"The past is prologue"
Shakespeare

Way back in 2009, conventional wisdom argued that the recovery from the "sub-prime crisis" would be tenuous at best. In fact, the majority argued real Gross Domestic Product (GDP; what our country earns; a measure of economic strength) would be a lackluster 2% at best for all of 2010.

We disagreed. The economy was not broken. It seemed obvious that once the panic ended, a natural economic recovery would start. Even without the initial quantitative easing (we're now into QE2), the Federal Reserve was already historically accommodating with rock-bottom interest rates and massive infusions of cash. The remaining ingredient supporting our optimistic view was a belief in growing productivity. With all of these factors in place, we projected that 2010 would see real GDP greater than 3%. In economic circles, such a huge departure from conventional wisdom borders on blasphemy.

As it now appears, although we were right, we may have underestimated the strength of this recovery. Thus, we now expect 4% real GDP for 2011. Here's why:

Consumption: Auto sales in Oct/Nov were up 30% from early 2009 levels, and according to JD Power and Edmunds.com, will be even higher this month. Meanwhile, consumer's financial obligations are at their smallest share of after tax income in more than 15 years and are headed lower. Thus, consumption will contribute to an improving economy.

Add 2.3 points to GDP.

Business Investment: Corporate profits and cash on balance sheets are at or near record highs. Brian W. Wesbury, Chief Economist for First Trust, believes "we are on the cusp of a boom in equipment and software".

Add 1.2 points to GDP growth.

Home Building: We still have substantial excess inventories. However, once these inventories are gone, and it may take several years to get there, the pace of housing starts will rapidly accelerate.

Add 0.4 points to GDP.

Government   Real government purchases are expected to increase at 1.5%, which is below the 30-year average of 2.2%.

Add 0.3 points to GDP.

Inventories We started 2010 with razor-thin inventories. 2010 was a rebound year and 2011 will be slightly better.

Add 0.1 to GDP.

Trade Expect a continual rollercoaster ride for trade in 2011. Since the US trade deficit is likely to expand again, this category will slow GDP.

Subtract 0.3 from GDP.

Mix all these assumptions into a blender, pour over ice and sip on a 4% GDP forecast for 2011.

A post-Christmas Gift

By the way, millions of workers will see their take home pay rise in 2011 because of a 2% payroll tax cut for employees. This cut reduces an employee's Social Security tax rate from 6.2 % to 4.2 % of wages paid. Congress promises this reduced withholding will not affect an employee's future Social Security benefit. We'll see.

Big Banks

"The people who run big banks in the US have had a good year", said Simon Johnson, MIT Economics Professor. They pushed back hard on financial reform legislation this spring and were able to defeat the most serious efforts to constrain their power. They and their non-US colleagues scored an even bigger win at Basel this fall. Basel is a city in Switzerland and the venue for the International Committee on Banking Supervision. They set financial safety standards and unfortunately, decided to keep the required levels of equity in banks at dangerously low levels.

This continued arrogance from bankers remains very troubling. We as taxpayers bailed out their reckless behavior in 2007 and 2008, only to watch them pay themselves obscene bonuses in 2009. Now they want to do this again in 2010.

If Congress finds its backbone, it should restrict or prohibit any bonuses for 2010 from being paid until we as a country can judge how well (or poorly) their actions helped or hurt the economy. No one should be too big to fail or allowed to repeat their mistakes at our expense.

Have a healthy and prosperous 2011.

James D. Hallett, MSFP, CFP®, ChFC, CLU, CDFA™, AIFA®. Hallett & Associates, P.S. is registered as an investment adviser with the SEC and only transacts business in states where it is properly registered or excluded from registration requirements.

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