QUARTERLY INVESTMENT OUTLOOK

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Summary and Major Conclusions:

The primary wild card in the investment outlook is the direction of inflation. The trend in inflation will dictate the future path of bond yields, the timing and magnitude of the monetary tightening cycle, and the sustainability of the economic expansion. In the most extreme scenario, a sustained wage/price cycle could culminate in a classic boom/bust cycle prior to 2024, which could trigger the most severe equity bear market since the world financial crisis in 2008.

- World financial markets posted another positive quarter during the three months ending June 30, with all major asset classes in the black. Commodity markets performed best, while world equity markets easily outperformed world bonds.
- Financial markets benefitted from strong economic growth, very low interest rates, extremely accommodative central bank policies, booming company profits, and substantial progress on the public health front.
- World financial markets are at a critical juncture. There are powerful economic crosscurrents currently in place that could accentuate volatility in all markets in coming months. Investment risks will increase progressively over the next two years.
- The medium-term outlook appears benign. Both economic output and earnings should continue to grow rapidly over the next 12 months; long-term interest rates should rise only modestly; and world central banks should remain highly accommodative.
- The business sector is in the early stages of the most spectacular earnings cycle in decades. Earnings per share (EPS) for companies in the S&P 500 rose by 50% in the first quarter, and an even larger gain is expected in Q2.
- The level of earnings is unlikely to peak until the middle of next year, when I expect corporate profit margins to weaken in response to a plateau in revenues and rising wage pressures. All else equal, stock prices tend to rise as long as actual reported EPS continue to exceed analyst estimates.
- The primary wild card in the investment outlook pertains to inflation. The trend in inflation will dictate the direction of bond yields, the timing and magnitude of the monetary tightening cycle, and the sustainability of the economic expansion.
- The Federal Reserve has conducted the most aggressive easing in monetary and credit conditions since the 1970s. Excess financial liquidity has boosted asset prices in virtually all markets and should continue to support global equity markets through the middle of next year.
- Federal Reserve policy will reach a significant inflection point during the second half of next year. A combination of rising inflationary expectations and the approach of full employment will compel the Fed to begin a new rate-tightening cycle, which will raise the risks associated with common stock investing.
- Fiscal policy support for the economy will peak this year and could fade rapidly in 2022 depending upon future legislation from Congress. Similar to monetary policy, fiscal policy should support the equity market for the remainder of this year but could become a significant headwind for stocks during 2022 and beyond.

- The world economy is poised to enjoy the first synchronized global recovery in many years. Expansionary forces already in place should spark a strong economic revival in all major economies, led by China and the US. Europe should rebound strongly in the second half of this year and throughout 2022.

- The principal investment significance of a synchronized world economic recovery involves global equity market leadership. Historically, coordinated world economic expansions have been consistent with non-US stocks outperforming those in the US.

- Measures of relative valuations add to the overall appeal of non-US stocks. International stocks are priced at an unusually large valuation discount to the S&P 500 Index. Finally, the outlook for sustained US dollar weakness should also benefit non-US equity markets.

- The current calm in the US fixed-income market is not sustainable. At a market yield to maturity of less than 1.5%, the current level of long-term government bond yields is fundamentally inconsistent with a booming economy and rising inflationary expectations.

- The outlook for the US equity market depends upon time horizon. The critical factors driving the stock market are likely to remain favorable over the next 12 months but could turn negative later next year.

- In the medium term, the path of least resistance for stock prices is likely to be to the upside. That said, investors should expect only modest returns from current elevated valuations.

- The growth rate in company earnings over the next four quarters could be the fastest in several decades but will likely lose momentum during 2022. Federal Reserve policy should remain highly accommodative over the next year but will become contractionary later next year and in 2023.

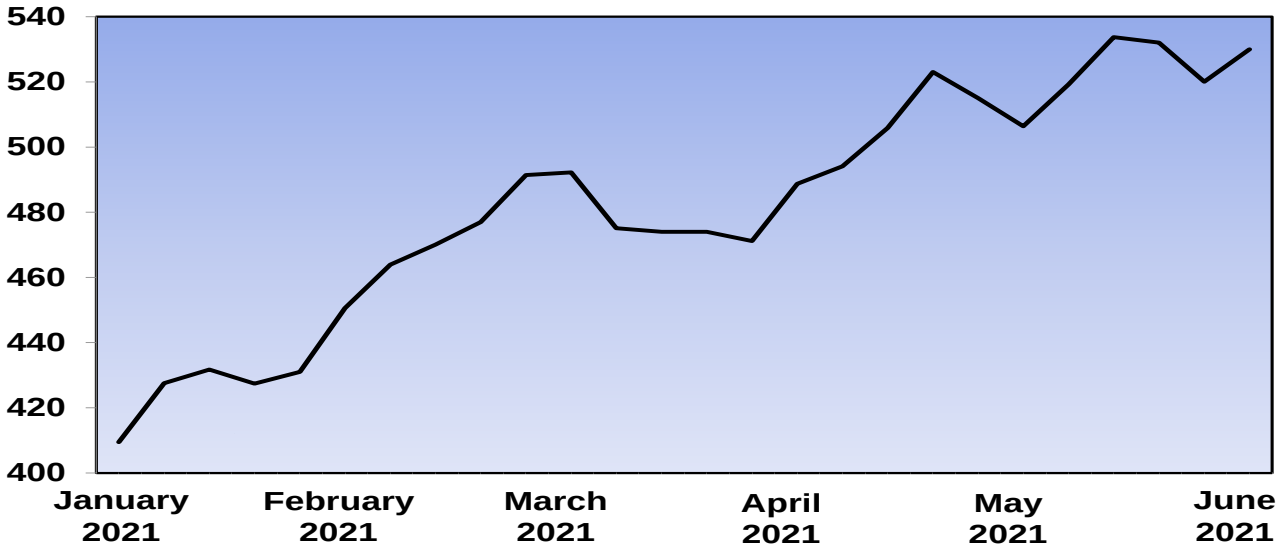
- Global equity markets are in the early stages of a shift in leadership. The dominance of US large-capitalization growth stocks appears to have ended approximately nine months ago, with value stocks moving to the forefront. International equity markets are also showing signs of overtaking domestic stocks.

FINANCIAL MARKET REVIEW

World financial markets posted another positive quarter in the three months ending June 30, with all major asset classes in the black. Commodity markets performed best, while world equity markets easily outperformed world bonds. Financial markets benefitted from strong economic growth, very low interest rates, extremely accommodative central bank policies, booming company profits, and substantial progress on the public health front.

Pandemic News: The number of US infections and deaths associated with COVID-19 has literally collapsed in recent months, while vaccinations have increased markedly. Since January of this year, new infections and deaths have declined by nearly 95%, while more than 155 million people, or 47% of the population, have been fully vaccinated. According to some medical experts, the US is on track to achieve herd immunity — an estimated vaccination rate of 80% — by Thanksgiving.

Chart 1: Commodities Were Best-Performing Asset Class
S&P GSCI Spot Commodity Index
Source: Standard & Poor's



Risk Assets: Risk assets performed well in this propitious environment. A diversified portfolio of commodities rallied by 13% in the quarter, led by crude oil and industrial metals. The S&P 500 generated a total return of 9%, easily outdistancing the 1.8% total return on investment-grade bonds.

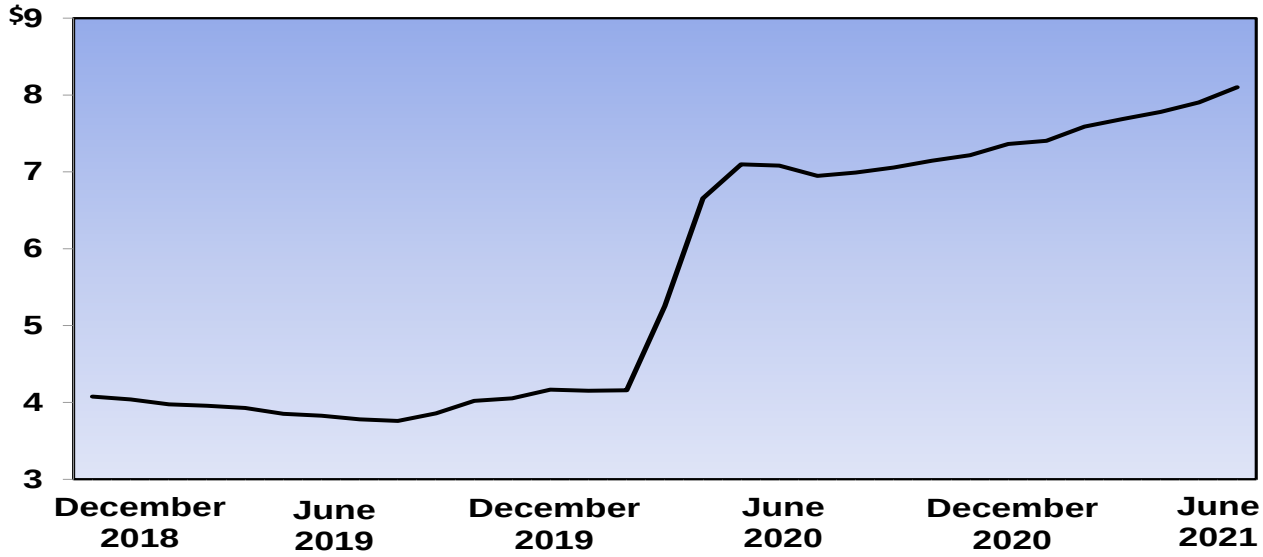
- **Strong Rally in Technology:** Domestic stocks outperformed international stocks, while growth stocks outperformed value stocks following two quarters of underperformance. Technology stocks recovered strongly in the quarter, as measured by the 11.5% total return in NASDAQ. Speculative-grade corporate bonds were the best performing sector of the fixed-income market.

Six Month Returns: Commodities also performed best during the first six months of the year, with a return of 30%. Domestic equities gained 15.2% while investment-grade bonds lost 1.6%. International stocks (+9.5%) lagged those in the US, while value stocks (+17.7%) easily outperformed growth stocks (+12.7%), as measured by Russell Investments. Speculative-grade corporate bonds were the best performing fixed-income sector with a total return of 3.5% (see chart 1).

FINANCIAL MARKET OUTLOOK

World financial markets are at a critical juncture. Powerful economic crosscurrents currently in place could accentuate volatility in all asset markets in coming months. In the positive column, economic and earnings trends for the upcoming year appear extremely favorable; both short-term and long-term interest rates are depressed; and world central bank policies remain highly accommodative, with no major changes imminent. There is an abundance of financial liquidity, which has served as a powerful tailwind for long-term financial assets.

Chart 2: Massive Federal Reserve Injection of Financial Liquidity
Assets Held in the Federal Reserve System ($ Trillions)
Source: Federal Reserve



Economic Risks: However, the economic recovery has been uneven and unstable. The supply of goods and services has been badly distorted by the pandemic and the sudden reopening of the economy, resulting in widespread shortages and rapidly rising input costs. Inflationary pressures are starting to build and could become disruptive to the world economy, eventually triggering a tightening response by the Federal Reserve. In addition, virtually all asset classes are in overvaluation territory. Although economic and profit growth should remain robust for all this year, each could slow abruptly as 2022 unfolds.

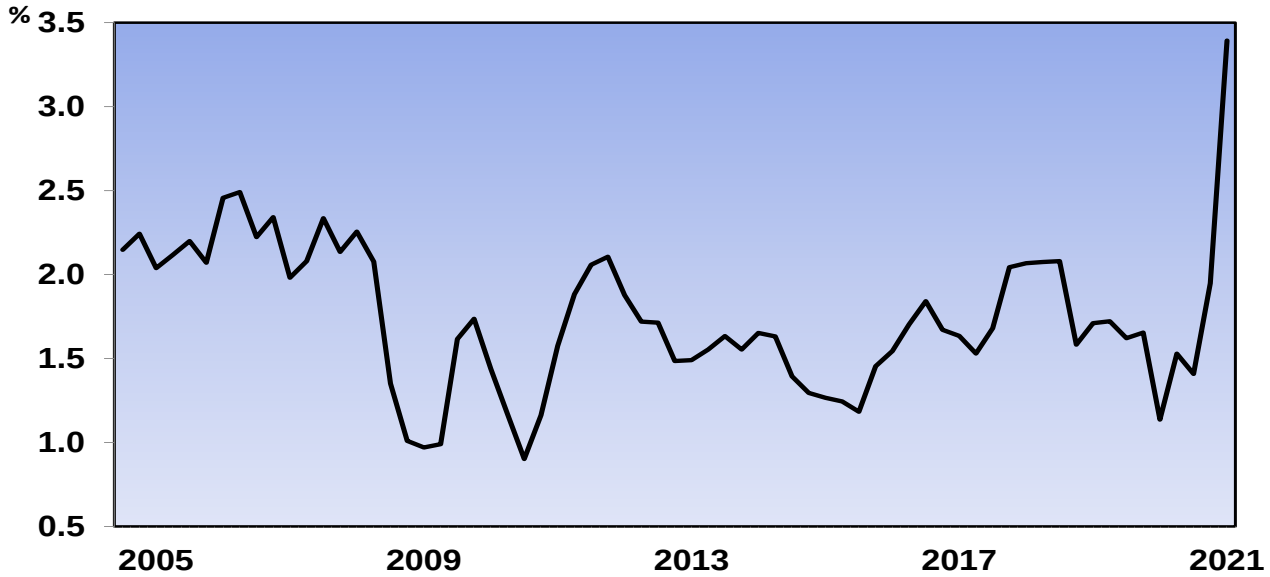
EXCESS FINANCIAL LIQUIDITY

Unprecedented monetary accommodation by world central banks has resulted in exponential growth in ***financial liquidity***, a condition that appears likely to persist for a while longer. Aggressive asset purchases by the Federal Reserve have contributed to extremely accommodative credit conditions (see chart 2). In classic textbook fashion, excess liquidity affects financial markets and the economy in a relatively predictable pattern:

- **Asset Prices:** Excess liquidity is initially manifested in higher asset prices. Over the past year there has been an unprecedented surge in a wide range of asset prices, including those of common stocks, commodities, residential real estate, precious metals, and cryptocurrencies.

- **Economic Conditions:** The second phase of a liquidity cycle involves the real economy, whereby low interest rates and an abundance of credit fuels a strong rebound in spending and output. This phase will be evident over the next four quarters.

Chart 3: Sudden Surge in Consumer Inflation
Core Personal Consumption Deflator
Year-Over-Year Percentage Change
Source: Bureau of Economic Analysis



- **Inflation:** The third and final phase involves an increase in the price of goods and services, with typically long lead times. The liquidity boom should begin to be reflected in a sustained rise in the inflation rate during the 2022 to 2024 timeframe (see chart 3).

In principle, the liquidity cycle reverses when the Federal Reserve begins to raise short-term interest rates to counteract a rising trend in inflation. The economy and financial markets respond in a similar sequence on the downside: A decline in asset prices; economic weakness; and eventually a decline in the inflation rate. I expect the Fed to begin a new rate-tightening cycle during the second half of next year, which would initially trigger a decline in stock and bond prices, followed by a weakening economy.

DOMESTIC ECONOMIC BOOM

The US economy is in the early stages of an outright economic boom, with GDP expanding at the fastest pace since the early 1980s. Boom conditions are expected to persist throughout this year and during the early months of next year before the rate of economic growth slows abruptly during the second half of next year and in 2023. The investment implications can be summarized as follows:

- Corporate earnings are increasing at the fastest rate in decades, providing fuel for the current equity bull market.

- The boom in spending and output will push the economy to full employment during the next 12 months, accentuating the shortage of workers and exerting upward pressure on wages.

- The arrival of full employment should trigger a rise in inflation, which could persist over a several-year period.

- The Federal Reserve will respond to a rising trend in inflation by tightening monetary conditions. A new Fed tightening cycle would result in higher bond yields, declining bond prices, a possible plunge in commodity prices, stabilization in house prices, and a sharp slowdown in economic and profit growth.

- The combination of tighter monetary conditions, rising bond yields, and an abrupt weakening in company earnings could result in a sustained decline in stock prices.

SYNCHRONIZED GLOBAL EXPANSION

The world economy is poised to enjoy the first synchronized global recovery in many years. A confluence of expansionary forces already in place should spark a strong economic revival in all major economies, led by China and the US. Europe should rebound strongly in the second half of this year, as vaccinations allow economies to reopen at a faster pace. Both Europe and the Asia-Pacific region should benefit from strong exports to China and the US, while pent-up domestic demand should prevail in all regions of the world.

The principal investment significance of a synchronized world economic recovery pertains to equity market leadership. *During periods of global economic weakness, safe-haven markets such as the US tend to attract international capital flows*. The US equity market is a risk-off investment bet while non-US stocks are ***risk-on*** bets. In short, the US is widely perceived as the world's primary safe-haven destination for international capital flows, and benefits during periods of heightened economic risk.

A synchronized global economic expansion — accompanied by growing economic confidence worldwide — means that non-US stocks should outperform those of the US over the next two years. Adding to their overall appeal are relative valuations: International stocks are priced at an unusually large valuation discount to the S&P 500 Index. Finally, the outlook for sustained US dollar weakness should also benefit non-US equity markets. *There is a strong positive correlation between the direction of the US dollar and the relative performance of domestic versus international stocks* (see chart 4).

Chart 4: Strong Recovery in Eurozone Business Growth Expectations
Monthly Survey of Eurozone Business Confidence
Source: Eurozone ZEW

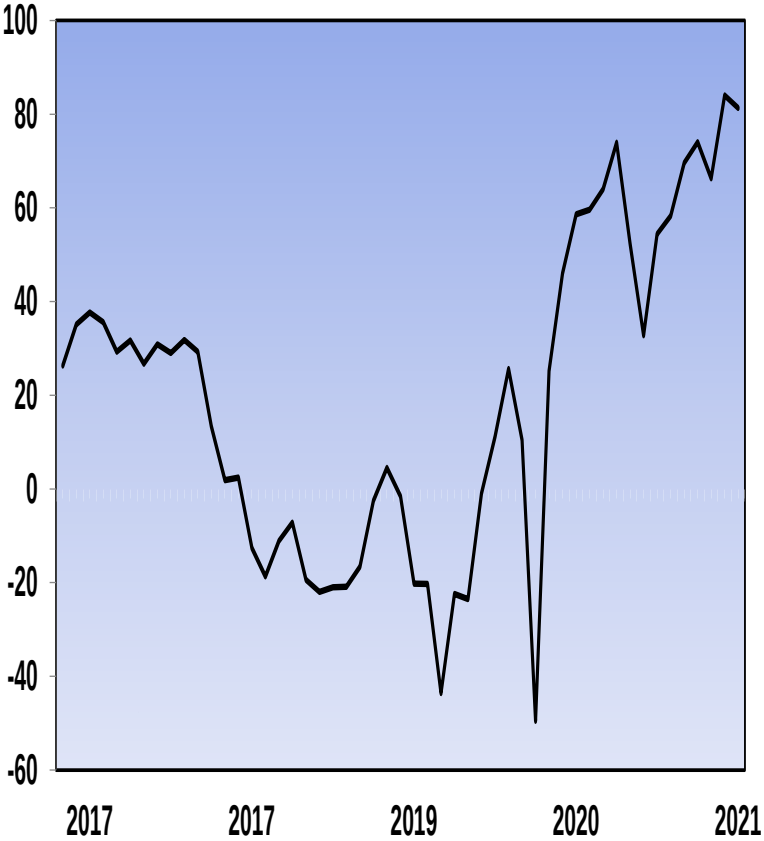


Chart 5: Strong Correlation Between Equity Prices
And Company Earnings
S&P 500 Index
Earnings Per Share (EPS)
Source: Standard & Poor's; FactSet

CORPORATE EARNINGS CYCLE

The business sector is in the early stages of the most spectacular earnings cycle in decades. Earnings per share (EPS) for the companies in the S&P 500 rose by 50% in the first quarter, and an even larger gain is expected in Q2. The level of earnings is unlikely to peak until the middle of next year, when corporate profit margins weaken in response to a plateau in revenues and accelerating growth in wages. *All else equal, stock prices tend to rise as long as actual reported EPS continue to exceed analyst estimates*. In the medium term, both the equity and corporate bond markets should benefit from solid growth in company earnings (see chart 5).

FEDERAL RESERVE POLICY EXCESSES

The Federal Reserve has conducted the most aggressive easing of monetary and credit conditions since the 1970s. Excess financial liquidity has boosted asset prices in virtually all markets and should continue to support global equity markets through yearend, at a minimum. However, the inevitable unwinding of these policy extremes during the next 12 to 18 months will loom as a progressively larger overhang on financial markets.

Because of the economic and financial market excesses caused by highly expansionary policies, the Fed is in a box. *The inevitable reversal of policy expected later next year could be extremely disruptive to economic growth and financial markets while increasing the odds of a policy mistake*. The main risk is that the Fed will defer the onset of a new tightening cycle until inflation has already been firmly established. *Historically, periods of aggressive tightening by a behind-the-curve Fed to contain inflation have been extremely negative for financial markets*.

FISCAL POLICY EXCESSES

Beginning with the Cares Act in March 2020, US fiscal stimulus over the past year has been the most aggressive since 1945. Cumulative government spending has amounted to a whopping 25% of GDP, and more could be on the way with President Biden's American Jobs Plan. Massive government transfer payments to individuals, businesses, the unemployed, and state and local governments cushioned the economic downturn last year and are contributing greatly to the 2021 economic boom.

Government fiscal support for the economy will peak this year and could fade rapidly in 2022 depending upon future legislation from Congress. *As is true of monetary policy, fiscal policy should support the equity market for the remainder of this year but could become a significant headwind for stocks in 2022 and beyond, for two reasons*:

- **Fiscal Cliff:** Economic growth could slow abruptly during 2022, as the one-time boosts to economic growth fade and as fiscal policy shifts from highly expansionary to contractionary. The implications would be negative for company earnings.

- **Budget Deficits:** The economic and financial legacy of the fiscal policy boom of the past year will likely be the following developments: A continued stream of large budget deficits; a steady rise in the ratio of public debt to GDP; and a sustained rise in inflationary pressures. The result could be much slower economic growth and chronic weakness in company earnings.

A NEW INFLATION CYCLE

The primary wild card in the investment outlook is the direction of inflation. The trend in inflation will dictate the direction of bond yields, the timing and magnitude of the monetary tightening cycle, and the sustainability of the economic expansion. In the most extreme scenario, a sustained wage/price cycle could culminate in a classic boom/bust cycle prior to 2024, possibly triggering the most severe equity bear market since 2008.

Chart 6: Real Yields on Government Bonds at Record Lows
Real Yield on Treasury Inflation-Indexed Bonds
Source: Federal Reserve

The weight of evidence points toward rising inflation in both wages and selling prices over the next several years. The implications would be a much sooner-than-expected and more aggressive monetary tightening cycle than is currently assumed. If so, stocks, bonds, precious metals, commodities, and real estate would be at serious risk.

In the interim, because Federal Reserve officials believe that the current spike in inflation is transitory, policy settings are likely to remain at maximum ease. However, the longer the Fed defers the onset of rate hikes, the greater the long-term risk to inflation, the economy, and financial markets.

A NEW INTEREST RATE CYCLE

The current calm in fixed-income markets is not sustainable. From a peak of 1.75% in March, the market yield on ten-year US Treasury bonds declined to a recent low of 1.42%. ***The current depressed level of long-term interest rates is totally inconsistent with a booming economy and rising inflationary expectations***. An analysis of the market for Treasury Inflation-Protected Securities (TIPS) is revealing:

- Inflationary expectations have declined from 2.6% to 2.2% in recent months, seemingly at odds with current inflation trends.

- The real bond yield has been stable at a ***negative*** 0.88%, near the lowest level in the history of the US government bond market. In theory, a negative yield on government bonds is a manifestation of a severely weak and troubled economy (see chart 6).

I expect both inflationary expectations and real bond yields to rise over the next several years, culminating in much higher ***nominal*** bond yields. As measured by the benchmark ten-year US Treasury bond, market yields could rise to over 2% by the end of this year and to 3% during 2022. The outlook for investment in global fixed-income markets remains dismal.

EQUITY MARKET OUTLOOK

The outlook for equity markets is dependent upon time horizon. Critical factors driving the US equity market are likely to remain favorable over the next 12 months but could turn negative later next year. In the medium term, the path of least resistance for stock prices is likely to be to the upside:

- Economic growth is likely to proceed at an exceptionally rapid pace over the next four quarters but could slow abruptly during 2022.
- The growth rate in company earnings over the next four quarters could be the fastest in several decades but is likely to lose momentum during 2022.
- Inflationary expectations are likely to be stable over the next year but will begin to trend higher beginning later next year.
- Federal Reserve policy appears likely to remain highly accommodative over the next year but become contractionary later next year and in 2023.
- Long-term bond yields are likely to remain stable in the short term but could begin to trend higher during the first half of next year.

Investors can expect further moderate gains in stock prices over the next year — possibly within a range of 5% to 10% — before a more challenging environment emerges during the second half of next year and in 2023.

Equity Market Leadership: Global equity markets are in the early stages of a shift in leadership. The dominance of US large-capitalization growth stocks appears to have ended approximately nine months ago, with value stocks moving to the forefront. ***The abrupt shift in relative performance last autumn has been stunning***.

- **Value Stocks Outperform:** For the nine months ending June 30, the **38%** total rate of return on value stocks compares favorably with the **26.5%** return on growth stocks, ***the widest margin since 2000***. International equity markets are also showing signs of overtaking domestic stocks. These trends could persist over the next 12 months, at a minimum.

There are four primary economic catalysts for the shift in equity market leadership to continue through much of 2022:

- **Rapid Growth in Company Earnings:** Value stocks tend to perform best when economic growth is robust and when corporate earnings are growing at an above-average pace.

- **Synchronized Global Recovery:** International stocks tend to perform best during periods of rapid global economic growth and vibrant world trade. A declining US dollar, as expected over the next year, reinforces the flow in capital from the US to foreign markets.

- **Rising Interest Rates and Inflation:** Value stocks tend to outperform growth stocks during periods of rising interest rates and inflation.

- **Relative Valuation:** Traditional measures of valuation favor value and non-US equities versus US large-cap growth stocks.

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.

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Bloomberg Barclays US Aggregate Bond Index: is a broad base, market capitalization-weighted bond market index representing intermediate term investment grade bonds traded in the United States. Investors frequently use the index as a stand-in for measuring the performance of the US bond market.

Dow Jones Industrial Average: is a stock market index that measures the stock performance of 30 large companies listed on stock exchanges in the United States.

MSCI World Excluding US Equity Index: is a stock market index comprising of non-U.S. stocks from 23 developed markets and 26 emerging markets. The index is calculated with a methodology that focuses on liquidity, investability, and replicability.

NASDAQ: is an American stock exchange at One Liberty Plaza in New York City. It is ranked second on the list of stock exchanges by market capitalization of shares traded, behind the New York Stock.

Russell 2000 Index: is a small-cap stock market index of the smallest 2,000 stocks in the Russell 3000 Index. It was started by the Frank Russell Company in 1984. The index is maintained by FTSE Russell, a subsidiary of the London Stock Exchange Group.

Russell 3000 Growth Index: is a market capitalization-weighted index based on the Russell 3000 index. The Russell 3000 Growth Index includes companies that display signs of above-average growth. The index is used to provide a gauge of the performance of growth stocks in the United States.

Russell 3000 Value Index: : is a market-capitalization weighted equity index maintained by the Russell Investment Group and based on the Russell 3000 Index, which measures how U.S. stocks in the equity value segment perform by including only value stocks.

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.

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