Economic Perspectives

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Evaluating recovery prospects.

The U.S. economy is in the midst of a significant contraction, brought about by the emergence of a potent global pandemic. Business activity has been intentionally curtailed in many areas, both domestically and internationally, as people naturally seek to avoid further transmission of a virus that holds considerable risk to human health.

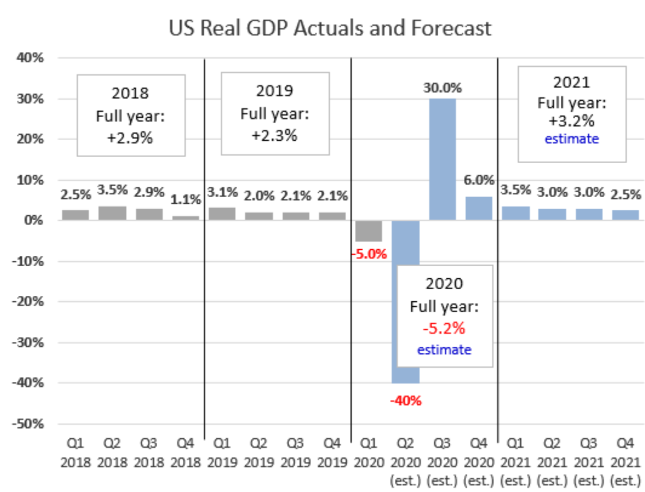
Given this backdrop, economic activity has downshifted significantly from its prior levels. At the time of this writing, however, many states are starting to lift their restrictions on business activity and personal movement. Many countries, particularly hard-hit European nations such as Italy, Spain and the U.K., have started the reopening process as well.

Financial markets have now turned their attention to the success or failure of these reopening efforts. The Federal Reserve and the federal government have done their part in providing historic levels of support during this period. Scientists and health care providers have likewise stepped-up to the challenge in heroic fashion. Antiviral medicines, therapies, and promising vaccines are being developed with unprecedented speed and effort. It's now time to test the reopening process as it will determine the timing and potential shape of the recovery that we all hope lies ahead.

As we move beyond this period of intentional pause, we believe the U.S. economy should experience a solid rebound in the second-half of the year. This would be unlike prior recoveries, but then, so too was the downturn. However, by year-end, we believe the U.S. economy is likely to still be about 5% to 6% smaller than it was when the year began. Additionally, after what we forecast could be a peak unemployment rate of just over 20% in May, we believe the rate could end the year at around 10% to 12%, a dramatic departure from the 50-year low of 3.5% as seen in February.

Our Outlook:

- We believe U.S. **Real GDP** will decline by historic proportions in Q2, followed by a solid, yet partial, rebound in the second half. We forecast the U.S. economy to end 2020 about 5% to 6% smaller than where it began the year.
- **The unemployment rate** should peak in May at just over 20% in our view and end 2020 in a range of 10%-12%. It may take until the end of 2022 to get back to a 'full employment' level of about 5%.
- **This time IS different:** Unlike conditions during the 2008 Financial Crisis, consumers entered this period in good financial condition and the banking system in solid health. Though neither can change the near-term "shelter-in-place" realties, they should provide strong support to recovery prospects on the other side.



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

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Recent Market Developments:

The stock market has understandably been on a rollercoaster ride this year. After starting the year with good momentum, the S&P 500 Index peaked at +4.8% (on a year-to-date, price-only basis) by February 19th.

About that time, however, new cases of the coronavirus began to proliferate here in the U.S. and in many other countries around the world. On March 11th, the world's worst fears were realized when the World Health Organization declared the coronavirus outbreak to be a global pandemic. By March 23rd, the S&P 500 was down 30.7% YTD, or about 34% below its peak just over a month prior.

Since its lows on March 23rd, however, the stock market has been meandering higher, although still with considerable volatility along the way. As of May 27th, the Index was just 6% lower YTD.

Four major factors seemed to lift investor sentiment since the market lows, in our view:

1. The Federal Reserve moved with unprecedented speed in delivering a massive amount of support for the financial system. Interest rates have been cut to near zero and Fed officials have pledged no limit on potential Treasury security purchases.
2. The federal government has also moved with remarkable speed in delivering unprecedented levels of economic support (despite today's sharp political divisions). Through May 14th, approximately $2.9 trillion in fiscal stimulus has been passed, equal to about 15% of U.S. GDP.
3. Trends related to the virus itself have also been slowly improving as most regions are reporting fewer new case volumes.
4. Generally favorable trends related to improving the outcomes for those that DO contract the virus. The development of antiviral pharmaceuticals, treatments, and vaccines are still a long-way from solving this problem, but tangible progress is being reported. The availability of testing supplies, for both the virus and bloodborne antibodies, is also improving, but is still a long way from where it needs to be.

Financial markets now need to see that economies can stand on their own as states and regions slowly start to re-open.

*Note: For more on the recent actions of the Federal Reserve and federal government, and their implications for the U.S. dollar, government debt, and inflation, please see our **Economic Views Brief** report as published May 12th.*

This is NOT a repeat of our grandparent's experience.

Economic measures covering this period will be simply awful. Real Gross Domestic Product (GDP) for the second quarter is very likely to see its largest decline in history (by a wide margin), job losses could reach 40 million (at least temporarily) and the unemployment rate could reach over 20%, in our view.

Such numbers need to be considered in the context of the uniqueness of the current situation, however. Many have made comparisons to the Great Depression. In our view, such comparisons are irresponsible, misleading, and often driven by a desire to instill fear or alarm.

There's no doubt that this is a very difficult situation. However, though some of the numbers may "match," we do not see the current experience as being comparable to the Great Depression. In the 1930's there was no unemployment insurance, not to mention social security or medical assistance programs. Nor was there FDIC insurance for bank deposits, leaving many people with nothing when their bank closed. Unfortunately for those that lived through the period, government policy in response to the situation also turned out to be a learning experience. Rather than offer support, government spending was reduced to better maintain the budget. An adolescent Federal Reserve (having been chartered in 1914) tightened policy as well.

Today, though its likely to take several quarters for economic activity to get back to where it was, we believe recovery prospects should see solid support from good underlying fundamentals.

Notably, consumer finances were strong when the pandemic hit, quite unlike the elevated consumer debt levels that normally precede economic downturns in the modern era. The U.S. banking system was, and is, also in good health. Although business and consumer bankruptcies are very likely to rise over the next several months, we believe they're unlikely to match the levels of 2008 /2009 recession. If they do, banks are in much better position to deal with the losses. New laws and regulations covering bank lending standards and raising bank reserve requirements were put in place or strengthened following the Financial Crisis.

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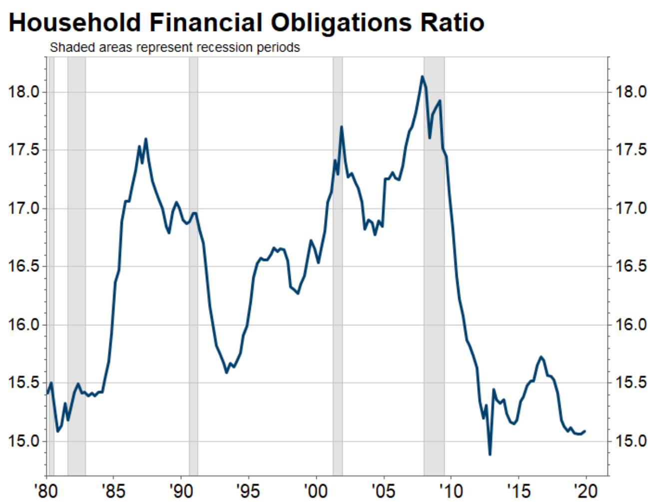
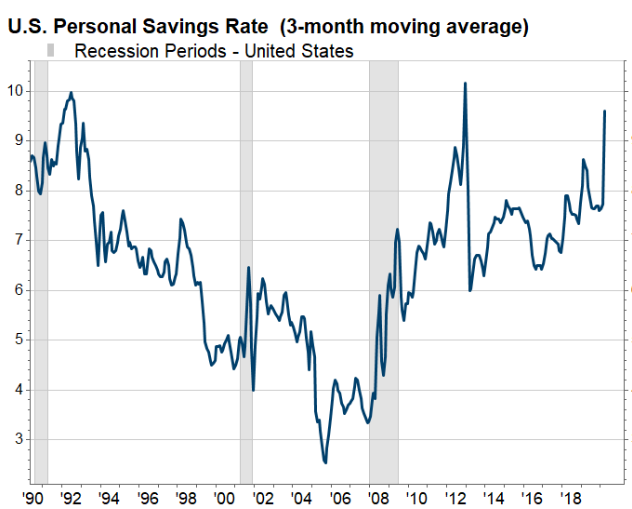
Consumers: Consumers entered this period in sound financial health. Since the Great Recession ended in mid-2009, consumer borrowing has been weak compared to past expansion periods. As a result, household debt relative to income was close to multidecade lows when the pandemic hit (see first chart below). Likewise, the personal savings rate, which usually goes down during economic expansions, has trended higher over the last decade and was recently at levels not seen since the early 1990's (see second chart below).

The Federal Reserve's Financial Obligations Ratio (FOR) has long been our favorite measure of consumer financial health. The ratio simply looks at required consumer payments, such as mortgage or rent, credit card, auto or personal loan payments, as well as property taxes, student loans and a few others. It measures these obligations in a very logical manner, against aggregate consumer income. Through the end of 2019, the ratio was very close to its all-time lows.



Source: FactSet



Source: FactSet

This backdrop is diametrically opposed to the very elevated debt levels that consumers held ahead of the Financial Crisis and nearly every other economic downturn of the modern era. While massive job losses will certainty alter this picture, the fact that aggregate debt burdens entered the period at relatively low levels should provide support for recovery prospects and could shorten the duration of the downturn relative to other periods that also had to work-down elevated consumer debts.

Additionally, over the intermediate-term, aggregate consumer income is experiencing strong support from expanded government benefit programs. Under the $2.0 trillion CARES Act, passed at the end of March, adults (those earning less than $75,000/year when working) will receive a one-time stimulus payment of $1,200. Unlike the stimulus payments provided during the last two recessions, these payments will go to social security recipients as well.

Laid-off workers will also receive a strong, temporary boost. Under the CARES Act, the federal government is providing an extra $600 per week in unemployment benefits (incremental to state payments). Unemployment benefits vary by state in terms of amount and duration. The average maximum benefit is currently $478 per week, according to the Labor Department, and the average weekly payment at the end of 2019 was $372, according to the *New York Times*.

The additional $600 as provided under the CARES Act would lift the average maximum benefit to $1,078/week, equal to an annualized rate of $56,056. Though not everyone is eligible for the maximum, this is higher than the median weekly earnings workers were receiving in 41 states pre-pandemic. The expanded benefits run until July 31st under the Act.

Given these support programs, aggregate consumer income should decline much less than consumer spending, at least over the next few months. In turn, this dynamic should give consumers the monetary fuel they need to re-stimulate activity as the economy reopens and the recovery begins. To wit, we only have one month's data to reflect this pattern, but in March, total consumer income dropped 2.0% relative to February levels, while total spending was down a much sharper 7.5%.

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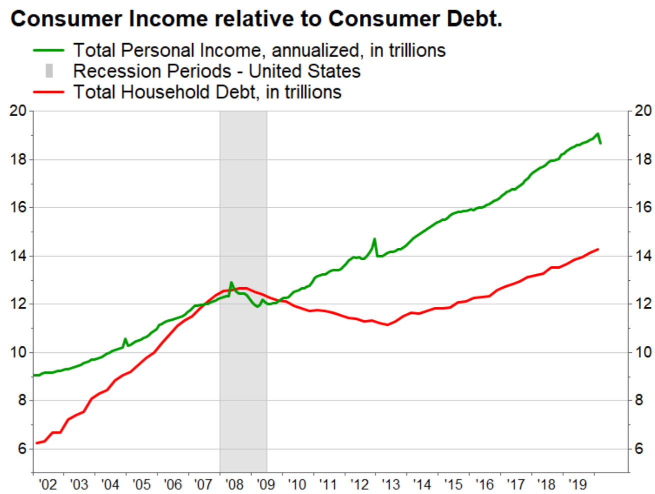
Consumers have simply been much more conservative with their finances since the 2008 Financial Crisis. Despite a strong job market, rising incomes and near record-low interest rates, consumer financial attitudes have been shaped by the Great Recession much the same way that the Great Depression affected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

From 2010 through the end of 2019, consumers spent only 75% of their income gains, based on Commerce Department data. 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.

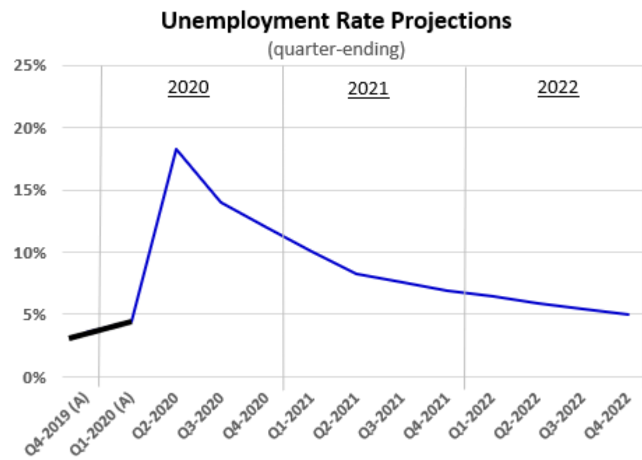


Source: FactSet

Employment: The unemployment rate was at a 50-year low of 3.5% in February, according to the Labor Department. The rate jumped to 4.4% in March and 14.7% in April. Labor Department officials further noted at the time of the April report that the rate would have been about 5% higher if not for a technicality in the manner in which the number is calculated.

We believe the unemployment rate should peak in May at around 21% (to be released June 5th). Thereafter, we believe the rate should slowly decline as business activity slowly resumes. By year-end, we believe the rate is still likely to be in a range of 10% to 12%, with another year likely needed to get it down to a range of about 6% to 8% and eventually near 5% in the second half of 2022.

Through mid-May, nearly 39 million people had signed up for unemployment insurance over the preceding two months. Unfortunately, it will simply take a lot more time to re-hire than it did to fire.



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

Housing: The sharp drop in home values experienced during the last recession is still fresh in the minds of many. We believe the housing market is very unlikely to experience a material decline in value in the current downturn.

At the end of 2007, there was a glut of housing in the U.S. Excessive building had resulted from speculative demand caused by lax bank lending standards. By contrast, the U.S. housing market is currently constrained by very tight availability. In February, the existing home market held just 3.1 months' supply of homes available for sale versus the 6.0 months that has traditionally reflected a balanced market. Additionally, data from the Census Department recently showed Q1 housing vacancy rates (for both owner-occupied units and rentals) were close to record lows, and generally at levels not seen since the early 1980s.

Fannie Mae, the government-sponsored mortgage guarantee provider, recently updated its U.S. housing market forecast to account for the pandemic. Fannie now forecasts:

- Existing home sales to be down about 15% in 2020 and new home sales down about 12% (reflective of the curtailment of new building activity).
- Existing home prices, meanwhile, are expected to be about flat on the year, as compared to Fannie Mae's pre-Covid-19 forecast for median prices to be up 4.6% on the year.

We generally concur with Fannie's outlook and we note that their current economic projections are somewhat similar to our own. The organization forecasts U.S. real GDP to fall by 3.1% in 2020 versus our estimate of a 5.2% decline.

INTERNATIONAL CONDITIONS & PROSPECTS:

In its April *World Economic Outlook* update report, forecasters at the International Monetary Fund (IMF) cut their forecast for 2020 global growth sharply in reflection of the coronavirus' impact on global activity.

In January, the IMF had forecast 2020 global growth of +3.3%, with U.S. real growth estimated at +2.0%. As seen in the table below, IMF forecasters now look for global economic activity to be down approximately 3.0% this year as estimates for every region of the globe were cut sharply. By comparison, the world economy declined by just 0.7% in 2009, the worst year of the global Financial Crisis, according to the IMF.

During the Great Recession, significant downturns in many developed economies were partially offset by huge stimulus actions taken by China. China's aggregate debt levels at the time were much smaller than they are today, and its economy was also smaller, making its stimulus spending more effective. Given the circumstances, nearly every country that can, is providing government stimulus, but it won't be enough to fully offset the intentional curtailment of activity during the outbreak period, in our view.

For the U.S., IMF forecasters currently expect U.S. real GDP to decline by 5.9% this year versus our estimate of a 5.2% decline. Recently, the Congressional Budget Office (CBO) projected real U.S. economic activity would decline by 5.6% in 2020.

IMF Global Economic Projections

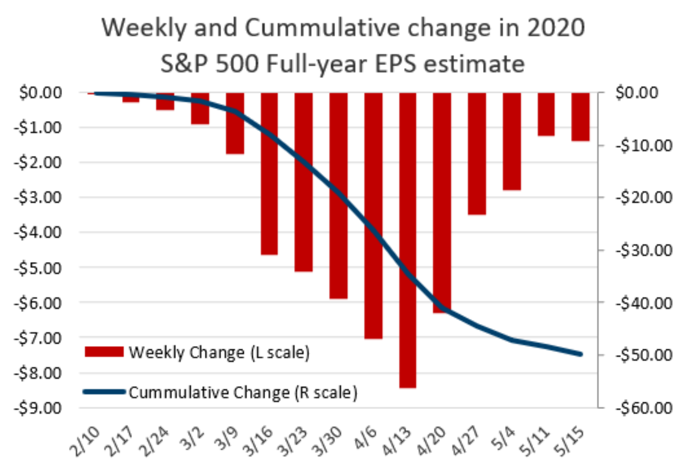
	Actuals			Projections		*Difference from January projections.*	
	2017	**2018**	**2019**	**2020**	**2021**	**2020**	**2021**
World	**3.8**	**3.6**	**2.9**	**-3.0**	**5.8**	**-6.3**	**2.4**
United States	2.2	2.9	2.3	-5.9	4.7	-7.9	3.0
Euro Region	2.4	1.9	1.2	-7.5	4.7	-8.8	3.3
Japan	1.9	0.3	0.7	-5.2	3.0	-5.9	2.5
Developing Asia	6.6	6.4	5.5	1.0	8.5	-4.8	2.6
China	6.8	6.6	6.1	1.2	9.2	-4.8	3.4
India	7.2	6.8	4.2	1.9	7.4	-3.9	0.9
Russia	1.6	2.3	1.3	-5.5	3.5	-7.4	1.5
Brazil	1.1	1.3	1.1	-5.3	2.9	-7.5	0.6
Mexico	2.1	2.1	-0.1	-6.6	3.0	-7.6	1.4

Source: IMF World Economic Outlook Update, April 2020

CORPORATE PROFITS: the bridge between the economy and equity markets. *(Note: unless otherwise noted, all actual and estimated sales and earnings cited below are sourced from FactSet.)*

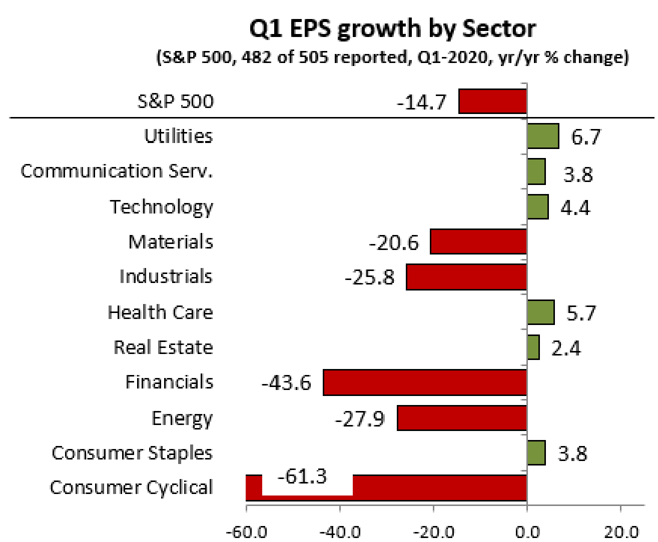
On January 6th, S&P 500 companies were projected to generate aggregate earnings per share (EPS) of $177.30 for 2020, representing an approximate 8% increase over 2019 earnings of $164.38.

Earnings estimates have been falling fast over the last three months in reflection of the pandemic. At the time of this writing, S&P 500 consensus estimates currently stand at $125.91, equating to a 23% yr/yr decline from 2019 levels. The pace of estimate cuts has been slowing in recent weeks, but we believe forecasts still have some downside.



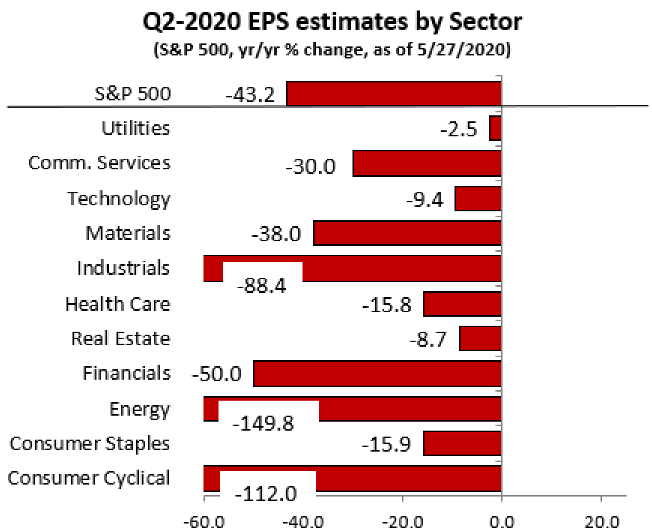
Source: FactSet and American Enterprise Investment Services Inc.

Though the pandemic declaration was only in effect for about three weeks of the first quarter, it had a dramatic negative impact on corporate financial results.



Source: FactSet

Many companies have suspended their sales and earnings guidance given the high level of uncertainty associated with the current situation. S&P 500 consensus EPS estimates for Q2 currently look for aggregate EPS of $23.74 (see table below), equating to a 43% decline versus year-ago levels. Sales, meanwhile, are forecast to decline 11.3% yr/yr (see table at right).



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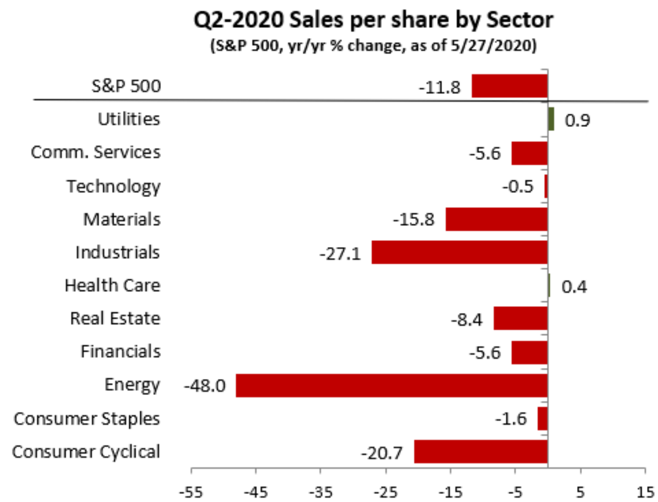


Source: FactSet

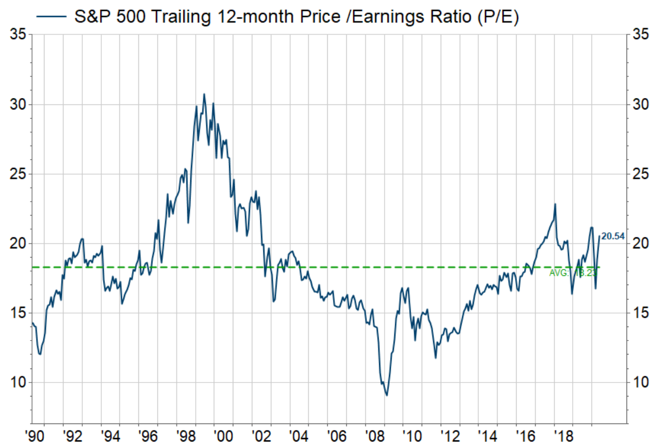
As we mentioned on page 2, equity markets have recently been looking beyond the current circumstances to the promise of a return to normalcy. Medical advancements have been remarkable and encouraging in many respects, but the combination of falling corporate earnings expectations and higher stock prices has resulted in rising equity market valuation multiples (see chart at top of next page).

Time will tell if the medical advances live up to their promise. But today's ultra-low interest rate environment should also be considered in determining if stock prices have become over-extended in the current situation. Lower interest rates naturally support higher equity market multiples based on the relative attractiveness of stocks versus bonds. Lower interest rates also boost present value calculations for any asset when discounting future earnings. Here too, time will tell if investors recent optimism is warranted. *Please see our most recent Quarterly Capital Markets Digest (as published 4/30/2020) for more on our financial market outlook.*

S&P 500 Earnings Estimates	2015	2016	2017	2018	2019				2020				2021				2022
As of: 5/26/2020	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Actual	Est.	Est.	Est.	Est.	Est.	Est.	Est.	Est.
					Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Full
Quarterly $$ amount					$38.80	$41.59	$42.21	$41.78	$33.35	$23.74	$32.04	$36.78	$37.65	$39.09	$42.89	$45.34	Year
yr/yr					0.2%	1.1%	-1.6%	1.1%	-14.0%	-42.9%	-24.1%	-12.0%	-14.0%	-42.9%	-24.1%	-12.0%	
qtr/qtr					-6%	7%	1%	-1%	-20%	-29%	35%	15%	-20%	-29%	35%	15%	
Trailing 4 quarters $$	$118.67	$119.64	$133.50	$164.05	$164.13	$164.59	$163.92	$164.38	$158.93	$141.08	$130.91	$125.91	$130.21	$145.56	$156.41	$164.97	$187.09
yr/yr	-0.3%	0.8%	11.6%	22.9%				0.2%				-23.4%				31.0%	13.4%
Implied **P/E** based on a S&P 500 level of: 2955									18.6	20.9	22.6	23.5	22.7	20.3	18.9	17.9	15.8

Source: FactSet

Valuation:



Source: FactSet

SUMMARY

At the time of this writing, restrictions on activity are being lifted and the recovery process is slowly beginning in many areas. Initial results, though early, have been somewhat encouraging, in our view. New virus cases have gone up in some areas, but not as much as many had feared. Employment levels are also recovering. In the week-ending May 23rd, the number of people still on unemployment benefits dropped by almost 4 million, to 21.05 million from 24.91 million, according to the Labor Department.

Nevertheless, the outlook still offers a great deal of uncertainty. Rather than looking at financial relationships and potential developments that normally direct our outlook, the next several months at least are likely to remain highly dependent on virus-related risks and medical advances aimed at containing such.

However, we believe the following aspects support the outlook for a solid recovery in the months ahead:

- Activity during this period was intentionally curtailed rather than the result of deteriorating fundamentals.
- Unlike the Great Recession, the banking /financial system is in good health in our view, and well supported by central bank and government actions.
- We believe consumer balance sheets were also remarkably healthy coming into this period, a position that should provide solid support to the recovery as it develops.
- Medical progress toward containing the negative effects of the virus have been remarkable. Though we are a long way from an effective vaccine or antiviral treatments, we believe recent developments have been encouraging.

However, tensions between the U.S. and China have also been growing more prominent. Left unresolved, such tensions could easily offer another layer of adverse economic pressure lasting well beyond the pandemic period.

Over the longer-term, we still 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, which could create more serious instability.

RISKS

The current outlook offers significant 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; but allowing debt levels to continue significantly higher would ultimately be worse.

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 have always been problems for the global economy /capital markets to deal with, and there always will be.

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