Ameriprise Financial

Economic Perspectives

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Is there a light on the 2021 horizon?

From its bottom in April, through the end of October, the U.S. economy recovered from its pandemic-induced lows at a much better than expected pace, in our view. In June, we had forecast a full-year decline for 2020 real Gross Domestic Product (GDP) of 5.8%; at the time, the International Monetary Fund (IMF) was projecting a full-year decline of 8.0%. With year-end now just weeks away, the contraction appears likely to be significantly smaller. We currently project this year's decline in economic activity to be 3.5% or less.

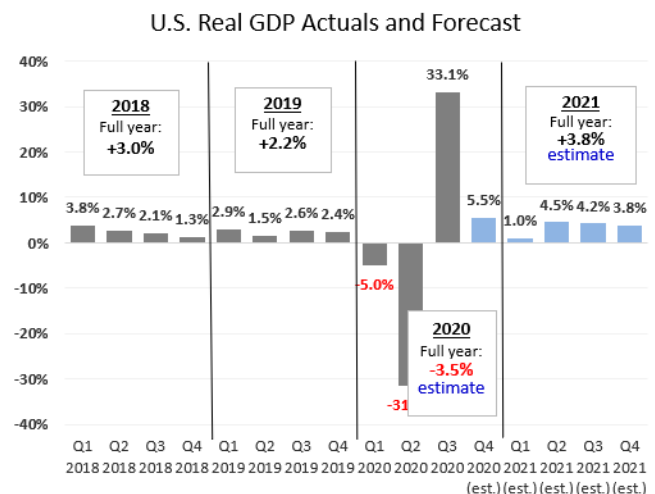
But does the strength of recovery to this point matter now that the economy faces its most difficult COVID-19 outbreak yet? We believe it does. Although activity is likely to slow over the near-term as many states reinstitute businesses activity restrictions, we do not expect the economy to lose ground on the progress its previously achieved.

This latest round of business restrictions primarily targets "contact intensive" businesses, such as bars, restaurants, theaters and the like. In the spring, it was the near-total shutdown of business, particularly nonessential manufacturing and services, that led to such a significant decline in overall activity. We believe officials are unlikely to go that far again. Although the current viral outbreak is much worse than that experienced earlier in the year, nonessential activity is likely to continue given the systems and personal protection equipment that is now available. The health risks inherent in economic stress are also seeing greater consideration.

At the time of this writing, one COVID-19 vaccine has been approved by the Food and Drug Administration (FDA) with two others reportedly close to submission for review. The vaccines offer hope that life may start getting back to normal next year; a hope that we believe could support financial market sentiment until we get there.

Our Outlook:

- **Economy recovering faster than expected.** The economy entered Q4-2020 with good momentum and activity remained sound into November. We now forecast Q4 real GDP to grow by +5.5% (versus a prior +3.8%).
- **Virus conditions remain a strong headwind.** Those most adversely affected by the current outbreak will find little government financial support available. We believe another stimulus program will eventually be passed, but the recovery could stall over the near-term the longer its delayed.
- **Fundamentals remain supportive.** In our view, consumer and corporate finances are in good position to support a more vigorous rebound once virus conditions ease. We believe there is a chance the economy could see a considerable, yet temporary, acceleration next summer.



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

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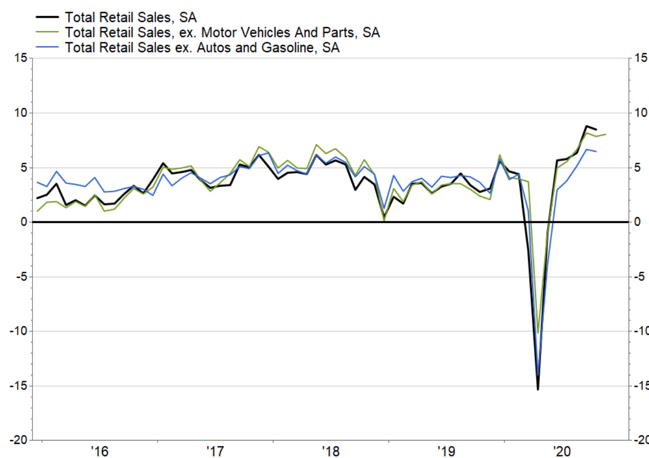
In this report:

Near-term Conditions & Outlook....................page 2
2021 Outlook.. page 3
GDP /Employment /Inflation........................ page 3
Interest rates /Housing /The U.S. dollar...... page 4
Corporate Profits.. page 5
Summary... page 6

A record decline in Q2 followed by a record bounce in Q3. At the end of the second quarter, the U.S. economy was 10.1% smaller than its 2019-ending level (on an inflation-adjusted basis). By comparison, at the lows of the Great Recession (2008-'09), the economy had contracted by just 3.9% from its peak.

The second-quarter's historically large decline was followed by a near equally strong rebound in the third-quarter. Yet the economy was still 3.5% smaller than its pre-pandemic level at the end of Q3. The gap appears likely to narrow further here in Q4 despite surging virus conditions. We currently forecast real GDP for the period at a strong +5.5%. If achieved, it would leave economic activity for the full year 2020 down about 3.5%, but just 2.2% lower when comparing the fourth quarter's annualized level of activity to that of Q4-2019.

Consumer spending grew at a solid pace of 0.5% month-over-month in October, and retail sales were a remarkable (given the circumstances) 5.7% above their year-ago levels in the month.



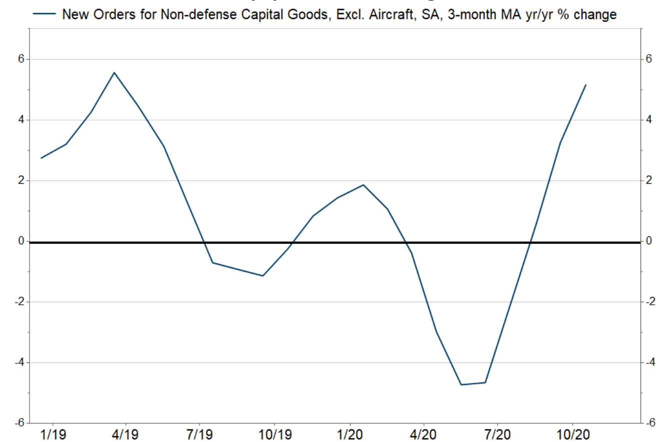
Source: FactSet

However, virus cases and hospitalizations were surging once again throughout October. As a result, we expected to see November retail sales decline. But data currently available suggests activity to have been generally flat in the month, thus, possibly better than we anticipated. *(The Commerce Dept. will release November retail sales results on Dec. 16th.)*

We still expect consumer spending (on a seasonally adjusted basis) to decline modestly in December. The virus outbreak is adversely affecting employment conditions, and individuals laid-off, or businesses forced to close, do not have the financial support from the government that was available to them earlier in the year. At the time of this writing, reports suggest political leaders in Washington may be moving closer to an agreement, but we've seen similar reports over the last few months with no resolution.

We still believe another round of fiscal support will eventually be passed. If so, the funds could offer a bridge of support for the economy until vaccines become more widely available.

Business investment spending trends have also maintained good momentum recently. The Commerce Department's October Factory Orders report showed new orders for business equipment 5.5% above year-ago levels. From a global perspective, Japan reported a 17.1% month-over-month (m/m) surge in core machinery orders in October, equating to a year-over-year (y/y) gain of +2.8%. We view the y/y gains as encouraging given the circumstances.



Source: FactSet

Consumer spending and business investment are the two most important components of economic activity and recent trends suggest they should both be solid contributors to growth in Q4. However, a third factor is also expected to add a material boost: business inventories.

Economic activity is measured by what is produced, not consumed. As such, when inventories decline, it subtracts from GDP as it reflects lower production. Conversely, when inventory levels expand, they add to economic growth.

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In the spring, most non-essential producers' shutdown for about two weeks, leading to a large drop in inventory levels. The drawdown subtracted 3.5 percentage points from GDP in the second quarter.

But that left business inventories too low. You may be familiar with this situation if you've recently tried to order new appliances or other home goods and been told delivery will take several weeks or a few months. Manufacturers have been making progress in re-stocking and expanding inventory levels could add a few percentage points to real GDP in Q4, in our view.

Our 2021 Outlook and Beyond:

Economic activity: We currently project U.S. real GDP to expand at a +3.8% rate in 2021. Activity is likely to be soft at the start the year given virus conditions, but it could surge should the virus threat ease in Q2 and people look to release pent-up demand as we head into summer. Of course, this outlook remains dependent on vaccine availability steadily improving, no problems with its effectiveness, and the willingness of people to get vaccinated.

Overall, we believe there could be upside to our 2021 growth outlook. The timing of each factor may be key, but activity could surge if a stimulus bill is passed, virus conditions improve, and consumers feel comfortable enough to release their pent-up demand. Importantly, we believe consumers have ample financial resources to do so.

Amreiprise Forecast:	2020	2021	2022
U.S. Real GDP	-3.5%	3.8%	3.0%

* Forecasts represent Q4 /Q4 change

Employment: We currently expect the unemployment rate to end 2020 at a level of 6.6% (versus a November actual of 6.7%, per the Labor Department). Net hiring is likely to remain soft into Q1-2021 as "contact intensive" businesses remain shuttered or operating at sharply reduced capacity.

Hiring could accelerate materially beginning in Q2-2021 if virus conditions allow. According to Labor Department data, in November, the Leisure and Hospitality (L&H) sector accounted for 35% of the 9.1 million jobs still lost relative to employment's February peak. Employment in this sector can recover much more quickly than others, in our view, if state mandated restrictions are lifted and consumers embrace the reopening by taking a vacation, going to a theater or music venue, or simply enjoying a night out at a restaurant. We currently believe the unemployment rate could end 2021 at 5.2%, improving further to 4.2% by the end of 2022.

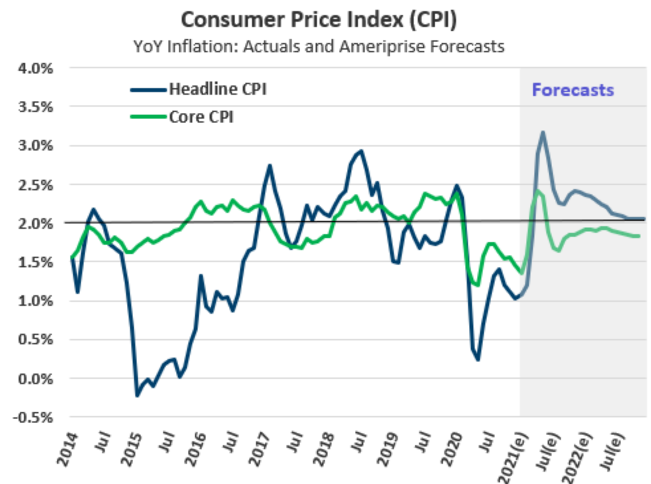
Amreiprise Forecast:	2020	2021	2022
Unemployment Rate	6.6%	5.2%	4.2%

* Forecasts represent year-ending rates

The chart below depicts the trend of our current forecast for the unemployment rate.

Source: Actuals, as represented by the black portion of the line in the chart above, are sourced from the Labor Department. Forecasts (in blue) are sourced from American Enterprise Investment Services Inc.

Inflation: We believe inflation rates are likely to rise over the first half of 2021, primarily due to comparisons with the depressed price levels of the second quarter of 2020. Even if we assume monthly CPI gains between now and the second quarter of 2021 maintain an average pace consistent with a 2.0% annualized inflation rate, the CPI would reach a rate of +2.9% y/y in May, according to our calculations (our forecast for May CPI is +3.2%). Over the next few years, however, inflation should remain relatively well-contained, in our view, primarily due to the demographic factors that have constrained prices over the last several years.



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

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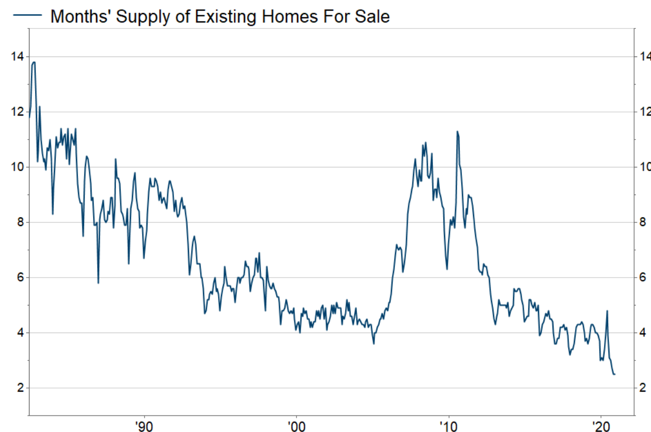
Interest rates: From an economic perspective, we believe interest rates could drift higher throughout 2021 as the economy improves. However, the eventual level of rates and their pace of change could be materially influenced by the Federal Reserve. Fed officials have made it clear that they intend to maintain interest rates at economically supportive levels until the economy fully recovers. Overall, from an economic perspective, we believe the yield on the ten-year U.S. Treasury security could rise to a level of approximately 1.5% at the top-end by the end of 2021. For more detailed outlook, please see reports from our fixed income research group.

The Housing market: The housing market has consistently been one of the strongest segments of the economy this year and we believe that should continue in 2021. Unlike the "housing bubble" period of 2004 through 2007, the sector currently suffers from inadequate supply as opposed to the over-supply conditions prior to the Great Recession.

In October, the number of existing homes available for sale in the U.S. was at a record low of just 2.5 months' supply, according to the National Association of Realtors (NAR). This compares to the 6.0 months' supply that has traditionally been viewed as a "balanced" market.



Source: FactSet

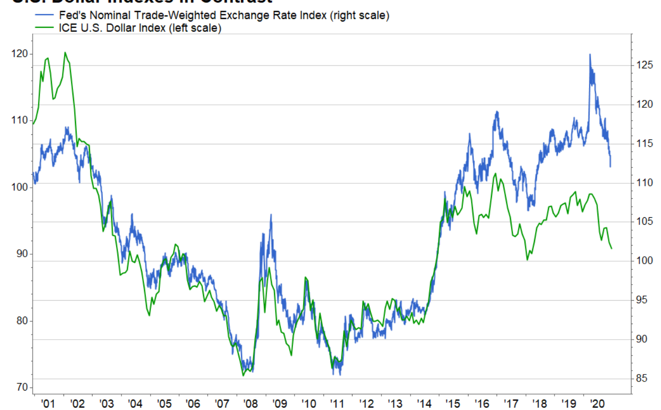
The housing market was already doing well before the pandemic. But this year's record low mortgage rates, combined with the sudden proof of the "work-from-anywhere" model, has fueled a considerable increase in demand. In October, existing home sales were a remarkable 27% higher than year-ago levels in the U.S., per the NAR. Meanwhile, new home sales in the month were up 42% y/y, according to the Census Department.

Homebuilders have increased new building activity in response, but it's done little to improve near-erm shortages and could take years to do so. In October, single family housing starts were 29% higher y/y, according to the Census Department, yet the months' supply of new homes for sale, relative to selling rates, remained at a record low of 3.3 months' in Census Department data that began in 1963.

The U.S. Dollar: Last year at this time we projected the value of the U.S. dollar via the Fed's trade-weighted Index to drift lower in 2020 by low single digits. We removed our forecast upon the onset of the pandemic as it led to a sharp increase in the dollar's value amid a flight to quality. In the months that followed, the dollar slowly returned to its pre-pandemic trend.

At the time of this writing, the value of the U.S. dollar via the Fed's trade-weighted Index is down 2.3% year-to-date. Meanwhile, the ICE U.S. Dollar Index, which measures the dollar's value against a narrower subset of foreign currencies, is down 5.6%.

Relative to the Fed's Trade-weighted Index, we believe the U.S. dollar could drift modestly lower in 2021 as well. At this time, we forecast it to end 2021 down about 4% to 8%.



Source: FactSet

A sound U.S. dollar is very important to U.S. economic strength. However, the dollar can be too strong, to the point where it acts as a drag on economic performance via larger trade deficits. A weaker dollar can also offer a tailwind to corporate profits as foreign-generated income is able to convert into more U.S. dollars at the end of each quarter when translated for financial reporting purposes. As seen in the long-term chart above, we believe there is ample room for the dollar to decline over time as to achieve a better balance with these objectives.

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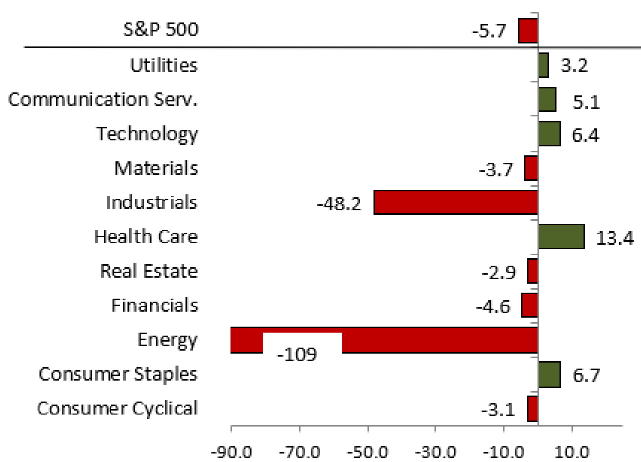
CORPORATE PROFITS: the bridge between the economy and equity markets. *(Note: Unless otherwise noted, all data cited below relative to corporate sales and earnings is sourced from FactSet.)*

Like the second quarter before it, corporate sales and earnings outperformed expectations by a wide margin in the third quarter (Q3). S&P 500 companies reported a 5.7% y/y decline in earnings per share (EPS) for the period on a 1.1% decline in sales. At the end of September, consensus analyst estimates had looked for earnings to drop by 21% y/y on a 4% drop in sales.

As seen in the graphics below and at right, the Energy and Industrials sectors experienced the greatest declines in both sales and earnings. In fact, with just these two sectors excluded, EPS were 3.6% higher on sales growth of 3.4%.

Q3-'20 S&P 500 Earnings per Share by Sector
(yr/yr % change)

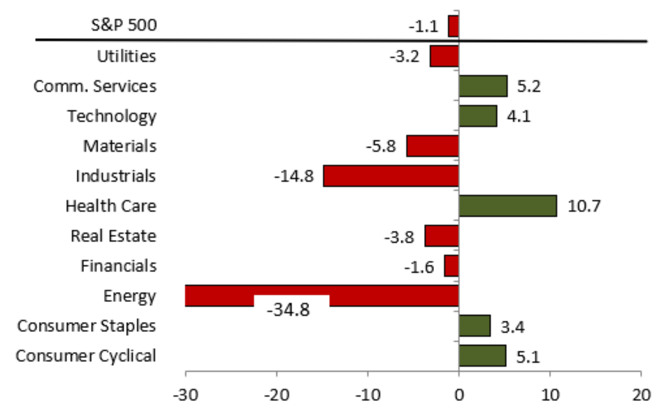


Source: FactSet

The number of companies that beat earnings estimates in Q3, as well as the magnitude of the "beats," were at or near all-time highs (at least since FactSet began tracking such data in 2008). Overall, we view the results of the last two quarters as very encouraging.

For the full-year 2020, consensus estimates currently look for S&P 500 companies to generate EPS of $138.21, for a 15.9% decline from 2019 levels. We're likely to see some outperformance of EPS expectations in Q4 as well, thus narrowing the decline further. We believe a full-year EPS decline of 12% to 15% would be a good outcome given the circumstances.

Q3 S&P 500 Sales per share by Sector
(yr/yr % change)



Source: FactSet

EPS estimates for 2021, meanwhile, currently look for earnings of $169.20, which would represent a strong 22% improvement over estimated 2020 EPS. The forecast 2021 earnings, however, would only be a slight 3.0% improvement over 2019's actual EPS of $164.38 but we believe earnings growth prospects appear favorable. By comparison, during the Great Recession of 2008 /09, S&P 500 aggregate EPS did not exceed their pre-recession peak until 2011.

S&P 500 Earnings Estimates	2016	2017	2018	2019				2020				2021				2022
12/10/2020	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	
Quarterly $$ amount				$38.80	$41.59	$42.21	$41.78	$33.32	$28.22	$39.41	$37.26	$38.13	$40.94	$44.59	$45.54	
yr/yr				0.2%	1.1%	-1.6%	1.1%	-14.1%	-32.1%	-6.6%	-10.8%	14.4%	45.1%	13.1%	22.2%	
qtr/qtr				-6%	7%	1%	-1%	-20%	-15%	40%	-5%	2%	7%	9%	2%	
Trailing 4 quarters $$	$119.64	$133.50	$164.05	$164.13	$164.59	$163.92	$164.38	$158.90	$145.53	$142.73	$138.21	$143.02	$155.74	$160.92	$169.20	$197.13
yr/yr	0.8%	11.6%	22.9%				0.2%				-15.9%				22.4%	16.5%
Implied P/E based on a S&P 500 level of: 3668										25.7	26.5	25.6	23.6	22.8	21.7	18.6

Source: FactSet

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SUMMARY

Recent reports related to effective COVID-19 vaccines offer hope on the horizon. After the sudden and very difficult decline in the global economy experienced in the spring, we believe the rebound in activity from those pandemic lows has been considerably better than expected in most areas of the world and in most sectors.

The outlook still faces considerable challenges to be overcome, but in our view the most likely path should return economic activity here in the U.S. to its pre-pandemic levels by the third quarter of 2021. Growth could also remain above trend for a period thereafter. It may take longer for the labor market to fully heal, but we currently believe the unemployment rate could once again drop below the 4% market by mid-2022.

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 slower 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 much 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 longer-term remains uncertain. The Federal Reserve, however, appears committed to keeping interest rates in check over the intermediate-term.

Separately, China's position in the global economy and the 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 path of development could someday intersect with those of presiding western powers, which could create more serious instability.

RISKS

The current outlook still offers material uncertainty. Aside from the 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.

Geopolitical risks (e.g., 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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