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The New Normal

by Troy Schrock and Scott Bahr

If you and your organization have been waiting for the economy to return to normal, your wait is over.

WHAT IS A "NORMAL" ECONOMY?

On any given day, factories manufacture, trucks deliver, retailers sell, and consumers buy. Employees drive to work, restaurants serve them lunch, and mechanics service their cars. Travelers park their cars, clerks check their bags, and pilots fly them to their destination. Some rent a car. Others hail a cab. Most check in to a hotel. Students ride the bus to school, teachers teach, and janitors clean. Families dine out, catch a movie, or watch a ballgame.

All in a day's work. All in a day's play. This is the "normal" economy.

On any given day, one factory schedules an extra shift while another lays off workers. One trucking company works overtime to deliver a huge order while another sends drivers home until the next call comes in. One retailer extends its hours while another closes its doors. Some office employees go out to lunch while others pack their own lunches to save a few bucks. One week, airlines are overbooked; the next week, they can't fill their planes. One business traveler enjoys a four-star room; others double up to satisfy tighter corporate budgets. Some school districts build to ease overcrowding while others lay off teachers, bus drivers, and janitors due to declining enrollment. Sports arenas that used to sell out now lower ticket prices to attract attendance.

Some incomes rise; some fall. Someone is promoted; someone else is laid off and enrolls for a second degree. One company expands; another company folds.

Big Rock Point (Phil Fisher)

This is the "normal" economy.

"Normal" does not mean zero unemployment, perpetual sales, and ever-increasing stock value. Not only is that not normal, it's not desirable. If everyone were always employed and sales guaranteed, you would still be driving to work in a horse-drawn buggy. Actually, you probably would not be driving to work at all. Instead, you would be tending your family farm, returning at sundown to a small, unheated log cabin and reading by candlelight. After all, in this imaginary world of full employment and perpetual sales, buggy builders, farmers, and candle makers need to make a living. Such a society cannot afford innovation, for innovation replaces old markets with new markets, and the transition requires some adjustment in attitudes and expectations. Buggy builders go out of business, but car manufacturers grow. Candle sales suffer, but electrical industries flourish.

"Normal" economies are full of disruption, and disruption is the catalyst for growth. Healthy economies don't fear the disruption; they embrace it. They don't fight the disruption; they exploit it. They don't see the disruption as an obstacle; they see it as an opportunity. In a healthy economy, new resources are constantly discovered or developed,

and changing resources generate new needs which demand new resources. The disruptions caused by the "new" and the "better" drive innovation, advance economies, and build wealth.

Some would try to squelch disruption in pursuit of so-called "stability," but economic stability is static, and static economies are impoverished economies. Economic disruption is dynamic, and dynamic economies are prosperous economies.

At first, it may seem that a disruption is the root cause of something that is out of order, but economically, a disruption is the *result* of something being out of order. For example, if consumers want widgits faster than companies can make them, a disruption in price – an increase, in this case – will rectify the situation. If a company makes a product which nobody wants, the market will force that company out of business. Such disruptions are what University of Missouri-St. Louis Professor Lawrence H. White calls "regulation by profit and loss."[1] They are the means by which natural market forces allocate resources to where they are most needed. Thus, when people move from one school district to another, the old district may lose a teacher while the new district gains a teacher. The economic message to the former is not, "Your services are no longer needed," but rather, "Your services are needed somewhere else."

This natural ebb and flow of the free market may not feel good in the short term, but it is the best thing for everyone in the long term. Historically, American workers and entrepreneurs have quickly adjusted, identified areas of need, and seized the opportunities in a continually changing economic landscape. As a result, our economy has grown from a few pilgrims trading food and furs with the Indians to the largest and most prosperous economy the world has ever seen.

As business leaders, disruptive change is the reality to which we are accustomed. Indeed, it's the reality that supports our business model. At its core, business is the practice of capitalizing on economic disruptions – the vehicle through which economic needs are met. We are comfortable with it. We thrive off it.

It's normal.

ECONOMIC SHOCKS

Our responses to normal economic disruptions should be considered standard operating procedure. We know things will change. We know we will have to innovate. We know we will have to adjust. Companies who survive and thrive anticipate disruption and prepare to profit from it.

However, we are occasionally hit with an event so unexpected and so significant that it shifts the assumptions by which we have been operating. A major war, a terrorist attack, a sharp increase in the price of a common commodity, a natural disaster, a major shift in government policy – these events are more than market disruptions. They are economic shocks, and they affect everyone in every industry.

Shocks rattle our worlds for awhile and prompt some fundamental changes, but even they don't derail our economy for long. We find ways to adjust, and soon, things are back to "normal." For example, a sudden increase in gas prices usually ignites a strong emotional reaction. Drivers get angry and the stock market may slide for a few days, but we adjust. Individuals and businesses restructure their budgets and modify their habits to accommodate the change. If these adjustments decrease overall demand for gas, prices gradually return to "normal" levels. Free market regulation has done its work again, using price to allocate resources and prompt us to adapt our lifestyles according to availability and need.

A shock may hurt initially, but the economy continues to hum. After all, shocks are just big disruptions, and we're used to disruptions. They're normal.

THE SUPER SHOCK ECONOMY

When multiple shocks happen in a short period of time, they amplify the impact of each, triggering more and more shocks in a tidal-wave type effect. These super shocks are more than just big disruptions; they're game changers. Long-term consumer and investor patterns shift, systems and structures must be revamped, and entire industries collapse under the weight of the changes.

In the last decade, the American economy has been hit with a super shock. We've had the bursting of the tech bubble, the 9/11 attacks, major accounting scandals, extraordinarily damaging hurricanes that directly hit oil refineries and nearly wiped out a major city, the bursting of the housing bubble, volatile gas prices, the credit crunch, major bankruptcies in the financial sector, and a domestic automotive industry fighting for its life. These shock factors, among others, have produced a tangled web of economic stimuli that is difficult to unravel. As Warren Buffett wrote in his 2002 letter to Berkshire Hathaway shareholders, "History teaches us that a crisis often causes problems to correlate in a manner undreamed of in more tranquil times."[2]

Still, at the risk of oversimplifying, we would like to suggest three major trends that exacerbate the super shock economy in which we now find ourselves. Two have been building for years, one is just now emerging, and all three are sure to continue for years to come.

THE BUBBLE FLOW

Before we feel too sorry for ourselves, we should recognize that a major contributor to the super shock economy is our own success. After years of worldwide economic growth and innovation, a large amount of capital has accumulated, and it needs somewhere to go. With today's technology, it can move very quickly, and due to instant mass communication of new information, it often does. Furthermore, much of this capital is pooled into large investment funds, meaning relatively few money managers decide where much of our capital goes.

Together, these factors drive bubbles. A particular investment area shows promise and quickly attracts large amounts of capital. This sudden supply of money drives up short-term valuations and prices, attracting more capital

from smaller investors and eventually drawing individual investors. As investors scramble to cash in on the "hot investment," they tend to exercise less due diligence in making their decisions. After all, speed is the first priority when an investment is hot and information is plentiful. Later investors are typically less sophisticated and somewhat ignorant of the true grade of their investments. In fact, the large investors, who have the technical resources to recognize a bubble faster than individual investors, might be on to the next wave before individual investors realize what is happening.

We saw this with the tech bubble. As the internet emerged in the mid-1990s, investors whipped themselves into a speculative fervor and threw money at any business idea with an "e-" prefix. When actual profits failed to materialize, capital flowed to the next hot investment: real estate. The euphoric rise and catastrophic fall of the housing market is well documented, and when this bubble burst, capital flowed into commodity markets. The price for a barrel of crude oil had already increased significantly to meet skyrocketing world demand, but from February to July 2008, it shot up another 50%. Stunned by high fuel costs, consumers and businesses cut back on consumption, causing the price of oil to drop 77% from its peak by the end of the year.

The bubble trends of recent years are certainly not new, but their scale is unprecedented. As the amount of capital has increased, the size of the bubbles and the amplitude of the economic swings have also increased. Thus, events that would have barely registered decades ago now constitute legitimate economic shocks.

GOVERNMENT INTERVENTION

The most powerful and damaging shock may be our change in economic approach. Rather than *react* to disruptions, we're now trying to *prevent* them through policy.[3] Government intervention quickly changes the rules by which everyone plays. Instead of responding to the natural forces of supply and demand (which are understandable if not always predictable), consumers, retailers, manufacturers, and service providers now respond to the judgment of legislators. Consequently, resources are allocated according to popular ideology rather than market-driven need. The resulting uncertainty can handcuff the economy, bringing the entire system to a standstill.

Though we may manipulate the rules of *our* game, however, we cannot change the natural laws of reality. Supply and

Elberta, MI (Phil Fisher)

demand still exist. Prices must still cover costs. Profitability is still the lifeblood of economic activity. If we cap prices below fair market value, consumers will pay less, but only while supplies last, and they won't last long if suppliers can't make money producing them. If we lower loan requirements, spending may increase, but so will loan defaults. If we legislate what car companies can make, costs will increase, consumer satisfaction will decrease, and less people will be able to afford a car.

So we can change the structural landscape through banking policy or government regulations, but these rules merely determine how expensive it is to play the game, and the cost to play greatly affects how businesses and individuals operate. Some may even choose not to play.

RETIREMENT OF BABY BOOMERS

Over the last century, the retirement rate has risen, the average age of retirement has declined, and life expectancies have increased dramatically. If the current trends continue, today's 20-year-old can expect to spend one-third of his life in retirement. Economically-speaking, that's one-third of life as a non-producing consumer.

Now the baby boomer generation is beginning to retire. In his book *Age Power,* Dr. Ken Dychtwald likens the baby boomers to a tsunami. The only warning people get of a coming tidal wave is when the coastal waters begin to suck away from the shoreline. Suddenly, the massive wall of water slams the shore, destroying everything in its path. We're about to be hit by the economic tidal wave of retiring baby boomers, and our economic and social systems will be crushed by this onslaught of consumers on a small producing population.[4]

Unless workers begin adjusting their retirement expectations, we are quickly approaching a time when consumers will far outnumber producers. Just as this model is untenable for General Motors, it will be untenable for our society.

THE NEW "NORMAL"

We do not wish to sound depressing; we *do* wish to frankly assess economic reality. Such realism is the bedrock of innovation. Today's recipe for success is the same as it has always been: look at current economic trends, identify new market needs, and innovate products and services to meet those needs. We must not be intimidated by the pace of change or the magnitude of market swings. Great leaders and great companies continue to play, and they play to win. We need them to win. Their victories are the counter shocks that dissipate the super shocks and get everyone moving in the right direction again.

Anyone "waiting out" the volatility of the market will be waiting for a long time. The massive bubble flow swings will continue their way through different market sectors, extending the wild ride for our investment portfolios. Hurricanes will again strike oil rigs and affluent coastal areas, and the volatility of the OPEC region will consistently fuel speculation and fluctuation of oil prices. As painful as the thought may be, we are likely to endure more terrorist strikes. Government intervention will always be a threat, and for the foreseeable future, a reality. Finally, global interconnectedness and the increasing economic influence of Asian nations will keep us vulnerable to a broader range of shock factors than previous generations encountered. In short, the super shock economy is far from over, and it may never end.

What is a "normal" economy?

This is.

Today's recipe for success is the same as it has always been: look at current economic trends, identify new market needs, and innovate products and services to meet those needs.

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End Notes:

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