Economic Perspectives

An Ameriprise Investment Research Group publication

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Will the economy finally downshift in Q4?

Economic growth looks to have surged in the third quarter amid strong consumer demand and solid contributions from most other sectors of the economy. Since our last report in late July, our estimate of Q3 real Gross Domestic Product (GDP) growth has risen dramatically. We currently forecast Q3 real GDP growth at +4.2%. In our *Economic Perspectives* report of July 14th, we estimated a 0.6% decline.

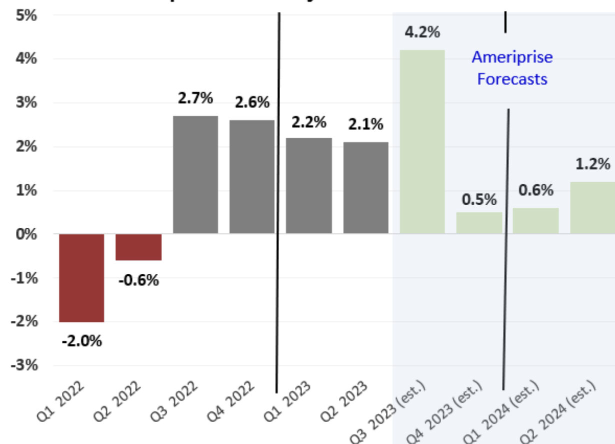
What changed? At nearly all levels, the economy has held up better than expected. But the greatest upside influence has been consumer spending. Notably, the resumption of required student loan repayments originally projected to begin in Q3 was subsequentially pushed out to October (Q4) by the Biden Administration. Additionally, consumers' access to "excess savings", built-up during the pandemic, has proven more resilient than anticipated.

We now look for activity to downshift in Q4 as consumers finally face greater headwinds. We believe the resumption of student loan repayments, higher gasoline prices and a further draw-down of excess savings should result in a slower, albeit positive, pace of consumer spending over the intermediate-term.

In this quarter's report, we focus on what we believe are the two most important considerations relative to the path forward: inflation and consumer financial health. In our view, inflation remains THE key to both intermediate term economic activity and financial market results. Simply put, sharply higher interest rates would not be pressuring economic activity and financial market sentiment if not for the elevated inflation backdrop. Fortunately, we believe core inflation trends have been encouraging and should remain so. Separately, we believe consumer balance sheets remain in good health and thus capable of supporting economic activity over the intermediate term (though at a slower pace).

Our Outlook

- **Q3 much better than expected.** As with first-half results, U.S. economic growth in Q3 is likely to be much stronger than previously forecast.
- **Key: inflation on an optimism-inducing path.** Core inflation continued to decelerate in August, but just as importantly CPI's "shelter" component is easing at a steady rate.
- **Headwinds still loom.** The resumption of student loan repayments should slow consumer spending in Q4 while small and medium-sized business are likely to see growing pressure from refinancing loans at much higher rates.
- **Corporate profits return to positive growth.** S&P 500 earnings projected to show y/y gains in Q4, but positive results could come in Q3.



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

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Inflation remains THE issue.

In our view, inflation remains critical to intermediate-term economic and financial market performance. Inflation directly reduces consumer purchasing power and its path will heavily influence the direction of interest rates. Interest rates have a direct inverse relationship to equity market valuations.

Fortunately, considerable progress has been made on the inflation front this year. Consumer prices, as measured by the Labor Department's Consumer Price Index (CPI), reached a 3-year low of +3.0% in June. However, since that time, rising energy prices have lifted the rate to +3.7% through August.

Nevertheless, the more important core inflation rate (which excludes food and energy costs) continues to decline steadily. In August, core CPI was up 4.3% year-over-year, its slowest pace since August 2021.

"Shelter" has been a key driver of inflation over the last two years and it remains the dominant issue relative to the path forward. The component accounts for nearly 35% of headline CPI and nearly 44% of the core rate. Costs in the segment are primarily measured in terms of housing rental rates. As seen in the chart below, shelter costs peaked at +8.2% y/y in March of this year but have since moderated to +7.3% thru August. We believe this moderation trend can continue as monthly price changes have been easing.

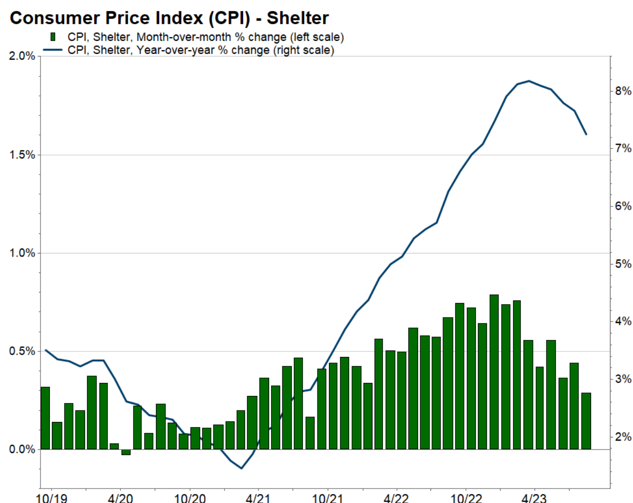
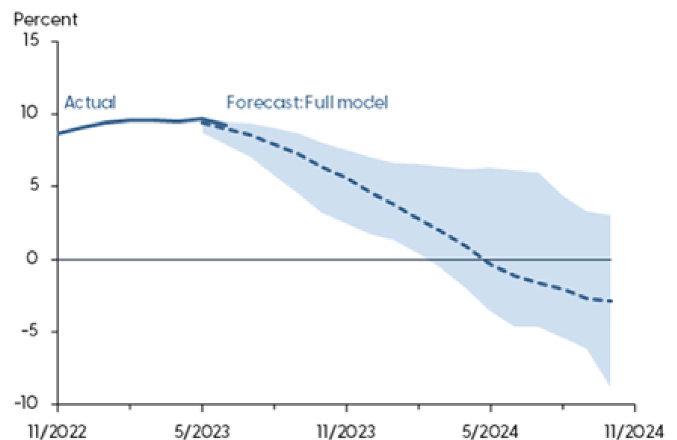


Chart source: FactSet

Further, analysts at the San Francisco Federal Reserve Bank (SFFRB) recently examined the potential intermediate-term path of the shelter component by analyzing several private sector apartment and housing price measures. Based on this work, SFFRB analysts concluded that…*"shelter inflation is likely to slow significantly over the next 18 months."*

The chart below is sourced from the SFFRB and shows their model's predicted path of CPI shelter costs. The dashed blue line represents the model's average forecast while the shaded blue area reflects the potential path at the 95% confidence level. If correct, a rapid decline in this key variable could result in a faster than anticipated fall in core CPI rates, a development that, if seen, could ease Fed inflation concerns, help moderate market-based interest rates (such as the 10-year Treasury) and offer support to equity market valuations.

Forecast of year-over-year shelter inflation: Full model



Note: Dashed line shows average forecast via model. Blue shaded area represents the forecast range at the 95% confidence level.

Chart source: San Francisco Federal Reserve Bank

Absent a reacceleration of price pressures for some unexpected reason, **we believe Fed officials are likely done raising interest rates for the current cycle**.

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As seen in the chart below, we currently forecast headline and core CPI inflation metrics to approach the Fed's target inflation rate of around 2% by the middle of 2024.

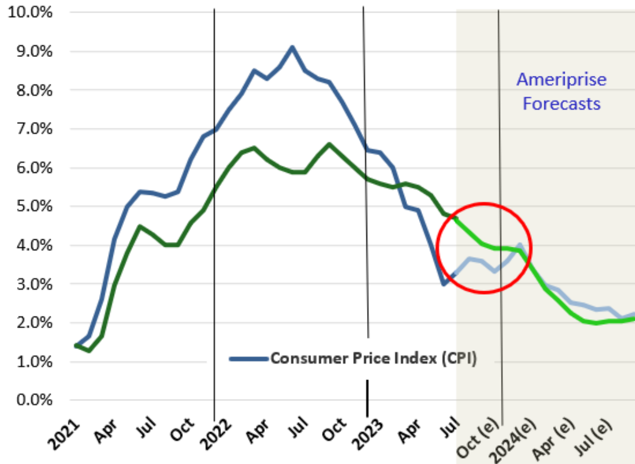

Chart source: AEIS Inc.

Consumer headwinds growing.

Consumers are still in strong financial condition in our view, but their pace of spending is likely to slow over the next few months amid growing headwinds. Specifically, student loan repayments begin in October, higher energy prices (particularly gasoline) are likely to sap real spending power, and most households have dwindling levels of excess savings.

Despite these headwinds, we believe consumers remain in relatively good financial shape. As seen in the chart below, the Federal Reserve's Financial Obligations Ratio (FOR) continues to portray consumer debt burdens as being very manageable relative to consumer income.

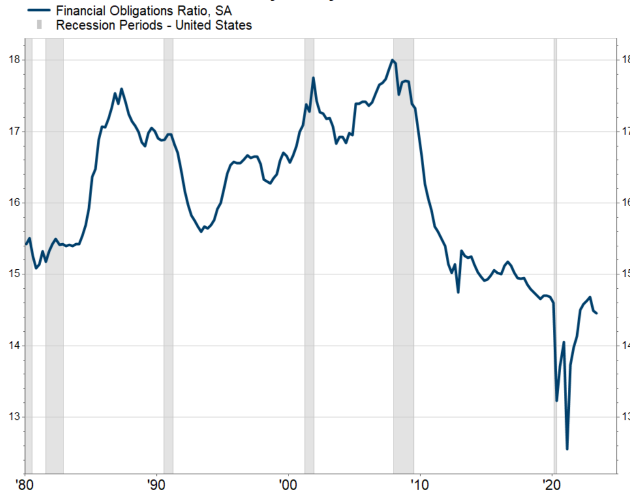

Chart source: FactSet

The FOR looks at consumers' required monthly payments such as a mortgage /rent, auto payments, credit card bills, student loans and other payments. These expenses are then evaluated in a very logical manner… against consumer income.

But what about credit card debt? Many people have likely heard or read about record levels of credit card debt. Yes, the dollar value of credit card debt outstanding is currently at a record high… as it often is during periods of economic expansion.

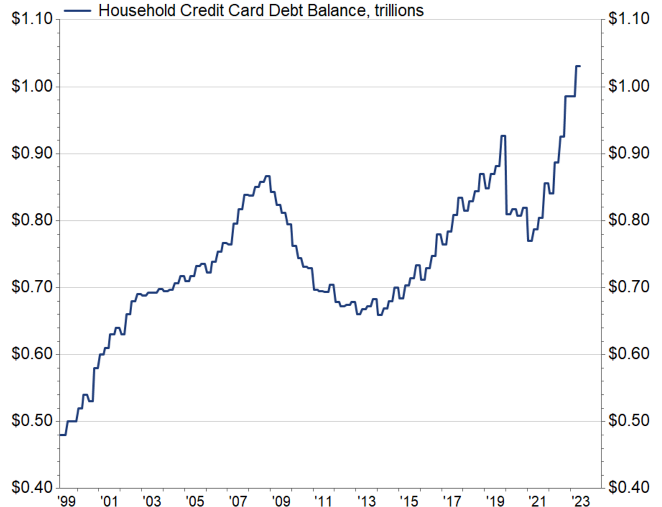

Chart source: FactSet

But should we be concerned about such a high dollar value of consumer credit card debt? In our view, not necessarily. Here's why…

The manner in which credit card debt is measured gives it a natural upside bias as consumers increasingly use cards for convenience. Credit card debt is measured on an average monthly balance basis. Thus, as consumers increasingly use credit cards for convenience, the average monthly balance naturally grows, regardless of any balance that may be carried over from month to month. For example, if you charge $2000 on your credit card during a given month and then pay it off completely, according to the Fed you have $1000 of credit card debt - because that was your average balance through the month.

There was a time when many people used credit cards for "emergency use only." Today, the majority of us use them for everything from gasoline and groceries to paying for coffee or the plumber. Certainly, there will always be a percentage of card holders that have too much debt, just as there always has been.

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Additionally, credit card debt as a percentage of consumer income is quite low. As seen in the chart below, total credit card debt as a percentage of total consumer income tells a dramatically different story. Currently, the credit card debt to income ratio is below its pre-pandemic levels – which was already at multi-decade lows.

Credit Card debt is low relative to income.

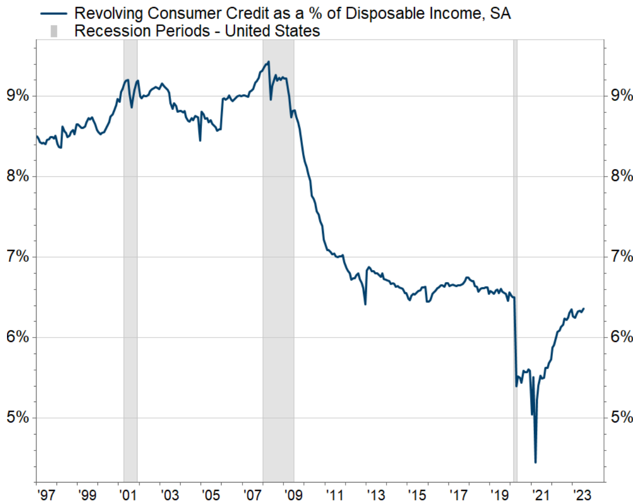


Chart source: FactSet

Interest rate sensitive sectors seeing pressure. The housing market is likely THE most interest rate sensitive sector of the economy. Existing home sales have thus declined sharply over the last 18 months as mortgage rates have more than doubled.

Property values, however, have seen strong support from the market's lack of availability. In fact, the median price of existing homes sold in August was up 6% year-over-year.

Existing Homes for Sale versus U.S. Population

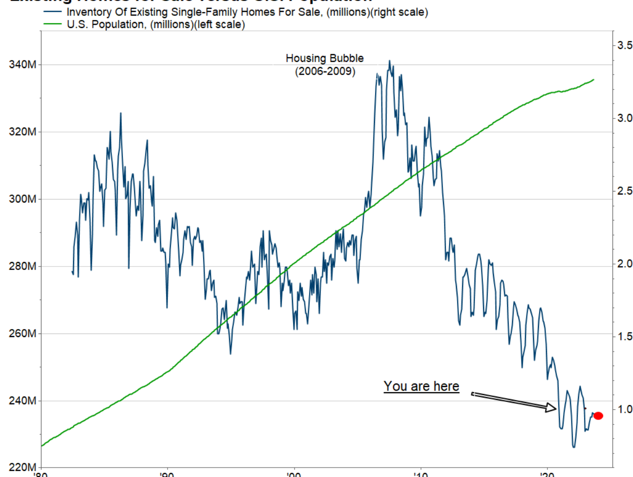
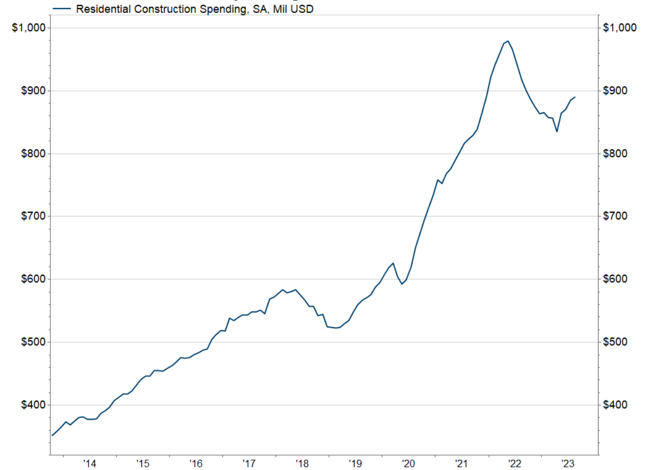


Chart source: FactSet

As seen in the chart at the bottom of the column at left, the number of homes currently available for sale in the U.S. is at multi-decade lows – which is a sharp contrast to the glut of supply seen during the housing bubble period (2006 thru 2009).

Residential Construction Spending



Source: FactSet

Sharply higher interest rates are also pressuring small businesses as their loans come-up for refinancing. As a result, the number of bankruptcies in the space has risen and is likely to rise further, in our view. While this factor should be expected to weigh on the pace of economic growth we do not see it as a material threat to broader economic conditions. Bankruptcies are part of the economic landscape even in the best of times and a higher level of such is to be expected when interest rates rise.

Office property values across the nation have also dropped over the last two years due to the partial shift to remote work. Additionally, property owners are now under considerable pressure as their property loans come-up for refinancing at much higher borrowing rates. Lenders (primarily banks) and property owners will likely share the burden of property and loan write-offs over the next several quarters. The write-downs are likely to be significant but largely manageable, in our view, and we currently do not see office related losses as a material threat to the nation's banking sector.

Of course, higher interest rates are also a strong headwind for the Commercial Real Estate sector more broadly. However, most segments of the market, such as industrial, multi-family residential, retail, warehousing and others, currently enjoy high occupancy rates and fairly sound fundamentals. As such, we see the office space as the primary risk to loan write-downs.

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Corporate profits: The bridge between the economy and equity markets.

(Unless otherwise noted, all data relative to corporate sales or earnings is sourced from FactSet and refers to the S&P 500.)

S&P 500 earnings per share (EPS) were down 4.2% year-over-year (y/y) in Q2 on sales growth of +0.9%. Though weak, the results were broadly better than expected. At the end of the quarter (June 30), analysts had forecast an EPS decline of 7.4% on a sales decline of 0.3%.

The second quarter was defined by a few notable influences: slower global economic growth, a strong U.S. dollar, and sharply higher interest rates. Inflation was also a key consideration, boosting the top-line results for some companies but offering higher costs for nearly all.

Consensus estimates for Q3 currently look for S&P 500 EPS to be down 0.4% y/y on sales growth of 1.4%. The Energy sector accounts for much of the expected downward pressure. *(See chart at top of next column.)* Excluding just this one sector, S&P 500 EPS would be projected to grow by 4.3% y/y on sales growth of 3.4%, according to FactSet. Given recent strength in crude oil prices we believe the negative pressure from the Energy sector may ultimately prove lighter than expected.

As seen in the table below, analysts currently project S&P 500 y/y earnings to turn positive in Q4, with relatively strong earnings growth forecast for 2024. Though we have a generally favorable view as to the economic path ahead, the projected EPS gain of 11.5% for 2024 appears optimistic, in our view. The upcoming earnings release season will be key to setting direction for the future path of earnings expectations.

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Q3-'23 S&P 500 Estimated Earnings Per Share
(yr/yr % change, with 16 of 503 reported)

Sector	yr/yr % change
S&P 500	-0.4
Utilities	11.7
Comm. Services	32.2
Technology	4.6
Materials	-23.3
Industrials	4.1
Health Care	-11.8
Real Estate	2.6
Financials	8.9
Energy	-38.7
Consumer Staples	0.5
Consumer Cyclical	21.9

Source: FactSet

Q3-'23 S&P 500 Estimated Sales growth by Sector
(yr/yr % change, with 16 of 503 reported)

Sector	yr/yr % change
S&P 500	1.6
Utilities	5.0
Comm. Services	6.2
Technology	1.3
Materials	-10.2
Industrials	1.6
Health Care	4.6
Real Estate	7.2
Financials	5.1
Energy	-18.9
Consumer Staples	3.8
Consumer Cyclical	7.2

Source: FactSet

S&P 500 Earnings Estimates	2019	2020	2021	2022				2023				2024				2025
10/9/2023	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 $$ amount				$54.09	$56.69	$55.65	$53.49	$53.33	$54.54	$55.80	$57.68	$57.74	$60.76	$62.97	$65.23	
yr/yr				10.3%	7.4%	3.3%	-3.4%	-1.4%	-3.8%	0.3%	7.8%	8.3%	11.4%	12.8%	13.1%	
qtr/qtr				-2.3%	4.8%	-1.8%	-3.9%	-0.3%	2.3%	2.3%	3.4%	0.1%	5.2%	3.6%	3.6%	
Trailing 4 quarters $$	$163.13	$140.46	$210.86	$216.14	$220.03	$221.81	$219.92	$219.16	$217.01	$217.16	$221.35	$225.76	$231.98	$239.15	$246.70	$276.23
yr/yr % change	1.0%	-13.9%	50.1%				4.3%				0.7%				11.5%	24.8%
Implied P/E based on a S&P 500 level of: **4309**									19.9	19.8	19.5	19.1	18.6	18.0	17.5	15.6

Source: FactSet and AEIS Inc.

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Summary

The depressive effect of higher interest rates on the broader economy continues to grow. Combined with what we see as near-term headwinds for consumer spending, we believe the pace of U.S. economic expansion is likely to downshift over the intermediate term yet remain modestly positive.

Still, if an economic downturn were to occur, we believe it would be shallow given what we see as the relatively good financial standing of consumers and most businesses.

Aside from the “mechanics” of near-term economic activity, we believe economic and market sentiment could slowly but steadily improve should inflation readings continue to ease as we project. Interest rates are currently at highly restrictive levels. However, we believe the Fed’s hiking cycle has likely ended and interest rate cuts could be on the horizon in the second-half of 2024. Rising interest rates have had a depressive impact over the last two years. Falling rates could become a solid tailwind for economic growth and stock and bond returns when seen.

Finally, at the time of this writing, a war between Israel and Hamas is just beginning. Currently, we do not see this very unfortunate and horrific circumstance as holding material implications for global economic growth. However, an expansion of the conflict in the region could lift energy commodity prices materially and heavily weigh on growth prospects.

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Risks

The current outlook still offers material uncertainty. Geopolitical tensions are particularly high, energy costs and tight labor markets remain a potential threat, and government debt loads are at 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 geopolitical sphere has grown considerably over the last 20+ years. The Chinese government 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 development path is increasingly intersecting with the established position of presiding western powers, a confluence which could lead to more serious instability.

Geopolitical tensions elsewhere (Israel, Russia, Ukraine, Taiwan, N. Korea, Syria, etc..) 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 severe problems. Of course, there always have been problems for the global economy /capital markets to consider, and there always will be.

Longer-term

We believe three fundamental factors: China, demographics, and global government debt will play key roles in the path of global economic activity and financial markets over the longer-term. Demographics across the industrial world reflect slowing population growth and aging societies; which implies slower potential economic growth than has been the case historically. Government borrowing, particularly here in the U.S., is also very high and going even higher in the near future (based on estimates from the Congressional Budget Office). 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.

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