When gross domestic product matters for investors

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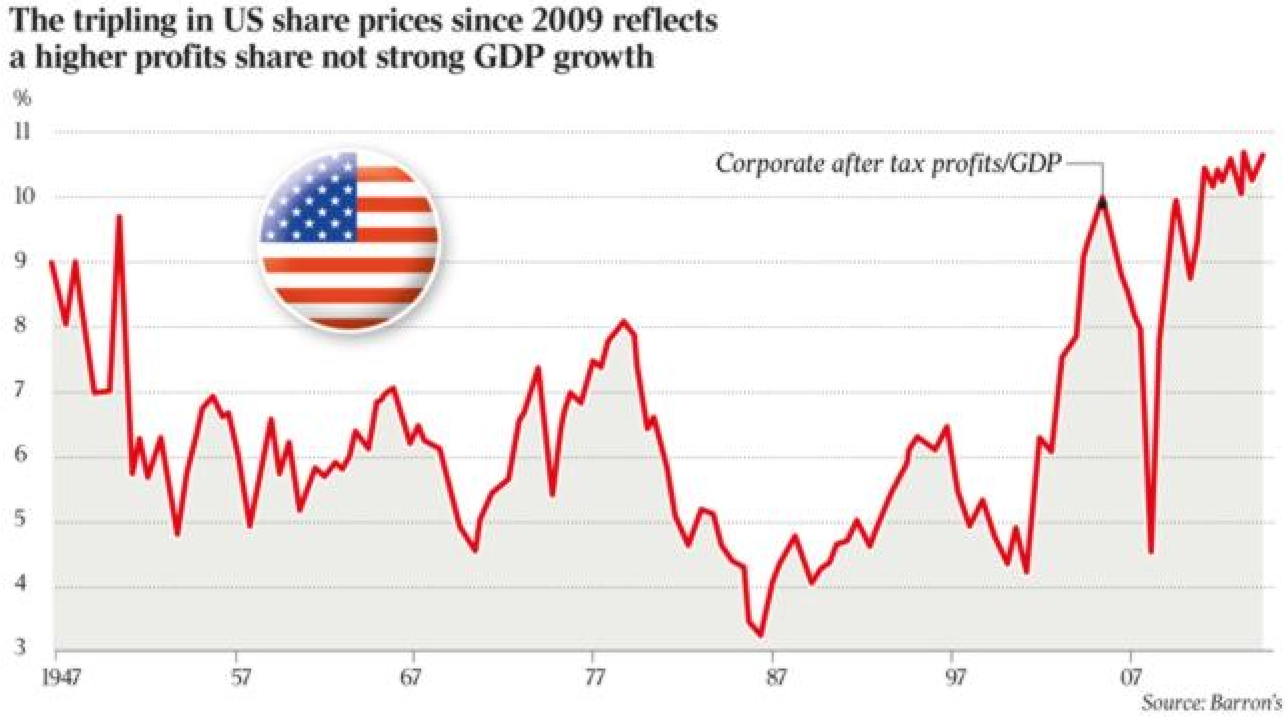

US on the rise *Source:* TheAustralian

Does keeping a close watch on statistics of our gross domestic product — and on the GDP of major economies such as China and the US — help Australian investors earn better returns?

First, a quick reminder. GDP, which is the total output of goods and services produced in the economy, is published quarterly in what are called the national accounts; these also record the industry composition of that output and what's happened to incomes.

Many of the major items in the national accounts, including GDP, are presented in two ways: in "constant price" (or "real") terms to show how things look when inflation is stripped out of the numbers, and in "current price" (or "nominal") terms to show how the various aggregates look when measured in the prices of that quarter.

Here are eight ways in which GDP statistics matter — or don't matter — for investors.

1. Strengthening growth in GDP is generally positive for shares (better revenues and profits) but mostly negative for bonds (higher inflation). However, there's not a close and consistent relationship between GDP and the share market — mainly because GDP statistics are backward-looking (and published with long lags) while share investors try to be forward-looking.

2. Share markets often respond to changes in market expectations for growth in real GDP. That’s why so much attention is currently being paid to forecasts for US real GDP. With valuations for US shares now somewhat stretched and interest rates likely to rise, there’s need for investor confidence in the continuation of reasonable economic growth in the US before its share market can move strongly upwards again.

3. As the graph shows, the profits share can vary a lot, both over the cycle and in trend terms. The tripling in US average share prices in the last six years owes a lot to the marked increase in the profits share in that country.

4. The US produces a quarter of the world’s output of goods and services. Understandably, investors in other countries keep a close watch on US real GDP — and many were concerned by the fall of 0.7 per cent in the March quarter. They can take comfort. For the rest of the world, US GDP isn’t what matters. Instead, what’s relevant is real total spending, including spending on imports, by residents of the US — and that measure rose by 1.1 per cent in the quarter.

Investors need also to allow that quarterly economic statistics in the US are published as annualised numbers: thus quarter-on-quarter rates of change are shown as though they’d been running for a full year. Expressed in the Australian way, US real GDP fell by 0.2 per cent in the March quarter and real total spending in the US rose by 0.3 per cent.

5. The big swings we experience in our terms of trade affect our incomes (and general wellbeing) but aren’t recognised in GDP, which shows only the volume of goods and services produced. In the year to the March quarter, Australia’s real GDP rose by 2.3 per cent while the relevant measure of incomes — real gross domestic income — declined slightly.

6. Over time, the yield on our long-term bonds tends to roughly match the rate of growth in nominal GDP.

7. China’s statistics on GDP, which are a highly politicised set of numbers, are given too much credence in shaping investors’ views on the strength or weakness of the Chinese economy. And investors need to recognise that China’s strong growth over recent decades means its achievable rates of growth in future years are being greatly reduced.

8. A recession is often defined as two or more consecutive quarters in which real GDP contracts.

On that definition, our economy hasn’t had a recession for almost 25 years. Common sense says that sharp collapses in household and business confidence should be allowed for in defining a recession — and that we were in recession in late 2008 and early 2009.

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