



GDP—Not All It's Cracked Up to Be

With all the talk about the need for more economic growth, we wanted to focus on our national Gross Domestic Product (GDP) and its relevance to making investment decisions. This article will explore how the United States measures economic growth, the shortcomings when using GDP to measure economic strength, and whether it should matter to anyone who is not an economist.

How does the U.S. measure its economic growth?

Gross Domestic Product measures the total economic output of a country and is the primary gauge investors use to determine the growth and health of an economy. The formula is $GDP = \text{Consumption} + \text{Investment} + \text{Government Spending} + (\text{Exports} - \text{Imports})$. The annualized quarterly percentage changes in GDP reflect the change in the growth rate of total economic output of a country.

In the United States, there are a variety of quarterly GDP reports — advance, preliminary and final — which are revised one, two and three months after the previous calendar quarter. Additionally, GDP is revised annually each year in July, affecting the five previous years of data. Because of the revision process, each data point can only be relied upon so much for accuracy in its future predictive value.



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Is GDP still a valid statistic?

While GDP is useful, it has some significant shortcomings. GDP measures the value of goods and services produced, but it doesn't measure the profitability of their production. As a result, a country could show growth in total economic output (GDP) and yet experience a decline in aggregate profits. While the rising GDP would make it look like the country was doing well economically, its economy could in reality be very unhealthy if producers were selling their products below their costs. (Trade deficits also do not measure profits, but we will save that discussion for another time.) Changes in inventories and net exports can potentially create large changes in GDP. For example, a large increase in inventories (which represents a lot of unsold goods) might be indicative of future weakness, rather than strength.

Does GDP include revenues from businesses overseas that are owned by Americans?

No, GDP only measures what is produced within a country's borders. It does not measure growth in

enterprises owned by citizens of one country that are domiciled in another nation. As an example, today a significant portion of the sales of many large U.S. companies are outside of the United States. These sales are not reflected in the U.S. GDP. Prior to 1991, the United States used Gross National Product (GNP) as its primary measure of production. GNP measures products produced by enterprises owned by a country's citizens, whereas GDP defines its scope according to location.

How does the deficit affect the GDP calculation?

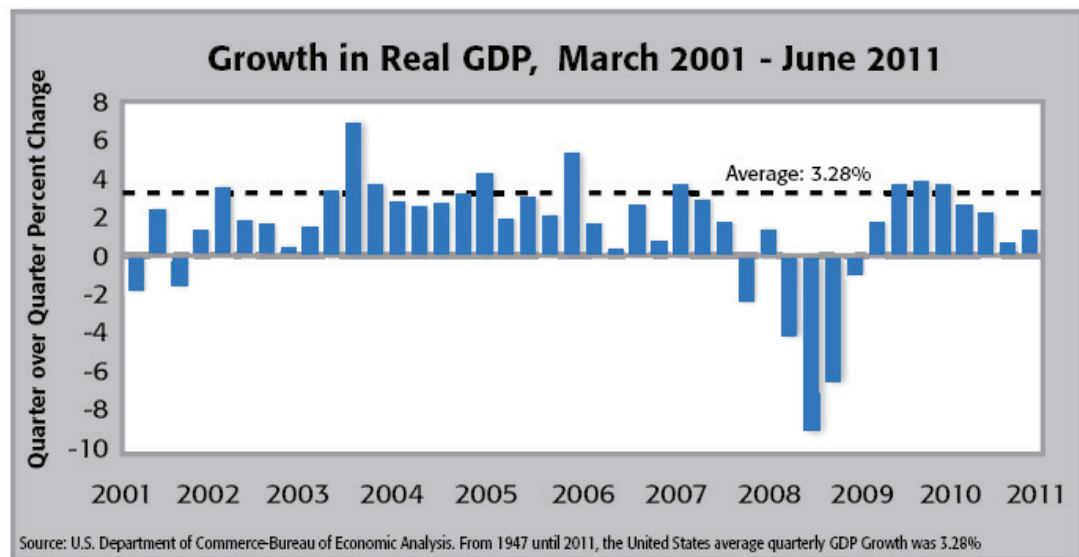
Probably the largest shortcoming of GDP is that its numbers are artificially enhanced by government deficit spending. Currently the U.S. federal government is borrowing and spending roughly 10 percent of GDP per year. This deficit spending is included in the GDP calculation, making it appear that economic growth is stronger than it really is, although borrowing and spending at such levels is not a reflection of a healthy economy.

The GDP calculation does not distinguish between changes in structural GDP and private GDP. To do that, the GDP calculation would have to be adjusted and shown net of deficit spending. The

United States may need our GDP to contract some in the short term (due to reduced governmental spending) for the structural and private sector GDP to be able to produce sustainable long-term growth.

How has the United States done in growing our economy over time?

Historically from 1947 until 2011, the average annual growth rate in U.S. GDP has been 3.28 percent, with a high of 17.20 percent (March 1950) and a low of -10.40 percent (March 1958). Over the past decade, the graph shows that U.S. GDP growth has been primarily up. We have had eight consecutive calendar quarters now with positive GDP growth. The term "recession" is typically defined as two consecutive quarters of negative GDP growth.



Watching GDP trends is a way some investors and economists try to read the tea leaves to determine if we may have the much talked about, but seldom historically experienced, double-dip recession. (It

has been humorously said that economists have accurately predicted 10 of the last two recessions.)

How is the United States doing now and what does future growth look like?

During the second quarter of 2011, the preliminary GDP figures rose at an annual rate of 1 percent, down slightly from the advance 1.3 percent rate the government estimated in July. Overall consumer spending, which makes up approximately 70 percent of GDP, grew only 0.4 percent during the second quarter; although that was better than the 2.1 percent decrease in consumer spending during the first quarter. Looking ahead, the Congressional Budget Office forecasts 2.6 percent growth in GDP for 2012 and then 3.6 percent for 2013, 2014 and 2015. While these are lower numbers than normal historically for the U.S. economy coming out of a large recession, they may be overly optimistic if the U.S. government does not get its financial house in order. But when our government begins to function properly and removes the regulatory and tax uncertainties for businesses, growth will begin again and could surprise us all on the upside.

Conclusion

GDP provides one way of measuring economic growth but has numerous shortcomings and should not be solely relied on to get a comprehensive view of how the economy is doing. The Brightworth Investment Committee and the various money

managers we use in client portfolios regularly monitor a wide variety of economic indicators from many angles to make disciplined investment decisions. This broad perspective, obtained by analyzing many different viewpoints, is essential for making wise investment decisions. 