

### **Look for economy to gain traction in new year**

I'm optimistic about 2011. The U.S. economy will gain traction as the year progresses, and by summer businesses will be hiring rapidly enough to bring down the unemployment rate measurably. Stock prices should hold their own, and while more declines in housing prices are likely, that sector's crash will be over by next New Year's. After three very lean years for most Americans, this one will feel much better.

Fueling this optimism is the financial health of U.S. businesses. Profits have fully recovered from the Great Recession after firms dramatically lowered costs and widened their margins. Despite only modest sales gains and weak pricing, earnings growth has rarely been stronger.

Business balance sheets are also about as strong as they can be. Corporations have slashed debt amid low borrowing costs; the proportion of cash flow going to debt payments has fallen significantly. Cash holdings have also surged to near-record levels as a proportion of short-term corporate debt.

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 happen increasingly over the coming months. In past recoveries, profits improved six to 12 months before job growth picked up. The logic is straightforward: Managers realize they cannot boost profits forever merely by cutting costs. To sustain 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 last year, affecting health care, financial regulation, and the tax code. Serious policy debates have also raged around the cap-and-trade plan to curb carbon emissions, immigration reform, and organized labor's "card check" proposal. None of these resulted in legislation, but all came close enough to worry business managers.

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

The recent compromise between the Obama administration and congressional Republicans on taxes and government spending adds significantly to the economy's near-term growth prospects. The size and scope of the deal were a surprise; besides keeping everyone's tax rates unchanged, it includes a cut in the payroll tax, more emergency unemployment-insurance benefits, and lucrative investment incentives for businesses. The deal will provide just enough economic juice to persuade firms to expand their operations.

### **The risks**

But while there are good reasons for optimism about 2011, the economy is still fragile and much could still go wrong. The continuing foreclosure crisis and the prospect of further declines in housing prices pose a serious threat. Nothing works well in the economy when housing prices are falling; the home is still most households' primary asset and a source of collateral for many small businesses seeking credit. Additional price erosion will push more homeowners underwater, adding to the millions already in this predicament and setting up more defaults, more distressed home sales, and thus more price declines. The same vicious cycle that plagued the economy during the recession could be reignited.

The European debt crisis also has yet to be brought under control. Greece and Ireland have been forced to borrow from a \$1 trillion EU bailout fund established when the crisis first flared in the spring, and Portugal

appears likely to follow soon. Investors are now questioning Spain's fiscal viability, as yields on that country's sovereign bonds have risen sharply.

Spain could overwhelm the European Union bailout fund, putting pressure on Germany and France to increase its size. The longer they resist, the greater the odds that financial turmoil will grow and the greater the chances for a European recession that would almost certainly reverberate back to the United States.

### **The most daunting challenge**

The U.S. outlook also depends on a soft landing in key emerging economies such as China, whose policymakers are working to rein in inflation and excessive financial speculation. Chinese authorities have raised bank-reserve requirements, tightened lending standards, and increased interest rates, but they remain reluctant to allow their currency to appreciate more quickly - though this would address their problems effectively and stem international complaints about the undervalued Chinese yuan. Even a bumpy landing in China could result in a hard landing elsewhere in the world, including the United States.

Yet our most daunting economic challenge is our own government's fiscal imbalance. Spending restraint and tax increases will eventually be needed. Unless U.S. policymakers lay out a credible path to fiscal sustainability soon, we will invite a backlash by global investors rightly nervous about the federal government's finances.

Despite these threats, 2011 will likely be a better year than the U.S. economy has seen in a while. After three years of recession and weak recovery, the change will feel significant. Optimism is not a guarantee, but it looks increasingly like a good bet.

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