The CJ Investment Newsletter

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Governmento Obscuro

Quick Look

Market	**Next Expected Move**
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- Government statistics are being manipulated by the government for their own ends. Some statistics bear little resemblance to what they are supposed to measure, especially as compared to the calculation of the original measures.
- Some space is devoted to the current government shutdown and related issues.

Governmento Obscuro

Note: Much, if not most, of this section comes from Chapter 13 (Fuzzy Numbers) of the outstanding book The Crash Course, Chris Martenson, 2011, John Wiley & Sons, Inc. The primary market and economic information in this book will be discussed in a future CJ Newsletter (CJ). Cites from this book will be notated by "CC" in parentheses, followed by a page reference.

Do you ever wonder why government statistics, especially about economics, seem not to jive with your personal experiences and those of other people you know? Perhaps that is because those same statistics are modified from how they were reported in the past in order to:

- forward the government's agendas
- keep us from realizing how bad things are at times, and blame the government.

It reminds me of a line from an obscure (even then) 1960's & 1970's comedy group called the Firesign Theater:
"Now if you're Mr. Common Sense, you won't believe me when I tell you that…"

Our governments are so omnipresent in our daily lives anymore that, for whatever reason, we rarely, if ever, apply the degree of skepticism about the activities of the governments that our founders intended us to. In our avoidance of that skepticism, we also trust our government to be at least trying to make our lives better. Clearly, we *want* to trust our governments. After all, to not trust them would mean we might have an obligation to *act* on something, and our lives are already so *busy*, aren't they?

Besides, they have all the police and military reporting to them, and all their guns. Still, there is that pesky 2nd Amendment thing. Guess our founders *really* didn't trust government much. They felt and believed that government, all too often, becomes an end unto itself or a vehicle for some to impose improper restrictions on humanity's God-given freedoms. So far, not one single government in history, including ours, has failed to justify their opinions.

Below is a description of how power is maintained and unrest avoided through the manipulation of government statistics.

The law of unintended consequences often rears its ugly head when it's the least helpful. "What if it turns out that our individual, corporate, and government decision making was based on deeply misleading, if not provably false, data?" (CC, p. 103)

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"Socialism is a philosophy of failure, the creed of ignorance, and the gospel of envy."
"If you have ten thousand regulations, you destroy all respect for the law."
- Sir Winston Churchill

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Martenson's organization of this chapter was so logical and reasonable; I'm going to use the same organization here.

Administrative Bias
Politicians are always aware of their need to be reelected as well as how history will view them, assuming they are important enough to even be mentioned by history. In this light, the integrity of all politicians will be tested. To be kind, some of them may not have a full understanding of any one subject and may rely on advisors who provide less than truthful advice. Others cannot claim ignorance when they change aspects of law, meanings of words, and methods of measurement. Below are some of the changes made to US officially reported economic measurements by various administrations since 1960.

In order to keep unemployment statistic low, President Kennedy authorized the creation of a new employment category – discouraged workers, *i.e.* people wanting work that found prospects so poor they stopped looking currently. *Real* unemployment includes them the same as it always was, but the *reported* numbers look better. Thus, also the politicians. Never mind that voters don't recognize the extent of the problem, nor demand it be addressed because of this misreporting.

President Johnson can claim the "unified budget," which rolled Social Security "surpluses" into the general budget funds, thereby creating the impending Social Security crisis we now face today through another accounting fiction. But, it kept federal taxes lower during his administration and some of the subsequent ones. What could have been substantially funded by payroll withdrawals has now become a massive looming liability with no answer in sight.

President Nixon authorized the creation of the inflation measurement known as "core inflation," the measure of inflation that strips out the costs of food and fuel. This is the number reported first by the Fed, at least since Bernanke became chair. As long as you don't eat, drive, use electricity or engage in most other normal daily activities, this is the measure of inflation for you!

President Clinton is responsible for adopting the Boskin Commission recommendations that further manipulate reported inflation statistics so that they bear even less resemblance to reality than the numbers reported as "core inflation." These changes will be discussed below.

Recommended Reading

http://www.mauldineconomics.com/outsidethebox/the-need-for-a-new-economics

If you read nothing else this year related to economics, (besides my newsletter, of course) read this article introduced by John Mauldin and written by George Gilder. This is transformational stuff. In my humble opinion, within 10-20 years, our views of economics and capitalism will be totally transformed by those thinking in these ways. If this is not the future, then we are, in fact, doomed to the dark future described by George Orwell, not the shining vision of Ayn Rand.

Critically Important: None of these changes has been returned to more honest reporting by subsequent administrations.

Not to let him do my work for me, but Martenson described the cumulative nature of these measurement changes perhaps better than I could:

"Unfortunately, the cumulative impact of all this data manipulation is that our measurements no longer match reality. In effect, we're telling ourselves lies, and these untruths serve to distort our decisions and jeopardize our economic future. .. However, with the current and emerging economic difficulties, we will find them to be as severe a liability as defective cockpit instruments would be to a pilot navigating a gap through the Rockies." (CC, pages 104-105)

Inflation
The classic way to measure inflation over time is to track the cost of a basket of goods, measuring price changes over a period of years. This is the method used by the US government prior to President Nixon's change to the "core inflation" method described above.

In 1996, President Clinton implemented the Boskin Commission methods, which added three new tools to the measurement of inflation in the US:

- Substitution
- Weighting
- Hedonics

These methods are applied to all inflation measures, including the traditional, core inflation, and any other measures reported by the government.

Substitution simply requires that if the price of some
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good in the basket of goods rises "too rapidly," it is *assumed* that the consumer would substitute a cheaper choice of the same type of good. Of course, we have now left the realm of measurement and moved into the field of judgment. Obvious questions with obvious answers:

- Who decides when the price of a good is rising "too rapidly?"
- Is the assumption valid in all cases?
- How do government personnel decide which substitute is to be used?
- How often is this standard applied?

This new method reported that food costs rose 4.9% in 2007. The Farm Bureau, which uses the traditional method of tracking the goods basket from year to year, reported that food costs rose 9.2% for the same period. I guess 4.9% does look better to an uninformed populace that 9.2%, even though our *real* costs did actually increase 9.2%. This might cause a little cognitive dissonance and confusion in the population as their real world experiences are not mirrored by government statistics.

The **weighting** method intentionally underweights the items in the economic basket which are rising most rapidly under the assumption that price increases in these items will cause consumers to use less of them. I take it these brilliant government economists and measurement specialists simply don't believe in price inelastic goods, then. Price inelastic goods are those goods in which usage does not change much because there is no real or reasonable substitute for the good in question. Examples abound: gasoline, heating oil, electricity, water, etc.

One particularly daunting statistical misapplication of this rule is health care (CC, p. 106-107). Currently, the Bureau of Economic Analysis (BEA) reports that health care represents about 17% of the US economy. However, the government's Bureau of Labor Statistics (BLS – one of the "official" government reporting agencies) includes health care price changes only to the amount of 6% of the CPI (consumer price index). This arbitrary underweighting of health care costs from what its actual represented weight should be dramatically understates inflation as measured by the CPI, as compared to how these prices really affect consumers.

Hedonics is a name translated from the Greek meaning "for the pleasure of." This adjustment is supposed to justify the changing of inflation measurements to compensate for increases in quality and utility of products included in the inflation measurement process. Clearly, this is a judgmental and arbitrary adjustment at best, and the BLS applies this adjustment to all measured goods. While there are periods when some products undergo rapid changes in quality, utility and price, there are no quantification standards by which such an adjustment can be applied or how much it should be, especially if you consider consistency in the mix. Therefore, at best, it is an arbitrary adjustment to governmental measures of inflation. Consider it like a "get out of jail free card" for when the government decides reported inflation is simply higher than they want to report.

Individually, each of the three adjustments applied from the adoption of the Boskin Commission methods can and do distort reported government inflation statistics in a major way. Taken together, it would be hard to argue that any reported inflation measurement from our government bears any resemblance to reality for any given year. Worse, though, is that any errors are also *cumulative*. Since annual adjustments are then applied to similarly arbitrary prior year numbers, whatever errors are present in this year's calculations are then additive to the cumulative errors present in the previous years reported amounts.

I think it important to remember here that these adjustments were incorporated into the calculation of inflation statistics in order to make the government look better to voters, not to increase the accuracy of the reporting. Once someone becomes informed about what all these adjustments are and how they are applied, it would seem ludicrous to attempt to convince him/her that government reported inflation statistics bear any resemblance to reality in any fashion whatsoever (in particular since 1996), especially as these techniques are applied cumulatively to the erroneously reported numbers of prior years. However, understanding what these techniques are does help us to understand *why we have to have so many people working for the government* involved in the calculation and application of these techniques.

GDP

"In theory, the GDP is the sum total of all value-added transactions within our country in any given year. Just like the CPI (inflation measure), the GDP measure has been so twisted and tweaked by government statisticians that it no longer tells a recognizable version of the truth."

"The reported GDP amount for 2003 was $11 trillion, implying that $11 trillion of money-based, value-added economic transactions occurred. But, that did

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"not actually happen. To begin with, that $11 trillion included $1.6 trillion of so-called imputation adjustments, where economic value was assumed ("imputed") to have been created, but where no cash transactions had actually taken place. Despite the fact that there was no trade and nothing changed hands, a value was still assigned to these assumptions and reported as part of the GDP." (CC, p. 109)

Additionally, hedonics rears its ugly head in the adjustment of reported GDP, only this time, instead of adjusting the number downward, this method is used to adjust the GDP upward. We certainly can't rely on actual economic transactions alone when reporting something as important as GDP! Total hedonic adjustments for 2003 were $2.3 trillion.

So, added to the $1.6 trillion of imputed income, the total government adjustments to 2003 GDP were $3.9 trillion, or 35% of the total reported GDP. Over 1/3 of the reported total was government adjustments!

Does anyone reading this still not understand why your real-world experience of our economy does not fit with the government's description of it as shown through the official statistics? Now, please re-read the final paragraph of page one and ponder its implications.

The Government Shutdown

Our federal government has been "shut down" since, I believe, 10/1/2013 because of the inability of DC politicians to manage to find enough agreement over budgetary items, especially the Affordable Care Act (ACA, aka Obamacare), to implement a spending bill or continuing resolution that would allow the federal government to continue operating as it usually does.

My purpose here is not to attempt to provide answers that should solve the dilemma, but simply to make a few observations germane to this event.

First, we should at least entertain the idea that some of the actions and words from the politicians are principled and that perhaps their constituents elected them to do just what they are doing. I just don't see what's wrong with that. It should actually be praised! Agree or disagree with the issue, I, would like my own representatives to be willing to stand up for their constituents' beliefs. I would also hope they told the truth during their election and that these were the particular politician's beliefs, also.

Second, politicians who criticize others who stand up for their honestly held beliefs break with the principles upon which the founders created America. Such criticism can only mean these criticizing politicians:

- disagree with those they are criticizing
- only want these founding principles applied when *they* are standing up for a cause.

Espousing such criticisms is incredibly disingenuous and hypocritical. After all, when the criticizer finds him/herself in a minority position later on a different issue, he/she will want to exercise the very rights the person being criticized is exercising now. Even if you *agree* with a person politically, be suspicious of the person who would deny *other* Americans their rights.

Finally, I think we need to give up on the idea of a media that reports in any way that resembles impartial or fair. It doesn't take a great deal of time, experience or intelligence to see which side a particular media outlet is favoring. Regardless of whom they favor, the fundamental taking of sides in the reporting of events is wrong. In fact, it's not reporting, it's opining and should be represented as such.

Purpose

The *CJ* Investment Newsletter deals with most of the spectrum of securities investing, including cash (money market funds), bonds, equities and derivatives. It will evaluate the overall investing environment and, from time to time, discuss the relative allocations (including avoidance) of these asset types, as well as strategies to implement them (individual stocks or bonds, CEF's, ETF's, open-end mutual funds, and derivatives). Essentially, it reflects what I'm actually doing with my clients.

However, that's not its only purpose. Even if you never become a client, if you want this information, I want you to have it – for a while, anyway. My hope is that providing this information and teaching you what I consider important when investing may help you. I'd also love to hear any questions or comments you may have about my letter.

These letters are not sent "cold." Either I know you or someone you know gave me your name. Yes, this letter *is* a sales tool. It communicates how I analyze the markets and economy, as well as how I apply my investment strategies, so that you can decide, without any sales pressure, if my thinking is compatible with how you want your money invested. If you're not already a client, I would like to discuss your *becoming* a client. Please contact me for more information.