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October Trade Deficit, Tax Games

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Narrower October Trade Deficit Is Positive Indication for Fourth-Quarter GDP

Proposed Tax Deal Would Not Forestall the Double-Dip

Federal Government's Fiscal Woes Would Be Exacerbated

PLEASE NOTE: The next regular Commentary *will be on Wednesday, December 15th, following release of the November CPI and Industrial Production, plus an assessment of the prior day's November PPI and Retail Sales releases. Also scheduled for release on December 15th is the U.S. Treasury's GAAP-Based* 2010 Financial Report of the U.S. Government. *If there is no delay in its publication (last year it was delayed by two months), a separate, standalone* Commentary *on the government's financial statements will be published on December 15th as well.*

-- Best wishes to all, John Williams

Last-Minute Tax Deal Would Damage Fiscal Conditions, While Helping But Fundamentally Not Turning the Economy. As this *Commentary* is posted, the fate of the tax-and-spend deal recently announced by President Obama and Republican members of Congress is uncertain, due to opposition from Congressional Democrats.

Whatever ends up being continued from the expiring Bush income tax cuts is a non-negative for the economy. The same is true for any extension of unemployment benefits. Where continuation of those items would maintain the status quo, expiration of same would be economic negatives.

On the plus-side for individuals and the economy, a one year's elimination of two percentage points in the Social Security withholding tax would boost, directly, the disposable income of individuals currently paying those taxes. As a result, there should be some consumption pick-up, but -- as with stimulus measures of the recent past -- gains will tend to be short-lived, with a reverse-effect after the one-time giveaway expires.

The positive effects on the economy would show up in general business activity being less-negative than it would have been otherwise. The proposed package would not trigger a recovery, and it would not forestall the intensification of the double-dip recession.

The federal deficit, however, would reflect full impact of all measures, as ongoing deficit projections usually would include the scheduled expiration of the Bush tax measures and non-extension of unemployment benefits. The fiscal effects of the short-term Social Security tax reduction also would not have been in any pre-existing official deficit projections.

Nothing here alters the broad outlook on the U.S. economy, financial markets and systemic liquidity, as discussed in *Special Commentary No. 333*. Aside from today's (December 10th) trade data, this has been a quiet reporting week, yet next week will be anything but quiet (see the *Week Ahead* section).

The factors and catch-up reporting that helped to generate a weaker-than-expected report on November's labor market also should help bring in a downside surprise or two in next week's key reporting of November retail sales, production and housing. Also, the intensifying impact of the Fed's preemptive move to debase the U.S. dollar increasingly should be reflected in some upside surprises to monthly inflation reporting.

Further, the U.S. Treasury's publication of the federal government's 2010 GAAP-based financial statements may offer some surprises, depending on how residual stimulus programs, the healthcare program and Fannie Mae and Freddie Mac are handled on the books.

Next week's *Commentaries* will update and review U.S. economic, inflation and solvency issues tied to those various economic and financial releases.

October Trade Deficit Narrowed. The October trade deficit narrowed both in nominal and real (not-adjusted-for inflation and inflation-adjusted) terms. This and next month's reporting (still shy the third month in the quarter) will be primary information used in determining the initial estimate of net exports in fourth-quarter GDP, due for release on January 28th. The first indication from today's trade data is that the net export account will contribute positively to fourth-quarter economic activity. This series remains volatile on a monthly basis and is subject to occasional large revisions.

Nominal (Not-Adjusted-for-Inflation) Trade Deficit. For October 2010, the Bureau of Economic Analysis (BEA) and the Census Bureau reported that the nominal, seasonally-adjusted monthly trade deficit in goods and services narrowed to $38.7 billion, versus a revised $44.6 (previously $44.0) billion in September, but it widened from the $32.3 billion monthly deficit of October 2009.

Against September 2010, the October trade balance showed a gain in exports and a decline in imports. The lower imports were influenced by oil activity, where unadjusted oil imports reflected the dominant effect of lower physical volume against higher prices. Specifically, for the month of October 2010, the not-seasonally-adjusted average price of imported oil was $74.18 per barrel, up from $72.36 in September 2010, and up from $67.37 in October 2009. In terms of not-seasonally-adjusted physical oil imports, October 2010 volume averaged 8.209 million barrels per day, versus 9.656 million in September 2010 and 8.336 million in October 2009.

Real (Inflation-Adjusted) Trade Deficit. A widening trade deficit directly reduces GDP growth and vice versa. As reported by the BEA with the October number, adjusted for seasonal factors and inflation (2005 chain-weighted dollars as used in reporting real GDP), the third-quarter goods deficit was running at an annualized pace of $542.0 billion. Again, that is based on only one of three months of reporting. Such was against a revised third-quarter annualized goods deficit estimate of $597.7 (previously $596.1) billion.

Week Ahead. Given the unfolding reality of an intensifying double-dip recession and more-serious inflation problems than generally are anticipated 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 should show up in prior-period revisions.

Retail Sales (November 2010). November retail sales data are due for release on Tuesday, December 14th, and are sensitive to seasonal factor distortions similar to those seen in recent payroll employment reporting. Where Briefing.com indicates a consensus outlook of 0.8% monthly growth for November, versus initial reporting of 1.2% growth in October, risks are fairly strong for a downside reporting surprise. Such should be particularly so, net of inflation effects.

Producer Price Index -- PPI (November 2010). November PPI is due for release on Tuesday, December 14th, and it should show some increase due to the recent dollar-debasement induced spike in oil prices. This series is randomly volatile, but likely will top a 0.5% consensus (Briefing.com), following October's 0.4% gain.

Consumer Price Index -- CPI (November 2010). November CPI is due for release on Wednesday, December 15th. With food and gasoline prices on the rise and seasonal factors likely to boost the effects of same, reporting risk should be to the upside of a consensus monthly gain of 0.2% (Briefing.com), versus a 0.2% increase in October. The nascent inflation here, again, has been fueled by the Fed's dollar-debasement efforts.

Year-to-year inflation would increase or decrease in November 2010 reporting, dependent on the seasonally-adjusted monthly change, versus the 0.23% adjusted monthly gain reported for 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 for same) versus the year-ago monthly change should be added to or subtracted from

October 2010's reported annual inflation rate of 1.17%. A consensus result of a 0.2% monthly gain in November would leave annual CPI-U inflation at about the 1.2% rounded level reported for October.

Industrial Production (November 2010). November industrial production is due for release on Wednesday, December 15th, and it likely will continue to be flat-to-minus on a monthly basis, versus an unchanged level in October and a contraction in September. Revisions could be meaningful.

GAAP-Based Financial Statements for U.S. Government (Fiscal-Year 2010). The annual, GAAP (generally accepted accounting principles) -based financial statements of the U.S. Government for fiscal-year ended September 30, 2010 are scheduled for release by the U.S. Treasury on Wednesday, December 15th. It will be particularly interesting to see how the accounting is handled for Fannie Mae and Freddie Mac. A separate *Commentary* will follow that data release.

Residential Construction (November 2010). November housing starts are due for release on Thursday, December 16th. Residential construction appears to be turning down anew, following a protracted period of bottom-bouncing at historically-low levels of activity. While the reported monthly change for November likely will not be statistically meaningful, if it is, it more likely will be on the downside rather than the upside.

