INVESTMENT FUNDAMENTALS

What is Gross Domestic Product?

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Snapshot

- Gross domestic product (GDP) represents the size of a nation's economy.
- Governments and central banks rely on GDP data to set fiscal and monetary policy, while some investors consider GDP when making investment decisions.
- While an important metric, GDP does not provide a full picture of a nation's economic health.

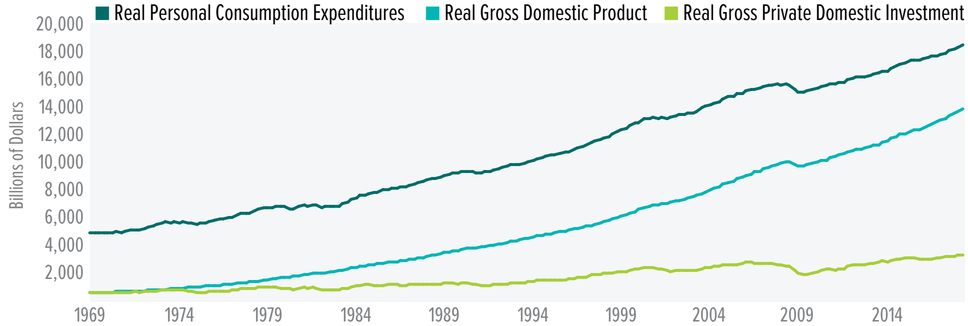
Gross domestic product (GDP) is the market value of all goods and services produced within a nation.

- It represents the size of a nation's economy and is used to determine the economic growth rate (or GDP growth).
- In the U.S., GDP is measured quarterly and includes four components: personal consumption; business investment (purchases made by companies to produce consumer goods); government spending; and net exports (exports minus imports).
- GDP is widely used to gauge a country's economic health and standing relative to the rest of the world.

GDP growth moves in cycles, as economies alternate between periods of growth and decline.

- Accelerating GDP growth generally indicates increased employment, consumption and investment. Slowing GDP growth suggests easing in these economic indicators.
- Two consecutive periods of declining GDP growth is widely considered a sign of economic recession.
- GDP growth generally shapes economic confidence, which, in turn has been known to influence companies' investing, hiring, consumption and wage-setting decisions. Greater economic confidence, for example, tends to increase these metrics. This is illustrated in Exhibit 1 below.

Exhibit 1: Relationship between GDP, consumption and investment from 1970 to 2018



Source: Federal Reserve Bank of St. Louis

GDP can signal certain economic trends that may impact capital markets.

- Investors monitor a country's GDP in order to identify economic developments that may affect their asset-allocation decisions.
- Comparing GDP growth across nations and time periods may also help inform investment decisions.
- Expanding GDP typically correlates with stronger-performing markets. When GDP growth accelerates, therefore, investors tend to favor riskier assets (which are expected to provide higher returns in stronger markets). When GDP growth weakens, investors are typically more risk-averse and flock to so-called safe-haven assets (such as higher-quality equities and government bonds).
- Strong GDP growth may also point to greater demand for credit among businesses and consumers alike—and increased borrowing usually coincides with higher interest rates, which may signal rising inflation.

Although a widely used metric of economic health, GDP does not include some important components of a nation's economy.

- The formula used to calculate GDP excludes child care, unpaid services and volunteer work, as well as so-called black-market activities (which, while illegal, impact economic growth).
- GDP calculations also omit external costs tied to certain goods and services, such as the disposing of materials that are otherwise inexpensive to create.
- A less-direct external cost of production not factored into GDP is air and water pollution generated by manufacturers, which can cause widespread illnesses that are often expensive to treat and can lead to decrease productivity.
- GDP per capita (total GDP divided by total population), which is used to measure a nation's standard of living, does not consider income inequality among citizens.

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