



The 'new normal' – what does it mean?

In this Point of View, AXA's Chief Investment Officer Mark Dutton looks at what the 'new normal' will mean for investors.

In brief

- When markets settle in to a more normal state, it will be a different normal than foreseen before the global financial crisis (GFC)
- Economic growth is unlikely to return to the previous growth path
- This has implications for investors creating many traps and opportunities.

The 'new normal'

Just over a year ago, Bill Gross, Managing Director of the global fund manager PIMCO, was among the first to coin the term 'the new normal'.

It's a term that gets straight to the heart of the issue: when economies get back to a more normal state, it will be a different normal than foreseen before the GFC.

It's likely that this new normal will feature a slower rate of growth in developed economies, and will see developing countries driving global growth.

Unlikely to resume the 'old' growth path

To understand why we are unlikely to resume the same growth path as before the GFC, let's look at Sue and Sam who run a fruit farm.

In their first year they produced 100 tonnes of fruit. Each year they extended their farm so they could produce more fruit than in the previous year.

In their tenth year, they produced 155 tonnes. The output from their farm had grown by 5 per cent per annum.

But last year was different. A serious flood washed away part of their farm, taking 10 per cent of the crop with it.

Instead of a 5 per cent increase, Sue and Sam produced 10 per cent less than they did in the previous year.

This year they are back to producing about 5 per cent more than they did last year.

If we look at the rate of growth of their output it looks like figure 1 below – a typical V shape recovery, which gives the impression that Sue and Sam are back on track.

Figure 1 – a percentage change V



But Sue and Sam are not really back on track. The growth rate looks fine, but we see a different picture if we look at the actual volume of Sue and Sam's annual crop.

This graph would look like figure 2 below – it shows that while the farm is growing again, it won't get back to the original path unless Sue and Sam can generate above average growth.

Figure 2 – a volume change V



And volume is only part of the story – dollars matter as well. For Sue and Sam to repair the flood damage and stop it spreading, they had to spend more than planned, and much of that was borrowed money.

Their new income line will not only be lower, but will have a lower growth rate than their old growth line because they have to make payments on their loans.

For major western economies, the post GFC outlook is similar to Sue and Sam's story.

Global economic growth rate projections suggest we are getting back to 'normal'. For example, the IMF estimates global economic growth to return to around 4.5 per cent over the next couple of years, which is equivalent to the average economic growth rate experienced during the ten years prior to the GFC.

The world economy shrank during the GFC period and the relatively quick turn around in global economic growth has come at a substantial cost, creating very large debts.

This means that even though global production has rebounded, global output will be less than before the crisis, and high levels of public debt will further weigh on developed world growth.

For volumes to get back to the blue line in Figure 3 below, the world would need above average growth. Average growth will only get back the green line. The debt burden across developed economies is likely to mean a 'new normal' closer to the red line.

Figure 3 – the path to 'normal'

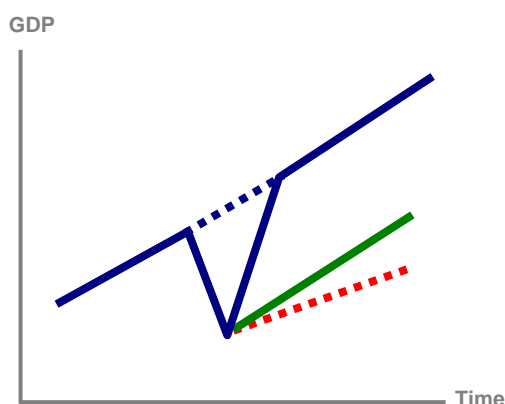
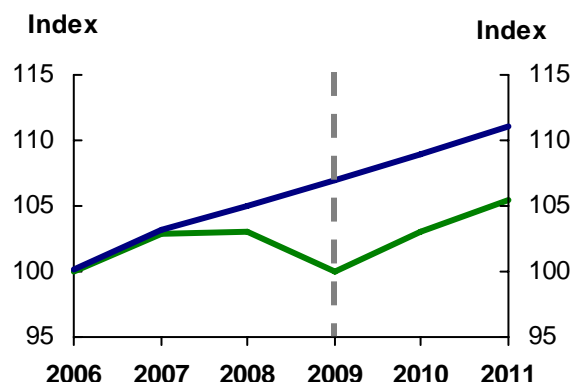


Figure 4 shows actual projections for US GDP which look very close to our green line in Figure 3. Markets are starting to look for a red line.

Figure 4 – a real world example US trend and forecast GDP



Source: Ecwin, Treasury and the Congressional Budget Office.

Traps and potential opportunities

In the 'new normal', many asset prices may struggle to rise as fast as they did in the debt fuelled growth period prior to the GFC.

Investors may be tempted to 'go where the growth is' and avoid lower growth economies. Research suggests caution here.

The expansion of the developing world does not in itself guarantee outsized returns for investors in emerging equity markets.

Surprisingly, there is no direct link between a country's economic growth rate and sharemarket returns for either developed or developing countries.

Strong investment returns in the 'new normal' will come from companies, not postcodes. The research challenge will be to identify industries and specific companies which will be the beneficiaries of structural shifts in the global economy and developing market growth.

The 'new normal' may be challenging, but there will still be many opportunities to build wealth wisely. A well researched and diversified portfolio has the best prospects.

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