QUARTERLY INVESTMENT REVIEW AND OUTLOOK
THIRD QUARTER 2019

by **Robert F. DeLucia, CFA**
Consulting Economist

Summary and Major Conclusions:

Most domestic asset classes are either overvalued or at full valuation. The US Treasury and corporate bond markets are especially overvalued. Commercial real estate markets are also richly valued, as are defensive stock groups such as utilities and consumer staples. Conversely, economically sensitive (cyclical) stock groups are undervalued, as are many non-US equity markets. Value stocks are significantly undervalued and should outperform growth and momentum stocks over the next several years.

- Most asset classes generated small positive returns in the third quarter against a background of generally negative news involving global growth, economic policy, domestic politics, and geopolitics. Total returns on large-cap domestic equities were 1.7%, while investment-grade bonds (+2.3%) registered slightly higher returns.

- Financial market performance for the nine months was excellent, with virtually all asset classes generating double-digit returns. The S&P 500 has been the best-performing market this year with a total return of 20.5%.

- Small-cap domestic equities (+14%), international stocks (+14%) and corporate bonds (+12%) have also performed quite well this year. A diversified balanced portfolio generated a total return of nearly 15% over the past nine months.

- The investment outlook is predicated upon the timing of an end-of-cycle recession. A recession in the next year - as expected by many investors - would favor government bonds over common stocks. Conversely, deferral of recession until 2021 or later would favor equities over bonds.

- Traditional business cycle analysis strongly suggests that a recession is not imminent because of the absence of classic cyclical imbalances and excesses. However, trade policy remains a serious threat to the economic expansion, and therefore, the primary determinant of the outlook for risk assets.

- The most likely outcome is a resolution to the trade conflict prior to yearend. Continued deterioration in economic conditions in both China and the US will exert pressure on both countries to seek at least an interim truce. Most important is growing political pressures will weigh on President Trump as the 2020 election comes into closer view.

- Financial markets would respond immediately to news of a truce - in anticipation of a rebound in world economic growth – by sending stocks higher and bond prices lower. Bond yields would rise sharply, commodities would rally, and the US dollar would drift lower.

- Although there are very few classic signals of an end-of-cycle recession, the current economic expansion is at a mature phase. The economy is at full employment and job creation is constrained by a shortage of skilled workers.

- Company profit margins are near all-time highs. In this advanced late-cycle economic environment, a dynamic growth phase is unlikely, reinforcing the prospects for more moderate rates of return in all asset classes.

- Virtually all domestic asset classes are either overvalued or at full valuation, most notably the US Treasury and corporate bond markets. Commercial property is also richly valued, as are defensive stock groups. Economically sensitive stock groups (cyclicals) are undervalued, as are many non-US equity markets.

- The outlook for inflation is likely to be a less significant variable than is normally the case at advanced stages of the economic expansion. Investors should expect only a modest uptick in core consumer inflation, which in itself is unlikely to alter the investment landscape.

- US monetary policy is also of less importance in the short term. The overarching obstacle to healthy and sustained economic growth in coming months is trade policy, and there is little that monetary policy can do to offset the economic pressures associated with protectionism.

- Monetary policy should be of much greater significance over the next 12 to 18 months because of the traditional time lag between policy and the economy. Federal Reserve officials are determined to boost economic growth and create more domestic inflation.

- This policy implies further rate cuts ahead, followed by faster growth and higher inflation. The Fed's aggressive pro-growth policy is very bullish for common stocks and very bearish for government bonds in 2020.

- There are several risks to financial markets, the most worrisome being the ongoing trade war between China and the US. An escalation in tariffs would cause great damage to the world economy and financial markets, possibly culminating in a world recession and global bear market in equities.

- Another risk involves a sharp slowdown in hiring and a rise in layoffs, which would have a catastrophic effect on the US economy. Continued escalation of the tariff war could lead to a jump in layoffs, triggering a sustained rise in the unemployment rate and slump in consumer spending.

- Failure of Chinese policymakers to engineer a healthy economic rebound would also be a serious negative because of China's role as the primary engine of world economic growth. Global equities are unlikely to outperform government bonds until there is a rebound in Chinese domestic demand and imports.

- Continued appreciation in the US dollar (USD) could culminate in a world recession. The persistent strength of the US dollar in recent years has been both a persistent deflationary and contractionary force for the global economy.

- The risk/reward balance for common stocks is modestly unfavorable at the present time, given widespread uncertainties associated with trade policy, Middle East tensions, weakness in corporate earnings, and rich valuations. The path of least resistance for the equity market is downward in coming months.

- Medium-term prospects are more promising. Common stocks should generate positive returns over the next year, predicated upon an end to the trade war and a rebound in world GDP and company earnings. Economically sensitive stocks could be the best-performing sub-asset class in 2020.

Chart 1: Investor Confidence Remains Deeply Depressed
State Street Investor Confidence Index
Source: State Street Global Markets

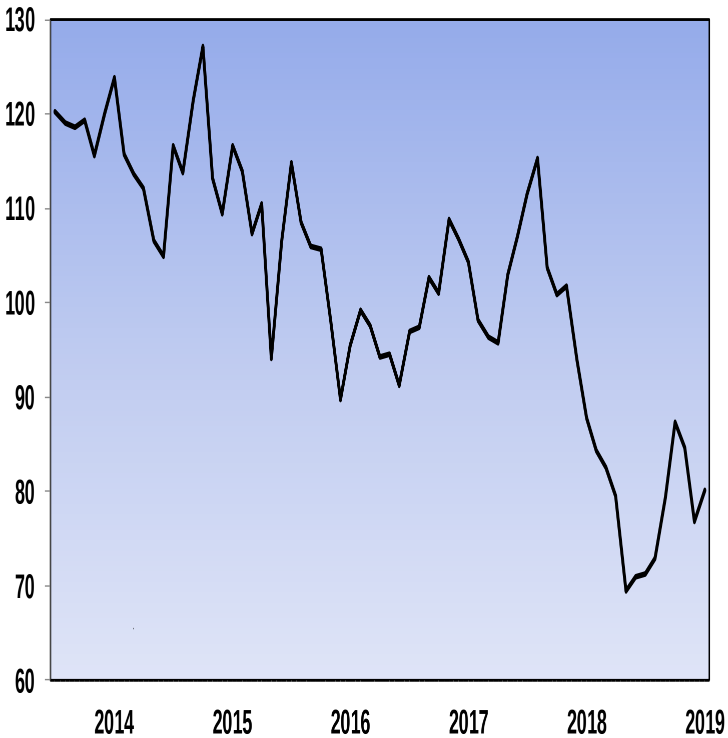


Chart 2: Residential Mortgage Rates Remain Near Three-Year Lows
Interest Rate on 30-Year Fixed-Rate Mortgage
Source: Freddie Mac

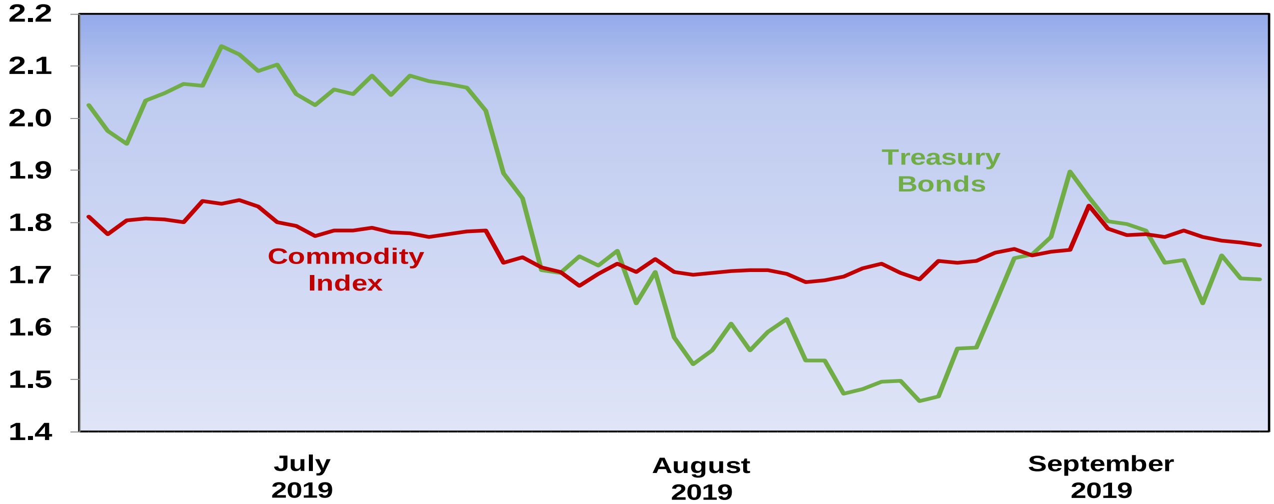
FINANCIAL MARKET REVIEW

Most asset classes generated small positive returns in the third quarter against a background of generally negative news involving global growth, economic policy, and geopolitics. World economic growth was sluggish in the quarter, although the domestic economy continues to expand at a respectable 2% annual rate. Personal consumption, services, and employment remain resilient in the major economies, while manufacturing and trade continue to undermine growth in Europe and Asia.

Economic Policy: The world economy remains in a giant tug-of-war as extremely favorable financial conditions worldwide are effectively offset by an escalating trade war between China and the US. Nearly thirty central banks have eased policy in recent months, while market yields on $17 trillion in government debt worldwide are less than zero. Record-low interest rates are a manifestation of very depressed confidence among investors (see chart 1).

- **Plunging Interest Rates**: Record-low borrowing costs have sparked a powerful ***refinance boom*** for businesses and households, resulting in improved private sector finances and enhanced purchasing power. Missile attacks on Saudi Arabia's oil infrastructure reinforced the worldwide demand for government bonds, as risks to political stability in the Middle East have risen markedly (see chart 2).

Chart 3: Strong Correlation Between Treasury Bond Yields and Commodity Prices
Market Yield on Ten-Year US Treasury Bonds (%)
Reuters/CRB Commodity Index
Source: Bloomberg



- **Risk-Off Markets**: In an environment of profound economic, geopolitical, and policy uncertainty, investors overwhelmingly favored safe-haven assets in the quarter. The correlation between stock prices and government bond yields rose to historical highs. Commodity prices and government bond yields also moved in lockstep (see chart 3).

Federal Reserve: The Fed lowered its policy rate to 2% at its September FOMC meeting, with the likelihood of one additional rate cut before yearend. Third quarter company earnings were flat - the third consecutive quarter of no growth - while core consumer inflation remains stable slightly below the FOMC's 2% target. In this environment, market volatility remained elevated, as uncertainty over the economy, monetary policy, politics, and geopolitics resulted in large swings in investor sentiment.

Third Quarter Returns: Most asset classes registered low single-digit returns, including large-cap domestic stocks (+1.7%), investment-grade bonds (+2.3%), high-yield corporate bonds (1.5%), and commercial real estate. Long-term government bonds performed best in the quarter with returns of 8%. Both small-cap and international equities were flat in the quarter. A diversified balanced portfolio generated a weighted-average return of 2%. Treasury bond yields and equity prices moved in virtual lock-step during the quarter.

Year-to-Date Returns: Financial market performance for the nine months was excellent, with virtually all asset classes generating double-digit returns. The S&P 500 was the best-performing market in the quarter with a total return of 20.5%. Small-cap domestic equities (+14%), international stocks (+14%), corporate bonds (+12%) all performed well. A diversified balanced portfolio generated a total return of nearly 15% over the past nine months.

Long-Term Returns: When evaluated over multi-year periods, equity market returns have been excellent. Domestic equities have performed best, followed by international stocks and corporate bonds. Over the past three years, a total return of 13.5% for the S&P 500 Index exceeded the 3% total return on investment-grade bonds and 7% return on non-US stocks.

FINANCIAL MARKET OUTLOOK

The investment outlook is predicated upon the timing of an end-of-cycle recession. US and world recessions are virtually inevitable within the next several years, but the precise timing is highly uncertain. *A recession in the next year - as expected by many investors - would favor government bonds over common stocks*. *Conversely, deferral of recession until 2021 or later would favor equities over bonds*.

Traditional business cycle analysis strongly suggests that a recession is not imminent because of the absence of classic cyclical imbalances and excesses. However, trade policy remains a serious threat to the economic outlook, and therefore the primary determinant in the outlook for risk assets. As such, developments on the trade front must be closely monitored.

THREE TRADE POLICY SCENARIOS

From a broad perspective, there are three plausible scenarios that could play out on the trade front over the next year:

1. Continuation of the ***status quo*** through the 2020 elections
2. An ***escalation*** in tariffs along with imposition of nontariff barriers
3. A ***negotiated truce***, culminating in a rollback of most tariffs announced since the middle of last year

Base Case Scenario: Scenario number three appears to be the most likely outcome and is my base case. Continued deterioration in economic conditions in both China and the US will exert pressure on both countries to seek at least an interim truce. Of greatest importance are growing political pressures on Trump as the 2020 election comes into closer view.

- **Investment Implications**: Financial markets would respond immediately to news of a truce – in anticipation of a rebound in world economic growth - with a rise in equity markets and a decline in bond prices. Bond yields would rise sharply, commodities would rally, the US dollar would drift lower, and gold prices would collapse. The Federal Reserve would hold policy rates steady at 2%, while company managements and Wall Street analysts would upgrade their estimates for future earnings.

FINANCIAL MARKET OUTLOOK: KEY FACTORS

Looking beyond the trade war, an assessment of potential financial market returns must begin with an analysis of prospects for economic and profit growth, an evaluation of credit market trends, and the likely direction of economic policy.

1. **World Economic Recovery**: The single most important variable in the investment outlook is the direction of the global economy. *A sustained rebound in world economic growth in 2020 would benefit common stocks and commodities at the expense of government bonds*. Moreover, healthy economic growth would also favor economically sensitive stocks over both defensive stocks and bond substitutes.

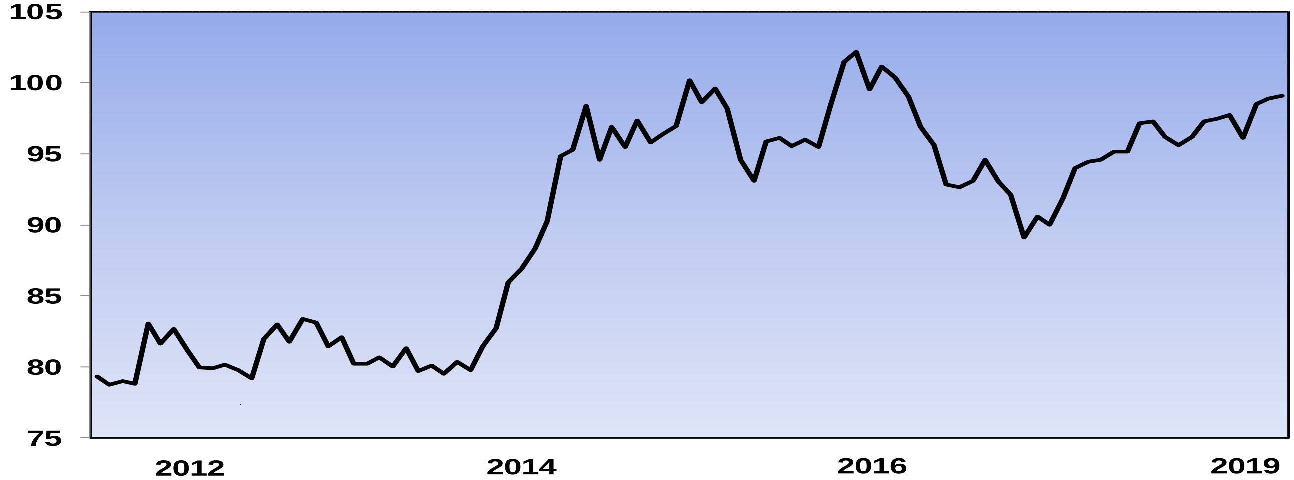
2. **Late-Cycle Expansion**: Although there are very few classic signs of an end-of-cycle recession, ***the current economic expansion is at a mature phase***. The economy is at full employment; job creation is constrained by a shortage of skilled workers; and company profit margins are near all-time highs, with very little further upside. *In this advanced late-cycle economic environment, a dynamic growth phase appears unlikely, implying more moderate prospective rates of return*.

3. **Fully Valued Markets**: *Virtually all domestic asset classes are either overvalued or at full valuation*. Most overvalued are the US Treasury and corporate bond markets. Commercial real estate markets are also richly valued, as are defensive stock groups. Conversely, economically sensitive (cyclical) stock groups are undervalued, as are many non-US equity markets.

4. **Modest Uptick in Inflation**: The outlook for inflation is likely to be a less significant variable than is normally the case in a mature expansion phase. The odds of outright deflation are extremely low, while a sharp acceleration in the rate of inflation is unlikely any time soon. Instead, *investors should expect a modest uptick in core consumer inflation, which is not likely to alter the investment landscape*.

5. **Federal Reserve Policy**: *Monetary policy is also of less importance in the short term* because of the time lags between changes in policy and economic growth. ***More importantly, the overarching obstacle to healthy and sustained economic growth is trade policy, and there is little that monetary policy can do to offset this major headwind to growth.***

Chart 4: US Dollar Climbs to a Multi-Year High
US Dollar Index
Source: Federal Reserve



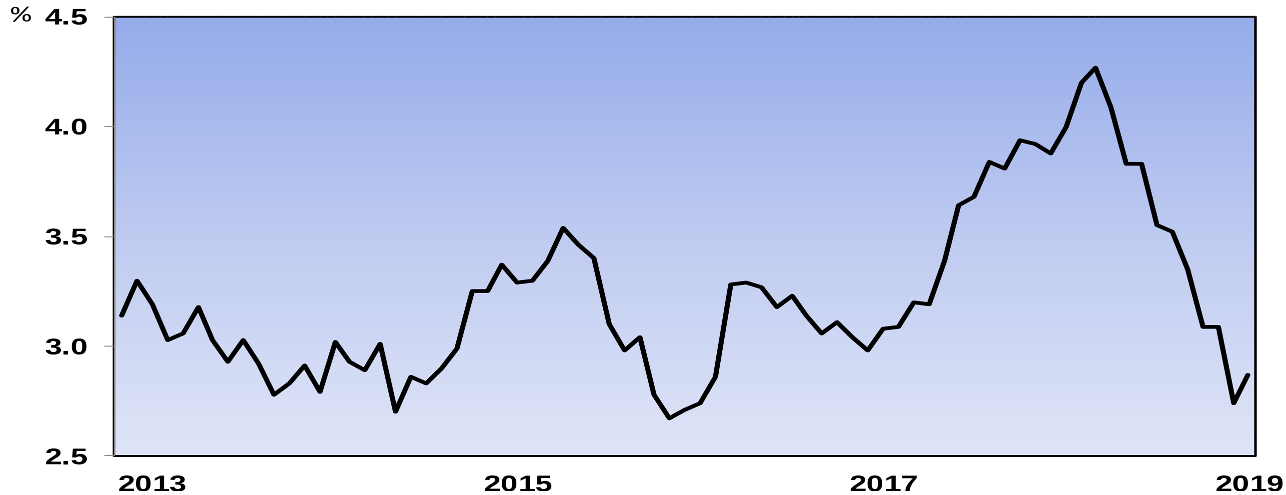
- **Aggressive Pro-Growth Strategy**: However, monetary policy will play a far more significant role over the next one to two years. ***Federal Reserve officials are determined to boost economic growth and to create more inflation***, implying further rate cuts ahead, followed by faster economic growth and higher inflation. The Fed's aggressive pro-growth policy is bullish for common stocks and bearish for government bonds.

6. **Rebound in Company Earnings**: Business profits will remain on a plateau for the remainder of this year, but should rebound as 2020 unfolds. My forecast assumes that corporate earnings will rise by 8% in 2020, which would be consistent with equity market returns of 10% to 12%. For companies in the S&P 500, earnings per share (EPS) should rise to $162 for all of this year, up from $160 last year, and rising to a projected $175 in 2020.

7. **US Dollar Depreciation**: The US dollar is a critical variable in the outlook and currently near an all-time high. Continued strength in the dollar would be a contractionary force for the world economy, while a reversal would be reflationary and supportive of growth. *My assumption is that the dollar is forming a cyclical peak and is likely to enter a prolonged period of depreciation beginning in 2020*. A weakening dollar would benefit common stocks and commodities over fixed-income markets (see chart 4).

The bottom line is that there is an unstable balance within world financial markets, with a slight negative bias, suggesting a volatile trading market in the short term. Defensive investment strategies are likely to continue to be rewarded in coming months until there is at least a modest breakthrough in the trade war. Spreading evidence of strength in export markets and manufacturing – along with signs of a recovery in Germany and China - would confirm the improving outlook for common stocks and other risk assets.

Chart 5: Investment-Grade Corporate Bonds Offer Poor Value
Market Yield to Maturity, US Corporate Bond Index
Source: Bloomberg Barclays



GLOBAL ASSET ALLOCATION

Developing an investment strategy in the current high-risk environment is a daunting task, mainly because of elevated uncertainties pertaining to trade policy, worsening geopolitical risks, and rich valuations in many asset classes. An optimal asset allocation would include the following:

Fixed-Income Market: Prospects for world bonds are extremely poor. Government bonds are likely to generate negative returns over the next year and should be at a ***maximum underweight*** in balanced portfolios. Corporate bonds should perform only slightly better and should also be underweight. Emerging market bonds should be overweight, along with inflation-protected (TIPS) securities (see chart 5).

Domestic Equities: Balanced portfolios should be ***modestly overweight*** in common stocks. ***However, the real challenge for asset allocators involves sector selection rather than assumptions regarding the direction of the overall market***. Equity investors ***underweight*** in balanced portfolio. Corporate bonds should produce very low single-digit percentage returns and should also be ***underweight***. Emerging market bonds, should *significantly overweight* ***value managers*** *and underweight growth managers because of a massive disparity in valuations*.

- **Compelling Valuations**: Compared with a price-to-earnings (P/E) ratio of only 15.5x for the Russell 3000 Value Index, the Russell Growth Index is priced at a P/E of nearly 25x. Growth stocks have outperformed value stocks for most of the past ten years, the longest period of outperformance in modern stock market history.

Non-US Equities: International stocks are expected to outperform domestic equities over the next several years, and should be ***overweight*** in balanced funds, for two reasons:

1. **Earnings growth** of non-US companies is likely to exceed that of US companies, based upon a more vigorous rebound in foreign economies.

2. **Valuations** are far more attractive relative to those in the US: The average P/E ratio for international stocks is only 14.4x, well below the 17.5x for US equities. The average dividend yield of 3.6% is nearly double the 1.9% yield for the S&P 500 Index. European and emerging Asian equity markets are most attractive.

Commercial Real Estate: Valuations in the commercial property market appear stretched, while real estate fundamentals are deteriorating. Developers have been aggressively making additions to space at a time when leasing activity is weakening. As a result, vacancy rates remain elevated and market effective rents have softened. A combination of rich valuations and sluggish rental income growth suggest an underweighting in balanced portfolios.

FINANCIAL MARKET RISKS

There are several prominent risks to the outlook for financial markets, pertaining to trade policy, the labor market, world oil prices, the US dollar, and the Chinese economy.

[1] Trade Policy: The ongoing tariff war between China and the US is the principal risk to the world economy and financial markets. *An escalation in tariffs would cause great damage to the world economy, and could culminate in a world recession and bear market in global equities*. World GDP growth has been reduced by nearly 1% over the past year because of the steady increase in protectionism.

[2] Employment: A sharp slowdown in hiring and a rise in layoffs – resulting from sinking business confidence - would have a catastrophic effect on the US economy and financial markets. Consumer spending has been the bulwark of the economy in 2019. A deterioration in labor market conditions could undermine household sector confidence and spending, therein raising the risk of recession.

[3] The Chinese Economy: China is the primary engine of growth for the world economy, most notably the eurozone, Japan, and emerging Asia. Failure of Chinese policymakers to engineer a healthy economic rebound would be a serious negative; until there is a rebound in Chinese domestic demand and imports, government bonds are likely to outperform common stocks.

[4] World Oil Markets: The recent attack on Saudi Arabia's largest oil facility creates a new risk to the stability of world financial markets. The damage to Saudi oil facilities was much less than originally feared, and the supply and demand balance in world oil markets has been restored more quickly. However, the longer-term risk involves a retaliatory strike by Saudi Arabia on Iranian oil production facilities, resulting in an outright Saudi-Iran war and a spike in world oil prices.

[5] The US Dollar: Continued appreciation in the US dollar (USD) could culminate in a world recession. The persistent strength of the US dollar in recent years has been a contractionary force for the global financial system and economy, as global liquidity has tightened. The most worrisome scenario would be a ***negative feedback loop*** between the dollar and the world economy, whereby persistent economic weakness leads to a stronger dollar, which in turn causes further weakness in the global economy, and further dollar strength.

Each of these factors - either in combination or on their own - could result in a global recession and widespread weakness in world financial markets. The investment implications would be a flight to safety, whereby government bonds would easily outperform equities over the next year. Investors would also likely sustain losses on both commodities and corporate bonds, as widening risk spreads would more than offset the benefits from lower Treasury bond yields.

Robert F. DeLucia, CFA, was formerly Senior Economist and Portfolio Manager for Prudential Retirement. Prior to that role, he spent 25 years at CIGNA Investment Management, most recently serving as Chief Economist and Senior Portfolio Manager. He currently serves as the Consulting Economist for Prudential Retirement. Bob has 45 years of investment experience.

The financial indices referenced herein are provided for informational purposes only. You cannot invest directly in an index. The statistical data regarding such indices has been obtained from sources believed to be reliable but has not been independently verified.

Bloomberg Barclays U.S. Treasury Inflation-Protected Securities (TIPS) Index: Measures the performance of rules based, market value-weighted inflation protected securities issued by the U.S. Treasury. It is a subset of the Global Inflation-Linked Index (Series-L).

CBOE Volatility Index: An index of implied equity market volatility, reflecting the market estimate of future volatility for the S&P 500 Stock Index over the next 30 days, using options.

MSCI Emerging Market Index: An index of equity market performance for developing markets, primarily in Asia, Latin America, and Eastern Europe. The index tracks both large-cap and small-cap stocks and is weighted by market capitalization.

MSCI World Ex US Index: Measures the performance of the large and mid cap segments of world, excluding US equity securities. It is free float-adjusted market-capitalization weighted.

Russell 2000 Small-Cap Index: Is an index measuring the performance of approximately 2,000 small-cap companies within the United States.

S&P 500® Index: Measures the performance of 500 widely held stocks in US equity market. Standard and Poor's chooses member companies for the index based on market size, liquidity and industry group representation. Included are the stocks of industrial, financial, utility, and transportation companies. Since mid 1989, this composition has been more flexible and the number of issues in each sector has varied. It is market capitalization-weighted.

State Street Investor Confidence Index: measures investor confidence or risk appetite quantitively by compiling actual buying and selling patterns of institutional investors.

US Trade-Weighted Dollar Index: An index that measures the value of the US dollar in relationship with other currencies, statistically weighted on the basis of importance to the US as trading partners.