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

COMMENTARY NUMBER 334
October Inflation, Retail Sales, Production, Housing Starts

November 17, 2010

Fed's Monetization Jawboning Spiked Energy Inflation

Fed Prefers to Ignore Energy Costs, Concentrating on "Core" Inflation Measures

Retail Sales Still Heavily Distorted

Production Appears to Have Topped

Housing Starts Resume Meaningful Decline

PLEASE NOTE: The next regular Commentary *will be on Wednesday, November 24th, following release of October New Orders for Durable Goods, along with assessments of the first-revision (second estimate) of third-quarter GDP and October New and Existing Home Sales.*

ERRATUM: The second paragraph of main text in Special Commentary No. 333 *included a typo that misstated a year as 2001 instead of 2011 in the initial postings. Although it was corrected in the postings quickly, early readers would have seen the erroneous text. I thank the numerous subscribers who sent us notes on the mistake, and I apologize for any confusion created by the typo. The corrected opening paragraphs follow (full text is found at link above):*

"*Fed Moves Preemptively to Debase U.S. Dollar*. In announcing the effective monetization of U.S. Treasury funding needs through mid-2011, the Federal Reserve not only has begun a process from which it will be increasingly difficult to withdraw, but also has begun a process that likely will have to be accelerated in the months ahead, in response to mounting U.S. fiscal and systemic-solvency problems intensified by a still-unexpected "double-dip" recession, as well as in response to intensifying selling and dumping of the U.S. dollar and dollar-denominated paper assets in the global markets.

"Such locks-in one of the underlying prerequisites for the U.S. economic environment to evolve into an unthinkable hyperinflationary great depression. The U.S. government effectively is bankrupt and remains extremely likely to resolve this ultimate sovereign insolvency by printing money to meet its obligations. As global pressures force the Fed into further Treasury debt monetization, as global confidence in the world's reserve currency evaporates, risks remain particularly high of a U.S. hyperinflation beginning to unfold in the first-half of **2011** [corrected from 2001], along with severe economic, social and political consequences that will follow. The outside timing for this manmade financial catastrophe remains 2014."

-- *Best wishes to all, John Williams*

Inflation Reporting Begins to Reflect Dollar-Debasement Efforts. When Mr. Bernanke first outlined his approach to fighting a possible deflation with debasement of the U.S. dollar (see page 22 of the *Hyperinflation Special Report*), he indicated that some debasement likely could be had simply through jawboning of same. Such was confirmed by market activity in the last couple months, with broad and general weakness in the U.S. dollar and higher oil and related gasoline prices resulting from mounting suggestions by the Fed that dollar-debasement was in the offing. The higher energy costs began to take a toll in October CPI and PPI reporting. Purported lack of seasonally-adjusted inflation outside of the energy sector should not last long, if anecdotal evidence has any relationship to the numbers, which it usually does, though often with a lag. Nonetheless, annual inflation started creeping higher in October, albeit slowly, in both the CPI and PPI. That problem will begin to intensify quickly.

Ironically, the initial energy inflation that consumers are seeing from the Fed's actions is the type of inflation the U.S. central bank usually likes to ignore, focusing instead on the reporting of "core" inflation -- inflation net of food and energy costs -- which is a worthless measure over the longer term. The effects of volatile food and energy cost cannot be ignored in aggregate over extended periods, and certainly they are not ignored by anyone who consumes food and/or energy.

The general outlook as discussed in *Special Commentary No. 333* has not changed. Currency values and precious metals prices can be volatile, but the long-term weakness in the U.S. dollar and relative purchasing-power-preservation of gold and silver and the stronger currencies outside the dollar remain in place. As with systemic risks in the United States, risks in other areas of the world -- such as among the countries using the euro -- likely will be addressed by the spending or creation of whatever money is needed (very possibly with U.S. backing) in order to prevent systemic failure. Keep in mind that the U.S. remains the proverbial elephant in the bathtub in terms of pending effective sovereign bankruptcies.

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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.*

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Softer-Than-Expected October CPI Still Was Dominated by Rising Gasoline Prices. As discussed in the opening comments, the softer-than-expected October inflation numbers were dominated by energy costs, which the Fed prefers to ignore, while anecdotal evidence suggests increasing problems with food prices that somehow did not make it into this month's consumer price inflation measures. Gasoline was up 3.5% not-seasonally-adjusted in October, per the Department of Energy, the BLS used 3.3%, which became 4.4% after seasonal adjustment. Whether or not the Fed ignores food and energy prices, its recent actions can be tied directly to the higher energy costs. Rising inflation, increasingly broad and increasingly strong, should be a serious problem in the months ahead.

CPI-U. The Bureau of Labor Statistics (BLS) reported this morning (November 17th) that the seasonally-adjusted October 2010 CPI-U rose for the month by 0.23% (up by a borderline-statistically-significant 0.12%, unadjusted) +/- 0.12% (95% confidence interval, not seasonally adjusted). Such followed a 0.10% gain (up 0.06% unadjusted) in September. Unadjusted, October's year-to-year inflation was 1.17% +/- 0.20% (95% confidence interval) against a 1.14% annual increase in September.

Year-to-year inflation would increase or decrease in next month's November 2010 reporting, dependent on the seasonally-adjusted monthly change, versus the 0.23% adjusted monthly gain seen in November 2009. I use the adjusted change here, since that is how consensus expectations are expressed. To approximate the annual inflation rate for November 2010, the difference in November's headline monthly change (or forecast of same) versus the year-ago monthly change should be added to or subtracted directly from October 2010's reported annual inflation rate of 1.17%.

CPI-W. The narrower, seasonally-adjusted October CPI-W, which has greater weighting for gasoline than does the CPI-U, rose by 0.31% (up 0.15% unadjusted) for the month, following a gain of 0.15% (up 0.05% unadjusted) in September. Unadjusted year-to-year CPI-W inflation rose by 1.45% in October, versus a 1.41% September 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 1.00% in October 2010, versus a 0.94% gain in September.

Alternate Consumer Inflation Measures. Adjusted to pre-Clinton (1990) methodology, annual CPI inflation was roughly 4.5% in October 2010, up a notch from 4.4% in September, while the SGS-Alternate Consumer Inflation Measure, which reverses gimmicked changes to official CPI reporting methodologies back to 1980, held at about 8.5% (8.51% for those using the extra digit) in October versus September.

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 November 9th's historic high gold price of $1,421.00 per troy ounce (London afternoon fix) and multi-decade high silver price of $28.55 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 $2,390 per troy ounce, based on October 2010 CPI-U-adjusted dollars, and would be $7,824 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 October 2010 CPI-U inflation, the 1980 silver price peak would be $139 per troy ounce and would be $455 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 *Special Commentary No. 333* the real contraction in October M3 (SGS-Ongoing) estimated for that *Commentary* was 4.6%. Based on today's CPI-U report and the latest estimate on the October SGS-Ongoing M3 Estimate, that annual contraction was 4.5%, narrower than September's 4.9% 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 renewed deterioration 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.

October PPI Reflected Higher Gasoline Prices. As reported yesterday (November 16th) by the Bureau of Labor Statistics (BLS), the regularly-volatile, seasonally-adjusted finished-goods producer price index (PPI) in October 2010 rose for the third consecutive month by 0.4% (up by 0.6% before seasonal adjustment) month-to-month, following unadjusted gains in September and August respectively at 0.3% and a contraction of 0.1%. The annualized, seasonally-adjusted PPI inflation over the last three months has been 4.9%. Unadjusted and year-to-year, October's annual PPI inflation was up 4.3% from October 2009, continuing on an upswing from 4.0% in September and from an annual inflation rate of 3.1% reported for August.

The reported seasonally-adjusted 0.4% monthly gain in October encompassed a 3.7% adjusted monthly increase in gasoline prices, which was reflective of higher oil prices and a weaker U.S. dollar engendered by the Federal Reserve's jawboning on pending treasury debt monetization.

Also on a monthly basis, seasonally-adjusted October intermediate goods rose by 1.2% (up by 0.5% in September), with October crude goods prices jumping by 4.3% (down by 0.5% in September). Year-to-year inflation in October intermediate goods was up by 6.4% (a 5.6% gain in September), with October annual inflation in crude goods up by 17.0% (up by 20.3% in September).

Retail Sales Had a Meaningful But Distorted Gain. Boosted predominantly by auto sales -- reported using seasonal factors that still are in uncharted waters following the bankruptcies of GM and Chrysler and the cash-for-clunkers program -- October sales were up with statistical significance. Other retail sales gains seemed surprisingly light for gas stations and grocery stores, given rising gasoline and food prices. With the bulk of actual annual retail sales ahead in November and December, reporting in those months should give a more-meaningful picture on what is happening with the liquidity strapped consumer.

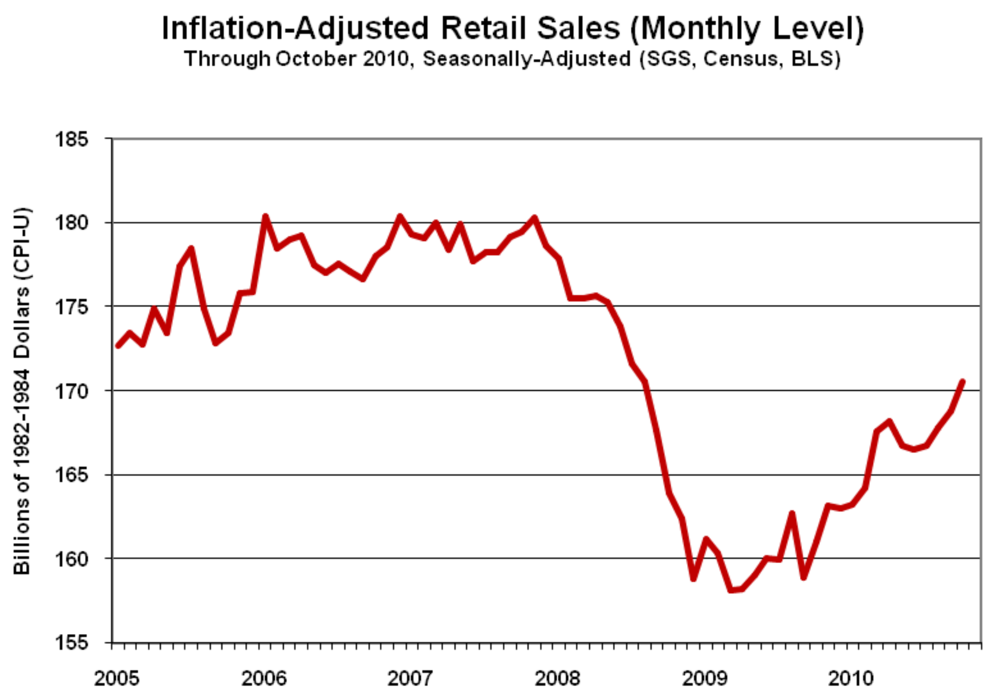
***Nominal Retail Sales*.** Monday's (November 15th) October 2010 retail sales report -- issued by the Census Bureau -- indicated a statistically-significant, seasonally-adjusted monthly gain of 1.23% (up 1.48% net of revisions) +/- 0.6% (95% confidence interval), versus a revised 0.71% (initially 0.62%) increase in September.

On a year-to-year basis, October 2010 retail sales were reported up by 7.31% from October 2009, versus a revised annual September gain of 7.40% (previously 7.34%). Annual changes still have been unstable due to year-ago comparisons ranging from a severe trough in activity to last year's cash-for-clunkers stimulus effects. At the same time the Census Bureau still continues to play games with the monthly seasonal factors and revisions to year-ago data.

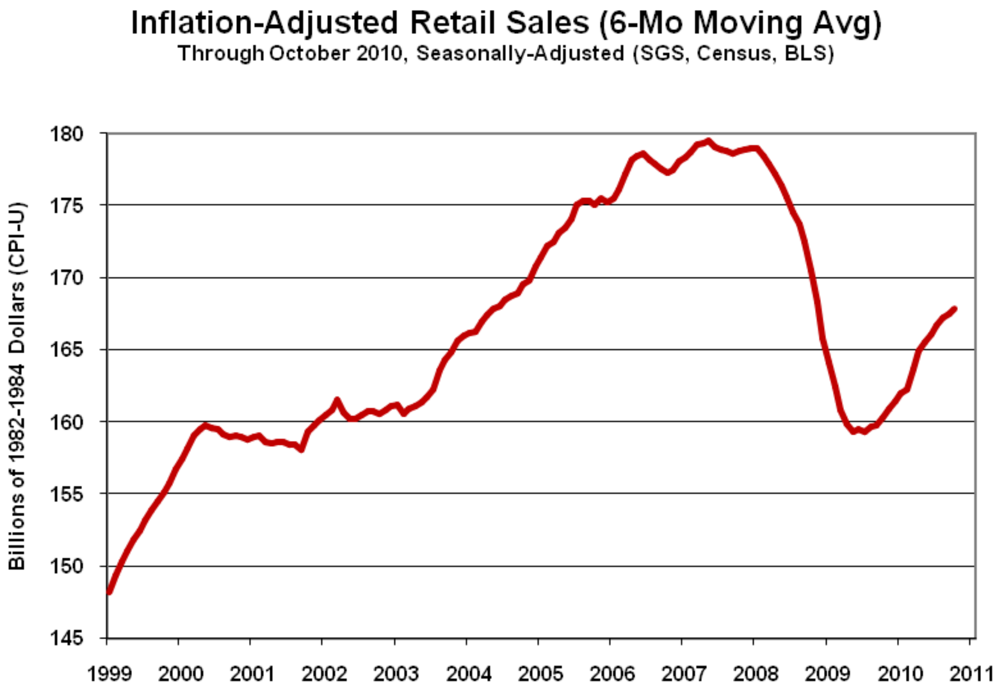
Real Retail Sales. Based on the October 2010 CPI-U reporting, inflation- and seasonally-adjusted monthly October retail sales increased by 1.04%, where before inflation adjustment the current number was up by 1.23%, versus a revised real monthly gain of 0.60% (was 0.53%) in September.

October real retail sales rose at a year-to-year pace of 5.92%, versus the revised 6.23% (previously 5.97%) annual gain reported for September.

Since November 2008, monthly real retail sales (CPI-U deflated) have been fluctuating around an average of $163.2 billion (the deflated October number was $170.5 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 still lingers in seasonal-adjustment problems, which should tend to run their course very shortly, 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.



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:

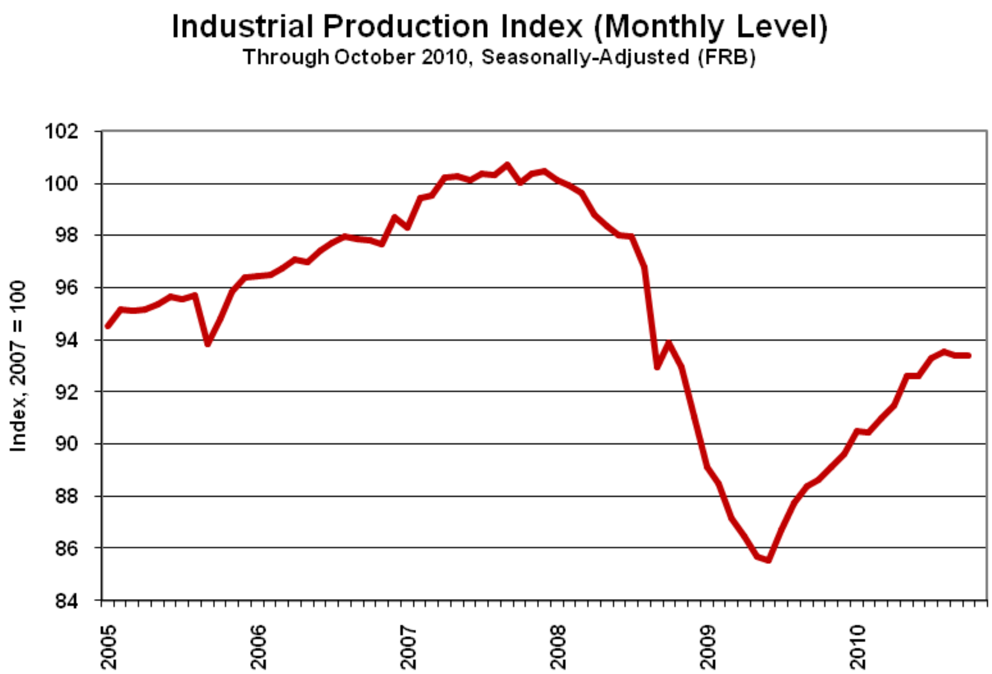
Version I: October versus September 2010 seasonally-adjusted retail sales -- net of total grocery store and gasoline station revenues -- gained by 1.5% versus the official aggregate gain of 1.2%.

Version II: October versus September 2010 seasonally-adjusted retail sales -- net of the monthly change in revenues for grocery stores and gas stations -- increased by 1.1% versus the aggregate gain of 1.2%.

Industrial Production Seems to Be Topping Out. With production reported down in September and little changed in October, the peak of monthly industrial production in the current cycle may have passed; if not, such likely is imminent. Although October utility usage was down due to unseasonable weather, and such not only contributed downside pressure directly to the industrial production index but also to production estimates of certain industries that are still guessed at based electricity consumption, production of consumer goods was unchanged. Production increasingly should move into decline, as excess inventories are worked down in an environment of soft real "inflation-adjusted" consumption.

As to the production numbers, the Federal Reserve Board reported Tuesday (November 16th) that seasonally-adjusted October 2010 industrial production was virtually flat at a gain of 0.01% (up by 0.20% before revisions to September's initial reporting, which were in the context of revisions to a number of prior months), versus a revised 0.16% (previously 0.22%) decline in September.

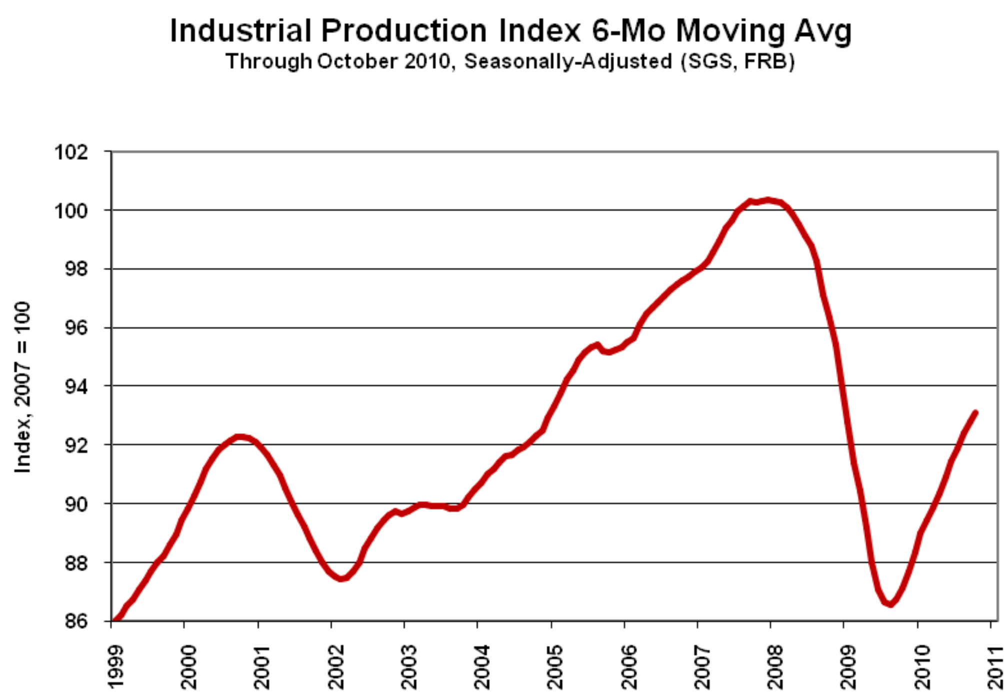
Year-to-year change in October production continued to ease back, to 5.35%, from a revised 5.62% (previously 5.42%) in September, and down from the revised near-term peak of 8.30% (was 8.27%) in June. As with retail sales, the relatively high volatility in annual growth is due largely to the pattern of collapsing activity a year ago (a May 2009 trough), followed by cash-for-clunkers-boosted production. The year-to-year contraction of 12.86% seen in May 2009 was the steepest annual decline in production growth since the shutdown of war-time production following World War II.



The preceding graph shows recent monthly detail, with a growing probability that the August number indeed marked the turning point of renewed decline in the production series.

The "recovery" in production is shown in the second graph, where month-to-month volatility is smoothed using a six-month moving average. For the last 22 months, the production index has averaged 89.76, around which the series has been fluctuating, with October's six-month moving average reading at 93.12, versus 93.37 for the single month. Production activity had leveled off at a low-level plateau of activity that effectively wiped out the last eight years of growth in industrial production; the current rally has topped the pre-2001 recession high, reclaiming levels last seen in 2004 (six-month moving average).

Despite the near-term upside gains generated by short-lived stimulus and seasonal-factor distortions, the series likely still is bottom-bouncing and should begin to soften anew, significantly, in the oncoming months. The six-month moving-average series remains 7.21% below its December 2007 historic high.

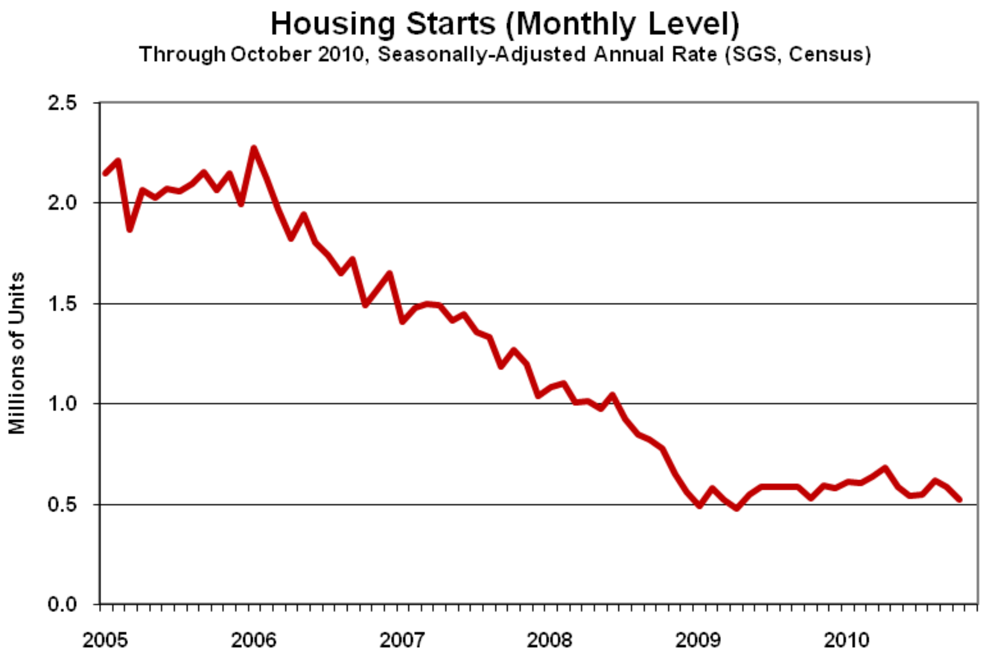


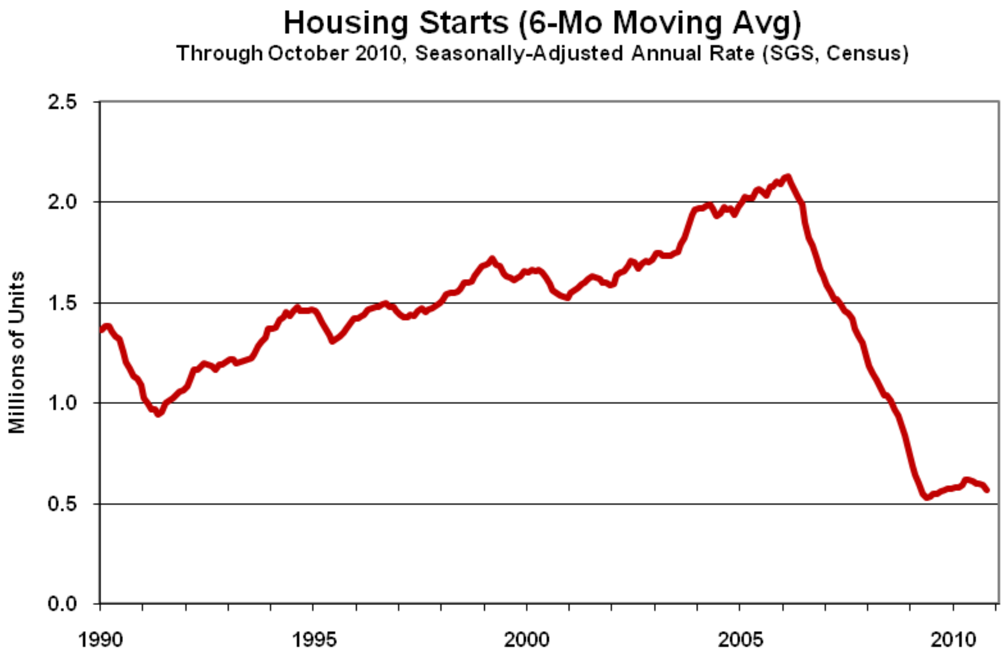
October Housing Starts Tumble Deepened by Revisions. The Census Bureau reported today (November 17th) a statistically-significant decline for October 2010 housing starts, down 11.7% (down by 14.9% before prior-period revisions) +/- 10.3% (95% confidence interval) on a seasonally-adjusted month-to-month basis. September's starts were revised to 4.2% contraction (previously a 0.3% gain).

Year-to-year change in October starts was a statistically-insignificant decline of 1.9% +/-11.2% (95% confidence interval), following a downwardly revised annual gain of 0.3% (previously 4.1%) in September.

Although the pattern of housing starts generally remains one of bottom-bouncing at an historically low-level plateau of activity, as seen over the last 22 months, recent activity has started to slow anew, meaningfully. Even-weaker monthly numbers remain likely in the months ahead. Since December 2008 housing starts have been bottom-bouncing, averaging a seasonally-adjusted annual rate of 571,300. In those 23 months, all monthly readings have been within the normal range of monthly volatility for the series around that average, although October 2010's reading of 519,000 is pushing the downside limit.

The "recovery" in housing is shown in these graphs. The first graph reflects the level of monthly activity in terms of the annualized monthly rate of housing starts, which is randomly volatile and subject to large revisions on a monthly basis. The second graph shows the six-month moving average, which tends to smooth out that monthly volatility.





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.

Gross Domestic Product -- GDP ("Second Estimate" Third-Quarter 2010). Due for release on Tuesday, November 23rd, the "second" estimate and first revision of third-quarter 2010 GDP is expected to reflect 2.3% annualized inflation-adjusted quarterly growth, up from 2.0% in the "advance" estimate, per Briefing.com. A significant revision (a 0.3% revision in annualized growth is largely statistical noise) is not likely and the revision could go either way.

New and Existing Homes Sales (October 2010). October existing home sales (National Association of Realtors) are due for release on Tuesday, November 23rd, followed by new home sales (Census Bureau) on Wednesday, November 24th. As with housing starts, theses volatile series should remain extremely weak, with any monthly change (new homes) again lacking statistical significance. With extreme volatility, reporting error and revisions in these series, with poor-quality seasonal adjustments, with extremely negative anecdotal evidence, and with massive distortions from increasingly volatile foreclosure activity, the monthly movements in these numbers remain particularly meaningless.

New Orders for Durable Goods (October 2010). Due for release on Wednesday, November 24th, October new orders for durable goods could be expected to see some weakness, following strong aircraft orders in September, but this irregularly volatile series likely will not show meaningful monthly change, even with upside biases built into these numbers in the last benchmark revision.

