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

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February Trade Deficit

April 5, 2016

First-Quarter Trade Deficit Continued to Deepen,
Worst Shortfall in Nearly Ten Years

In Advance of Likely Downside Benchmark Revisions,
First-Quarter 2016 GDP Increasingly Is Unfolding as a Contraction

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PLEASE NOTE: The next regular Commentary, *scheduled for Wednesday, April 13th, will cover March nominal Retail Sales and the PPI, followed by one on the 14th covering the March CPI and real Retail Sales, and one on the 15th covering Match Industrial Production.*

Best wishes to all — John Williams

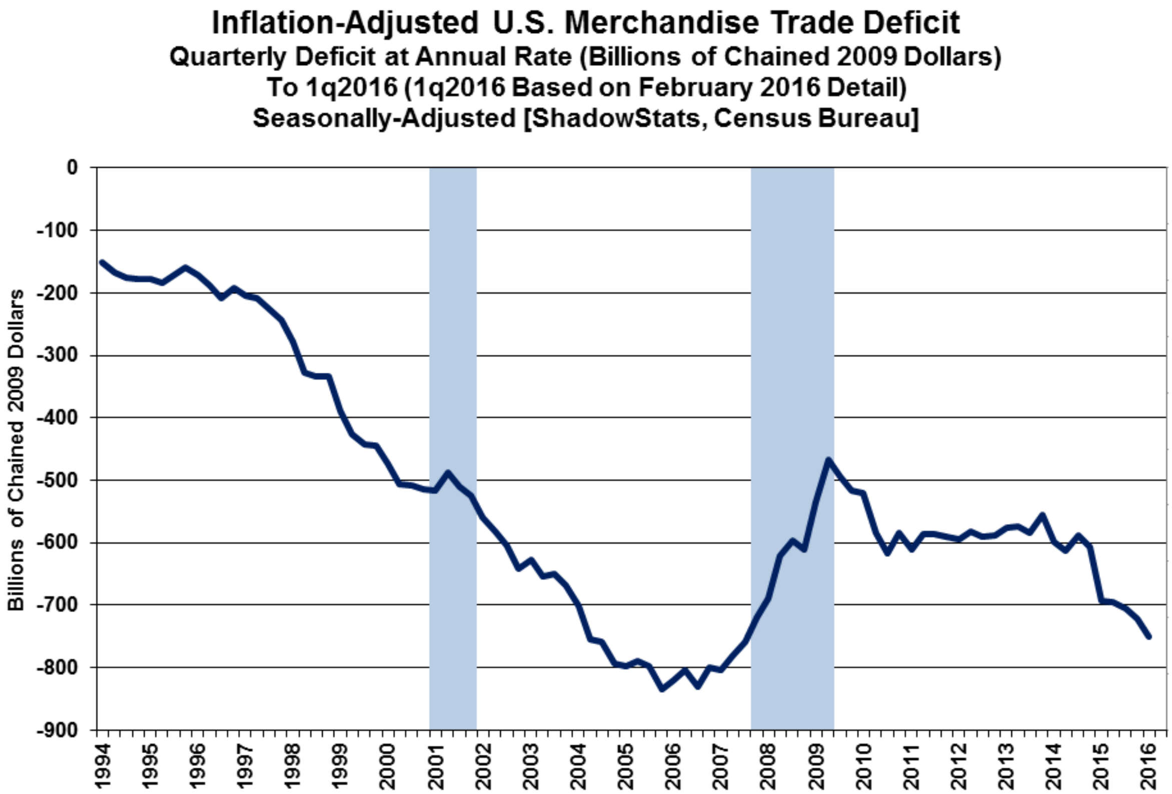
OPENING COMMENTS AND EXECUTIVE SUMMARY

Outlook for First-Quarter GDP Dims with Faltering Trade. By the end of next week, full reporting of first-quarter 2016 Industrial Production and real Retail Sales should be showing quarterly downturns. In conjunction with today's deteriorating trade outlook—based on two months of reporting in first-quarter 2016—the current quarter's GDP is at high risk of showing a headline quarterly contraction, well before the July 29th GDP benchmarking shifts some prior quarters (likely including first-quarter 2015 and fourth-quarter 2015) into negative territory. Such will be reviewed carefully in *Commentary No. 800* of April 15th, coincident with the release of March 2016 production detail (see *Week Ahead* section).

Continued Deterioration in First-Quarter 2016 Real Trade-Deficit—Still on Track for Worst Reading Since 2007. Headline detail for the January and February 2016 real merchandise trade deficit showed a sharp worsening of the unfolding first-quarter 2016 inflation-adjusted real merchandise trade deficit, which is on track to be the worst trade shortfall since (albeit close to) third-quarter 2007, as shown in *Graph 1* and discussed in the *Reporting Detail*.

The currently implied quarterly trade deterioration should be enough to contribute negative, annualized quarterly growth of roughly 0.4% (-0.4%) to the initial estimate of first-quarter 2016 GDP on April 28th.

Graph 1: Inflation-Adjusted, Quarterly U.S. Merchandise Trade Deficit to 1q2016 (February)



Today's *Commentary* (April 5th). The balance of these *Opening Comments* provides summary coverage of the February 2016 Trade Deficit. The most recent *Hyperinflation Outlook Summary* is found in *Commentary No. 783*, again with *No. 777 Year-End Special Commentary* as background to currently unfolding financial-market circumstances.

The *Week Ahead* section previews next week's reporting of the March CPI and PPI, nominal and real Retail Sales and the monthly Industrial Production release, all for March 2016 and for initial full-reporting of related first-quarter 2016 economic activity.

U.S. Trade Balance—February 2016—Real First-Quarter Deficit Continued to Deepen, on Track for Worst Showing in almost a Decade. With the initial estimate of inflation-adjusted real February

2016 merchandise trade deficit in hand, deterioration in the first-quarter 2016 real deficit remained on track for the worst quarterly trade shortfall since third-quarter 2007 (see *Graph 1*). The latest detail suggested that first-quarter 2016 GDP would suffer a continuing negative-growth contribution from the deteriorating U.S. trade balance.

The just-scheduled June 3, 2016 annual benchmark revision for the trade data is a virtual certainty to show even greater trade-deficit deterioration since 2013 (see *Ongoing Cautions...* section in the *Reporting Detail*). That would place further downside-revision pressure on the July 29th GDP benchmarking, as seen with the recent Industrial Production benchmarking (*Commentary No. 796-A*) and as is likely to be seen with pending benchmark revisions to retail sales, durable goods orders and housing starts.

Nominal (Not-Adjusted-for-Inflation) February 2016 Trade Deficit. The nominal, seasonally-adjusted monthly trade deficit in goods and services for February 2016, on a balance-of-payments basis, widened by $1.178 billion to $47.060 billion, versus a deficit of $45.882 billion in January, which had widened in revision. That February 2016 nominal deficit also deteriorated sharply versus a $38.550 billion trade shortfall in February 2015 (see *Ongoing Cautions...* section).

In terms of month-to-month trade patterns, the headline $1.178 (-$1.178) billion deterioration in the February deficit reflected a gain of $1.778 billion in monthly exports with a more than offsetting increase of $2.956 billion in monthly imports. Consumer goods, net of a decline in automotive imports, dominated the jumps in both exports and imports. Once again, declining oil prices skewed the relative impact of oil imports, in inflation-adjusted real terms.

Energy-Related Petroleum Products. For February 2016, the not-seasonally-adjusted average price of imported oil declined to $27.48 per barrel, versus $32.06 per barrel in January 2016, and versus $49.53 per barrel in February 2015. Where spot oil prices rallied sharply in March 2016, the reflection of that in trade reporting likely will not be seen until April, if not May. When the higher prices are recognized, the headline, aggregate nominal monthly trade deficit should soar. Separately, not-seasonally-adjusted physical oil-import volume in February 2016 averaged 7.404 million barrels per day, up from 7.312 million in January 2016 and from 6.859 million in February 2015.

Real (Inflation-Adjusted) February 2016 Trade Deficit. Adjusted for seasonal factors, and net of oil-price swings and other inflation (2009 chain-weighted dollars, as used in GDP deflation), the February 2016 merchandise trade deficit (no services) widened to $63.346 billion, from a revised $61.771 billion in January 2016. The February 2016 shortfall also widened sharply versus a $52.266 billion real deficit in February 2015.

As currently reported, the annualized quarterly real merchandise trade deficit was $588.6 billion for third-quarter 2014, $605.5 billion for fourth-quarter 2014, $692.4 billion for first-quarter 2015, $694.8 billion for second-quarter 2015, $706.1 billion for third-quarter 2015, and $721.7 billion for fourth-quarter 2015.

Indicated in prior *Commentaries*, the real fourth-quarter 2015 deficit was the worst quarterly shortfall since third-quarter 2007, and the real first-quarter 2016 deficit is on track to be even worse (again, see *Graph 1*). Based solely on the reporting of the January and February 2016 real merchandise trade shortfalls, the first-quarter 2016 is on track for an annualized deficit of $750.702 billion. That would be the new worst such deficit since third-quarter 2007, and again, it would contribute negative annualized growth to the first-quarter 2016 GDP estimate by roughly 0.4% (-0.4%). Based solely on the initial January 2016 detail, first-quarter 2016 was on track for an annualized quarterly deficit of $743.7 billion.

Headline real deficits likely will get even deeper in the months ahead, intensifying the already negative impact on GDP growth.

[Though largely Repetitious the *Reporting Detail* includes some added information on the February Trade Deficit].

REPORTING DETAIL

U.S. TRADE BALANCE (February 2016)

Real First-Quarter 2016 Deficit Continued to Deepen, on Track for Worst Showing in almost a Decade. With the initial estimate of inflation-adjusted real February 2016 merchandise trade deficit in hand, deteriorating reporting of the first-quarter 2016 real deficit remained on track for the worst quarterly trade shortfall since third-quarter 2007 (see *Graph 1* in the *Opening Comments*). The latest detail suggested that first-quarter 2016 GDP would suffer a continuing negative-growth contribution from the ongoing U.S. trade balance deterioration.

The just-scheduled June 3, 2016 annual benchmark revision for the trade data is a virtual certainty to show even greater trade-deficit deterioration since 2013 (see *Ongoing Cautions*... section). That would place further downside-revision pressure on the July 29th GDP benchmarking, as seen with the recent Industrial Production benchmarking (*Commentary No. 796-A*) and as is likely to be seen with pending benchmark revisions to retail sales, durable goods orders and housing starts.

Nominal (Not-Adjusted-for-Inflation) February 2016 Trade Deficit. The Bureau of Economic Analysis (BEA) and the Census Bureau reported this morning, April 5th, that the nominal, seasonally-adjusted monthly trade deficit in goods and services for February 2016, on a balance-of-payments basis, widened by $1.178 billion to $47.060 billion, versus a revised $45.882 [previously $45.677] billion in January.

That February 2016 nominal deficit also widened versus a $38.550 billion trade shortfall in February 2015 (see *Ongoing Cautions*... section).

In terms of month-to-month trade patterns, the headline $1.178 (-$1.178) billion deterioration in the February deficit reflected a gain of $1.778 billion in monthly exports with a more than offsetting increase of $2.956 billion in monthly imports. The jumps in both exports and imports were dominated by consumer goods, net of a decline in automotive imports. Once again, declining oil prices skewed the relative impact of oil imports, in inflation-adjusted real terms.

Energy-Related Petroleum Products. For February 2016, the not-seasonally-adjusted average price of imported oil declined to $27.48 per barrel, versus $32.06 per barrel in January 2016, and versus $49.53 per barrel in February 2015. Where spot oil prices rallied sharply in March 2016, the reflection of that in trade reporting likely will not be seen until April, if not May. When the higher prices are recognized, the headline, aggregate nominal monthly trade deficit should soar.

Separately, not-seasonally-adjusted physical oil-import volume in February 2016 averaged 7.404 million barrels per day, up from 7.312 million in January 2016 and from 6.859 million in February 2015.

Ongoing Cautions and Alerts on Data Quality. Potentially heavy distortions in headline data continue from seasonal adjustments. Similar issues affect other economic releases, such as retail sales and payrolls, where the headline number reflects month-to-month change. Discussed frequently (see *2014 Hyperinflation Report—Great Economic Tumble* for example), the extraordinary length and depth of the current business downturn and disruptions have distorted regular seasonality patterns. Accordingly, the markets should not rely too heavily on the accuracy of the monthly headline data.

Today's (April 5th) monthly trade release formally announced an annual benchmark revision to the trade data on June 3, 2016. Revisions will go back to January 2013.

Noted in trade-related *Commentary No. 748*, at least a three-percent understatement of the historical U.S. trade deficit awaits correction in the benchmark revision, along with implied, subsequent downside benchmark revisions to historical GDP growth pending for July 29, 2016.

Beginning with the headline reporting for July 2015, the Bureau of Economic Analysis (BEA) and the Census Bureau introduced a change in the trade-deficit calculation, now counting low-value imports, which previously neither were reported nor calculated in the monthly balance-of-payments estimates. To allow for near-term reporting consistency in recent headline data, trade detail back to January 2015 also was restated with July 2015 and subsequent reporting to incorporate a "temporary balance of payments adjustment for low-value imports," included in the trade calculations.

Where imports are counted on the negative side of the trade balance, the change in reporting methodology indicated that imports had been understated regularly, with the effect of underestimating the size of the U.S. trade deficit by at least three-percent. Such has negative implications for historical, broad economic growth and indeed for future GDP benchmark revisions.

Real (Inflation-Adjusted) February 2016 Trade Deficit. Adjusted for seasonal factors, and net of oil-price swings and other inflation (2009 chain-weighted dollars, as used in GDP deflation), the February 2016 merchandise trade deficit (no services) widened to $63.346 billion, from a revised $61.771 [previously $61.973] billion in January 2016. The February 2016 shortfall also widened sharply versus a $52.266 billion real deficit in February 2015.

As currently reported, the annualized quarterly real merchandise trade deficit was $588.6 billion for third-quarter 2014, $605.5 billion for fourth-quarter 2014, $692.4 billion for first-quarter 2015, $694.8 billion for second-quarter 2015, $706.1 billion for third-quarter 2015, and $721.7 billion for fourth-quarter 2015.

As indicated in prior *Commentaries*, the real fourth-quarter 2015 deficit was the worst quarterly shortfall since third-quarter 2007, and the real first-quarter 2016 deficit is on track to be even worse (again, see *Graph 1*). Based solely on the reporting of the January and February 2016 real merchandise trade deficits, the first-quarter 2016 is on track for an annualized shortfall of $750.702 billion. That would be the new worst such deficit since third-quarter 2007, and again, it would contribute negative growth to the first-quarter 2016 GDP estimate by an order of magnitude of roughly 0.4% (-0.4%). Based solely on the initial January 2016 detail, the first-quarter 2016 was on track for an annualized quarterly deficit of $743.7 billion.

Headline deficits likely will get even deeper in the months ahead, intensifying the already negative impact on GDP growth.

WEEK AHEAD

Economic Reporting Generally Should Continue on the Downside of Expectations, Increasingly Pummeling the Dollar and Boosting Gold, Silver and Oil Prices. Likely moving to the downside, amidst intensifying, negative headline reporting in the weeks and months ahead, market expectations for business activity should deteriorate sharply. The broad trend in weakening expectations for business activity, and in movement towards looming recession recognition, continues, as discussed in *Commentary No. 796-A*, *Commentary No. 795*, *Commentary No. 794*, *Commentary No. 789* and in *No. 777 Year-End Special Commentary*.

In response to ongoing non-recovery and down-trending in underlying economic activity, increasingly-negative reactions have surfaced in trading of the U.S. dollar and in related financial markets, with some related upside movement in prices for gold, silver and oil. These reactions reflect, at least in part, faltering expectations for near-term Fed tightening.

Weaker headline reporting of the regular monthly economic numbers increasingly should be accompanied by much worse-than-expected—negative—reporting for at least the next several quarters of GDP (and GDI and GNP). That includes a developing possible outright quarterly contraction for first-quarter 2016 GDP activity on April 28th, as well as pending downside revisions to GDP history (including fourth-quarter 2015) in the July 29th annual benchmark revisions.

In line with recent downside revisions to industrial production and pending negative benchmark revisions to retail sales, construction, durable goods orders and trade, expectations for the GDP benchmarking should fall sharply. That GDP benchmarking now is the most-likely point at which the elements for a "formal" recession call will be in full play.

CPI-U consumer inflation—intermittently driven lower in 2015 and early-2016 by collapsing prices for gasoline and other oil-price related commodities—likely has seen its near-term, year-to-year low. Although headline monthly February inflation was negative, annual inflation remained positive. Monthly prices should turn positive in headline March 2016 detail, in tandem with rising gasoline prices (see *Pending Releases*). Inflation will rise more sharply, going forward, boosted by a weakening U.S. dollar environment, and a continued, related upturn in oil prices and other commodities. Fundamental reporting issues with the headline CPI also are discussed here: *Public Commentary on Inflation Measurement*.

Note on Reporting-Quality Issues and Systemic-Reporting Biases. Significant reporting-quality problems remain with most major economic series. Beyond the pre-announced gimmicked changes to reporting methodologies of the last several decades, which have tended to understate actual inflation and to overstate actual economic activity, ongoing headline reporting issues are tied largely to systemic distortions of monthly seasonal adjustments. Data instabilities—induced partially by the still-evolving economic turmoil of the last nine-to-eleven years—have been without precedent in the post-World War II era of modern-economic reporting. The severity and ongoing nature of the downturn provide particularly unstable headline economic results, when concurrent seasonal adjustments are used (as with retail sales, durable goods orders, employment and unemployment data). That has been discussed and explored in the labor-numbers related *Supplemental Commentary No. 784-A* and *Commentary No. 695*.

Further, discussed in *Commentary No. 778*, a heretofore unheard of spate of "processing errors" has surfaced in recent surveys of earnings (Bureau of Labor Statistics) and construction spending (Census Bureau). This is suggestive of deteriorating internal oversight and control of the U.S. government's headline economic reporting. At the same time, it indicates an openness of the involved statistical agencies in revealing the reporting-quality issues.

Combined with ongoing allegations in the last year or two of Census Bureau falsification of data in its monthly Current Population Survey (the source for the BLS Household Survey), these issues have thrown into question the statistical-significance of the headline month-to-month reporting for many popular economic series (see *Commentary No. 669*).

PENDING RELEASES:

Nominal and Real Retail Sales (March 2016). The Census Bureau has scheduled release of March 2016 nominal (not-adjusted-for-inflation) Retail Sales for Wednesday, April 13th, which will be covered in *Commentary No. 798* of that date. Real (inflation-adjusted) Retail Sales for March will follow the next day, April 14th, in ShadowStats *Commentary No. 799*, in conjunction with the publication of detail on headline March CPI-U. With high odds of a month-to-month increase in the March CPI (see the CPI coverage), there is a parallel chance for real sales growth in March to be more-negative or weaker than the headline nominal sales activity. The pace of annual CPI-U inflation also should remain positive, helping to generate a continuing recession signal in historically low-level, annual real Retail Sales growth.

Market expectations likely will be around flat for the monthly change in headline nominal March Retail Sales, with risks heavily to the downside of expectations for the headline March change as well as for revisions to January and December details. Nonetheless, all the pending headline detail will be revamped anew in the annual benchmark revisions to Retail Sales on Friday, April 29th, back through at least 2012. ShadowStats will attempt to get an assessment of same out on the 29th, which could go into the weekend, depending on the actual timing, availability and complexities of the revisions. As indicated by the April 1st Industrial Production benchmarking, historical downside revisions likely loom for the Retail Sales series (see *Commentary No. 796-A*).

If March 2016 nominal Retail Sales and CPI-U inflation come in close to expectations, first-quarter 2016 real Retail Sales likely will contract quarter-to-quarter for the first time since first-quarter 2015, again, all subject to the subsequent annual benchmarking.

Constraining Retail Sales activity, the consumer remains in an extreme liquidity bind, as fully updated in *Commentary No. 796* and *No. 777 Year-End Special Commentary*. Without sustained growth in real income, and without the ability and/or willingness to take on meaningful new debt in order to make up for the income shortfall, the U.S. consumer is unable to sustain positive growth in domestic personal consumption, including retail sales, real or otherwise.

Producer Price Index—PPI (March 2016). The Bureau of Labor Statistics (BLS) will release the March 2016 PPI also on Wednesday, April 13th. Odds favor a headline gain in wholesale inflation, at least on the goods side of the reporting, due to a rebound in oil prices and related products.

Unadjusted oil prices rose sharply in March 2016, along with rising gasoline prices. Based on the two most-widely-followed oil contracts, not-seasonally-adjusted, monthly-average oil prices rose by 19.1% and 23.8%, in conjunction with a weakening U.S. dollar. That was accompanied by a 10.6% rally in unadjusted monthly-average retail-gasoline prices (Department of Energy). Where PPI seasonal adjustments for energy costs in March are negative, they still should leave the adjusted Final Demand Goods component of the PPI up by about 0.4%.

The aggregate PPI number, though, likely will be hit by offsetting, more-negative "inflation" in the dominant services sector, reflecting counterintuitive pricing pressures from shrinking profit margins with the sharply rising oil prices (see *Inflation that Is More Theoretical than Real World?* on page 12 of *Commentary No. 792*). The final headline PPI change, combining positive-product and negative-services inflation, likely will be weaker than whatever ends up as the consensus outlook for the aggregate, thanks to instabilities in the services surveying and estimations.

Consumer Price Index—CPI (March 2016). The Bureau of Labor Statistics (BLS) will release the March 2016 CPI on Thursday, April 14th. The headline March CPI-U should be on the upside by roughly 0.2%, or so, reflecting rebounding gasoline prices plus higher non-energy inflation. Despite a likely monthly increase in the seasonally-adjusted March CPI-U, unadjusted headline annual inflation in March should hold around its February 2016 level of 1.0%.

Changing Gasoline Impact. Average gasoline prices rebounded in March 2016, up by 10.63% for the month on a not-seasonally-adjusted basis, per the Department of Energy (DOE). Where BLS seasonal adjustments to gasoline prices in March traditionally are sharply negative, they would reduce the unadjusted price gain, but not turn it negative. Adjusted gasoline prices should rise by enough to add a positive 0.07% to the headline CPI-U monthly change. Boosted as well by somewhat higher food and "core" (net of food and energy) inflation, a headline monthly CPI-U gain of 0.2%, plus-or-minus, is a reasonable expectation.

Annual Inflation Rate. Noted in *Commentary No. 793*, year-to-year, CPI-U inflation would increase or decrease in the March 2016 reporting, dependent on the seasonally-adjusted monthly change, versus the adjusted, headline gain of 0.18% in March 2015 CPI-U. The adjusted change is used here, since that is how consensus expectations are expressed. To approximate the annual unadjusted inflation rate for March 2016, the difference in March's headline monthly change (or forecast of same), versus the year-ago monthly change, should be added to or subtracted directly from the February 2016 annual inflation rate of 1.02%. For example, a seasonally-adjusted, headline monthly gain of 0.2% in the March 2016 CPI-U would keep the headline annual CPI-U around 1.0%, plus-or-minus, depending on rounding.

Index of Industrial Production (March 2016). In the context of massive downside benchmark revisions through February 2016, as published on April 1st (see *Commentary No. 796-A*), the Federal Reserve Board will release its estimate of Industrial Production activity for March 2016 on Friday, April 15th, with coverage in *Commentary No. 800* of that date. Headline reporting likely will continue on the downside, both month-to-month and year-to-year, with further revisions to recent months, despite the just-published benchmarking.

First-quarter 2016 production is likely to contract quarter-to-quarter for the second consecutive quarter (the fourth in the last five quarters), and it is virtually certain to be negative year-to-year, for the second consecutive quarter (the first time since the economic collapse). A monthly gain above 0.64%, net of prior-period revisions, would be needed to push quarterly production growth above zero. A monthly gain above 4.08% would be needed to push the quarter into positive year-to-year growth.

Expectations likely will come in on the downside of flat, but as has been the case here for some time, headline reporting and revisions remain a good bet to offer negative surprises versus the consensus outlook, even in the context of recent downside historical revisions.

