Ameriprise Financial

Economic Perspectives

An Ameriprise Investment Research Group publication

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July 14, 2023

Mid-year Update: Recession risks fading but not eliminated.

The U.S. economy has maintained a fairly consistent pace over the last few quarters despite high inflation and sharply higher interest rates. Growth has slowed in the economy's most interest-rate-sensitive sectors of housing and manufacturing, but we see spending by consumers and businesses as having remained sound.

Recession 'calls' have also faded in recent months. However, we believe there is still a chance of seeing a short and shallow downturn in the second half of the year as consumers face some added near-term burdens, bank lending is likely to tighten further, and interest rates are likely to move higher.

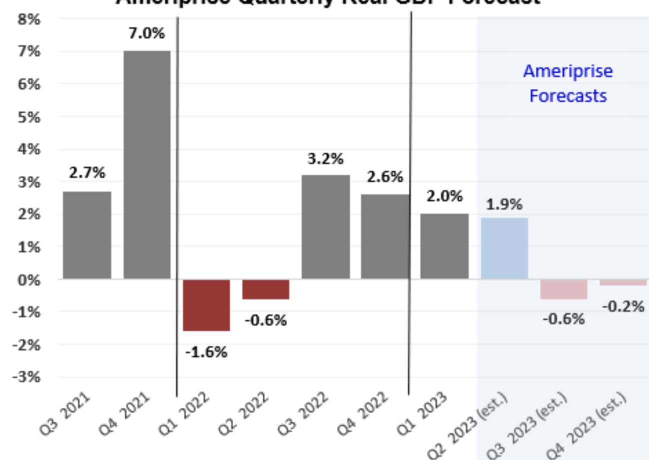
Coming into 2023, we had finally said that recession odds were likely better than 50/50. Consumer spending at the end of last year slowed abruptly, businesses were trimming inventories, and investment spending appeared to be slowing. Such dynamics, however, proved temporary. The Commerce Department reported solid Q1 real Gross Domestic Product (GDP) growth (the broadest measure of overall economic activity) of +2.0%, and we're currently forecasting a similar +1.9% pace for Q2.

Recession risks aside, investors could face a notably different economic landscape in the second half of the year. Over the last six months, investor sentiment likely benefited from a "goldilocks" scenario of rapidly falling inflation rates yet strong job growth. We believe there is a risk these measures "flip" in the second half of the year; that is, headline inflation re-accelerates in year-over-year (y/y) terms, and job growth moderates or even contracts.

We currently forecast the Consumer Price Index to end the year at about +3.6% versus its June rate of +3.0%. Meanwhile, we believe there is ample room for job growth to decelerate sharply from what has been a remarkably strong pace over the last year.

Our Outlook

- **Recession still possible.** The economy's steady pace has recession calls on the run. Some near-term consumer burdens, however, could yet have the economy slip into a brief downturn.
- **Fundamentals still supportive.** Consumer and corporate balance sheets are still in good shape, in our view.
- **Inflation not going away without a fight.** Inflation has dropped sharply over the last year. Progress may be much harder to come-by in the second-half of the year as comparisons come-up against much lower year-ago energy prices.



Source: Actuals via the Commerce Department, forecasts via American Enterprise Investment Services Inc.

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A mid-year recession outlook review.

Some forecasters have been predicting a recession for almost two years. Now, as an end to the Federal Reserve interest rate hiking cycle seems in sight and with inflation pressures abating, financial markets finally seem to be 'giving up the ghost' and trimming their near-term recession odds.

Should they? We believe recession risks have diminished (relative to our expectations at the beginning of the year), but a short and shallow near-term downturn should not be ruled out. If a recession were to emerge, however, we believe financial markets could look past such and maintain a focus on the economy's brightening intermediate-to-longer-term normalization prospects as reflected in the improving outlook for interest rates and inflation.

The recession 'math' looks weak. As reflected in the chart on page 1, our current estimates look for a modest contraction in real GDP over the second half of the year. That said, we believe the 'math' of a potential recession looks weak as some sectors of the economy, notably housing, and manufacturing, appear to be stabilizing or even rebounding.

Historically, recessions have been comprised of a downturn across several sectors of the economy. A pull-back in consumer spending is usually the most important factor, as consumers account for nearly 70% of U.S. economic activity, according to the Commerce Department. Lower consumer spending is usually met with reduced home construction, lower business investment, a trimming of business inventories and contractions in other segments. It's the cumulative effect of these declines that typically add up to a recession.

Applying that historical "math" to the current situation makes a near-term recession seem less likely, in our view. New home construction plunged in 2022 but has since stabilized and more recently begun to grow again. New home demand has also been strengthening as the existing home market remains exceptionally tight on inventory. Further, business inventories appear to be in solid shape after being trimmed over the last four quarters. At the end of May, the Commerce Department's retail inventory-to-sales ratio stood at a relatively low 1.29 versus a pre-pandemic (February 2020) 1.43.

Meanwhile, business investment spending has also slowed rather than declined, a trend we believe can continue. As seen in the chart below, new orders for non-defense capital goods, excluding aircraft, a commonly used proxy for business investment spending, have been resilient over the last year. Though generally flat in recent months, new orders for business equipment reached a new all-time high in May of $74 billion, according to the Commerce Department.

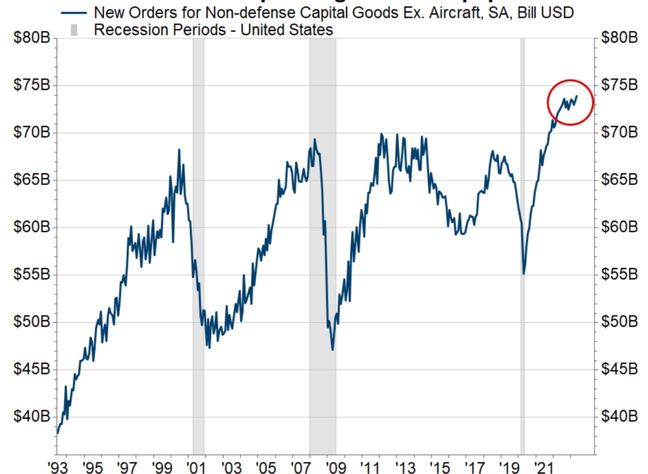

Chart source: FactSet

<u>What's fueling business spending?</u> Despite pockets of slower growth in various parts of the economy, businesses are still finding it difficult to hire the workers that they want with the skills they require. In the absence of such workers, many businesses are investing in new equipment, software, and other technology to make the workers that they do have more productive. Spending in the sector should also see further benefit from the massive federal stimulus dollars targeted at reshoring the production of some critical manufactured goods such as semiconductors.

Over the intermediate term, we believe business investment spending is likely to remain generally flat rather than seeing a material decline, thus offering support to the general level of economic activity.

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Inflation Update: Solid progress, but the fight is far from won.

Headline inflation, as reflected in the Labor Department's Consumer Price Index (CPI), dropped to +3.0% in June while the core rate (which excludes food & energy prices) eased to +4.8%. The headline rate was the lowest since March 2021, and for the core, it was the softest pace since October 2021.

The progress achieved in slowing inflation has been notable, but we believe the pace of improvement may stall or even backtrack over the second half of the year due to lower year-ago comparisons. Currently, we project a year-ending headline CPI rate of 3.7% and a core rate of +4.1%.

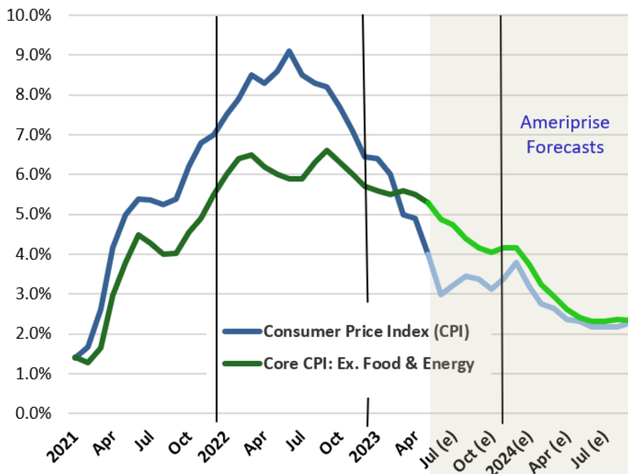

Chart source: American Enterprise Investment Services Inc.

Core inflation is the more important metric as it eliminates the non-economic fluctuations sometimes seen in food and energy prices. But as seen in the graphic at the top of the next column, the month-over-month (m/m) pace of core inflation (the lower section), remained quite high before seeing a welcome drop in June. Still, over the 6 months through June, core CPI inflation has grown at an average monthly pace of 0.38% (equal to an annualized rate of +5.1%).

Currently, we forecast headline and core CPI inflation metrics to approach the Fed's target inflation rate of around 2% by the second half of 2024. We believe Fed officials will likely conclude their interest rate hiking cycle once core inflation rates appear to be on a steady and sustainable deceleration trend towards its targets, a development we believe should come at some point late this year. Overall, we believe the Fed will raise their overnight lending rate, the fed funds rate, two more times this year.

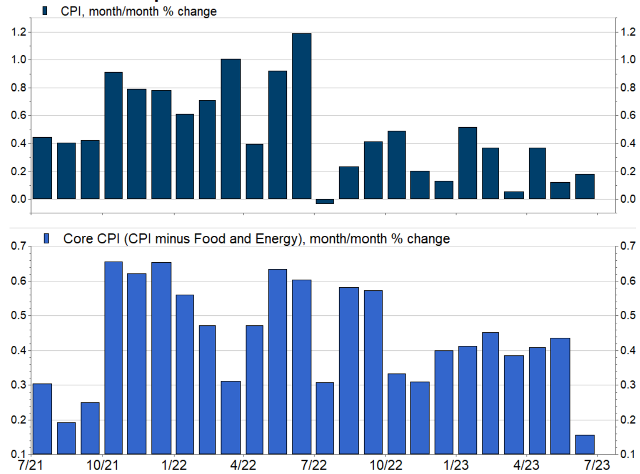

Chart source: FactSet

Outlook: While we believe headline inflation could stall, y/y core inflation rates should continue to see a steady, yet slow, deceleration in the months ahead.

The deceleration may not come fast enough for Federal Reserve officials as they consider their monetary policy decisions over the next several months. The Fed paused its hiking cycle in June, though some officials, particularly Fed Chair Powell, have indicated a willingness to carry on with additional rate hikes over the intermediate term until inflation further subsides. Given the slow progress with core inflation, we see it as hard to argue with this position.

Wage inflation easing. A primary source of core inflation's "stickiness" has been elevated rates in the broad Services sector. A primary cost input for Service providers is labor. To that end, wage inflation, as measured by the Labor Department's Average Hourly Earnings measure, has been steadily easing over the last year.

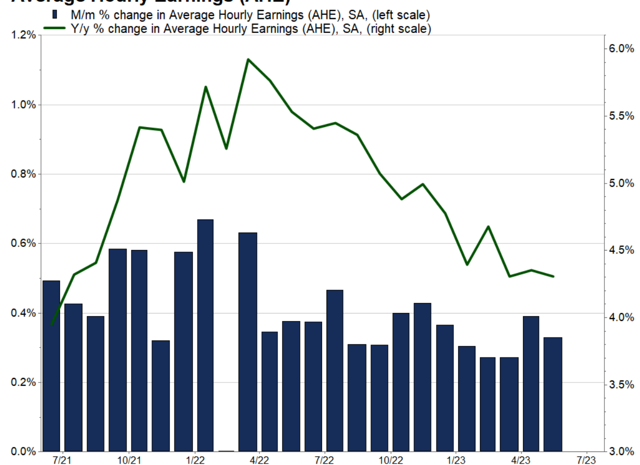

Chart source: FactSet

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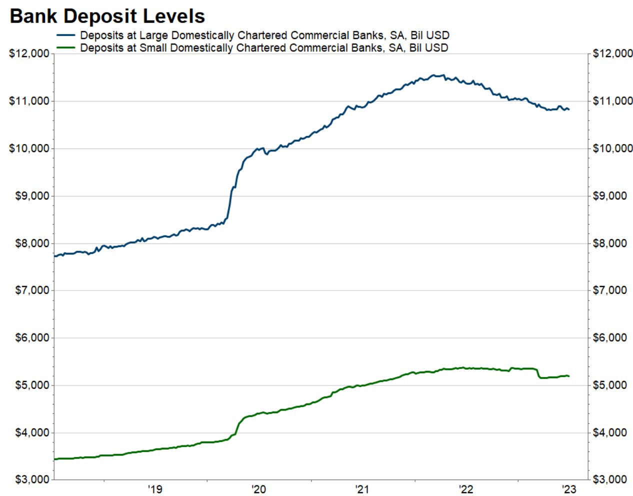
Will banking system stress send the economy into a spin? At the time of our last report in April, banking system deposit flows were a concern for investors as three domestic financial institutions had dissolved, largely under the pressure of deposit outflows.

Measures since put in place by the Fed, combined with self-implemented changes implemented by many banks (paying somewhat higher rates on deposits), appears to have abated the outflows – at least for now. Aggregate bank deposit levels have stabilized, according to Fed data. However, outflows could accelerate again and become problematic as the Fed further hikes its overnight lending rate (the fed funds rate).



Source: FactSet

More recently, Commercial Real Estate (CRE) loans have dominated banking sector concerns. Higher interest rates are leading to higher loan refinancing costs, and higher vacancy rates are negatively affecting property values. We believe this situation will lead to higher default rates in the CRE space and burden bank earnings, but for now, we see the situation as manageable.

CRE is a very broad grouping that includes loans made to various economic sectors, including multi-family residential, warehousing, office, industrial, retail, and others. Each segment will face higher refinancing costs, but for most, we believe fundamental operating environments are in good shape. In fact, outside of the Office sector (and to a lesser extent, Retail), utilization rates are at solid levels in our view.

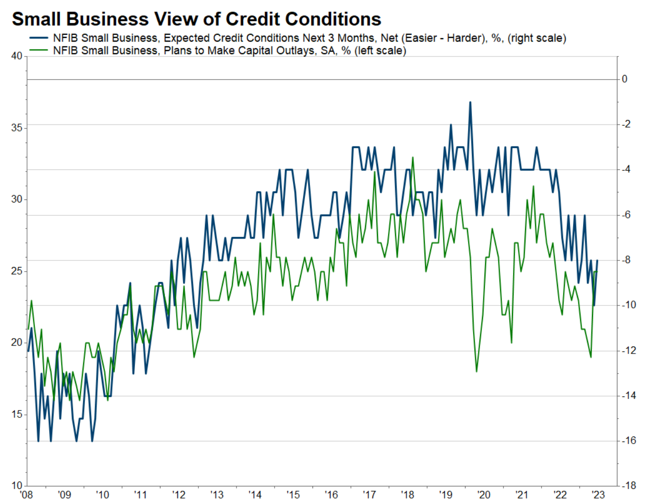
The primary problem resides in the office space, which accounts for about 15% of total CRE value, according to the San Francisco Federal Reserve Bank. CRE loans have relatively short maturities (versus mortgage borrowing, for instance) and need to be refinanced with regularity.

In some segments and geographies, CRE operators have given 'the keys to the bank' and defaulted on their loans. Again, such actions have been generally contained to the Office sector primarily and, to a lesser degree, Retail.

Given this backdrop, we believe CRE defaults are likely to rise materially in the months and quarters ahead, but we believe the cycle should be manageable for the broader banking system. Losses will be incurred as properties are re-valued under higher capitalization rates and higher vacancy rates, but properties still have value at some level (which should help put a floor under losses), and lenders have been building their loan-loss reserves for just such a development.

Small business owners not too worried about tighter credit conditions? Tighter credit conditions typically hit small business owners particularly hard. So far, at least, small businesses do not see credit conditions as all that problematic – at least according to the latest NFIB Survey.

As part of its monthly Small Business Optimism survey, the National Federation of Independent Business (NFIB) asks respondents questions about credit conditions, including interest rates being paid and their outlook on credit conditions over the next three months. As seen in the chart below, the net number of respondents expecting credit conditions to tighten over the next 3-months (the blue line in the chart) improved modestly (to -8 from -10 on the right-hand scale), while the percentage of respondents indicating plans to make capital investments (the green line) matched its best levels of the past year (a net +25% on the left-hand scale).



Source: FactSet

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Corporate profits: The bridge between the economy and equity markets.

(Unless otherwise noted, all data relative to corporate sales or earnings is sourced from FactSet and refers to the S&P 500.)

S&P 500 earnings per share (EPS) were down 2.1% year-over-year (y/y) in Q1 on sales growth of +4.1%. Though weak, the results were much better than expected. At the end of Q1 (March 31), analysts had forecast an EPS decline of 6.1% on sales growth of +2.0%.

The first quarter was defined by a few notable influences: slower global economic growth, a strong U.S. dollar, and sharply higher interest rates. Inflation also remained a key consideration, boosting the top-line results for some companies but offering higher costs for nearly all. Given the operating environment, we believe it was encouraging that only 3 of 11 S&P 500 sectors experienced negative y/y sales growth.

Consensus estimates for Q2 currently look for S&P 500 EPS to be down about 7% y/y on flat sales. Almost all the decline, however, can be attributed to lower energy commodity prices. Excluding the Energy sector, aggregate EPS are projected to be down just 0.7%. *(See chart at top of next column.)*

As seen in the table below, analysts currently project y/y earnings results to turn positive in the second half of the year – partly due to easier year-ago comparisons. Separately, as seen in the chart at right, forward-looking estimates have declined sharply over the last year but more recently appear to be stabilizing. The upcoming earnings release season will be key to setting direction for the future path of earnings expectations.

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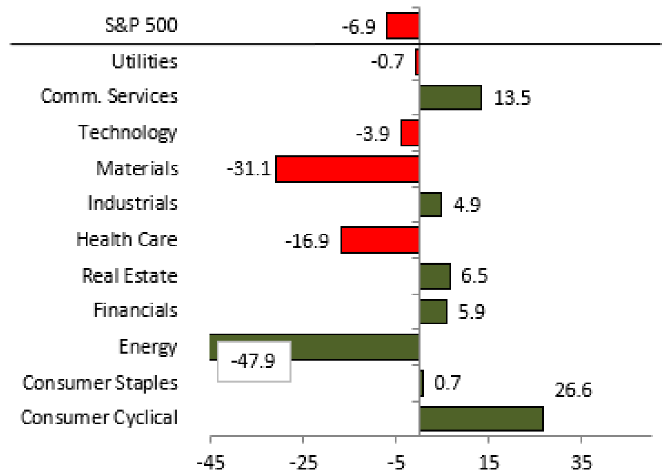
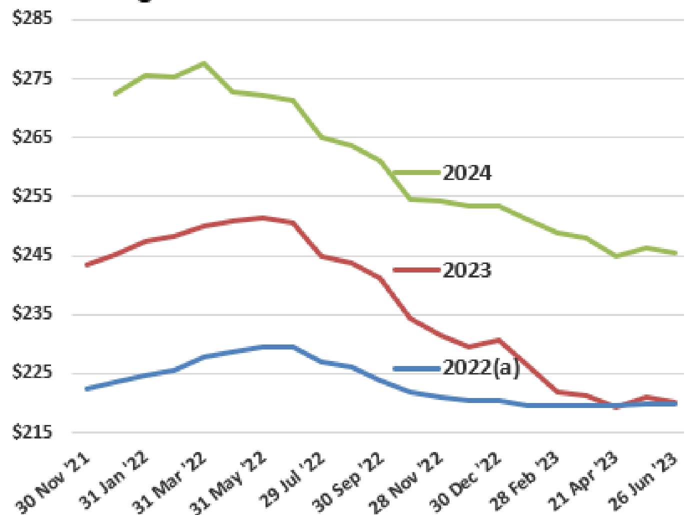


Source: FactSet



Source: Data sourced from FactSet as of 6/26/23. The chart itself is sourced from American Enterprise Investment Services Inc.

S&P 500 Earnings Estimates	2019	2020	2021	2022				2023				2024				2025
6/26/2023	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Est.	Est.	Est.	Est.	Est.	Est.	Est.	Est.
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	FY
Quarterly $$ amount				$54.09	$56.69	$55.65	$53.49	$53.25	$53.12	$56.15	$57.75	$57.83	$59.87	$63.14	$64.98	
yr/yr				10.3%	7.4%	3.3%	-3.4%	-1.6%	-6.3%	0.9%	8.0%	8.6%	12.7%	12.4%	12.5%	
qtr/qtr				-2.3%	4.8%	-1.8%	-3.9%	-0.4%	-0.2%	5.7%	2.8%	0.1%	3.5%	5.5%	2.9%	
Trailing 4 quarters $$	$163.13	$140.46	$210.86	$216.14	$220.03	$221.81	$219.92	$219.08	$215.51	$216.01	$220.27	$224.85	$231.60	$238.59	$245.82	$275.77
yr/yr % change	1.0%	-13.9%	50.1%				4.3%				0.2%				11.6%	25.2%
Implied P/E based on a S&P 500 level of: 4348							19.8	19.8	20.2	20.1	19.7	19.3	18.8	18.2	17.7	15.8

Source: FactSet as of 6/26/23 and AEIS Inc.

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Summary

The U.S. economy has held up surprisingly well over the last year and a half in the face of high inflation and rapidly rising interest rates. Over the intermediate term, however, we believe a confluence of factors could lead to slower consumer spending, resulting in a negative quarter or two of real GDP growth. If an economic downturn were to occur, we believe it would be shallow given what we see as the relatively good financial standing of consumers and businesses.

Our outlook includes an expectation of tighter lending standards over the intermediate term. Reduced credit availability would be expected to weigh on the pace of economic activity. The impact, however, will be contingent on the degree to which credit is reduced, a value we believe should be economically manageable. Overall, we believe tighter credit conditions could reduce overall growth this year by 0.2 to 0.3 percentage points, which is factored into our estimates.

More broadly, the global economy remains in a period of transition, in our view. Circumstances related to the pandemic (strong demand at a time of reduced supply) created a significant bulge in inflation, a situation that was made much worse by Russia's invasion of Ukraine.

At the time of this writing, European economic growth appears to have stalled, though with a modest positive pace still evident. Economic activity in Asia, meanwhile, has been modestly weaker than expected, primarily due to ongoing weakness in the world's second-largest economy, China. The Chinese economy was widely expected to accelerate after eliminating COVID-19 restrictions near year-end, but activity has remained sluggish. The country's sluggish pace of growth is also placing greater pressure on its real estate and local government debt problems.

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Risks

The current outlook still offers material uncertainty. Geopolitical tensions are particularly high, energy costs and tight labor markets remain a potential threat, and government debt loads are at exceptional levels in most of the world's developed economies. The hard choices associated with correcting these imbalances are likely to weigh on economic performance over time.

Separately, China's position in the global economy and geopolitical sphere has grown considerably over the last 20+ years. The Chinese government has been very strategic in wielding its expanding power to its own advantage, and the country's policies and actions do not always adhere to established norms of fair dealing. China's development path is increasingly intersecting with the established position of presiding Western powers, a confluence that could lead to more serious instability.

Geopolitical tensions elsewhere (Russia, Ukraine, Taiwan, N. Korea, Syria, etc.) are also more difficult than they have been in recent memory. The impact of these issues on economic and financial market activity has been reasonably restrained thus far, but tensions could evolve quickly into much more severe problems. Of course, there always have been problems for the global economy /capital markets to consider, and there always will be.

Longer-term

We believe three fundamental factors: China, demographics, and global government debt will play key roles in the path of global economic activity and financial markets over the longer term. Demographics across the industrial world reflect slowing population growth and aging societies, which implies slower potential economic growth than has been the case historically. Government borrowing, particularly here in the U.S., is also very high and going even higher in the near future (based on estimates from the Congressional Budget Office). This is somewhat of a new dynamic for fixed income markets to deal with, and its impact on interest rates over the intermediate to longer-term remains uncertain.

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