

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

**No. 445: SPECIAL COMMENTARY**

**Review of Economic, Systemic-Solvency, Inflation, U.S. Dollar and Gold Circumstances**

**June 12, 2012**

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**Economic and Systemic Crises of 2007/2008 Continue**

**Don't Blame the Economy on Europe**

**Global Markets to Turn Against U.S. Dollar**

**Hyperinflation Outlook Updated**

**Gold Remains the Ultimate Hedge**

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*PLEASE NOTE: This Special Commentary updates and supplements [Hyperinflation 2012](#) of January 25, 2012. It also builds upon [Special Commentary No. 426](#), [Special Commentary No. 429](#) and intervening Commentaries that previously had updated the major economic and systemic-liquidity issues.*

*Best wishes to all — John Williams*

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## U.S. ECONOMIC, SYSTEMIC-STABILITY AND INFLATION REVIEW OVERVIEW

The U.S. economic and systemic-solvency crises, which began to unfold in 2006 and 2007, and which brought the domestic financial system to the brink of collapse in September 2008, still are playing out and still threaten systemic collapse. Coming into those crises, unsustainable and uncontrollable growth in the federal budget deficit already was threatening a hyperinflation in the United States by 2018.

The unfortunate reality remains that there were not then in 2008, and are not now in 2012, any quick or politically-easy fixes for the intertwined systemic-solvency, fiscal and economic woes. Bank problems largely have been papered over and propagandized or jawboned away, out of public sight, as much as is possible. Given the politicians that currently run the U.S. government, there is no chance of meaningfully addressing the deteriorating fiscal solvency issues currently dooming the U.S. dollar. On the economic front, structural income problems—inhibiting near-term improvement in business activity—are getting worse. Despite growing public, market and news-media recognition in the last several years of the intractability and severity of these underlying issues, common perception and understanding of the problems remains woefully shy of actual conditions. Ongoing numbers games played by politicians, the Fed, Wall Street hysteresis and elements of the news media, help to downplay the ongoing crises.

Crises-related actions taken by the Federal Reserve and the federal government in 2007 and after, and the systemic impact from the severe economic downturn, rapidly accelerated dollar selling and official efforts at dollar debasement. These issues also triggered massive deterioration in the government's already untenable fiscal circumstances, moving the likely outside timing for a U.S. hyperinflation to 2014 from 2018. The outside timing for the onset of a U.S. hyperinflationary great depression remains 2014 at this time, but the vulnerability today of the U.S. dollar to a massive sell-off leaves open the real prospect of dollar a panic at any time, a panic that could provide the start-up conditions for a hyperinflation.

For those living in a U.S. dollar-denominated world, physical gold remains the primary hedge against the ultimate dollar crisis, along with physical silver and assets outside the U.S. dollar and in stronger major currencies such as the Swiss franc, Australian dollar and Canadian dollar, as discussed in *Section I — Inflation, U.S. Dollar, Gold*.

**Hyperinflation Update—Great Financial Tempest Heads for Landfall.** I have been warning of a hyperinflation for at least seven years, but those warnings have been about a hyperinflation that was sometime in the future, generally in 2018 or 2014 timeframes mentioned above. Now, however, along with the passage of time, circumstances have evolved and are aligned for the hyperinflation to develop in the near future, specifically, within the next two years or so, by the end of 2014. Key developments, such as global loss of confidence in the U.S. dollar, and the dollar losing its safe-haven status, fell into place during 2011 (see *Section I – Inflation, U.S. Dollar, Gold*). The general outlook has not changed, but underlying circumstances continue to unfold and evolve. See [Hyperinflation 2012](#) for a discussion on hyperinflation in the United States and how that circumstance would be disruptive to the normal flow of domestic commerce, pushing the current near-depression environment into great-depression status.

**Why 2014?** While inflation is far from being out of control at the moment, the U.S. dollar is relatively strong, due to the euro crisis, that can change rapidly as global markets and domestic holders of the U.S. currency begin to flee the dollar, along with dumping dollar-denominated assets. Fiscal, systemic-solvency and economic conditions are deteriorating markedly, with a confluence of unstable circumstances likely to come to a head within the next year or so, placing extremely heavy selling pressure on the U.S. dollar and, before 2014, setting the stage for hyperinflation.

The damage to the U.S. financial system and to U.S. dollar credibility have been so severe in recent years, that countermeasures likely to be taken by authorities—such as currency intervention and/or restrictions on capital flows—should be short-lived and of limited impact. Those unstable circumstances—the looming dollar killers—include, but certainly are not limited to:

- Economic Deterioration. The U.S. economy is far weaker than commonly viewed—it never recovered from the 2006/2007-to-2009 plunge in activity—and has begun to show renewed deterioration in terms of already moribund consumer income growth. Official projections for the federal budget deficit, for U.S. Treasury funding needs and for the stability of the U.S. banking system under financial and economic stress, all are based on overly optimistic economic assumptions. Accordingly, unhappy surprises in these areas await the system.
- Rapidly Deteriorating Budget Deficit. Fundamental effects of the crises already have been seen in deteriorating funding conditions for Social Security and the annual budget deficit in general.
  - Coming into the economic and systemic crises, the cash-based federal budget deficit was running in the \$200 to \$300 billion range in 2005 and 2006, and the annual cash surplus then generated by Social Security—a regular annual prop to the aggregate cash-based results—was projected to continue until 2017 or 2018.
  - Reflecting the impact of the recession, Social Security cash flows began turning negative in 2010, seven or eight years ahead of schedule. Also reflecting the effects of the recession and the crises responses of the Fed and federal government, the annual cash-based federal deficit exploded, hitting \$1.3 trillion or above for each of the last three years, with annual GAAP-based deficits running at \$5 trillion or more.
  - Economic and political issues rapidly will expand the current federal budget deficit well beyond existing official projections or market expectations. In response, the global markets should turn on the U.S. dollar, with massive selling and dumping of dollar-denominated assets.
- GAAP-Based Budget Deficit/Government Obligations Worse Than Expected. Pending the results of court challenges, the Affordable Care Act (ACA) healthcare legislation likely will add more than \$10 trillion in unfunded liabilities (net present value) to the government's 2012 GAAP-based accounting, due for release in December 2012. That, plus consideration of accounting for Freddie Mac and Fannie Mae and otherwise normal annual transactions, could push the reporting of total GAAP-Based U.S. obligations—including gross federal debt and net present value of unfunded liabilities—from \$80 trillion in 2011, into the \$120 trillion range for 2012, or roughly eight-times the level of U.S. GDP.

- In terms of the backing for major Western currencies, U.S. fiscal conditions are the worst, by far, as best I have been able to determine. Varying estimates have been made of the obligations and unfunded liabilities of some other major Western countries and the euro currency block—all have problems—but consistent GAAP-based numbers simply are not available. In terms of severity of fiscal impairment, the United Kingdom and Japan appear to be next in line, following the United States. An analysis here of the limited published estimates will be covered in a future *Special Commentary*.
- Renewed Federal Reserve Accommodation, Debt Monetization. Flight from the dollar is likely when the Federal Reserve moves once again to support the still-troubled banking system with new liquidity or “easing” measures. The global markets view such actions as highly inflationary and as direct efforts at debasing the U.S. dollar. For example, some flurry of speculation was seen in the last week or so as gold rallied sharply and briefly, amidst speculation of possible new Fed easing, following the weaker-than-expected May jobs report. The Fed easing will come, but as a prop to the banks, not to the economy, although the action politically will be touted and explained as an effort to stimulate the economy.
  - For the duration of the Fed’s second round of quantitative easing (QE2), the U.S. central bank effectively monetized all U.S. Treasury debt issued for public consumption. The process not only weakened the U.S. dollar, spiking oil prices and related domestic inflation, but it also provided a boost to the broad money supply (M3).
  - In the likely circumstance of the potential for a failed auction of U.S. Treasuries, or in the circumstance of massive dumping of foreign and/or domestically held U.S. Treasuries, the Fed probably would opt for monetization of Treasury debt, as opposed to allowing a crash of the financial markets and a potential systemic collapse. The precedent for such monetization has been set.
- Explosive Growth in Treasury Funding Needs; Troubled Auctions. With the budget deficit deteriorating beyond expectations, cash funding needs for U.S. government operations would expand beyond current projections. That circumstance has the potential for destabilizing the domestic financial markets and for setting up a possible failed auction, as discussed in the previous comments on Federal Reserve accommodation.
- Renewed Threat of Systemic Collapse. A major risk that also remains in play—likely coincident with some combination of the above circumstances—would be the movement of the U.S. financial system, again, to the brink of collapse. As before, the federal government and Federal Reserve would do everything within their powers to prevent such an event, creating, spending and lending whatever money was needed, and guaranteeing whatever assets had to be back. As seen in 2008, the Fed’s actions likely would be similar, and would extend—out of necessity—to contain the threat of a global systemic collapse. Such would be subject, of course, to continuing, though increasingly reluctant support of the U.S. dollar in the global markets.
- Euro Crisis Resolution. Separately, at such time as the euro crisis is resolved—whether the solution is dissolution of the monetary union, a true fiscal union of the involved sovereign states, or something in between—the strongest players in the current currency union (such as Germany and the Netherlands) still will remain the strongest players in whatever circumstance follows. In

the view of the global markets the stronger surviving euro entities likely will not be facing the debilitating sovereign solvency issues savaging what always have been the weaker euro players and the United States. Accordingly, global concerns should shift again, focusing on the proverbial elephant in the bathtub of sovereign solvency risk: the U.S. dollar.

- Surprises. Always out there are surprise economic statistics and unexpected political, market or systemic developments that suddenly can tip the currency markets in a new direction.
- Loss of U.S. Dollar Reserve Status. As global dollar holders move to dump the U.S. currency and dollar-denominated paper assets, an early victim of intensifying flight from the dollar likely would be the U.S. dollar's status as the world's primary reserve currency. Loss of reserve status likely would be close to, or coincident with, other instabilities, exacerbating any dollar crisis. By itself, it could trigger a dollar crash. A strongly related area is the pricing of key commodities, particularly oil, in U.S. dollars. A move to price oil in terms of something other than the dollar would be highly inflationary for the United States, in the likely circumstance of an accompanying decline in the exchange rate of the U.S. currency.

A confluence of debilitating economic, fiscal, political and systemic-solvency issues threaten to collapse the U.S. dollar and to lay the foundation of domestic hyperinflation in the not-too-distant future. The major sections ahead will review current conditions for those underlying fundamentals.

***Broad Outlook Has Not Changed, as Hyperinflation Crisis Continues to Unfold with the Passage of Time.*** The updating of concerns mentioned above largely reflects the ongoing evolution and unfolding of underlying factors that move the system ever closer to the ultimate dollar crisis. The big issues generally remain as they were discussed in [Hyperinflation 2012](#); the broad underlying picture has not changed. Supplemented by this *Special Commentary*, *Hyperinflation 2012* remains the latest full version of the hyperinflation story, which basically is the same story told in prior years' versions (accessible from links in the current report). The unavoidable big change, of course, is the passage of time and the nearing of the event horizon, beyond which the hyperinflation cannot be escaped. In all likelihood, the event horizon already has been passed; that circumstance just has not been recognized, yet.

***When The U.S. Sneezes The Rest of The World Catches A Cold?*** In the post-World War II era, the United States has dominated the world with its economic, military and political might. Supporting that has been the "Almighty Dollar," but circumstances have been shifting in recent decades. With "the dollar does not matter" outlook of most administrations and the Federal Reserve, the trade-weighted dollar has lost half of its strength since the mid-1980s. Ahead lies the prospect of the U.S. currency losing virtually all of its value in a very short period of time.

Out of necessity, the rest of the world will have to break with the dollar, including using the dollar as a reserve currency. Countries such as China, which tend to tie their currency to the dollar, will let their currencies float or face the importation of significant inflation. Other than dollarized countries, though, the initial hyperinflation problem should be contained to the United States. On the economic front, however, as U.S. economic activity plunges anew, a significant global recession would be unavoidable. These issues are discussed further in [Hyperinflation 2012](#).



**Systemic-Solvency Crisis.** Initially, the U.S. Treasury and the Federal Reserve moved to prevent systemic collapse in 2008 by creating, spending and lending whatever money was needed, or otherwise by guaranteeing whatever assets were at risk. While the system gave the appearance of having been stabilized, the U.S. banking industry has remained dysfunctional, with ongoing solvency issues having been papered over by accounting, disclosure and reporting gimmicks, along with a tremendous amount of unfounded positive hype from Wall Street and from officials in Washington, D.C.

Continuing solvency issues in the U.S. banking system are evident not only from ongoing impaired lending activity, but also by a renewed faltering in broad money supply growth, as discussed in *Section II — Systemic Liquidity*. “Stress tests” for the banking system have been based on overly optimistic and artificially limited assumptions.

The Fed’s various accommodations or “easings” have been undertaken primarily to help prop up the banking system, but the cover story of economic stimulus has been used for political reasons with a public not much enamored of bailing out banks. There is little the Fed can do at the moment to stimulate broad economic activity or to contain inflation. Further accommodation by the Fed for the banking system should be needed soon, but again it likely will be under the cover of “economic stimulus.”

**Economic Crisis.** From 2006 into 2009, U.S. economic activity plunged at a pace not seen since the early days of the Great Depression, and business activity never recovered. The purported economic recovery in place since mid-2009 has been just an illusion created by the use of too-low inflation numbers in calculating the government’s headline GDP estimates. As discussed and graphed in *Section IV — Economic Conditions*, the economy has remained stagnant, at a low level of activity, ever since 2009. Now, indications of renewed downturn are surfacing in official reporting.

The massive economic downturn had been looming for decades, as consumer income increasingly became structurally impaired, unable to keep up with CPI inflation, let alone with realistic estimates of inflation. During his term as Federal Reserve chairman, Alan Greenspan did his best to encourage excessive debt expansion. He realized that if the U.S. consumer lacked sustainable real (inflation-adjusted) income growth, then there could not be sustained growth in the consumer-dependent U.S. economy, unless the consumer’s need to cover the shortfall in living standards could be met by ever-expanding debt.

The attitude at the Fed, as well as within the federal government, was that neither the U.S. dollar nor the federal budget deficit mattered, politically. Excessive debt growth was encouraged at all levels of the economy. Leverage was built upon leverage, and debt growth was accelerated by the creation of new financial instruments that packaged lending risks (such as mortgages) into investment vehicles for both U.S. and rest-of-world institutional investors.

The consumer’s structural liquidity issues, however, began to take their toll on the U.S. housing industry in 2006, which triggered problems with the mortgage market, and a crisis for mortgage backed securities and other collateralized debt obligations. The weakening economy triggered the credit crisis, and the ensuing credit collapse exacerbated the economic plunge.

With post-collapse consumer income growth still unable to keep pace with inflation, and with the consumer unable to expand debt, as before, to compensate for lack of income growth, prospects for a near-term economic recovery remain nil, as discussed in *Section III — Consumer Liquidity*.

***Finger Pointing and Misdirection.*** Recognizing that the economy still is in trouble—not recovered—and that consumers very much will be voting pocketbook issues in this presidential election year of 2012, politicians, incumbent and otherwise, already are pointing fingers in various directions—always away from themselves—attempting to dodge responsibility for the ongoing negative economic news. As discussed in [Commentary No. 442](#), pocketbook issues can determine elections. In the last twenty presidential elections—as far back as consistent income data are available—years in which annual real disposable personal income growth was below 3.0%, the incumbent party always lost the White House. Reported real annual growth in 2012 disposable income likely will not top 1.0% and even could be negative for the year.

With election concerns mounting, the crisis in the euro-area has become particularly popular as a scapegoat for U.S. economic woes, where the fault would be outside the control of U.S. policymakers. The effects of euro-area improprieties supposedly have countered otherwise successful stimulus and jobs creating programs put forth by the current government, potentially pushing the U.S. into a new recession. Those claims are nonsense.

The cause of the ongoing economic crisis in the United States, a crisis that has not responded meaningfully to short-lived stimulus gimmicks, lies in decades of shortsighted, self-serving, special-interest policies put forth by the federal government (both sides of the aisle) and the Federal Reserve. For example, various trade policies and government regulations—that drove higher-paying production jobs offshore—largely have been responsible for declining real household income.

As to the euro, a recession in Europe has not touched the U.S. economy meaningfully, so far. In the latest trade data, for the four months through April 2012, the U.S. deficit with the euro-area widened by 11.3% versus the same period in 2011, indeed, an economic negative for the United States. How a euro-area recession could damage the U.S. economy, though, would be through reduced consumption and imports, where U.S. exports to the euro-area would decline. Instead, U.S. exports to the euro-area were up by 1.6% in the four-month period. It was, instead, a 4.5% jump in U.S. imports from the euro-area—reflecting the still-increasing inability of the U.S. to produce the goods it consumes—that accounted for the widening deficit and any euro-area trade hit on the U.S. economy.

The euro-area has turned out to be a favorite whipping boy for Wall Street and Washington, where the euro also has been used as a foil in distracting global attention from the even more severe sovereign-solvency issues facing the U.S. dollar. It also is worth remembering that what became a global financial crisis—tearing the Western financial system asunder—had its roots primary in the United States among the financial geniuses on Wall Street and in the global banking system.

***Official Recovery in U.S. GDP Is An Illusion Created by Underestimated Inflation.*** As discussed above, in recent *Commentaries*, and as detailed in [Hyperinflation 2012](#) and updated in *Section IV — Economic Conditions*, the bulk of the recovery reported in U.S. GDP activity is an illusion tied to the use of understated inflation. When too-low inflation is used in deflating a series from nominal (not-adjusted-for inflation) conditions to the resulting real (adjusted-for-inflation) series, real growth is overstated.

Series that have no ties to inflation calculations (such as payrolls and housing starts) tend to show the pattern of a plunge in economic activity from 2006/2007 into 2009, followed by low-level stagnation or no recovery up to present day. If the deflating inflation-rates are corrected in the GDP, the pattern of economic plunge and ensuing stagnation is seen as well.



## Section I — INFLATION, U.S. DOLLAR, GOLD

**Fundamentals Remain Strongly Against the Dollar.** Underlying fundamentals that influence one currency's relative valuation against another usually include, but are not limited to, the areas detailed in *Table 1*.

**Table 1: Underlying Fundamentals versus U.S. Dollar**

### Underlying Fundamentals versus U.S. Dollar

Fundamental	Relative Condition	Near-Term Trend	Impact on USD	
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Trade Balance	Severe Deficit	Deterioration	Negative	
Interest Rates	Extreme Low	Neutral	Negative	(1)
Economic Growth	No Recovery / Low	Deterioration	Negative	(2)
Inflation	High	Improvement	Neutral	(3)
Financial-System Stability	Low	Deterioration	Negative	(4)
Political Stability	Low	Deterioration	Negative	(4)
Fiscal Condition	Extreme Instability	Deterioration	Negative	(5)

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(1) Basically at zero.

(2) Not fully recognized in the markets.

(3) Renewed deterioration pending.

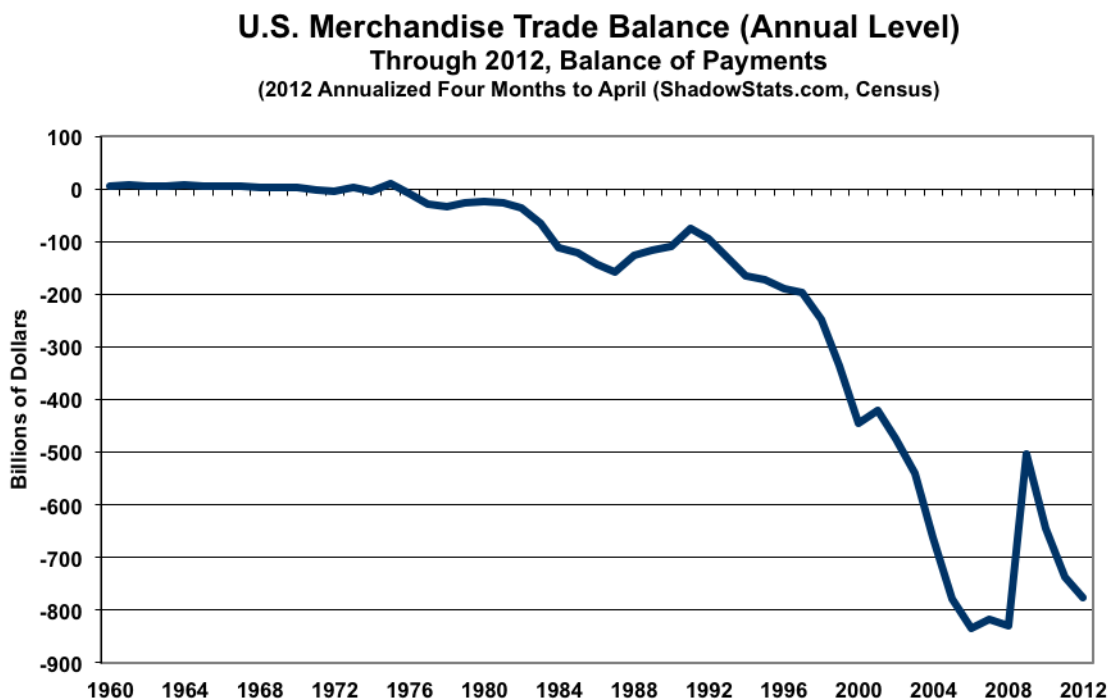
(4) Euro-area concerns temporarily dominating global attention.

(5) U.S. GAAP based-deficit and obligations are the worst of major Western countries.

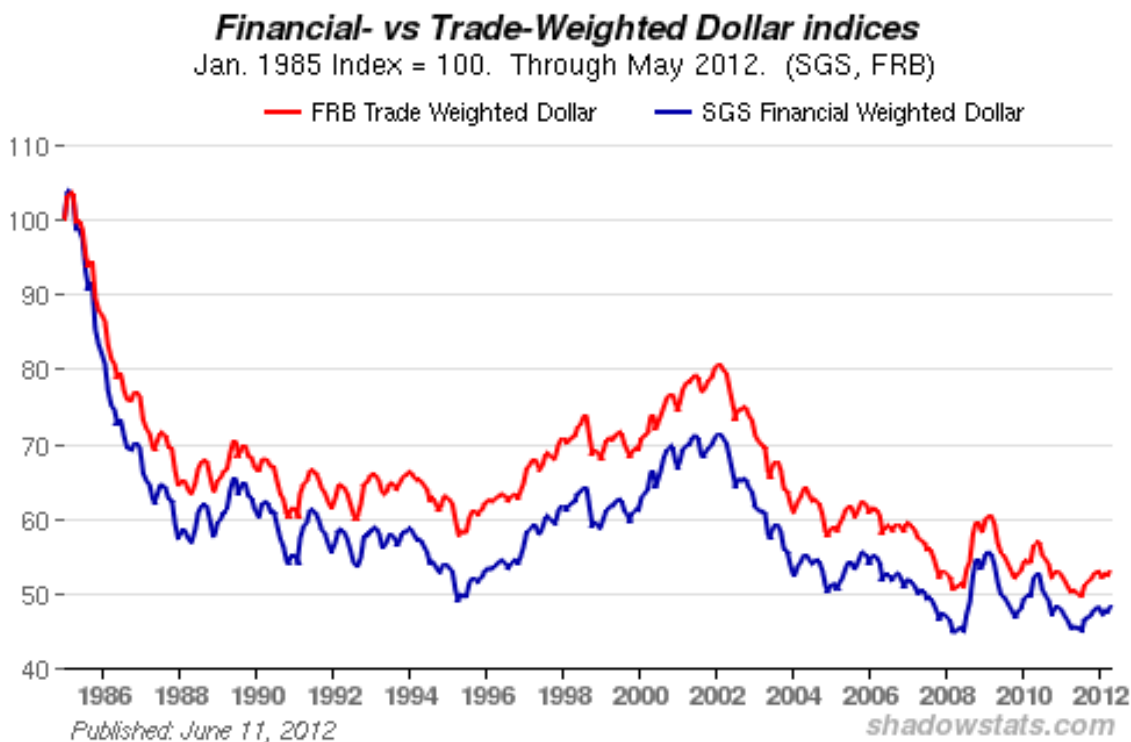
Underlying fundamentals could not be much weaker for the U.S. dollar, against other major Western currencies. The U.S. trade deficit is near its extreme and deteriorating (see *Graph 1: U.S. Merchandise Trade Deficit*). U.S. interest rates could not be lower. Although not fully recognized by the markets, economic activity is low and deteriorating. On the plus-side, inflation will appear relatively tame in May reporting, thanks to a temporary decline in gasoline prices. Financial-system stability and political stability both are issues, and fiscal conditions are horrendous and getting worse.

Yet, the U.S. dollar is enjoying some near-term strength, as seen on both a trade- and financial-weighted basis (*Graph 2: U.S. Dollar Indices*). This is due to the crisis in the euro area, which temporarily has spiked the dollar relative to the euro. The euro is second only to the dominant U.S. dollar in global financial transactions, and the sovereign-solvency issues besetting the euro area temporarily have masked the fundamental weakness in the dollar.

**Graph 1: U.S. Merchandise Trade Deficit**



**Graph 2: U.S. Dollar Indices, Financial- versus Trade-Weighted**



As discussed in [Hyperinflation 2012](#), in 2011 the U.S. currency not only lost its primary role as a safe-haven currency, but also global confidence in the dollar appeared to collapse, following the budget-deficit-negotiations fiasco and the Fed's earlier monetization of U.S. Treasury debt.

The fundamental issues against the dollar remain in place, while the distractions of the euro crisis should prove to be short-lived, either because there is some euro-area resolution, or the Federal Reserve or federal government takes egregious-enough actions to refocus global concerns on the United States. As discussed in the *Overview*, developments are likely in both areas.

**Euro.** From the euro standpoint, the currency union always has been dominated by Germany, and Germany most likely will determine the currency's ultimate fate. I would bet against euro area countries relinquishing sovereign authority over financial or other matters, which suggests a currency break-up.

However the circumstance evolves, whatever currency structure results, the surviving entity that ends up encompassing the German mark—including a standalone mark—should end up a strong currency relative to the dollar. At the same time, the Swiss franc likely will be freed from its self-imposed euro constraints.

Despite politically popular comments aimed at salving concerns of domestic exporters, traditionally both Germany and Switzerland have enjoyed the benefits of having a strong currency. A strong currency usually reflects strong trade surpluses, prudent fiscal policies and a stable government. Wealth creation is common to those circumstances as well. *Graph 3: Gold versus Swiss Franc* presents a fair idea of the long-term trend in Swiss currency versus the U.S. dollar. In contrast, the United States deliberately has run extreme deficits in both its trade and fiscal operations, destroying wealth and ultimately destroying its currency.

**Federal Reserve's Quandry.** The Fed's primary mission is to keep the banking system solvent and afloat. While the system has not failed, yet, it has not improved enough since 2008 to be considered stable. As discussed in *Section II: Systemic Liquidity*, a variety of factors suggest mounting stress again in the banking system. All the Fed's crisis easings have been aimed at propping up the banks; boosting economic activity is only a secondary concern. Rates at or near zero are negative for business activity.

With renewed stress and stability threats to the bank system from the economy, the Fed will need to "ease" again soon. Mr. Bernanke realizes that his QE3—likely to be touted as an economic stimulus—very easily could trigger massive dollar selling and rapidly rising inflation, as oil prices soar anew.

Faced with a devil's choice of letting the banking system fail or triggering a serious currency/inflation problem, I would bet on the Fed trying to save the banks. The dollar does not matter, anyway, per Fed tradition of recent years.

Of course the dollar matters, and so too does the deficit, but the eventual day of reckoning is near, and there appears to be no one in the Fed or the current government willing to tackle the problems. There simply are no easy solutions available.

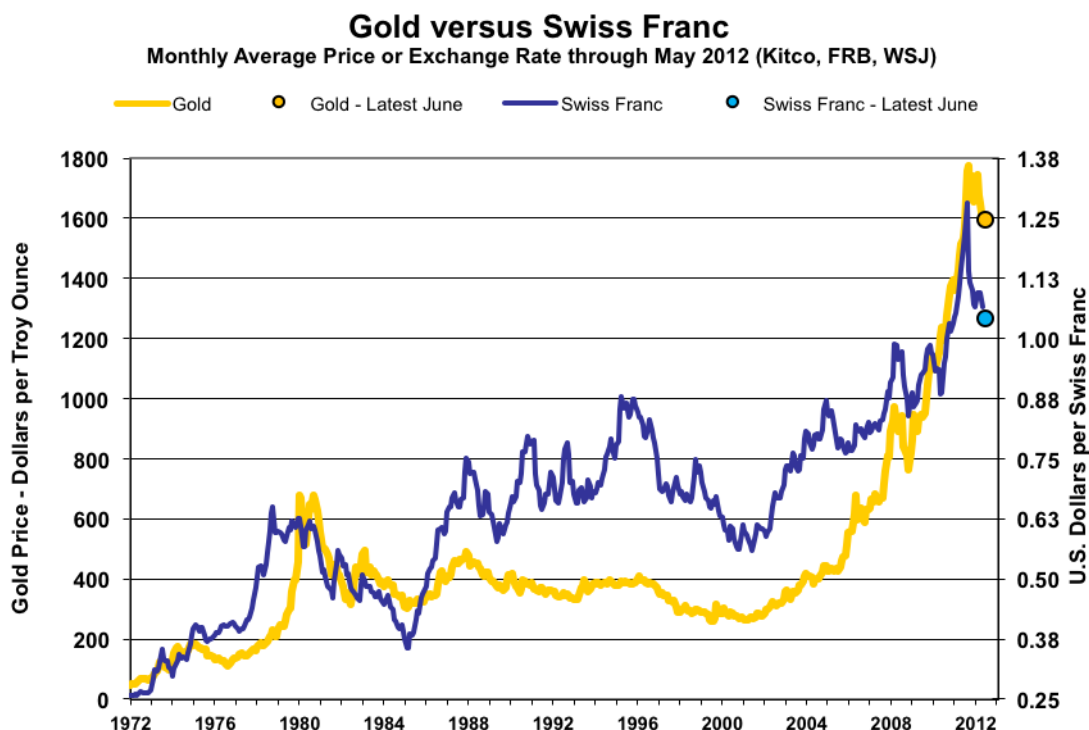
**Gold Remains the Ultimate Hedge As A Store of Wealth.** For those living in a U.S. dollar-denominated world, physical gold remains the primary hedge against the ultimate dollar crisis, along with physical silver and assets outside the U.S. dollar in stronger major currencies, such as the Swiss franc, Australian dollar and Canadian dollar.

In this circumstance, it never is too early to move to protect the purchasing power of one's wealth and assets against the nearing dollar tempest. The prices of precious metals and currency values will remain volatile and become increasingly unstable as the ultimate currency crisis breaks. Over the long haul, though, gold will remain the primary hedge against lost purchasing power. Whether gold is purchased at \$500, \$1,500 or \$5,000 per ounce, the upside potential effectively is unlimited against the U.S. dollar in a hyperinflation. Whether prices hit \$10,000, \$100,000 per ounce or much higher, it is important to remember that any apparent "profits" in dollar terms largely are no more than a reflection of the preserved purchasing power of the dollars initially invested in gold.

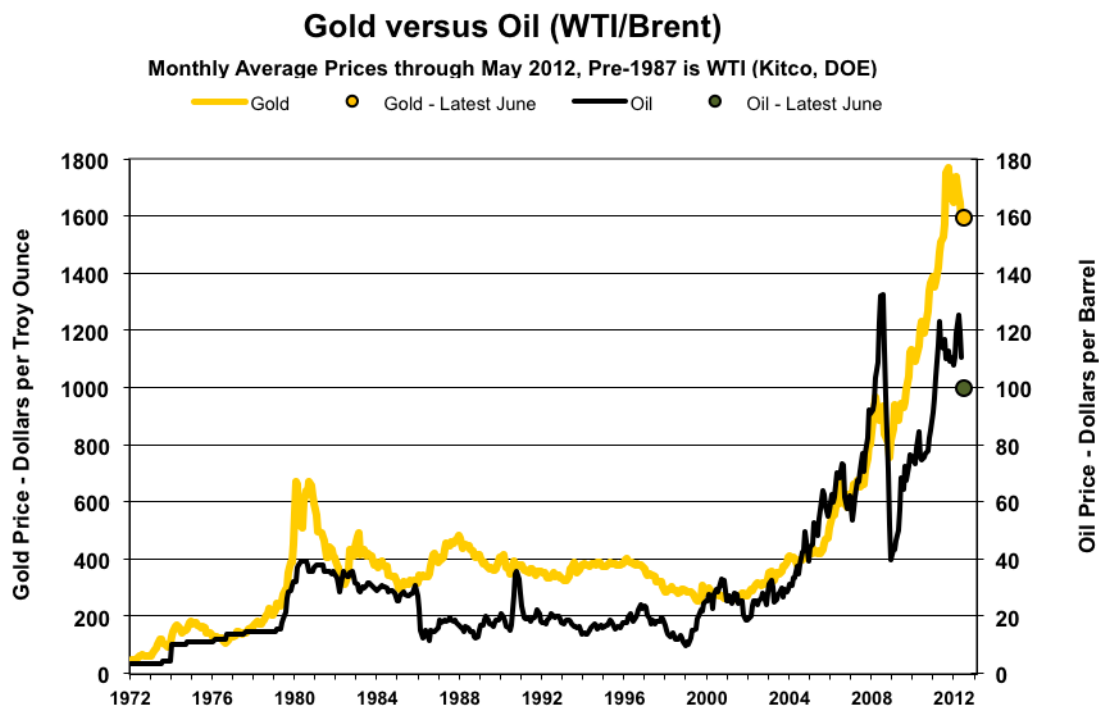
Following are the regular graphs of gold versus the Swiss franc, oil and silver. Much of the recent downturn in prices here for gold, silver, oil and the Swiss franc, is due to U.S. dollar strength versus the euro. That circumstance should be relatively short-lived.

On the currency front, through direct intervention by the Swiss, the Swiss franc has been tied temporarily to the euro and dragged down artificially in value against the U.S. dollar. Direct intervention usually is expensive and a difficult effort against market fundamentals, which almost always win out.

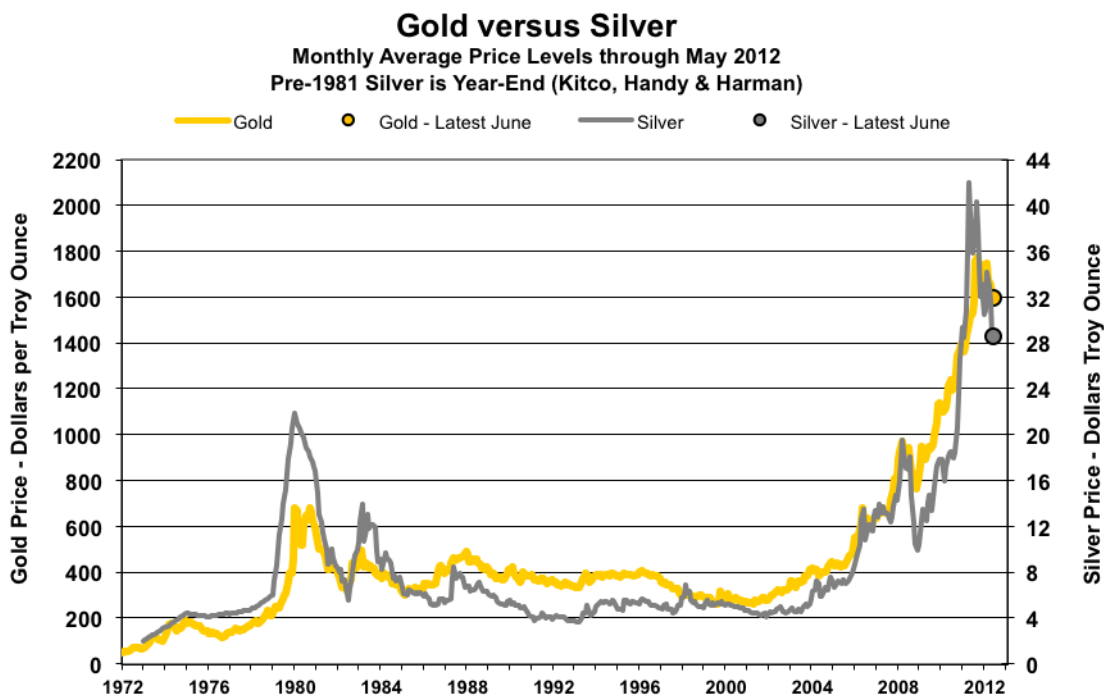
**Graph 3: Gold versus Swiss Franc**



**Graph 4: Gold versus Oil**



**Graph 5: Gold versus Silver**

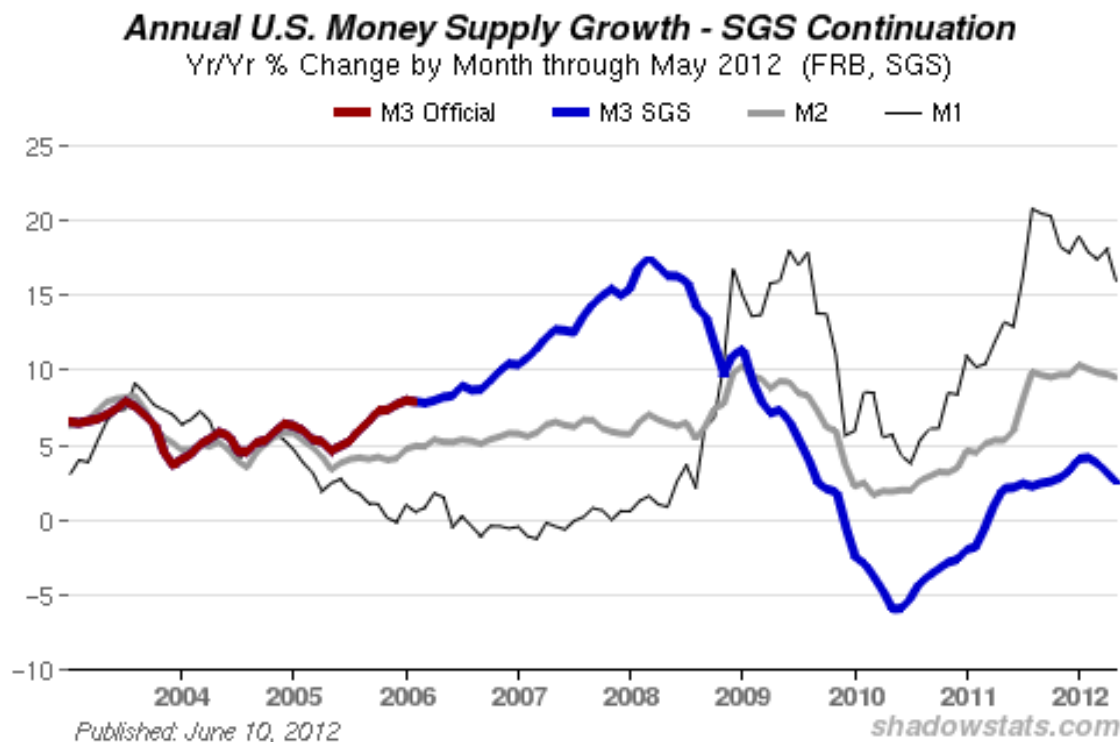


## Section II — SYSTEMIC LIQUIDITY

**Money Supply Shows Signs of Mounting Systemic Stress.** Coming into the 2008 systemic crisis, and in the months and years that have followed, stress in the banking system has been signaled by declining patterns of growth in the broad money supply M3 (SGS Continuation), particularly in the context of massive funds pumped into banks and the related monetary base by the Federal Reserve. In turn, some form of accommodative Fed action often has followed.

As shown in *Graph 6: Year-to-Year Money Supply Growth*, M3 growth has turned down anew in the last several months, suggestive of increasing banking-system stress.

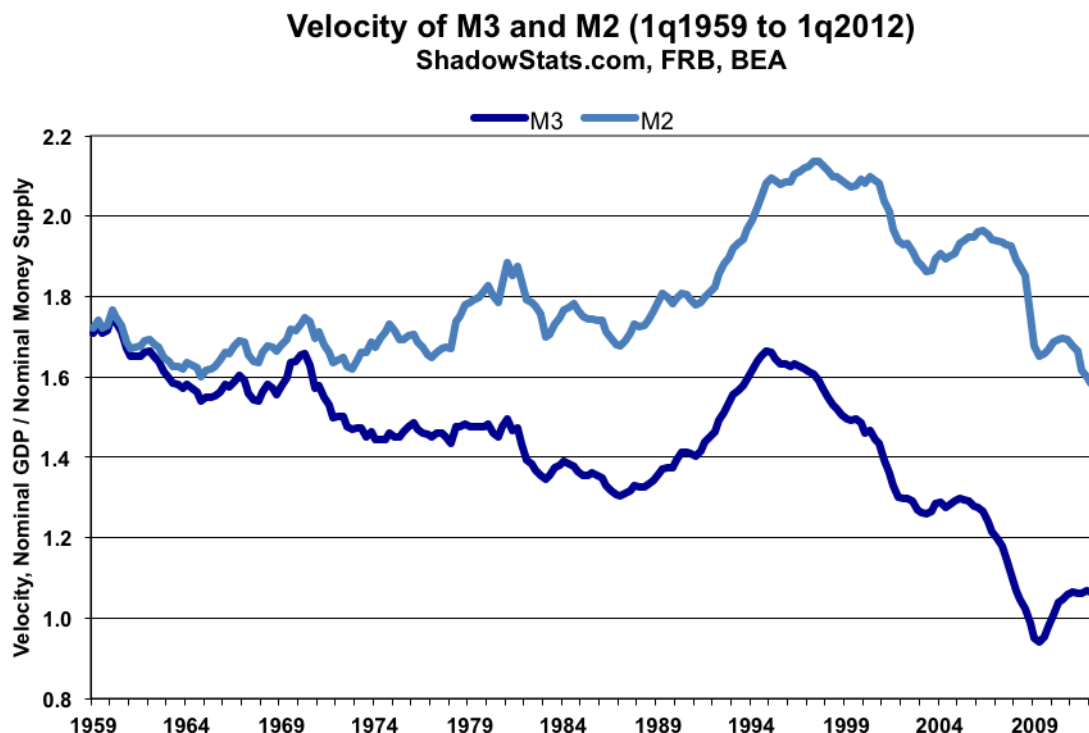
**Graph 6: Year-to-Year Money Supply Growth**



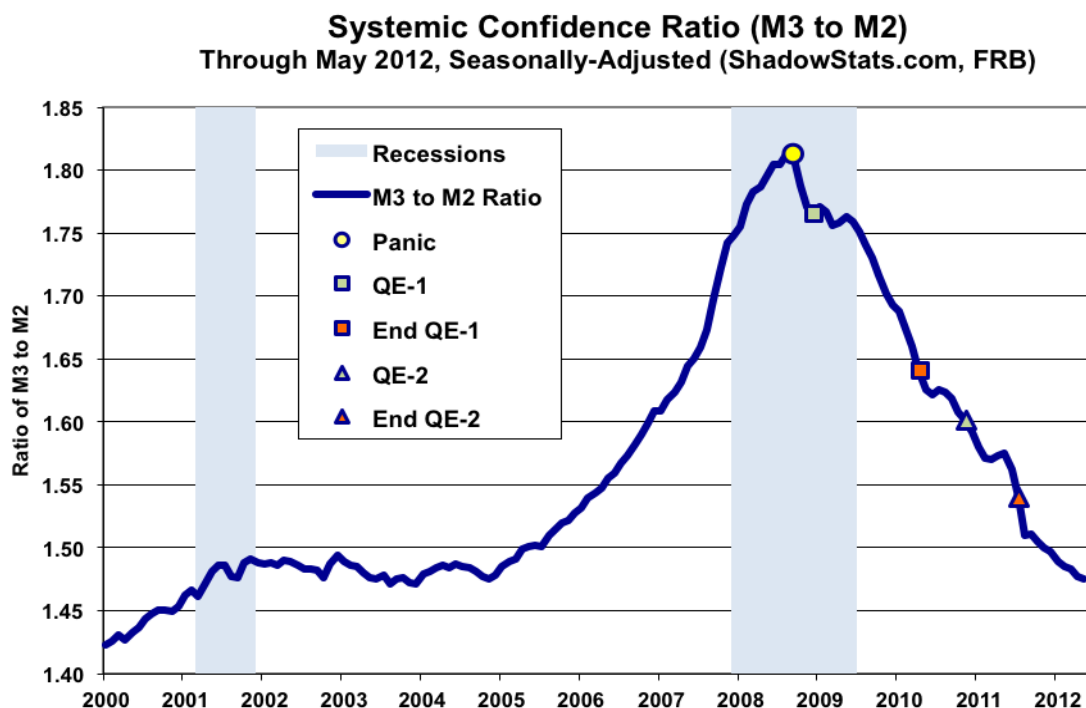
As noted in [Commentary No. 435](#), the broader M3 measure incorporates M2, which, in turn, incorporates M1. Recent stronger growth in M2 was nothing more than the flow of cash out of M3 accounts, such as institutional money funds and large time deposits, into M1 and M2 accounts. As a result, a downturn noted by some in the velocity of M2 (how many times the money supply turns over in a year versus the GDP) actually was an upturn in velocity for M3 (see *Graph 7: Velocity of M2 and M3*).



**Graph 7: Velocity of M2 and M3**



**Graph 8: Systemic Confidence Ratio**



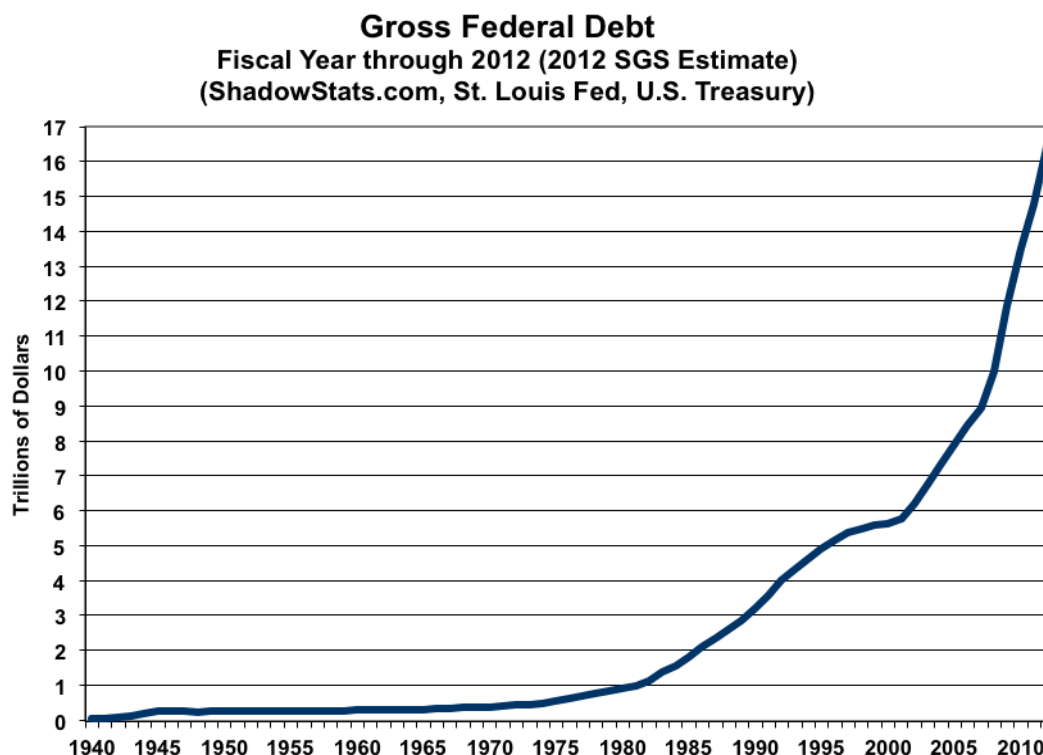
M3 velocity is posted here for those who are interested, but it is the reason for the difference in pattern for M2 versus M3 that is of interest at the moment.

The declining M3 measures are larger accounts that—at best—are only partially covered by government guarantees in normal times. Accordingly flight from the M3 accounts to the M2 level can reflect confidence in the banking system (other factors at play include interest rates). Where some of the earlier movement out of M3 reflected flight from too-low interest rates, the current circumstance is almost four years after the near-collapse in the system, and the broad money measure is sinking anew.

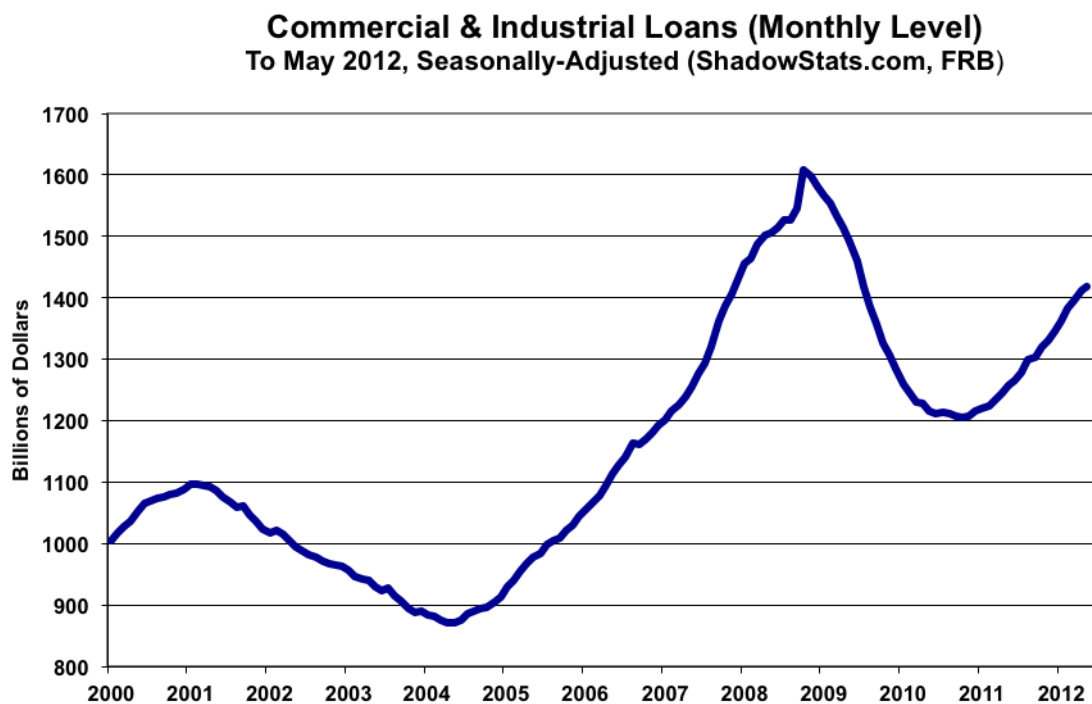
*Graph 8: Systemic Confidence Ratio* reflects the ratio of M3 to M2, which has not recovered from the plunge that began with the 2008 panic. The ongoing nature of the decline appears indicative of mounting systemic stress, or declining confidence, and well could be suggestive of a perceived, growing need by Mr. Bernanke to provide new liquidity to the system.

**Lending and Borrowing Remain Abnormal.** Based on the highly unstable and unreliable reporting of the latest flow-of-funds analysis from the Federal Reserve, the largest growth in borrowing in first-quarter 2012 was by the federal government. The Fed reports on debt issued for public consumption, not gross federal debt, which includes debt issued for the Treasury's borrowings of Social Security tax receipts. Nonetheless, gross federal debt is graphed below. Bank lending, however, still is far from normal, a sign of ongoing systemic stress.

**Graph 9: Gross Federal Debt**



**Graph 10: Commercial and Industrial Loans**



**Graph 11: Commercial Paper Outstanding**



As shown in *Section III — Consumer Liquidity, Graph 22: Consumer Credit Outstanding*, regular bank lending to consumers has been bottom-bouncing. The only growth in consumer credit in recent years has been in student loans from the federal government.

On the business front, the flow-of-funds accounting reflected growth in corporate bond issuance, and bank lending in commercial and industrial loans has picked up, but it remains well off its peak. Commercial paper continues to be under downside pressure.

### Section III — CONSUMER LIQUIDITY

**U.S. Economy Is Going Nowhere Without the Consumer.** The U.S. consumer accounts directly for 71% of GDP activity with “personal consumption expenditures” and indirectly for the bulk of the remaining 29% of economy. With consumer income and credit structurally impaired, as has been discussed frequently in the regular *Commentaries* and in [Hyperinflation 2012](#), growth in consumer spending and the broad economy is not sustainable. Not only has the U.S. economy not recovered, as discussed in *Section IV — Economic Conditions*, but also the consumer’s ongoing liquidity problems indicate that there is no economic rebound pending in the immediate future. To the contrary, deepening income difficulties suggest that near-term economic activity is headed lower.

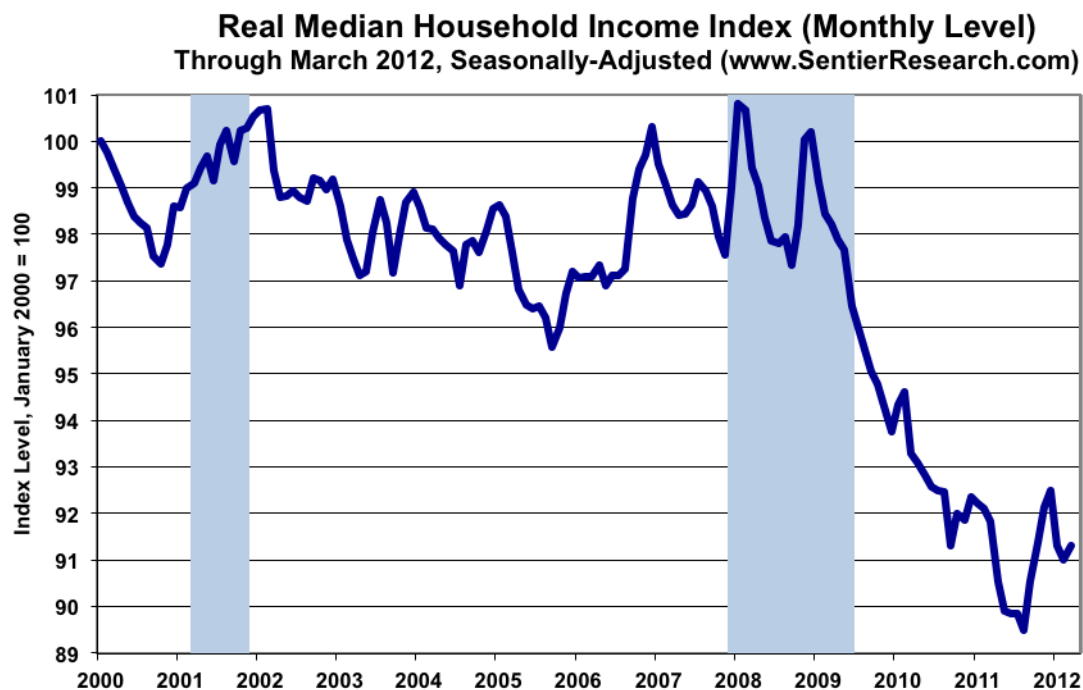
*Graph 12: Real Median Household Income* and *Graph 13: Real Average Weekly Earnings* show weakening consumer income. The median household income number ([www.SentierResearch.com](http://www.SentierResearch.com)) is deflated by the CPI-U and—allowing for the normal volatility of the monthly series—effectively shows the series at its lowest level in more than a decade. Real average weekly earnings (officially deflated by the CPI-W) have been in decline for six months and still are well below peak levels in the early-1970s. Deflated by the SGS-Alternate Consumer Inflation Measure (1990-Base), the series has been in relatively steady decline for some years.

Disposable personal income (DPI) effectively is take-home pay, but it comes from the same national income accounting that generates the GDP estimate. Accordingly, it is bloated with government imputations of income, such as interest income the government deems consumers earned by having no-charge banks accounts, or the rental equivalent income that homeowners pay themselves for living in their own homes. The inflation-adjusted (or real) numbers officially are deflated by the PCE-deflator, with full substitution and hedonic effects, which severely understates inflation and overstates inflation-adjusted levels and growth rates (see [Public Comment on Inflation](#)).

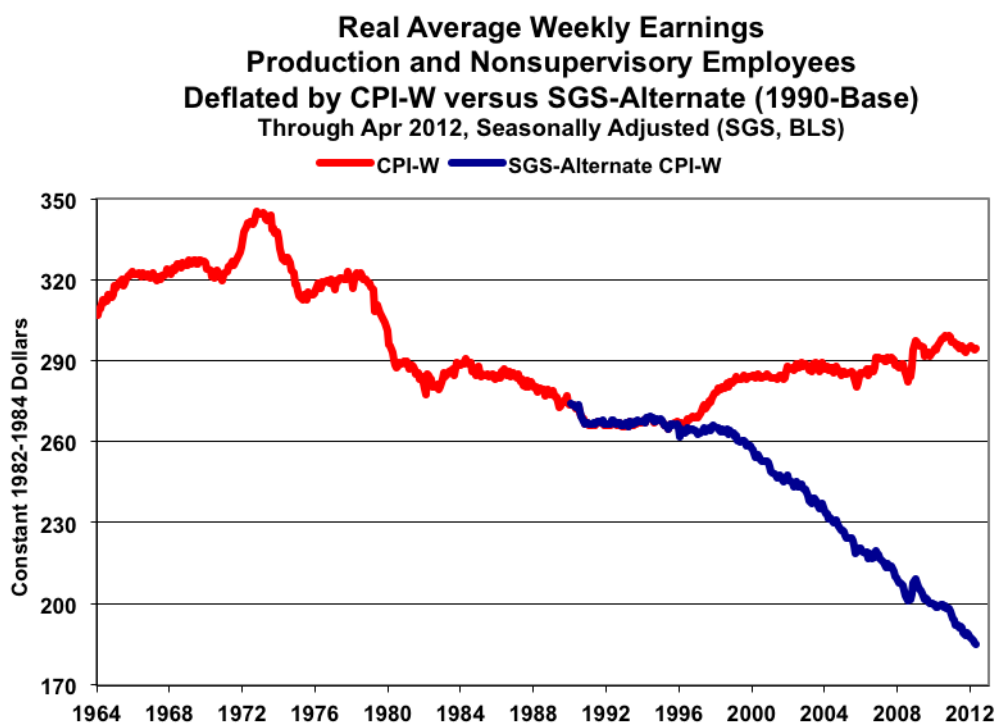
That said, graphs 14 through 19 reflect a series of plots of real disposable income, both national aggregate and per capita, deflated first by the PCE deflator (official), second by the more-robust CPI-U, and third by the SGS-Alternate. The official series shows real DPI to be above pre-recession levels, although that is not the case on a per capita basis, which has been flat or in slow decline. Based on the CPI-U, the aggregate number has been flat for two years, declining on a per capita basis. Based on the SGS-Alternate, both the aggregate and per capita series have been in decline since mid-2010.

With lack of positive, real growth in income, there can be no sustainable growth in real personal consumption. Temporary consumption gains could be fueled by debt expansion, but that option also is not available to most consumers. Consumer sentiment and confidence levels (graphs 20 and 21) remain at low levels not otherwise seen historically outside of the worst post-World War II recessions. Confidence affects willingness to borrow, but even with limited consumer willingness the still financially-stressed banking system is not lending in normal fashion. As seen in *Graph 22: Consumer Credit Outstanding*, there has been no growth in consumer credit outside of the extraordinary growth in student loans issued by the federal government. From the standpoint of consumer spending, consumer credit has been bottom-bouncing since the economic plunge. The plot also shows the recent benchmark revision (June 7th), in which the levels of reported consumer credit outstanding were revised lower.

**Graph 12: Real Median Household Income**

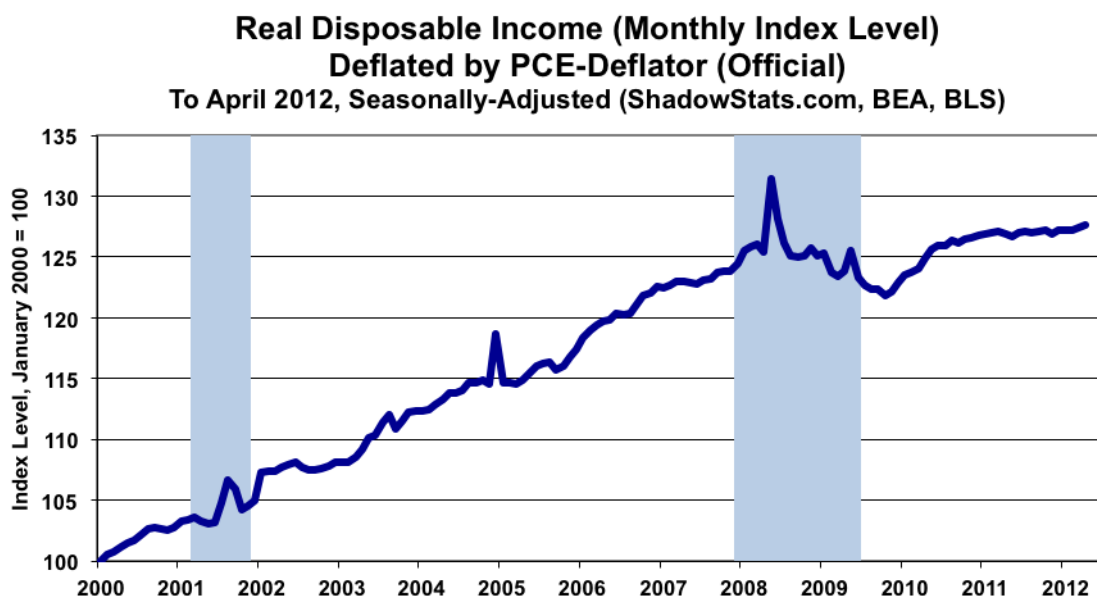


**Graph 13: Real Average Weekly Earnings**

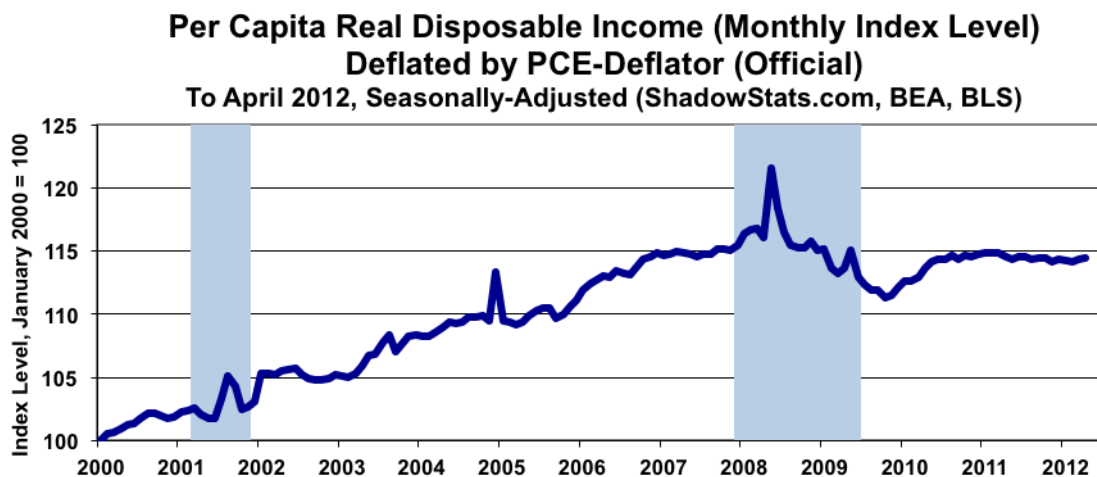




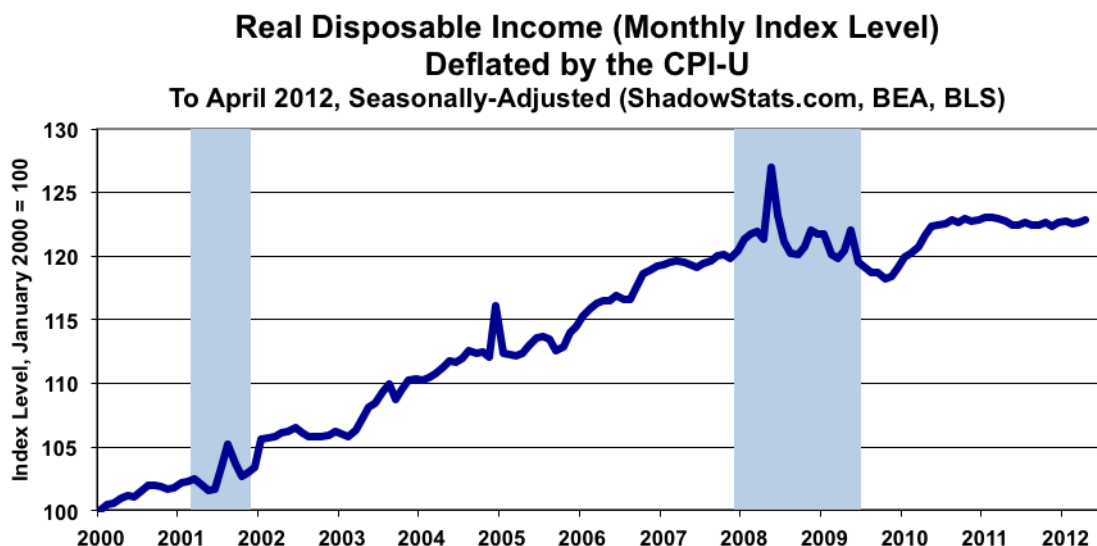
**Graph 14: Real Disposable Income (PCE-Deflator Based)**



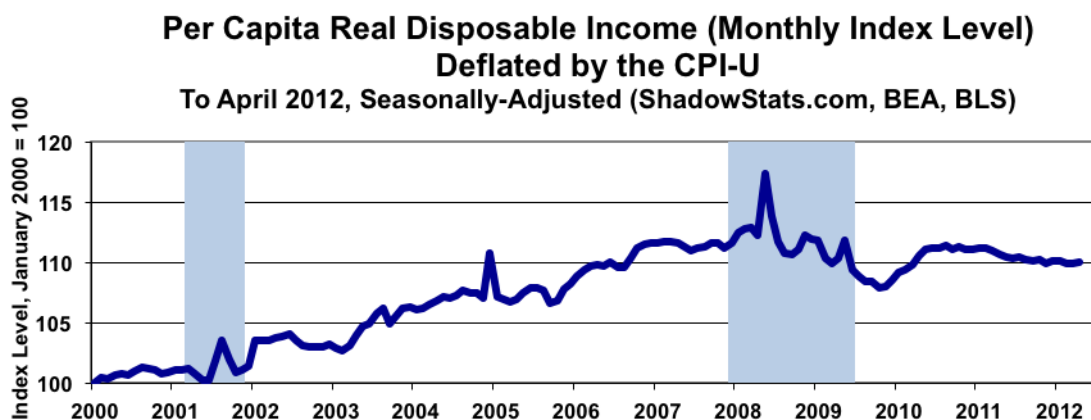
**Graph 15: Per Capita Real Disposable Income (PCE-Deflator Based)**



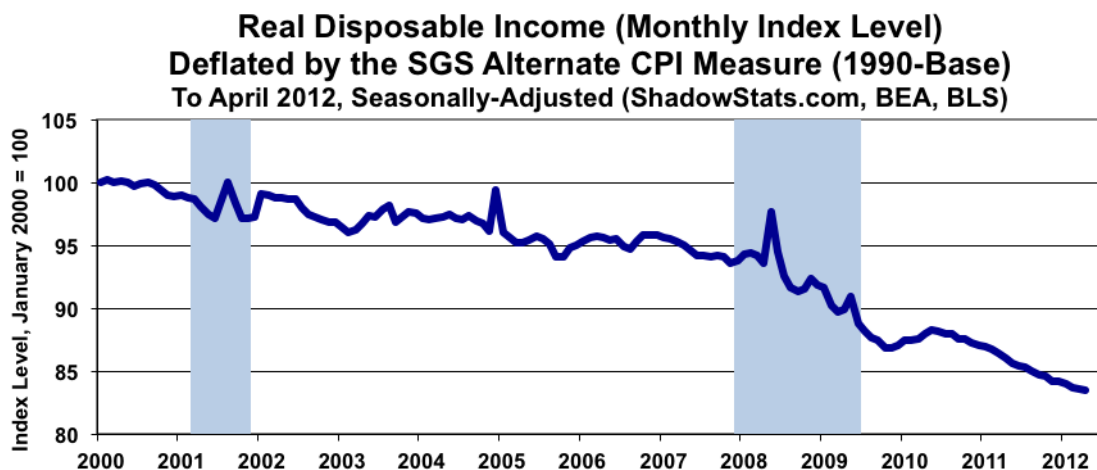
**Graph 16: Real Disposable Income (CPI-U Based)**



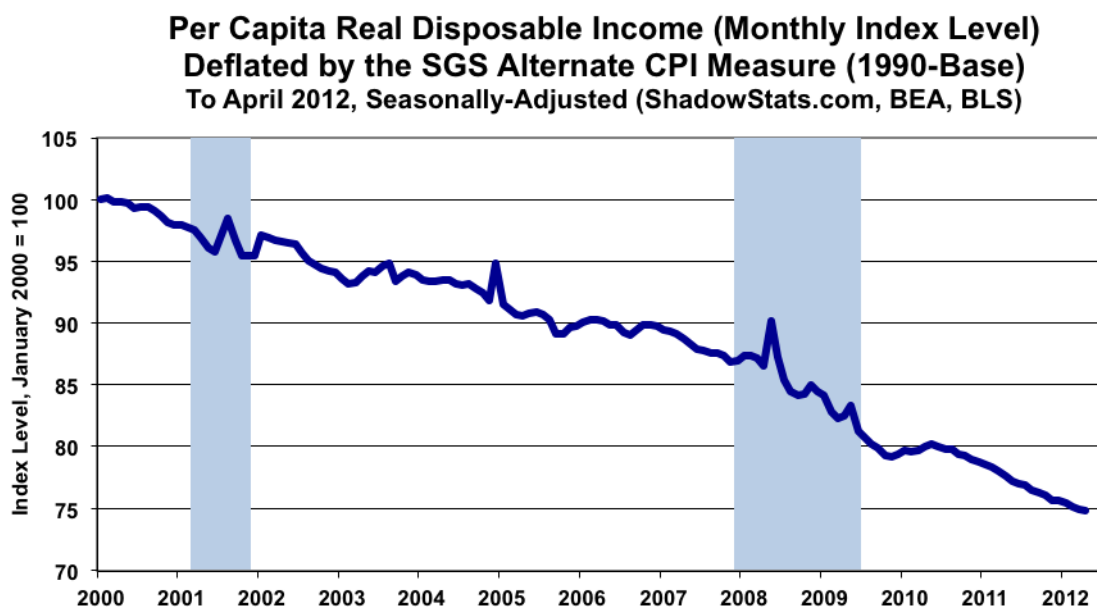
**Graph 17: Per Capita Real Disposable Income (CPI-U Based)**



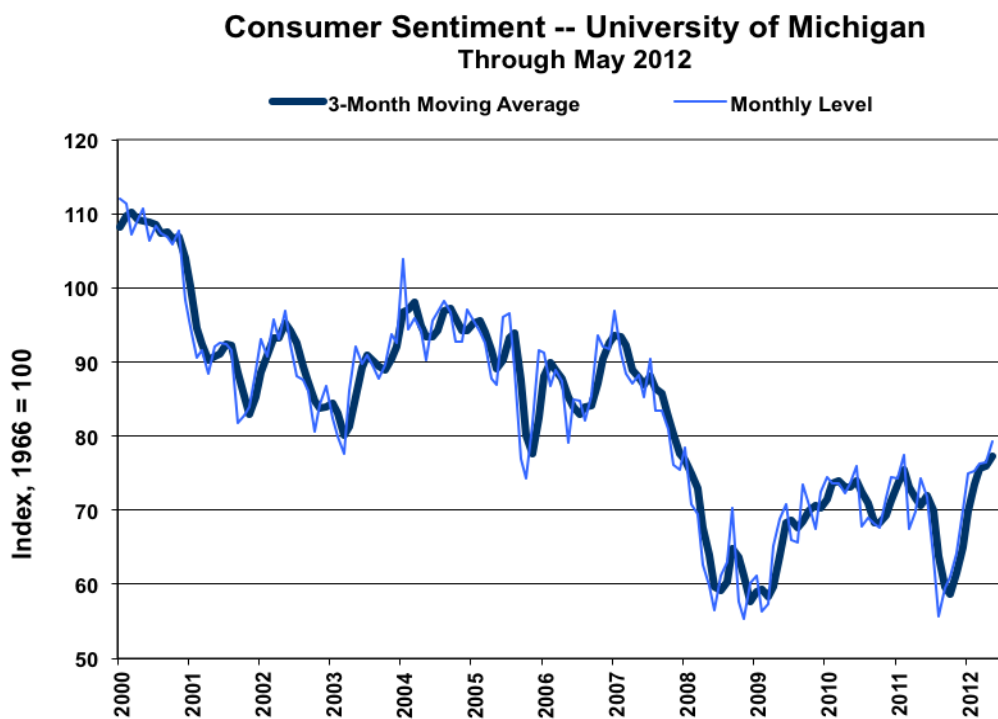
**Graph 18: Real Disposable Income (SGS-Alternate Based)**



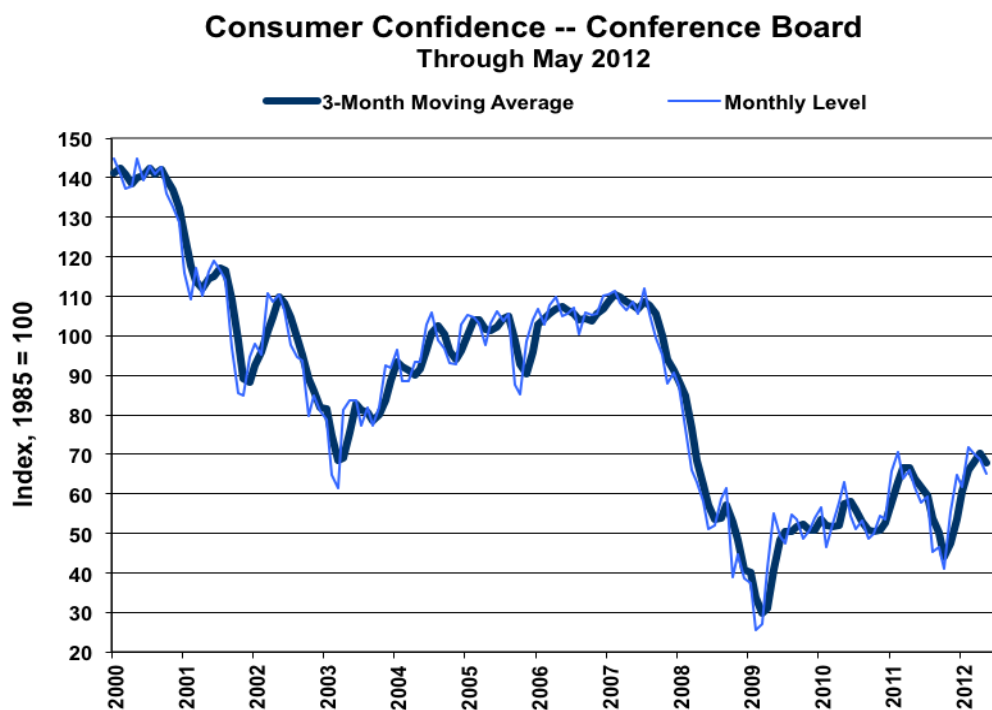
**Graph 19: Per Capita Real Disposable Income (SGS-Alternate Based)**



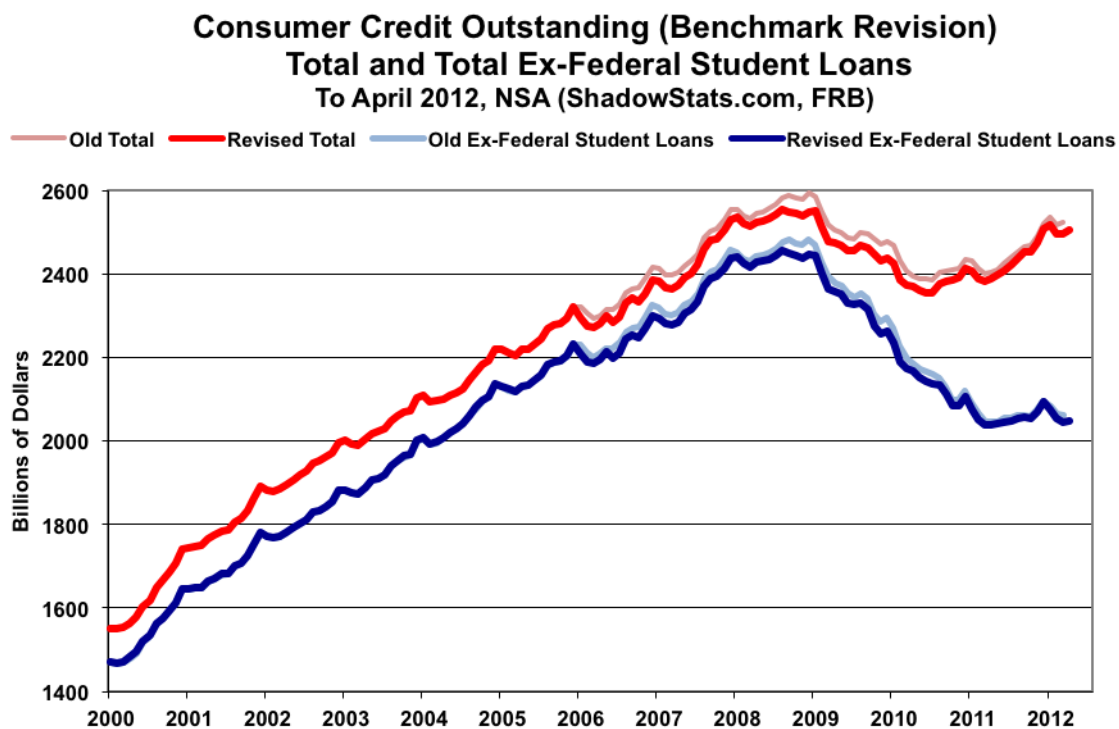
**Graph 20: Consumer Sentiment**



**Graph 21: Consumer Confidence**



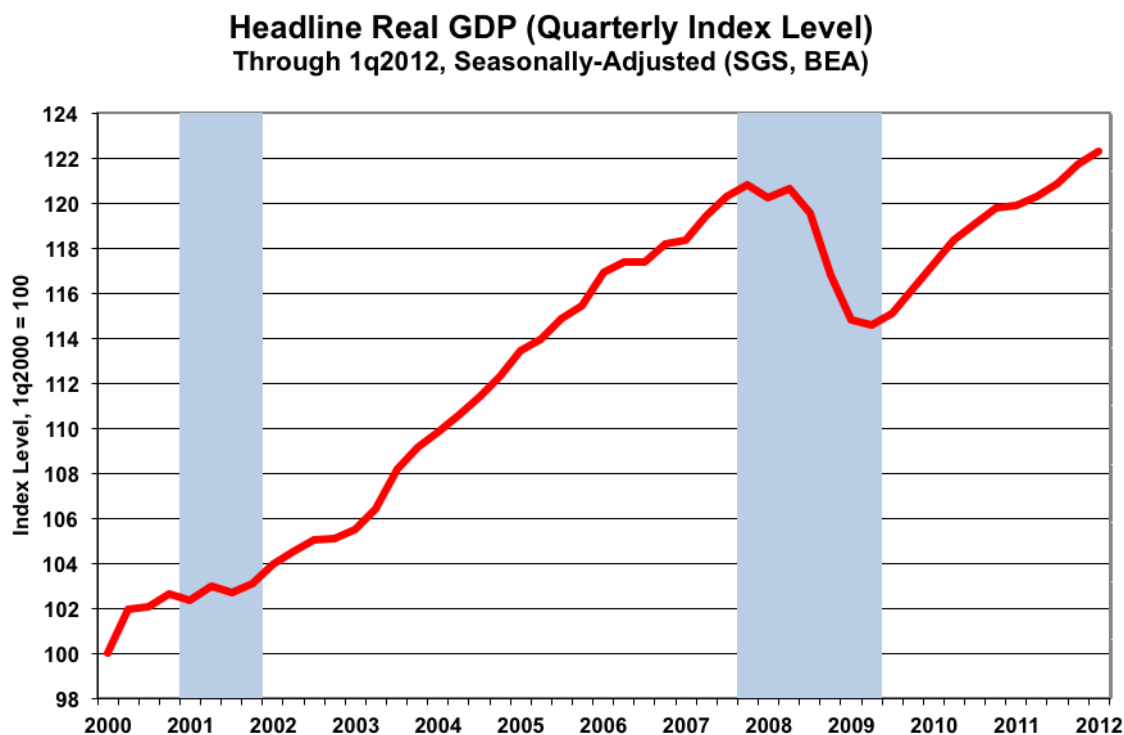
**Graph 22: Consumer Credit Outstanding**



## Section IV — ECONOMIC CONDITIONS

**Official GDP Recovery Remains Inconsistent with All Other Major Economic Series.** Official GDP reporting (*Graph 23: Headline Real GDP*) indicates that a full economic recovery has been in place since third-quarter 2011, with the real (inflation-adjusted) GDP level now topping the pre-recession peak seen in fourth-quarter 2007. While some series—adjusted for inflation—have shown upturns in recent years, not one has shown a full recovery. That suggests a major problem in current economic reporting; if the recovery were real, other series would be confirming the GDP-reporting pattern. Come July 27th, the annual benchmark revision to the GDP will be published. Expect downside revisions to the GDP history since 2009. It will be interesting to see if the “full recovery” pattern survives.

**Graph 23: Headline Real GDP**



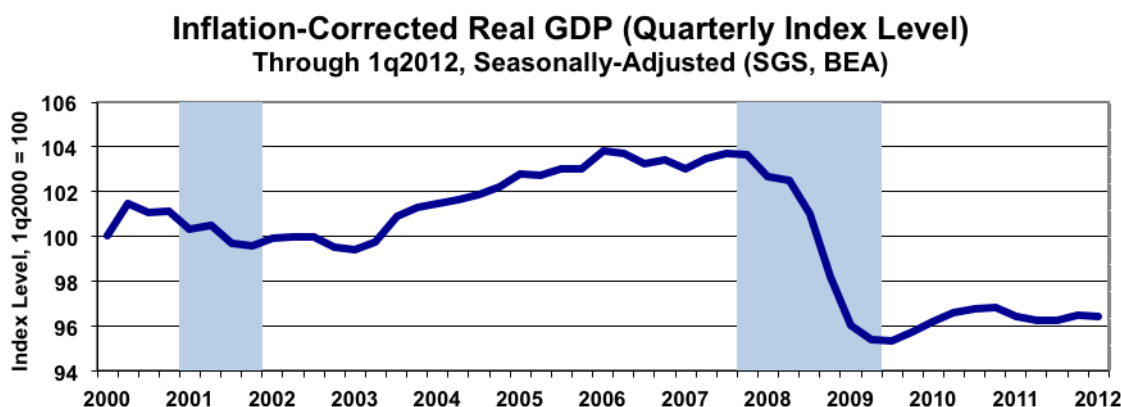
As discussed in [Hyperinflation 2012](#), a major reporting problem in the system is the understatement of inflation used in deflating the economic series (also see [Public Comment on Inflation](#)). The use of understated inflation in deflating data, results in an overstatement of the inflation-adjusted numbers and related growth rates. Updated from the referenced hyperinflation report, the following graphs represent official reporting or they have been corrected—at least partially—for inflation understatement. A new series of related graphs on disposable income (numbers 14 to 19) was added to *Section III — Consumer Liquidity*.



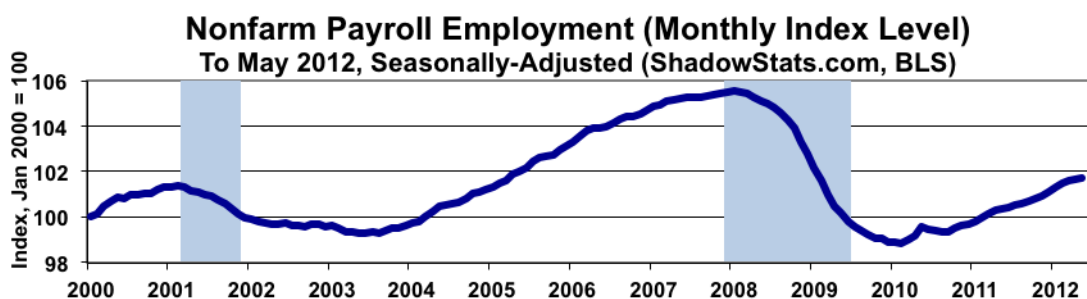
Also included or referenced are graphs of economic series that have no relationship to inflation adjustment. They all show an economic pattern in recent years of business activity plunging from 2006/2007 into 2009, followed by a period of low-level stagnation up to date, no recovery as otherwise indicated by the official GDP accounting. As seen in *Section III*, the consumer's liquidity conditions are deteriorating and signaling intensifying economic difficulties ahead.

*Graph 23* above shows the official GDP reporting, while *Graph 24: Inflation-Corrected Real GDP* shows the same series, to the same scale, in an inflation-corrected version that removes the effects of an estimated two-percentage points of annual growth spiked by hedonic adjustments to GDP inflation. Computer models generate lowered inflation numbers, adjusting for nebulous hedonic quality improvements. The estimation and graph here are simple approximations, but they show the significant impact of changes in assumed inflation. The inflation-adjusted estimate here is not the same as the SGS-Alternate GDP measure, which involves significantly greater and varied adjustments and is not estimated on a seasonally-adjusted quarterly basis.

**Graph 24: Inflation-Corrected Real GDP**

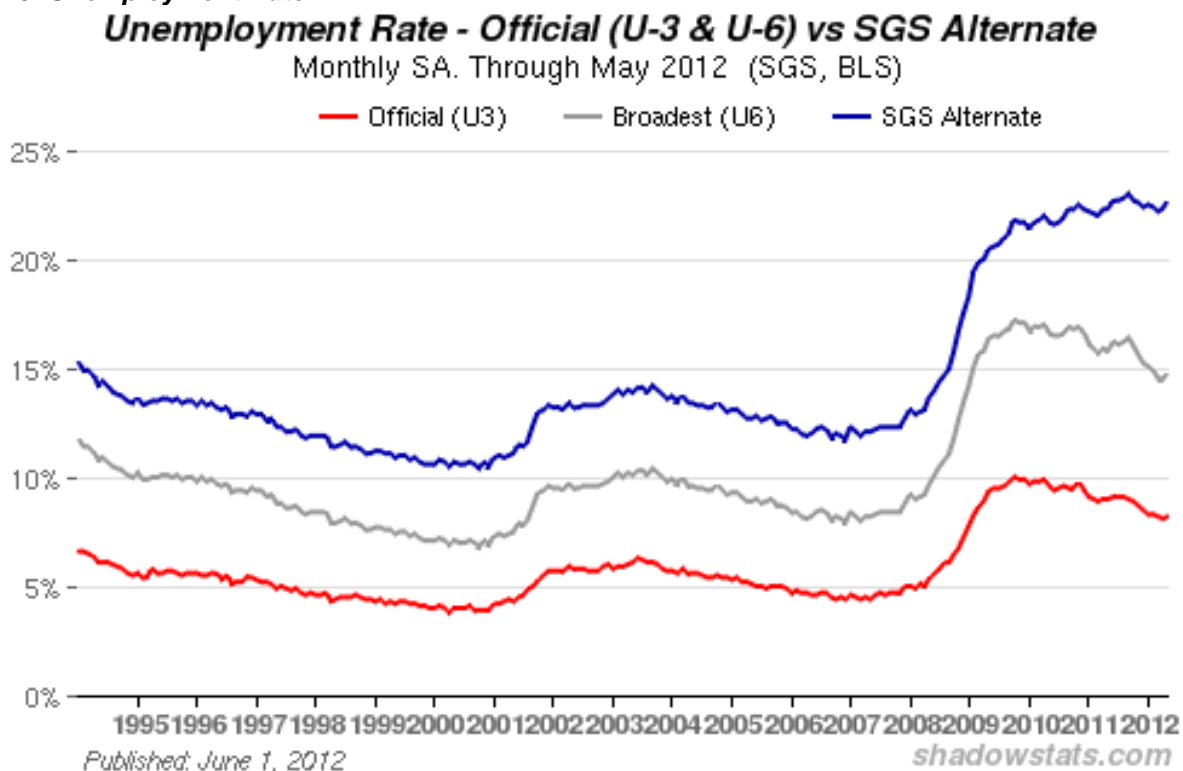


**Graph 25: Nonfarm Payroll Employment**



The inflation-corrected GDP series shows no meaningful pattern of recovery, one that is similar to the pattern of reported nonfarm payroll employment levels seen in *Graph 25*. While the relationship between employment and GDP is not one-to-one, the payroll series—which has no inflation adjustment imbedded in its reporting—shows a pattern of activity that is much more consistent with the inflation-corrected GDP than the official, headline GDP.

**Graph 26: Unemployment Rate**



**Graph 27: Housing Starts**



A lack of economic recovery also is evident when viewing the various measures of unemployment seen in *Graph 26*, or when viewing levels of activity in *Graph 27: Housing Starts*. The plunge-and-bottom-bouncing economic series all tend to lack any inflation-adjusted factors, including the unemployment and housing starts just discussed, and including various graphs seen in *Section III — Consumer Liquidity*. The specific graphs in the previous section include: the real disposable income series (graphs 14 to 19), and graphs 20 and 21 on consumer sentiment and consumer confidence.

The major series not confirming a full GDP recovery, but showing a good bounce-back, include only real retail sales and industrial production (shown in graphs 28 and 30). What they have in common with the GDP measure is a reliance on inflation-adjustment. When inflation-corrected, using the SGS Alternate Consumer Inflation Measure (1990-Base) versus the CPI-U, the retail sales pattern shown in *Graph 29: Inflation-Corrected Real Retail Sales* becomes one of plunge and stagnation, as seen in the other non-inflation-based or inflation-corrected series. The inflation-corrected retail sales graph also shows a pattern of activity that is more consistent with all the income, confidence and credit graphs shown in *Section III — Consumer Liquidity*.

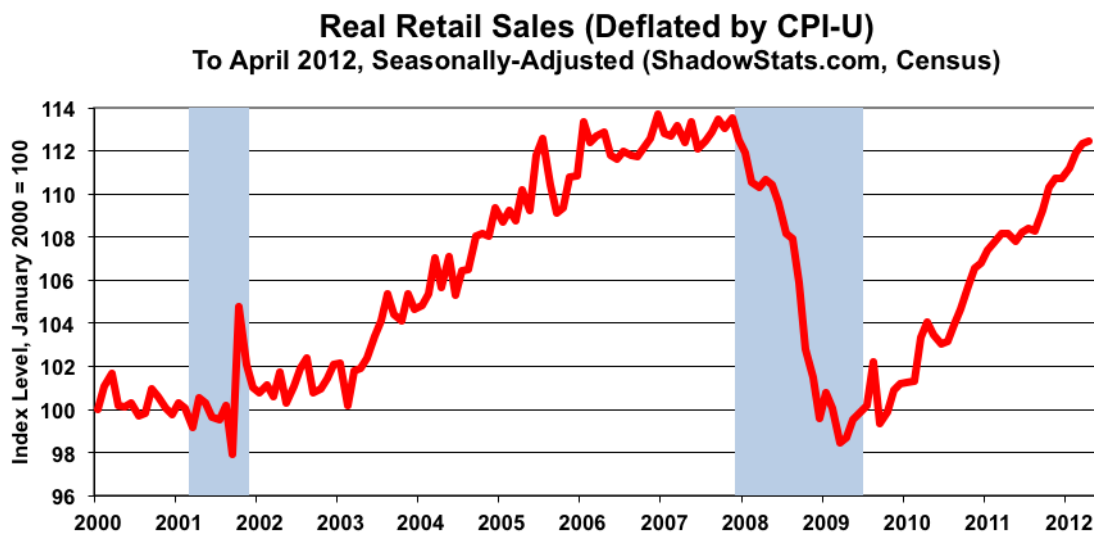
*Graph 31: Inflation-Corrected Industrial Production* has minor inflation-correction, reflecting the removal of the effects of hedonic inflation adjustments on affected production components. While there remains some weakened upturn in the series, production levels remain below those seen going into the 2001 recession, and certainly show no full recovery in the current circumstance.

*Graph 32: Real New Orders for Durable Goods* has not been inflation-corrected for hedonic adjustments, yet it still shows a pattern similar to that of inflation-corrected industrial production. Durable goods order activity remains below the level seen going into the 2001 recession, and it remains well below a full recovery in the current circumstance.

**The Broad U.S. Economy Remains Mired in A Recession/Depression.** I contend that the graphs in this and the preceding sections suggest that there has been no recovery in economic activity, since the economy plunged from 2006/2007 into 2009. Worse, the consumer liquidity numbers indicate a renewed softening of activity to be underway.

**Surprises for the Markets.** Aside from weaker-than-expected data in the months ahead directly surprising the markets, the lack of positive economic growth will have wider implications. Pending negative surprises for the financial markets and the financial system—tied to the federal budget deficit, Treasury funding needs and the level of financial stress faced by the U.S. banking system—will be generated by significantly worse-than-expected economic activity. Official forecasts, ranging from U.S. fiscal performance in the coming years, to the ability of major banks to survive adverse economic and financial conditions, generally rely on overly-optimistic economic assumptions. The U.S. economy does not face actual 2% to 3% growth in the near future, but rather stagnant to negative activity, and that difference will blow apart a number of happy forecasts helping to support the U.S. political system and financial markets.

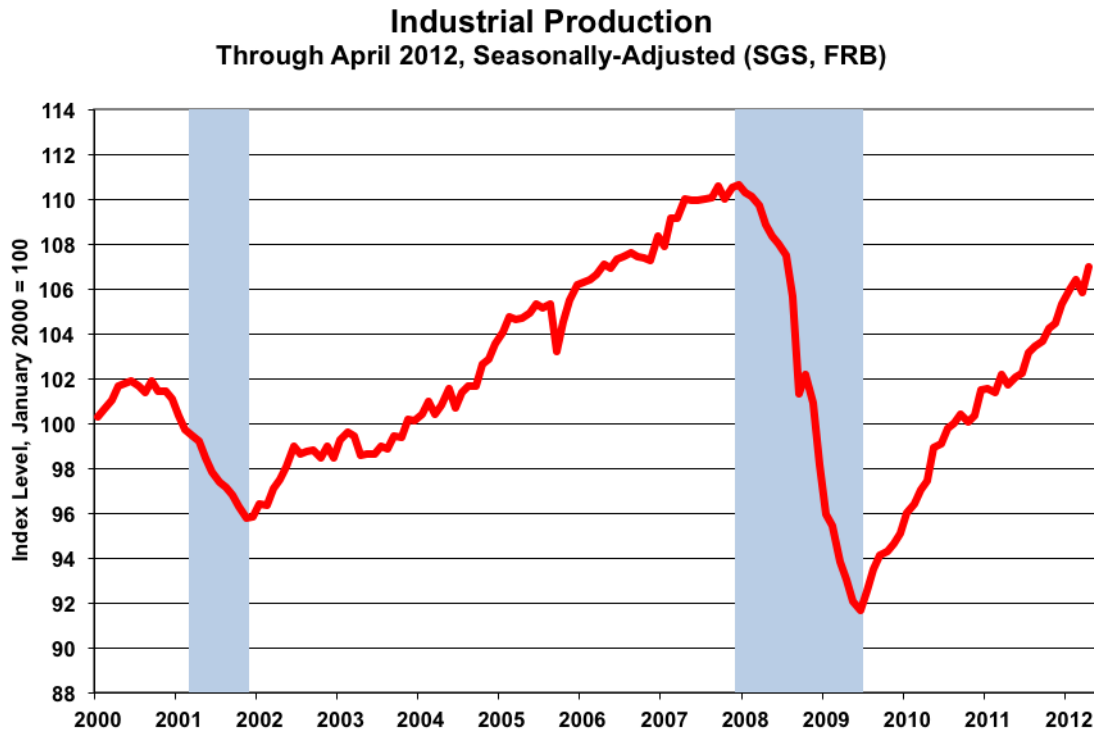
**Graph 28: Real Retail Sales (CPI-U Deflator)**



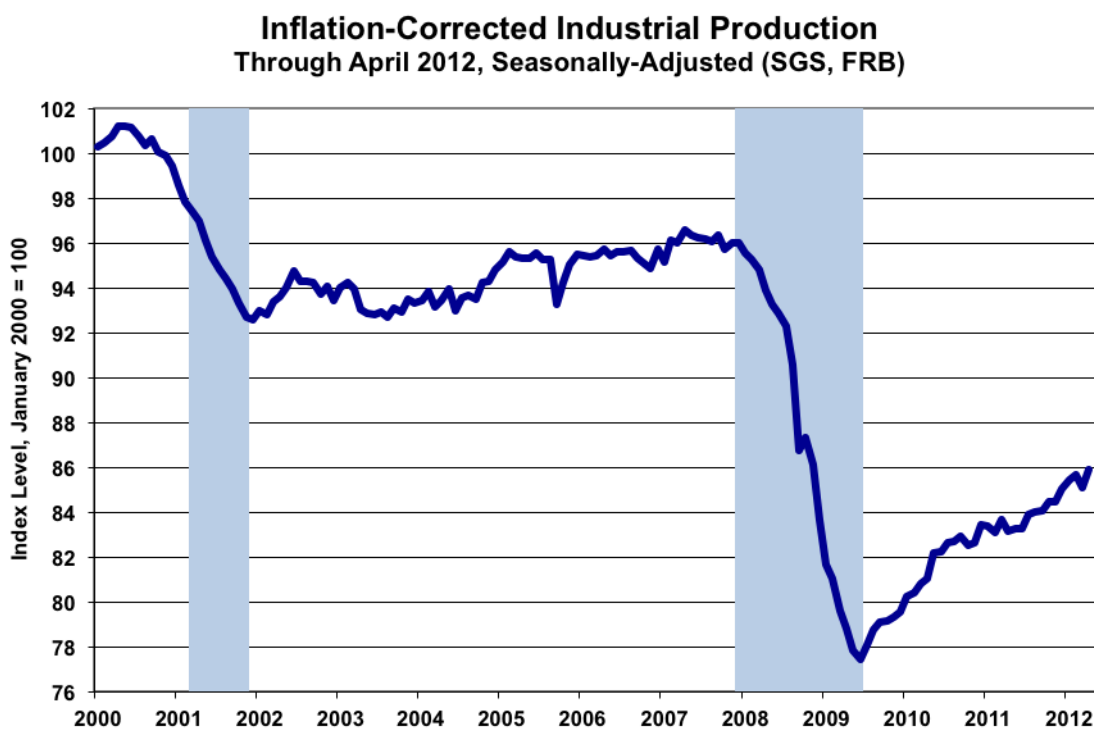
**Graph 29: Inflation-Corrected Real Retail Sales (SGS-Alternate Deflated)**



**Graph 30: Industrial Production**



**Graph 31: Inflation-Corrected Industrial Production**



**Graph 32: Real New Orders for Durable Goods**

