MID-QUARTER ECONOMIC REVIEW

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Summary and Major Conclusions:

Prospects for the domestic equity market are mixed, depending upon time horizon. Stocks should generate positive returns over the next year on a cyclical basis, as the world economy emerges from a classic mid-cycle slowdown that began 18 months ago. Common stocks could generate returns of 10% between now and the 2020 election, based upon an improving trend in company earnings and continued expansionary monetary conditions. Expected returns over a three-year time horizon are less favorable.

- The US economy remains in a slowdown phase, led by weakness in manufacturing, capital formation, and export trade. Growth is supported by private consumption, residential construction, and services. Real GDP is currently increasing at an annual rate of 2%, well below the 2.5% growth rate of the two previous years.

- The proximate cause of the slowdown is the protracted tariff war with China. The trade conflict has undermined growth through various channels, the most important of which is a sharp decline in business confidence.

- Profound uncertainty among business managers has resulted in postponement of capital projects, vital for healthy long-term growth. Tariffs have also increased the cost of imported goods for businesses and consumers, and reduced US exports.

- Following another six months of sluggish growth, the US economy should gather momentum as 2020 unfolds. My forecast assumes real GDP growth of 1.5% in Q4, 2% growth in Q1, and an average growth rate of 2.5% to 3% during the final three quarters of next year.

- Domestic company earnings have stabilized at a high plateau and are unlikely to expand in the short term. Resumed growth in earnings is likely in 2020, but only if there is meaningful progress in trade negotiations, a prerequisite for a sustained rebound in global manufacturing and trade.

- Because inflation is a lagging indicator, inflationary pressures have moderated in recent months. The core Consumer Price Deflator is currently increasing at a 1.7% annual rate, below the Federal Reserve's target of 2%. US inflation appears likely to remain below that target over the next 12 months, at a minimum.

- The Federal Reserve wants faster growth and higher inflation, and will therefore maintain an easy monetary posture for the foreseeable future. Low policy rates will be reinforced by renewed expansion in the Federal Reserve's balance sheet, all of which should support economic growth in 2020.

- Despite some improvement in recent weeks, market sentiment continues to be dominated by fears of a world recession. I continue to believe that the probability of recession is low because the classic preconditions for recession — cyclical excesses and imbalances — are not evident.

- Most importantly, inflation is stable; the Treasury yield curve has returned to its normal upward slope; credit is available to all borrowers and on favorable terms; and capital goods and single-family homes are in short supply.

- Finally, businesses and investors remain cautious. Recessions seldom occur when they are broadly anticipated; rather, economic downturns tend to happen during periods of business, lender, and investor complacency.

- Although incoming data point to continued weakness in China, leading indicators of future growth are becoming increasingly positive. Most important is growing evidence of policymakers' willingness to provide monetary and fiscal stimulus.

- Growth prospects for the euro area economy should gradually improve as 2020 unfolds. Compared with a current rate of 1%, GDP growth should approach 2% one year from now. The European Central Bank (ECB) continues to ease policy through rate reductions and bond purchases.

- Prospects for a satisfactory resolution to Brexit have improved enormously in recent weeks. The probability of a widely feared no-deal Brexit — a disorderly UK exit from the European Union (EU) — has declined significantly.

- The investment outlook is predicated upon a rebound in world economic growth, which in turn is dependent upon an easing of trade policy. A synchronized easing of monetary policy by world central banks has fueled a surge in global liquidity.

- The outlook for global fixed-income markets remains unfavorable, with government bonds in most countries overbought and overvalued. Investors should expect negative rates of return from government bonds over the next year, while corporate bonds should perform only slightly better.

- The US equity market should generate positive returns over the next year on a cyclical basis, as world economic conditions gradually improve. Common stocks could generate returns of 10% between now and the 2020 election, based upon an improving earnings outlook and continued monetary accommodation.

- Less favorable are expected rates of return over the next three years, a period that will be characterized by slowing economic growth, a rising risk of recession in late 2021 or 2022, rising bond yields, slowing profit growth, and less favorable monetary conditions.

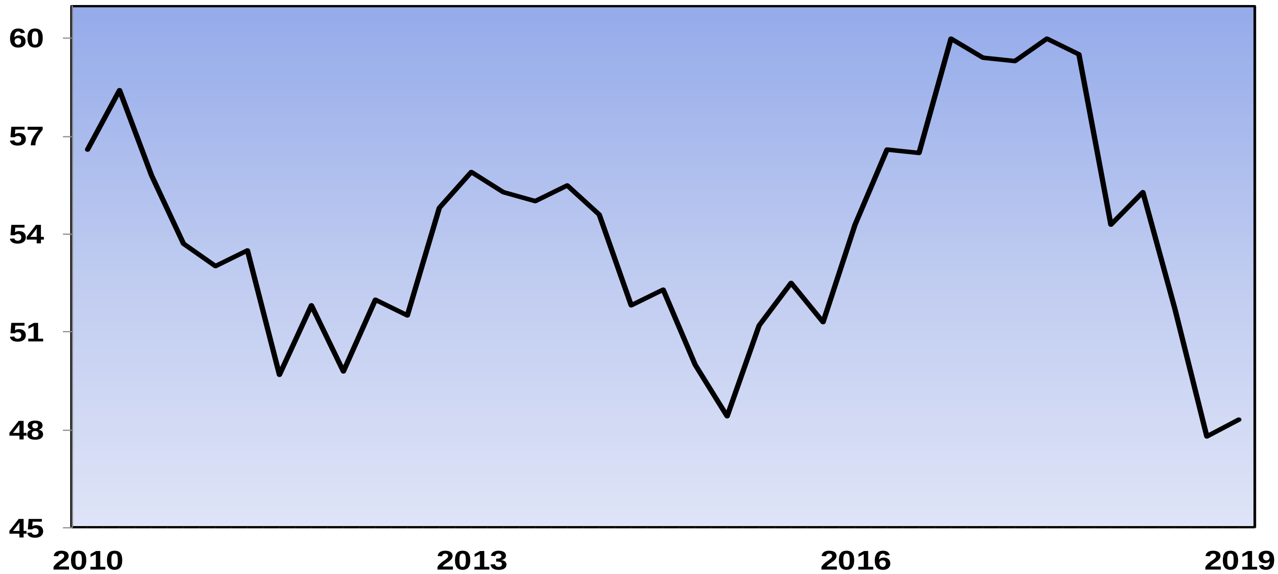
- Equity market leadership appears to be at an important inflection point. Market perception of recession risk is the primary determinant of relative market performance, which appears to be diminishing.

- In terms of economic sectors, the defensive safe-haven leaders of the past several years should begin to lag economically sensitive stock groups, including industrials, materials, energy, transports, financials, and consumer discretionary.

- I also expect value managers to significantly outperform growth managers over the next 12 months. Following many years of underperformance, value stocks (+9.5%) have significantly outperformed growth stocks (+3.3%) since September 1.

- An expected rebound in the world economy should favor non-US stocks over the next year. Eurozone and emerging Asian equity markets should perform best over this period.

Chart 1: The Third Manufacturing Recession of the Current Expansion Cycle
Index of US Manufacturing Activity
Monthly Purchasing Manager Survey
Source: Institute For Supply Management (ISM)

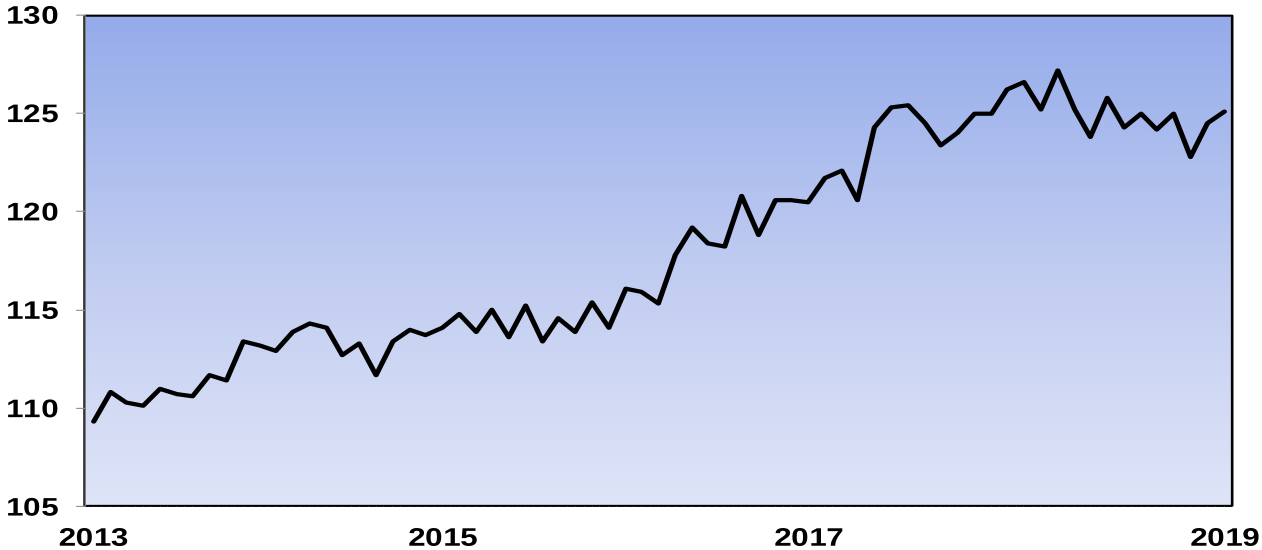


The domestic economy remains in a slowdown phase, led by weakness in manufacturing, capital formation, and export trade. Growth is supported by private consumption, residential construction, and the large service sector. Real GDP is currently increasing at an annual rate of 2%, well below the 2.5% growth rate of the two previous years and the long-term average of 3%. *The US manufacturing sector is in recession for the third time since the current expansion began in 2009* (see chart 1).

Trade War: The proximate cause of the slowdown is the protracted tariff war with China. The trade conflict has undermined growth through various channels, the most important of which is the sharp decline in business confidence. Profound uncertainty among business managers has resulted in postponement of capital investment projects vital for healthy long-term growth. Tariffs have also increased the cost of imported goods for businesses and households, while reducing exports.

The World Economy: The global economy has weakened to a far greater extent relative to the US economy because of a greater dependence upon both world trade and manufacturing. World GDP is currently expanding at a 3% annual rate, down from a peak of 4% in 2017, and the slowest pace since the 2008 recession. The overall impact of tariffs on the world economy is estimated at one full percentage point. World trade is contracting for the first time since 2009 (see chart 2).

Chart 2: Sharp Slowdown in World Trade
Index of World Trade Volume
Source: International Monetary Fund (IMF)



- **Growth Slowdown**: Most of the major economies of the world are expanding at a 1% annual rate, including those of Japan, the UK, South Korea, and the eurozone, with further weakness immediately ahead. China's economy is growing at a 6% annual rate, the slowest pace in 27 years. Overall, emerging market economies are expanding at a 4% annual rate.

US ECONOMIC OUTLOOK

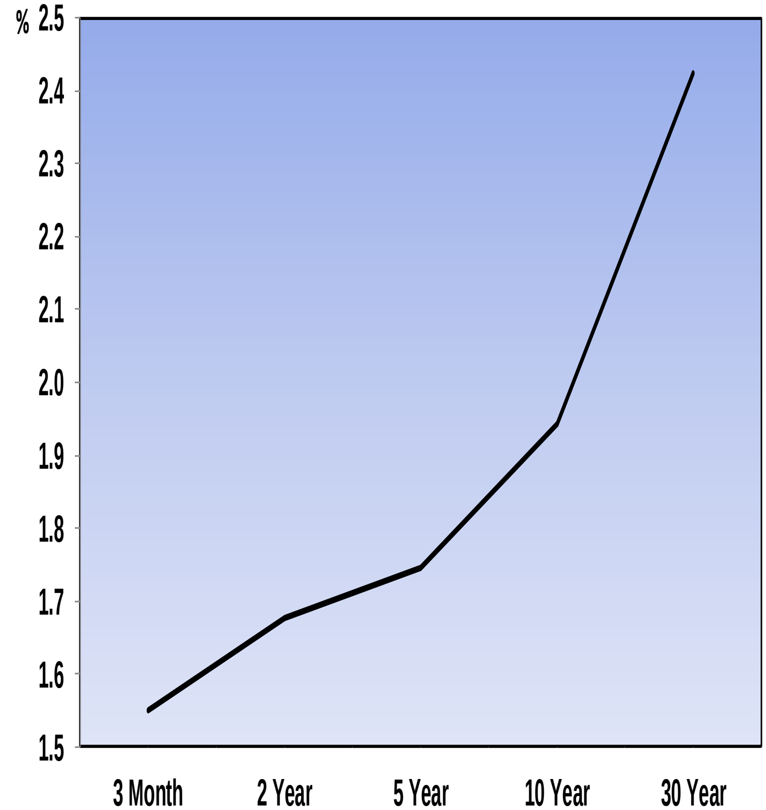
Following another six months of sluggish growth, the US economy should gather momentum as 2020 unfolds. My forecast assumes real GDP growth of 1.5% in Q4, 2% growth in Q1, and an average growth rate of 2.5% to 3% during the final three quarters of next year. GDP growth should slow once again to 2% in 2021, with the risk of recession drifting higher over the course of 2020.

Economic Sectors: Private consumption, residential construction, and business capital investment should be the economic sector leaders in 2020. Currently declining at a 1% annual rate, manufacturing should expand at an average 2.5% rate during 2020, led by machinery, transportation equipment, chemicals, IT equipment, and building materials.

US Corporate Earnings: Domestic company earnings have stabilized at a high plateau and are unlikely to expand in the short term. *Following zero growth in Q1 and Q2, profits are likely to remain flat for the remainder of this year*. Resumed growth in earnings is likely in 2020, but only if there is meaningful progress in trade negotiations, a prerequisite for a healthy rebound in global manufacturing and trade.

Chart 3: Consumer Inflation Under Excellent Control
Core Consumer Price Deflator
Excluding Food and Energy, Annual % Rate
Source: Bureau of Economic Analysis

Chart 4: The Yield Curve Returns to a Normal Upward Slope
The Term Structure of Interest Rates, US Treasury Market
Source: Federal Reserve



Consumer Inflation: Inflationary pressures have moderated in recent months, suggesting that government data on inflation will be favorable over the foreseeable future. Inflation is a lagging indicator, and will therefore likely soften in response to the economic weakness of the past year. Domestic inflation is also affected by global forces, which remain deflationary.

- **Core Inflation**: Core consumer inflation is currently increasing at a 1.7% annual rate, comfortably below the Federal Reserve's target of 2%. Core consumer inflation appears likely to remain below the Fed's target over the next 12 months, at a minimum, suggesting that the Fed will be in no hurry to raise rates (see chart 3).

Federal Reserve Policy: As expected, the Fed cut interest rates again last month to 1.75%, but indicated that it had no plans for further rate cuts. The Fed reiterated its intention to remain "data dependent" suggesting that signs of economic weakness and/or falling inflation could trigger more rate cuts in future months. Importantly, the Fed also indicated that policy tightening was not imminent given the favorable outlook for inflation. As a result, the Treasury yield curve is no longer inverted, and is currently in a normal upward-sloping pattern (see chart 4).

Chart 5: Federal Reserve in a Prolonged Monetary Easing Phase
Target Overnight Federal Funds % Rate
Source: Federal Reserve

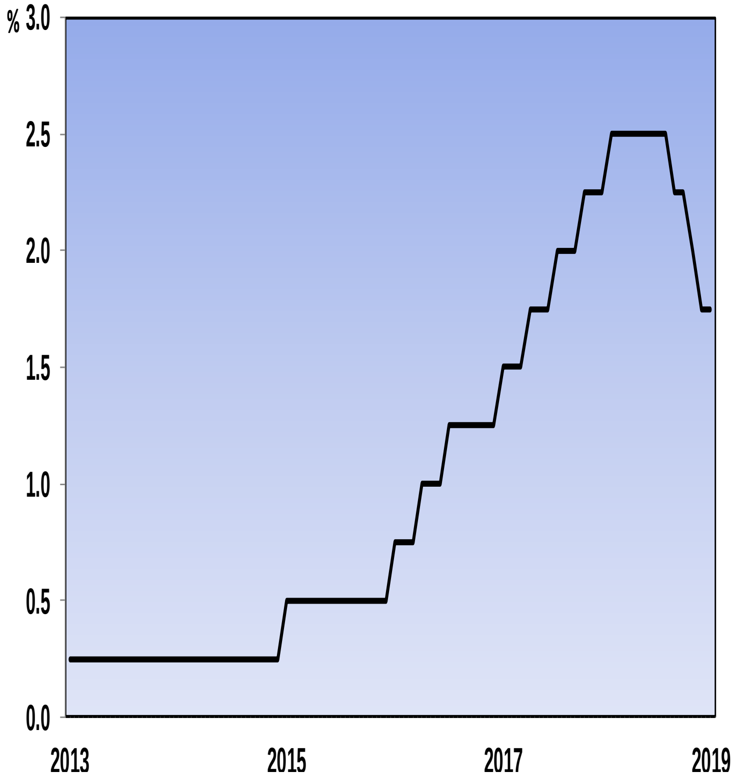
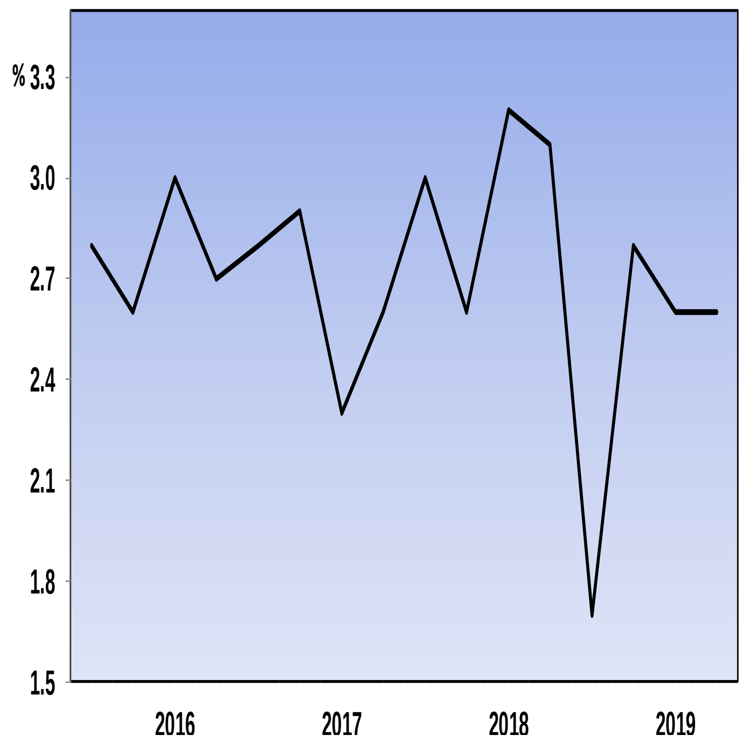


Chart 6: Continued Solid Growth in US Household Spending
Personal Consumption Expenditures, Annual % Growth
Adjusted for Inflation
Source: Bureau of Economic Analysis

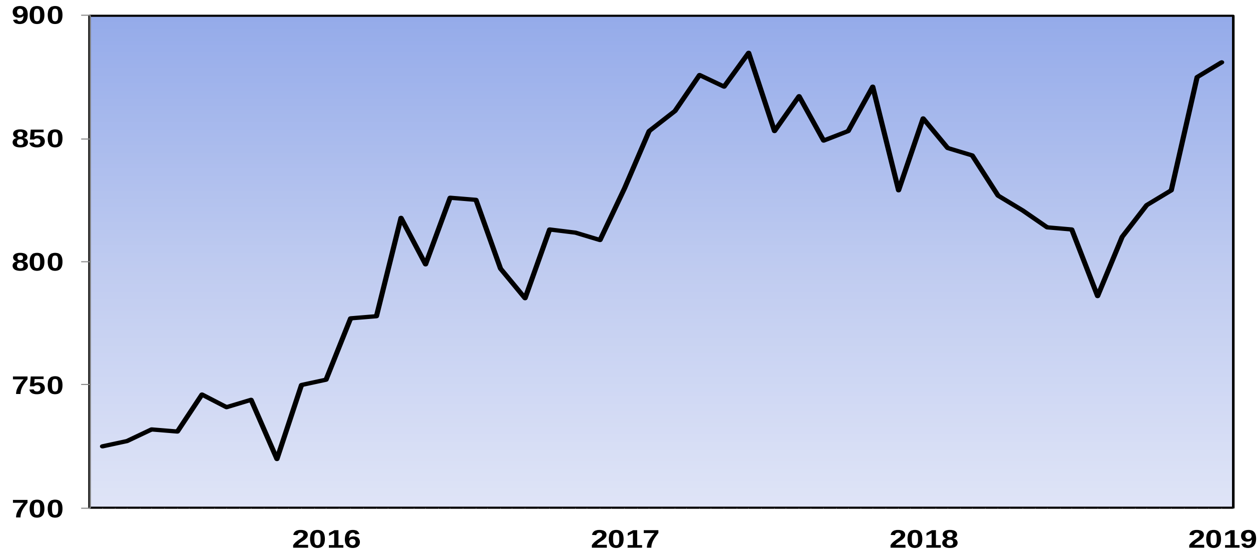


- **More Accommodation**: *The Fed wants faster growth and higher inflation and will therefore maintain an accommodative monetary posture for an extended period*. Low policy rates will be reinforced by a renewed expansion in the Federal Reserve's balance sheet, all of which will provide more than ample liquidity to support economic growth in future quarters (see chart 5).

Consumer Sector Strength: Aside from powerful headwinds emanating from the trade conflict, US economic and financial conditions are healthy and supportive of continued economic growth, led by private consumption. Employment is increasing at a pace sufficient to maintain downward pressure on the unemployment rate, near a 50-year low. Adjusted for inflation, personal income is increasing at a robust 3% annual rate, which should support 2.5% growth in personal consumption in 2020 (see chart 6).

Residential Construction: The housing market is in the early phase of a sustained cyclical rebound that began earlier in the year. All measures of housing activity are in a solid recovery phase, including single-family housing starts (+15%) and building permits (+12%); existing home sales (+10%); new single-family home sales (+25%); and new orders (+13%). *Homebuilder confidence is the strongest it has been in nearly two years*. There has never been a recession with housing in an expansion mode (see chart 7).

Chart 7: Home Construction in a Strong Recovery Phase
Building Permits, Single-Family Homes, Thousands
Source: Census Bureau



- **Supply Shortages**: The slower pace of existing home sales relative to that of the new home market can be explained by an extreme shortage of listings, with inventories near all-time lows. The housing outlook is favorable, based upon low mortgage rates, improving affordability, a strong labor market, and rapid growth in household formations.

Business Capital Investment: Capital spending continues to weaken. New orders for core capital goods are declining, while expenditures for business equipment have slowed over the past month from a growth rate of 10% to only 1%. The primary headwind to capital formation is the profound uncertainty regarding trade policy. Businesses tend to retrench during periods of uncertainty, and have postponed capital projects until there is at least some resolution to the trade conflict.

- **Positive Backdrop**: Except for trade policy, traditional fundamental factors are favorable for investment spending — there is strong growth in cash flow and a low cost of capital. I expect another capital goods cycle to begin six months following a truce on trade, augmenting GDP growth later next year and in 2021.

RECESSION RISK

Although economic confidence has improved in recent weeks, market sentiment continues to be dominated by fears of a world recession. I continue to believe that the probability of recession is low because the classic preconditions for recession — cyclical excesses and imbalances — are not evident.

- **Recession Catalysts**: The most important of these imbalances are spreading inflationary pressures, excesses in investment spending, deterioration in credit conditions, business and investor complacency, and monetary restraint. Inflation is stable; credit is available to all borrowers and on favorable terms; and spending on capital goods and single-family homes is depressed.

- **Widespread Caution**: In addition, the Treasury yield curve has returned to its normal upward slope, and the demand for labor remains strong. Finally, businesses and investors are cautious. ***History reveals that recessions seldom come about at a time when they are widely anticipated*** — but rather occur during periods of business and investor optimism and complacency.

WORLD ECONOMIC OUTLOOK

The outlook for financial markets is predicated upon the direction of the world economy and a recovery in world trade. <u>World equity prices and bond yields will move higher in response to signals of a global economic recovery</u>. <u>There are five compelling reasons why world economic growth should rebound during 2020</u>:

1. **Manufacturing Cycle**: The classic three-year manufacturing cycle appears to be approaching an important inflection point. Both the drawdown in excess inventories and the worldwide automotive recession are nearing an end, implying a recovery within the next three to six months.

2. **Global Liquidity**: Policymakers have provided massive monetary stimulus over the past year, with more than 85% of central banks in a highly accommodative mode. A surge in global liquidity is typically followed by an acceleration in world GDP, with a time lag of one year.

3. **Recovery in China**: Because China serves as the primary engine for the world economy, a reversal in Chinese consumption, production, capital investment, and imports will be beneficial for a revival in global economic growth. While achieving only minor success so far, policymakers will continue to provide stimulus until the Chinese economy is in a recovery mode.

4. **Trade Policy**: There is preliminary evidence of a thawing in trade relations between China and the US. The two countries are in discussions that could lead to a "phase one" agreement that would reduce business and investor anxiety over trade. A substantive agreement in coming weeks would be a catalyst for a resumption in healthy growth in business investment spending.

5. **Preliminary Signs**: Although there are few obvious signs of a world economic recovery, incoming data suggest that manufacturing may be in a bottoming process. Economic data should begin to show signs of a recovery over the next six months, on a sequential basis.

China: Although incoming data point to continued weakness in China, leading indicators of future growth are turning positive at the margin. Most important is growing evidence of policymakers' willingness to provide monetary and fiscal stimulus. Monetary conditions have eased and credit growth appears to be at a turning point.

- **Fiscal Stimulus**: The government has also reduced taxes by nearly 3% of GDP, while increasing spending on infrastructure. Stabilization and revival of the Chinese economy will become evident over the next six months. The eurozone and emerging Asia will be the prime beneficiaries of an economic recovery in China.

The Eurozone: Growth prospects for the euro area economy should gradually improve as 2020 unfolds. Compared with a current rate of 1%, GDP growth could approach 2% one year from now, led by recoveries in Germany and Italy and continued solid growth in France and Spain. The German economy is the engine of growth within Europe.

- **Policy Stimulus**: An expected reversal in world trade and the global auto cycle should boost German manufacturing, beginning in the new year. Government stimulus should also boost growth. The European Central Bank (ECB) continues to ease policy through rate reductions and bond purchases, while fiscal policy has begun to loosen.

- **Brexit**: Prospects for a satisfactory resolution to Brexit have improved enormously in recent weeks. The probability of a widely feared no-deal Brexit — a disorderly UK exit from the European Union (EU) — has declined significantly, leaving two possible outcomes: (1) An eventual trade deal, along with reduced tariffs; and (2) Another referendum similar to that of July 2016, with a likely no-exit vote.

The US Dollar: Following several years of strong appreciation, the US dollar (USD) has peaked and is likely to decline over the next one to two years. The USD is a *countercyclical currency*, which appreciates during periods of economic weakness and depreciates during periods of healthy world economic growth. Evidence of a sustained revival in world economic activity will trigger a sustained downturn in the dollar.

- **Dollar Overvaluation**: A widening US current account deficit along with a sharp slowdown in US capital inflows will accentuate pressure on the USD. Finally, the USD is overowned and overvalued. A weak dollar would be a distinct positive for the world economy because of its beneficial effect on global liquidity conditions.

THE INVESTMENT OUTLOOK

The investment outlook is predicated upon a rebound in world economic growth, which in turn is dependent upon an easing in trade policy. The gradual slowdown in global economic growth over the past 18 months has favored defensive, safe-haven assets, including government bonds; bond proxies, such as utilities and real estate; and defensive economic sectors, such as consumer staples and healthcare.

Fixed-Income Markets: Global fixed-income markets are unattractive, and are vulnerable to rising rates over the next two years. Government bonds in most countries are overbought and overvalued as a result of strong underlying demand for ultra-safe financial assets, stemming from widespread economic gloom.

- **Negative Returns**: Long-duration US Treasury bonds have already declined by more than 5% since September 1, and further losses lie ahead as interest rates drift higher. Investors should expect negative rates of return from government bonds over the next year, while corporate bonds should perform only slightly better. Total returns on speculative-grade bonds could approach 5% over this same period.

US Equity Market: Prospects for the domestic equity market are mixed, depending upon time horizon. Stocks should generate positive returns over the next year on a cyclical basis, as the world economy emerges from a classic mid-cycle slowdown that began 18 months ago. Common stocks could generate returns of 10% between now and the 2020 election, based upon an improving trend in company earnings and continued ultra-accommodative monetary conditions.

- **Lackluster Long-Term Returns**: Expected rates of return over the next three years are less favorable in an environment of slowing economic growth, a rising risk of recession in late 2021 or 2022, slowing profit growth in 2021, a rising trend in bond yields, and less favorable monetary conditions beginning in 2021. Average annual returns over the next three years are unlikely to exceed 5%.

Value Versus Growth Stocks: Equity market leadership appears to be at an important inflection point. The outperformance of growth stocks over value stocks since 2007 has been unprecedented in both duration and magnitude. There are preliminary signs that this trend may be reversing: Since the end of August, the total return on the S&P 500 Value Index (+9.5%) has significantly outperformed the S&P 500 Growth Index (+3.3%) through the middle of November.

- **Catalyst:** *Market perception of recession risk is the primary determinant of relative performance*. Investor sentiment regarding economic and policy risk has improved, sparking a shift in market preference for value stocks. I expect value managers to significantly outperform growth managers over the next 12 months. Beyond 2020, growth managers should resume market leadership, as investors begin to anticipate the next recession, likely to occur in late 2021 or 2022.

- **Economic Sectors**: In terms of economic sectors, the defensive safe-haven leaders of the past several years should begin to lag economically sensitive stock groups, including industrials, materials, energy, transports, financials, and consumer discretionary. Utilities, consumer staples, real estate, and healthcare stocks are likely to be laggards over the next year. The technology sector should track the broad market.

International Equities: Non-US equity markets have lagged that of the US since 2007, but appear to be at a turning point. Since the end of August, the return on international stocks (+7.5%) has slightly exceeded that of the S&P 500 (+6%). Emerging Asian equity returns have risen by 9% over that same period. *Because of their greater economic sensitivity, international equities are pro-cyclical and move directionally with global economic growth*. Eurozone and emerging Asian market equities should perform best over this period. Non-US equities also enjoy a significant valuation advantage over domestic equities.

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.

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.