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**ECONOMICS:** US PERSPECTIVES—DECEMBER 17, 2010

# Jagged Recovery Provides Important Lessons for 2011 Outlook


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The US recovery continued in 2010, but the pattern was uneven amid uncertainty on domestic policies, high joblessness and a debt crisis in Europe. We expect stronger growth in 2011, but the journey will likely be volatile again as new policies are deployed and a new political balance emerges in Congress.


It's been an erratic year for the US economy and markets. The year started off well, with growth and financial markets exceeding expectations in early 2010. But pockets of turbulence in the second and third quarters left investors leery and anxious about the future—and unprepared for the rebound at year-end.

When the history books are written, we don't think 2010 will be considered a watershed year in the recovery of the US economy from the deep recession of 2008. But we do think there are several key lessons and observations that investors should keep in mind as 2011 begins.

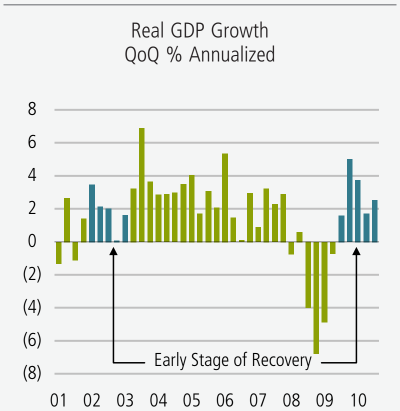
### Economic Recoveries Are Bumpy

Economic recoveries are never linear and double dips are rare events. The historical record shows that even during years of relatively strong growth, the variation from high to low growth quarters could be as much as three to four percentage points.

This means that the slowdown between the first and second quarters of 2010, when gross domestic product (GDP) growth slowed by two percentage points from 3.7% to 1.7%, was well within the pattern of US historical recoveries **(Display 1)**. Nonetheless, slowing growth—especially in the early phases of recovery—often stokes fears of a so-called double dip. But in reality, these are rare events. The US economy has only suffered one double dip in the postwar period, and that followed a dramatic tightening of monetary policy over a span of several months in 1981.

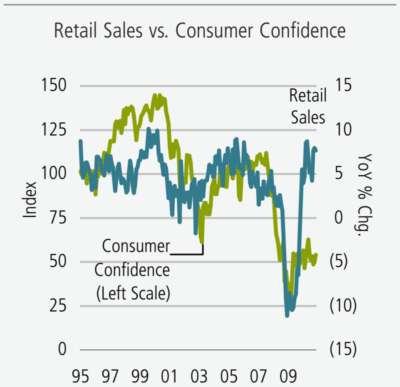
This year, in contrast, extremely relaxed financial conditions and low interest rates failed to quell concern over a potential relapse into recession during the summer, which triggered a sharp drop in equity prices and fall in bond yields. Yet not only did the recovery prove durable, but the pace of real GDP growth in the second half exceeded the most bullish forecasts, including ours. As the US economy showed its resilience late in the year and defied the pessimists, the U-turn in growth and forecasts prompted a sharp reversal in bond yields and a rally in equity prices.

Display 1
**Economic Recoveries Are Often Uneven**




As of December 17, 2010
Source: Bureau of Economic Analysis and Haver Analytics

Display 2
**Spending Rises Despite Poor Sentiment**




As of November 2010
Source: Census Bureau, Conference Board and Haver Analytics

## Recoveries Surmount Bad News

During downturns, especially severe recessions, people are often gripped by fears of an endless and uninterrupted economic decline. Recoveries are not considered complete until the bad news ends. Yet economic recoveries don't depend on the total elimination of bad news or imbalances. In fact, recoveries often begin as industries and sectors at the center of the recession start to stabilize at depressed levels, while growth in other areas—led by investment and spending decisions of consumers and business—begin to lead the economy on an upward trajectory.

Several trends in 2010 reminded us of the US economy's remarkable ability to surmount bad news. For example, consumer spending posted a sharp rebound at year-end, with retail sales rising at an annualized rate of 12.4% over the past three months, the strongest gain since the fourth quarter of 2001 **(Display 2, previous page)**. With the jobless rate stuck at 9.8% and little changed from the start of the year, many observers were puzzled by the strength in consumer spending. Although the strength in retail sales exceeded our expectations as well, the factors and processes behind these gains were unsurprising to us.

Cyclical recoveries in consumer spending start when the employed workforce enjoys a sustained improvement in cash flows and balance sheets, while gaining confidence in the security of their jobs and the economy. That shift in sentiment is often reflected first in spending trends, particularly in discretionary spending categories which have done well in recent months.

## Uncertainty Can Stifle Rebound

In the early stages, recoveries are often fragile and narrow, and anything that creates uncertainty can lead the economy to stall. In early 2010, Congress passed legislation to re-regulate healthcare and the financial industry. Both pieces of legislation only provided a framework, leaving all the new rules and regulations to be decided in the future. That created too much uncertainty for many firms, perhaps even leading some to delay investing or hiring until the specifics were clarified.

Uncertainty surrounding US tax policy was even more damaging, in our view. With tax rules set to expire at year-end on Bush-era tax cuts, as well as treatment of dividends, capital gains and a host of other items, it was difficult for consumers and business to plan for the future. Even firms that were not directly affected by the changes were hesitant to act until these issues were resolved because there was a good chance that many end-market customers would be hit if the current set of tax rules was not extended.

The outlook on tax law change gained substantial clarity after the election results of November 2. Once it became clear that the Republicans had won commanding control in the House of Representatives, it looked increasingly likely that the tax rules would be extended by a year or two, in line with the party's stated policy of opposing any tax hikes at this point in the economic recovery. That's why even before the tax deal between the White House and the Republican leadership was reached earlier this month, companies started to gain confidence and plan accordingly.

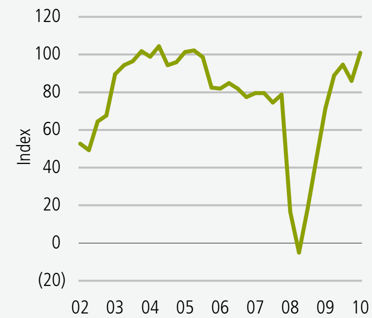
According to the Business Roundtable CEO survey, the CEO confidence index surged by 15 points in the fourth quarter to the highest level since early 2006 **(Display 3)**. In addition, the survey showed that capital expenditure rebounded sharply **(Display 4)**, ending one point shy of its previous record, while hiring plans for the next six months hit an all time high **(Display 5)**.

## Liquidity Is a Key Indicator

Liquidity remains the lifeblood of economic cycles. Our proprietary liquidity index continued to post strong gains over the summer months, signaling that there was ample financial fuel to keep the economy moving forward and that growth might

Display 3
**Businesses Are Gaining Confidence**

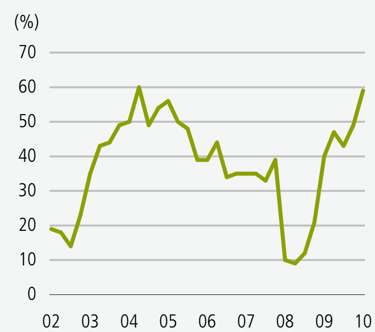
Business Roundtable CEO Confidence Index




As of December 17, 2010
Source: Business Roundtable and Haver Analytics

Display 4
**Increased Optimism Leads to More Capex…**

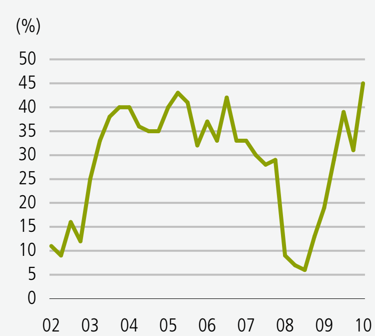
CEO Outlook: Percentage to Increase Capex in Six Months




As of December 17, 2010
Source: Business Roundtable and Haver Analytics

Display 5
**…and Plans to Hire More Workers**

CEO Outlook: Percentage to Increase Employment in Six Months




As of December 17, 2010
Source: Business Roundtable and Haver Analytics

even exceed expectations once restraining factors began to fade in importance.

In recent years the more important signal from liquidity flows has been the simple year-on-year changes as opposed to the smoothed, 12-month moving average of the year-on-year changes. The year-on-year signal **(Display 6)** is conveying important information on the near-term direction of the economy, while its overall growth rate provides intelligence on the vulnerability of the economy to an exogenous shock.

## Volatility Likely to Persist in 2011

Liquidity flows are currently running in the 4% to 5% range through November, and are poised to accelerate further as the Fed completes its latest quantitative easing program (QE2), while promising to keep official rates low for an extended period.

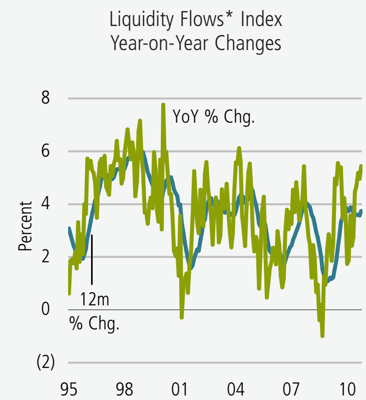
At the same time, Congress is finalizing its work on tax legislation, which should eliminate uncertainty and provide additional stimulus. All these factors suggest that our real GDP growth forecast of 3.8% for 2011 may prove too conservative, and 10-year Treasury yields at the end of 2011 may exceed our current estimates of 4.5% to 4.75%.

Although fiscal and monetary policies are clearly aimed to support faster growth, we expect economic and financial conditions to remain volatile for several reasons. First, some policies such as QE2 are untested and scheduled for a limited time. Second, a new political balance is emerging in Congress and many fiscal issues need to be resolved. Third, global issues of currency realignment and sovereign-debt troubles in Europe are still unfolding. However, we think the right conditions are in place to sustain the growth cycle, even though the economic and financial climate may prove stormy at times.

When the economy hits a rough spot, it's important to remember that economic growth after a recession is driven by a reduction of problems—not the complete resolution of all weaknesses. In our view, understanding the dynamics of economic recoveries is the key for investors to maintain focus and navigate through the complexities that are sure to unfold during 2011. ■

Display 6

**Liquidity Is Lifeblood of Economic Cycles**




As of October 2010
*12-month moving average of year-on-year percentage change
Source: AllianceBernstein