MV Capital Management Thought Content Series: Markets in Transition

The Growth Paradox: GDP, Businesses and Consumers

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For once, it seems, you actually could attribute the stock market's performance to the day's big news item. On Friday morning we learned that US GDP growth slowed to 2.4% in the second quarter, and at the end of the day the market was flat. You get the sense that the DJIA looked at the 2.4% figure and its component parts, scratched its head for a few minutes, then shrugged, dropped a point and went out for a Friday afternoon beer.

We have a sense – sort of – about a couple things. First, the 2007-09 recession was more severe than earlier GDP releases indicated – this we learned from the spate of revisions issued by the Bureau of Economic Analysis. Second, it seems the economy is rather weaker than previous recoveries have been at this stage – mostly due to the persistence of high unemployment and underemployment and its effect on consumer spending. As we all know, consumer spending is the machine that keeps the economy going – accounting for over 70% of total GDP. Consumer spending slowed to a rate of 1.6% in the quarter just passed.

But wait – there are two other data points here that don't adhere to the weakness narrative. Business investment was up a whopping 29% - a number that does not seem at all unusual in the context of the very upbeat tempo of the current earnings season. The other unusual number is imports: in the second quarter we had a net negative export-import balance. That means, on the one hand that net foreign trade activity subtracted from GDP: when imports are higher than exports GDP goes down – by 2.8 percentage points according to analysts' estimations. On the other hand, though, high imports are a sign of demand – after all anything we buy from China or Germany or wherever falls into this category. But isn't "weak demand" supposed to be the meta-theme here?

No wonder Mr. Market shrugged and pulled the blanket back over his head.

This is not a particularly opportune time to be getting mixed signals about the economy – policymakers have important decisions to make about interest rates, stimulus measures, tax cuts, deficits and so forth – and in making these decisions it is sort of helpful to know if we are heading into a deflationary quagmire or if global growth is going to trigger inflation – if the world's dominant economy is going permanently soft in the middle or if that is silly talk – the kids are alright, thank you very much. But the fact of the matter is that we don't know – "we" including you, including us, including market veterans in New York and renowned Princeton economists.

It is worth remembering, though, that GDP is just a number. Like any metric it has its strengths and its weaknesses. GDP tells us what households, businesses and government entities domiciled in the US are spending. It does not, however, give us a complete picture about what businesses are *earning*. Here's what we mean by that. If I go down to my local car dealer and buy a Chevrolet made at a factory in Michigan, that purchase shows up in GDP in the Personal Consumption Expenditure (PCE) column. Obviously the local car dealer and GM have both earned some money from my purchase, but for GDP purposes all that matters is that an American consumer bought an American-made product in America.

Now consider another case: GM operates a production facility in China that manufactures and sells cars to Chinese households. GM makes money from these sales just the way it makes money from selling to me – but that transaction shows up nowhere in GDP. At least not in US GDP – of course the sales of

Chinese-made GM cars to households in Shanghai and Shenzhen do show up in the PCE column of *China's* GDP.

There is nothing new about this: GDP has been computed this way for some time now. What is new, however, is the volume: simply, the percentage of economic activity by US companies that *never shows up in our domestic GDP* measure is increasing rapidly. In nearly any major industry sector the income statements of the leading enterprises will show that non-US sales are the fastest-growing component of revenue by far. You've heard it before from us – the emergence of the six billion-strong global middle class is one of the dominant stories of our time. When business investment is up 29%, when US corporate earnings grow in double digits even while US GDP limps along – *these are signs that the third postwar economic era has arrived*. Briefly, the first era was that of Bretton Woods and managed trade, with the US leading the eviscerated economies of Western Europe and Japan back to stability and health. Bretton Woods fell apart in the early 1970s and gave way to the era of privatization, deregulation and globalization. In that era capital flowed out of the rich West into emerging markets and their cheap sources of labor.

The third era is that of global location. "Emerging markets" is no longer useful to describe what are instead becoming regional clusters of consumer, production and capital markets. GE builds giant R&D facilities in India, employing thousands of local Indians who in turn are buying Cisco telephone systems from local production sources. Investment bankers based in Hong Kong or Singapore compete for the rights to lead-manage the hot new initial public offerings (IPOs) coming out of China or Malaysia.

This new world is taking shape, perhaps sooner than one would have predicted. It may be a very prosperous world in the aggregate, with millions of humans climbing out of poverty into a higher standard of living than even their parents, let alone grandparents, could have ever foreseen. But "prosperous in the aggregate" will mean very little to an out-of-work resident of Detroit or Dortmund, Providence or Palermo, for whom this new world is likely to present tough lifestyle choices, tougher indeed than their parents may have ever foreseen. There are opportunities ahead, but there are also challenges.

With warm regards,

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