Economic Views Brief

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OPTIMISM DOMINATES THE 2018 OUTLOOK.

The U.S. economy appears set to enter 2018 with good momentum and solid fundamentals. Unemployment recently reached a 17-year low, while consumer confidence is at a 17-year high. Small business optimism also recently attained its highest level since 1986. Often when economic sentiment levels reach such highs, consumer and corporate debts are also rising. That is not necessarily the case this time. The dollar level of debt in many categories may be at an all-time high, but so is income, the level of economic activity, and population. Consumer debts in comparison to consumer income are actually quite manageable (please see chart on page 3) and delinquency rates, though rising a bit, remain well below historical norms.

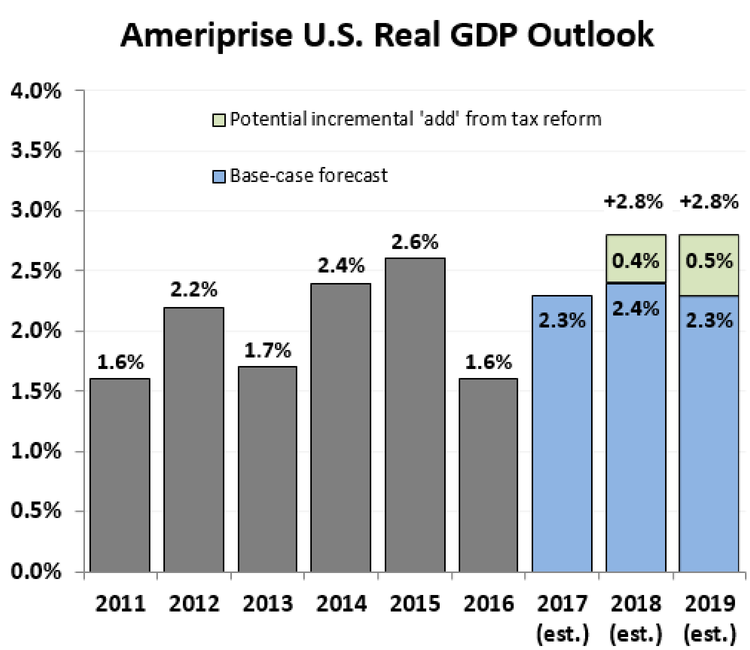
In nearly every sector of the economy, we see reason to be optimistic about the year ahead. However, that is not to say that the outlook does not offer risks. There always are risks and there always will be.

Aside from ever-present geopolitical risks, which are indeed elevated at the moment, we believe inflation and interest rates could hold the most prominent risk to the economic outlook. Trade disruptions could also threaten the pace of economic activity should North American Free Trade Agreement (NAFTA) negotiations turn sour or our trade relationship with China becomes more strained.

Sound fundamentals and rising confidence levels should enable U.S. economic growth to accelerate modestly, in 2018. However, we believe growth could see a more pronounced improvement should tax reform be achieved.

As the chart at right depicts, we see the U.S. economy as likely to grow by +2.4% in 2018 under our base-case projection, and +2.8% should tax reform be enacted.

At the time of this writing, tax reform legislation remains in conference committee with House and Senate leadership working out the differences between their two bills.



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

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Global economy finally running on all cylinders.

The global economy is also gaining traction. A broader base of growth adds support to intermediate-term economic prospects, in our view, as demand builds off a wider foundation. For the first time in nearly a decade, the Organization for Economic Cooperation and Development (OECD) recently noted that the 45 largest economies in the world are all in expansion mode.

The International Monetary Fund (IMF) forecasts global growth for 2018 at +3.7%, which would be the strongest pace in six years if achieved. We believe IMF projections would likely be revised modestly higher should U.S. tax reform legislation be achieved.

IMF Global Economic Projections

	Actual		Projections		*Difference from projections of 3-months ago.*	
	2015	2016	2017	2018	2017	2018
World	3.4	3.2	3.6	3.7	0.1	0.1
United States	2.6	1.6	2.2	2.3	0.1	0.2
Euro Region	2.0	1.8	2.1	1.9	0.2	0.2
Japan	1.1	1.0	1.5	0.7	0.2	0.1
Developing Asia	6.8	6.4	6.5	6.5	0.0	0.0
China	6.9	6.7	6.8	6.5	0.1	0.1
India	8.0	7.1	6.7	7.4	-0.5	-0.3
Russia	-2.8	-0.2	1.8	1.6	0.4	0.2
Brazil	-3.8	-3.6	0.7	1.5	0.4	0.2
Mexico	2.6	2.3	2.1	1.9	0.2	-0.1

Source: IMF World Economic Outlook Update October, 2017

Inflation in focus.

The U.S. economy could also over-heat somewhat if growth accelerates too much. At a time when labor markets are already tight, incremental acceleration - primarily stemming from tax reform, if enacted - could fuel a stronger pace of inflation. Should this occur, we believe Federal Reserve officials may be compelled to hike their ultra-short (over-night) bank lending rates (the fed funds rate) more often than the 3 hikes (of a 1/4 percentage point each) currently expected by financial markets (as measured by CME Group fed fund futures). A more aggressive Fed could weigh on economic and financial market prospects. Yet we would not expect modestly higher inflation or added Fed actions to foster a material deterioration of economic activity. In our opinion, consumer and corporate financial fundamentals are strong enough as to endure modestly higher rates.

Overall, we believe the most likely scenario is one in which inflation pressures rise modestly, yet remain generally well contained. Headline inflation will always be susceptible to non-economic fluctuations in energy and food commodity prices, but in our opinion, core inflation (consumer price changes minus food and energy costs) is likely to remain near, or below, the Federal Reserve's target range of about +2.0%. In October, the Fed's preferred inflation measure, the Core Personal Consumption Expenditure (PCE) Price Index, as published by the Commerce Department, was +1.4%. Nevertheless, core inflation is likely to see some incremental upward pressure from rising labor costs as the labor market further tightens. *The red-line in the chart at right depicts the Fed's preferred inflation measure, the Core PCE.*

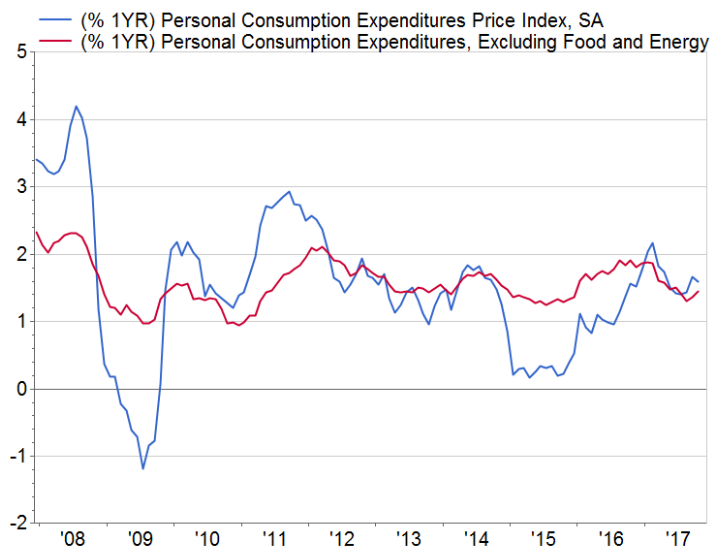

Chart Source: FactSet

Watch the dollar as well.

A weaker U.S. dollar (vis-à-vis other major global currencies), has been a nice tailwind for U.S. economic activity and corporate earnings in 2017. At the time of this writing, *The Wall Street Journal's* Dollar index is 6% lower year-to-date. U.S. produced goods and services generally become cheaper to potential foreign customers as the dollar's value declines. Corporate earnings can also benefit as foreign generated profits translate into more U.S. dollars when results are converted into dollars at the end of each quarter for financial reporting purposes.

Higher U.S. interest rates, relative to other major global market rates, could attract foreign money to the U.S. in the year-ahead, thus potentially pushing up the value of the dollar. A materially higher dollar could reverse the positive short-term trends noted above.

Consumers still in surprisingly good shape.

Consumers are always the most important component of any economic outlook as they account for 70% of total U.S. economic activity. Consumer spending has been growing at a solid pace over the last several quarters as their incomes have benefited from a strong job market and slowly improving wage growth. While wage gains have enabled consumer's <u>ability</u> to spend, recently rising confidence levels should bolster their <u>willingness</u>. In November, the Conference Board's Consumer Confidence Index hit its highest level since December 2000. As the labor market gets tighter, we believe individual wage growth should further improve, thus putting more money in consumer pockets, and providing the sector with a 'second wind.'

This late in an economic cycle consumers are usually deeper in debt. Historically, as we move further from an economic downturn, people become more comfortable with their own financial situation and become more optimistic about the outlook; consequently they often take on more debt. Indeed, the dollar value of most debt categories is at, or near, record highs. But so too are aggregate income levels and net worth.

As seen in the chart at right, the Federal Reserve's Financial Obligations Ratio, which measures consumer financial obligations relative to consumer disposable income, remains at relatively low levels. This metric, in combination with others, leads us to believe consumers in aggregate remain in sound financial condition.

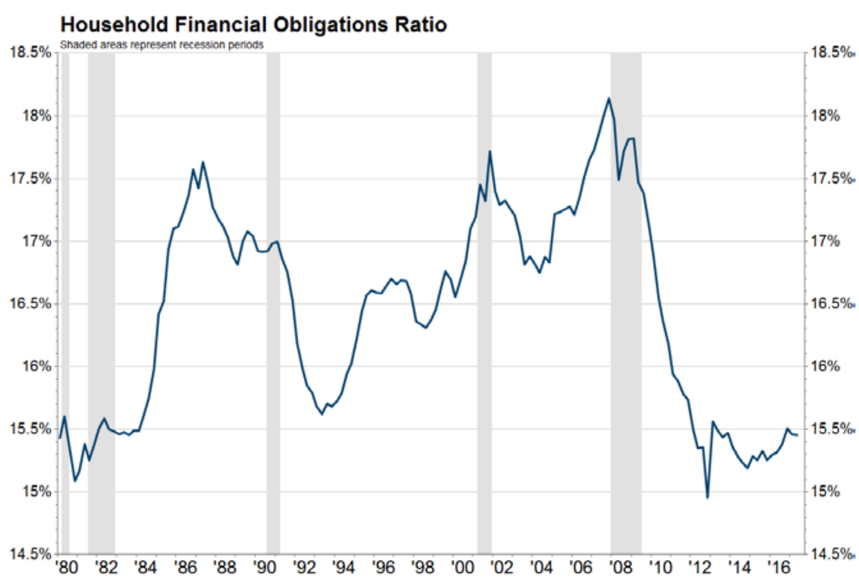

Chart Source: FactSet

Key metric forecasts for 2018:

Jobs: We expect the pace of job growth to slow as there are fewer people still on the sidelines available to be brought back into the market. We forecast 1.7 million net new jobs will be created in 2018 (a monthly average of about +142,000), and for the unemployment rate to end the year at 3.6%. **If achieved, this would be the lowest unemployment rate seen in the U.S. in almost 50 years (since 1969).** At the time of this writing, 2017 is on-pace to see 2.1 million net new jobs created (+171k per month) and we forecast the unemployment rate to end the year at about 4.0%.

Inflation: As we previously discussed, inflation pressures could slowly rise in 2018, but much depends on the outcome of tax reform. Over the next three years, we forecast the Consumer Price Index (CPI) to rise at an annual average pace of +2.0% to 2.25% with core rates of approximately 1.8% to 2.2%.

Interest rates: At the time of this writing, the 10-year Treasury security is yielding 2.38%. We believe the path of interest rates will also be heavily influenced by tax reform, but our base-case assumption is that the 10-year treasury rises to +2.7% by year-end 2018. From an economic perspective, however, we believe the odds are to the upside if tax reform is enacted.

Housing: Housing still enjoys strong demand supported by demographics, and availability remains tight. The supply of homes for sale in both new and existing home markets, as well as most geographies, is below historical averages. As such, we believe modestly higher interest rates, or a reduction in the tax deductibility of mortgage interest, could curtail some potential upside in the market, but conditions overall should remain quite healthy. In the third quarter of 2017, the Federal Housing Finance Agency's (FHFA) House Price Index (an estimate existing home prices nationwide) was 6.5% higher than year-ago levels. We believe, price appreciation could ease slightly in 2018, yet generally remain firm.

Corporate earnings: At the time of this writing, FactSet consensus estimates for 2018 S&P 500 earnings per share growth is at +11.0%. With one more quarter of earnings to go for 2017, analysts currently estimate S&P 500 companies will post 2017 year-over-year EPS growth of +10.3%. Given what we see as sound domestic economic fundamentals and improving growth prospects internationally, we believe 2018 earnings estimates appear achievable. However, as we mentioned previously, a higher U.S. dollar could act as a strong headwind to results and remains an issue to watch.

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