing of foreclosed properties. Until the foreclosure problems get worked out in the system, monthly changes in these home sales numbers cannot be taken as meaningful positive indicators (when the numbers are positive) of underlying activity in homeowner real estate, as it relates to general economic activity.

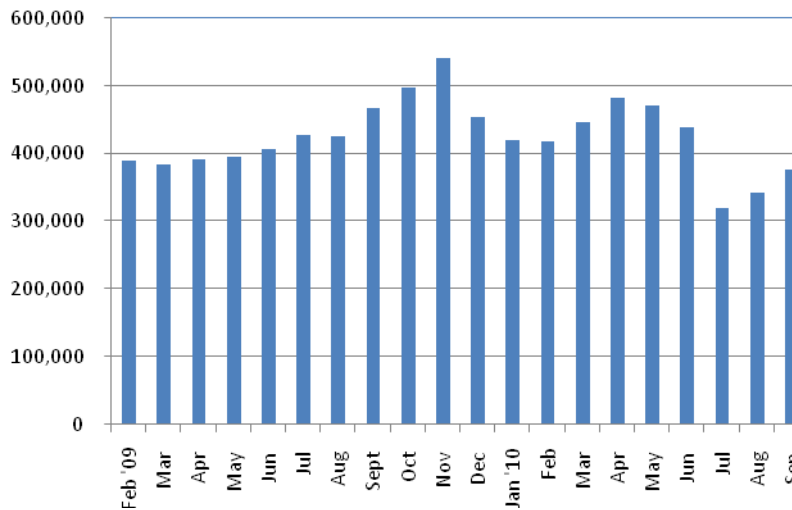
The following updated graphs reflect different measures of home sales activity since February 2009. The numbers, through September 2010, reflect the seasonally-adjusted level of monthly sales, rather than the annual rates usually published by the industry.

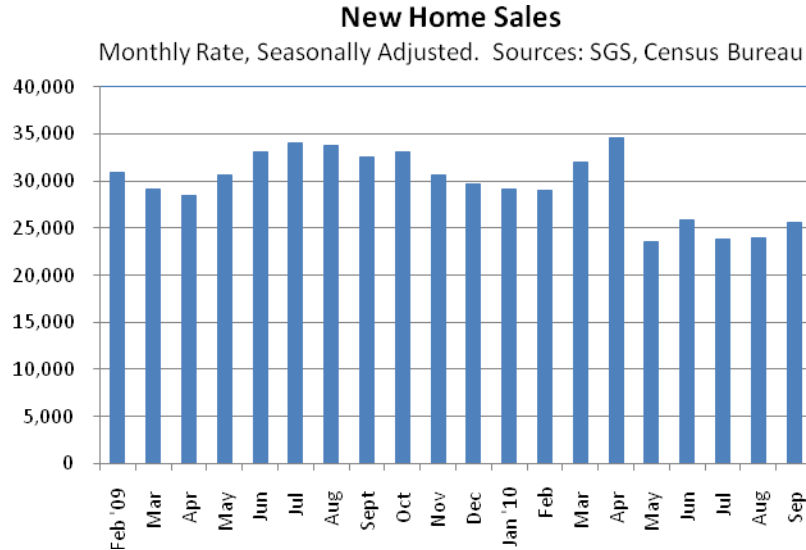


Existing Home Sales - Foreclosed and Not
Monthly Rate, Seasonally Adjusted. Sources: SGS, NAR



Existing Home Sales - Total
Monthly Rate, Seasonally Adjusted. Sources: SGS, NAR





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 will show up in prior-period revisions.

Employment and Unemployment (October 2010). October jobs and unemployment data are due for release on Friday, November 5th. Consensus estimates are for a gain of 45,000 in payrolls versus a 95,000 jobs loss in September, and for the U.3 unemployment rate to hold again at 9.6%, per Briefing.com. Of the 95,000 jobs reported lost in September, 77,000 were due to layoffs of temporary census workers. The effect from census layoffs has run its course, with no more than the aggregate remaining total of 6,000 as of September to be lost in October and in any subsequent periods.

I expect a monthly contraction in October payrolls, as was seen last month even net of census layoffs, with the headline unemployment rate increasing, along with continued upside movement in the broader unemployment rate measures. To the extent that meaningful signals are generated next week -- in advance of the government's reporting -- by underlying and related series, a brief update on the employment reporting outlook will be published.