Is the "New Normal" Idiotic?
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Dear Fellow Investors:

The largest bond mutual fund company on the planet has built its entire thesis around what they call the "New Normal". It is the idea that the large overhang of debt in the US and the deleveraging which governments and households need to execute will cause an extended period of meager economic growth. At a conference in Sydney, Australia last week, another well-known money manager called that view "idiotic" and boldly predicted a very bright next ten years for our economy and the US stock market. Who should you believe?

Most of the respected money managers who fall into the "new normal" camp make their assumptions by looking at the twenty years of agony which Japan has gone through since 1990. In the aftermath of their stock and real estate bubbles breaking in 1990 (those of you excited about China should take note) fiscal and monetary policies all seemed to fail in a liquidity trap. Since their stock market and economy haven't grown in 20 years of deflation, the thesis goes, we must have a very long penance period to go through ourselves. The theory is that the financial sins of the last fifteen years were so egregious that the punishment must match the crime. Another way of looking at it is that the economic system got very dirty and it will take a lot longer to clean it.

We have found a wonderful statistic to follow provided by the Federal Reserve Board that speaks directly to this subject. It is called the Household Debt Service Ratio (HDSR). It computes how much of US household income is required to service household debts. The statistics go back to 1980 and paint a picture of an economy that has to heal itself every ten years or so. Here is the link to the chart: http://www.federalreserve.gov/releases/housedebt/.

As you can see by looking at the chart, household debt service has ranged from close to 14% in late 2007 and early 2008 to as low as 10.6% in 1980 and 1983. It peaked at around 12.4% in 1987 and bottomed in 1993 at 10.8%. After peaking at nearly 14% two years ago, it has fallen to 12.13% as of June 30, 2010. Our conclusions from this chart are as follows. First, you could conclude that to have an extended period of robust economic growth that you need to start with HDSR below 11%. Growth was strong from 1982 to 1987 and again in 1993 through 2000 because US households had plenty of ability to add debt and service the additional payments.

Second, economic growth is muted as debt service ratios improve. The Bank and Savings & Loan debacle of the late 1980's and early 1990's included a six-year stretch of slow economic growth which brought the HDSR down from 12.38% to 10.8%. President George Bush I failed to get re-elected in 1992 because "It's the Economy, Stupid". Economic growth was slow as Americans were more inclined to improve debt service than to spend. Third, "new normal" advocates are correct that we had a great deal more work to do to get the HDSR down to attractive levels. To drop from 14% HDSR to below 11% is a huge task and is likely to take one to two more years to accomplish. Therefore, economic growth in the US should remain slow during the remainder of this HDSR reduction stretch.

Lastly, the Japan comparisons are wrong and outlandish. It took six years from 1987 to 1993 to get our HDSR down to attractive levels the last time we had a major cleansing episode, a drop of 1.58%. We just knocked it down by 2% in two years! At the pace we are on, we could get below 11% in five quarters of results which is one year from now, September 30th, 2011. Japan didn't confess their financial sins in the 1990's and didn't clean out their financial system of its bad loans. If you don't confess, you don't heal. Their population shrank due to low birthrates and slim immigration practices. Their economy is limited by a lack of natural resources and limited useful land.

As we maintain ownership of companies which fit our eight criteria, we choose to assume that the dreariest scenarios are wrong because of their expected length. The ability of Americans to adapt by necessity is legendary. The only question to answer is how long the healing will take. There is an arrogance surrounding the "new normal" camp because they believe they know what the economy is going to do. The great money manager, Peter Lynch, of Fidelity Magellan fame said, "*If you spend more than 13 minutes analyzing economic and market forecasts, you've wasted 10 minutes*". It appears that the vast majority of market participants have forgotten his rule. CNBC's broadcasts used to be about stocks and stock picking. The drama in the financial markets today is centered on economic statistics.

History shows that once the healing is complete US economic growth at the 4 to 6% level can ensue. We happen to agree that investors are setting themselves up for disappointment if their view of the next ten years is too negative. There is more work to do, but the US stock market is an anticipatory vehicle. Our positive view of the US stock market is contrary and it makes us feel more comfortable.

Best Wishes,

William Smead

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