

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

COMMENTARY NUMBER 386
GDP Revision, July Durable Goods Orders and New Home Sales

August 26, 2011

Revised Second-Quarter GDP Change Remained Statistically Insignificant
—Could Have Been a Contraction as Easily as a Gain

Money Supply M2 Surge Reflects Shift from Large M3 Accounts

PLEASE NOTE: The next regular Commentary is scheduled for Friday, September 2nd. It will cover the release of employment and unemployment data for August 2011. A Special Commentary would be published, as appropriate, in response to any unusual market or economic developments.

—Best to all, John Williams

Opening Comments and Executive Summary. The economic data of the last week held no real surprises, although the smallest variation against the consensus outlook often is hyped to move the broadly irrational U.S. stock market. The small decline in July new home sales and the gain in July new orders for durable goods were within the normal volatility of those series, and did not signal any change in the general economic outlook. The downside revision to the estimate of second-quarter GDP growth was no more than statistical noise in a generally worthless series.

There has been a pattern developing in the Federal Reserve's weekly money supply reporting, however, that is worthy of note, with surging M2 growth being reported in the Fed's now-broadest money measure.

The growth largely can be accounted for by an apparent flight from large time deposits and institutional money funds (officially ignored components of the Fed's once-broadest money measure, M3). The cash flows here are suggestive of concerns over banking-system solvency (see *Hyperinflation Watch*).

Indeed, the U.S. systemic-solvency and economic crises remain in broad deterioration, with banking-system solvency issues likely to drive the Federal Reserve into some form of QE3, soon, despite Fed Chairman Bernanke's qualified protestations to the contrary in today's (August 26th) speech. Any further liquefaction of the system, though, likely will be under the guise of propping a weakening economy.

The global financial markets remain unstable and highly volatile. The cautions of recent *Commentaries* remain in place, as do the general outlooks for the U.S. economy, inflation, systemic-solvency and dollar.

GDP Revision. The reported growth in the revised second-quarter 2011 GDP was statistically meaningless, as usual, with the 95% confidence interval around the reported growth easily encompassing a possible quarterly contraction. The revision itself was little more than statistical noise.

Annualized real (inflation-adjusted) quarterly growth in second-quarter GDP was lowered to 0.99% from 1.28%, versus an annualized growth rate of 0.36% in the first-quarter. Year-to-year growth slowed further to 1.55% (previously 1.62%), versus 2.24% reported for the first-quarter.

The downside revision reflected a weakening trade picture (see [Commentary No. 384](#)) and a downward revision to inventories, offset by an upside revision to healthcare and commercial construction. None of those components are measured meaningfully by the Bureau of Economic Analysis (BEA), in this most heavily followed, most heavily massaged and most worthless of government economic series.

Initial reporting of second-quarter gross national product (GNP) and gross domestic income (GDI) showed stronger annualized real quarterly growth rates than reported for the GDP. Neither alternate measure was statistically meaningful. Money flow distortions from the ongoing systemic-solvency crisis have boosted GNP, with revamped income estimates impacting GDI.

Hyperinflation Watch—Unusual Money Supply Activity. Just a month ago, the markets recoiled in revulsion and disbelief to the U.S. government's unwillingness and inability to address its long-term fiscal insolvency. In response, rapid flight was seen from the U.S. dollar into gold and the Swiss franc, although the Swiss National Bank moved fairly quickly to discourage the franc's safe-haven status, with jawboning and direct policy action. Such discouragement should prove to be short-lived.

At the same time, M2—the broadest money supply measure currently published by the Fed—exploded, with the average for the week-ended August 1st rising by \$159 billion from the week before, as the debt crisis was in its final resolution. Not seasonally adjusted, the gain was \$176 billion. The two-week gain (week-ended August 8th) was \$201 billion (\$252 billion unadjusted).

One advantage to looking at the broadest money measure available (formerly M3) is that it encompasses a broader view of the flows in the financial system than do narrower measures. The SGS-Ongoing M3 Estimate includes as components M2 (which includes M1), plus large time deposits and institutional money funds, which are published by the Fed on a weekly basis. Some monthly adjustment to the large time deposit numbers and estimates of also-included Eurodollar deposits and repos are modeled by SGS.

The surge in M2 did not reflect a sudden increase in the money supply; it largely reflected a shift out of M3 accounts to checking and savings accounts in M2 (and the included M1), which bloated the M2 reporting. Of the unusually large \$201 billion gain reported for two weeks of seasonally adjusted M2, roughly \$200 billion was accounted for in Fed reporting by declining former-M3 components, large time deposits (down about \$90 billion) and institutional money funds (down \$110 billion). The big move out of the M3 accounts likely was due to nervousness about banking-system solvency.

For the week-ended August 15th, the pace of weekly increase in M2 slowed to more-normal volatility (up \$5 billion for the week, adjusted, up \$20 billion unadjusted). Unless there is something startling in today's (August 26th) after-market release on bank assets and liabilities, the preceding data will be updated in the next regular *Commentary*.

The broad inflation and economic outlooks discussed in the [*Hyperinflation Special Report \(2011\)*](#) continue to unfold and are unchanged. As noted in recent *Commentaries*, the financial markets remain unstable and extremely volatile, roiled by crises of confidence in the U.S. dollar and in the long-term outlook for U.S. financial, economic, systemic and political stability. For those living in a U.S. dollar-denominated world, regardless of further near-term extreme volatility in the U.S. dollar—in either direction—versus the stronger major currencies and gold, the stronger currencies and precious metals remain the fundamental hedges against what lies ahead.

Massive, fundamental dollar dumping and dumping of dollar-denominated assets could start at anytime, with little or no further warning. With a U.S. government unwilling to balance or even address its uncontrollable fiscal condition; with the federal government and Federal Reserve standing ready to prevent a systemic collapse, so long as it is possible to print and spend whatever money is needed; and with the U.S. dollar at risk of losing its global reserve currency status; much higher inflation lies ahead, in a circumstance that rapidly could evolve into hyperinflation.

REPORTING DETAIL

GROSS DOMESTIC PRODUCT—GDP (Second-Quarter 2011, Second Estimate, First Revision)

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.

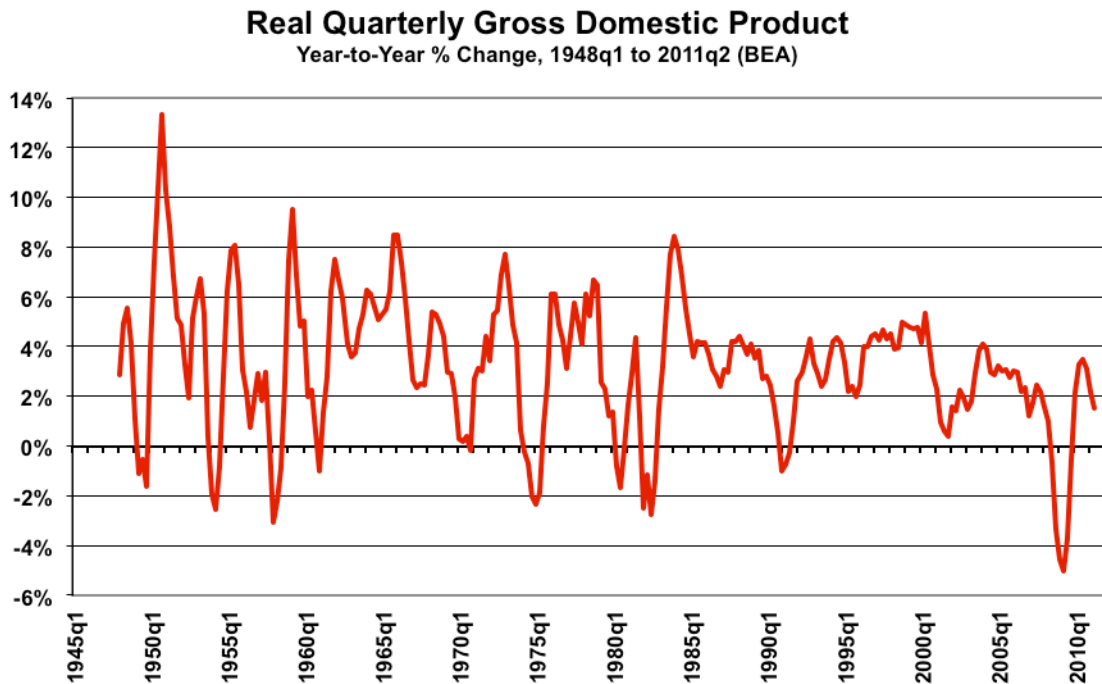
Quarterly growth, unless otherwise stated, is in terms of seasonally-adjusted, annualized quarter-to-quarter growth, i.e., the growth rate of one quarter over the prior quarter, raised to the fourth power, a compounded annual rate of growth. While some might annualize a quarterly growth rate by multiplying 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.

Reported GDP Growth Remained Statistically Indistinguishable from Contraction. As discussed in the *Opening Comments and Executive Summary*, the revised second-quarter GDP growth estimate remained statistically insignificant, while the revision itself was little more than statistical noise. The sharp deterioration in the reported June trade deficit was a major contributor to the downside revisions, as was a downside revision to inventories. Offsets from upside revisions to healthcare spending and commercial construction rounded out the revisions, but the Bureau of Economic Analysis (BEA) tracks none of these series accurately, at least in the first or second year following the initial estimates.

GDP. Published today, August 26th, by the BEA, the second-estimate or first-revision of second-quarter 2011 gross domestic product (GDP) showed annualized real quarterly growth of 0.99% (initially estimated at 1.28%) +/- 3% (95% confidence interval), versus an estimated annualized gain of 0.36% for first-quarter 2011. Not annualized, second-quarter GDP growth revised to 0.25% from 0.32%, up from 0.09% in the first-quarter. In this most worthless of major economic series, the reported annualized growth rates for the last two quarters are little more than statistical noise around the unchanged level. They possibly have been massaged to keep the quarterly growth rates in minimally-positive as opposed to minimally-negative territory.

Year-to-year real change in second-quarter 2011 GDP continued its slowing trend, up by a revised 1.55% (that rounds to 1.5%) versus initial reporting of 1.62%, and against 2.24% in the first-quarter. Such remained well off the near-term peak in reported growth of 3.51% in third-quarter 2010.



The estimate of the second-quarter GDP implicit price deflator was revised to 2.50% (initially at 2.39%), versus 2.73% in the first-quarter. In contrast, annualized seasonally-adjusted quarterly inflation for the CPI-U in the second-quarter eased to 4.09% from a seasonally-adjusted 5.22% in the first-quarter. The lower the inflation rate that is used in deflating the GDP, the stronger is the resulting inflation-adjusted number and vice versa. A slightly more realistic inflation number would have pushed the second-quarter GDP quarterly growth rate into negative territory.

The SGS Alternate-GDP estimate for second-quarter 2011 remains an approximate annual contraction of 2.8% versus the official revised estimate of a 1.5% gain. Such is more negative than the alternate 2.6% annual contraction (2.2% official gain) in the first-quarter (see the [Alternate Data](#) tab). While annualized real quarterly growth is not estimated formally on an alternative basis, a meaningful quarter-to-quarter contraction appears to have been realistic for the second-quarter, in what generally has been a protracted period of business bottom-bouncing.

GNP. GDP is Gross national product (GNP) net of international flows in factor income (dividend and interest payments). Although boosted by money flow distortions from the ongoing systemic-solvency

crisis, GNP growth still is statistically insignificant, with annualized real quarterly growth reported at 1.70% in the second-quarter, versus 1.45% in the first (0.42% versus 0.36%, not annualized).

GDI. Gross domestic income (GDI) is the theoretical income-side equivalent to the GDP's consumption-side. Reflecting revamped income reporting, the statistically-insignificant, annualized real quarterly growth in GDI was 1.55% in the second-quarter, versus 2.45% in the first (0.38% versus 0.61%, not annualized).

NEW ORDERS FOR DURABLE GOODS (JULY 2011)

Jump in July Durable Goods Orders Reflected Regular Volatility and Likely Ongoing Impact of Bad Seasonals. The Census Bureau reported August 24th that the regularly-volatile, seasonally-adjusted new orders for durable goods rose by 4.0% (up by 4.9% before prior-period revisions) month-to-month in July 2011, following a revised 1.3% (previously 2.1%) decline reported for June. July's monthly gain included a 43.4% surge in irregular, long-term nondefense aircraft orders, a category that showed a revised 24.0% (previously 28.9%) plunge in June. Airplane orders usually are placed years in advance of delivery and rarely impact near-term economic activity.

Unadjusted, year-to-year growth in total July 2011 new orders was 9.2%, versus a revised 7.9% (previously 7.4%) annual gain in June. Current durable goods reporting remains subject to many of the same sampling and seasonal-adjustment problems that are seen with retail sales and payroll reporting.

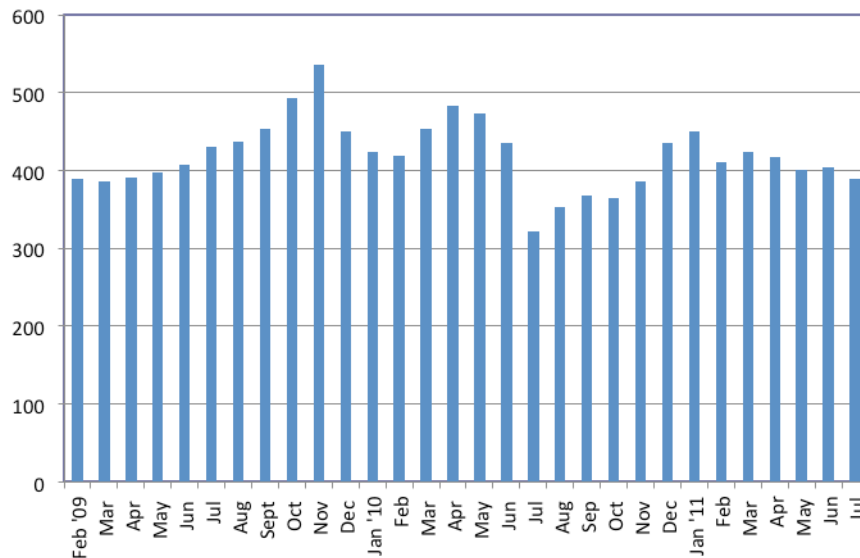
The widely followed nondefense capital goods orders increased by 2.4% (up by 4.2% before prior-period revisions) in July, versus a revised monthly 2.6% (previously 4.1%) decline in June. For July, the unadjusted year-to-year growth in the series was 12.5%, up from the revised 7.6% (previously 6.3%) annual growth estimated for June.

NEW HOME SALES (JULY 2011)

July New Home Sales Showed an Ongoing, Downtrending Bottom-Bounce. Consistent with the long-term negative trends in housing starts and existing home sales (See the prior [Commentary No. 385](#) for July details), the August 23rd release of July new-home sales (counted based on contract signings, Census Bureau) showed an ongoing pattern of bottom-bouncing near historic lows, with a statistically-insignificant monthly decline of 0.7% (down 4.5% before prior-period revisions) +/- 15.1% (95% confidence interval) from June. In turn, June's decline was revised to a 2.9% drop (previously down by 1.0%) versus May. The year-to-year gain in July 2011 new-home sales was a statistically-insignificant 6.8% +/- 14.7% (95% confidence interval). What previously had been reported as a 1.6% annual gain in June revised to a 2.3% annual contraction.

The high volatility in annual change remains due to the lapsing of stimulus effects a year ago. As with existing home sales, part of the new sales volume is due to foreclosure activity, but the Census Bureau does not provide an estimate of foreclosure volume.

Existing Home Sales - Total
Monthly Rate (000's), Seasonally Adjusted. Sources: SGS, NAR



Week Ahead. Though still not widely acknowledged, there is both an intensifying double-dip recession and a rapidly escalating inflation problem. Until such time as financial-market expectations fully catch up with underlying reality, reporting generally will continue to show higher-than-expected inflation and weaker-than-expected economic results in the month and months ahead. Generally, previously unreported economic weakness should show up in prior-period revisions.

Unemployment Rate and Payroll Employment (August 2011). Nonfarm payrolls and the unemployment rates for August 2011 are due for release on Friday, September 2nd, and this first major indicator of August economic activity likely will confirm deteriorating economic conditions. Data published in recent months have indicated slowing economic activity and generally have disappointed overly-optimistic consensus forecasts, except for July's numbers, where the "surprises" were slightly in a more-positive direction. That pattern of disappointed expectations likely will renew itself in August's reporting.

Payrolls remain at risk of showing an outright monthly contraction, with the unemployment rate notching higher. Also, as seen with last month's July numbers, any reporting in a more-positive direction likely would include a payroll contraction and higher unemployment rate within the 95% statistical reporting confidence intervals (+/- 129,000 for payroll change, +/- 0.2% for the unemployment rate). As has been the case for some time, unstable seasonal adjustments can distort the reported monthly changes in these series meaningfully.