U.S. News & World Report

The Fiscal Cliff Masks an Improving Economy

October 26, 2012

By Rick Newman

If President Barack Obama wins a second term, he may enjoy the kind of honeymoon he didn't get the first time around. And if Republican challenger Mitt Romney wins, he may wonder why Obama got all that gray hair.

At the moment, economists, politicos and pundits are obsessed with the looming election, to be followed by a tense lame-duck session in which Congress and the president must figure out what to do about the "fiscal cliff." If all of the tax hikes and spending cuts set to go into effect at the end of the year actually do, it could torpedo economic growth and cause another recession. Congress could also delay those big decisions or dicker indefinitely, with the economy shackled to political ineptitude.

But if Congress does its job, and legislates some kind of compromise, the prospects for the economy could brighten considerably in 2013. "Assuming the fiscal cliff is resolved in a relatively benign manner, a post-resolution rebound is likely," Bank of America Merrill Lynch advised in a recent report. There are several reasons for optimism:

Housing seems to have turned around for good.

After a six-year housing bust, prices seemed to have stopped falling in most markets, and mortgage rates remain near record lows. A variety of indicators show that real estate agents, home builders and even buyers are increasingly bullish. That could turn housing from a drag on the economy into a driver of growth. "The odds are strong that housing will resume its long-absent role as a key contributor to GDP growth," says **Bernard Baumohl, chief global economist of the Economic Outlook Group.**

Consumers are surprisingly upbeat.

Confidence surveys show an unusual divergence between business leaders, who have been getting gloomier, and ordinary people, who have been feeling better. The gap might exist because business leaders get paid to worry about problems like the fiscal cliff and the European debt crisis, while regular people may be tuning out such worries. If the economy manages to bypass the cliff, rising consumer confidence could generate a kind of self-sustaining lift.

Car sales are robust.

Auto sales have become one of the stronger segments of the economy, despite higher gas prices and a weak job market. That suggests a few important things: Credit is loosening up, including subprime lending; many consumers feel confident enough to make big purchases; and the Federal Reserve's low-interest-rate policy may actually be working, at least in the car market.

Business spending is poised to pick up.

CEOs have increasingly voiced their concern over political gridlock in Washington, deferring plans to invest or hire. That's probably slowing the economy today, which partly explains anemic growth of just 2 percent. But that might also indicate pent-up demand. "Corporations have accumulated profits and increased cash, suggesting they are primed for greater investment," according to Merrill Lynch. And with nearly $2 trillion of cash on hand, corporations have the means to administer quite a jolt to the economy, if their leaders choose to.

Hiring has to pick up at some point. Uncertainty caused by the elections and the fiscal cliff has probably depressed hiring, but if housing, car sales and other factors continue to improve, that will eventually generate stronger overall demand and force companies to expand their payrolls. "If we can get past the danger of a fiscal cliff," **Baumohl** says, "then the employment outlook should continue to brighten."

In this economy, of course, ifs are a constant, and there are plenty of things that could still derail growth next year, even if Congress doesn't. The dispute over Iran's nuclear program could heat up again. Europe might finally face a do-or-die moment over Greece leaving the euro zone. China's economy is a wild card that could turn out to be flimsier than believed. Still, sooner or later, the economy will pick up momentum for good. That moment could be closer than we think.