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Sluggish economy feels like 'new normal'

Post-recession dogged by slow growth and high unemployment

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Remember the "new normal"? It's back on investors' minds.

The idea behind "the new normal" was that you can't count on a recovery after a financial crisis to be similar to what has been the typical post-recession period. Instead of a surge in growth, the sickness that begins in the financial system lingers in the economy for a long time, creating a sluggish period that lasts long enough to begin feeling normal. The scenario includes high government debt, slow economic growth of about 2 to 2.5 percent and sticky unemployment that will ease slowly.

Amid a strong stock market rally and improving economic data late last year, investors forgot the term coined toward the end of the financial crisis.

Now, investors are stewing over conditions far weaker than they would have expected during last year's peppy fourth quarter.

Home prices are still falling, despite losing 33 percent from the 2006 peak; manufacturing is slowing; and May's unemployment rate of 9.1 percent is worse than March's 8.8 percent.

"Pretty near everyone is confused," said Vincent Farrell, chief investment officer of Soleil Securities Corp. He notes that there is too little to show for all the stimulus the government's provided to resuscitate the economy.

On Tuesday, Federal Reserve Chairman Ben Bernanke shook investors as he talked about a "frustratingly slow" economic recovery and "weak demand for labor," while asserting that the Fed would have to remain vigilant. After his speech, the Dow Jones industrial average, which had been up about 90 points, gave back all of that and more, closing down 19.15, to 12,070.81.

Economic weakness doesn't mean a disaster for investors. But it does mean a readjustment in bullish thinking.

If the economy is weaker than investors would have assumed, then profit expectations are probably off too. Bringing profit assumptions down can drag stocks down. During the last month the Dow lost 4 percent.

Morgan Stanley strategist Adam Parker noted at the end of last week that analysts are likely to be busy adjusting their estimates. Despite some slight revisions lower for energy, consumer discretionary and financial earnings over the last two weeks, he notes analysts had been raising expectations over the last three months.

"The second half of the year looks challenged," he said. "We see labor, depreciation, less factory absorption and commodities as more likely to be head winds than tail winds heading into 2012."

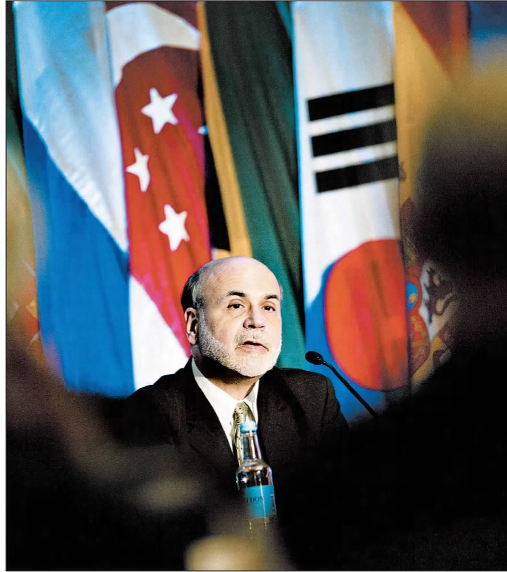
Barclays strategist Barry Knapp also thinks "reduced growth expectations should weigh on equities through the summer." There's a shift back toward the thinking of "the new normalists," he said.

In other words, there's a return to concerns about impaired growth as Americans struggle to pay down extraordinary levels of debt, while unemployment remains high and credit still tight.

"Despite the reasonable excuses for sluggish growth (which include high commodity prices and disruptions in supplies from Japan) we found ourselves rereading Carmen Reinhart's papers on the aftermath of a debt crisis," he said. Reinhart is recognized as an expert on the history of financial crises, and her work, along with Ken Rogoff's, is the foundation for "new normal" thinking.

Knapp thinks analysts will be reviewing Reinhart's work over the next few weeks and months as they try to understand why growth has been so sluggish and debate whether they should expect GDP to climb 2.5 or 3.5 percent.

"The growth debate will likely weigh on the equity market," he said. He expects the Standard & Poor's 500 to remain in a trading range between 1260 and 1360 until there is more visibility around growth in the third quarter. The index closed Tuesday at 1285 after losing 4.5 percent over the last five days.



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Fed chief Ben Bernanke said Tuesday that the central bank is battling an "uneven" and "frustratingly slow" recovery. After his comments, the Dow surrendered its gains for the day and finished 19 points down.

With increased caution, investors will be more attentive to stock valuations than they had been up to May, Knapp believes. That favors technology and health care rather than energy and financial companies, he said.

The turning point for the market could come if there is a strong back-to-school selling season, Knapp said, but he warns that June could remain difficult.

Meanwhile, the rising jobless rate remains troubling.

"Hiring is the main missing piece in this recovery," said Credit-Suisse economist Henry Mo. Although layoffs have declined to pre-crisis levels, the number of unemployed people able to find a new job "is now even lower than at the end of the Great Recession. Even if all job vacancies were filled overnight, almost 11 million workers would still be left unemployed."

Now, almost two years into the recovery, the economy has displayed growth a lot like the "new normal" course. Standard & Poor's economists have called the recovery "a half speed" advance, compared with the surge that follows the typical recession.

During the first year of recovery, U.S. GDP advanced 3 percent, or less than half the normal pace of the usual post-recession period, according to Standard & Poor's. The economy will complete its second year of recovery at month's end, and it appears GDP will be 2.7 percent versus the typical 4.1 percent.

new normal, economy, 2011

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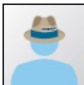

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