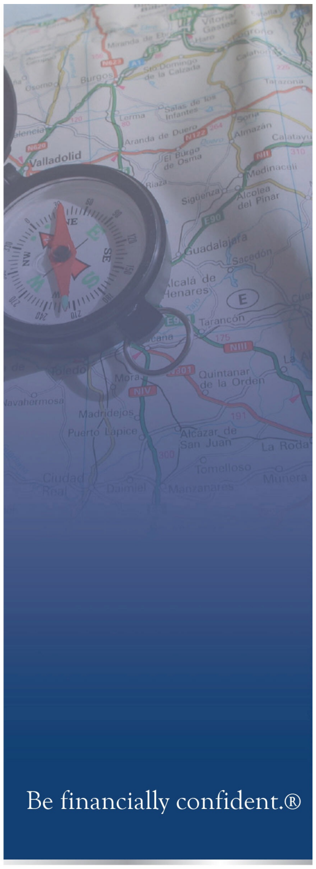
The Good News... Maybe

by Craig Carnick, CFP®



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So many aspects of our economy still seem seriously hobbled, nearly two years after the official end of the Great Recession: Unemployment is still at 9.0 percent, and here in Colorado Springs, home sales are still falling; they slipped another 0.9 percent in January from a year earlier. Yet the landscape for investors looks surprisingly positive. It's terrible that so many people are still out of work, or are still facing foreclosure on their houses, but there is also plenty of good news about our economy, and that good news is having a more direct impact on our ability to meet our financial goals. Despite our troubles, there are very good reasons to be optimistic.

We can see this most obviously in the performance of the equity market over the past year. In spite of the other economic turmoil going on, the Dow finished 2010 with a gain of just over 11 percent on the year. And the Dow was the least robust of the major indexes: The S&P 500 finished up 13 percent, and the Nasdaq was up 17 percent. That strong performance has continued into 2011 as well. As of the end of January, when about half of the S&P 500 companies had reported their final quarterly earnings from the end of 2010, corporate profits overall were up 17 percent from the previous year.

In part because of all those profits, American corporations are flush with cash right now. One estimate shows that large companies have roughly $2 trillion in cash or cash equivalents sitting in their coffers right now. To take one example, high-tech giant Cisco Systems has nearly $40 billion in cash on hand. But some of that extra money has been finding its way back to investors: As of mid-February, the median dividend for S&P 500 companies had increased by more than 12 percent over 2010. S&P estimates that more than $200 billion in dividends will be paid out this year.

All that cash on hand also helps to explain why we've seen so little movement in the employment figures. Like consumers, companies are still somewhat unsure about the overall direction of the economy. Consumers have ratcheted down their debt levels, using their credit cards more sparingly until the economy returns in full force; similarly, companies are holding back on expansion and hiring until the landscape looks more favorable. When corporations do begin investing that money back into their operations, then we probably also will start to see a real change in the unemployment rate.

Unemployment and the housing market have always been expected to be lagging indicators; they will recover after other segments of the economy – including stock prices, which are necessarily forward-looking – have regained their health. Normally, unemployment runs at about 5 percent, so the problem isn't really the 9 percent we're at now; it's the 4 percent excess.

The unemployment rate should gradually drift back to normal, although probably over a period of years. But we can't expect the housing market to ever again be what it was in the middle of the last decade, when too many people bought too many houses that they simply couldn't afford. As the excess capacity is flushed out of the market, we should see it stabilize, and prices start to increase again. We seem to have reached the bottom of the housing market; the biggest question is how slow the climb back up will be.

And although it's been little reported, the economy has mostly moved beyond the government programs that were enacted during the depths of the recession. The federal government has laid out $389 billion for the TARP program since it was established in October 2008, but $270 billion, or nearly 70 percent of the total funds, has been recouped, including some $25 billion in interest. In many significant ways, the recession continues to fade further into our background.

The uprisings in the Middle East provide another level of uncertainty. Many of the nations in turmoil, such as Libya, furnish us with a great deal of our foreign oil. There's no telling how future leaders of the Middle East nations will deal with us economically, or what the impact will be on our energy costs. Another oil shock, such as we experienced in the 1970s, would have unforeseen effects on this fragile recovery.

For the moment, though, America is back in business. We saw 2.9 percent GDP growth in 2010, and the Federal Reserve has forecast growth of between 3.4 and 3.9 percent for this year. The upper range of that estimate would be stronger growth than we've seen in any year since 2000. So even if we're cautiously optimistic about the near-term future of America's economy, and mindful of the obstacles that remain in our way, we're still optimistic. It may take years for us to regain our full economic health, but we're on the right track to do so.

History tells us that since the Great Depression, the S&P 500 has suffered a decline of around 15 percent in every single decade. And the same thing has happened each time: over the ensuing five years, the average total return was up by at least 100 percent. Of course, there's no guarantee that we're headed for the same outcome this time around. But there is every reason to think that America will rise to the challenges we face, and emerge as strong as ever.

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