The term “new normal” has become so familiar in the American lexicon that it can be easy to forget that PIMCO introduced it to the financial industry as a new paradigm for long-term investors just five years ago.

PIMCO first formally addressed the new normal framework in a publication entitled simply “A New Normal,” a summary of PIMCO’s 2009 secular forum, which generates the firm’s long-term macroeconomic and investment outlook for the next three to five years. At its foundation, the new normal concept recognized that many of the extraordinary events that had shocked the global financial system in previous years were not simply flesh wounds that would heal quickly, as soon as the cycle had run its course. Instead PIMCO’s prognosis was that these injuries could more accurately be described as critical—and they would not heal any time soon.

Today it may be worthwhile to assess where we are in this new normal economy (see figure 1). The new normal is morphing, and as the world continues to transform over the next several years, we expect regional pivot points—three-way intersections that do not accommodate continued sluggish forward momentum along the status quo, but will mean a sharp turn, either in a more constructive direction or toward a potential crisis.

Birth of the New Normal

We formally articulated the new normal concept in 2009, but PIMCO had been formulating this worldview and watching it gather momentum for years. Well before the financial crisis occurred, we began to recognize that markets and the global economy were approaching a dramatic transformation, based on three observations:

- Several years earlier, PIMCO’s investment professionals had rejected the consensus opinion that the economy was headed for a great moderation—a Goldilocks economy that was neither too hot nor too cold. Instead, our macroeconomic analysis indicated that global growth was in a state of stable disequilibrium, appearing steady on the surface but jeopardized by underlying economies that demonstrated starkly contrasting fundamentals—a multi-speed world.
- Further, it became evident that the excessive leverage that had fueled the heady economic expansion of prior years would soon intersect with a cooling of the economy to shift the global investing landscape in fundamental and disruptive ways.
- Specifically, we identified three forces at work that would depress economic expansion and inhibit recovery: deleveraging, deglobalization, and reregulation (DDR).

This concept of a stable disequilibrium and the prospects of widespread deleveraging crystallized into the new normal. By 2012 the term had galvanized into such a popular catchphrase that NBC launched a television series called “The New Normal” (it was cancelled after six months on the air). And by the fall of 2013, the head of the International Monetary Fund used the concept of a multi-speed world as a frame of reference for a policy meeting in Washington, DC, putting to rest any lingering doubts about the validity of the new normal framework.

As PIMCO hypothesized in the May 2009 secular outlook: “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 [financial companies] will no longer be afforded a pre-eminent role in post-industrial economies.”

Redefining Normal

Distilled to its most essential elements, the new normal foresaw a global economy of starkly contrasting markets, policymakers who would become more actively engaged in propping up local economies, and a protracted uncertainty and uneasiness among investors—a toxic combination that would contribute to sluggish economic growth, higher unemployment, and unprecedented levels of activity among central banks and policymakers.

Let’s look at the three major constructs of the new normal, both in terms of where we started five years ago and developments that have shaped our view since then.
Multi-Speed World
In 2009, we identified the multi-speed world as consisting of three segments of the global economy: (1) developed economies such as Japan and Europe that were stuck in neutral or reverse, (2) somewhat healthier countries such as the United States, Canada, and Australia that were recovering modestly but struggling to reach escape velocity, and (3) emerging markets that continued to expand at a fervent pace (although their stamina remained questionable).

What happened since 2009? During the new normal era, we have witnessed a wholesale transformation in dynamics among these three segments. Conventional notions of safety have been turned upside down as creditworthiness concerns migrated from emerging markets to more mature markets, including the once unthinkable credit downgrade of the United States in 2011 and Grecce's downgrade to below investment grade in 2009. Today, the disequilibrium of a multi-speed world remains. But the hyperactivity of central banks has caused a shift in fundamental dynamics:

1. The United States experienced moderate growth, although the recovery is restrained by serious structural and political headwinds.
2. Europe continues to face severe challenges to growth.
3. Growth in emerging markets is still expanding collectively but with highly differentiated performance among individual countries.

Central Bank Activism
Our new normal forecast also envisioned more intervention from central banks, arguing that the failure of Lehman Brothers in September 2007 and other shocks to the system would require central banks around the globe to administer strong medicine in the form of unconventional monetary policy. Notwithstanding the fact that programs were broadly implemented and that productivity gains were observed in some pockets of the economy, we noted in 2009 that “there are insufficient demand buffers and fast-acting structural reforms to provide for a spontaneous and sustainable recovery in the global economy.” As we noted then, policymakers were fully engaging, and although there were some bold fiscal responses at the outset (such as the Troubled Asset Relief Program [TARP] program in the United States) most of the heavy lifting was left to the central banks, which followed dramatically accommodative and unprecedented rate reductions.

When it became apparent that reducing interest rates alone would not rouse the global economy or curb persistent unemployment, central banks in the largest economies embarked on unprecedented and audacious quantitative easing (QE) programs, which infused huge amounts of cash into the market and resulted in an explosion of liquidity.

What happened since 2009? The unprecedented level of intervention by global central banks has thus far fallen short of its targeted growth and employment goals. In the United States, financial repression has pushed yields down to historical lows, making it harder for fixed-income investors to achieve long-term objectives such as capital preservation, income, steady returns, and portfolio diversification. At the same time, it was clear that at both the individual country and supranational level regulations and regulatory structures would evolve, continuing to add uncertainty to the global economic operating environment.

As shown in figure 2, earnings growth has been largely absent from the 2012 and 2013 U.S. stock market rallies. At the same time, with return on investment so low, corporations have little incentive to extend risk into the real economy.

Uncertainty
Finally, the new normal recognized the likelihood that market volatility would remain elevated as investors struggled with the persistent lack of clarity about the direction of the global economy, an environment that former Fed Chairman Ben Bernanke characterized as “unusually uncertain.” The DDR phenomenon (deleveraging, deglobalization, and reregulation) exacerbated this discomfort as new regulations pressured banks to continue deleveraging, tighten lending standards, and expand capital reserves. Global policymakers remained so preoccupied with budget issues at home that they were unable to organize any meaningful, coordinated response to worldwide instability. And at the same time, it was clear that at both the individual country and supranational level regulations and regulatory structures would evolve, continuing to add uncertainty to the global economic operating environment.

What happened since 2009? Despite the unprecedented levels of stimulus injected into the economy by the Federal Reserve, the
Bank of Japan, the European Central Bank, and even many central banks in emerging markets, policymakers have not been able to hand off the responsibility of driving economic growth to the private sector—a necessary step for sustained expansion. This frustratingly slow transfer is due in no small part to the inability or unwillingness of fiscal policymakers to act cohesively and constructively, and it has contributed to ongoing market volatility. Indeed, in May 2013, when Chairman Bernanke merely hinted at the prospect of the Fed tapering its QE program, his comments triggered an abrupt rise in rates and drop in bond prices. Full confidence in bonds was shaken as individual investors struggled to understand how fixed-income returns could turn negative so quickly.

Looking Ahead
As financial professionals, we are all keenly aware of the challenges this new normal environment has created for investors who are saving for retirement and trying to reach other long-term goals. PIMCO’s secular outlook for the next three to five years offers the possibility of a new direction—one that harkens back to the stable disequilibrium that shaped our worldview in 2006. On the surface, we see the gradually improving market conditions, relatively stable interest rates, and lower performance correlations among many global asset classes. But below the surface, we see fundamental contrasts—the disequilibrium of political dysfunction, Europe’s economic morass, China’s split personality, and the fragmentation of monetary and fiscal policies.

As the new normal begins morphing, we believe that each of the world’s major economies is headed toward an intersection where the current road comes to an end, requiring a turn in one direction or another. Some transitions will occur within the next three to five years, whereas others will occur well beyond that point:

- Europe is closest to this ultimate intersection. European Central Bank actions have stabilized financial markets, but structural problems persist.
- The United States is on a longer journey that will culminate in either reaching escape velocity—characterized by 3-percent economic growth—or the disappointment of remaining stuck in the muddled middle. The latter would add to significant political tensions as well as challenges for deleveraging.
- In Japan, Abenomics1 will deliver above-average growth for the near term, but that level of growth will not likely be sustainable.
- Emerging-market growth has slowed uniformly, but we expect these economies to continue to feed global growth.
- Finally, China will either adopt new growth models and preserve its economic expansion or miss the opportunity altogether, resulting in both economic and political challenges.

Until we see what route these economies take, investors will be confronted with many of the same challenges that have embodied the new normal for the past several years: repressive financial policies that make it increasingly difficult to find attractive sources of yield, hyperactive central banks amid heightened market volatility, and correlations among asset classes across the globe.

Many of the headwinds that remain in place are the remnants of an economy that became overheated by excessive leverage as creditors essentially borrowed from future returns. As uncomfortable as it may be, we believe that investors should adjust their return expectations and plan accordingly. Now is the time to re-examine long-term goals and appetite for risk, and reset investment postures accordingly.

As the new normal persists, we have established secular and cyclical guidelines for our portfolios in an effort to add value for our clients. These guidelines also may help frame the discussions you are having with your clients about positioning their portfolios. In our view, the dramatically altered landscape requires fresh thinking in order to meet long-term investment goals.

- First, given the risks that remain embedded in the system, we recommend an approach that is generally defensive and selectively offensive—with an emphasis on preserving capital by generally reducing risk in portfolios and focusing on new growth opportunities.
- Second, investors should expand their horizons—broadening the diversification in their portfolios by looking beyond traditional geographic markets and exploring more-tactical approaches to a dynamic market environment. A number of innovative investment vehicles and strategies are now available to help investors do just that, including unconstrained, benchmark-agnostic approaches that provide portfolio managers with the freedom and flexibility to “go anywhere” and strategically respond to rapidly changing conditions.

As we adjust to the morphing of the new normal landscape, the conventional mindset and models will be less useful. Rather, smart investors will need to anticipate and avoid landmines, nimbly capitalize on emerging opportunities, and explore more innovative solutions in order to continue building wealth as we approach the crossroads ahead.

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Endnote
1. From Wikipedia: Abenomics refers to the economic policies advocated by Shinzo Abe since he was elected to a second term as Japan’s prime minister in December 2012. Abenomics is based upon “three arrows” of fiscal stimulus, monetary easing, and structural reforms.

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