QUARTERLY ECONOMIC REVIEW

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Summary and Major Conclusions:

In the short term, economic conditions will worsen significantly before beginning to stabilize in the summer months. However, it is important to understand that the depth of declines in second quarter GDP and company earnings is of little enduring relevance, simply because this data is temporary, artificial, and not sustainable. What is important for investors is the level of GDP and corporate profits in the fourth quarter of this year and for all of 2021 and 2022.

- The US economy is in the midst of a self-induced recession that began in March and will deepen significantly in the second quarter. This recession is unlike any of the 12 recessions that have occurred since World War II. It is unique in that the crucial underpinnings of the economy were extremely healthy when the recession began.

- Historically, the typical textbook recession is triggered by large imbalances in the economy and credit markets, none of which were evident prior to the COVID-19 pandemic. Recessions are also triggered by excess debt accumulation, a weak and fragile banking system, and credit market stress, also not present.

- Typically, economic contractions also result from an overbuilding of inventories, residential and commercial structures, and plant and equipment. These excesses trigger an adjustment process that requires a sharp pullback in spending and output. None of these conditions were present as 2020 began.

- First quarter GDP declined at an estimated 3.5% annual rate. Layoffs were widespread, pushing the unemployment rate to greater than 5% in March, the highest in many years. As measured by companies in the S&P 500, earnings per share (EPS) declined by an estimated 15%, the worst quarterly decline since 2008.

- Second quarter GDP should be the weakest of the recession by far, with an unprecedented contraction in output in excess of 20%. A further small decline in GDP is possible in Q3 prior to a strong gain in the fourth quarter.

- It is important to understand that the depth of declines in quarterly GDP and company earnings is of little enduring relevance, simply because it is artificial and not sustainable. What is important for investors is the level of GDP and corporate profits in the fourth quarter of this year and during all of 2021.

- Policymakers swung into action during the quarter with a massive rescue package. The Federal Reserve slashed its policy rate to zero and announced a greatly expanded program of asset purchases. It is impossible to overstate the magnitude of stimulus provided by the Federal Reserve.

- Most importantly, the Fed established lending facilities to prevent a seizing up of various credit markets, including the commercial paper market, money market funds, and the market for asset-backed securities.

- These unprecedented policies should bolster the financial system and help prevent a self-reinforcing negative feedback loop of financial deleveraging that occurred in 2008 and 2009. The open-ended monetary support pledged by the Fed should be reassuring to investors.

- Fiscal policy measures were also implemented. Congress passed legislation to provide $2 trillion in funds in response to intense liquidity and cash flow pressures currently faced by businesses and households.

- Predictions regarding the depth of the economic contraction in coming quarters are futile. The outlook for 2020 is predicated upon the duration of the COVID-19 pandemic. The most important independent variable is the timing of a peak in the number of new cases in the US and Europe, which cannot be predicted at this time.

- When the number of new cases reach a peak, the focus should return to the real economy to gauge the speed at which businesses are able to restart the economy. Most important are survey responses from businesses regarding hiring intentions and plans for capital investment.

- There are also timely data regarding the direction of the economy, including initial jobless claims, consumer confidence surveys, the new-orders-to-inventory ratio, rail car loadings, port traffic, airline bookings, and homebuilder surveys. Investors should also track the pace of openings by restaurants, retail stores, and offices.

- For the full year, US GDP could decline by more than 5%, the weakest calendar year since the Great Depression. Under this scenario, the US economy could rebound strongly in 2021, with full-year GDP growth in excess of 5%. Corporate earnings could decline by more than 25% for all of this year but rebound strongly in 2021.

- Following two or three quarters of declines beginning with Q1, GDP could end this year at a level more than 10% below that of the fourth quarter of 2019, resulting in a massive demand gap. The result will be a large buildup in pent-up demand, along with high unemployment and exceptionally low capacity utilization rates in manufacturing.

- The outlook for inflation is very favorable. Inflation is the quintessential lagging indicator and tends to remain dormant for several years following an economic downturn. Core consumer inflation has averaged 1.75% over the past two years but is virtually assured of falling in both 2020 and 2021.

- This expected abundance of economic slack and absence of bottlenecks should support sustained economic growth for many years. The implication is that the next recession could be many years into the future.

ECONOMIC REVIEW

Developments surrounding the economic downturn, financial markets, policymaker actions, and public health are changing at a frenetic pace. Of greatest immediate importance are trends pertaining to public health conditions. In the negative column, the number of new cases in Europe and North America are increasing at an accelerating pace; economic trends continue to worsen; unemployment is rising; and company earnings are set to decline precipitously during the first half of the year (see chart 1).

Chart 1: Confirmed Cases of Coronavirus Rising Exponentially
Number of US Cases of COVID-19 in the US
Source: The Center for Disease Control

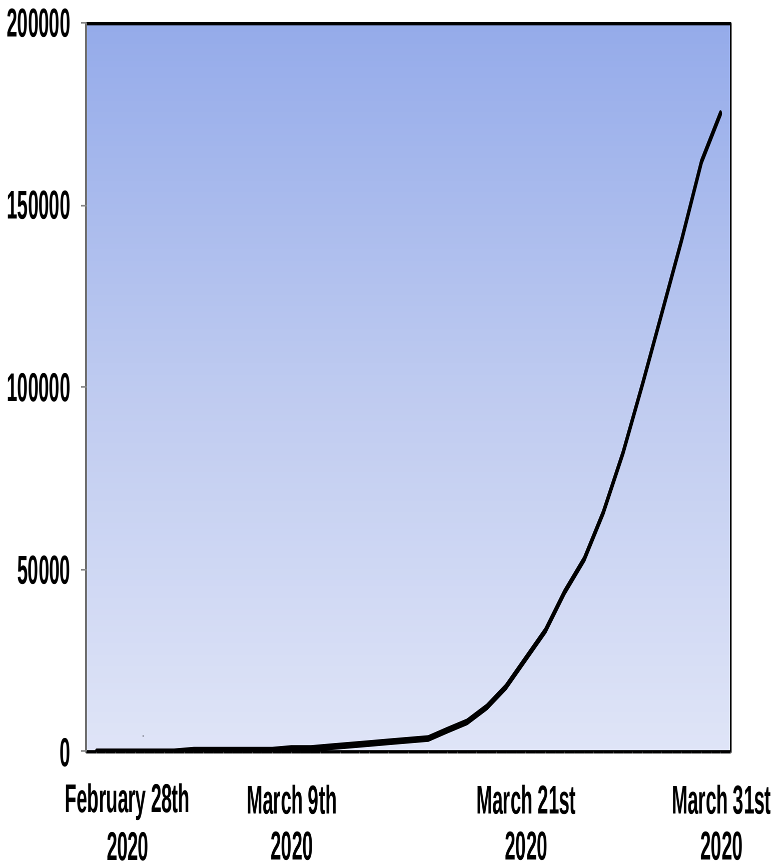
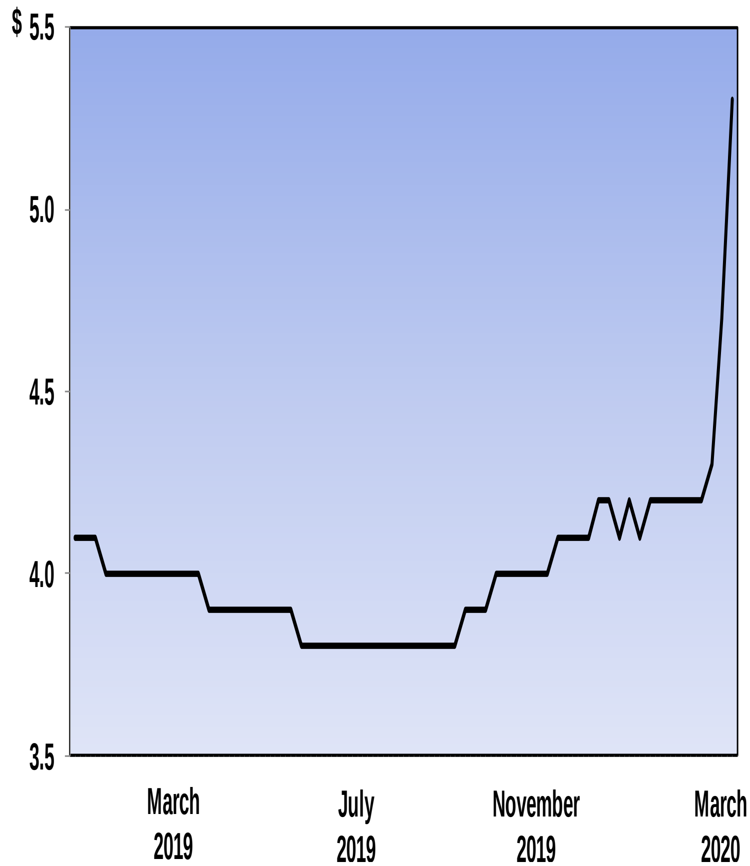


Chart 2: Federal Reserve Resumes Quantitative Easing
Asset Holdings Within the Federal Reserve System ($ Trillions)
Source: The Federal Reserve



Sense of Urgency: In the plus column, policymakers have responded aggressively with commitments of trillions of dollars to support the economy and credit markets on both the fiscal and monetary policy front. In addition, public health officials have finally begun to exhibit a greater sense of urgency in dealing with the pandemic. Although still in short supply, vital medical supplies — masks, ventilators, gowns, and test kits — are becoming increasingly available. The Federal Reserve announced plans to make unlimited purchases of government, mortgage-backed, municipal, and corporate bonds (see chart 2).

Public-Private Partnership: There is encouraging evidence of a growing public-private partnership. Companies are converting production facilities to augment the production of such necessities as masks, hospital gowns, and ventilators. Finally, progress is evident in medical science: Abbott Laboratories has begun mass production of an advanced diagnostic test, while Johnson & Johnson has announced a breakthrough in development of a vaccine for COVID-19 that could be available during 2021.

Chart 3: US Service Sector in a Steep Decline
Monthly Index of Service Sector Business Activity
Source: IHS Markit

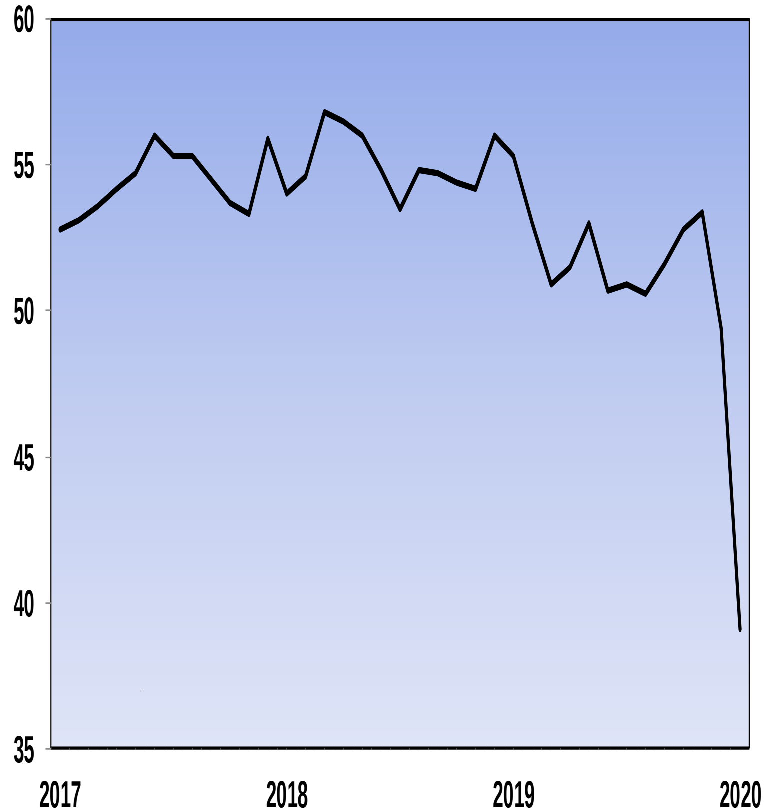
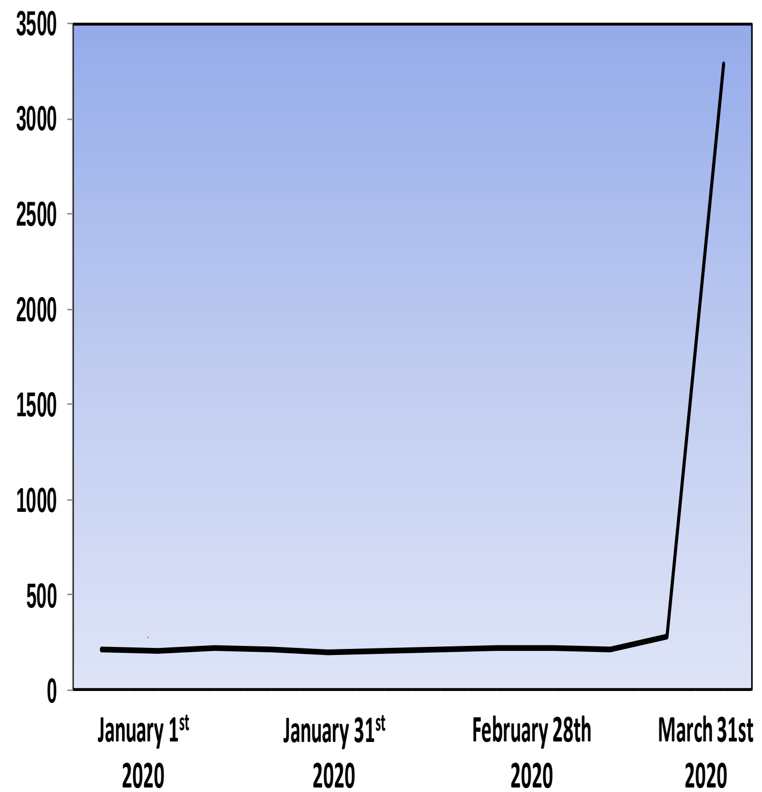


Chart 4: Initial Jobless Claims Surge to Highest Level on Record
Initial Claims for Unemployment Insurance (Hundreds)
Source: Labor Department

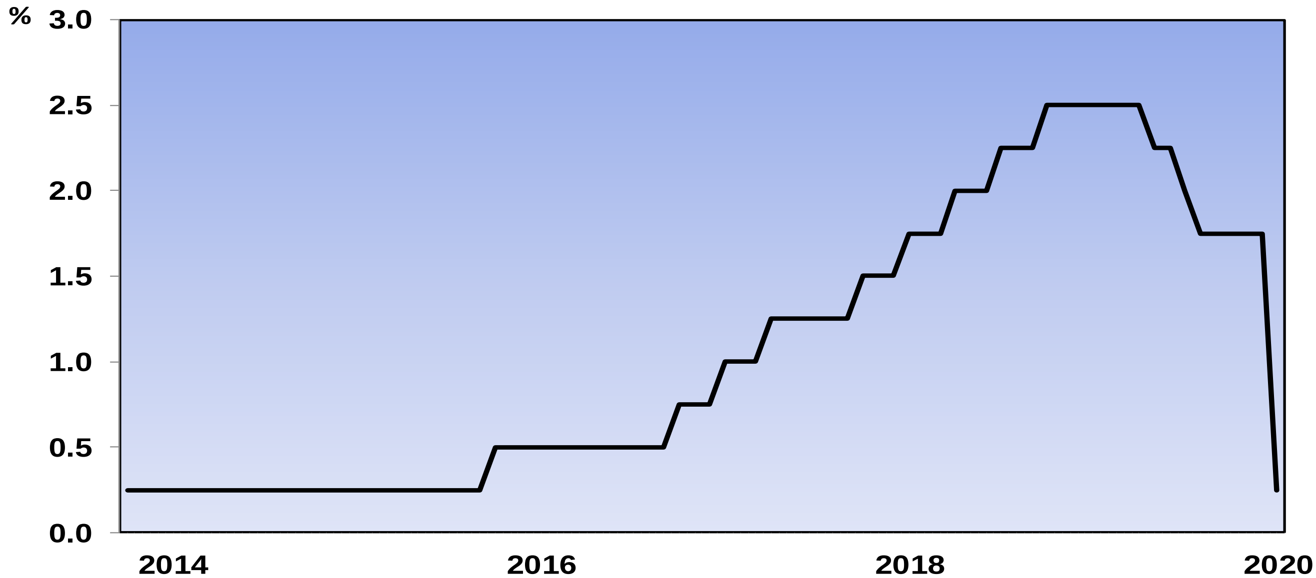


Economic Conditions: The quarter began on a favorable note, with evidence of broad economic strength in January and February across most sectors of the economy. Job creation was strong, consumer spending and housing remained on a solid growth path, and airline bookings were increasing at a rapid clip. However, March witnessed the beginning of an arduous process of containment and lockdown, with a virtual shutdown of commercial activity that would become more widespread in subsequent weeks. The service sector was especially hard hit (see chart 3).

First Quarter GDP: Virtually all economic sectors suffered declines in the month, including retail sales, airline travel, manufacturing, leisure and recreation, business capital investment, and a full range of consumer and business services. When combined, declines in these industries and sectors resulted in an estimated 3.5% slump in first quarter GDP.

- **Unemployment**: Layoffs were widespread, pushing the unemployment rate from 3.5% to an estimated 5% in March, the highest level in many years. Weekly jobless claims spiked to a record of more than three million, up from fewer than 300,000 in the previous week. As measured by companies in the S&P 500, corporate earnings declined by 15%, the worst quarter since the 2008 financial crisis (see chart 4).

Chart 5: Federal Reserve Slashes Policy Rates to Zero
The Overnight Federal Funds (%) Rate
Source: The Federal Reserve



The Federal Reserve: The most significant economic developments during the first quarter involved announcements of government rescue measures, the most dramatic of which were bold and unprecedented initiatives by the Federal Reserve to support credit markets and the economy as the lender of last resort. The Fed moved into uncharted waters by offering to provide trillions of dollars to support dysfunctional credit markets and a collapsing economy.

- **Quantitative Easing**: Plans to purchase government bonds were greatly expanded, while corporate, asset-backed, and municipal bonds were added to the list of eligible assets for purchase. The Fed will also provide direct support for the commercial paper and asset-backed markets, while bolstering liquidity in money market funds. The federal funds rate was slashed to zero (see chart 5).

Fiscal Policy: Congress finally reached an agreement on an estimated $2 trillion stimulus package — the largest fiscal spending bill in history — to provide direct assistance for households and businesses. The legislation will provide direct funds for many Americans, greatly expand unemployment insurance, and grant hundreds of billions in loans to small businesses. Funds will also be provided for banks to expand their lending capacity.

European Policymakers: The European Central Bank (ECB) followed the lead of the Federal Reserve, announcing a massive asset purchase program, including both eurozone government and corporate bonds. In addition, Germany announced that it would raise 375 billion euros of government debt to support a massive public spending program.

ECONOMIC OUTLOOK

The US and world economies are engulfed in an unprecedented economic contraction that was self-induced to suppress transmission of COVID-19. Predictions regarding the magnitude of declines in GDP in coming quarters are futile. The outlook for 2020 is predicated upon the duration of the coronavirus outbreak. *The most important independent variable is the timing of a peak in the number of new cases of COVID-19 in the US and Europe*.

Quarterly GDP Outlook: I have little conviction in my GDP forecast in 2020 and 2021, but can provide ballpark estimates. *In the short term, economic conditions will worsen, before beginning to stabilize in the summer months*. I expect first quarter GDP to decline at a 3.5% annual rate, followed by an unprecedented contraction of 20% in Q2. A further mild decline in GDP is possible in Q3 before economic growth resumes in the fourth quarter. Fourth quarter GDP could increase at a double-digit annual rate.

- **Calendar GDP**: For the full year, the decline in US GDP could be in a range of 5% to 10%, the weakest calendar year since the Great Depression. Under this scenario, the economy could rebound strongly in 2021, with full-year GDP growth well in excess of 5%. Robust growth is also likely in 2022 as the economy and financial system return to full strength. Nonfarm payrolls could decline by more than ten million, pushing the unemployment rate to 12% by yearend.

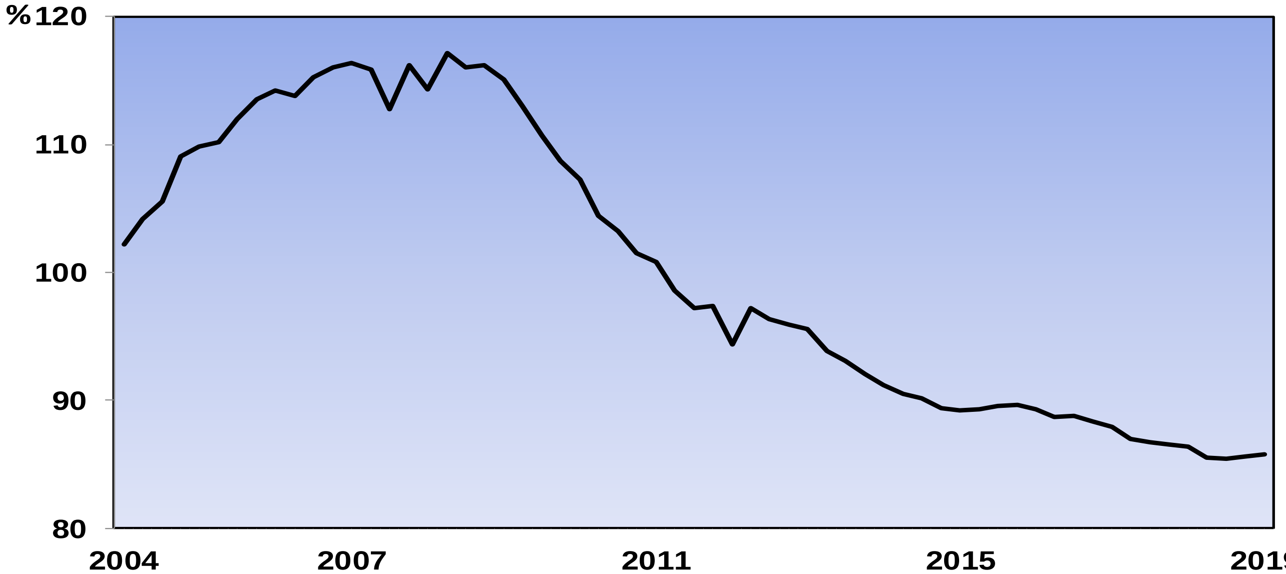
It is important to understand that the depth of declines in quarterly GDP and company earnings is of little enduring relevance, simply because this data is temporary, artificial, and not sustainable. What is important for investors is the level of GDP and corporate profits in the fourth quarter of this year and during all of 2021 and 2022.

HOW STRONG AN ECONOMIC RECOVERY?

Although an economic recovery appears plausible during the second half of this year, the strength of the recovery may be constrained ***initially*** by logistical challenges, as companies and workers return to business. That said, there are credible reasons to support a forecast of a strong revival in economic growth next year and in 2022, with GDP growth exceeding its long-term potential in each year. There are several reasons to support this assumption:

- **Momentum**: It is a well-known fact that the US economy began this year on a very strong note. *The shock to the economy should be transitory, implying a U-shaped recovery. A return to the previous trendline could generate very strong GDP growth later this year and in 2021*.

Chart 6: Household Balance Sheets Benefit From Protracted Deleveraging Cycle
Household Debt as a Percentage of Personal Income
Source: The Federal Reserve



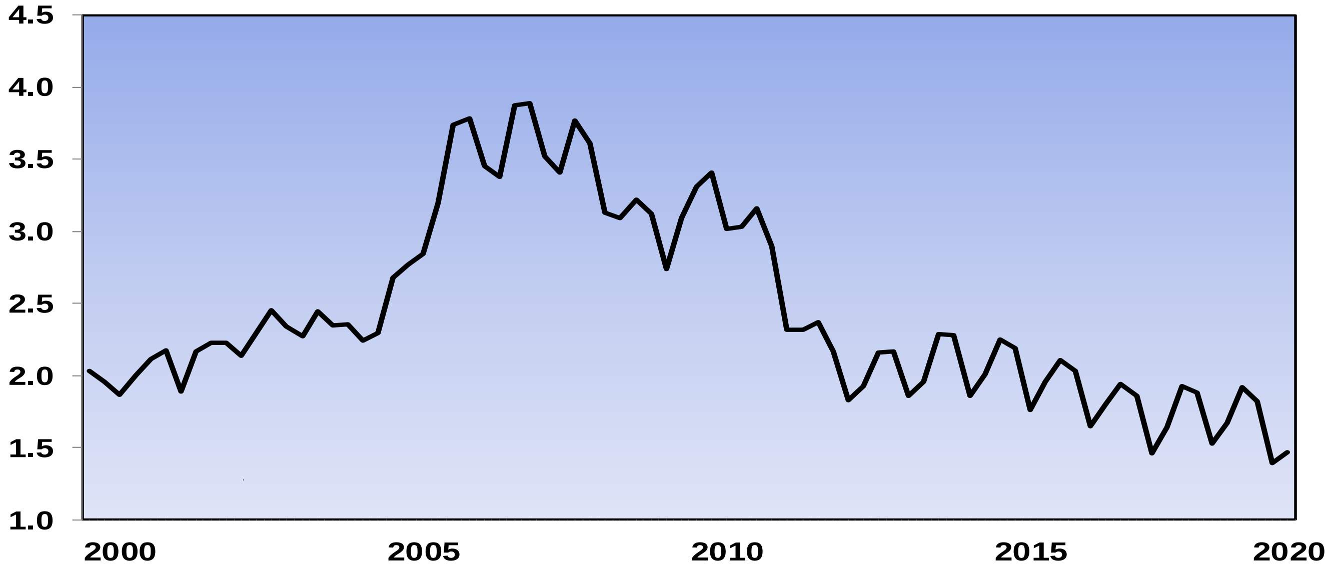
- **Healthy Underpinnings:** Unlike the 2008 recession, the current recession was not caused by deep underlying imbalances and excesses within the economy. In sharp contrast to 2008, the banking system is overcapitalized; the housing market is vastly undersupplied, rather than grossly overbuilt as in 2008; and household balance sheets are healthy, following a nearly decade-long deleveraging cycle (see chart 6).

- **Monetary Policy**: The response of the Federal Reserve has been unprecedented both in scope and in size, easily exceeding that administered in 2008. Although the thrust of these policy initiatives was designed to stabilize credit markets, this added stimulus should augment the strength of the economic recovery. In addition, the current unprecedented lows in interest rates are likely to persist for an indefinite period.

- **Fiscal Policy**: The $2 trillion fiscal rescue package passed by Congress provides funds to assist businesses and employees in numerous industries. Deficit-financed spending programs are extremely potent stimulus measures, albeit at the expense of budget deficits in future years.

- **Pent-Up Demand**: The artificial plunge in spending will create sizeable pent-up demand for both households and businesses. In particular, demand for consumer durable goods, business and consumer services, and housing construction has been suppressed. Inventories of both, while home inventories at near an all-time low. The result should be a strong economic rebound in the quarters following the recession (see chart 7).

Chart 7: Nationwide Shortage of Existing Homes
Inventory of Unsold Existing Homes (Millions)
Source: National Association of Realtors



CORPORATE EARNINGS

Although precise forecasts for company earnings are not possible, rough estimates of the general pattern of future earnings are possible. My profit forecast assumes the following:

- Year-over-year profit will decline in the next three quarters, beginning with the first quarter. Earnings should begin to stabilize in the third and fourth quarters, which should build a foundation for very strong growth throughout 2021.

- As a rough approximation, earnings for the companies in the S&P 500 could decline by 15% in Q1, followed by a 35% decline in Q2 and a 20% decline in Q3. Company profits could rise by 5% in Q4 on a ***year-over-year basis***, but increase sharply on a ***sequential*** Q3-to-Q4 basis.

- Corporate earnings could decline by 25% for all of this year but could rebound strongly in 2021. Assuming revenue growth of 10%, earnings for all of 2021 could rise by 30%. Another 20% increase is possible in 2022.

Economic Sectors: The sector composition of S&P 500 earnings should help cushion the decline in profits. For example, four economic sectors — technology, health care, consumer staples, and communications services — comprise more than 55% of the total earnings. *These four sectors are less vulnerable to profit declines and should cushion the decline in total earnings*. The sectors at greatest risk — materials and energy — comprise less than 10% of total earnings in the index.

The key point is that corporate earnings will suffer several quarters of steep declines but bounce back relatively quickly. My forecast assumes that the number of COVID-19 cases peaks in May or June, implying a restarting of the domestic economy in July and August and improving corporate profitability in both 2021 and 2022.

ECONOMIC SIGNALS: WHAT SHOULD INVESTORS WATCH?

<u>There are important indicators that should be closely monitored in order to assess the magnitude of economic weakness in the short term and to better understand the possible timing of an economic recovery</u>:

1. **New Cases**: A decisive peak in the number of new cases in the US but also in Canada and Europe, especially Italy.

2. **Asian Countries**: Health trends in China, South Korea, and Singapore should also be monitored to ensure that a second wave of infections does not occur.

3. **Public Health System**: Positive trends in public health, including much greater availability of test kits, masks, and ventilators, along with greater success in identifying and containing the spread of COVID-19.

4. **Medical Innovation**: Introduction of new therapeutic (anti-viral) medicines to mitigate the illness along with state-of-the-art diagnostic testing equipment.

5. **Continued Policy Response**: The willingness of policymakers to provide open-ended economic assistance to businesses, workers, and credit markets.

6. **Credit Conditions**: Evidence of effective functioning of money and credit markets and maintenance of a smooth flow, and continued availability of credit to individuals and businesses.

7. **Restarting the Economy**: When new cases reach a peak, the focus should shift to the real economy to gauge the speed at which businesses are able to restart the economy.

8. **Business Surveys**: Responses of businesses in surveys regarding hiring intentions and plans for capital investment. The monthly homebuilder survey is an accurate assessment of housing market conditions.

9. **Real-Time Data**: The focus should be on timely data regarding the direction of the economy, including initial jobless claims, hiring intentions, consumer confidence surveys, the new-orders-to-inventory ratio, rail car loadings, port traffic, airline bookings, and the pace of openings by restaurants, retail stores, and offices.

10. **Asian Models**: Close inspection of economic trends in the early-infection countries — especially China and South Korea — as a possible guide or template for how quickly and effectively the US economy might restart once the coronavirus has been contained.

11. **The US Dollar**: As the quintessential safe-haven currency, the US dollar (USD) has soared since the COVID-19 outbreak, reflecting a global flight to safety. Evidence of a sustained reversal in the USD would signal an increase in economic confidence and expectations of improving business conditions.

12. **Business Inventories**: The level of business inventories will determine the pace of the rebound in manufacturing output.

A LONGER EXPANSION CYCLE

There is a silver lining to the expected steep decline in economic activity with implications for sustained economic growth beyond 2020. The long-term potential growth of the US economy is estimated at 2%. When GDP growth exceeds its speed limit, it is in effect ***borrowing** from the future, thereby effectively **shortening the duration** of the business expansion cycle*. *The opposite is also true: A period of profound economic weakness and/or an outright recession tend to **prolong** the subsequent expansion*.

The economic expansion that began in 2009 was the longest in American history because the average annual GDP growth rate of 2% did not exceed its potential growth of 2%. The result was a prolonged period of minimal pressure on productive resources and an absence of bottlenecks. A comparable situation currently exists. Following three quarters of steep declines beginning with Q1, GDP could end this year at a level more than 12% below the fourth quarter of 2019.

The result would be a massive demand shortfall and unprecedented lows in capacity utilization in manufacturing. Rising unemployment will add to the abundance of underutilized productive resources available to support sustained economic growth for many years. *This absence of bottlenecks could defer the next **traditional** recession until 2023 or 2024, at the earliest*.

On a related note, the outlook for inflation is very favorable. *Inflation is the quintessential lagging indicator and tends to remain dormant for several year following an economic downturn*. Core consumer inflation has averaged 1.75% over the past two years but is virtually assured of falling in coming quarters.

Inflationary expectations have plunged since the onset of the global pandemic — from an average of 1.75% to less than 1%. My forecast assumes a decline in the inflation rate to 1.25% or less over the next two years. A rebound in inflation is possible in 2023, depending upon future actions by the Federal Reserve.

ECONOMIC PERSPECTIVE

The US economy is in the midst of a recession that began in March and could persist into the third quarter. This recession is unlike any of the 12 recessions that have occurred since World War II in that it was a self-induced downturn deemed necessary to suppress the transmission of the coronavirus.

It is also unique in that the underpinnings of both the economy and financial sector were healthy when the recession began. In particular, the banking sector was the healthiest in many decades.

Historically, the typical textbook recession is triggered by large imbalances in the economy and credit markets, none of which were evident prior to the onset of the COVID-19 virus. In most instances, an overbuilding of inventories, residential and commercial structures, and capital equipment render the economy vulnerable to a pullback in spending and output necessary to correct the excesses that came about during the previous expansion.

Recessions are also triggered by excess debt accumulation, a weak and fragile banking system, and credit market stress. None of these conditions were present as 2020 began. The implications are profound: Whereas the economic recovery from the 2008 recession was undermined by a *protracted period of balance sheet deleveraging, recapitalization of the banking sector*, and working off the enormous bubble of excess houses, there are minimal economic and financial headwinds to impede the recovery from the 2020 recession.

Moreover, policymakers have responded with unprecedented speed and urgency to the profound weakness in the economy and the financial system. The $2 trillion fiscal relief package voted by Congress will provide badly needed funds for individuals, small businesses, vulnerable industries, and reeling state and local governments. The aggressive actions by the Federal Reserve are unprecedented in the history of the Fed, and have demonstrated the will to do “whatever it takes” to support the economy.

There is no reason to doubt that the US economy will ultimately embark on a healthy and sustained economic expansion that could persist over the next two or three years, at a minimum. The only unknown is the timing of a new business cycle expansion.

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.