Headwinds Fade, Tailwinds Build

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Headwinds Fade, Tailwinds Build

BY MARK ZANDI

The U.S. economy performed much better in 2010 than it did in 2009 and is set to do better still in 2011. Headwinds that have been impeding growth such as the housing crash, household and corporate deleveraging, and the credit crunch are fading, and the tailwinds—including healthy corporate finances and pent-up demand—are gathering strength.

The surprising political compromise to extend tax cuts and benefits, achieved late in 2010, adds to this optimism. The agreement ensures that fiscal policy will not drag on the economy this year, as had appeared likely. Real GDP is now expected to grow a strong 3.8% in 2011. This represents a significant upgrade in the outlook, with the tax deal adding approximately 1 percentage point to U.S. growth.

Given that the economy's potential growth rate—the pace consistent with stable unemployment—is estimated to be 2.7%, the U.S. should begin adding sufficient numbers of new jobs by this summer to significantly reduce the unemployment rate. Although the jobless rate may touch double digits before then as people who lost jobs during the recession return to the labor force, unemployment is expected to fall below 9% by the end of 2011.

Deflation worries will fade as the unemployment rate falls, but joblessness will continue to constrain underlying inflation. Core CPI inflation is not expected to exceed 1% this year. The Federal Reserve will battle high unemployment and low inflation by following through on its quantitative easing commitment and holding interest rates unchanged.

There are still considerable threats to this hopeful economic script. Housing remains fragile, with many foreclosures still in the pipeline, while budget cutting by state and local governments remains a serious threat. Europe's efforts to solve its debt problems or China's attempt at a soft landing could go astray and derail the anticipated U.S. recovery.

Under the best of circumstances, moreover, unemployment is still painfully high, and households' nest eggs remain significantly diminished. Nevertheless, 2011 should feel much better for most Americans.

Housing hits bottom

Ground zero for the financial panic and Great Recession was the housing crash. Since the real estate bubble burst nearly five years ago, residential construction has fallen to pre- World War II levels, house prices have plunged more than 30%, and nearly 5 million households have lost homes through foreclosure or short sales.[1]

House prices have not quite finished falling. With more than 4 million first mortgage loans in the foreclosure process or likely to default, distressed properties will account for a larger proportion of total home sales.[2] Loan modification efforts, including the government's HAMP plan and other private plans, will be helpful in reducing the number of distress sales, but even so, the share of such sales will rise and house prices will fall.[3]

Further house price declines should be relatively modest and gradual, averaging about 5% through next fall. With better job growth, near-record housing affordability, and ample credit from Fannie Mae, Freddie Mac and the FHA, housing demand should slowly revive. Barring further serious fallout from foreclosure processing problems, investor demand for distressed properties should be sturdy. Prices have fallen enough for investors to see opportunities in fixing and renting these houses.

Home construction will also slowly revive to replenish the inventories of new homes, which have never been this lean. Overbuilding during the bubble left the market glutted with existing homes, but this excess inventory is being worked off despite depressed demand, because new construction is even weaker. The glut is concentrated in places such as Florida, Atlanta, Nevada, Arizona, and the Central Valley of California. In most other parts of the nation, inventories will return near historically normal levels next year.

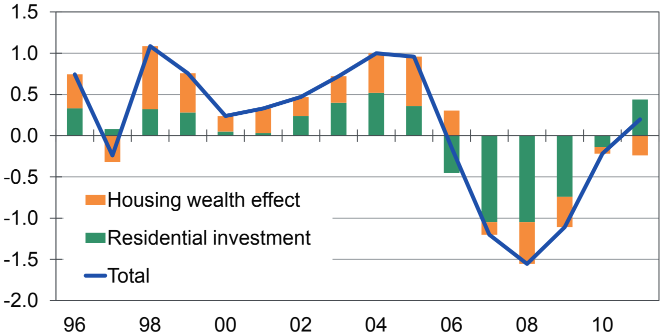
1 This is based on the Fiserv Case-Shiller national house price index. This index includes distress sales, which are generally sold at a large discount to nondistress sales. The estimate of lost homes is a Moody's Analytics estimate based on Equifax, RealtyTrac and Realtors data.

2 According to Equifax credit file data, there are just over 51 million first mortgage loans outstanding.

3 There will be approximately 1.75 million first mortgage loan modifications in 2010, including about 500,000 HAMP modifications and 1.25 million private modifications.

Chart 1: Housing Hits Bottom in 2011

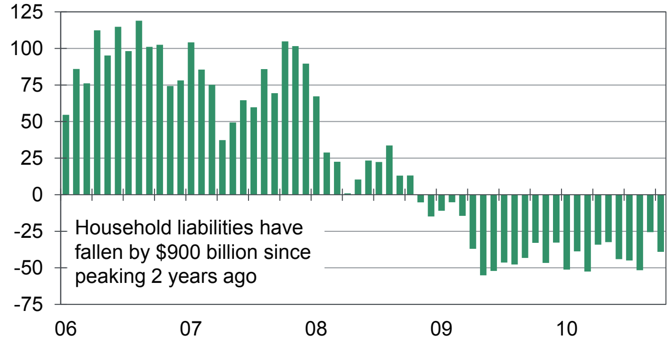
Contribution to real GDP growth, %



Source: Moody's Analytics

Chart 2: Deleveraging Is Well Under Way…

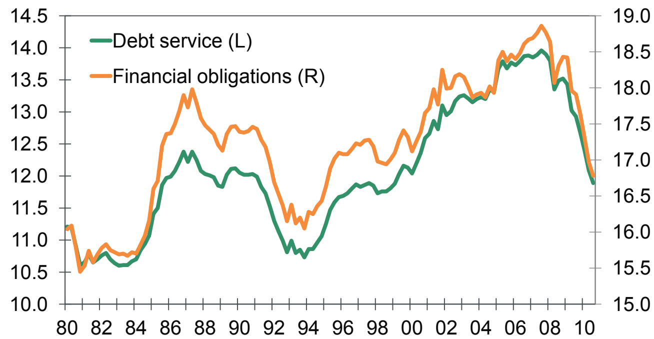
Change in household liabilities, $ bil, 3-mo MA



Sources: Equifax, Moody's Analytics

Chart 3: …Pulling Debt Burdens Lower

% of disposable income



Sources: Federal Reserve, BEA, Moody's Analytics

Housing's drag on the broader economy is thus expected to fade in 2011. The anticipated increase in new construction will offset house price declines and resulting negative wealth effects as homeowners save more and spend less (see Chart 1). This is a big swing since the depths of the recession, when housing was subtracting a couple of percentage points from real GDP growth.

Deleveraging winds down

With weak asset prices and high unemployment, households have been under extraordinary pressure to reduce their debts. This deleveraging has been a powerful drag on consumer spending but should begin to wind down later this year. As the pace of debt reduction slows, consumer spending and thus broader economic growth will gain traction.

Key to consumer spending growth is the pace of household borrowing. Consumer spending is powered by household cash flow, which equals the sum of income, realized capital gains and net borrowing. The growth rate of consumer spending thus equals the rate of income growth, the change in realized capital gains, and the change in net borrowing.

During the housing boom and bubble, households borrowed aggressively, pulling an unprecedented amount of cash from their homes via home equity borrowing and cash-out refinancing. At the peak of the equity withdrawal in the summer of 2006, homeowners were extracting almost 9% of their disposable income in cash from their homes. This compares with about 3% at the start of the decade.[4]

With the housing crash, homeowners are no longer taking equity out of their homes, and some higher-income households are likely repaying their mortgages more quickly. With deposit rates near zero and returns on other investments uncertain, homeowners could be opting for the sure, if low, return of lowering their mortgage debt.[5] Supporting this scenario is a relatively high share of recent refinancing deals that involve switching from 30-year mortgages to 15- or even 10-year mortgages.

Even more striking is a reduction in credit card borrowing. According to Equifax, there are more than 100 million fewer bankcards in use today than there were in the summer of 2008, a 25% decline.[6] With mortgage and card debt falling rapidly, total household liabilities are declining at an unprecedented rate of almost $500 billion annually (see Chart 2).[7]

Deleveraging is thus at its apex and expected to slow in the coming year. Key to this view is the plunge in household debt burdens—the share of after-tax income that households must devote to servicing debt to remain current. Falling debt outstanding, combined with record-low interest rates and better income gains, has pushed the debt service burden down by more than 2 percentage points since it peaked two years ago (see Chart 3). The debt burden has already fallen below its long-run average and will approach a record low by this time next year even under conservative assumptions regarding further deleveraging, interest rates and income growth.[8]

Households are less focused on how much they owe and more on how much of their cash goes to paying that debt. With debt service burdens easing, households will relax a bit. They will not be releveraging any time soon, but simply not deleveraging means they will be spending more freely before long.

4 California homeowners were the most profligate, taking out equity closer to a fifth of income at the peak; Central Valley homeowners withdrew almost a third of their income. These are Moody's Analytics estimates based on data from the Federal Reserve and Equifax.

5 For the average homeowner, the after-tax rate on a mortgage is just above 5%.

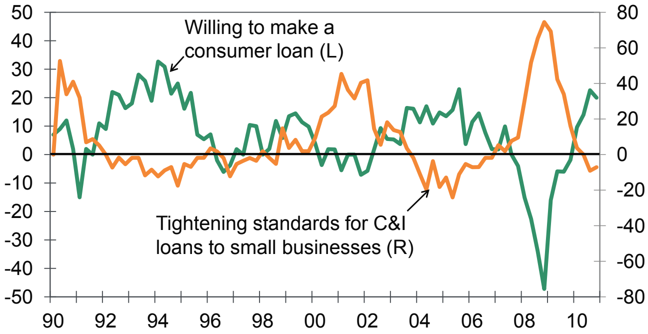
6 The number of bankcards outstanding has collapsed from a peak of 435 million in the summer of 2008 to 327 million.

7 This is despite steady growth in student loans outstanding and a recent increase in auto debt.

8 The financial obligation ratio—a broader measure of obligations that also includes rent, property taxes, homeowners' insurance and lease payments—tells a similar story.

Chart 4: The Credit Spigot Is Opening

Net % of senior loan officers…



Source: Federal Reserve Senior Loan Officer Survey

Credit spigot opens

Tight credit has been strangling the economy, but this will ease in coming months. Creditors will be persuaded to loosen the credit spigot by improving credit quality and by the financial system's return to profitability. More credit will fuel more spending and investment, particularly by small and midsize companies.

Credit dried up during the financial crisis and Great Recession. Even the highly liquid commercial paper market—a vital source of funding for the bluest-chip multinational corporations—would have turned dry without help from the Federal Reserve at the height of the panic. Lenders to households and smaller businesses all but shut down. The net percentage of senior bank loan officers willing to lend to consumers reached its lowest level since the 1970s, when the Carter administration temporarily imposed credit controls in an attempt to stem inflation. Nearly all loan officers said they were tightening criteria for commercial and industrial loans (see Chart 4).

Credit conditions have eased a bit already. The percentage of loan officers willing to lend to consumers is back to levels seen in better times. Lenders are also easing standards for C&I lending, and although standards remain tight, they should loosen soon.[9]

The conditions necessary for a much more substantial easing in lending standards and better credit flows are largely in place. A large number of first mortgage loans are still in the foreclosure process or likely headed there, but otherwise credit quality is good and improving rapidly. As of October, fewer than 12 million loans (not including first mortgages) were between 30 and 90 days delinquent.[10] This is down from more than 17 million in early 2009 and is the smallest number since the early 1990s. Even early-stage first mortgage delinquency is improving, with 1.7 million loans 30 to 90 days delinquent, down from more than 2.1 million at the peak.

Improving loan quality, wide net interest margins, and improving investment banking revenue are propelling better bank profits. Commercial banks' returns on assets are still well below their prerecession levels, but they have come back strongly from the recession. Big banks are doing particularly well after the rigorous stress tests in the spring of 2009 that forced institutions to add sufficient capital to insulate against a potential economic depression. While the recession was extraordinarily severe, it was not nearly as bad as envisaged by the stress tests; these institutions are now arguably overcapitalized, at least in aggregate. Many small banks have not been able to raise capital and are still struggling with troubled commercial real estate mortgage and construction loans, but they account for only a very small part of banking system assets.

Lending is already showing signs of turning up. New originations for credit cards, auto loans, and consumer finance loans are above year-ago levels for the first time since 2007. This is even the case for borrowers with lower credit scores. The size of credit lines is also growing. Most encouraging is that C&I loans outstanding have finally turned the corner. This is one of the best lagging indicators of the business cycle, historically providing positive proof that the downturn is ending.

Healthy corporations

Surging corporate profits and increasingly sturdy corporate balance sheets will form arguably the most powerful economic tailwind in 2011, persuading businesses to finally boost investment and hiring. Earnings have fully recovered from the recession, after firms dramatically lowered costs and widened profit margins. This is particularly impressive given generally weak pricing and only modest sales gains. Earnings growth among both large, publicly traded companies and small, privately held firms has rarely been stronger; it is expanding at a yearly rate above 25%. Such comparisons are still easy given the downdraft in earnings during the recession, but the profit gains enjoyed during this recovery are among the strongest recorded since World War II.

Business balance sheets are also about as strong as they can be. Corporations have deleveraged amid low borrowing costs, thus the interest coverage ratio—the proportion of cash flow going to debt payment—has fallen significantly. Under reasonable assumptions regarding future borrowing, interest rates and cash flow, it will approach a record low by this time next year. Cash holdings have also surged, and in proportion to short-term corporate liabilities, they have never been higher (see Chart 5).[11] Balance sheet strength is evident in nearly every industry.

There is no longer any doubt about businesses' ability to expand; the only question is when they will be willing to do so. If history is a guide, this should begin to happen over the next few months. In past recoveries, profits improved six to 12 months before job growth picked up (see Chart 6). The logic is straightforward: Managers realize they cannot boost profits forever merely by cutting costs. To sustain

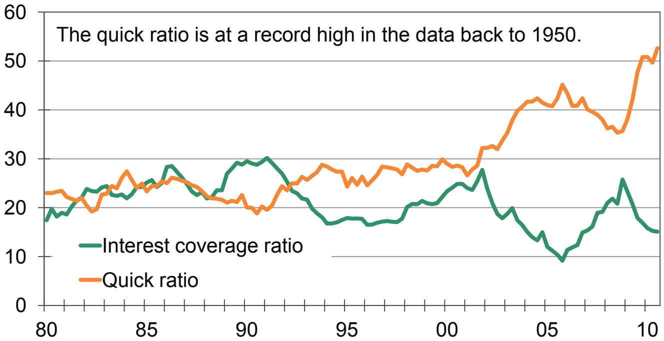
9 The Federal Reserve's quarterly survey asks senior loan officers whether they have eased or tightened underwriting since the last quarter. In recent surveys, more officers have reported easing than tightening after several years of substantial movement in the other direction. This suggests standards are easing, even if they remain tight by historical standards.

10 This is based on seasonally adjusted Equifax credit file data. Lower delinquency is also reflected in improving average credit scores.

11 This is based on the Federal Reserve's Flow of Funds data. Short-term corporate liabilities include all liabilities that come due within one year.

Chart 5: Solid Business Balance Sheets

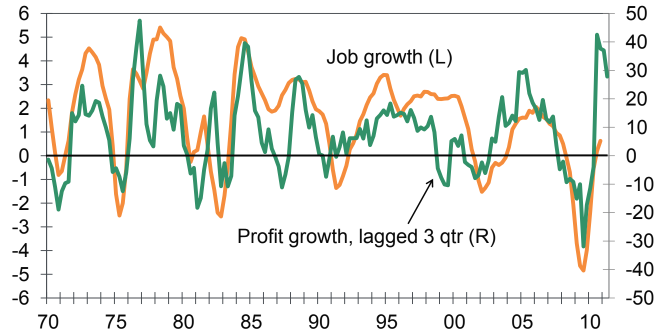
Nonfinancial corporate businesses



Sources: Federal Reserve, Moody's Analytics

Chart 6: Profits Surge; Jobs Should Follow

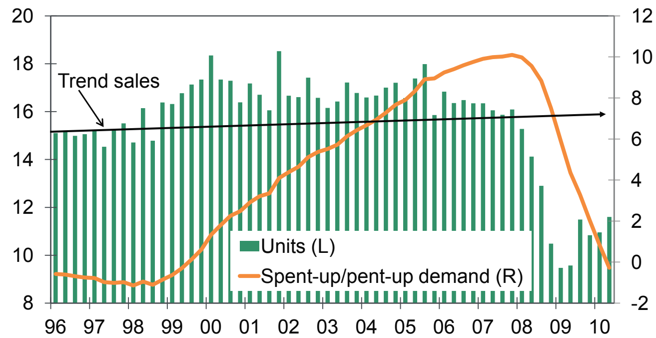
% change yr ago



Sources: BLS, BEA

Chart 7: Pent-Up Demand Is Developing

Light vehicle sales, mil



Sources: BEA, Moody's Analytics

strong earnings growth and support their stock prices, they need to seek revenue opportunities. That means greater investment and more hiring.

The process has been more attenuated in the current recovery, probably because of credit constraints on smaller businesses and the psychological battering all firms have taken. Many managers still seem shell-shocked from their near-death experiences during the Great Recession. Businesses have also been unnerved by the epic policy changes of the past year, affecting healthcare, financial regulation, and the tax code. Debates have raged as well around the cap-and-trade plan to curb carbon emissions, immigration reform, and organized labor's "card check" proposal, none of which resulted in legislation. Still, each came close enough to worry business managers.

The collective business psyche should slowly improve, however, as the credit spigot reopens for small businesses and the next Congress blocks further major economic policy changes. Better business sentiment, combined with strong profits and sturdy balance sheets, should make for a better year.

Unleashing demand

Economic growth should also receive a lift in 2011 from unleashed pent-up demand. Such demand develops during recessions when scared households cut spending below levels typical of their income, wealth and demographics. When confidence improves in the recovery, this pent-up demand propels outsize spending and faster growth, at least for a while. Such a pattern is typical and should play out in the current cycle.

Pent-up demand is most evident in the vehicle market. If the economy were operating normally, vehicle sales should be running close to 15.5 million units annually. This estimate is derived from the long-run trend equation in an error correction model, in which vehicle sales are a function of real household income, net worth, the auto loan rate, the number of households, and the age composition of the population. Estimated trend sales change over time, but only slowly in response to changes in these variables (see Chart 7).

Actual vehicle sales can and often do deviate from trend sales because of short-term factors. During the early 2000s, vehicle manufacturers used aggressive price discounting and easy lending to keep sales running consistently at 17 million annual units, well above trend. This created "spent-up" demand, equal to some 10 million units by late 2007, just prior to the start of the Great Recession.

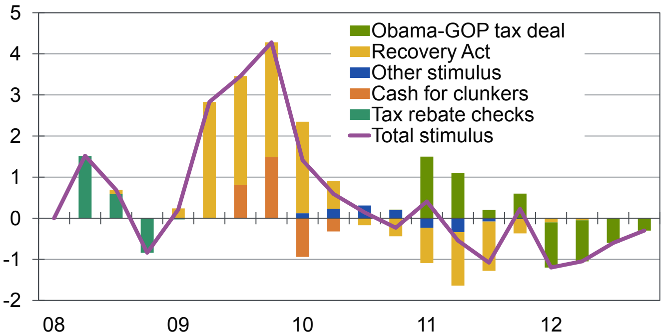
Spent-up demand helps explain why the auto industry was hit especially hard during the downturn. Sales plummeted to a pace of only 9.5 million annual units in early 2009; they have since improved but are still well below trend at just over 12 million units. Spent-up demand has given way to pent-up demand, which is now growing rapidly. Vehicle sales are expected to rise gradually through 2011 as the job market improves and credit eases; they could even take off once confidence revives sufficiently.

Even so, pent-up demand probably will not provide the same sales boost as in past recoveries, given the earlier excess demand. Trend sales may also be lower than estimated if the recession has significantly reshaped consumer behavior. The model of sales is based on historical experience, and that experience may not apply in the same way going forward.

Pent-up demand has grown to differing degrees for other consumer discretionary items as well—including jewelry and other luxury goods, judging by the strength of Christmas sales. Spending on various consumer services may also be buoyed by pent-

Chart 8: Fiscal Stimulus a More Modest Drag

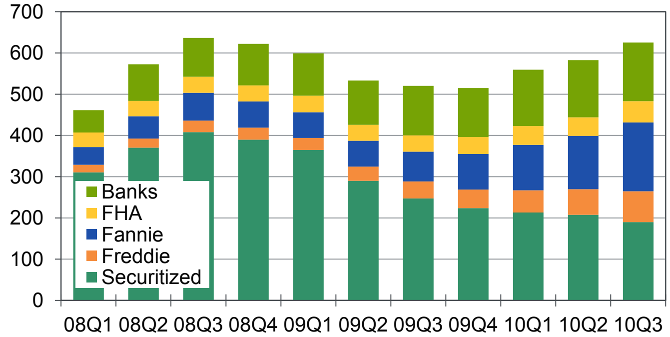
Contribution to real GDP growth, %



Source: Moody's Analytics

Chart 9: REO Inventory Is Building Again

REO Inventory, ths



Sources: Fannie, Freddie, FHA, Moody's Analytics

up demand such as discretionary medical and dental procedures and travel.

More policy support

The December compromise between the Obama administration and congressional Republicans on taxes and government spending adds significantly to growth prospects in 2011. The size and scope of the deal were a surprise; as a result, while fiscal policy still will add little to growth next year, at least it will not create much drag (see Chart 8). The agreement will add approximately 1 percentage point to real GDP growth in 2011, double expected job growth from 1.3 million to 2.6 million, and reduce unemployment by about a percentage point. Instead of hovering near 10% throughout the year, the jobless rate will fall below 9% by the end of the year.

Even without the tax deal, the economy would probably have made it through 2011 without falling back into recession, but this compromise improves those odds significantly. It also reduces pressure on the Federal Reserve to engage in more aggressive quantitative easing, which even its most ardent supporters did not expect to substantially boost growth. Quantitative easing has complicated the Fed's dealings with other global central banks, by helping push up the exchange value of their currencies against the U.S. dollar. It also has inflamed Republican legislators who claim it will unleash high inflation or that it constitutes fiscal policy that is outside the Fed's mandate.

There are some downsides to the tax deal. Congress will make little progress toward reducing the budget deficit in the current fiscal year. The deficit appears set to come in near $1.3 trillion in fiscal 2011, equal to 9% of GDP, about the same as in fiscal 2010. While the impact on long-term interest rates should be limited, there is a risk of backlash by global investors rightly nervous about the U.S. fiscal outlook.

It is also important to note that U.S. economic growth will be lower in 2012 than previously anticipated, as the fiscal drag expected in 2011 is pushed off a year. The economy will end in roughly the same place by mid-2013 as measured by GDP, jobs and unemployment. The compromise of tax and spending policies could have also been better designed to maximize economic efficacy. The deal includes a range of tax cuts for households and businesses, some of which pack little bang for the buck.

Foreclosure crisis

While there are good reasons to be optimistic about 2011, the economy is still fragile and many things could still go wrong. Topping the list of concerns are the foreclosure crisis and prospects that future house price declines will be more severe than anticipated.

The same vicious cycle that plagued the economy during the recession could be reignited, with house price declines pushing more homeowners under water and precipitating more defaults, which drive prices lower still. An estimated 14 million homeowners are already under water, with far more than half owing more than 20% above their homes' market values.[12] Beyond this threshold, many more homeowners decide strategically to default rather than continue to make mortgage payments with little prospect of ever rebuilding equity.

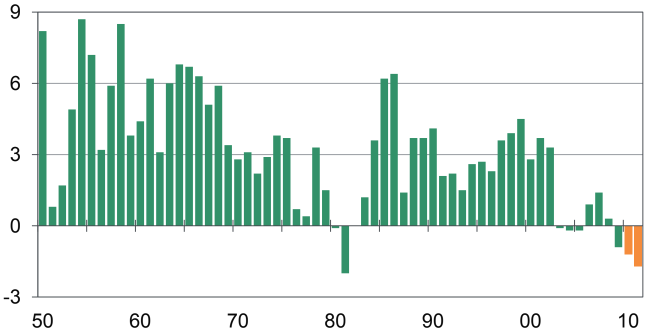
The number of repossessed properties classed as real-estate owned by banks, the last stage before they are resold, is also rising, even though it has already reached levels similar to those seen in late 2008, when house prices were plunging (see Chart 9). Mortgage owners appear increasingly interested in pushing distressed loans to foreclosure and resale, regardless of the prices they are receiving. This is a big change from a year ago, when mortgage owners were slowing foreclosures because of uncertainty regarding the amount of capital they would need to digest their credit problems.

Nothing works well in the economy when house prices are falling; the home remains the most important asset for most households and a key source of collateral for many small businesses seeking credit. The fallout on the financial system and broader economy could be serious if house prices decline much more than a further 5%, the amount we estimate is still ahead.

12 The estimate of 14 million negative equity homeowners is based on Equifax credit file and Case-Shiller house price data and is measurably greater than the commonly used estimate from Core Logic of closer to 11 million. The Moody's Analytics estimate of negative equity homeowners is nearly the same as Core Logic's in California, much lower in Florida, and higher most everywhere else. A possible explanation for the difference is the difficulty Core Logic may have in measuring mortgage debt in rural areas where homeowners generally see little equity appreciation even in good times (as house prices never rise much) and assume small negative equity positions in difficult times. The Moody's Analytics estimates are much higher in Texas, for example. Core Logic also does not have data for half a dozen small states.

Chart 10: State and Local Government Retrenches

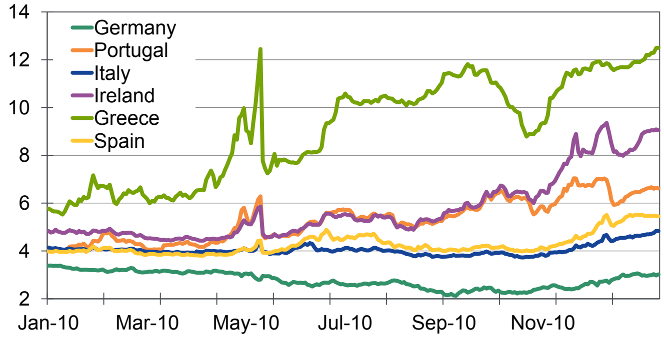
Growth in real state and local government spending, %



Sources: BEA, Moody's Analytics

Chart 11: Debt Problems Threaten to Boil Over

10-yr sovereign yields, %



Sources: Bloomberg, Moody's Analytics

Local government meltdown

While substantial federal fiscal austerity has been put off for another year, state and local governments are scrambling to close prodigious budget holes. This is despite stiff budget cutting in 2010, which included a quarter-million job cuts, big program reductions, and tax increases. These steps have been necessary even with the $175 billion in increased federal grants-in-aid that states are due to receive as part of the fiscal stimulus.[13]

Without additional help from Washington, which seems unlikely, federal aid will dry up at the end of the current fiscal year, in June for most states. Nominal state and local government spending will have to remain flat for the remainder of this fiscal year and next if states are to balance their budgets, even assuming tax revenue growth of 6%.[14] This suggests declines in real state and local government spending of almost 2% in calendar year 2011; since World War II, only the 1980 recession year was harder on state and local government budgets (see Chart 10). Accounting for these spending cuts and tax increases and their economic multipliers, state and local governments will be responsible for shaving approximately 0.4 of a percentage point from real GDP growth in 2011.

This anticipated state and local government drag on growth is serious but manageable. A string of sizable municipal bond defaults would be unmanageable. Investors are nervously considering this prospect. Muni credit default swap spreads—a measure of the cost of purchasing insurance against a municipal government default—and interest rate spreads between munis and Treasuries are much wider than historical norms.

Odds that a state would default on its debt obligations are remote. The biggest and most hard-pressed states such as California and New York have graduated income tax systems that produce significant revenue when the economy improves, as it should this year.[15] States also have low debt loads, and their interest payments account for only a small percentage of their cash flow.

The odds that local governments might default are much higher. While there has been a handful of recent small local defaults because of mismanagement or fraud, it is not hard to construct scenarios in which defaults spread given weaker house prices, falling property tax revenues, and mounting pension obligations. It is also not inconceivable that such a wave of defaults could re-ignite turmoil in financial markets and derail the economy.

European debt crisis

Another serious worry is the European debt crisis, which has yet to be brought under control. Greece and Ireland have been forced to borrow from a $1 trillion bailout fund established by the European Union and International Monetary Fund, and it appears inevitable that Portugal will have to follow them soon.[16]

Investors also have questioned Spain's fiscal viability, pushing up yields on that country's sovereign bonds sharply. Ten-year Spanish sovereign bond yields are just under 6%; if rates rise much above this, Spain's debt servicing costs will be overwhelming (see Chart 11). Rescuing Spain would likely exhaust the bailout fund. Prospects of this are making global investors increasingly edgy, further driving up interest rates in what could become a vicious cycle.

To break this cycle, European policymakers, and more specifically German and French officials, need to do more. A bailout fund closer to $1.5 trillion is necessary to convince investors they will get all the money back that they have invested in European sovereign debt. This may be too much of a financial strain for Europe to credibly handle on its own; thus the IMF may have to ante up more.

The European Central Bank will also have to step up its purchases of troubled sovereign debt. To date, the ECB has purchased close to $100 billion in Greek, Irish and Portuguese bonds, which have kept yields and thus borrowing costs down for these nations, but clearly not sufficiently. The ECB may also have to soon purchase the debt of other na-

13 The increased federal grants-in-aid have taken many forms, including additional monies for Medicaid, educational and unemployment insurance expenses, and infrastructure spending.

14 State and local tax revenue growth has been more or less consistent with nominal GDP growth over the past 40 years. Tax revenue growth is expected to be somewhat stronger than nominal GDP growth in 2011 and 2012 because of some further modest tax increases.

15 The troubled state of Illinois and its low flat income tax are notable exceptions.

16 The European Financial Stability Fund, established in May 2010 by all 27 member states of the European Union and IMF, can issue debt to provide loans to euro zone countries in financial trouble.

Chart 12: China Threatens to Overheat

Chinese consumer price inflation, % change yr ago

Source: National Bureau of Statistics China

tional governments, including Spain. This will weaken the ECB's balance sheet, but it would be better for the ECB to try to manage this debt than for the fragile European banks and other financial institutions that are choking on it. The ECB may also have to end its policy of sterilizing bond purchases, although given its criticism of the Federal Reserve's quantitative easing policy, it is likely to do so only under severe duress.

European banks must also be put through substantive stress tests, with transparent results that require the banking system to raise significant new capital. Europe's stress tests last summer were opaque, and little capital was raised. It is clear that the processes were woefully inadequate, given that the Irish banking system was all but nationalized just a few months later. Compare this with the U.S. bank stress tests completed in the spring of 2009, which forced big banks to envision a depression scenario and build capital accordingly. The depression never came, and the U.S. banking system is now well capitalized.

The longer European policymakers resist these steps, the greater the odds that financial turmoil will grow and that the European economy will suffer a double-dip recession, all of which would reverberate back on the U.S.

Chinese hard landing

U.S. growth prospects also depend on a relatively soft landing in key emerging economies, particularly China, where policymakers are working hard to avoid overheating. The Chinese economy was the first to recover from the global recession, and due in large part to the aggressive use of a monetary and fiscal stimulus, its subsequent recovery has been vigorous. China's economy is now operating near or above its capacity, as evidenced by sharply accelerating inflation (see Chart 12). There is also on-again, off-again nervousness about speculation in the property and equity markets.

Chinese authorities have responded by raising bank reserve requirements, tightening lending standards, and raising interest rates. They also resumed a policy of gradual currency appreciation, letting the yuan rise more than 3% against the dollar since then. Faster appreciation is warranted, since it seems to be the most effective way to both address China's domestic economic challenges and quiet the complaints of its trading partners such as the U.S. Chinese authorities do not see it that way, however, remaining concerned about the impact of faster currency appreciation on their export-oriented economy.

Other emerging economies have allowed market forces to push up their currencies' values more quickly, with benign effects so far. Chile, India, Indonesia and Turkey are good examples of nations successfully following this policy approach. But this has not convinced the Chinese.

While China will likely pull off a soft landing despite its currency policy, it might not be as graceful as hoped. A hard landing seems unlikely given the country's massive international reserves, which could be used to finance another massive dose of a fiscal stimulus, but even a bumpy landing could cause significant problems. Many commodity-producing emerging economies would struggle given the likely drop in global commodity prices—Chinese demand for everything from oil to copper and soybeans is pushing prices higher. Developed economies, including the U.S., would also suffer given how important the emerging world has become as an export market and the fallout this would have on global equity markets.

Conclusions

After three lean years of recession and weak recovery, the coming year is shaping up to be much better for the U.S. economy. The wrongs that undermined the financial system and economy are slowly being righted; households are deleveraging, banks are recapitalizing, and government budget gaps, while still yawning, are finally narrowing. It will take years to work through all the mistakes that generated the financial panic and Great Recession and even longer to pay for cleaning it up, but clear progress is being made.

U.S. businesses are also in excellent financial shape. Big and midsize firms in particular are highly profitable, and their balance sheets could not be much better. Corporate executives have been reluctant to invest and hire more aggressively, but that seems set to change soon. The nightmare of the Great Recession will not be forgotten for a generation or two, but its psychological sting is fading. The policy uncertainty that may have frozen corporate decision-making will also abate, as no major new policy initiatives seem likely soon. Unless businesses begin to expand, they will be hard-pressed to maintain earnings growth acceptable to their shareholders.

There are substantive threats to this optimism. It is hard to get too excited as long as house prices keep falling, which seems inevitable given the bulge of properties in the foreclosure pipeline moving toward distress sales. The tough budget and tax decisions being made in state and local government offices across the country will be a major drag, dampening enthusiasm. Europe's efforts to solve its debt woes and China's attempt at an economic soft landing may also not stick to script. Moreover, even under the best of circumstances, unemployment will remain painfully high and Americans' nest eggs will be much smaller than before the crisis.

Still, while the economy is not guaranteed to meet our optimistic expectations, they seem an increasingly good bet.

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