Ameriprise Financial

Economic Perspectives

An Ameriprise Investment Research Group publication

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Higher Inflation + Rising Interest Rates = Slower Growth

High inflation and higher interest rates will weigh on the pace of economic growth in coming quarters. Overall, however, we believe U.S. fundamentals remain strong enough as to keep the economy on a positive path.

Inflation was already a significant drag on real economic activity upon entering 2022. Russia's invasion of Ukraine in late February, further pushed some commodity prices materially higher, thus increasing inflation's drag. In response, the Federal Reserve has laid-out a path for interest rates hikes this year that is more aggressive than previously expected.

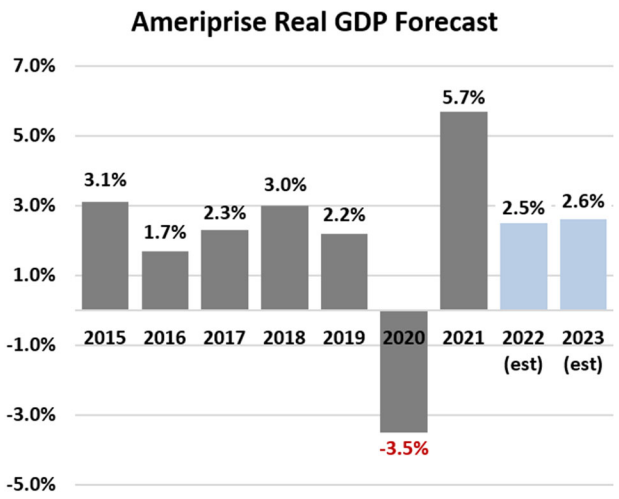
Though these developments are direct negatives to the economic outlook, they are unlikely to fully over-power the economy's strong fundamentals, in our view. Consumers remain in good financial shape, and we believe the job market is likely to remain strong. Corporate balance sheets and the financial system are in good health as well, in our opinion.

We believe recession odds remain below 50 /50 but given the dynamic circumstances of inflation, ongoing supply chain issues, fast rising interest rates, and the war in Ukraine, the risk has clearly increased. Should the economy slip into a recession, however, we believe it would be short and shallow given the strength of underlying fundamentals.

We now forecast U.S. real Gross Domestic Product (GDP) to grow by +2.5% from a prior +3.5% (coming into 2022 we had projected real growth at +4.5%). Additionally, we look for the Consumer Price Index to end the year at a level of approximately +5.5% versus our prior estimate of +3.7%.

Our Outlook

- **Recession risks?** Despite excessively high inflation and what could be an aggressive Fed response, we believe the U.S. economy is most likely to avoid a near-term recession.
- **Can the Fed shake inflation's hold?** Higher interest rates are meant to reduce demand but much of today's inflation problems reside on the supply side of the ledger.
- **Reduced outlook:** The war in Ukraine and a more aggressive Fed have led us to lower our 2022 growth outlook. We now see the U.S. economy as growing at a 2.5% real rate.



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

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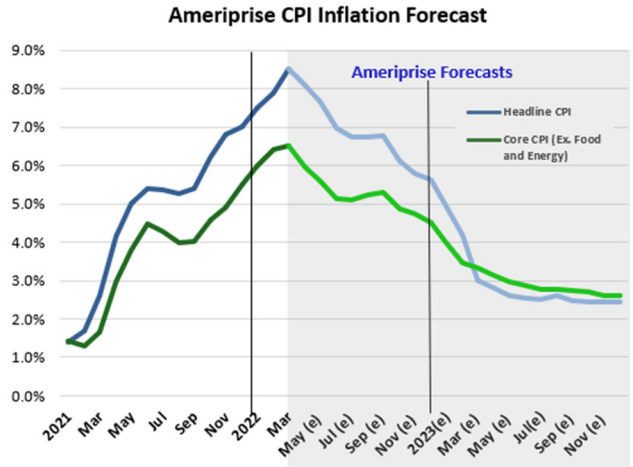
In this report

Inflation

In March, the Consumer Price Index, a measure of price changes for a basket of consumer goods and services, was a sharp 8.5% higher than year-ago levels, according to the Labor Department. Even after excluding the volatile food and energy components, what's called "core" inflation, was still a sharp 6.5% higher y/y.

We believe there are good reasons to suspect that the March rate may represent inflation's near-term peak, however, especially if gasoline prices stabilize or continue to moderate as they have done the last few weeks.

As seen in the chart below, we still believe y/y inflation rates could start to ease in the months beyond. We currently see inflation ending 2022 at about +5.5% - a level that would still be very high, but a considerable improvement over current rates. *Keep in mind that prices do not have to actually decline for the rate to ease, the pace of price appreciation just needs to slow*.

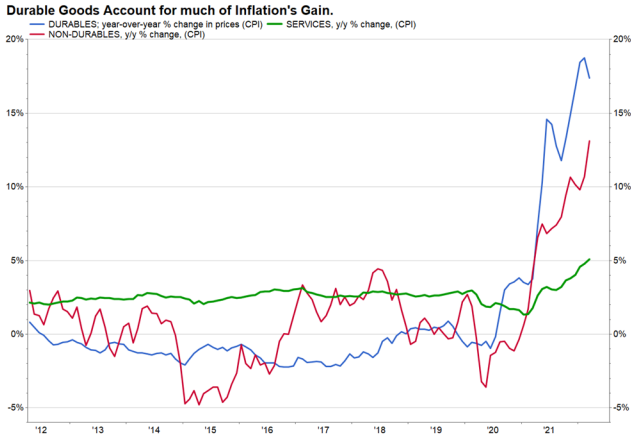


Source: Actuals via the Labor Department, forecasts via American Enterprise Investment Services Inc.

Our expectations may seem overly optimistic given recent inflation patterns, but we believe there are tangible factors that should ease price pressures in the quarters ahead, including:

1. Easing demand for goods (relative to services) combined with an improving supply of goods in some categories. The price of durable goods eased in March (to 17.4% y/y from February's +18.7%) in a trend we believe can continue.
2. Increasingly difficult year-over-year comparisons.
3. Stabilizing energy and housing costs. Again, prices don't have to decline for inflation to ease, the pace of price appreciation simply needs to slow.

Should virus conditions continue to improve here in the U.S., we believe consumer spending patterns should slowly rebalance with greater allocations to services, relative to goods, as the availability of services improves. If so, this could alleviate a material portion of the upward pressure we've seen on the price of goods. As seen in the chart below, durable goods (items such as autos, furniture and appliances) have experienced the largest price gains followed by non-durable goods (items such as food, apparel and gasoline).

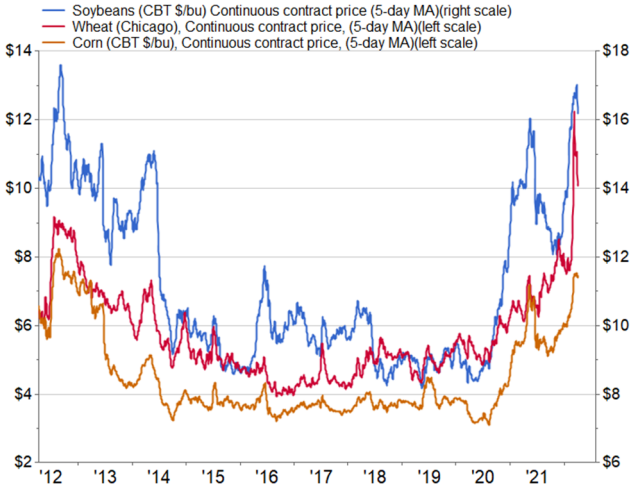


Source: FactSet

Crude oil prices came into 2022 at an elevated level, but Russia's invasion of Ukraine sent prices materially higher. Prices have come-off of their recent highs but there remains upside risk to energy prices if western nations impose added sanctions on Russian energy exports.

Unfortunately, the conflict's influence on rising prices does not end with energy. Agricultural commodity prices have also jumped in response to the war. Russia and Ukraine are major grain exporters. Exports from the region and harvest prospects are now sharply diminished by the circumstances on the ground.

Agricultural Commodity Prices

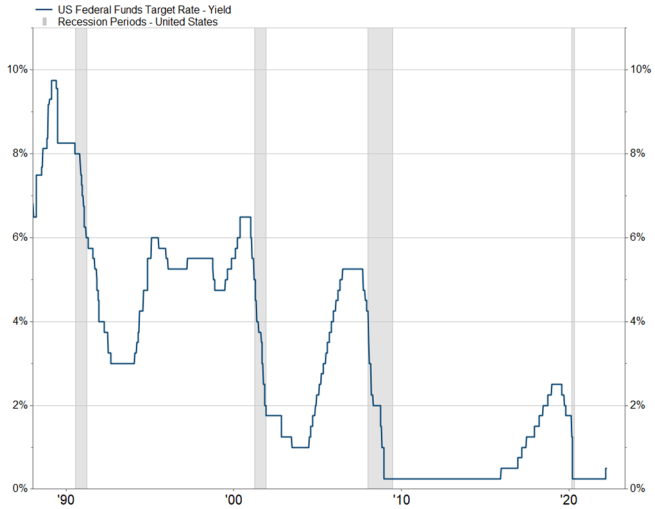


Source: FactSet

Will Federal Reserve interest rate hikes lead to a recession?

Somewhat belatedly, the Fed has begun raising its key overnight lending rates to slow the pace of economic activity and alleviate inflation pressures. Unfortunately, the Fed has a poor track record of triggering recessions when it steadily raises interest rates. As seen in the chart below, four of the last five rate hike cycles were soon followed by recession. (To be fair, the pandemic induced recession of March 2020 shouldn't count). Will we see the same again? Not necessarily, in our view.

Fed Funds Rate and Recessions



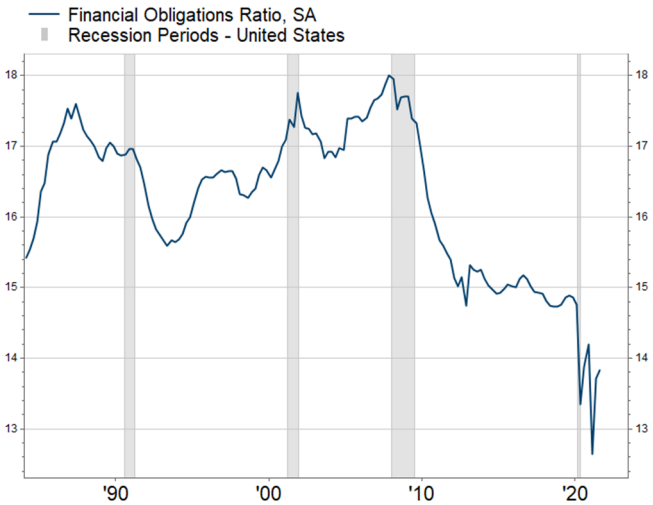
Source: FactSet

This time, the key translation mechanism between interest rates and the economy is weak: consumer debt.

Usually, the Fed is able to slow the economy via higher interest rates because people have been borrowing money to spend. Reduce that propensity to borrow by raising interest rates and it negatively impacts spending. Consumers pull-back on their spending, businesses follow suit, and there you have a recession.

However, as seen in the chart below, consumer debts are currently very low on a historical basis, meaning consumer borrowing has been weak and not a major contributor to consumer spending.

Consumers have been conservative with their finances.



Source: FactSet. Note: The Federal Reserve's Financial Obligations Ratio measures consumer debt payments as a percentage of consumer disposable income.

Higher interest rates should still be expected to slow economic activity, but the resulting slowdown in consumer spending may be weaker than history would otherwise suggest, in our view.

There's little doubt however, that recession odds have increased. The war in Ukraine, the pending Fed interest rate hiking cycle, exceptionally high inflation levels and China's continuing efforts to contain the COVID-19 virus via large-scale lockdowns, each present unique challenges to growth over the next 12 to 24 months.

Overall, however, we believe the most likely scenario is still one in which the U.S. economy avoids recession, but if one were to occur, we believe it would be a relatively shallow.

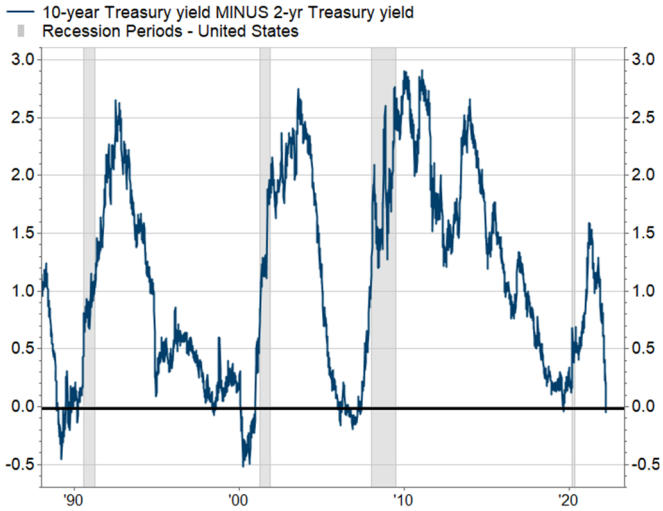
What does an inverted yield curve tell us?

The Federal Reserve's efforts to lift interest rates at the low-end of the interest rate maturity spectrum briefly pushed the yield curve for Treasury securities into "inversion" recently. (Recall, the Fed controls overnight lending rates between banks, rates that then typically influence longer-term borrowing costs.)

When the difference in yield between the 2-year and 10-year Treasury securities (or any other short vs. long maturities) turns negative, the yield curve is said to be "inverted." In other words, short-term rates are higher than longer-term rates – which should not be the case under normal circumstances.

As with Federal Reserve interest rate hikes, a 2/10 inverted yield curve (IYC) has a good track record of indicating pending recessions. In fact, over the last 45 years, inversion between the 2-year Treasury yield and the 10-year Treasury yield has a perfect track record of predicting each of the 6 recessions that occurred over that period – with no false positives. (See chart below.)

The 2-year /10-year yield differnce and recessions.



Source: FactSet

But what is an IYC actually telling us? And how is it able to predict economic downturns? Essentially, an IYC reflects the collective views of bond market participants. When the curve inverts, it shows that they believe interest rates will be lower in the longer-term than they will be in the shorter-term – implying a corresponding belief that economic activity will be weaker.

Investors should keep three things in mind: 1. An IYC in no way causes, or contributes to, economic downturns – other than any psychological influences on sentiment. 2. In past observations, the inversion signal has been maintained for a period of time, usually months – not just a brief interlude (as has recently occurred). 3. Though the track-record is strong, a yield curve inversion is not infallible. It is still just the collective views of bond market participants – not directly reflective of underlying financial fundamentals – which still matter, in our view.

The international economic picture.

Recession odds in Europe appear higher than those here at home, in our view. Though higher energy prices have been a direct drag on real economic activity across the globe, the negative effects have been greater in Europe. According to the International Energy Agency (IEA), Europe typically derives about 40% of its natural gas needs from Russia and 25% of its crude oil. Ready alternatives to replacing these supplies is largely nonexistent over the near-term and natural gas inventories were already low prior to the war.

Thus far, there have been no sanctions placed on Russian energy exports (Russia produces about 10% of the world's crude oil, according to the International Energy Agency) but most western European nations are actively seeking alternatives.

Many forecasters believe the war in Ukraine and high inflation pressures will be too much for the European economy to bear and it could slip into an economic downturn. Consensus estimates for the Euro Zone economy this year still look for growth, but such estimates have likely not had time to catch-up with the circumstances on the ground. According to Bloomberg, a consensus of forecasters still sees the Euro Zone economy as growing by 3.0% this year. The International Monetary Fund will release its detailed look and projections for the Euro Zone economy when it releases its World Economic Outlook Update on April 19th.

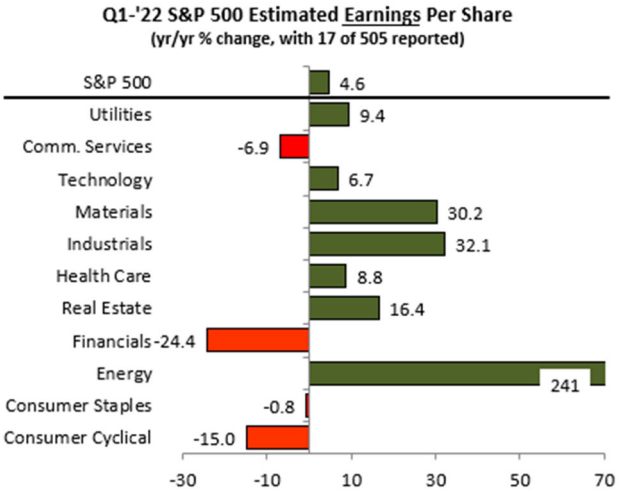
Growth in Asia is also suffering under the burden of sharply higher energy and commodity prices. But activity in the region is being further strained by China's continuing efforts to forcefully contain outbreaks of the COVID-19 virus as they occur.

China recently placed its largest city, Shanghai, on lockdown amid a COVID outbreak affecting thousands. To offset this negative economic influence, as well as a slowdown in its residential construction sector, the central government plans to invest approximately $2.3 trillion this year in added infrastructure projects, according to Bloomberg.

Corproate profits: The bridge between the economy and equity markets. *(Note: Unless otherwise stated, all data cited below relative to corporate sales and earnings is sourced from FactSet and refers to the S&P 500.)*

Corporate profitability generally remains a source of support for equity markets, but the outlook remains susceptible to war-related negative influences, in our view. S&P 500 companies reported strong sales and earnings for Q4-2021. For the period, earnings per share (EPS) expanded by 31% year-over-year (y/y) on sales growth of 16.2%. Both figures were well in excess of expectations.

As of this writing, S&P 500 companies are expected to see fairly sound results for Q1. Year-over-year EPS growth, however, is expected to decelerate significantly due to tougher year-ago comparisons (EPS were 52% higher y/y in Q1-2021) and higher labor and commodity costs. Overall, Q1 consensus estimates look for S&P 500 companies to post y/y EPS growth of 5% on sales growth of 11%.

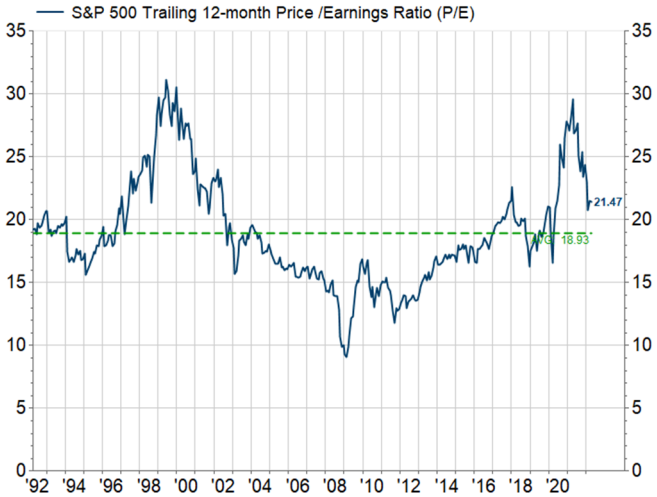


Recent earnings strength has enabled the S&P 500's trailing Price to Earnings (P/E) ratio to improve materially. The P/E metric reached a recent high of 29.7 in April 2021.

Since then, strong earnings growth has brought the metric down to 21.5, according to FactSet, even as the S&P 500 registered a gain over the period of 7.3% on a price-only basis (Apr. 30, 2021 through April 8, 2022).

Source: FactSet

S&P 500 Valuation: Price to Earnings Ratio



Source: FactSet

The Ameriprise Global Asset Allocation Committee believes valuation metrics should see some further moderation this year in reflecting a slower pace of future earnings growth and the likelihood of higher interest rates over time. Still, rising earnings should largely offset lower valuations to enable some further upside for stock prices. We believe there could be some further potential upside to EPS estimates as well.

S&P 500 Earnings Estimates	2017	2018	2019	2020				2021				2022				2023
12/13/2021	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Est.	Est.	Est.	Est.	Est.	Est.
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	FY
Quarterly $$ amount				$33.35	$28.25	$39.40	$42.30	$49.03	$52.81	$53.86	$51.19	$52.12	$55.06	$57.57	$58.03	
change over last week										$0.00	$0.14	$0.12	$0.06	$0.12	$0.20	$0.90
yr/yr				-14.0%	-32.1%	-6.7%	1.2%	47.0%	86.9%	36.7%	21.0%	6.3%	4.3%	6.9%	13.4%	
qtr/qtr				-20%	-15%	39%	7%	16%	8%	2%	-5%	2%	6%	5%	1%	
Trailing 4 quarters $$	$133.50	$164.05	$164.38	$158.93	$145.59	$142.78	$143.30	$158.98	$183.54	$198.00	$206.89	$209.98	$212.23	$215.94	$222.78	$244.37
yr/yr % change	11.6%	22.9%	0.2%				-12.8%				44.4%				7.7%	9.7%
Implied P/E based on a S&P 500 level of: 4712										23.8	22.8	22.4	22.2	21.8	21.2	19.3

Source: FactSet

Summary

The odds of recession have clearly risen, in our view, but presently, we believe the most likely path is one in which the U.S. economy avoids an economic downturn. Admittedly, there is little room for error. There is always the possibility that the Fed over-tightens, or supply-chains suffer additional set-backs. But if so, we believe any economic downturn that might occur would be shallow given the current fundamental strength of consumer and corporate balance sheets.

Over time, we believe global supply /demand imbalances should work themselves out. But this path is made more difficult by China's adherence to its "zero COVID" policy which seeks to contain the very easily transmittable virus. Until virus conditions are controlled globally, not just domestically, some product supply-chains may not get back to normal operating levels.

Assuming further progress in managing virus risk, we believe fundamentals are in good position to support an economic expansion period of multiple years. The U.S. economic outlook is always very reliant on the financial health of consumers, and we believe consumer balance sheets are currently strong with relatively low aggregate debt-to-income ratios, strong home values, significant savings, and generally favorable financial market conditions.

Over the longer-term, we still believe three fundamental factors: China, demographics, and global government debt will play key roles in the path of global economic activity and financial markets. Demographics across the industrial world reflect slowing population growth and aging societies; this implies slower potential economic growth than has been the case historically. Government borrowing needs, particularly here in the U.S., are also very high and going higher in the foreseeable future. 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.

Risks

The current outlook still offers material uncertainty. Aside from the war in Ukraine and the ongoing coronavirus threat, government debt loads are rising to 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 its geopolitical sphere of influence 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 path of development could someday intersect with those of presiding western powers, which could create more serious instability.

Geopolitical risks (N. Korea, Syria, Venezuela, relations with China, and Russia, most notably) 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 serious problems. However, there always have been problems for the global economy /capital markets to consider, and there always will be. ■

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