Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist

TRENDMACRO LIVE!

On Q2 GDP, and the Intellectual Property Revolution

Wednesday, July 31, 2013

Donald Luskin

The new information economy is bigger than we knew -- but it's not growing any faster.

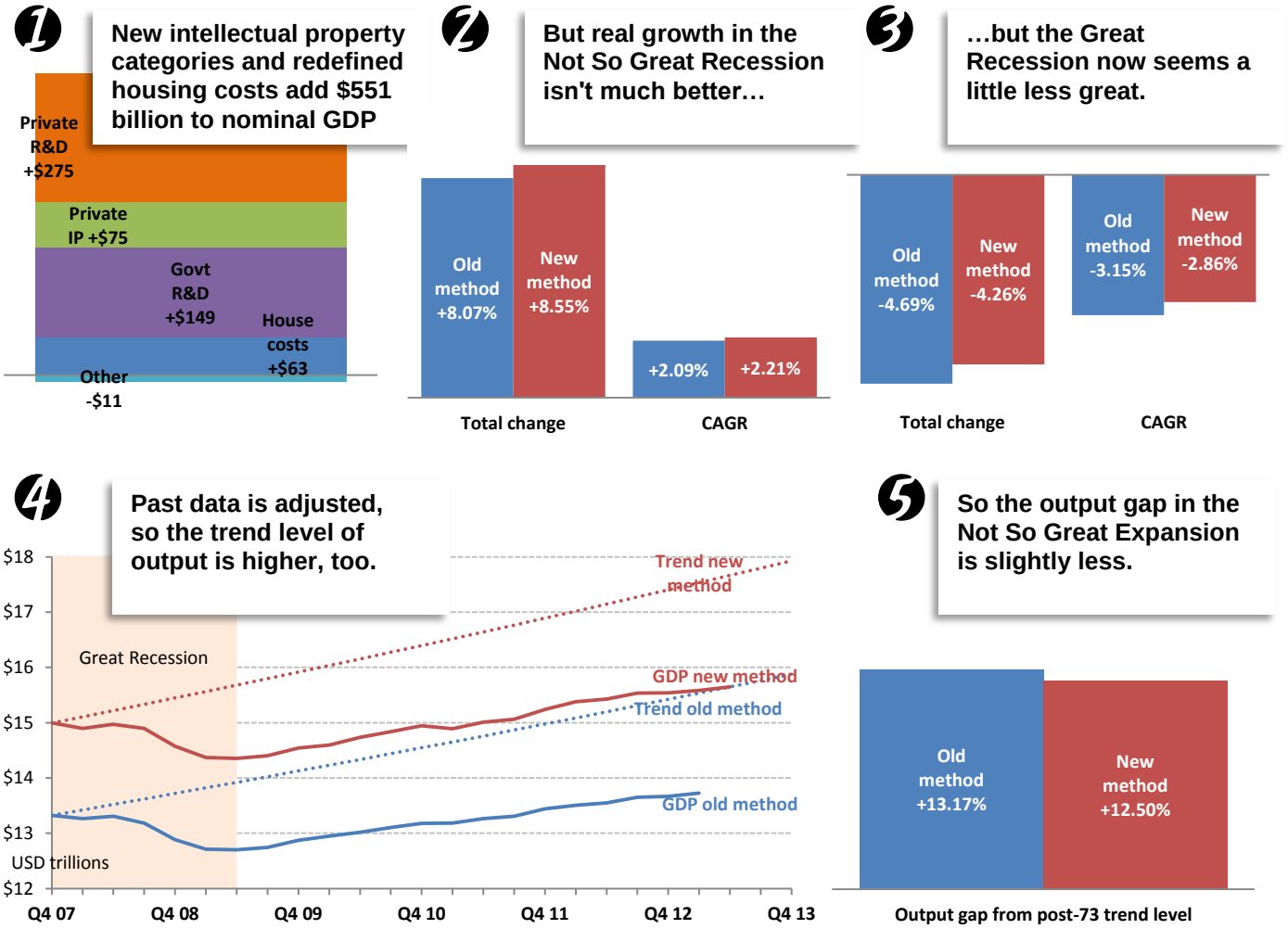
This morning's advance estimate of Q2-2013 gross domestic product at 1.7% real growth beat very low expectations for 1.0%, but Q1 was revised down by the amount of the Q2 beat. The already Not So Great Expansion staggers under new supply-side and demand-side blows from January's tax hikes (see "Tax Hikes Have Consequences" January 2, 2013).

Of more interest today are the revolutionary revisions in the fundamental definition of GDP introduced today, which ripple backward in time in a complete recalculation of all the data beginning as far back as 1929.

Update to strategic view

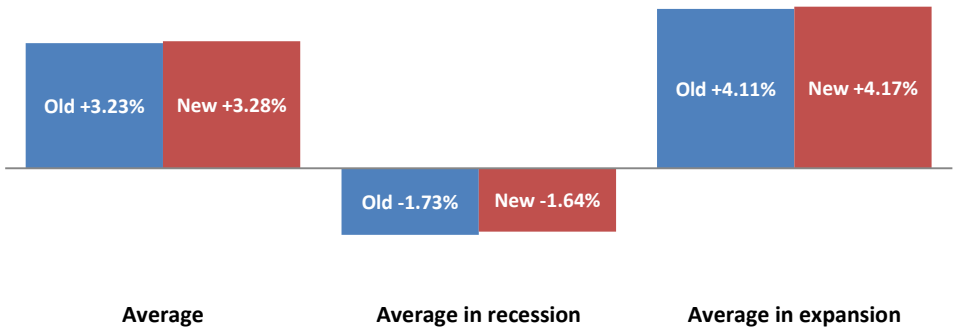
US MACRO: No surprise -- another quarter of slow output growth as an already Not So Great Expansion staggers …

[continued on next page…]



- *The key change is recognition of "intellectual property products."*
- Until now, software was the only IP product that counted as output, and was included in fixed investment. Research and development, and the creation of artistic or entertainment products -- or "originals" as the Bureau of Economic Analysis (BEA) is calling them -- were treated as a unmeasured intermediate steps in the service of consumable output -- not as output *per se*.
- Another major change is the inclusion in residential fixed investment -- that is, housing -- of previously uncounted transaction costs beyond the brokerage commissions already included.
- *By broadening the definition of what is included in output, of necessity these methodological changes make GDP look bigger.*
- The changes boost nominal GDP by $551 billion, or 3.4% (please see the charts on the previous page).
    - Including private R&D adds $275 billion.
    - Including private investment in entertainment and artistic originals adds $75 billion.
    - Including government R&D adds $149 billion.
    - Including new housing transaction costs adds $63 billion.
- *But these additions to output would not necessarily boost growth rates, because the same additions are made backwardly to the entire history of the data.*
- *The present expansion remains the weakest on record.*
- The new method improves the real compound annual rate of decline in the Great Recession from 3.15% to 2.86%. And it improves the growth rate in the Not So Great Expansion from 2.09% to 2.21%.
- *All in all, the changes leave real output still far below trend output. Under the new methodology, the output gap narrows from 13.17% to 12.5%* (again, please see the charts on the previous page).
- Looking at the long-term data from 1929, on average the new methodology boosts the *level* of nominal GDP by 2.8%.
- But it changes long-term growth rates very little. From 1929, average real growth rises from 3.23% to 3.28%. In recessions, the average decline eases from 1.73% to 1.64%. In expansions, growth rise from 4.11% to 4.17% (please see the chart below).

Real GDP, quarterly growth rates, SAAR, 1929-2012



Source for chart above an on previous page: BEA, TrendMacro calculations

[continued from first page]

…under the supply-side and demand-side blows of January's tax hikes. Today's revisions to GDP methodology are revolutionary, and they make GDP look larger by including more in it. But growth rates are not much changed. The biggest effect was to make the Great Recession look less great -- the recovery looks no better. The inclusion in fixed investment of two new types of intellectual property, and of new housing transaction costs, does virtually nothing to close the gigantic output gap -- the vast shortfall between what we are producing and the trend level of what we've always been able to produce before.

[Strategy Dashboard home]

Contact TrendMacro

On the web at
trendmacro.com

Follow us on Twitter at
twitter.com/TweetMacro

Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

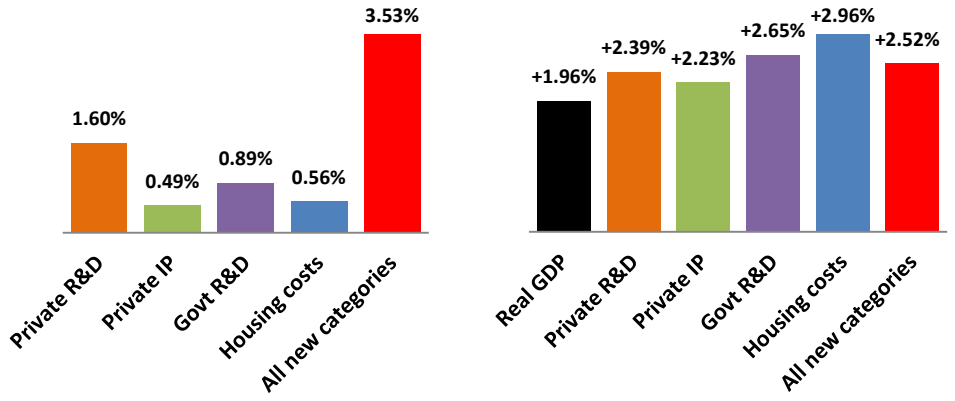
Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
617 600 6969
lorcan@trendmacro.com

[About us]

- Inclusion of new categories does so little to change overall growth rates because their growth rates are not radically higher than overall growth rates (please see the chart below).
- And the new categories represent small shares of total output -- together, make up only 3.53% of current real GDP (again, please see the chart below).

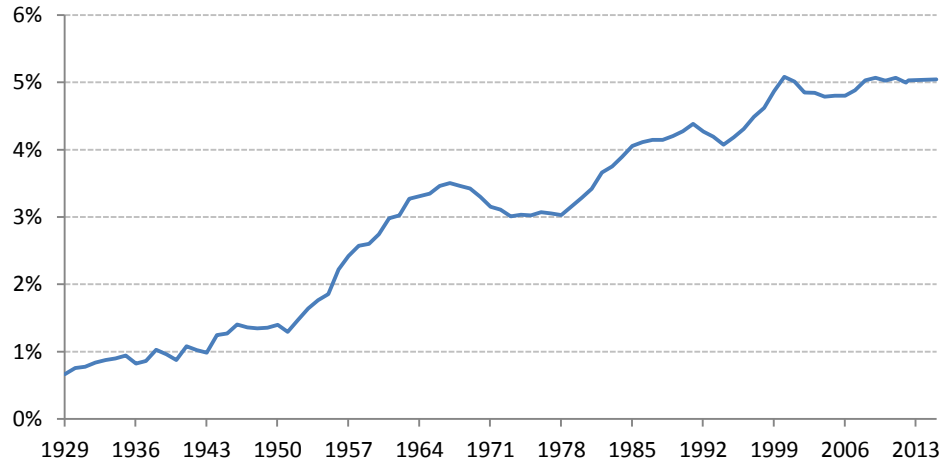
Current share of real GDP **CAGR Q1-99 to present**



Source: BEA, TrendMacro calculations

- That said, over time the broad category that the BEA is calling "intellectual property products" has become a larger and larger share of GDP (please see the chart below).

Intellectual property products share of nominal GDP

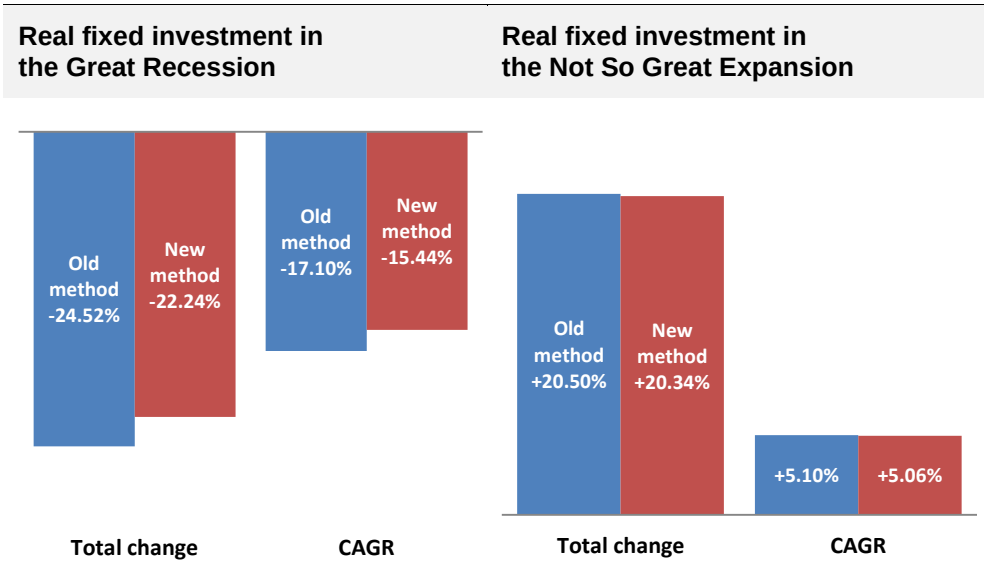


Source: TrendMacro calculations

This relates to our ongoing counter-narrative to the conventional "new normal" view. We have said that the key difficulty of the Not So Great Recession has been that, in the presence of lingering systemic risks, fixed investment hasn't vigorously bounced back from its all-time low GDP share

at the bottom the Great Recession (see "On Q4 2009 GDP" January 29, 2010).

- We have often heard from clients the critique that perhaps fixed investment has bounced back more than we realize -- it just hasn't been captured in the statistics, because it we're seeing an increasing replacement of measured physical capital with unmeasured intellectual capital.
- Today's down-payment on measuring capital that had previously gone unmeasured tests that critique to some extent, and suggests that it may not really explain very much.
- Excluding the new types of intellectual capital added today, real fixed investment fell 24.52% in the Great Recession. Including the new types lessens the fall to 22.24% (please see the chart below).
- Excluding the new types, real fixed investment has rose 20.5% from the Great Recession trough. But including the new types, it has risen slightly less, 20.34% (again, please see the chart below).



Source: BEA, TrendMacro calculations

Many clients have asked us whether today's changes to GDP are politically motivated. Are they intended to make the economy look better than it actually is? Not an entirely unfair question, especially considering memories of the highly suspicious drop in the unemployment rate just in time for last year's presidential election (see "On the September Jobs Report" October 5, 2012).

- But we don't think so. For one thing, if they *were* intended to flatter economic optics, they don't do a very good job of it. The changes do make the economy look bigger. But growth coming out of the Great Recession doesn't look any better.
- That said, the optics created by the new methodology make the *structure* of the economy look more balanced.

- Because all the new additions to GDP are in the category of fixed investment, perforce they boost the very low fixed investment share of GDP and lower the very high consumption share.
- *Voila! Suddenly, America looks less like a nation of reckless spenders and more like a nation of forward-looking savers and investors.*
- Hard to believe that this administration would go to much trouble to create such an impression, though. *Private* capital formation has never been a priority for our current president -- the man whose best-known comment on the subject is "you didn't build that."
- *We're going to all take this at face value. We're going to assume that the BEA has recognized that intangible capital is an increasingly important element in our services-dominated information-driven economy.*
- Until now, software -- a very straightforward instantiation of intellectual property -- was the only form of fixed investment in intangible capital captured directly in GDP. Today's addition of expenditures on research and development, and on entertainment and artistic originals, is a logical next step. But there are many more steps that could be taken.
- Why not include expenditures for the development of managerial know-how? We have always included Wal-Mart's costs to build a warehouse -- and now, Seegrid's costs to develop the software to automate the forklifts that work in it. Why not include Wal-Mart's costs to develop managerial and logistical know-how that may well produce over the years more wealth, more durably, than the warehouse or the software?
- A rigorous case can be made that untold millions of small ideas cumulatively create more innovation and more growth than official research and development expenditures (see *The Venturesome Economy* by Amar Bhidé, Kauffman Foundation Series on Innovation and Entrepreneurship, 1999). Why not include them in GDP? Just because they are difficult to measure doesn't mean they *shouldn't* be measured.
- In the extreme, why not include education and health care? Surely they can be seen as fixed investments in human capital that will pay dividends for many years.

Bottom line

No surprise -- another quarter of slow output growth as an already Not So Great Expansion staggers under the supply-side and demand-side blows of January's tax hikes. Today's revisions to GDP methodology are revolutionary, and they make GDP look larger by including more in it. But growth rates are not much changed. The biggest effect was to make the Great Recession look less great -- the recovery looks no better. The inclusion in fixed investment of two new types of intellectual property, and of new housing transaction costs, does little to close the gigantic output gap -- the vast shortfall between what we are producing and the trend level of what we've always been able to produce before.