Economic Perspectives

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Recovery slows as inflation bites.

The U.S. economy lost some momentum in recent months primarily due to issues related to Delta-variant COVID-19 virus outbreaks domestically and around the world. Despite the moderation, intermediate-term growth is still expected to be strong relative to historical rates.

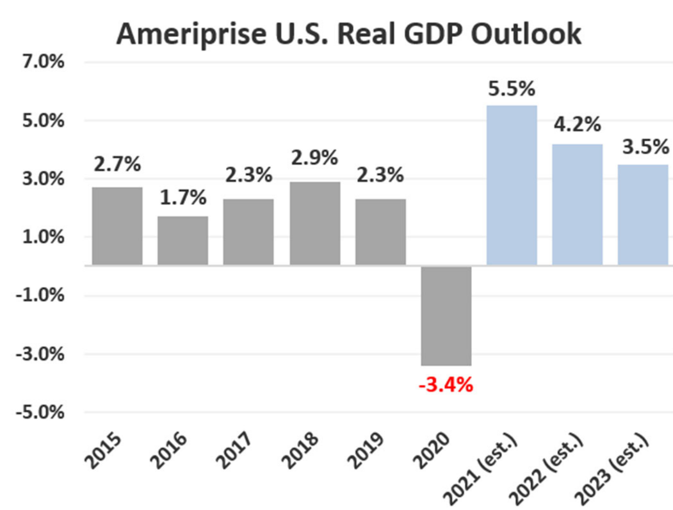
In our July *Economic Perspectives* report, we lowered our full-year real Gross Domestic Product (GDP) estimate to +6.0% from +6.5%. Recently, we lowered our full-year estimate again, this time taking it to +5.5%, and there could be additional downside ahead depending on COVID-19 developments. Additionally, we see much of the near-term impact because of the Delta-variant surge to be growth delayed rather than lost. Consumers still have the dollars to spend once virus conditions improve and availability problems fade. Virus conditions are likely to remain volatile, however, but we believe progress is clearly being achieved.

We believe at least some of the consumption subtracted from 2021 could likely be seen in 2022. As such, our forecast for 2022 has grown to +4.3% from a prior +4.0% and a pre-July estimate of +3.5%. Further, we now see real U.S. economic growth as likely to expand by +3.2% in 2023 versus our prior forecast of +2.5%. These estimates do not yet include any provision for added spending as is currently being debated in Washington.

Overall, U.S. economic growth is still likely to be strong this year but our estimate of just how strong has been moving lower. Supply constraints are lasting longer than we had anticipated and they may not improve materially until a much greater percentage of the global population is vaccinated or more fully protected from the worst of the COVID-19 virus.

Our Outlook:

- **Growth still limited by supply.** Consumer finances are in solid shape, in our view, but businesses and global supply chains have been caught off guard by the rebound. It may take several quarters for supply and demand to reattain a semblance of balance.
- **Inflation surges and remains a key risk.** Many goods and services are seeing higher prices as demand outstrips current supply. Through August, inflation has been stronger and broader than anticipated and year-over-year rates could go higher still, which could dent consumer and market sentiment.
- **Washington policy unknowns.** At the time of this writing, there remains a great deal of uncertainly relative to fiscal policy. A boost in infrastructure spending could aid growth but it could also add further upside and longevity to inflation pressures.



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

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In this report:

A look at both sides of the coin: The pandemic has created an imbalance between supply and demand like no other, a miss-match that's affecting the pace of recovery and the price of many goods and services.

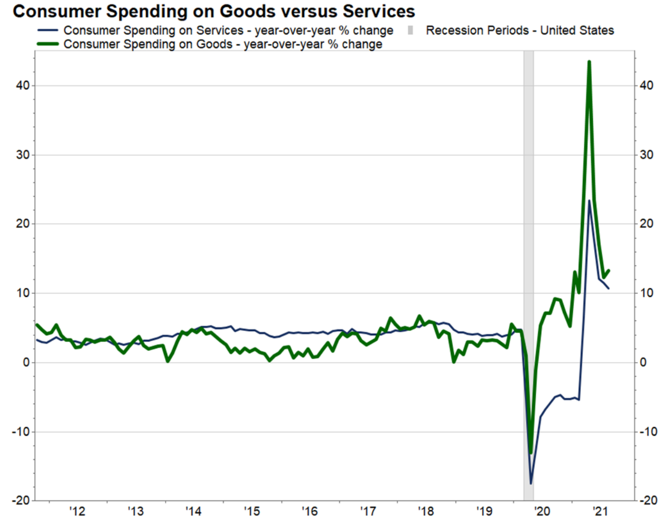
Historically, demand usually recovers at a modest but accelerating pace following an economic downturn. How long it takes to re-attain prior levels of activity usually depends on the depth of the downturn and the speed at which employment, consumer income and consumer confidence return. Supply is usually not an issue as business owners are typically incentivized to produce and sell their products or services to make a profit.

The current recovery barely resembles such historical norms. Although it was the only global downturn of the modern era initiated by a viral pandemic. Contrary to historical patterns, not only did consumer finances improve over the last year (with considerable help from the government) but consumers also entered the downturn in generally good financial health as well. Consumer's strong financial position has enabled a much quicker and stronger rebound in total demand.

The unusual circumstances of the downturn also led to a major shift in what consumers spent their money on. Not able to spend as they normally would on such services as vacations, sporting events, concerts, or restaurant meals, last year consumers shifted more of their spending to goods.

How much? In the two-years prior to the pandemic, consumers allocated a steady 31.0% of their total spending to goods, according to the Commerce Department. In the first year of the pandemic, (July 2020 through July 2021) goods captured 34.5% of consumer spending.

Measured differently, in the 15 months that followed the initial economic shutdown in April /May 2020, consumer spending on goods rose 15% while spending on services declined by 2%. *(See chart at top of next column.)* This caught manufacturers off guard. Demand for goods usually declines during an economic downturn and typically does so by a larger amount than services. Yet as demand for goods jumped over the last year, global production fell due to virus conditions.



Source: FactSet

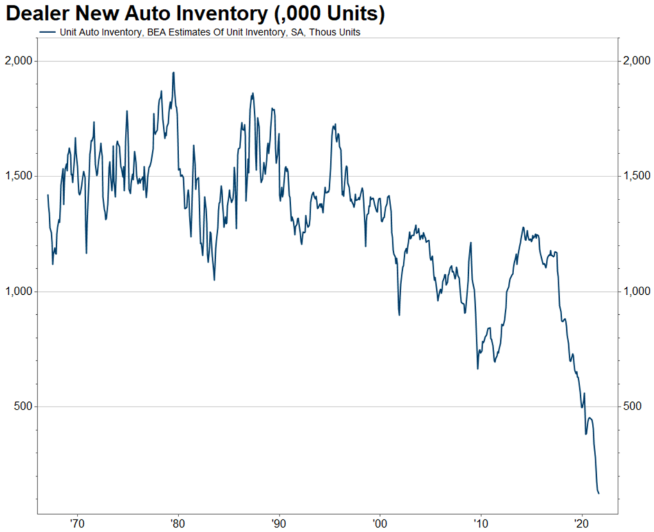
Inflation: This combination of surging demand for goods and slower production of the same has restrained the pace of recovery and spurred a significant jump in inflation.

The number of goods and services currently seeing higher prices seems much longer than the list of items that are not. Few items have added more upside pressure to inflation in recent months, however, than new and used autos. In the early months of the pandemic, auto production was shut down and the industry thought a protracted soft patch – as seen in prior downturns – would be likely. Most major manufacturers canceled orders for semiconductors, orders that were subsequently taken-up by the electronics industry. When auto demand turned out to be much more resilient than anticipated, the semiconductors were not available for the global auto industry's needs.

The resulting shortfall in auto production relative to demand created a significant shortage of vehicles for sale and much higher prices. In August, new car prices were a sharp 7.6% above year-ago levels, according to the Labor Department, while used car prices were a remarkable 32% higher.

It's easy to see why auto prices are so high when looking at dealer inventory. Between 2014 through 2019, U.S. auto dealers typically carried about 1.02 million new vehicles on their lots, according to the Bureau of Economic Analysis (BEA). In August, the number was just 125,000, or just 12.3% of the pre-pandemic norm. (See chart at top of next page.)

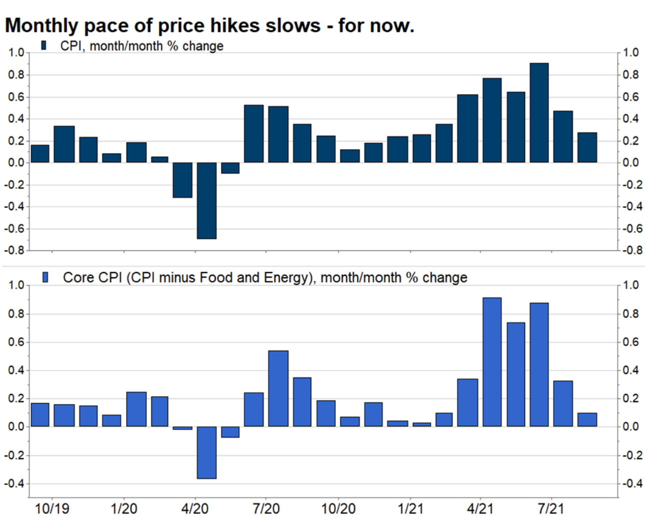
Semiconductor availability appears to have stabilized, but at levels still well below end demand. Some industry experts believe the global auto production volumes may not see a meaningful improvement until mid-2022 or later.



Source: FactSet

In the late spring /early summer, some services such as airfares, entertainment, and hotel stays experienced a jump in prices as workers in these areas returned more slowly than did customers. More recently, however, the COVID-19 Delta-variant outbreak caused some socialization concerns that softened demand for such services, thus easing prices somewhat.

Month-over-month price pressures easing: As seen below, price increases on a month-over-month basis have been easing. Though somewhat encouraging, we believe the pattern is unlikely to be fully sustainable and we look for this period of heightened inflation to persist for a few more quarters at least.



Source: FactSet

We believe year-over-year inflation rates are likely to move moderately higher by year-end due to accumulated gains. Additionally, some goods and services may see further upside price pressures for a prolonged period due to a variety of circumstances. In this regard, we're most concerned with housing costs, travel and leisure prices, energy prices, and the cost of shipping goods.

Wages have also been rising at a fast pace in recent months, primarily at the lower levels of the income-spectrum. Hourly workers, commonly those working at such places as grocery stores, manufacturers, retailers and restaurants, are seeing the best wage hikes. In August, wages for all hourly workers were up +4.1%, according to the Atlanta Federal Reserve Bank, their strongest pace since mid-2007. Wages in the Leisure and Hospitality sector, meanwhile, were a sharp 10.3% higher, according to the Labor Department.

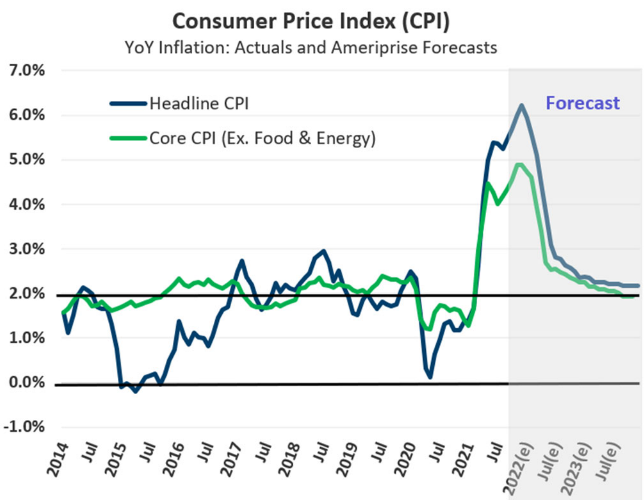
Higher hourly wages are certainly adding to inflation's near-term upside. But over time, the upward shift in wages at the lower end of the market (with some follow-on upward push to wages a segment or two above) should be good for the economy's longer-term health, in our view. The chart below shows hourly wages for the Leisure and Hospitality and Retail sectors as a % of total hourly wages, per the Labor Department.

Source: Labor Department and American Enterprise Investment Services, Inc.

At this time, we believe hourly wages could continue to see solid upside into next year at least. But this is very unlikely to be a sustained rate of appreciation – a factor that is most important relative to inflation implications. Additionally, the strong gains in worker productivity of the last few quarters (i.e., economic activity exceeded its pre-pandemic levels in Q2 despite there being 5.5 million fewer people employed) would be a clear benefit to economic conditions should these gains be maintained.

In August, the Consumer Price Index (CPI) was 5.2% above year-ago levels. Excluding the Food and Energy sectors, which can often be influenced by non-economic factors, the Index was up 4.0%.

Our Inflation Outlook: We believe inflation (as measured by headline CPI) could yet exceed +6.0% by year-end due to the accumulated effects of price increases already in place. We project Core CPI could see a few months close to +5.0%.



Source: FactSet

The Federal Reserve's preferred inflation measure, the Core Personal Consumption Expenditure (PCE) Price Index, typically reflects more moderate price changes relative to CPI due to technical factors. Nevertheless, the y/y Core PCE rate was +3.6% in August.

We currently believe the Federal Reserve could begin tapering its purchases of Treasury and mortgage-backed bonds over the next few months, but we see the Fed's reduced activity as already priced into Treasury yields at current levels. Our Chief Fixed Income Strategist, Brian Erickson, CFA, currently projects a year-end 10-year Treasury yield of approximately 1.5%.

Over time, we believe global supply/demand imbalances should largely work themselves out. In some product and service categories we believe there is already evidence of that occurring. However, until virus conditions are controlled globally, not just domestically, some product supply-chains may not get back to normal operating levels for some time. As we mentioned previously, we are most concerned about energy prices (natural gas especially), product shipping costs and housing over the next several quarters.

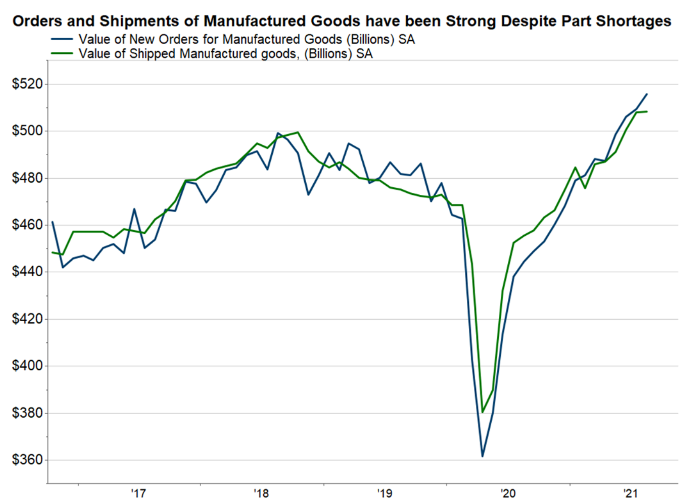
The Employment Picture: Through August there were still 5.3 million fewer jobs in the U.S. economy relative to February 2020. The unemployment rate was also nearly 2 percentage points higher (5.2% versus 3.5%) than its pre-pandemic level.

As is the case with many aspects of the recovery, the numbers are somewhat misleading. A broader examination of the data, or a simply monitoring of the demand for labor in local markets across the country, the job market is much tighter than the official numbers would suggest.

There is increasing evidence that many of the workers still "on the sidelines" since the pandemic arrived may not be coming back to the job market soon, or at all. Labor force participation amongst older age groups, including those over the traditional retirement age of 65, has declined and many of these people may have left the workforce permanently or at least wait for much safer conditions to return.

Overall, we currently project a 2021 year-ending unemployment rate of approximately 5.0% or slightly lower, and a 2022 year-ending rate of approximately 4.0% or less.

Manufacturing remains strong: Despite shortages of materials and parts, the U.S. manufacturing sector is still rebounding at a strong pace. The backlog of orders for manufactured goods suggests sustained expansion is likely as component availability improves. It could take a few years of above-trend production in the auto sector to re-attain its normal market conditions.

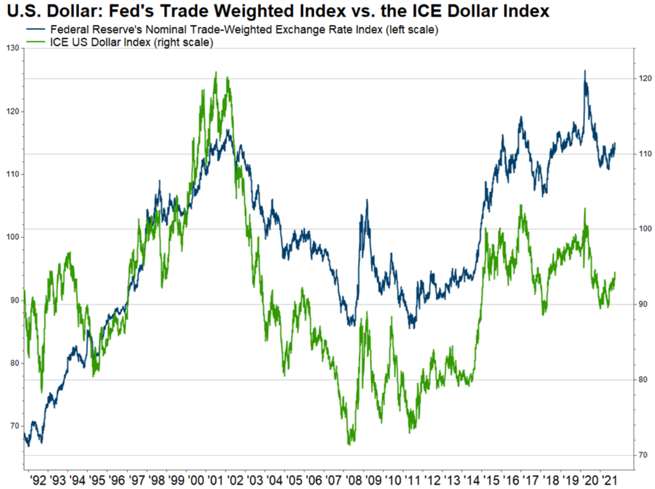


Source: FactSet

The U.S. Dollar: Coming into 2021, we had forecast the U.S. dollar (as measured by the Federal Reserve's Trade-Weighted Dollar Index), to decline by 4% to 8% in 2021. That projection was made prior to the passage of the two most recent federal stimulus bills. The added spending contained in those bills enhanced U.S. growth prospects, which created some incremental demand for dollars, all else remaining equal. We now see the U.S. dollar as likely to be fairly flat this year, with a projected range of +2.0% to -2.0%.

Through October 1st, the Fed's Trade-weighted Dollar Index is 2.8% higher year-to-date, according to FactSet. The ICE U.S. Dollar Index, which measures the dollar's value against a narrower subset of foreign currencies, is up 4.6%, according to FactSet.

U.S. Dollar: Fed's Trade Weighted Index vs. the ICE Dollar Index



Source: FactSet

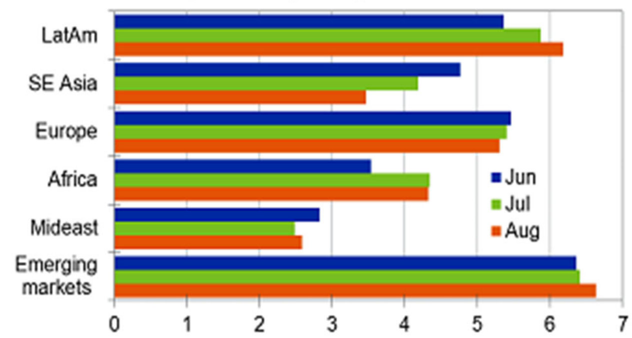
The international economic picture. Product shortages and delays caused by the COVID-19 Delta-variant outbreaks have been far from a U.S. story alone. Growth expectations for most areas of the globe have seen similar estimate cuts yet forecasts are still solidly positive – though varied.

As tracked by Moody's Analytics, economic growth forecasts for Latin America and Emerging Markets have been the only key regions to see estimates rise over the last four months.

Latin American countries have largely abandoned containment measures, thus allowing regional economy's the benefit from the underlying aggregate recovery. The approach could hardly be more different in SE Asia (where estimates have declined) as Vietnam, Malaysia and the Philippines have recently implemented shutdowns resulting in slower growth.

Interestingly, Moody's attributes upward revisions to GDP growth estimates for Brazil to also have boosted Emerging Market growth forecasts (Brazil is contained in both measures).

Real GDP, % change, 2021, by vintage



Source: Moody's Analytics

China: Growth in China has also been under pressure recently amid a bankruptcy for one of the country's largest property developers and energy shortages. We do not see the prospective bankruptcy for developer, Evergrande, to have lasting material implications. Though the company had debt of just over $300 billion, we believe authorities in China have more than adequate resources over their financial system to manage the situation.

Contagion influences should also be limited by the manageable amount of company debt owned outside of China. According to the Associate Press (AP), Evergrande recently had $18 billion of outstanding foreign currency bonds, but much of that is owned by banks in China and other domestic institutions, according to AP.

Separately, at the time of this writing, China and some other areas of the globe are seeing energy shortages and/or dealing with much higher energy prices. China has been experiencing rolling black-outs, according to CNBC. A major drought has curtailed much of the country's hydro-electric production. Self-imposed curbs on the importation of coal from Australia, its major source of electricity generation fuel and the country's primary supplier, has led to a growing shortage of coal used for electricity generation

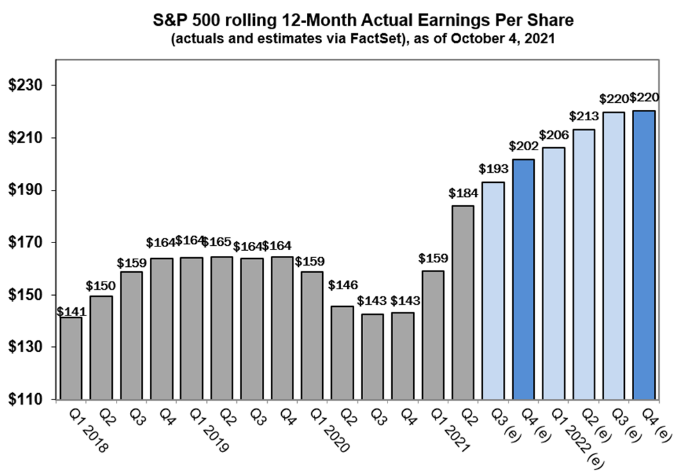
Energy supplies are also a concern in Europe. In the U.K., gasoline and other liquid fuels are in short supply. The shortage is being blamed primarily on a shortage of tanker truck drivers on account of Brexit. The government has called in Army reserve tanker drivers to get fuel to stations, but consumers are reportedly hording fuel as soon as it arrives.

On the continent, the concern is more centered on natural gas and electricity supplies ahead of the approaching winter. Europe receives much of its natural gas supply from Russia. Some have accused Russia of reducing its natural gas shipments to the region but apparently Russia is well within its contractual obligations.

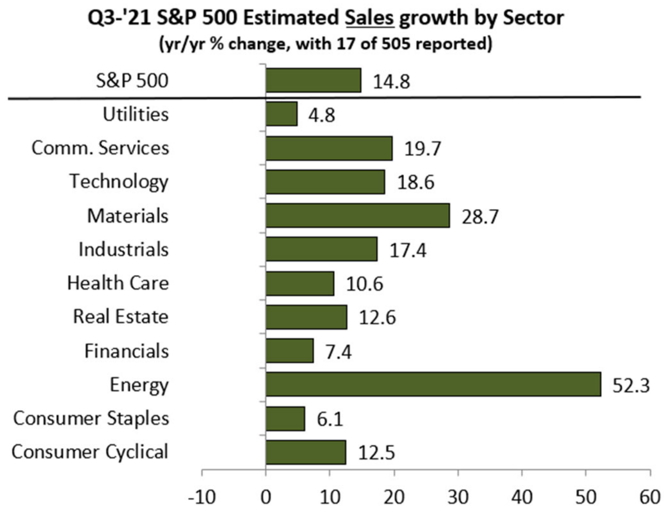
CORPORATE PROFITS: the bridge between the economy and equity markets. *(Note: Unless otherwise noted, all data cited below relative to corporate sales and earnings is sourced from FactSet and refers to the S&P 500.)*

S&P 500 companies reported strong corporate sales and earnings for the second quarter (Q2). Sales were up 23% y/y and up 11% from 2019 levels. Earnings per share (EPS), meanwhile, were up 87% y/y and 27% higher versus 2019 levels.

As of this writing, S&P 500 companies are expected to see strong results for Q3 as well. Q3 EPS are expected to be 27% higher y/y on a sales gain of 15%. The recent deceleration in global growth due to continuing COVID problems, however, has led to some pull-back in earnings estimates for the period. As shown in the table below, consensus S&P 500 estimates for the period of $48.91 are down about $0.43 from a month prior (August 30th).



Source: FactSet



Source: FactSet

Separately, the S&P 500's trailing Price to Earnings (P/E) ratio ended 2020 at a lofty 27.8. It continued to rise and hit a recent high of 29.7 at the end of April. Since then, it has eased to 27.6, according to FactSet. Our *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
10/4/2021	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Est.	Est.	Est.	Est.	Est.	Est.	Est.
				Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	FY
Quarterly $$ amount				$33.35	$28.25	$39.40	$42.30	$49.03	$52.80	$48.91	$51.06	$51.60	$54.57	$55.96	$57.69	
yr/yr				-14.0%	-32.1%	-6.7%	1.2%	47.0%	86.9%	24.1%	20.7%	5.2%	3.4%	14.4%	13.0%	
qtr/qtr				-20%	-15%	39%	7%	16%	8%	-7%	4%	1%	6%	3%	3%	
Trailing 4 quarters $$	$133.50	$164.05	$164.38	$158.93	$145.59	$142.78	$143.30	$158.98	$183.53	$193.04	$201.80	$204.37	$206.14	$213.19	$219.82	$238.66
yr/yr % change	11.6%	22.9%	0.2%				-12.8%				40.8%				8.9%	8.6%
Implied P/E based on a S&P 500 level of: **4326**									23.6	22.4	21.4	21.2	21.0	20.3	19.7	18.1

Source: FactSet

SUMMARY

We believe the “supply/demand” picture should slowly improve in the second half of the year and through 2022. Nevertheless, limited availability could likely push some consumer spending (i.e., economic activity) out of 2021 and into 2022 and beyond.

Washington: A key element of the outlook we failed to discuss in this report is the possible economic implications flowing from legislation currently under consideration on Capitol Hill. First, we believe the debt ceiling could be raised in a timely manner (just barely). *(Please see our recent Economic Views Brief report dated September 29th on this issue*.) We believe the two infrastructure bills are also likely to pass but with uncertain terms, scope or offsetting tax hikes. Net/net, however, the bills could likely add to intermediate-term economic growth, but if too large, the added spending could be largely offset by higher costs.

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. We believe consumer balance sheets are currently solid with relatively low aggregate debt-to-income ratios, strong home values, significant savings, and favorable financial market returns.

Over the longer-term, we still believe three fundamental factors: China, demographics, and global government debt could 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 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 intermediate to longer-term remains uncertain. The Federal Reserve, however, appears committed to keeping interest rates at economically supportive levels for the time being.

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.

Separately, China’s position in the global economy and the geopolitical sphere has grown considerably over the last 20 years. The government in China 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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