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The Old Normal

"The New Normal" is the latest phrase du jour among economic commentators. The consensus seems to be the new normal will be worse than the old normal. This reminds of the famous Neils Bohr quote: "I never make predictions, especially about the future."

In our opinion, no one knows whether the economic future will be "normal" or not, at least with the specificity cited in most economic forecasts. Our approach to the economic future is to assume the economy functions. By function, we mean wages are paid, income spent, and profits earned. Additionally, functioning means long run economic progress via better products and lower costs.

Functioning also means bouts of unemployment and contraction. Temporary upheaval is a fixture of economic history. While attempting to understand and eliminate economic fluctuations is a noble endeavor, there is no reason to expect we will ever enter a contraction-free zone.

Our approach of assuming a functioning economy does not mean we ignore the potential for an epic calamity. Our economic work today is focused on the nature and size of troublesome economic imbalances and our ability to survive them. Our position continues to be that this past year's financial crisis is manageable, though clearly larger compared to the recessions of more recent years.

As the year comes to an end, the world has come around to this view. This was not the case earlier this year. At the market bottom in March, sheer panic was the order of the day. This was the time to buy. The S&P closed on March 9 at 676.53. After having been very defensive for the past several years, Alpine backed up the truck and bought as much as we could. In turn, our equity portfolios had the good fortune of outpacing the S&P 500, which rose 65% in less than ten months to close at 1115.10. More importantly, Alpine clients have more wealth today than at the beginning of the financial crisis, whereas the overall market still remains 29% below its 2007 peak.

Of course, we did not know when the market would bottom, and were even less sure how sustained the rally would be. All we knew is prices relative to normalized profits were very attractive. In our opinion, this all-important measure is the compass which will always lead the investor out of the emotional woods of his own and everyone else's fears.

Today the compass is starting to point back toward caution. At a price 22 times higher than normalized earnings, the market is once again getting rich. Crash or soar from here, we do not know. Historically, the market has been as low as 8x and as high as 40x.

Regardless of the historical peaks and valleys, the conservative investor will become defensive at 20-25x and enterprising at 10-15x. The Alpine equity portfolio is currently selling around 13x normalized earnings, which gives us a measure of comfort and optimism about the long run potential for our holdings.

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As always, the case can be made for both lower or higher stock prices in the short run. The main case for lower stock prices rests on an anemic recovery and widespread deleveraging (debt reduction and higher savings).

While this scenario is plausible, a weak economy does not mean a profitless economy. The cash earnings of our companies are very real. The key is to make sure we get this cash via dividends or profitable growth. We are reasonably confident on that score. A key selection criterion for the businesses we own is management returns cash to shareholders absent attractive growth opportunities.

The case for higher stock prices has been made on the back of painfully low interest rates. Governments are keeping rates low. Cash rates are 0%. 5-year CDs are 2.6%. 10-year Treasuries are 3.8%. Investors experiencing interest rate sticker shock are moving to riskier assets as we speak. Some argue this will produce new bubbles, which may very well turn out to be true.

Alpine will not get caught investing in riskier assets or new bubbles. Our discipline is to pay a reasonable price for the cash income produced by quality companies. History is littered with stories of investors who have ignored cash income or succumbed to higher risk and prices to their own detriment.

The propensity for new bubbles so soon after last year's crash leads us to believe "The Old Normal" is alive and well. "Normal" in the financial markets is a place one passes going from one extreme to another. The key is to lighten up at speculative peaks and to load up after everyone panics.

The most important lesson of the past year is this is a lot easier said than done. The emotional impulse is to do just the opposite – an impulse we will continue to fight on our clients' behalf.

We wish you peace and prosperity in the coming year, normal or not.

Nick Tompras
December 2009

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