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A New Look at the "New Normal"

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By Philip Ashton

In the spring of 2009, the manager of the largest bond fund in the world, Pacific Investment Management Company (PIMCO), introduced the concept of the "New Normal" to an investing public that was still reeling from the economic catastrophe of 2008. Over the next two years, the phrase would dominate the national financial headlines as market analysts attempted to assess the path of the economic recovery. In PIMCO's New Normal world, subdued global growth and high unemployment would combine with a heavier hand of government in economic activity to lower investment returns across all asset classes. In particular, the U.S. and other developed markets would suffer as there would be "a continuing shift away from the G-3 and toward the systemically important emerging economies, led by China" (1). Shell-shocked investors readily accepted this rather pessimistic scenario at the time, and took it as a validation of their internal instinct to chart a more "conservative" path by reallocating their investments away from the stock market and seeking a safe harbor in historically less risky assets. With the benefit of two years of hindsight, it seems reasonable to revisit the New Normal and compare the economic and investment expectations contained therein to the real-world conditions actually experienced over that time.

Many have interpreted the New Normal as advocating a retreat from developed market equities and have pointed to the outstanding recovery in the U.S. stock market to disprove this theory. In a presentation at the Investment Management Consultants Associations annual conference, held in Las Vegas last week, Richard Marston, professor of finance at the University of Pennsylvania's Wharton School gave voice to this view. He criticized PIMCO CIO Bill Gross's introduction of the New Normal in May 2009 stating that "from that point through March of this year the stock market gained 94%." Dr. Marston saw the New Normal as advocating a reduced allocation to domestic equities and an expectation of lower investment returns, and explained that "if your clients bailed out of the market during that grim winter of 2008 and 2009 they lost out on an almost 100% rally". Mr. Gross would no doubt disagree with this assessment and argue that the New Normal only predicted a *relative* underperformance in developed market equities when compared with those in emerging markets (which have, in fact, produced even stronger returns) and point out that despite the performance of the equity markets, unemployment has remained high and the economic recovery has been less than robust, particularly in the advanced economies.

What precisely was it, then, that the New Normal was predicting, and what were the implications for investors with real return requirements?

One trait shared in common by all successful market prognosticators is their ability to forecast a future that is sufficiently vague to allow wiggle room in the event that circumstances change. PIMCO's May 2009 investor letter, in which it introduced its concept of the New Normal certainly reflects this truism, even caveating its risk scenarios by quoting the economist John Maynard Keynes as stating "when the facts change, I change my mind. What do you do, sir?" PIMCO's broad economic outlook does not get much more specific than its initial premise that "global growth will be subdued for a while and unemployment high; a heavy hand of government will be evident in several sectors; the core of the global system will be less cohesive and, with the magnet of the Anglo-Saxon model in retreat, finance will no longer be accorded a preeminent role in post-industrial economies. Moreover the balance of risk will tilt over time toward higher sovereign risk, growing inflationary expectations and stagflation." (2) While unemployment has remained high, world GDP growth, which averaged 4.75% from 2003 through 2007 and 3.3% in the ten years through 2002, rebounded from a -0.5% rate in 2009 to hit 5.0% in 2010 (3). Furthermore, IMF projections now call for

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growth of 4.4% in 2011 and 4.5% to 4.7% over the longer term; figures which can hardly be referred to as subdued. To be fair, growth in the advanced economies, which had been advancing at a 3.0% rate for the ten years through 2007, are only expected to average a relatively modest 2.5% going forward. The more subjective pronouncements about the "heavy hand of government" and the "less cohesive" core moving away from the "Anglo-Saxon model" are more difficult to measure, but a case could be made that they have largely come to fruition through the various government interventions undertaken in both the U.S. and Europe. Higher sovereign risk has been realized on international issues, although rather than coming from more traditional emerging market regions as expected, its source has been the periphery of the Euro area due to the credit concerns of countries such as Greece, Ireland, Portugal and Spain. Lastly, with regard to inflation, while commodity inflation has worked its way into the system (although at lower levels than many expectations), broader based inflationary concerns have thus far been more frequently discussed than realized.

Specific investment implications discussed in the investor letter were also somewhat ambiguous as PIMCO suggested that opportunities were to be found in "the front end of yield curves in many countries (as the authorities overstay with negative real policy rates), income-generating instruments (which will dominate the pure equity premium), and an international orientation (as the U.S. faces the prospects of a plateau shift in sovereign risk and the return of higher inflationary expectations)." On these counts, the New Normal's record is more defensible. The yield curve in the U.S. and most other countries has steepened somewhat, with most of the gains coming in the front end, and an international orientation has resulted in even greater gains than a domestic focus (unless one was overweighted towards certain Euro area issues as discussed earlier). "Income-generating instruments" could mean different things to different people, and this is the area in which Mr. Gross and his detractors would most likely disagree. While many saw this as a call to reduce equity exposure in general, Mr. Gross could argue that was not his intent at all.

Were investors wrong in interpreting the New Normal to advocate a retreat from equities in general and domestic equities in particular? In looking back at comments made by Mr. Gross and his number two, Mohamed El-Erian, it's clear that even PIMCO believe the New Normal called for a shift away from equities. In the spring of 2009, El-Erian appeared on CNBC and said "I am very underweight equities", adding that he had cut his exposure to stocks to 30% compared with 60% in normal market conditions. In July of that year, Mr. Gross stated that "the outlook for risk assets – stocks, high yield bonds, and commercial and residential real estate will involve just that – risk. Investors should stress secure income offered by bonds and stable dividend-paying equities." (4) By October 2009, PIMCO was suggesting "pulling back risk positions that have been acquired over the last six months", (5) and in a July 22, 2010 interview with CNN Money Gross claimed the New Normal would mean "Instead of 10% returns for stocks, look for five or so. And instead of the past 20 years' return on bonds, which are actually better than stocks, - close to double digits –it's 4% going forward." At the time of that July 2010 interview the S&P 500 was trading near 1,070, approximately 24% lower than its current level.

The definition of the New Normal has changed over time (or evolved, depending on your viewpoint), to the point where PIMCO has in the last year launched its first active equity strategies and in December of 2010 it changed the rules for its flagship Total Return Fund, allowing it to purchase equity-linked securities for the first time since 2003. Now, a lot has happened between the Spring of 2009 and today – the European debt crisis, Quantitative Easing I and II, the

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Arab spring and the Japanese earthquake and tsunami – and the "facts have changed". The new case for the New Normal rests on the idea that government interventions have borrowed from tomorrow to fund today and we have merely put off the day of reckoning. It would be irresponsible to ignore these facts and rigidly abide by a strategy that once made some sense.

In the final analysis, however, it is clear that a reallocation away from risky assets was a fundamental element of the New Normal as it was originally envisioned, and its followers could not be faulted for believing that these risky assets would have included equities. Those investors who chose to follow such a strategy have been left poorer today than they would otherwise be.

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(1) Secular Outlook, PIMCO, May 2009.

(2) Secular Outlook, PIMCO, May 2009.

(3) World Economic Outlook, IMF, April 2011.

(4) Investment Outlook, PIMCO, July 2009.

(5) Economic Outlook, PIMCO, October 2009.

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