The Patti Brennan Show

Does a Growing Economy Guarantee a Growing Portfolio? The Surprising Truth About GDP

Guests: Eric Fuhrman, Chief Planning Officer & Brad Everett, Chief Investment Officer

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Eric Fuhrman: Hello and welcome to the Patti Brennan Show. Whether you have $20 or $20 million, this show is for those of you who want to protect and grow your wealth to live your very best life. My name is Eric Fuhrman, Chief Planning Officer here at Key Financial and frequent contributor to the Patti Brennan Show, but today I have the distinguished privilege of filling in as your guest host. I've certainly got some big shoes to fill, but helping me with today's podcast and joining me in studio is our very own Chief Investment Officer, Brad Everett. Brad, welcome to the show.

Brad Everett: Thanks, Eric.

Eric: Well, Brad, I don't know if you're excited, but I certainly am. Today, we're going to be covering a very important macroeconomic data point: GDP, otherwise known as gross domestic product. For economists and investors and data nerds like you and I, we follow this number very closely. But this podcast is really timely, in my opinion, because the third quarter GDP number is actually going to be released this Thursday on the eve of Halloween. And dare I say that investors are hoping for a spooktacular result, would you say? I've been saving that one all week. My kids love that joke.

But in any event, GDP is really important, and I want our listeners today to understand why it's so important, especially if you're retired or planning to retire. Ultimately, GDP really measures the overall health of the economic picture, which is so vital to our wellbeing and our standard of living—certainly the one that we enjoy today and into the future.

So Brad, you and I have a kind of monumental task here in about 20 or 25 minutes, which is really to unpack GDP: what it is, how it's measured, and really why it's so important and critical for those who are accumulating wealth to retire someday in the future. So why don't we kick this off and really just at a high level explain for our listeners—what is GDP? How is it measured? And really, what does it represent in terms of the essence of that number?

Brad: Yeah, I think on a high level, it's just the best attempt to measure the output of a nation, right? Not necessarily the nation, but the borders of the nation—the total amount of goods and services produced over a period of time. So there are a couple of ways we can kind of dive into the way it's defined. Really, it's just the sum of the individual components of that spending, right? And that production—basically just the final sales, really, of all the goods and services.

And I think what's interesting about that is you can kind of flip it around and look at another way to measure GDP, which would give you, I believe, the same answer with a couple of tweaks. But ultimately, GDP is measuring the final sales of goods and services. But at the end of the day, one person's expense is another person's income, so that sale translates into a salary or wage that is paid to the laborers who produce, and then the profit ultimately goes to the providers of capital through interest, dividends, and so forth. So in another way, it's kind of measuring the income of the nation, which ultimately we all rely upon.

Eric: Sure. And I guess we're saying "final goods" because if you added up all the sales in between before they get to that product, you'd be double counting a lot of things on the way.

Brad: Exactly. If you sell a car, you can't re-include the price of the tires and re-include the price of the brakes and everything that goes into it. So you just take the final goods sold—the total value of the car—and that's what gets included.

Eric: Exactly. And not to kind of jump ahead here, but to make the point—often when you look at trade statistics, for example, which is obviously a topic that's been circulating around out there, if you think about an iPhone that is sold and imported from China, the wholesale value of the iPhone is being counted, but not necessarily the value that's contributed from what China adds along the way, right? So it's counting the full value, but not just the incremental value. So that, I think, artificially makes the trade statistic look much bigger than it actually is.

Brad: Yeah, I think that's probably one of the main—I think growing up, we used to hear a lot more about GNP, gross national product, which I think was quite a headache data-wise to keep track of. I don't think people thought it was particularly accurate. I guess they still track it, but they've replaced it in favor of GDP. It's a little easier to keep score.

But I think what's most important for the listeners here is really just to understand that when you think about a country's standard of living, it's really defined by the output. So it is not the quantity of money, it is not the military might of a country. Ultimately, output is really what defines the prosperity for a nation, and that's really what GDP is capturing—output, which basically relates to our standard of living.

Eric: I just think back to, you know, just in our lifetime—I was born in the '70s—but just in my lifetime, real per capita GDP (and again, that is a measurement that is adjusted for population growth and inflation, right, so you're really getting a true measurement and the change in one's financial wellbeing) has more than doubled from $32,000 to over $69,000 just in my lifetime. And you just think about how we live versus, say, our parents at this age, or grandparents, or great-grandparents, and it's amazing to think that that progress in terms of GDP has just led to a standard of living that would be unfathomable by somebody that was born 50 or 100 years ago.

Brad: Yeah, I think just even the obvious examples from when I was a kid—we didn't have the internet in the house, and we didn't have air conditioning. Both of those things seem outrageous today.

Eric: So you were sweating it out in July and August.

Brad: You know, when you would open the windows to keep air moving, the hot air made it somehow seem not quite as hot.

Eric: Yeah, I don't remember that providing a lot of relief. That was a long time ago at this point.

But, you know, I think it's important, though, when you think about somebody that's retired, right? So we have so many clients that are retired, so now they have left the workforce. They are no longer producing. But the reality is that someone's success in retirement requires the country to be successful in producing goods and services, because ultimately, if you receive, let's say, Social Security, that is a claim on labor. Ultimately, the people that are still working are paying the taxes that finance your Social Security.

Brad: Really hoping productivity stays high after you're going from the workforce. You need the workforce and productivity to remain stable or grow.

Eric: And you know, for most of our clients, they accumulate financial assets over their lifetime with the intention of utilizing or liquidating those assets in retirement to fund consumption. But ultimately, financial assets are a claim on capital. It requires profits and dividends and interest. So all these things are intertwined into that GDP picture. And again, back to our original point, it is so important for GDP to continue to remain stable and grow in order for people today, or people that hope to retire into the future, to be able to have the means to have a sound and healthy retirement.

Brad: Yeah, it does require a little bit of a leap of faith to believe that humans are going to keep coming up with new ideas. It just seems like we've thought of everything, but we have to continue to find new ways to be more productive forever.

Eric: Yeah. So for our listeners, why don't we take that second quarter number, for example? So we don't have the third quarter number yet, but the second quarter number was pretty strong. It came in at 3.8%, which I think for an advanced, mature economy like the United States, that's a very strong number. But why don't you kind of break down the different components of what contribute to GDP? Because really, there are kind of four main areas.

Brad: Yeah, I think you've got—it really is just the major sources of spending, right? It's the government spending, which is not, I mean, in the grand scheme of things, huge. I think consumption is by far the largest, like 70%—consumer spending.

And then you've got, I think there are a couple of ways you can look at it. You could just look at it on the high level and just call it investment. But then I think a more useful number is they have investment without housing investment, and then there's housing investment specifically. So you can kind of see whether the investment is being spent on business productivity, or if it's actually consumer spending on homes and equipment and machinery. You get a little bit better information if you split that up. And then just net exports.

Eric: Okay, gotcha. So when I was looking at the second quarter number, what I thought was interesting is, again, consumer spending came in strong. That's one of the big drivers of economic growth. But what's interesting to me is that that 3.8% number—investment declined rather substantially. It ebbs and flows. It goes up and sometimes it goes down, but last quarter it declined. And I think that's important, right? Because ultimately, future growth requires investment today, right? To not consume everything we make, and to defer a portion of that. So I think investment is always a number we want to pay attention to, because that's a key contributor to future growth.

But I think the one that really stood out is basically that net export number. You know, take what we export minus what we import, and historically, we import more than we export, right? That's why we have a trade deficit. And in terms of how we account for GDP, that's actually a subtraction, because it's essentially saying we're consuming more than we produce.

Brad: Right. And if you have to import consumption from overseas, that's a subtraction. It's coming off our production and being included in someone else's.

Eric: Exactly, exactly. But the interesting part is that 3.8% number was only positive because imports cratered. And I, you know, obviously, I think that has a lot to do with what's going on in the news and the trade and tariff policies that are being implemented.

Brad: A lot to do with why investment fell, too.

Eric: Yeah, exactly. So it's just interesting. The headline number is a very robust number, but when you get under the hood and you break apart the components, really, it was just driven by a dearth of imports—that there was less of a subtraction than there usually is.

Brad: Were our exports largely the same, or—

Eric: No, exports fell a little bit, but they were more than dwarfed by the decline in imports.

Brad: So much lower investment and a much lower import largely crossed each other off, I guess.

Eric: Yep, more or less. So still, the other ones are still pretty good.

Brad: Yeah.

Eric: So I guess the question is, obviously, I think this is just kind of a short-term reaction to what's going on. I don't know if it's part of a longer-term trend, but I think ultimately the policy objective is to make sure that there's greater balance between exports and imports. So you would think that the policy goal long term is to make sure that those two things are in greater balance, and so forth, but we'll see, right?

Brad: Yeah, we'll have to come back and review that on another podcast.

Eric: But, you know, I think when we look to the third quarter, which is going to come out this week, again, I think looking at consumer spending is important, investment is important, and again, looking at that export piece.

So, you know, for our listeners, when we think about GDP, obviously this is a very big and kind of long-term number. But is there any way to kind of relate that to stock market returns, or say portfolio performance? Is there a predictive quality that shows up in the data that, in some sense, you can kind of relate that number to how the investment markets might perform?

Brad: Unfortunately, not really, right? There is—I mean, intuitively, it makes sense that it would. If the economy is growing, you would think that corporations would have higher earnings, which would flow through to shareholders, and then higher earnings per share would lead to increased stock prices. It seems intuitive, right?

Eric: Yeah, it makes sense to me.

Brad: But I guess there are a couple of things that get in the way there that make it so there is not really much of a correlation at all actually. And you can actually see, if you kind of step back, the real obvious differences between the performance of the US market and our relatively consistent, strong GDP versus an emerging market or a developing market, where their GDP numbers can be extremely high for very long periods of time, because they have a lot of catching up to do, right? But their stock markets, especially over the last 20 to 30 years, have not performed very well at all. China is a great example.

Eric: Yes.

Brad: There's actually, for very long periods of time, can be a negative correlation between GDP and stock market excess returns. So there are a few things that get in the way there. But I think, you know, first of all, corporate earnings are actually a very small part of GDP, like a twentieth. It kind of trends between 4% and 6%. So I mean, the vast majority of spending is from private—you buy from private entities. You know, housing—you buy a house from a non-publicly traded corporation. So publicly traded corporate earnings are a very small part. So just that part makes it difficult to quantify.

But the interesting thing is that actually is pretty consistent. If you look at just public corporation earnings, the sum of all corporate earnings do tend to follow GDP very closely. The question, I guess, becomes how that flows through to shareholders.

So part of it is dilution. Just in general, I think there's a big difference between the total of all the money that's in public corporations versus the growth rate of those same companies. So you think of new share issues, IPOs, things like that. That's something that increases the size of the economy and the market cap of traded corporations. But that's not something that is reflected in the change in earnings per share, right? That's a new share that you have to buy. Like, if you want part of those earnings, you need to go buy that stock. That's not actually growth in the stocks that you already hold.

So that's one sort of issue, and that's actually pretty big. I think we found a study that suggested that could be like 2%—a full 2% difference in return every year, as the market cap of the S&P is outpacing the growth of the underlying holdings.

So you have some big things like that that ultimately—it's just a really, really distant kind of path from an increase in our productivity all the way down to how it shows up in stock market returns.

Eric: Gotcha. Gotcha. That's interesting. But I guess in the long run, there should be some kind of connection there, right?

Brad: There should, but, you know, it's so far—I mean, we're basically in this almost 50-year sort of secular increase in valuations in stocks. So, you know, how long are any of us going to be alive to see the reversal and when that actually comes back to work? I mean, you know, you read about Warren Buffett's earlier career buying stocks at three or four times earnings. You know, if you were going to try to sell a bookstore in town, you might be able to sell it for three or four times earnings. You know, that's a normal sort of valuation to sell a private business. But the S&P is trading around 23 times earnings right now, so that just continues to expand and expand and expand. So you know, the change in valuation has just overwhelmed the effect of the growing GDP underneath all that.

Eric: Certainly. So I guess what's critical long term is to set the proper expectation. I think, you know, when we think about what a portfolio might be able to generate going forward and so forth. So, you know, certainly that valuation piece—that almost feels like, if I'm understanding you right, it's really kind of pulled forward a lot of the future return.

Brad: Yeah, which is why markets have been really so robust, you know, in the last decade or so.

Eric: Yeah, I thought it was Bogle's book where he has the earnings growth per decade. And it's very consistent, you know, I think it's between 5% and 6% every single decade. If you sum the S&P companies over a 10-year period, they're just in a very narrow range of total performance, but the vast majority of returns comes from this ebb and flow of the price-to-earnings multiple.

So if you believe, you know, look at the next 10 years and compare it to the past 10 years—maybe earnings are exactly the same growth, but we've seen significant price-to-earnings expansion to a number that's very high historically. And even if you take that 5% to 6% earnings, and then, you know, over the past decade, we've added another 5% to 6% just from multiple expansion to get to 12% or 13% a year on the S&P—if that just returns back to normal at 2% or 3% a year, you could really have a decade with no return, even though companies are performing just as well as they've been. You could have 2% or 3% a year very easily. And that's no fault of the underlying companies that are plugging away just as they always have, but it's just the way they get priced in the market, right?

Brad: So I guess the interesting part is, really, you know, to use your example of Bogle there—what he really talked about was the fundamental return of stocks, which is essentially the earnings growth and the dividends. And then there's the speculative return.

Eric: Yeah, which you can almost think of valuation as kind of like air filling or coming out of a balloon. You know, it's either you're going to expand or contract. It doesn't stay the same for very long.

Brad: Yeah.

Eric: So I guess, if anything, the takeaway here is definitely the importance of diversification in an environment like that. You know, geographic, not just here in our domestic markets.

Brad: Well, there certainly are markets that aren't overinflated that way. Not every market is trading at 23 times earnings, for sure.

Eric: Yeah, ultimately. So I guess, as we kind of turn the page here, and we're looking for the third quarter number this week, I guess is there anything intriguing, when you kind of think about the different components here, things that you might be looking out for? Or do you feel like, ultimately, there's just so much movement in the number there that it's just hard to say?

Brad: Yeah. So I think investment's always the interesting one, right? I mean, that is the one that seems to spur future growth. I think the import-export thing, you would think fundamentally, has to stay within a range before currency valuation takes over and things like that. You know, at some point goods become so cheap elsewhere that you just have to buy them there, until you bid the prices up on those things, and it comes back more. So you would hope there's a bound to where that can possibly get to. Of course, we could always be surprised, and it just keeps going.

But investment's the one that you would think has to drive long-term GDP growth, right? That's the one that actually can define GDP growth on its own. You have to keep trying new means of increasing productivity, and if that stops, or that stays depressed for a long period of time, GDP will not be something we talk about, because it won't be moving very much.

Eric: I actually think it's interesting too. I did look at a chart on one of my favorite websites, the St. Louis Fed, which has a copious amount of charts and data you can pull up. But they did have a chart that kind of mapped out investment as a share of GDP, and it's pretty consistent. I mean, if you go back to like the 1950s, usually it seems like anywhere between 14% to 17% of our output is ultimately committed to investment, which is—some of that, you know, think about depreciation. Some of that is just replacing equipment that is used in the process of production, as it wears down and it depreciates, but then a portion of it is also applied to investing in new growth, expanding capacity. But it's always been in a fairly tight range, you know, in terms of that.

But it's different. Some countries like China—investment is substantially higher, you know, but that's a bigger part of their growth. They get more of their growth from investment and not from consumer spending, which eventually a balanced economy, I think, veers towards where

America is, which is supported far more by consumer spending and not so much investment, right?

Brad: Yeah, I guess the other thing about investment that's interesting is that investing just for investing's sake isn't necessarily good either, right? Like you have to invest in the right things. So it's always interesting to see where the investment actually goes. Some years, you know, we've had a long wave where the investment was just outfitting an office with computers, right? Like that actually was probably the wisest thing to do. But eventually you can only have so many computers in the same building before the next computer doesn't help you very much.

So it seems like, I think it's probably not a surprise that a lot of investment is going into AI and building out data centers and things like that. So I think where the investment is going is also a very interesting part of choosing how to allocate portfolios and things like that.

Eric: Well, I guess, you know, you bring up a good point here—when we think about investment, we're thinking about the future growth. So, you know, GDP is kind of a complicated thing. If we start to unpack it, you can become more and more granular. But if we really had to distill GDP growth into kind of two or three components, I mean, what ultimately are the main drivers that determine growth in the future?

Brad: I mean, I think it really comes down to—yeah, we were talking before. That's like a total dollar amount of GDP, right? And then you can find a percentage change by calculating that total dollar amount one quarter and again the next quarter, and figure out a percentage difference. But another way to, kind of like you said, simplify the whole thing and say what actually are the inputs that would change it—not the absolute level, but what makes a difference from here—would be a change in productivity and the change in the size of the labor force. Those are really the two things.

Eric: Right. So if I hear right, just to kind of define that—labor force, just the size, the more people?

Brad: Yeah, the greater the more hours do you have, and are they being more or less productive than they were before?

Eric: All right, meaning that when we think about productivity, if everyone's given an hour, how many widgets can you produce, right? So productivity would be going from like 10 widgets to 12, on average in the same hour.

Brad: Yeah, right, right, correct, yeah.

Eric: So, I guess ultimately, when we look at—if we break those two things apart, just to kind of bring this to a close—what are the current trends that are driving the size of the labor force today? What should we pay attention to?

Brad: Yeah, well, that seems to be maybe our bigger hurdle, right? I think productivity, I think AI has—I think by all accounts there are a lot of employees that are more productive based on

that, right? They can do certain functions of their job much faster with the help of certain tools. I think the labor force is probably the larger of the bottlenecks. I think you have an aging population. I think we're in a period where there's a little bit of a political tension, I guess, around immigrant labor and things like that. So how that shakes out, you know, could make a difference in several million employees across the country. So I think that's kind of—the labor seems to be the one that may be the hardest to improve.

Eric: You know, it's interesting too. You see countries like Japan, for example, where the working-age population—the size of the labor force—is actually, you know, been shrinking. So I guess the question is, in America, you know, maybe our demographic destiny is a little bit more favorable here than some other countries around the world. But if that does slow, you know, it doesn't have to stop, but if it does slow significantly, I guess ultimately, you know, productivity is going to really be the key to the future, to continue and sustain the present level of economic growth.

I mean, even back to your original point about Social Security, for example—like, how many, you know, if you go back 30 years ago, how many currently working employees used to support a single retired receiver of Social Security?

Brad: I think they call that the age dependency ratio.

Eric: Yeah, and now it's, I mean, just much less of a current workforce per retired person.

Brad: Yeah, it actually, I was looking at this before the show. But I think the age dependency ratio, which kind of looks at the number of retirees per 100 workers, I think, is the statistic. You know, if we went back to my generation—when I was born back in the '70s, I think it was around 16 or 17 retirees for every 100 workers—and now the number is about 28 and it's continuing to rise.

Eric: Yeah, I guess is that because—we'll expect life expectancy is growing faster than the age at which people are choosing to receive Social Security. Are we living longer faster than the start date is increasing?

Brad: Sounds like that might be the material for—we're not going to figure out here today, but I think that's the point. I think, just to bring this full circle, is that, you know, ultimately, when you think about GDP, and we kind of unpack that number, I mean, the reality is, if you're retired and you're no longer in the workforce, ultimately you are reliant on the workforce for retirement income, either through pension schemes or Social Security or just delivering returns to capital. Because, again, most retirees accumulate financial assets or capital, and ultimately that capital needs to provide a productive return, which ultimately flows from economic growth over time. You know, so really, if you're retired—or when we retire—we'll be reliant on our kids, who will then be relying on their kids.

Eric: Well, the jury's out so far, but they have time to figure it.

Brad: Yeah, exactly right.

Eric: All right. Well, let's kind of wrap this all up with a fun little game, which we don't know, but we're gonna try something new, right? So you know, always to keep it fun and interesting. So I figured you and I would engage in a little true or false and kind of see your knowledge of these questions. So I'll start first.

So gold seems to be in the headlines just because it's been surging in price. So true or false: gold miners, the actual public companies that mine gold, have underperformed the gold price.

Brad: Oh, good question. Since when? This year?

Eric: Oh, this year, I think they have underperformed the gold price.

Brad: False.

Eric: So if you look at a gold miner ETF, gold miners are up 125%, gold price up 47%.

Brad: Wow.

Eric: But you are correct. If you look over a longer span of time, the gold price has outperformed the actual companies.

Brad: So they are benefiting from their mining operations in addition to the gold price on their inventory or on their balance sheets?

Eric: Yes, it's actually interesting. If you look, a lot of gold miners—normally, when you're engaged in producing a commodity, they will typically hedge production to kind of lock in a price, you know. But I believe back in 2009 or so, a lot of these major producers got rid of their hedges, so they were kind of directly exposed directionally. So certainly, if those hedges come back, that might be an interesting commentary, if you will, on where gold's gonna go. So it's a good one. 0 for 1.

All right. So next question: a gold bar is 100% pure gold, true or false?

Brad: I think that's false.

Eric: It is false. You know why?

Brad: I think it would be kind of a sloppy pile of mess. If not, I need something to like, a little more viscous to hold it together, right, or less viscous? I forget what viscous—

Eric: Yes, you got it basically. So number one, it would be extremely—to try and produce and refine gold to be 100% pure. So it's just not worth the cost to get it there. But to your point, to be able to transport it, stack it and so forth, gold is an extremely soft material, so they have to embed things like, for example, copper, to strengthen it and make it more of a solid.

Brad: So I think the gold bars they sell on Costco website always say 99.99% gold.

Eric: Pretty close. Yeah, it's a lot of gold, but not all gold. Yep. So great job. So 1 for 2.

Brad: 50/50, yeah.

Eric: I feel bad. We might need to give you more questions.

Brad: Yeah, a little small here, but you ask a few questions while they're rolling credits here at the end.

Eric: Yeah, so they're not true and false, but we'll see what you got. Over the past three years, which market has seen the best stock market performance: Europe, Japan, or the S&P without Nvidia? Over the past three years. Order one, two, and three: Europe, Japan, or the S&P without Nvidia.

Brad: You know, I am going to say Japan, Europe, and then United States.

Eric: Close. Europe, then Japan, then the S&P without Nvidia.

Brad: Oh, how about it? Yep.

Eric: Okay, gotcha. Kind of a follow-up question: one of these stocks over the past five years was up 1,264%, the other stock was up 1,420%. Which is Nvidia and which is Build-A-Bear Workshop?

Brad: Gosh, that's funny. I would actually have to say Build-A-Bear is the 1,400% and Nvidia is 1,200%.

Eric: It actually was Build-A-Bear until like a month ago. Build-A-Bear's down 20% over the last 30 days, but it was leading. It was at like plus 1,600% when we first started talking about these questions.

Brad: Yeah, so one of those hidden gems that doesn't really make the news cycle.

Eric: Who would have guessed? All right. Well, one more. One more real serious one, and we'll ask a silly one.

According to the Bureau of Engraving and Printing, how many double folds forward and backward do you think a $1 bill can withstand before it's expected to rip? What's the folding lifetime of a $1 bill?

Brad: Gosh, I guess I would have to estimate how long it stays in circulation for, but I'd say maybe 100,000?

Eric: 4,000.

Brad: Oh. All right, yeah, I was way off.

Eric: It's actually not paper—it's 75% cotton and 25% linen. Like 4,000 folds.

Brad: Okay, gotcha.

Eric: All right. Gosh, way off on that one. All right, this is more of a personal question. Any favorite ticker symbols?

Brad: Oh, gosh. HOG. That's Harley-Davidson.

Eric: Is HOG? Oh geez. There's a cannabis ETF that's YOLO. It always makes me laugh.

Brad: Yeah, I thought there was one of them called MJ.

Eric: Now I always like the creative ones. Like, you know, the old Aqua America, which I think is Essential Utilities, is WTR—water.

Brad: Gosh, that's a good one. I don't know. I know I've seen some out there. There's a high-yield bond fund that's JUNK.

Eric: Yeah, JUNK. That's a good one. So, yeah, there are a couple of witty ones out there that make me laugh. But, you know, outside of those, nothing that comes to mind.

Brad: Yeah, I think Dynamic Materials is BOOM, which is funny.

Eric: Oh yeah, dynamite and explosives.

Eric: Well, Brad, thanks. It's been great fun today, and certainly for our listeners out there, hopefully this has been educational for you, just to kind of understand the importance of this upcoming release on Thursday for the GDP number, but also to be able to look at it with an educated perspective and understanding what it means, how to unpack it, and certainly how it might impact your planning for retirement and beyond.

So folks, with that, I'd like to thank you all for joining us. If you have any questions or ideas for a future podcast, feel free to call the office or reach out to us at www.keyfinancialinc.com. Thanks so much and be well.