Ameriprise Financial

Economic Views Brief

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Will the U.S. economy avoid a recession?

As of May 26th, the S&P 500 is down 12.2% year-to-date (on a total return basis) as investors anticipate an economic slowdown that has yet to materialize. For the last few months markets have been reacting to the idea that today's high inflation environment may require aggressive Federal Reserve interest rate hikes, hikes that could lead to an economic slowdown or even recession.

Higher interest rates should be expected to slow the pace of economic activity. In some areas of the economy, such as manufacturing and housing, we're seeing the early signs of such. Just how far the Federal Reserve will have to go in raising interest rates will depend on the path of inflation over the next few quarters. However, complicating this outlook is that much of today's inflation stems from supply constraints rather than excessive demand – which is what higher interest rates are meant to contain.

Some price pressures have started to ease. Yet a few key costs, such as energy and housing, are at risk of seeing added upside in the months ahead, in our view. This makes these components particularly key to the interest rate outlook while offering potential downside to the pace of economic activity.

We believe the most likely path forward is one in which the U.S. economy avoids a recession. Regardless, financial markets already appear to be pricing one in. Financial markets have been responding not just to actual inflation and likely interest rate adjustments, but also to the uncertainty of how high rates could go. Even if the news is bad, financial markets prefer certainty over uncertainty.

An economic slowdown would also be expected to negatively affect corporate earnings. Yet, as of this writing, forward earnings per share (EPS) estimates for the S&P 500 have seen little movement.

Key Takeaways

- Economic uncertainty is likely to remain elevated until additional evidence of easing inflation pressures can be ascertained.
- Consumers remain in sound financial condition but higher prices and a jump in borrowing costs should be expected to hinder spending.
- Energy prices currently hold the greatest risk to the inflation outlook, in our view. Domestic production continues to lag demand. Fuel prices are at record highs and may go higher in the months ahead.
- Markets do not like uncertainty and right now the inflation outlook, and by extension the outlook for interest rates, remains very uncertain.
- We believe a recession could be avoided, but if one comes we believe it would be relatively short and shallow.
- Investors should avoid material portfolio re-allocations at this time as we believe financial markets could be close to bottoming.

In this brief report, we'd like to address two important questions:

1. *What might it take for the economic outlook, and thus financial markets, to stabilize?,* and
2. *What factors are we looking at that lead us to believe that inflation might slow in the second-half of the year as we currently predict?*

Overall, we believe markets are likely to remain volatile until greater clarity can be discerned relative to the path of inflation. Inflation's intermediate-term path will drive Fed interest rate policy, thus indicating how strong (or weak) the economic headwinds are to become. Inflation and higher interest rates are both strong impediments to economic growth.

Inflation, as measured by the Consumer Price Index (CPI), reached a four-decade high of 8.5% in March before easing somewhat (to +8.3%) in April. If March was indeed the peak for the current inflation cycle, we believe financial markets may stabilize and start to recover in the weeks and months ahead. However, there is also a path in which inflation expands, upside that would likely be fueled by higher energy prices, in our view.

Energy prices have become a key factor in the outlook for both inflation and economic growth. Gasoline and diesel fuel prices are both currently at record highs. A traditional "rule of thumb" is that every $10 increase in the price of crude oil equates to an approximate 0.1% cut in real GDP. Under current circumstances, the negative impact is likely to be larger. Gasoline and diesel fuel costs have gone up by more than the price of oil would otherwise indicate due to refinery capacity constraints. It may, or may not, be too aggressive to say that every $10 change in the price of crude oil currently equates to a 0.2% negative impact, in our view. In thinking about this, we would note that we came into 2022 forecasting real GDP growth at +4.5%. Today, our estimate is down to +2.5% largely due to the added inflationary burden offered by Russia's invasion of Ukraine and the expected Fed response. Our GDP estimate may still be too high, but we believe most of the negative impact from crude oil is factored in at this point (absent further material increases).

On an individual basis, every $0.10 increase in the price of gasoline at the pump costs the average driver about $55 per year. As of May 23, the national average price of gasoline was $1.57 higher than year-ago levels, thus suggesting an approximate added fuel bill for the average driver of about $887/yr. (or about $74/month).

Crude oil prices were already high when we entered the year as global production volumes were responding more slowly than the rebound in demand. The situation was made much worse by Russia's invasion of Ukraine, following which, many countries have been seeking alternative sources.

U.S. crude oil production has been growing at a slow pace; and global producers are offering little help. Amid record high gasoline prices, U.S. crude oil production is improving, but at a disappointingly slow pace. For the week-ended May 13, U.S. domestic production was running at a rate of about 11.9 million barrels per day. As seen in the chart at right, that level of production is about a million barrels /day above COVID period lows, but still about a million barrels /day below pre-pandemic (i.e., "normal") levels. The number of "rigs" drilling for oil has been growing, but like production, it's been frustratingly slow. According to Baker Hughes, there were 563 rigs drilling for crude in the U.S. in the week-ending May 13th, versus 480 at the start of the year.

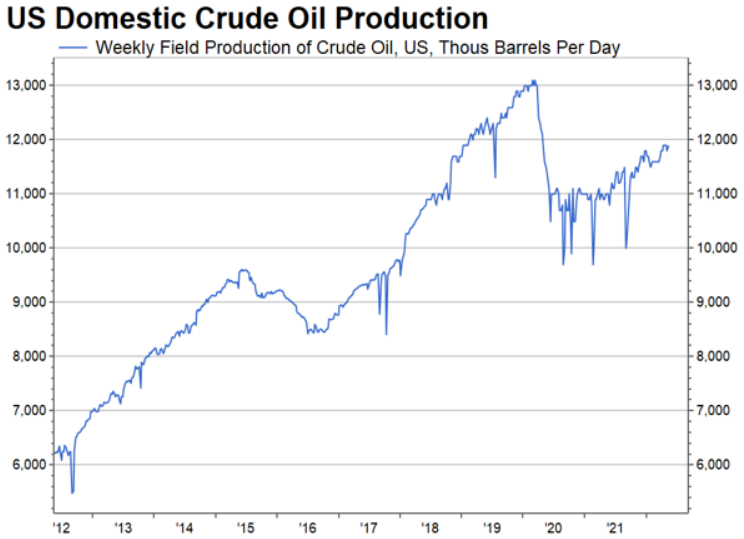

Chart Source: FactSet.

To narrow oil's supply /demand short-fall, the Biden Administration announced on March 31st that it would release additional crude oil from the nation's Strategic Petroleum Reserve at a targeted rate of about million barrels a day. The added availability helps, but it does nothing to improve the refinery bottlenecks that are also adding to gasoline prices. SPR draw-down rates have accelerated in recent weeks, but since the beginning of April the daily drawdown has averaged about 619,000 bls/day. In the week-ended May 13th, the daily net decline in the SPR was 716,000 bls/day.

Inflation Outlook: We believe year-over-year inflation rates could ease in the months ahead, but the improvements are likely to be slow and uneven. It should be stressed that we are not expecting prices to decline in absolute terms, but rather for the pace of price appreciation to slow.

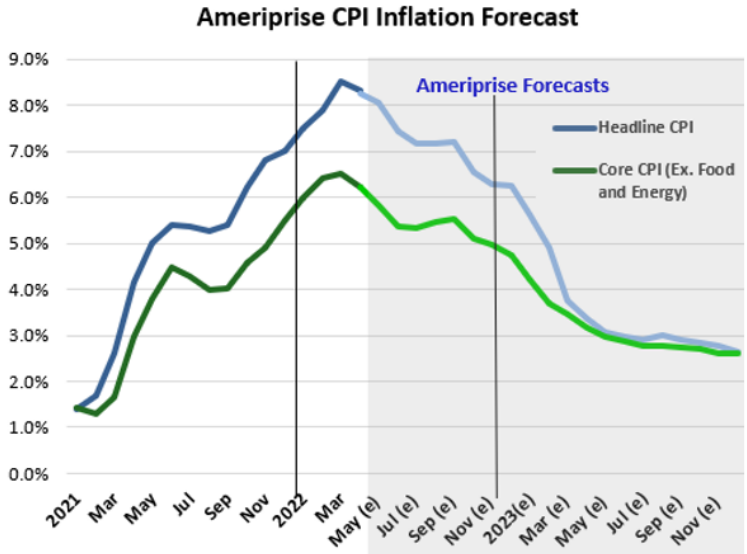

Chart source: American Enterprise Investment Services Inc.

It certainly seems as though prices for everything are rising at a fast pace and likely to continue to do so. But just like higher interest rates, higher prices are themselves disinflationary. That is, higher prices alone are likely to create some demand destruction, thus easing the "demand-pull" side of the inflation equation. During the 1970's, CPI inflation was 12.0% at the end of 1974 and ended 1976 at 5.5%; and that was without any real policy effort from the Federal Reserve although aided by some bad short-term policies (such as price controls). Food and energy prices are likely the largest risks to our forecast but we have higher levels for these items baked-in to our forecast model.

We believe inflation could decelerate… *"How?"*

1. Headline and Core CPI inflation both decelerated on a year-over-year basis in April. We believe this trend could generally continue – again, prices don't need to come down in absolute terms, the pace of price appreciation just needs to slow.
2. Tougher year-ago comparisons. Even if month-over-month rates were to be maintained at their recent pace, year-over-year rates would naturally come down because of tougher year-ago comparisons.
3. Prices for some items are already showing some encouraging deceleration. As shown in the chart at right, durable goods prices (goods such as autos, furniture and appliances) have been a primary source of inflation pressures over the last year, yet they have been "rolling over" the last few months and are likely to continue to do so, in our view. These prices have "rolled-over" in recent months.
4. Prices for some key basic commodities have also been declining. As seen in charts at the top on the next page, lumber and basic metals prices have been declining at a solid pace. Such basic commodity prices are first movers when it comes to prices further down the supply chain.

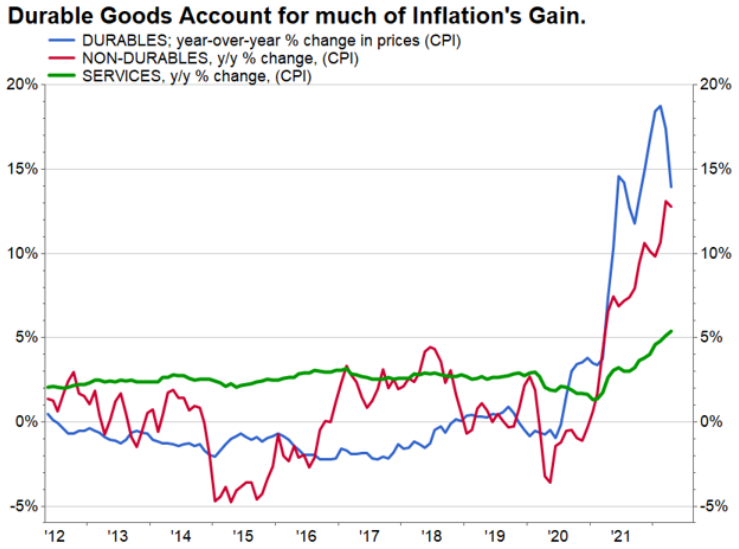

Chart Source: FactSet.

5. Wage appreciation is likely to slow.
   Higher wages, particularly those at the low end of the income scale, have been a notable contributor to overall inflation in the last year. We believe the most material wage increases (largely taking starting wages from about $11/$12 to $16/$17) has mostly run its course. Will we see further wage increases? Yes, most likely – but likely not at the same pace.

Demand for labor appears to be slowing, and with it wage inflation. Yes, there's a huge number of Job Openings, per the JOLTs report. But the number of new job listings has been slowing at a fast pace. Many companies are still citing a tight labor market, but a growing number (including such prominent employers as Amazon and Wal-Mart) are now saying that

they may be overstaffed. Further, the vast majority of the wage increases thus far have been at the lower end of the wage scale, at places such as grocery stores, retailers, restaurants and manufacturers. A large portion of the "jump" in wages in these categories has likely run its course, in our view. As seen in the charts below, prices for some commodities such as lumber and basic metals have been declining as supply and demand in these categories slowly rebalances. Such basic commodity prices are the first movers when it comes to prices further down the chain.

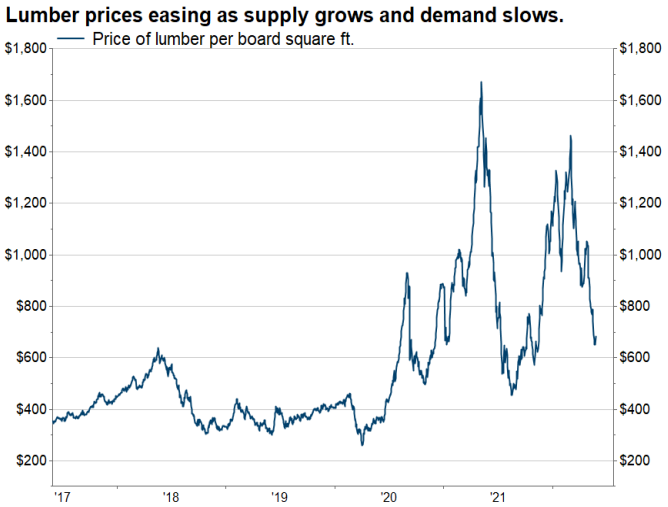

Chart source: FactSet

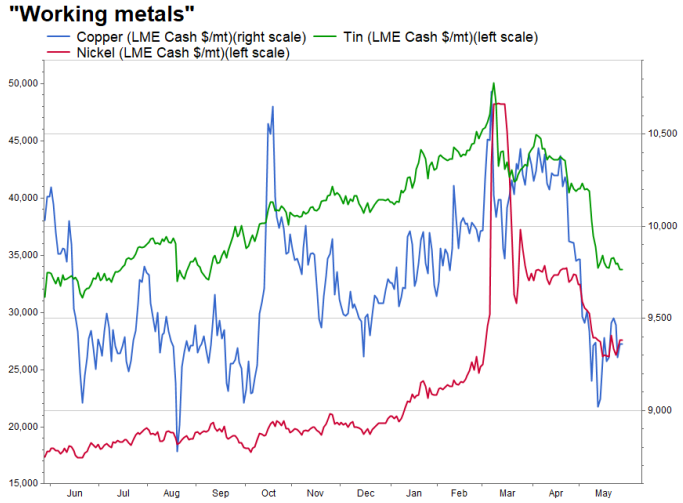

Chart source: FactSet

Summary: High inflation and rising interest rates should be expected to slow the economy, thus corporate profits, over the intermediate term – and markets have been responding to this outlook over the last few months. But the simple uncertainty of just how high inflation may grow or how high interest rates could go in response has also contributed to the market's negative sentiment in recent months. We believe economic /market uncertainty could ease in the months ahead, thus improving market sentiment, should inflation continue to ease as we currently anticipate.

Aside from inflation, the U.S. economy's underlying fundamentals remain sound, in our view. Consumer finances appear strong with a high savings rate, low debt burdens and strong property values. We believe aggregate business balance sheets are also in solid health. Under normal circumstances the conversation would end there, leaving an encouraging landscape for growth. However, elevated inflation pressures, and ongoing supply risks related to the Ukraine situation and global COVID developments (primarily in China) remain risks and will pressure the pace of economic expansion this year.

Forecast:	Full-year				Quarterly						
	Actual 2020	Actual 2021	Est. 2022	Est. 2023	Actual Q2-2021	Actual Q3-2021	Actual Q4-2021	Est. Q1-2022	Est. Q2-2022	Est. Q3-2022	Est. Q4-2022
Real GDP (YOY)	-3.4%	5.7%	2.5%	2.3%	6.7%	2.3%	6.9%	-1.5%	2.0%	2.4%	3.0%
Unemployment Rate	6.7%	3.9%	3.2%	3.2%	5.9%	4.8%	3.9%	3.6%	3.4%	3.2%	3.2%
CPI (YoY)	1.4%	7.0%	6.0%	2.6%	5.4%	5.4%	7.0%	8.5%	7.4%	6.8%	6.0%
Core PCE (YoY)	1.5%	4.9%	4.5%	2.6%	3.6%	3.7%	4.9%	5.2%	4.8%	4.6%	3.9%

Sources: Historical data via FactSet. Estimates (Est.) via American Enterprise Investment Services Inc.

YoY = Year-over-year, Unemployment numbers are period ending. GDP: Gross Domestic Product; CPI: Consumer Price Index

PCE: Personal Consumption Expenditures Price Index. Core excludes food and energy.

All estimates other than GDP are period ending. **Last Updated: May 26, 2022**

The table and estimates shown above are sourced from American Enterprise Investment Services Inc.

Publicly Traded Companies Mentioned in this report - Amazon (NASDAQ; AMZN; $2,302.93); Walmart (NYSE; WMT; $128.48).

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As of March 31, 2022

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