Economic Perspectives
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Chief Economist
December 13, 2019

Outlook:
• We forecast **U.S. economic growth of +2.1% in 2020 and +2.0% in 2021.** Recession odds remain modestly elevated due to the combination of slow growth and external threats, but the most likely path is still one of continuing expansion, in our view.
• **Two factors appear to hold the greatest risk.** Despite recent suggestions of progress, the U.S. /China trade dispute holds considerable uncertainty with notable potential consequences. The harsh rhetoric and societal division of election-year politics could also strain U.S. economic sentiment. Handicapping the post-election policy landscape, however, likely holds more risk for financial markets than economic activity.

• **Consumers still in the driver’s seat.** Strong consumer fundamentals remain the U.S. economy’s key source of support, but consumer sentiment and spending could be susceptible to negative developments.

Despite periodic recession fears along the way, the U.S. economy is about to close out another year of economic expansion. In our estimation, the expansion is likely to live on in 2020 and 2021. Though we believe growth will remain slow relative to historical standards, the recent pace has been a successful formula for reaching full-employment yet keeping inflation pressures well-contained.

Strong U.S. consumer fundamentals remain the primary source of fuel for the expansion. Consumers represent 70% of U.S. economic activity, and quite unlike previous periods when the economy has been expanding for several years, consumer finances are in remarkably strong shape, in our view. In aggregate, consumers have simply not been outspending their means as they usually do during expansions, thus leaving their capacity to spend on a sound and sustainable path, in our view.

Reduced business investment spending, however, has slowed the pace of U.S. economic growth in recent quarters. We believe this has been a natural reaction to the material uncertainty contained in ongoing trade disputes. Recently, however, business investment has shown some tentative signs of bottoming. Our confidence in an actual bottom would increase materially should the recently revised North America Free Trade Agreement (NAFTA), now called the United States, Mexico, Canada Agreement (USMCA), were to be officially ratified. The prospects for which have improved significantly over recent weeks.

**Economic Outlook:** We have not changed our 2019 U.S. real GDP forecast since June, when we trimmed it to +2.2% from +2.4% due to adverse U.S. /China trade developments. Conversely, a 2-year federal budget deal passed in August turned a scheduled 2020 cut in government spending into an increase of about $50 billion over the next two years. This change took our 2020 Real GDP outlook from +1.6% to +2.1%.

![Ameriprise U.S. Real GDP Outlook](image)

Source: Actuals via the Commerce Department, forecasts via American Enterprise Investment Services, Inc.
Highlights of our 2020 outlook:

**Employment:** For 2020, we are forecasting net U.S. employment growth of 1.6 million (equating to average net payroll growth of +135,000 per month) and a year-ending unemployment rate of 3.3%.

The U.S. economy appears on pace to generate approximately 2.0 million net new jobs in 2019, and the unemployment rate in November was 3.5%. Our forecast of a deceleration in job growth over the year-ahead is largely reflective of fewer workers still on the sidelines, thus available to be hired.

**Inflation:** We forecast inflation to accelerate modestly in 2020 while remaining well-contained overall. The Consumer Price Index (CPI) was 2.1% higher year-over-year in November, while the Federal Reserve’s preferred inflation measure, the Core Personal Consumption Expenditure (PCE) Index, was +1.6% higher in October (November not yet available). The Core PCE excludes the influence of fluctuating food and energy prices.

We believe inflation pressures could see some further modest upside from tariffs on imported goods – primarily from China. We look for slowly rising labor costs and a possible rebound in transportation costs as likely factors as well. Overall, we are forecasting a full-year CPI rate of +2.1% for 2020 and a full-year Core PCE rate of +1.8%.

Inflation pressures have been weak throughout the current expansion. This runs contrary to the historical norm of inflation pressures rising in the later stages of economic expansions. There are two factors fueling the current pattern, in our view. First, consumers have not been outspending their means as they normally have during economic expansions. Second, demographic forces, namely slower population growth and aging societies, have been growing in influence for decades. Such dynamics typically result in moderating demand, thus limiting the price gains producers are able to implement (i.e., reducing inflation).

**Interest rates:** Much like our inflation forecast, we believe interest rates could drift slightly higher in 2020 but remain at levels conducive to ongoing economic expansion. Inflation is part of our reasoning for slightly higher interest rates given that lenders typically require a rate that at least covers such.

Interest rates could see a more pronounced increase if we see material progress toward a tangible trade agreement with China, but at this time we believe the prospects for a comprehensive agreement are low.
Consumer spending: Consumer spending is key to our outlook for a generally steady pace of economic growth over the intermediate-term. The sector is always vital to U.S. economic prospects, but its role is even more critical presently given a downshift in business investment spending over the last year.

As seen in the chart below, consumer activity has been a solid and consistent source of support to U.S. economic growth for the last several years.

In fact, aggregate consumer disposable income (which is generally after-tax income) was up $692 billion yr./yr. in the third quarter, according to the Commerce Department. Total consumer spending, meanwhile was up just $555 billion.

Think of consumers as a battery; are they charged-up and ready to provide energy to economic activity? Or are they run-down, saddled with a lot of debt, and thus needing a break to re-charge? We believe the consumer battery currently has a strong charge.

Consumers could always be scared into a pull-back in spending due to some outside event (adverse geopolitical developments, for example), but under their current fundamental circumstances they are quite unlikely to pull-back simply due to a lack of fuel (i.e., income or savings), in our view.

In fact, from 2011 through the of 2018, consumers spent just 84% of their total income gains. By comparison, during the economic expansion running from 2002 to 2008, consumers spent 105% of their income gains, and from 1992 to 2001, consumers spent 102%. In both instances, the difference was made up with debt.
The result of income growth being faster than that of spending has been a solid rise in the Personal Savings Rate. As shown below, the rate has recently been around 8%, a level not seen consistently since the early 1990’s.

Overall consumer debt burdens have also remained low, rather than the rise that is normally seen during expansions.

The Federal Reserve’s Financial Obligation Ratio (FOR) has long been our favorite measure of overall consumer indebtedness and overall financial health. The metric looks at the payments that we, as consumers, are required to make, against our disposable income. So rather than just looking at the dollar amount of debt, it looks at whether we, as consumers, can afford it.

As seen in the chart at the top of the next column, the ratio is currently very close to its all-time lows. In fact, it is even below the levels seen in the early 1980’s, a time when exceptionally high interest rates made borrowing very undesirable. (The yield on the 10-year Treasury averaged 13.9% in 1981).

Consumers have simply been much more conservative with their finances since the 2008 Financial Crisis. Despite a strong job market, rising incomes and near record-low interest rates, consumer attitudes have been shaped by the Great Recession much the same way that the Great Depression affected prior generations – just not to the same magnitude.
INTERNATIONAL PROSPECTS:

Internationally, we believe there is room for economic growth to improve modestly in 2020. The International Monetary Fund (IMF) currently projects global growth for 2020 of about +3.4%, versus its estimate for 2019 of +3.0% (a 10-year low).

Contributing to the improvement, growth is expected to accelerate modestly in Europe, and some Emerging Market economies are expected to see modest rebounds.

As seen in the table below, global growth slowed in 2019. The U.S. /China trade dispute has been a material constraint on growth, but so too has the uncertainty of both Brexit and the USMCA agreement.

Should the USMCA be finalized (which appears likely at the time of this writing) and the United Kingdom able to achieve a generally smooth exit from the European Union (the odds of which appear to be improving), we believe the IMF’s outlook for a moderate rebound in global growth may prove modestly conservative.

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Source: IMF World Economic Outlook Update, October 2019

CORPORATE PROFITS: the bridge between the economy and equity markets.

Over time, financial markets generally follow the path of underlying economic conditions. Intuitively, stronger economic growth should produce greater corporate sales, higher sales should produce better earnings, and higher earnings directly support the value of a company.

Over the last two years however, this relationship has gone awry. In 2018, S&P 500 companies reported earnings per share (EPS) growth of 23%, yet the S&P 500 Index was down 7.0% (on a price-only basis). This year, the S&P 500 is approximately 25% higher (at the time of this writing), despite corporate earnings that have been flat to slightly lower.

The fluctuation in earnings has been partially due to the temporary, yet significant, profit boost seen in 2018 from the tax cuts enacted at the end of 2017. This year, those tougher comparisons have combined with slower economic growth and lower commodity prices to weigh on results.

During such periods, we believe corporate sales results can often provide a cleaner view of business conditions. In the chart below, the bars represent the quarterly change in yr./yr. sales growth for S&P 500 companies. The green line, however, shows sales growth with the Energy and Materials sectors factored out. We factor out these sectors because simple changes in commodity prices can have a significant effect on sales in these sectors, which can distort the message of overall sales conditions.

As can be seen in the chart, this year sales growth ex-Energy and Materials has only been modestly below that of the S&P 500’s historical sales pace of about +6%. To us, this suggests that the sales environment has been sound, thus a rebound in EPS appears achievable and a rational expectation for the year ahead.

Source: FactSet American Enterprise Investment Services, Inc.
As we head into 2020, we believe financial markets and earnings prospects are generally in balance. In other words, we believe equity market results are likely to perform generally in-line with the performance of corporate earnings. Please see our most recent Quarterly Capital Markets Digest report for more on our outlook on financial markets.

**EPS Outlook for 2020:** Consensus estimates as compiled by FactSet currently suggest S&P 500 EPS as forecast to grow by approximately 9% in 2020. Estimates, however, have been falling at a steady pace throughout the year. As mentioned previously, there should be less drag going forward from commodity prices, but trade developments will remain a key variable as well.

A stronger U.S. dollar has also weighed on reported earnings over the first three quarters of 2019. A strong dollar can reduce demand for U.S. made products by making U.S. products more expensive for potential foreign customers. But a strong dollar can also have a negative impact on reported corporate sales and earnings as foreign generated results translate into fewer U.S. dollars for quarterly financial reporting purposes.

In 2018, the **value of the U.S. dollar** increased by approximately 7% on a trade-weighted basis, according to the Federal Reserve. The dollar strengthened a bit further over the course of 2019 but was just 1% higher year-to-date at the end of November. For 2020, we believe the trade-weighted dollar may see some modest depreciation, and we believe it may be flat to down about 4% on the year.
SUMMARY

Trade disputes remain a key threat to the economic outlook, but recent signs of progress relative to the USMCA agreement and Brexit have been encouraging. The ongoing U.S./China trade dispute, however, still offers significant uncertainty, but its impact on the U.S. economy has been less than feared thus far. We believe a “phase one” deal is achievable over the near-term, but it is very unlikely to address the key conflicts of the relationship.

Unlike a dispassionate evaluation of economic conditions, this issue basically comes down to a battle of wills between a select few individuals. In such cases, we believe the rational path (i.e., eventually coming to an agreement), will ultimately prevail as the economic consequences grow. In the last few months, U.S./China trade negotiations do not appear to be getting materially worse, but neither do they seem to be making tangible progress. As such, we believe the situation could still get worse before getting better, and for an adversarial relationship to remain a long-term problem.

Separately, the job market is also close to being about as good as it can get, and labor constraints are likely to weigh on the pace of growth going forward. 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 longer-term, we believe three fundamental factors: demographics, China, and government debt will have an outsized influence on 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 high and about to go much higher over the next few decades. 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. 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 expansion, 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 over-time; but allowing debt levels to continue significantly higher would ultimately be worse.

Furthermore, we are still in unchartered territory in terms of potential policy response should the economic expansion falter. Monetary and fiscal policy, the traditional levers of stimulus employed to counter a downturn, are largely exhausted. Interest rates have 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 (e.g., N. Korea, Syria, Venezuela, 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 restrained 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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