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INVITED EDITORIAL COMMENT

What's New about the "New Normal"?

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In 2009, PIMCO's Mohamed El-Erian famously coined the expression the "new normal" to describe a world of lower yields and slower growth in the developed economies than past generations have enjoyed.

The expression tacitly presumes that the economic growth and lofty capital market returns of the last half-century were normal. High real returns from stocks and bonds, paired with reasonably rapid real GDP growth of 2% to 4% from the end of World War II until recently, must have seemed entirely normal by the late 1990s.

Why will we not return to these past norms? Because they were abnormal.

A normal market or economy must have some sort of steady-state equilibrium.

In recent years we've described a three-dimensional hurricane, based on the interconnected influences of deficits, debt, and demography, on the macroeconomy and the capital markets. It's really just another way to describe the new normal.

Consider the developed world's addiction to debt-financed public spending. In equilibrium, a fiscal deficit can't exceed long-term real GDP growth without the debt eventually blossoming out of control. Yet, under Generally Accepted Accounting Principles (which would require including off-balance-sheet spending and any net change in our unfunded entitlements in our official spending measures), deficits have averaged 10% of GDP for 30 years. We've been in disequilibrium for a generation.

In the past two centuries, we've also had a demographic disequilibrium. For millennia the world experienced a demographic equilibrium: births equaled deaths. Life was, in the words of philosopher Thomas Hobbes, "poor, nasty, brutish, and short." Astronomer Edmond Halley (of Halley's Comet fame) measured life expectancy in 17th-century London at 16 years, from any starting age after the first 5 years, which were lethal for more than half of all newborns. The world was awash in kids, who often died before adulthood. Beleaguered parents struggled with a horrific support ratio: Two workers supported an average family of eight, plus the rare surviving grandparent. Yikes.

Roll the clock forward a century or two from today, and we will necessarily achieve a new demographic equilibrium, with births again equaling deaths. We naturally hope that the new equilibrium is characterized by very long and healthy lives, accompanied by an economy robust enough to permit prosperity for all—and greater prosperity for the innovators of this brave new world.

Perhaps we do better to think of life in the past 200 years as a whole succession of "new normals." Today's developed economies saw a series of transitions that facilitated rapid growth and lofty capital market returns. The first "new normal" was driven by the Industrial Revolution, which freed most citizens from bleak squalor, paired with modern medicine, which allowed the biblical life span of "three score and ten" to become less of a rarity.

As life expectancy soared and birth rates tumbled, we experienced unnaturally benign support ratios. A fertility rate[1] below the "replacement rate" of 2.1 is fundamentally incompatible with a rising population. And yet, for the developed world, this has been our stable disequilibrium for most of the last half-century. As an extreme example, we have DINKs (double income, no kids) with parents still in the labor force: multiple workers, supporting no non-workers! As our recent work (Arnott and Chaves [2012]) demonstrates, this is wonderful for GDP growth and, as the DINKs and their parents age, for stock and bond returns.

The "new normal" is transitional, as we move towards an eventual steady state, and it's notably different from anything we've seen in the past 200 years. Consider that GDP growth is simply the sum of labor force growth and productivity growth, assuming that we misleadingly use GDP per worker to measure productivity. If the labor force is growing more slowly than in the past—and in many developed economies it is now shrinking—then, barring a remarkable surge in technological innovation, GDP will grow more slowly than in the past.

If the average age of those in the labor force rises, demography creates another GDP headwind: Productivity growth for mature adults is far slower than for young adults. Compare your own productivity growth in the past five years with your productivity growth from age 20 to 25 (assuming, of course, that you are well past 25!). For most of us, recent productivity growth is modest, but our productivity growth as young adults was stupendous.

Low current yields are the last important piece in the "new normal." Low yields imply lower forward-looking returns, even without macroeconomic headwinds. What should we expect from the broad U.S. markets? Bond aggregates yield a bit over 2%; that's our sensible expectation for bonds. TIPS yields tell us to expect a negative real return on 10-year government bonds. Broad U.S. stock indices yield 2%; the 100-year real growth in dividends and earnings has averaged 0.9% and 1.5%, respectively. This suggests real stock market returns of 2.9% to 3.5%, perhaps 5% to 6% nominal returns, assuming the headwinds exact no toll!

Why does any of this matter to the JPM's readers?

Current market conditions in the developed world expose us to a wide array of headwinds. Slower labor force growth and an aging workforce mean slower GDP growth. An addiction to debt-financed public spending hurts GDP growth and can siphon resources out of the private sector, compromising stock and bond market opportunities. Lower yields mean lower future returns.

It's important that we align our own—and our clients'—expectations to the upcoming, transitional "new normal." We owe it to ourselves and our clients to stop projecting future returns by extrapolating the abnormal past returns of recent decades. If we set our expectations low and then perform better than we expect, we win. But if we encourage our clients to expect that the past's lofty returns will come back, we risk a truly life-altering shortfall.

ENDNOTE

[1]The fertility ratio is the lifetime total number of children borne by the average woman. We might expect to achieve demographic equilibrium with every woman having two children. The higher number of 2.1 reflects the fact that some children die before adulthood and some adults are infertile.

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