COMMENTARY NUMBER 354
GDP Revision, Durable Goods Orders, Home Sales, Tax Receipts, Political Crises

February 25, 2011

Safe-Haven Flight from Mounting Political Turmoil in North Africa and Mid-East Favors Precious Metals and Swiss Franc over U.S. Dollar

Payroll-Tax-Deposit Series to Offer New Economic and Fiscal Insights

4th-Quarter GDP Growth Revised Lower But Quality Issues Continue

Home Sales Remain Troubled

PLEASE NOTE: The next regular Commentary *is scheduled for Friday, March 4th, following release of the February employment and unemployment data.*

The Hyperinflation Special Report (Update 2011) *should be published by early next week (targeted for Monday afternoon, February 28th). Its posting on the Web site will be advised by e-mail.*

— Best wishes to all, John Williams

U.S. Dollar Losing Its Safe-Haven Status? With political upheaval surfacing in the Mid-East and North Africa, global capital increasingly has been moving into traditional safe-haven investments such as precious metals, or into safe-haven currencies such as the Swiss franc. What is of particular significance here is that flight capital has been seeking shelter outside of the U.S. dollar, which for decades had been the favored safe-haven currency. Against the U.S. dollar, the Swiss franc – another traditional safe-haven currency – hit a record high in the last day or so. Other than for the British pound, the U.S. currency has been losing exchange-rate value against the other major currencies (Australian dollar, Canadian dollar, Japanese yen and even the euro) during this period of mounting political instabilities. Gold has neared its all-time high, while silver recently has set a multi-decade high.

Oil prices have spiked in response to the various crises, adding further upside pressure to U.S. consumer inflation from oil supply fears and ongoing dollar weakness. As with the dollar-debasement efforts of the Fed, these inflation pressures reflect factors other than strong economic demand.

At the same time, the fragility of the faux U.S. economic recovery is becoming more obvious to the markets, with economic data increasingly surprising consensus forecasts on the downside, as seen in this week's home sales and GDP revision reporting. In the months ahead, an intensifying "renewed" decline in broad economic activity should gain increasing market recognition.

Irrespective of whether the political turmoil spreads or dies down, irrespective of Saudi efforts to help contain panicked oil price rises, irrespective of short-lived fluctuations in exchange rates and precious metals prices, the U.S. now stands at a point where it is particularly vulnerable to an evolving global loss of confidence in the U.S. dollar. Heavy selling of the U.S. currency and panicked dumping of dollar-denominated paper assets, which could trigger U.S. financial market upheaval and the early stages of a hyperinflation, is possible at any time with little or no warning. It could be triggered by an unhappy economic or political surprise, or otherwise. Where risks remain high of U.S. financial turmoil unfolding in the months ahead, the onset of a hyperinflation still has an outside timing estimate of 2014.

A full review on the economy, inflation and systemic-solvency issues follows in next week's update to the *Hyperinflation Inflation Report*. The broad outlook and potential hyperinflation timing remain consistent with last year's missive, and regular readers of the SGS *Commentaries* should find few surprises in the revamped report.

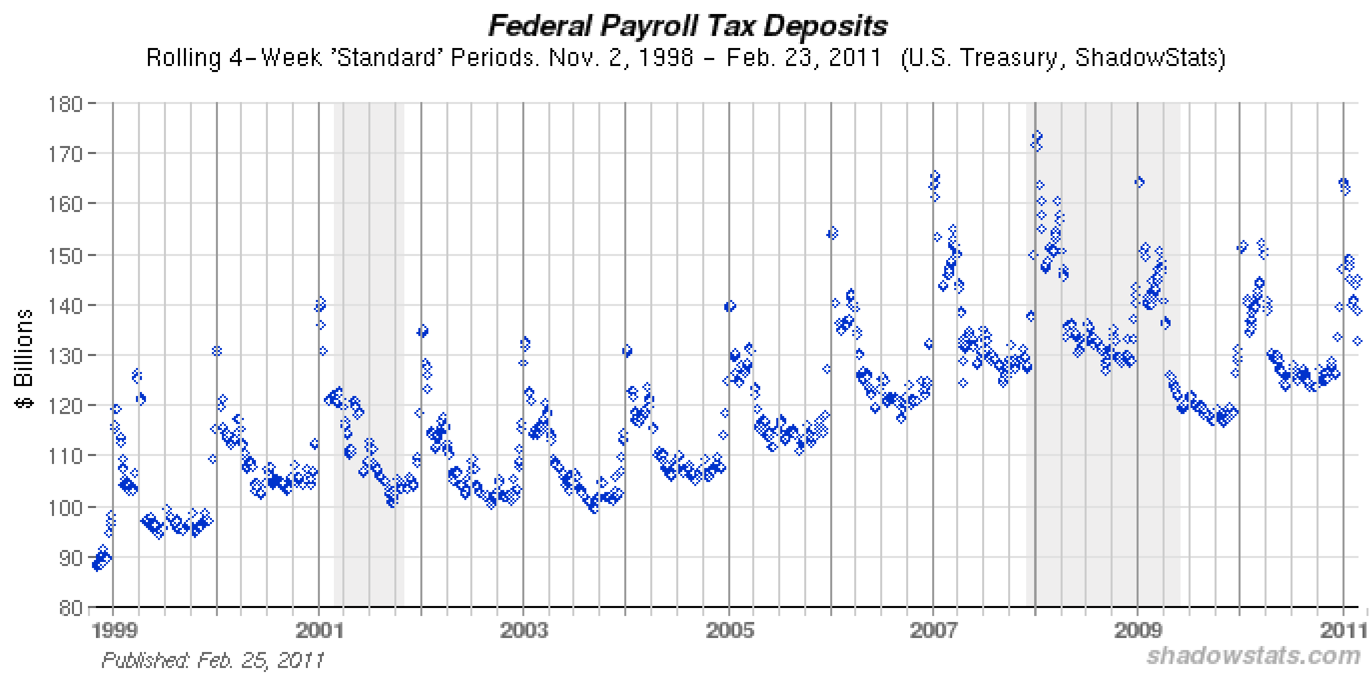
New Withholding-Tax Series Should Provide Insights to Employment, Earnings and Fiscal Conditions. Although still a work in progress, we are pleased to introduce a new analysis of a highly meaningful but not widely tracked statistic: federal receipts of payroll withholding taxes. Several subscribers have requested that we cover the series as an economic indicator, where withholding-tax receipts should rise and fall with employment, earnings and tax law changes. This series has two advantages over the Bureau of Labor Statistics (BLS) payroll survey, where the tax data become available one day after they are deposited to the U.S. Treasury, and where the series covers all employers. It is not a sample, and filing accuracy by employers is mandatory.

Unfortunately, though, working backwards from the data to get a clear picture of what is happening in the labor market is unusually complex, but much of that complexity can be overcome. At present, we can get some useful quantitative signals and checks against other statistics; ultimately we hope to provide a more timely and accurate indication of changes in the employment picture than currently is available from the BLS.

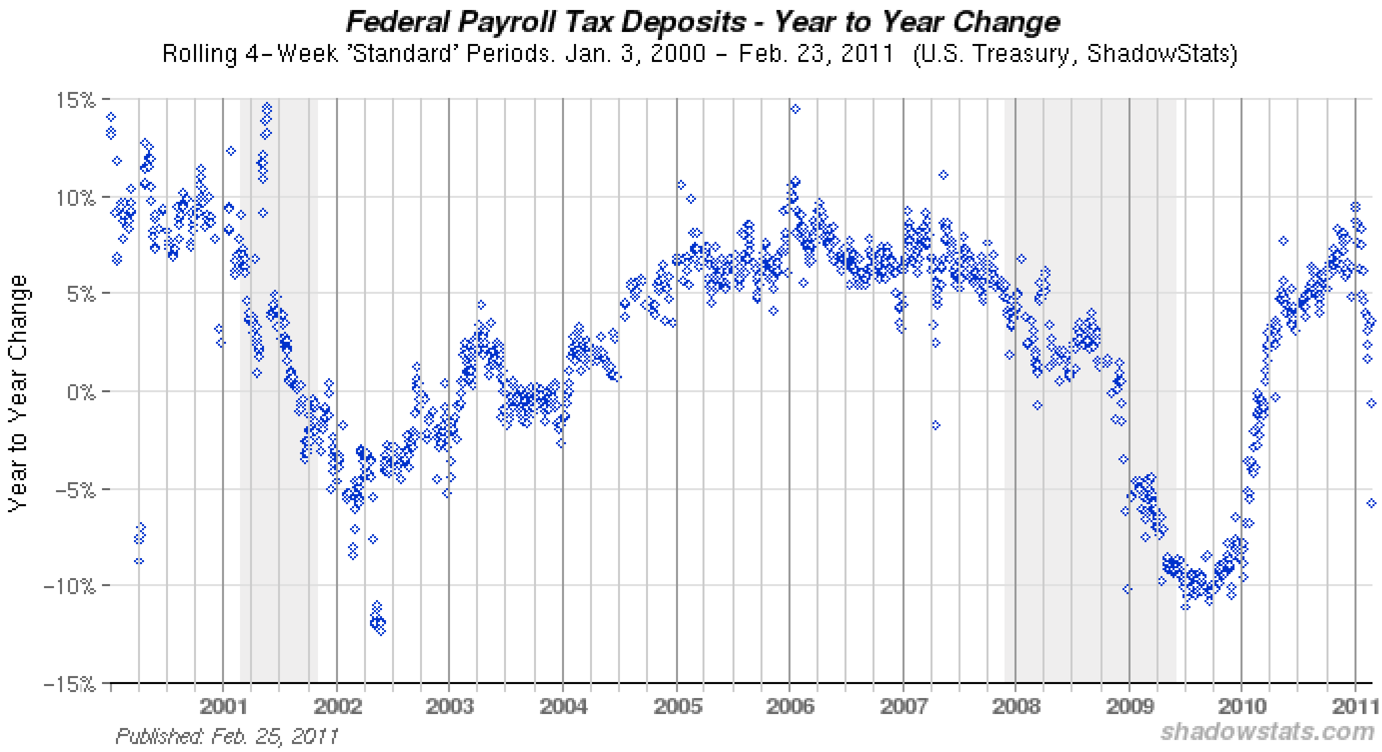
The complexity generally results from the tax deposits with U.S. Treasury being concentrated on days arising from interacting payroll calendar cycles and deposit schedules. This makes the significance of daily or weekly totals, and even their comparison with prior years, difficult. Further, since withholding tax is a non-linear function of wages, and there is a distribution of wages and personal tax situations across the population, conclusions about overall job and wage levels or growth cannot be reached easily.

Our contribution here has been to create a process for standardizing tax receipts during a four-week period – comparable with the four-week period the year before – enabling year-to-year comparison with some meaning. Further detail on this series and our approach will be posted on the SGS Web site in the next week, with subscribers being advised of that posting by e-mail.

The graph following reflects the raw standardized data, without any adjustment for seasonal variation. Formal recessions are marked by the shaded areas. Again, keep in mind that numbers are driven by employment, earnings and tax laws. The regular peaks in activity tend to be tied to the payment of year-end bonuses.



Year-to-Year Change in Payroll-Tax Receipts – Volatility Ahead of Sustained Impact from Lowered Social Security Withholdings. The next graph shows the year-to-year change in payroll-tax deposits at the U.S. Treasury, with the latest data showing a particularly sharp drop in the past week, extending a general trend of slowing or contracting annual growth in the last month. Individual data can be highly volatile, and not too much should be read into any individual data point. That said, an annual decline could be expected from this year's temporary two-percentage point cut in Social Security withholding taxes, and such should be affecting tax deposits soon, if it has not already started to do so. Also the effects of the relative timing and accounting strategies for year-end bonus payments, which have affected data of the last couple of months, also have a few weeks to play out. After that, it should be possible to extract some meaningful information on the developing trends for 2011 U.S. fiscal 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 x 1.01 x 1.01 x 1.01 = 1.0406 or 4.1%, instead of 4 x 1% = 4%.*

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

BEA's "Second" Guesstimate on Fourth-Quarter 2010 GDP Was Increasingly Flimsy. The downside revision to fourth-quarter GDP growth reflected slower growth in personal consumption and in spending by local governments than had been estimated in initial reporting. The trade deficit – as reflected in the net export account – actually narrowed, despite the extraordinary divergence between the GDP estimates and the trade deficit reporting as of December 2010. The December trade report suggested a much smaller quarterly improvement in the fourth-quarter trade deficit than was reflected in the GDP accounting (see *Commentary No 350*.)

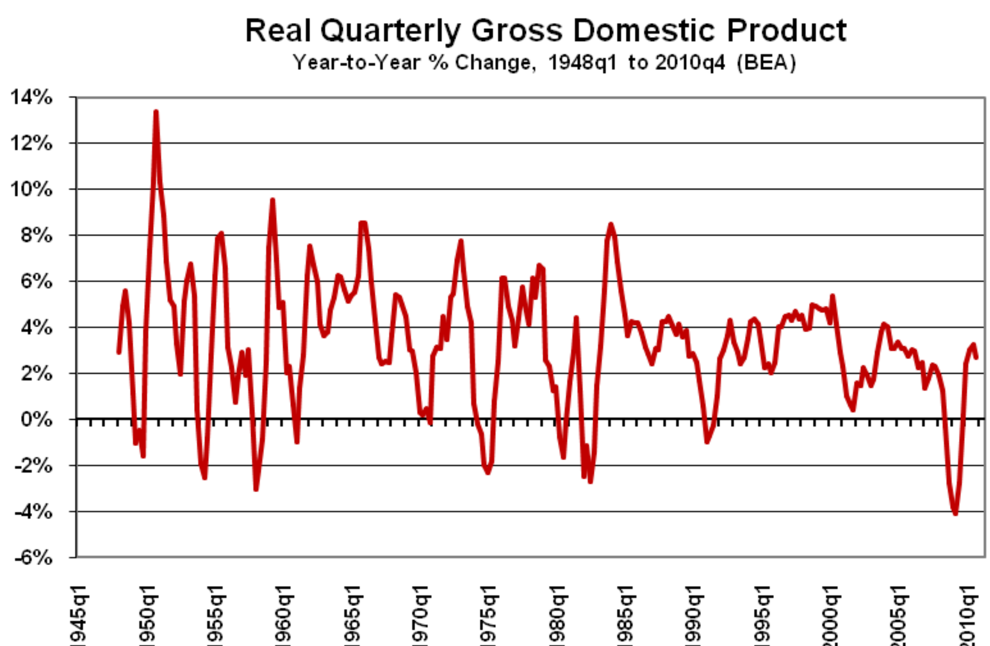
Of the 2.79% annualized real growth now estimated for fourth-quarter GDP, the purported improvement in the trade deficit accounted for 3.35 percentage points of growth (the GDP contracted net of the trade gains), while much slower growth reported for inventories knocked 3.70 percentage points off what otherwise would have been reported. Given the unreliability of these underlying series, current GDP is less meaningful than usual. This number will go through one more regular revision at the end of March, and then it will be subject to annual benchmark revisions in July, when economic history of the last couple of years will be revised, likely showing a much weaker economic environment than currently is perceived by the financial markets.

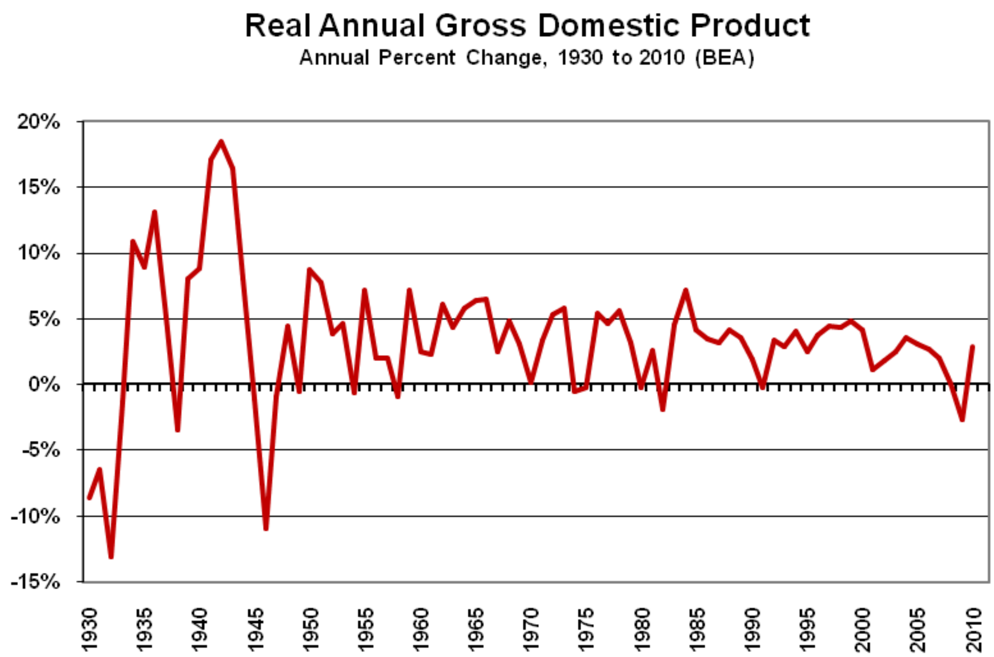
GDP -- The Detail. Published this morning, February 25th, by the Bureau of Economic Analysis (BEA), the "second" estimate (first revision) of real (inflation-adjusted) fourth-quarter 2010 Gross Domestic Product (GDP) annualized quarterly growth was 2.79% +/- 3% (95% confidence interval), down from an initial estimate of 3.17% but still marginally higher than the 2.56% growth estimated for the third-quarter. For the year, average 2010 GDP versus 2009 was revised to 2.83% (initially 2.86%), versus a 2.63% decline in 2009 against 2008, while year-to-year change in fourth-quarter 2010 over fourth-quarter 2009 was up by a revised 2.70% (initially 2.79%), higher than the 1.95% year-to-year gain in fourth-quarter 2009, but lower than the 3.25% seen in third-quarter 2010.

The fourth-quarter GDP implicit price deflator was estimated at a revised annualized pace of 0.38% (initially 0.26%), versus 2.03% annualized quarterly inflation for third-quarter 2010. In contrast, annualized seasonally-adjusted quarterly inflation for the CPI-U in the fourth-quarter spiked to a recently-revised seasonally-adjusted 2.62%, from 1.43% annualized inflation in the third-quarter (see *Commentary No. 353*). The lower the inflation rate used in deflating the GDP, the stronger is the resulting inflation-adjusted number and vice versa.

The SGS Alternate-GDP estimate for fourth-quarter 2010 remains an approximate annual contraction of 2.1% versus the official estimate of a 2.8% gain. Such is more negative than the alternate 1.4% annual contraction (3.2% official gain) in the third-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 still appears to have been realistic for the fourth-quarter, in what generally has been a protracted period of bottom-bouncing.

Reflecting the latest revisions, the following graphs show, first, year-to-year percent change in the official 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 second graph shows the average annual real growth by year for the history of the series. The record annual contraction there, following the World War II production shutdown, was 2.63% in 2009.





GNP and GDI. The initial estimates for fourth-quarter GNP (Gross National Product) and GDI (Gross Domestic Income) will not be published until the "third" estimate of fourth-quarter GDP on March 25th, since the actual data underlying these national income aggregate numbers remains of such little substance – sometimes educated and sometimes hopeful guesses – that the BEA recognizes these data would not be meaningful at present. What the markets and the financial media do not realize is that today's aggregated GDP report is as worthless as the aggregated GDI and GNP measures would have been had they been reported also.

January Durable Goods Bounced Higher Within Normal Series Volatility. The Census Bureau reported yesterday (February 24th) that the regularly-volatile, seasonally-adjusted new orders for durable goods rose by 2.7% (up by 5.0% before prior-period revisions) month-to-month in January 2011, after a revised 0.4% (previously 2.5%) decline in December. The monthly gain was more than accounted for by a sharp jump in irregular, long-term aircraft orders. Unadjusted, year-to-year change in total January new orders was a gain of 8.2%, up from the revised 7.7% (previously 6.2%) annual increase reported for December.

The widely followed nondefense capital goods orders rose by 4.6% (up by 8.0% before prior-period revisions) in January, versus a revised monthly decline of 3.4% (previously down by 6.3%) in December. For January, the unadjusted year-to-year growth in the series was 12.4%, up from a revised 9.3% (previously 6.2%) gain in December.

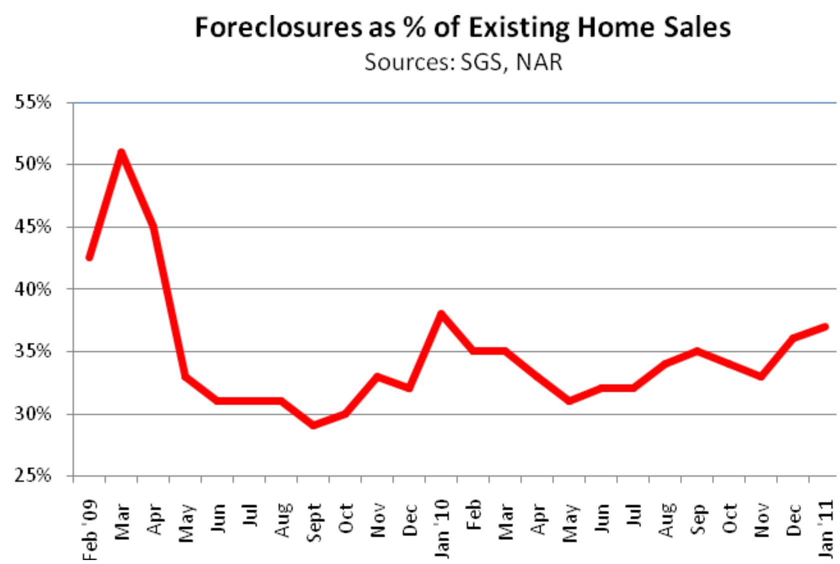
Home Sales Problems Mount. Both existing and new home sales continued a pattern of bottom-bouncing in early 2011, with distressed sales increasing.

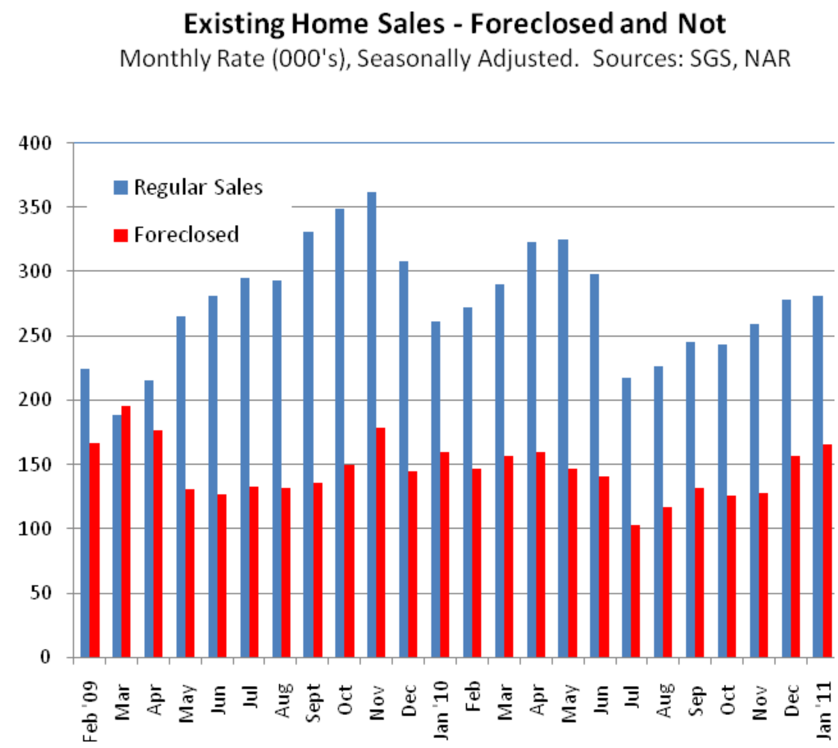
Yesterday's (February 24th) reporting of January new-home sales (counted based on contract signings, Census Bureau) showed a marginally, statistically-insignificant monthly decline of 12.6% (up 13.7% before prior period revisions) +/- 13.1% (95% confidence interval) from December. December’s revised level was up by 15.7% (previously 17.5%) from November. The year-to-year decline in new-home sales in January 2011 was a statistically-significant 18.6% +/- 18.0% (95% confidence interval), versus a revised 8.7% (previously 7.6%) decline in December.

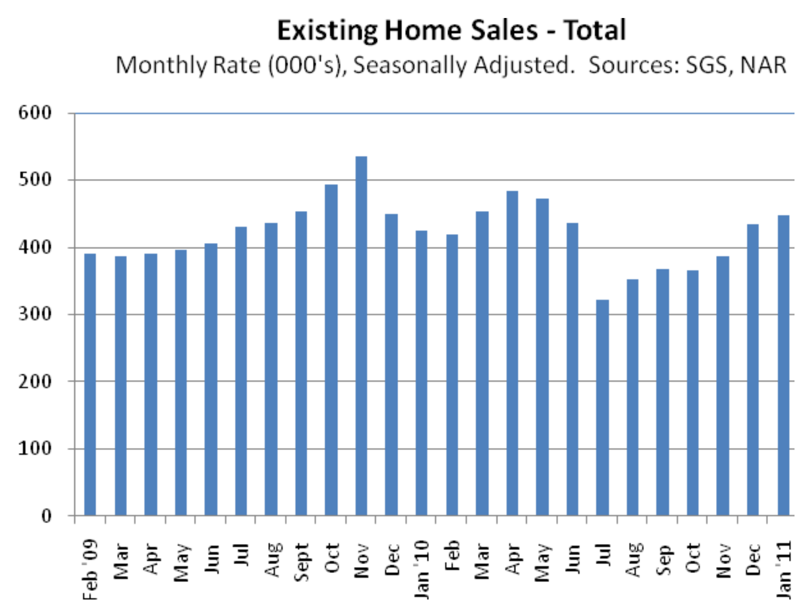
Wednesday’s (February 23rd) release of January existing-home sales (counted based on actual closings, National Association of Realtors [NAR]) showed a 2.7% monthly increase (a decline of 0.1% net of prior-period revisions), versus December’s revised 12.5% (previously 12.3%) increase. On a year-to-year basis, January sales were up by 5.3% from the year before.

Foreclosure activity remained a major distorting factor for home sales, with "distressed" activity accounting for an estimated 37% of existing sales in the NAR's January reporting, up from 36% in December.

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.




Existing Home Sales - Foreclosed and Not
Monthly Rate (000's), Seasonally Adjusted. Sources: SGS, NAR
Regular Sales
Foreclosed
400
350
300
250
200
150
100
50
0
Feb '09
Mar
Apr
May
Jun
Jul
Aug
Sept
Oct
Nov
Dec
Jan '10
Feb
Mar
Apr
May
Jun
Jul
Aug
Sep
Oct
Nov
Dec
Jan '11


Existing Home Sales - Total
Monthly Rate (000's), Seasonally Adjusted. Sources: SGS, NAR
600
500
400
300
200
100
0
Feb '09
Mar
Apr
May
Jun
Jul
Aug
Sept
Oct
Nov
Dec
Jan '10
Feb
Mar
Apr
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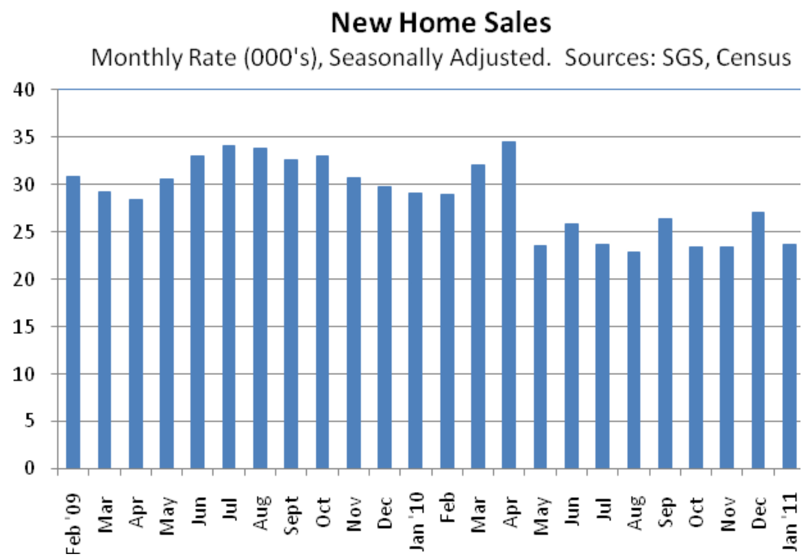
Sep
Oct
Nov
Dec
Jan '11



The preceding graphs reflect different measures of home sales activity since February 2009. The updated numbers, through January 2011, reflect the seasonally-adjusted level of monthly sales, rather than the annual rates usually published by the industry.

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.

Unemployment and Payroll Employment (February 2011). Detail on February labor conditions is due for release on Friday, March 4th. Briefing.com indicates consensus forecasts of a 172,000 gain in February payrolls, versus a 36,000 increase in January, with the headline U.3 unemployment rate rising to 9.1% from 9.0%. Once again, with economic activity generally below market expectations, the payroll employment growth likely will disappoint the consensus outlook (possible outright monthly contraction), and the unemployment rate is at risk of an upside jump to 9.4% or more, if seasonal factor distortions begin to reverse out.