Ethan Harris, former chief U.S. economist at Lehman Brothers Holdings Inc., recalls packing his family photos and top research into a suitcase five years ago on the Friday before the company went under.

Anticipating he might not be able to go back to his office in New York, he exchanged phone numbers with colleagues and talked to his supervisor, Paul Sheard, who agreed it would be disastrous for markets if Lehman wasn’t rescued.

“My boss at the time said to me: 'Well, we know it’s going to be a devastating event, and therefore they’re not going to let it happen.' And I said: 'Well, I don’t know; maybe they will,’” said Harris, now co-head of global economics research at Bank of America Corp. (BAC)

While Harris’s premonition proved true -- Lehman’s bankruptcy filing on Sept. 15, 2008, exacerbated the worst financial crisis since the Great Depression -- the economy, with help from the Federal Reserve, has emerged from the ruins “in much better health,” he said. The U.S. is weathering federal budget cuts and higher payroll taxes, growth is picking up and some economists predict the expansion, now in its fifth year, may last longer than most.

The signs of resilience are everywhere: Households continue to spend. Businesses are investing and hiring. Home sales are rebounding, and the automobile industry is surging. Banks have healthier balance sheets, and credit is easing. All this coincides with the economy shedding the excesses of the past, such as unmanageable levels of consumer and corporate debt.

‘Better Place’

“We are in a much better place than we were five years ago,” said Mark Zandi, chief economist at Moody’s Analytics Inc. in West Chester, Pennsylvania. “Consumers are feeling much, much better; certainly investors are.”

Confidence is hovering around a five-year high, and the Standard & Poor’s 500 Index has climbed 80 percent since the 18-month recession ended in June 2009.

“Considering the trauma we went through and the panic in the markets, the economy has really done pretty well,” and is “strong enough to support higher equity prices,” said John Carey, a portfolio manager at Pioneer Investment Management Inc. in Boston, which manages about $200 billion. “Stocks look attractive relative to bonds,” and shares of consumer-related and regional banks will benefit the most from growth in spending and demand for credit.

Political Wrangling

After months of political wrangling, Congress worked out a deal with President Barack Obama on Jan. 1 that let the payroll tax revert to 6.2 percent from 4.2 percent while avoiding broad-based income-tax increases. Across-the-board cutbacks in federal spending began in March.

Even with these restraints, GDP kept growing, and as their effects fade, the expansion will accelerate in the second half of 2013, according to a Bloomberg survey.

“Given how well the economy’s done in the last year, in spite of everything that’s happened in Washington, that’s a pretty good sign” of its underlying strength, said New York-based Harris, who projects a 2.7 percent growth rate next year after an estimated 1.5 percent this year and a step up to 3 percent in 2015.

Zandi’s more optimistic forecast shows the pace almost doubling to 3.3 percent in 2014 after 1.7 percent this year and reaching 4.1 percent in 2015. A growth rate of 3 percent or more would be the best since 2005, and exceed the 2.2 percent average since the recovery began.

“As we move into next year, the better private economy will start to shine through,” he said.
Bolster Spending

Improving job prospects, together with rising stock and home prices, are bolstering consumer spending, which accounts for about 70 percent of the economy. Households, after recouping wealth lost during the severest recession since the 1930s, now have record net worth, and a ratio of liquid assets to cover liabilities is the strongest since 2000.

Americans’ finances are in the best shape in decades and they’re ready to borrow again as credit conditions thaw, signaling the start of a “stronger growth phase,” said Joseph Carson, director of global economic research at AllianceBernstein LP in New York.

“Consumers’ ability to take on more risk is greatly improved,” he said. “They can go out and spend, take that vacation, do home repairs and buy more durable goods. All those things kick in.”

Historic Lows

The Fed’s attempt to keep borrowing costs near historically low levels has revived demand in interest-rate sensitive industries, which is sustaining manufacturing. Combined purchases of new and existing homes are the highest since 2009, according to data compiled by Bloomberg. Car and light truck sales are headed for the best year since 2007, figures from Ward’s Automotive Group show.

The vehicle industry “has been a very significant participant” in the general economic recovery, said Steven Rattner, a New York financier who led the bailouts of General Motors Co. (GM) and Chrysler Group LLC predecessors in 2009.

“The automakers have gone from being unprofitable, with huge excess costs and very restrictive union agreements and dealer arrangements, to being a group of companies that is now highly profitable, very lean and exceptionally competitive,” he said.

Banking, which bore the brunt of the Lehman collapse, has come a long way, helped by higher standards in the 2010 Dodd-Frank Act and by supervisory prodding. Regulators have been compelling banks to retain earnings and reinforce their buffers against possible losses, and new international and domestic rules are prompting stronger capitalization.

Withstand Recession

The 18 largest U.S. banks had more than doubled one measure of capital at the end of 2012 compared with the end of 2008, and 17 of the 18 had enough funds to withstand a deep recession, according to Fed analysis this year.

“The leverage in the system has been taken out” for the financial sector and households, said Joseph LaVorgna, chief U.S. economist at Deutsche Bank Securities Inc. in New York. “That would make the economy more immune to shocks.”

One sign the U.S. is now “more resilient”: It didn’t fall back into a recession when the euro area slumped into a record-long contraction in 2011, he said.

Alan Blinder, a former Fed vice chairman, said financial-market bubbles may continue to burst, as he’s “not sure we’ve done anything to reduce the frequency of those things.” Even so, the new regulations “ought to reduce the severity. And that’s very, very important.”

Housing Rebound

Residential real estate, rebounding from the subprime-mortgage meltdown that triggered the credit crunch in 2007, is “out of the bubble-bursting period,” and poised for further gains, said Robert Shiller, a Yale University professor and one of the creators of the S&P/Case-Shiller Index of home prices. “People are substantially more confident about the housing market.”

The optimism is sparking spending on remodeling. Atlanta-based Home Depot Inc., the largest U.S. home-improvement retailer, and smaller rival Lowe’s Cos. (LOW), in Mooresville, North Carolina, each reported second-quarter profit that topped analysts’ estimates and raised their annual forecasts.

The number of foreclosure filings is 64 percent below the 2010 peak, and the share of seriously delinquent mortgages -- those more than 90 days behind or in the foreclosure process -- plunged in the second quarter to an almost five-year low, according to industry data.
‘Pristine’ Lending

“Mortgage lending has been so pristine since the recession that mortgage-credit quality is improving quickly, and a year or two from now it’s going to look absolutely beautiful,” Zandi said.

As a result, lenders are becoming more confident. The Fed’s latest quarterly survey of senior loan officers showed banks are seeing an increase in demand for credit and providing loans more readily to home buyers and businesses.

Pent-up demand for goods and services, along with the absence of many excesses that presage the start of a slump, indicates the current expansion could last another four or five years, according to some economists. That would make it almost twice as long as the average, which since the end of World War II has been 58 months, or just shy of five years.

Even so, the U.S. is “still in that process” of returning to its pre-recession strengths, said Julia Coronado, New York-based chief economist for North America at BNP Paribas and a former Fed economist.

Budget Battle

A budget battle on raising the $16.7 trillion debt limit is looming between Obama and House Republicans, who have threatened a default or a government shutdown next month over disagreements about federal spending and the president’s health-care law.

Another risk to the outlook is the Fed’s ability to make “a graceful exit” from its so-called quantitative easing and the near-zero interest rate policy it has maintained since late 2008, Zandi said. While July’s 7.4 percent unemployment rate was the lowest in more than four years, economic and job growth still are short of what the Fed wants.

Central bank officials were “broadly comfortable” with Chairman Ben S. Bernanke’s plan to start reducing bond buying later this year if the economy improves, minutes of their July meeting showed. Borrowing costs are rising in anticipation.

Bank of America’s Harris said his bigger concern is that Fed officials “get confronted with a problem that they can’t fix because they don’t have much room to add additional stimulus; they are almost out of ammunition.”

Harris still is encouraged by the transition since the Lehman collapse.

“We haven’t had very robust growth, but we’ve seen a lot of the wounds of the crisis heal,” he said. “We’re moving towards a fully healthy economy.”

To contact the reporters on this story: Kasia Klimasinska in Washington at kklimasinska@bloomberg.net; Shobhana Chandra in Washington at schandra1@bloomberg.net

To contact the editor responsible for this story: Chris Wellisz at cwellisz@bloomberg.net