

Mitch on the Markets

The Problem with GDP Calculations



By Mitch Zacks
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For the better part of a century, economists have been wrangling over the most effective and accurate way to measure the U.S. economy's size and growth. Spoiler alert: they haven't found it yet.¹

To be fair, the task before them is monumental – measuring an economy as diverse, massive, and ever-changing as the U.S. economy is incredibly challenging. And it's only becoming harder as the 'invisible hand' of technology touches nearly every facet of social and business life, adding value in ways that simply cannot be measured.

A good way to understand the GDP problem is to think about the economy in the 1960's versus the economy today. Back then, when a company bought a new machine, it was easily counted as an investment and contributed directly to measured GDP. Today, when a group of entrepreneurs at Amazon come up with a new business idea and form a team to pursue it, the new endeavor

doesn't count as anything. Or when a firm reorganizes to improve productivity, for instance, there is no change to GDP. Yet these changes and new business pursuits are happening all of the time.²

In the 1970s, the value of all of the machines and equipment and inventory accounted for something like 80% of a company's valuation.³ For technology companies today, the dynamic is arguably just the opposite, where the majority of a company's value lies with intangibles like intellectual property, users, technology patents, and human capital. Research and development, for instance, has only recently been added to GDP calculations.

Another flaw I see with GDP is how imports are treated. The calculation subtracts imports from exports and ultimately does not treat imports as domestic demand. That's a problem, in my view! Imports are often a critical component of total output, as often times imports are simply components used to develop a final product – which may be sold domestically. In my view, it's total trade that matters – not surpluses or deficits.

At the end of the day, these GDP flaws are not new or groundbreaking revelations. In fact, the government agencies in charge of the calculation have themselves acknowledged that official data has almost certainly understated the changes in real output and productivity over the last few decades. According to officials at Bureau of Labor Statistics (BLS) and the Bureau of Economic Analysis (BEA), real GDP growth may have been underestimated by about -0.4% *annually* from 2000 – 2015.⁴ Do the math on that, and we're talking trillions of dollars of unaccounted-for GDP.

Bottom Line for Investors

I'm not sure there is a great solution for calculating GDP in the digital age, and I do not envy the economists tasked with the challenge of doing so. And the point of my writing the column this week is not to thrash the GDP calculation – it's to remind investors not to rely solely on GDP as the holy grail of economic health. In my view, it's too flawed to have such influence over investor sentiment.

The better measure of the economy's overall health, in my view, is not a backward-looking indicator like GDP, but rather a forward-looking indicator that may give us some insight into the future value of the economy. I'm talking, of course, about the stock market.

About Mitch Zacks

Mitch is a Portfolio Manager at Zacks Investment Management. Mitch has been featured in various business media including the Chicago Tribune and CNBC. He wrote a weekly column for the Chicago Sun-Times and has published two books on quantitative investment strategies. He has a B.A. in Economics from Yale University and an M.B.A in Analytic Finance from the University of Chicago.

¹ The Economist, April 30, 2016, <https://www.economist.com/briefing/2016/04/30/the-trouble-with-gdp>

² The Economist, April 30, 2016, <https://www.economist.com/briefing/2016/04/30/the-trouble-with-gdp>

³ The Economist, April 30, 2016, <https://www.economist.com/briefing/2016/04/30/the-trouble-with-gdp>

⁴ The Economist, April 30, 2016, <https://www.economist.com/briefing/2016/04/30/the-trouble-with-gdp>

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