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

COMMENTARY NUMBER 448
May Industrial Production

June 15, 2012

Manufacturers Cut Production, Trying to Reduce Excess Inventories Versus Slack Demand

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PLEASE NOTE: The next regular Commentary *is scheduled for Tuesday, June 19th, covering May housing starts.*

Best wishes to all — John Williams

Opening Comments and Executive Summary. The major economic reports for May consistently have shown weaker activity than was expected by the markets. Not only did employment and unemployment, retail sales and industrial production show weakening or contracting economic activity, but also the employment and retail sales data included downside revisions to recent, prior-period reporting.

In combination, these numbers suggest a possible further downside revision to the first-quarter 2012 GDP estimate, when the next re-estimation for that quarter is published on June 28th. The data also suggest a weaker second-quarter GDP than generally has been expected. Keep in mind that the initial estimation of second-quarter 2012 GDP will be released on July 27th, along with the annual benchmark revision to GDP that likely will lower estimates of broad economic growth for recent years.

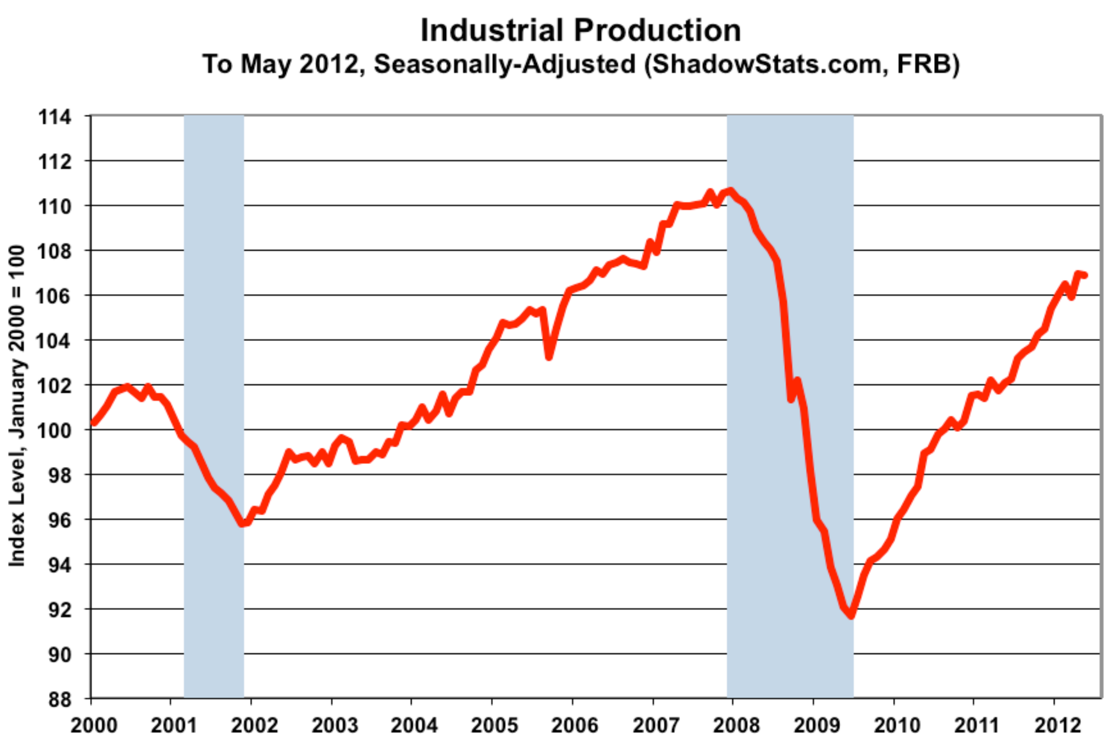
The economic outlook discussed in the June 12th *Special Report No. 445* has not changed. Instead, underlying circumstances are unfolding in line with what has been anticipated in the general outlook. In the current circumstance, the most recent economic reporting has started to solidify the anticipation of renewed stagnation and downturn surfacing in official government reporting**.**

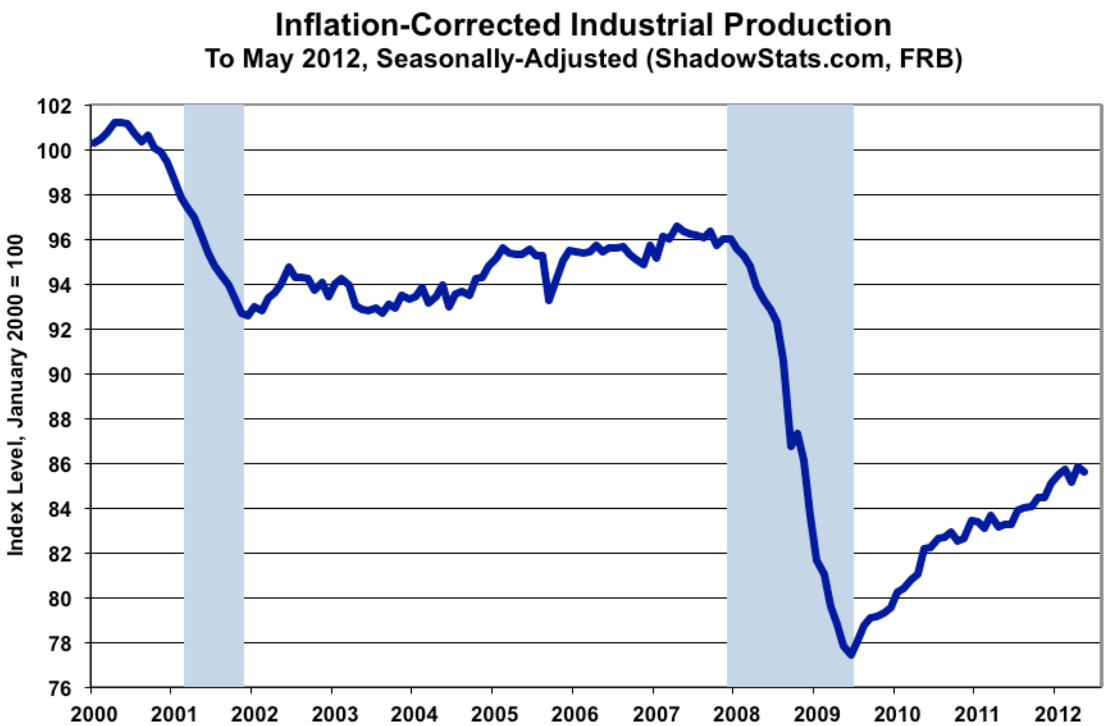
Index of Industrial Production. The headline 0.1% monthly contraction in May 2012 industrial production followed a downwardly revised 1.0% (previously 1.1%) gain in April.

Looking at the three industry groups that are aggregated into the index, manufacturing production fell by 0.4% in the month, after a 0.7% gain in April. The May decline included a 1.9% cutback by automakers looking to reduce inventories against weak demand. The labor strike at Lockheed apparently also was a factor.

Utility output slowed to a more-stable 0.8% monthly gain in May, versus the 4.6% jump in April that was linked to unseasonable weather and that had spiked the aggregate production number.

Mining output growth also was stable, gaining 1.0% in May, versus a 0.8% increase in April, reflecting increased oil and coal production.





Inflation-Corrected Industrial Production. A portion of industrial production (largely high tech, such as computers) is estimated by deflating nominal (not-adjusted-for-inflation) numbers with inflation measures of a nature similar to those used in the GDP estimates. Hedonic price adjustments usually lower estimated inflation for nebulous quality improvements that otherwise cannot be measured directly. Where those inflation estimates are understated, the resulting inflation-adjusted production growth is overstated.

As discussed and graphed in *Hyperinflation 2012* and *Special Report No. 445*, and as graphed above, the inflation-corrected industrial production series is an approximation of what production would look like with the hedonic inflation gimmicks removed.

The two preceding charts update *Graphs 30* and *31* in *Special Report No. 445*. They are indexed to January 2000 = 100 and are plotted on the same scale for purposes of comparison. The production graphs in the *Reporting Detail* section are indexed with 2007 = 100, which is as used by the Federal Reserve.

Hyperinflation Watch. *Special Report No. 445* (June 12th) just updated the hyperinflation outlook, as well as U.S. economic, U.S. dollar, and systemic-solvency conditions. The *Special Report* is a supplement to *Hyperinflation 2012* (January 25th), which remains the primary missive detailing the hyperinflation story.

REPORTING DETAIL

INDEX OF INDUSTRIAL PRODUCTION (May 2012)

Manufacturers Cut Production to Reduce Excess Inventories. The headline 0.1% decline in May industrial production, which followed a 1.0% gain April, was below consensus expectations. The net contraction in production was dominated by automakers trying to reduce excess inventories. Utility and mining output showed stable growth.

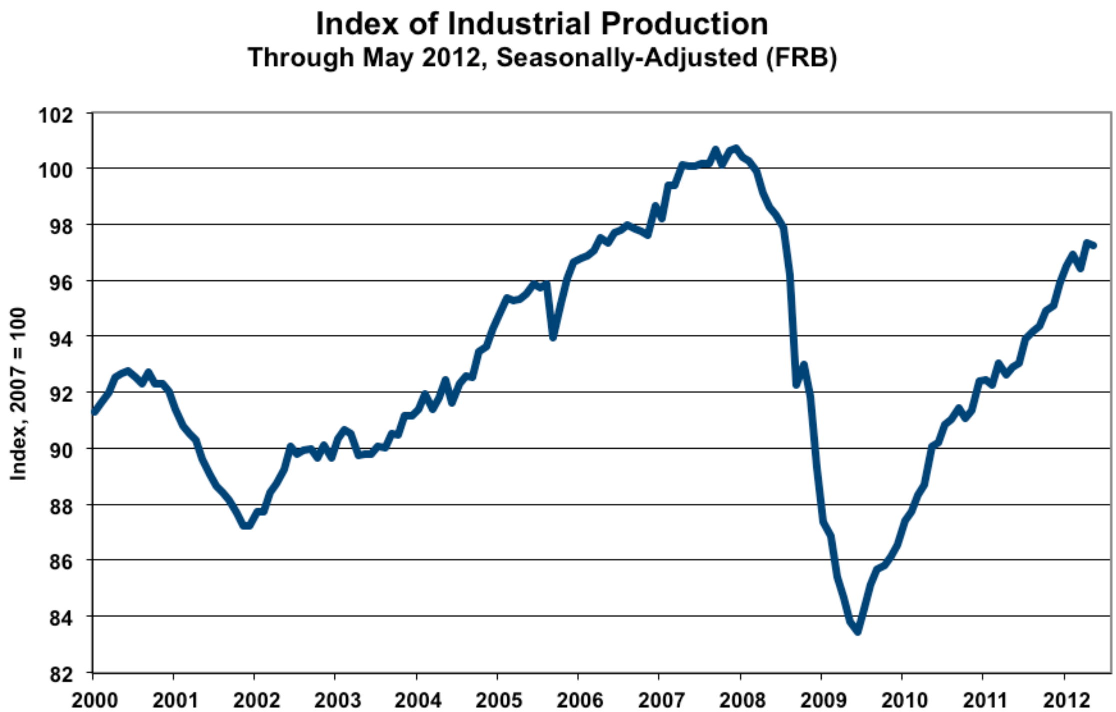
May 2012 Reporting. This morning's (June 15th) release by the Federal Reserve Board of seasonally-adjusted May 2012 industrial production showed a headline contraction of 0.09% (down by 0.13% before prior-period revisions) in monthly activity. April production showed a revised 0.97% monthly gain (previously 1.09%).

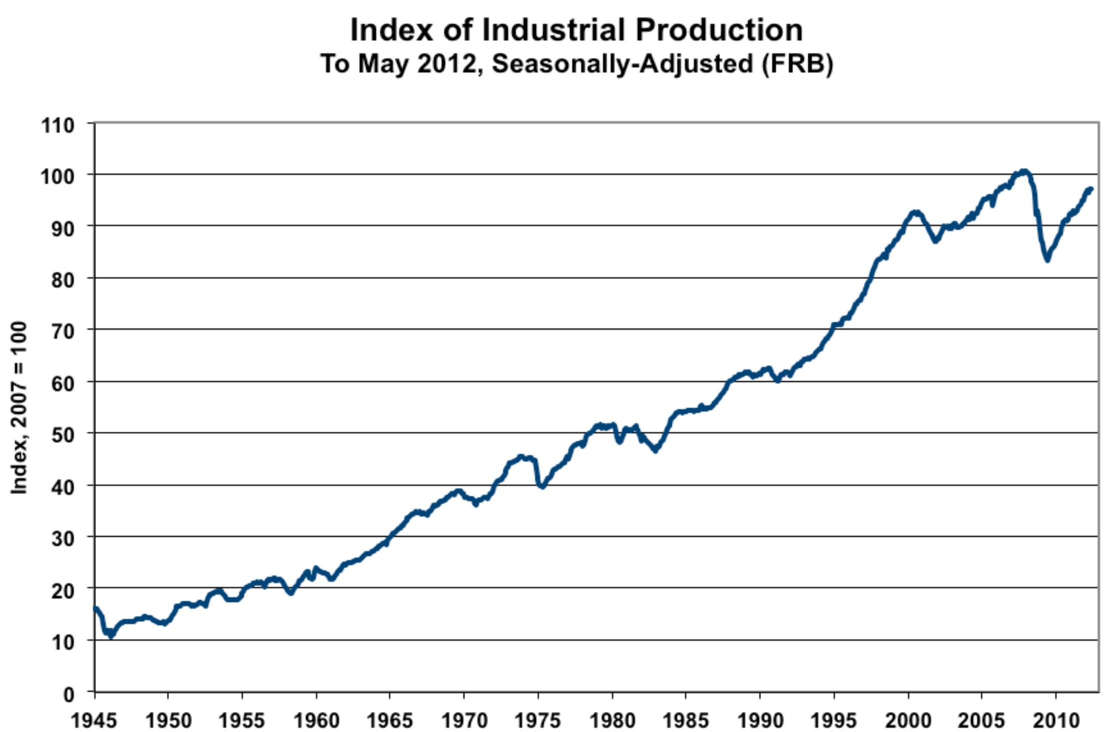
Manufacturing production fell by 0.4% in the month, after 0.7% gain in April. The May decline encompassed a 1.9% drop in production of automotive products, where manufacturers generally were looking to cut excess inventories in the face of slack sales. Utility output slowed to a more-normal 0.8% monthly gain in May, versus the 4.6% jump in April that was tied to unseasonable weather. Mining output gained 1.0% in May, versus a 0.8% increase in April, with increased oil and coal production. Again, aggregated together, production in these three industry groups fell by the headline 0.1% (rounded to the first decimal point) in May.

The May 2012 release was the second since the annual benchmark revision to the production series (see *Special Commentary No. 426* of March 30th). The benchmark resulted in minor downside revisions to data of recent years. The subsequent April production release, however, was beset by unusually large and unstable revisions. In contrast, revisions in today's release were reasonably minor and stable.

Year-to-year growth for May 2012 aggregate production was 4.67%, slightly below the revised annual pace of 5.12% (previously 5.16%) seen in April. That still was well off the series' recent relative peak annual growth of 8.13% in June 2010. The year-to-year contraction of 15.15% seen in June 2009, at the end of second-quarter 2009, was the steepest annual decline in production growth since the shutdown of war-time production following World War II.

The "recovery" in industrial production is reflected in the following graphs. Both graphs show the monthly level of the production index. The first of these shows recent historical detail for the period beginning in 2000, the second shows the same data in historical context since World War II. The recent instability and potential topping-out of current production activity is evident in the first graph.


Index of Industrial Production
Through May 2012, Seasonally-Adjusted (FRB)
Index, 2007 = 100
102
100
98
96
94
92
90
88
86
84
82
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012


Index of Industrial Production
To May 2012, Seasonally-Adjusted (FRB)
Index, 2007 = 100
110
100
90
80
70
60
50
40
30
20
10
0
1945
1950
1955
1960
1965
1970
1975
1980
1985
1990
1995
2000
2005
2010

Corrected for the understatement of inflation used in deflating portions of the industrial production index, the series has shown more of a bottom-bouncing pattern since 2009, and is appears to be topping out in the latest reporting. The inflation-corrected production series is graphed in the *Opening Comments and Executive Summary* section. The graphs there update *Graphs 30* and *31* in *Special Report No. 445*.

Week Ahead. *Market recognition of an intensifying double-dip recession has started to take a stronger hold, at the moment, while recognition of a mounting inflation threat remains sparse. The political system would like to see the issues disappear until after the election; the media does its best to avoid publicizing unhappy economic news; and the financial markets will do their best to avoid recognition of the problems for as long as possible, problems that have horrendous implications for the markets and for systemic stability.*

Until such time as financial-market expectations move to catch up fully with underlying reality, or underlying reality catches up with the markets, reporting generally will continue to show higher-than-expected inflation and weaker-than-expected economic results in the months and year ahead. Increasingly, previously unreported economic weakness should show up in prior-period revisions.

Residential Construction (May 2012). Reporting on May housing starts is due for release on Tuesday, June 19th. The four-year pattern of housing starts stagnation at an historically low level of activity has not changed. As has become the standard circumstance, any reported monthly gain likely will not be statistically significant.

