Economic Perspectives

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Economic prospects remain strong, although there are legitimate risks in the form of trade disputes, inflation and interest rates.

Key points:
- U.S. economic prospects remain strong, albeit with risks. We have not made material changes to our base-case forecasts.
- Consumer and corporate balance sheets are in good shape, in our view, thus supporting odds of an ongoing economic expansion.

Key risks:
- Stronger inflation pressures and rising interest rates are a normal consequence of an improving economy. However, there is a risk that either /or both, could over-shoot current expectations.
- Trade tensions have evolved into a serious and unpredictable wildcard to the outlook.

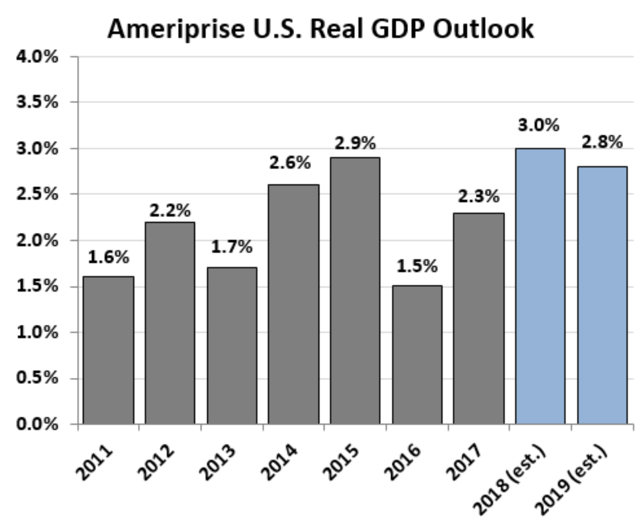
Financial market activity has taken on a much more turbulent tone this year – especially when compared to the exceptionally calm nature of trading last year. Central to market concerns is an economy that may be too strong for its own good.

The most prominent topics of investor angst have been growing inflation pressures, higher interest rates, and rising trade tensions.

Each is a legitimate concern that could evolve to have serious economic consequences; however, it should be noted that higher inflation and interest rates are a normal consequence of an improving economy. Although both have shown stronger upside this year than we had expected, we do not believe either is likely to rise to overly problematic levels.

The recent escalation of trade tensions, however, is a material wildcard. Logic suggests that trade tensions should eventually calm, but as of this writing, this appears more of a hope than a likelihood. A trade war would simply be economically damaging to all involved, especially in today's global economy. Nevertheless, there are legitimate issues that need to be resolved; issues which some nations, particularly China, are very reluctant to rectify without a fight.

Ultimately, a fair playing field for international trade should be the desired outcome of rational negotiations. Unfortunately, politics, personalities and nationalism appear to be much larger factors in this debate than is comfortable, thus raising the odds of an adverse outcome, at least temporarily.



Source: Actuals via U.S. Commerce Department, estimates via American Enterprise Investment Services Inc.

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Fundamentals support further expansion.

Absent a deterioration of trade relationships, we believe the U.S. economic outlook remains quite solid. Interest rates and inflation are each likely to be higher than we initially thought for 2018 and 2019, but our initial forecast was made prior to the tax cuts passed at the end of December, and the added fiscal spending agreed to by Congress and the administration in January.

Consumers currently enjoy sound financial health and a very strong job market. Corporate America, meanwhile, is seeing its strongest profit growth in years, in combination with strong balance sheets in most sectors. In some respects, however, the economy has become too strong, as a growing number of industries are facing significant labor shortages. The Labor Department recently said there were more job openings in the month of April than there were people unemployed.

As shown in the graphic on page one, we see U.S. economic growth this year and next as at the upper end of a +2.5% to +3.0% range. By comparison, the U.S. economy has experienced an average growth rate of +2.2% since the Great Recession ended in the second quarter of 2009. The accelerated pace over the near-term is primarily reflective of lower tax rates, higher business investment, and incremental government spending.

An escalation of recent trade threats is likely the greatest risk to economic momentum. Currently, we believe the odds of a material disruption are low, although some tariffs and counter-tariffs have already gone into effect. Tariffs are ultimately borne by consumers and will add to inflation pressures. Export demand could also be impacted, as could the end-sales of U.S. companies in foreign markets, particularly China. (This issue warrants its own report. Please see our recent Economic Views Brief on the Trade issue for more.)

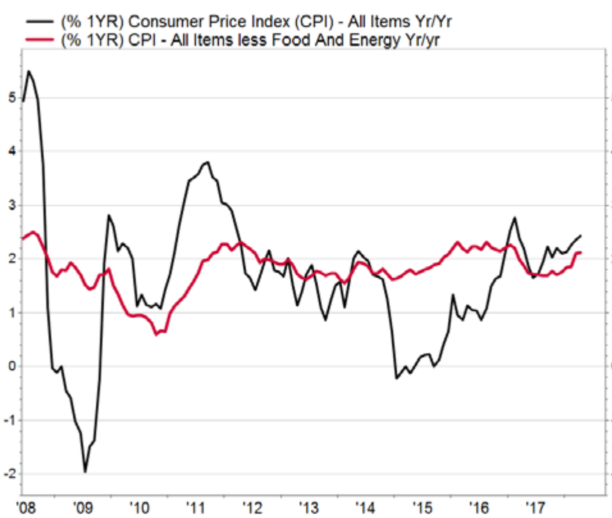
Rising interest rates and inflation pressures also offer risk to the outlook.

Inflation: As is often the case during periods of strong economic expansion, the U.S. economy is also likely to see greater inflation pressures this year and next. Though we see inflation as likely to run a bit "hotter," we do not see it as rising to economically damaging levels, nor causing the Fed to accelerate its pace of interest rate hikes.

Higher energy costs, rising labor costs, elevated commodity prices, and higher transportation costs, should all contribute to rising prices as the year progresses. There are offsets, however, that should help contain the upside. Housing costs (as measured by rents) are heavily weighted in the Consumer Price Index (CPI) (approximately 24%) and rental rates have been easing. Inflation pressures should also continue to see some containment from demographic influences and a modestly stronger U.S. dollar. Slower population growth and aging demographics typically result in moderating demand, thus limiting the price gains producers can implement.

Overall, we forecast headline inflation, as measured by CPI, could reach approximately 3.0% over the next few months primarily due to this year's higher energy costs. Headline inflation could also see some added incremental upside depending on the path of tit-for-tat tariff actions.

Core inflation rates are also likely to run slightly above the Federal Reserve's traditional 2% target over the intermediate-term and could approach 2.5%. The core rate of inflation was +2.1% in May (as depicted by the red line in the chart below) but this is not new territory. As seen in the chart, the rate was above the 2.0% level for most of 2016, as well.

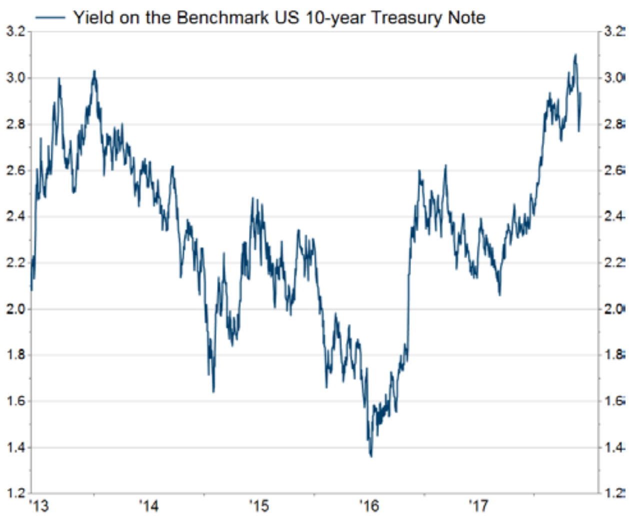


Source: FactSet

Interest rates: The Federal Reserve has been pushing interest rates higher at the very short-end of the maturity spectrum (over-night, bank-to-bank lending), while market-based borrowing costs have also been rising. Higher market rates are partially due to the Federal Reserve actions, but also reflective of a huge amount of borrowing the Treasury Department will require over coming quarters.

As seen in the chart at the top of the next page, the yield on the 10-year Treasury Note ended 2017 at 2.4%. Rates began to rise quickly thereafter, fueled by inflation concerns and higher government borrowing projections.

After a brief pause in March, the 10-year Treasury yield broke above the psychologically important 3.0% level in late April, a level maintained through much of May. As of this writing the yield is 2.98%. (As a reminder, yields rise as bond prices fall.)



Source: FactSet

Rising interest rates are normal at this point of an economic cycle (as are inflation pressures). Nonetheless, higher rates are usually greeted with financial market apprehension as investors fear the increases could "overdo it" and quell the pace of economic activity.

Whether rates rise to economically burdensome levels remains to be seen. Unfortunately, there are some considerations that could drive them there. According to Congressional Budget Office (CBO) projections, the federal government will soon need to cover annual deficits of more than a trillion dollars, with no excess Social Security tax payments to borrow via IOUs. (Social Security became a net distributor in 2010.) At the same time, the Fed is still in the process of ramping-up the roll-off its balance sheet.

Currently the Fed is allowing $18 billion per month of Treasury securities to mature without reinvestment, in addition to $12 billion of mortgage backed securities. In July, the roll-off increases to $24 billion and $16 billion, respectively, before jumping again in October to what the Fed says will be the program's terminal rates of $30 billion and $20 billion, respectively.

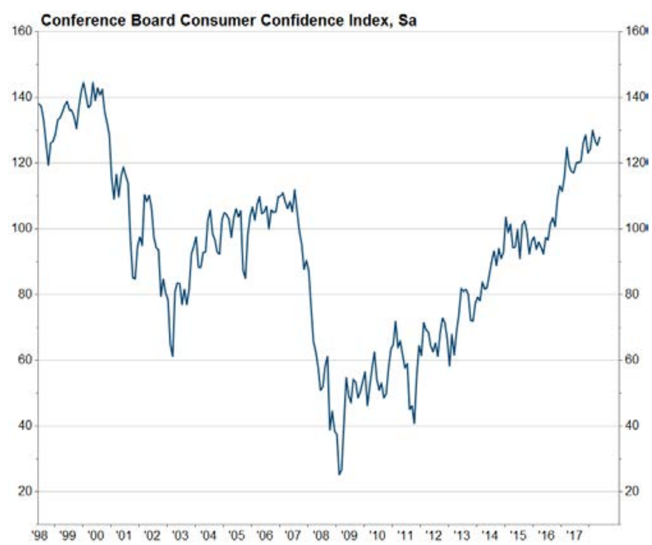
It's often said that the market for U.S. Treasuries is the largest and most liquid market in the world. It need be. In the coming months, quarters and years, fixed income buyers will be asked to purchase an unprecedented amount of government debt. We have confidence that markets will find their "clearing rate," but it remains to be seen just what that rate will be.

BTW…those trillion-dollar annual deficits around the corner? For comparison, the total amount of U.S. government debt <u>outstanding</u> at the end of 2007 was $5.14 trillion. Over the next four years, the CBO projects the total amount of Treasury debt outstanding to <u>increase</u> by $5.7 trillion.

Economic conditions:

<u>A soft start:</u> U.S. economic growth was somewhat modest in the first quarter (Q1) of the year. The Commerce Department estimates quarter-over-quarter (qtr./qtr.), annualized real Gross Domestic Product (GDP) growth for the period at +2.2%.

Central to the modest pace was a lackluster pace of consumer spending. Despite the fact that Consumer Confidence hit a 17-year high during the quarter (see chart below), consumer spending was up just +0.3% versus Q4 levels; its slowest pace in four years.



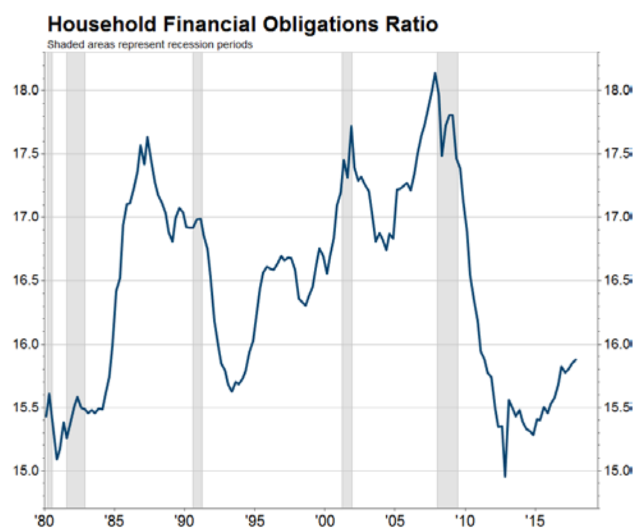
Source: FactSet Sa = Seasonally adjusted

We would be much more worried about conservative consumer spending if it were not for strong consumer fundamentals. The job market is strong, wage and salary growth is slowly accelerating, asset values are near all-time highs (real estate and financial market values, primarily), and debts remain very manageable, in our view.

Consumers account for 70% of U.S. economic activity, so their financial health matters greatly to the economic outlook. Often this late into an economic expansion, consumers can become overly confident. Such confidence can lead to over-spending and the debt accumulation that accompanies it. Eventually, as the debts grow, people must pull-back on their spending to get their finances back in order, which can result in a recession.

After nearly nine years of economic expansion, however, consumer debts are still at manageable levels. The Federal Reserve's Financial Obligation Ratio (FOR) has long been our favorite measure of consumer indebtedness, as it measures monthly consumer financial obligations against consumer disposable income. So rather than just looking at the dollar amount of debt, it looks at whether consumers can afford it.

As seen in the chart below, the ratio is off of its recent lows but it is still at very manageable levels when compared to historical standards. In fact, the ratio is barely above its trough of the early 1990's.



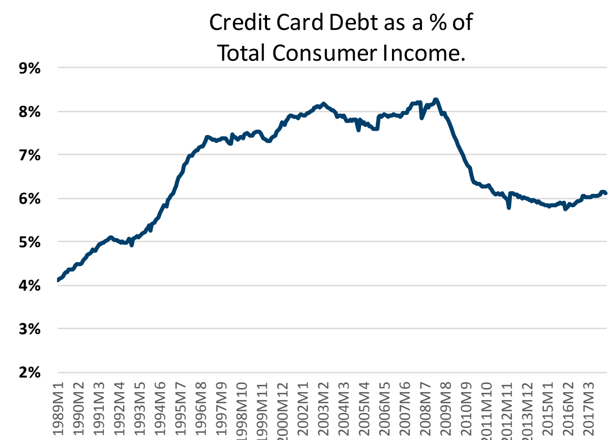
Source: FactSet

Required payments considered in the ratio include: mortgage or rent, property taxes, auto payments, homeowners' insurance and required consumer debt payments (largely credit cards).

One notable obligation that is NOT considered in the FOR is student loans; primarily because student loan debt was minimal when the Fed initiated the FOR metric in 1979. Doing the math: assuming an average interest rate of 7% on the $1.5 trillion in student loans currently outstanding, amortized over a 20-year period, would add approximately 0.5 percentage points to the current FOR reading, per our calculations.

Credit card debt. It's been widely touted recently that consumer credit card debt has finally eclipsed it pre-financial crisis highs. Indeed, according to the Federal Reserve, consumer revolving credit (primarily credit cards) was $1.03 trillion at the end of March 2018.

However, consumer incomes are also at an all-time high. In fact, credit card debt as a percentage of total personal income, is near 20-year lows (see chart below). The ratio plunged during the financial crisis and consumers have been rather conservative in their credit utilization since. This, despite the ever-growing utilization of credit for convenience purposes and reward points.



Sources: Federal Reserve, Bureau of Economic Analysis

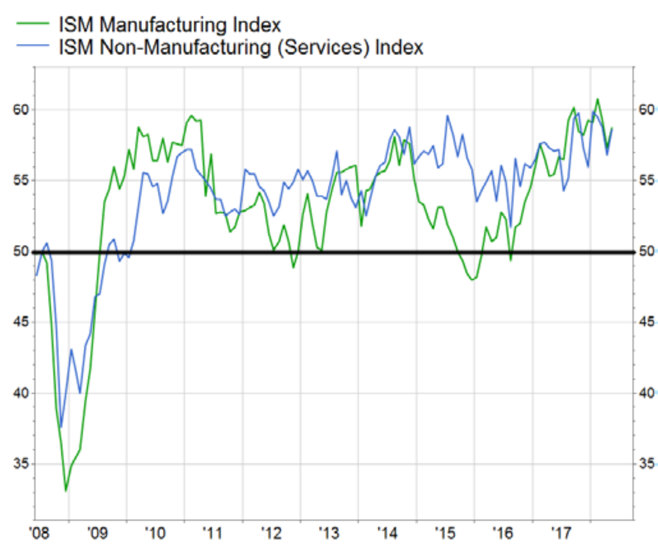
The consumer picture is not perfect, however. This year's higher gasoline prices will siphon away some of the benefit of the recent tax cuts.

By how much? Last year the U.S. consumed approximately 144 billion gallons of motor fuel, according to the Energy Information Administration (EIA). Every $0.10 change in fuel prices (assuming steady fuel volumes) could alter consumer purchasing power by approximately $14.4 billion. Through the end of May, gasoline prices have been approximately $0.33 above year-ago levels on average, but more recently prices have been approximately $0.50 higher yr/yr.

If the differential for the full year were to average $0.40 to $0.50, the impact on consumer spending would be in a range of $57 billion to $72 billion, per our calculations. This is a material impediment that would largely offset the benefit of personal income tax cuts enacted at the end of 2017. However, consumers would still be left with solid income expansion via job gains and wage hikes.

The pace of business activity remains strong. Nationwide surveys of business activity for manufacturers and service provides have been strong.

The Institute of Supply Management's (ISM) Manufacturing and Non-manufacturing (Services) indexes have each reflected strong business conditions over the last year. The trends are particularly impressive given that the surveys represent month-over-month changes in business conditions. As such, the steady acceleration seen in both surveys over the last year suggests very healthy demand conditions, in our view.

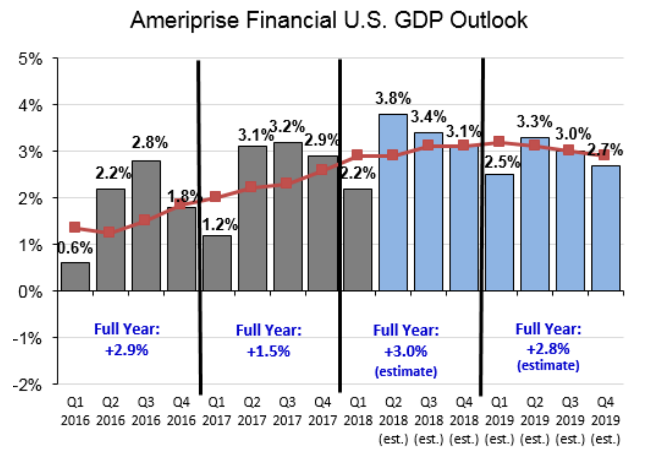


Source: FactSet

Such patterns however, are simply unsustainable and we expect some stabilization and eventual deceleration in both measures in the coming months and quarters. A modestly stronger dollar and trade tensions could weigh on the pace of overall activity, as well.

Near-term Forecast

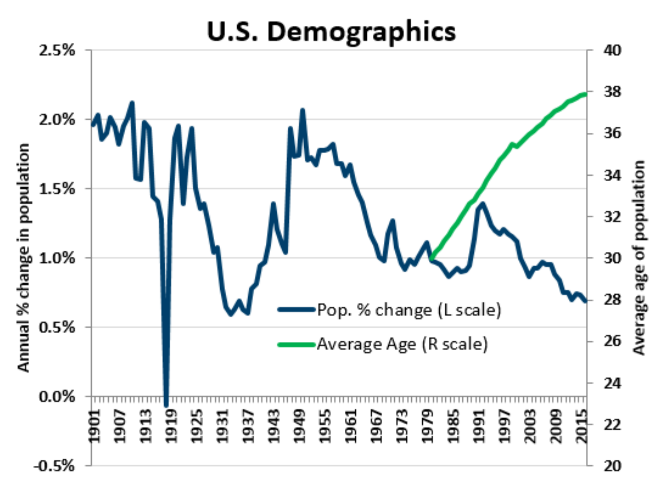
Our real GDP forecast on a quarterly basis is shown at the top of the next column. The red line in the graph represents the U.S. economy's year-over-year (yr/yr) growth rate (normally, U.S. GDP is almost always quoted on a quarter-over-quarter, annualized basis). As can be seen, we forecast the U.S. economy to grow at, or slightly above, +3% on a yr/yr basis for the next several quarters. Over time, the pace of growth should ease back to what we see as the economy's current long-term potential rate of about +2.25%.



Source: Actuals via U.S. Commerce Department, estimates via American Enterprise Investment Services Inc.

Such growth rates may seem weak, especially considering historical averages. From 1950 to 1970, U.S. real GDP grew at an average year-over-year rate of +4.4%; from 1970 to 2000 the average was +3.2%. Currently, we see the U.S. economy's "speed limit" (i.e., the rate that can be sustained without creating inflation pressures yet consistent with full-employment) as likely being in a range of +2.0% to +2.5%. In its long-term projections, the Federal Reserve sees the rate as 1.8%.

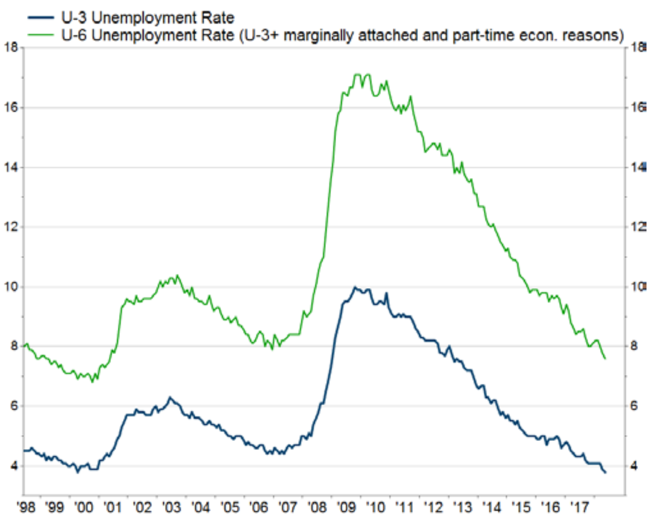
Demographic considerations (i.e., slower population growth and an aging population) are the primary factor behind the economy's slower growth potential. Fewer people simply means less people to buy goods and services as well as fewer people to produce them.



Source: U.S. Census Department, American Enterprise Investment Services Inc.

The job market is good – maybe too good.

The U.S. unemployment rate was 3.8% in May, according to the Labor Department. We maintain our forecast of a year-ending unemployment rate of 3.6%. If achieved, this would be the lowest unemployment rate seen in the U.S. in almost 50 years (1969).



Source: FactSet

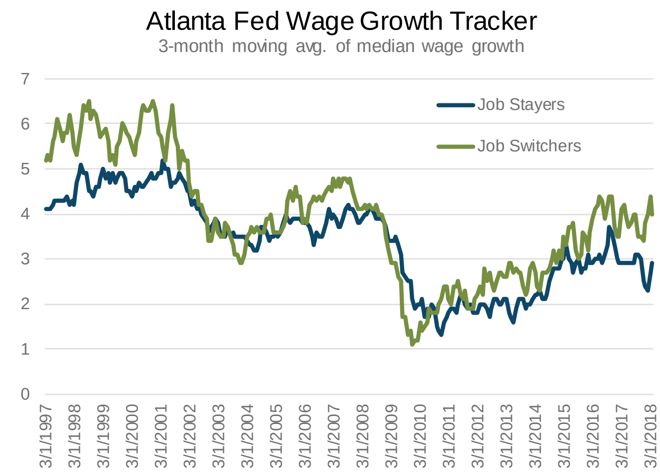
The pace of monthly job growth should slow primarily due to the simple fact that there are fewer people still on the sidelines available to be brought back into the job market. We forecast 1.9 million net new jobs will be created this year for a monthly average of about +158,000. Through the month of May, the average monthly gain in nonfarm payrolls has been 207,000, so ultimately our forecast may prove too conservative.

For comparison: there were 2.1 million net new jobs created in 2017 (+175k per month) while the unemployment rate ended the year at 4.1% from its 2016 year-ending level of 4.7%.

Wage and Salary growth. The ever-tightening job market has finally been producing better gains in wage and salary growth as well. In looking at certain measures, wage growth, or lack thereof, has been somewhat of a mystery over the last few years.

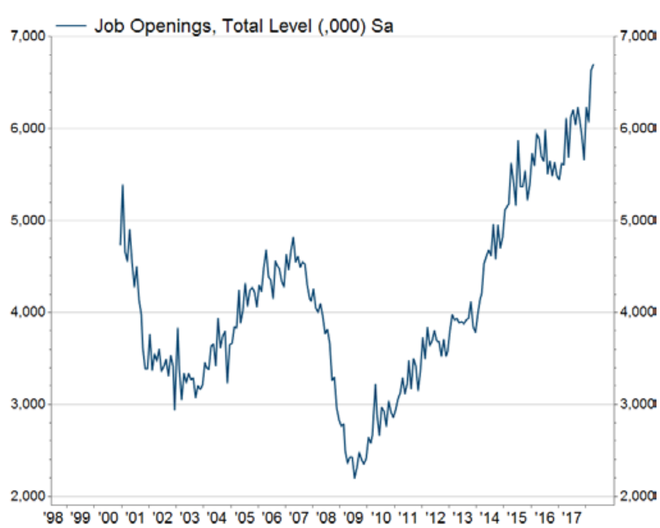
Steady declines in the unemployment rate should give workers the confidence to switch jobs, if they desire. Throughout this expansion, many workers appeared reluctant to switch jobs given the still fresh memory of the harsh job market conditions during the financial crisis.

This is an important issue as data from the Atlanta Fed shows that job switchers almost always see stronger wage gains. Recently, Labor Department data shows that the number of people switching jobs is accelerating – a trend that should further fatten consumer paychecks overall.



Source: Atlanta Federal Reserve Bank

Demand for additional hiring also remains strong. The labor Department's most recent Job Openings and Labor Turnover (JOLTs) report showed a record number of job openings across the American economy. In fact, for the first time since the Labor Department began the survey (Dec. 2000) there were more job openings (6.7 million) than there were people unemployed (6.3 million).

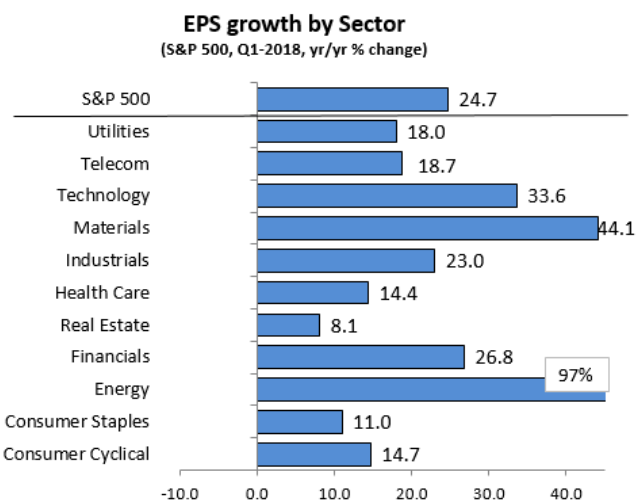


Source: FactSet

Corporate Profits: the bridge between the economy and equity markets.

Corporate profit performance was spectacular in the first quarter. Companies of the S&P 500 generated yr/yr earnings per share (EPS) growth of 25% on revenue growth of 8.5%. A record 77% of companies reported EPS results which exceeded analyst expectations, according to FactSet. Further, forward earnings estimates, which usually decline during an earnings release season, experienced notable expansion.

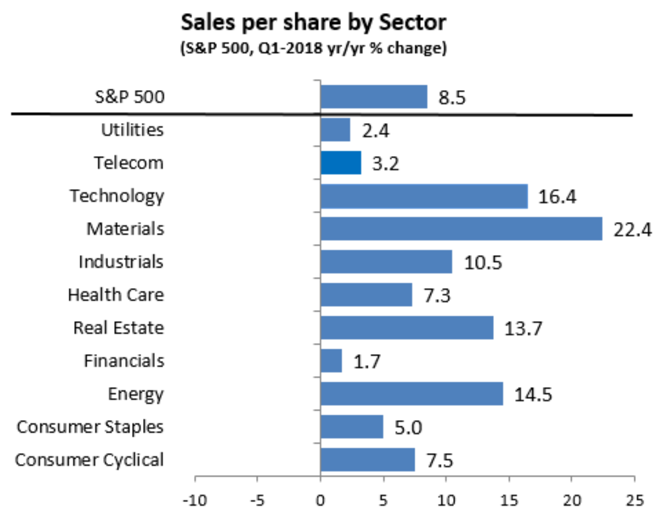
Much of the performance can be attributed to the tax cut legislation passed at the end of the year. It's impossible to dissect the exact tax cut influence, but we loosely estimate that about half of the EPS gain for S&P 500 was due to the lower tax rates. The influence of strong business conditions was evident in the strong revenue growth figure, given that revenues are unaffected by a lower tax rate.



Source: FactSet

Outlook: 2018 full-year expectations rose during the first quarter reporting season. Additional insight from management into the influence of lower tax rates, in combination with evidence of strong business conditions appeared as the primary drivers.

Consensus estimates as complied by FactSet current forecast full-year earnings growth of 21.0% for S&P 500 companies. Earnings growth for 2019 is current forecast at 9.4%.

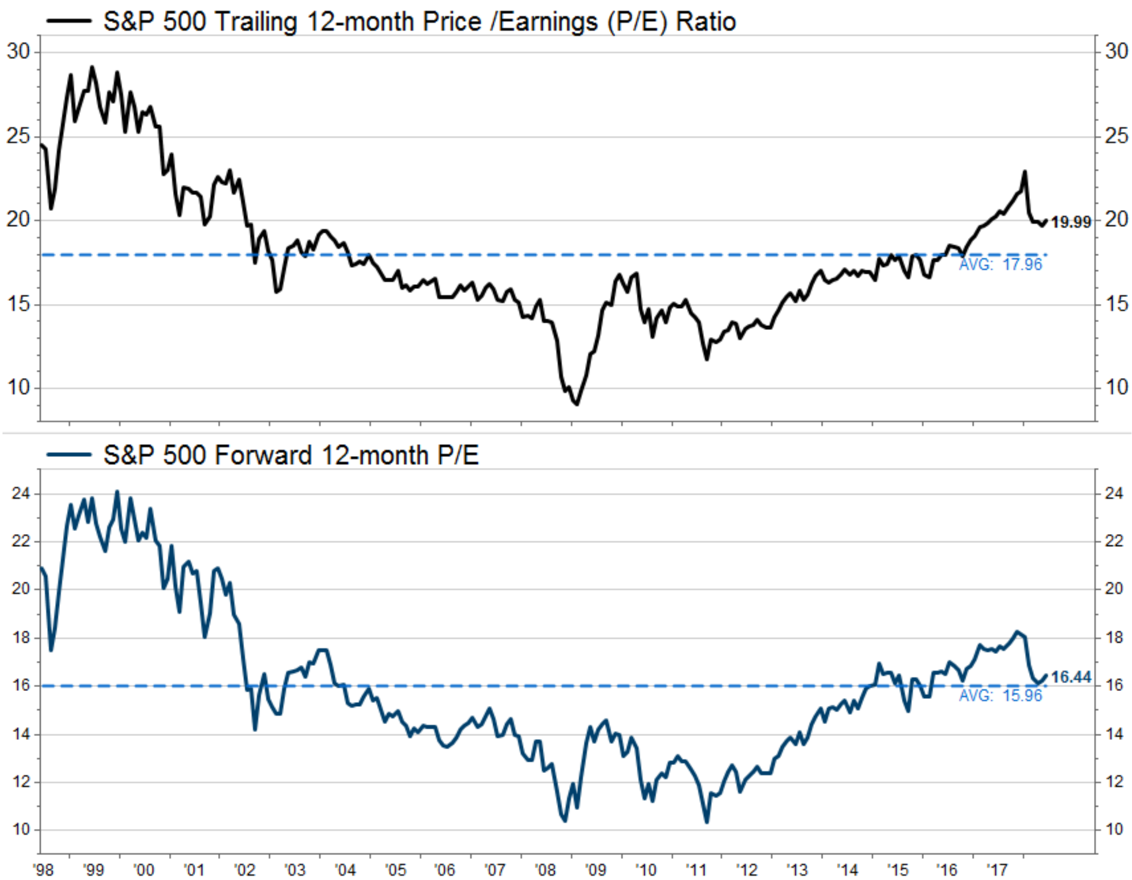


Source: FactSet

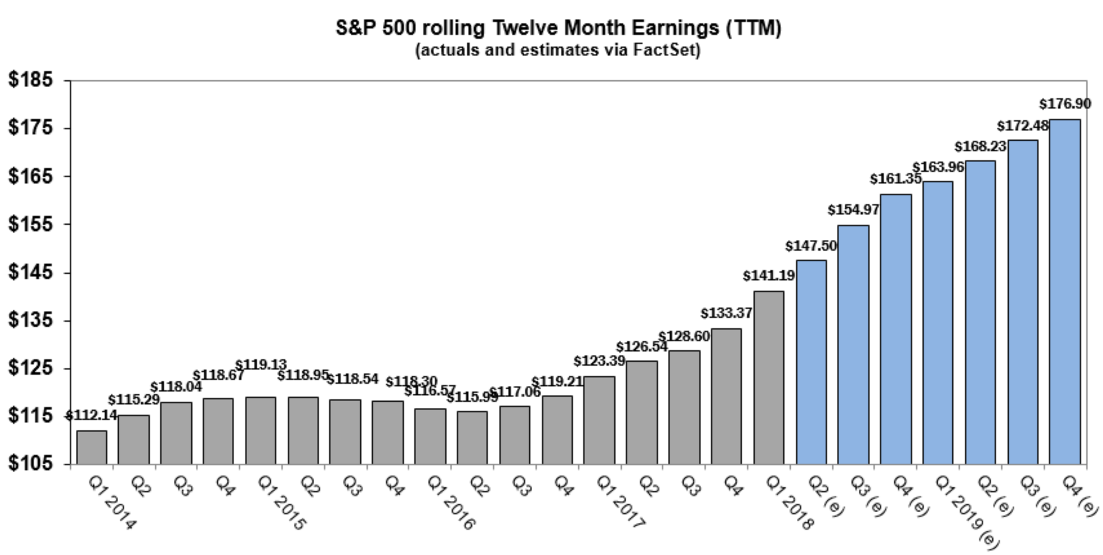
S&P 500 Earnings Estimates	2013	2014	2015	2016				2017				2018				2019
6/4/2018	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Est.	Est.	Est.	Est.
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Quarterly $$ amount				$27.11	$29.63	$31.43	$31.47	$30.86	$32.78	$33.49	$36.24	$38.68	$39.09	$40.96	$42.62	
change over last week																
yr/yr				-5.2%	-1.3%	3.8%	7.1%	13.8%	10.6%	6.6%	15.2%	25.3%	19%	22.3%	18%	
qtr/qtr				-8%	9%	6%	0%	-2%	6%	2%	8%	7%	1%	5%	4%	
Trailing 4 quarters $$	$111.41	$119.02	$118.67	$116.57	$116.24	$117.49	$119.64	$123.39	$126.54	$128.60	$133.37	$141.19	$147.50	$154.97	$161.35	$176.59
yr/yr	5.8%	6.8%	-0.3%				0.5%				11.5%				21.0%	9.4%
Implied P/E based on a S&P 500 level of: **2735**												19.4	18.5	17.6	17.0	15.5

Source: FactSet

<u>Valuation metrics have improved considerably, but are still elevated</u>. The strong earnings growth registered in Q1, combined with fairly flat stock prices, has resulted in a notable decline in market valuation metrics. Charts below are as of June 6.



Source: FactSet



Source: FactSet

Summary

Overall, we believe the U.S. economic outlook remains solid and the current period of expansion could continue for a few more years – absent negative developments on the key risk factors we discussed throughout this report. Most importantly, consumers and corporations both appear to be in sound financial condition.

However, conditions may be too good. The job market in particular, is close to being about as good as it can get and labor constraints are likely to weigh on the pace of growth within the next few quarters. Higher labor productivity (i.e. an increase in output per hour worked) can overcome labor constraints but this would require a material improvement in productivity trends.

Over the long-term, we believe three fundamental factors: demographics, government debt, and China, will have an outsized influence on the path of global economic activity and financial markets. Demographics across the industrial world reveal slower population growth and aging societies; this implies slower potential economic growth than has been experienced historically. Government borrowing needs, particularly here in the U.S., are high and about to go much higher over the next few decades. This is somewhat of a new dynamic for fixed income markets and it remains to be seen at what rates markets will clear. Meanwhile, China has become a major influence in the global economy over a very short-period of time. Chinese leadership has been very strategic in wielding its expanding power 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 in a messy way.

Risks

Though we have confidence in our forecast of a slower-than-desired, yet continuing, global recovery, we recognize that a number of serious economic and financial market challenges remain. Government debt loads remain exceptionally high in most of the world's developed economies. The hard choices associated with correcting these imbalances are likely to weigh on economic performance for some time; but allowing debt levels to continue higher would ultimately be much worse. Recent volatility in foreign market capital flows, as well as wide currency swings that correspond with such, are also an economic risk that bears careful watching.

Furthermore, we are still in unchartered territory in terms of potential policy response should the economic recovery falter. Monetary and fiscal policy, the traditional levers of stimulus employed to counter a downturn, are largely exhausted. Interest rates have very little room to go lower and government debts are already on an unsustainable path. Should another adverse global economic shock occur over the intermediate-term, there is little government officials could do to directly counteract the results.

Geopolitical risks (N. Korea, Syria, relations with China and Russia, most notably) are also more difficult than they have been in a long time. The impact of these issues on economic and financial market activity has been reasonably contained thus far, but tensions could easily evolve into much more serious problems. There always have been problems for the global economy /capital markets to deal with, and there always will be.

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As of March 31, 2018

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