MID-QUARTER ECONOMIC REVIEW AND OUTLOOK

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Summary and Major Conclusions:

It seems reasonable to assume that lost sales and output in the third and fourth quarters will be deferred to the subsequent several quarters, as adjustments to supply chains will restore factory output and deliveries and increase the supply of goods for consumption. The implication is that the transition from an economic boom earlier in the year to a sudden economic slump in the second half of this year should lengthen the expansion cycle beyond 2022 as pent-up demand is released. An extended business cycle expansion would be a positive for financial assets.

- The US and world economies weakened significantly during the late spring and summer months in response to a surge in infections and hospitalizations caused by the Delta variant of COVID-19.
- Although current headlines depict a weak and foundering economy, underlying fundamental conditions are healthy and supportive of sustained economic growth. The deep and widespread damage to the economy caused by the pandemic cannot be overemphasized but should be totally resolved by yearend 2022.
- The most notable impact has been widespread disruptions to the supply side of the economy, in terms of scrambled global supply chains in disarray; widespread labor shortages; and surging costs of freight, containers, materials, components, and transportation.
- The government's preliminary estimate for Q3 GDP growth was the weakest in five quarters, with annualized growth of only 2% after adjustment for inflation. Consumer spending on durable and nondurable goods was the primary drag on GDP.
- The automotive market is the poster child for the worldwide supply crunch, given the industry's heavy reliance on computer chips. Consumer spending on autos plunged at a 45% annual rate in the quarter, one of the worst declines in recent history.
- Economic confidence has been crushed by the Delta wave, widespread supply chain disruptions, and an extremely weak GDP report. There are some economists who are on record declaring that the US economy is already in recession.
- The most reliable signals of recession include a peak and decline in the index of leading economic indicators; a sustained decline in corporate earnings; an inverted yield curve; a plunge in commodity prices; and broad weakness in equity prices. None of these conditions are apparent today.
- Real GDP could expand at a 5% rate in 2022, before slowing to 2.5% in 2023. Primary engines of US economic growth include private consumption, business equipment and software, and inventory investment.
- It seems reasonable to assume that lost sales and output in the third quarter will be deferred to the next several quarters, as supply chains are restored to normal, thereby allowing factory output and deliveries to expand the availability of goods that were not consumed in the third quarter.
- Steadily improving public health conditions should also support a solid recovery in consumer services. The sudden economic slump in the second half of this year should lengthen the expansion cycle beyond 2022, as above-average spending and output are smoothed over a longer timeframe.

- US corporations continue to report quarterly earnings that exceed Wall Street analyst estimates by a comfortable margin. Third quarter earnings per share are on track to grow by nearly 40% on revenue growth of 16%.

- My forecast assumes full-year 2022 earnings growth of 20%. Companies have been excelling throughout the pandemic in managing operations to grow sales and improve profitability. Strong productivity growth, timely selling price increases, and overhead cost reductions have resulted in record-high profit margins.

- The outlook for inflation is a major wild card in the outlook. My forecast assumes that inflation will peak this year and moderate during much of 2022 before experiencing a potentially sharp reacceleration in 2023 and 2024.

- Financial markets are obsessed with the *timing* of the first policy rate hike even though the *pace* at which the Fed raises short-term interest rates is of far greater consequence for financial markets. My forecast assumes that the Fed will move very slowly in raising policy rates for fear of derailing the economic recovery.

- The basic belief among Fed officials is that the risk of a stagnant economy far exceeds that of an overheating economy. The implication is that the shift in Fed policy from accommodative to restrictive is likely to play out over an extended period, possibly not ending until 2024 or later.

- US fiscal policy is approaching a significant inflection point. Passage of President Biden's two major spending initiatives before yearend will likely be followed by an extended period of congressional gridlock into 2025. Tax increases are likely to be less severe than currently feared.

- World economic growth slowed in all regions, as the Delta variant of COVID-19 disrupted global commerce. An uneven economic recovery is a manifestation of varying public health and government policy measures on a country-by-country basis. World GDP should grow by 4.5% in 2022 and 3.5% in 2023.

- The bond market remains extremely overvalued and vulnerable to negative returns over the next several years. Real government bond yields are in deep negative territory, virtually guaranteeing real losses for bond investors in coming years. Both corporate bonds and mortgage-backed securities are also overvalued.

- Prospects for the equity market are mixed. Robust growth in corporate earnings and accommodative monetary conditions are major positives, but a rising trend in bond yields and rich valuations are negatives. Equities should post positive returns in 2022, but returns are likely to fall short of the long-term average of 10%.

- In an environment of strong growth and rising interest rates and inflation, cyclical stocks and value managers should outperform defensive stocks and growth managers. A more synchronized global expansion accompanied by solid growth in world trade should favor international over domestic stocks.

The US and world economies lost significant momentum during the late spring and summer in response to a surge in infections and hospitalizations caused by the Delta variant of COVID-19. The fourth wave of the pandemic began in June and peaked in September, inflicting considerable pain and hardship on the global economy. Investor confidence deteriorated as closely watched monthly economic data repeatedly disappointed.

However, the domestic economy is much stronger than it might appear on the surface. *Although the headlines depict a weak and foundering economy, underlying fundamental conditions are healthy and supportive of accelerating economic growth during 2022*.

COVID-19 and the Economy: The severe damage to the economy caused by the pandemic cannot be overemphasized. The most notable impact has been the sizeable disruption to the supply side of the economy, in terms of scrambled supply chains; labor shortages; and surging costs of freight, containers, materials, components, and transportation. As an example, freight costs have risen by 300% over the past year. *The direct and indirect economic impact can be summarized as follows*:

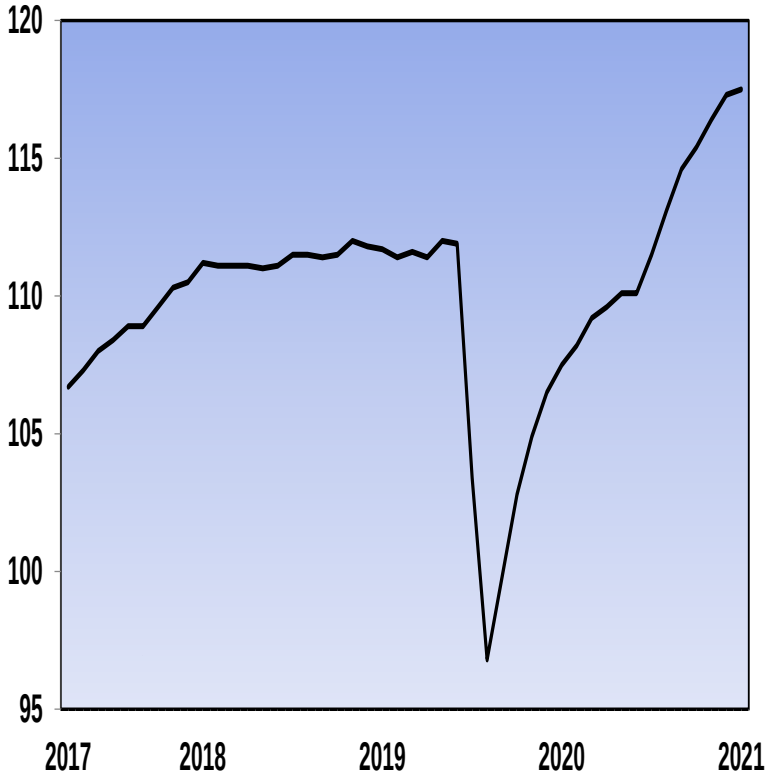
- A significant shortfall in lost spending and output
- Higher costs for raw materials and components
- Higher labor costs
- Higher consumer inflation
- Weaker employment
- Shrinking workforce

Third Quarter GDP: The government's preliminary estimate for third quarter GDP was the weakest in five quarters, with annualized growth of only 2% after adjustment for inflation. *The sharp slowdown in spending and output was driven by a confluence of supply factors, rather than by weak demand*, highlighted by widespread disruptions to global supply chains and a shrinking labor force.

- **Consumer Durable Goods:** The poster child for the supply shock to the global economy is the automotive sector. *Consumer spending on autos and parts plunged at a 45% annual rate in the third quarter, one of the worst declines in recent history*. Total spending on consumer durable goods subtracted nearly 3% from Q3 GDP. Auto inventories plunged to the lowest level on record (see chart 1).

Chart 1: Service Sector in Full Recovery Mode
Index of Purchasing Managers, US Service Industries
Source: Institute for Supply Management (ISM)

Chart 2: Leading Economic Indicators Signaling Strong Growth Ahead
The Index of Leading Economic Indicators
Source: The Conference Board



Already in Recession: Economic confidence has been crushed by the Delta wave, widespread supply chain disruptions, and an extremely weak GDP report. There are some economists who are on record declaring that the US economy is already in recession. Is this a plausible conclusion? Unlikely. I believe that this analysis is flawed and highly inconsistent with current underlying economic and financial conditions:

- The index of *leading economic indicators* is growing at a double-digit rate (see chart 2)
- *Company earnings* are booming, and analysts continue to ***upgrade*** their estimates, while *profit margins* are at all-time highs
- The *Treasury yield curve* is on a solidly upward slope (see chart 3)
- The quintessential leading economic indicator of future economic trends — the *equity market* — is at an all-time high
- *Commodity prices* are at the highest levels since 2014 (see chart 4)
- The ratio of *business inventories* to sales is at an all-time low, the exact opposite of what is typically seen during recessions

Chart 3: Yield Curve Has Flattened But Remains Upward Sloping
Long-Term Interest Rates Above Short-Term Rates
Ten-Year US Treasury Bond Yield
Two-Year US Treasury Note Yield
Source: Federal Reserve

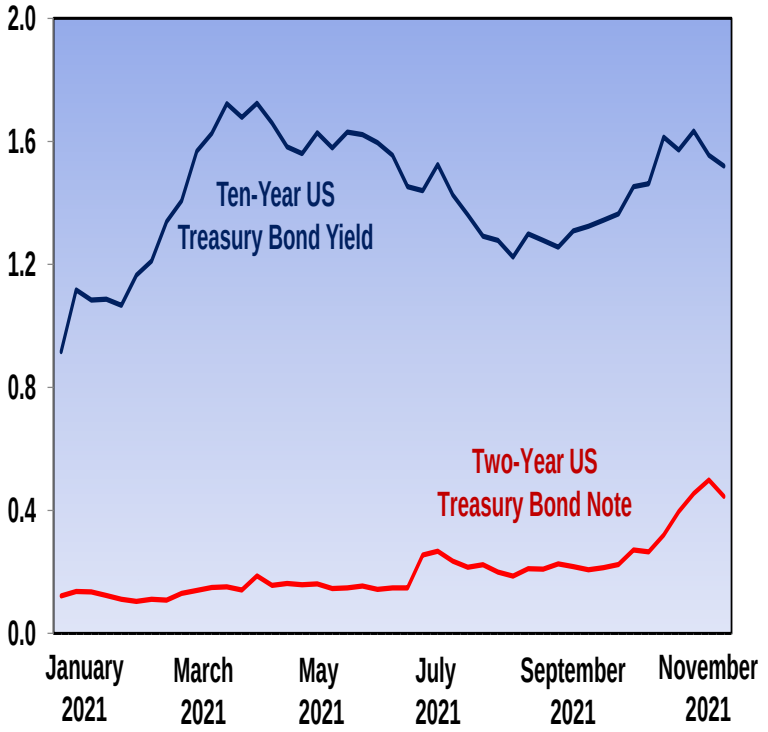


Chart 4: Commodity Prices at a Multi-Year High
The S&P Goldman Sachs Commodity Index
Source: Bloomberg

- Recessions are typically caused by weakness in *aggregate demand*; the sharp slowdown since the spring was caused by shortfalls in supply, while indicators of demand remained strong

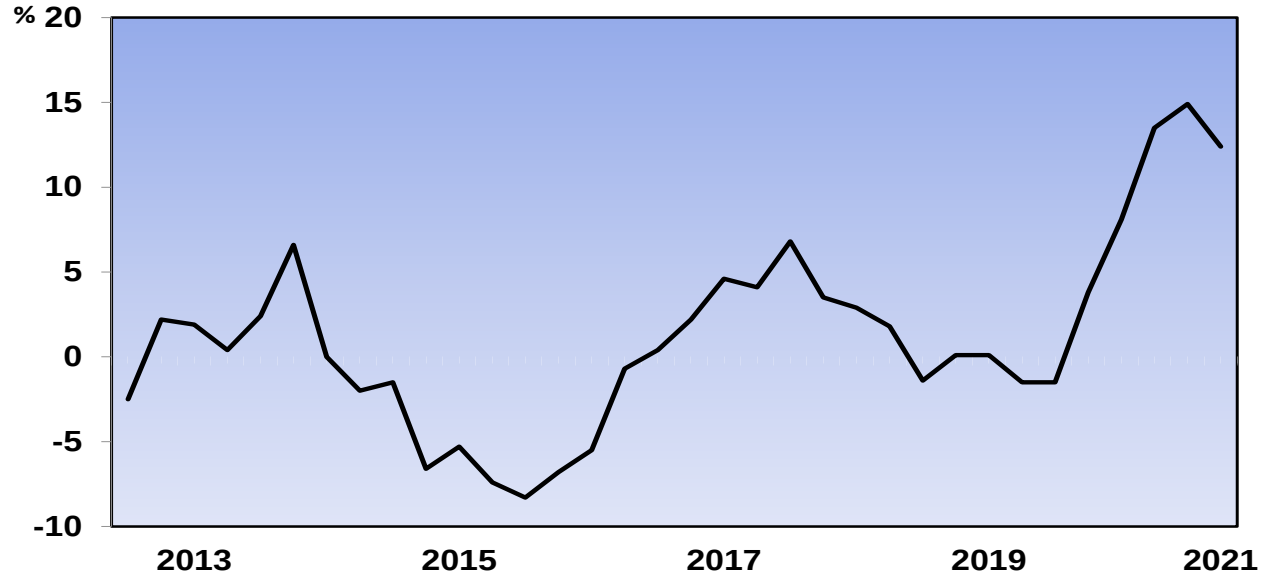
- Business orders for capital goods are increasing at a double-digit rate (see chart 5)

ECONOMIC OUTLOOK

My forecast assumes a strong rebound in economic growth over the next year. *An eventual resolution of supply chain disruptions should allow economic growth to accelerate in the fourth quarter of this year and during all of 2022*. I expect a solid rebound in fourth quarter GDP of 4.5%, with real GDP growth of 5% in 2022, before slowing to 2.5% in 2023.

- **Engines of Growth:** Primary engines of US economic growth include private consumption, business investment in plant and equipment, and inventory investment. Passage of President Biden's infrastructure bill will boost aggregate spending and output beginning in 2023. Spending on services is on a strong recovery path.

Chart 5: The Early Stages of a New Capital Goods Cycle
New Orders Core Capital Goods, Annual Percentage Growth
Source: US Census Bureau



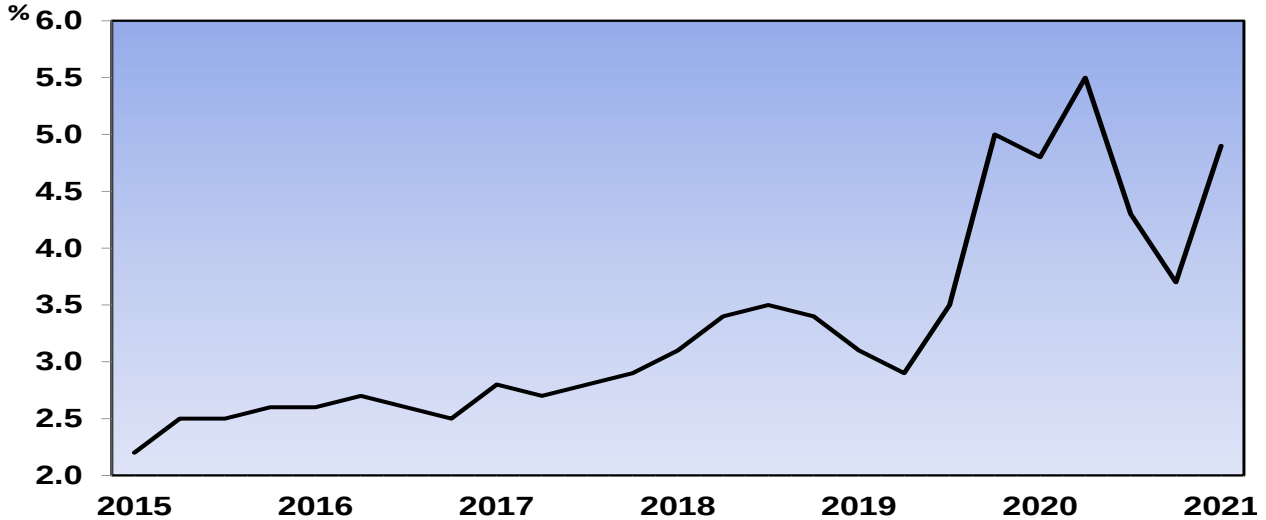
- **Inventory Investment:** A prolonged period of inventory building should support manufacturing activity in 2022. The ***inventory-to-sales ratio*** has plunged to an all-time low at the retail, wholesale, and manufacturing stages of production. I expect the economy to return to full employment by the first quarter of 2023, three years following the onset of COVID-19.

The US Expansion Cycle: It seems reasonable to assume that lost sales and output in the third and fourth quarters will be deferred to the subsequent several quarters, as adjustments to supply chains will restore factory output and deliveries and increase the supply of goods for consumption. Steadily improving public health conditions should also support a solid recovery in consumer services. *The key point is that the transition from an economic boom earlier in the year to a sudden economic slump in the second half* of this year should lengthen the expansion cycle beyond 2022 as pent-up demand is released.

Corporate Earnings: US corporations continue to report quarterly earnings that exceed Wall Street analyst estimates. Third quarter earnings per share (EPS) are on track to grow by 39% on revenue growth of 16%. My growth assumptions for Q4 and full-year 2022 EPS are 20% and 10%, respectively. Companies have excelled throughout the pandemic in managing operations to expand sales and improve profitability. Strong productivity growth, timely selling price increases, and overhead cost reductions have resulted in record high profit margins.

Consumer Inflation: The future direction of inflation is a major wild card in the outlook. There is a raging debate among economists as to the "transitory" nature of the current surge in inflation. My assumptions for inflation have not changed, and consist of three distinct phases that could play out over the next three years:

Chart 6: Wage Growth in an Accelerating Trend
Average Hourly Earnings
Year-Over-Year Percentage Change
Source: The Bureau of Labor Statistics



1. The current ***cost-push inflation*** phase triggered by widespread disruptions to global supply chains, with a 2021 peak in inflation around 5%

2. An interim period of ***disinflation***, with the inflation rate bottoming around 2.5% during the middle of next year

3. An accelerating rise in ***demand-pull inflation*** beginning later next year and persisting into 2024, with inflation possibly reaching 5%

Prospects for ***wage inflation*** appear even more worrisome, with average hourly earnings rising by more than 5% in 2022. The expected sharp upturn in inflation beyond mid-2022 would be a result of the lagged effect of the unprecedented monetary and fiscal stimulus of the past two years and a return to full employment by early 2023 (see chart 6).

Federal Reserve: Monetary policy is another major wild card in the outlook. The Fed has signaled a strong bias toward support for the economy and the labor market but is faced with a dilemma. The rate of inflation is the highest in several decades and is unlikely to moderate until supply chains are restored to normal, which might not occur until the middle of next year. Assuming only moderate disinflation during 2022, the onset of a new rate-tightening cycle could begin less than one year from now.

- **Speed of Tightening:** While financial markets are obsessed with the ***timing*** of the first policy rate hike, far more important is the ***pace*** at which the Fed raises short-term interest rates. *My forecast assumes that the Fed will move very slowly during its rate-tightening cycle* because it believes that a stagnant economy is a greater risk than rising inflation. In other words, *rather than an aggressive monetary squeeze, the shift in Fed policy from accommodative to restrictive is likely to play out over an extended period, possibly not ending until 2024*.

Fiscal Policy: US fiscal policy is approaching a significant inflection point. Following an unprecedented volume of federal expenditures over the past two years, fiscal policy is likely to be frozen from 2022 through 2024, at a minimum. Passage of President Biden's two major spending initiatives — $550 billion in infrastructure investment and a watered-down $1.75 social safety-net program — should mark the end of the fiscal windfall for an extended period, as congressional gridlock resumes.

THE GLOBAL ECONOMY

World economic growth slowed sharply in all regions, as the Delta variant of COVID-19 disrupted commerce across the globe. The multi-year transition from fossil fuels to renewables along with scrambled supply chains in Asia and Europe also undermined spending, output, employment, and investment.

Desynchronized Recovery: *The desynchronized economic recovery is a manifestation of varying public health and government policy measures on a country-by-country basis*. *GDP levels are returning to **pre-pandemic peaks** on a systematic, sequential basis*, led by China (Q2/2020), Taiwan and Vietnam (Q3/2020); the US and India (Q2/2021); South Korea, Japan, Canada, and the eurozone (projected Q4/2021); and the UK (projected Q3/2022). Globally, world GDP surpassed its pre-pandemic peak in the second quarter of this year.

Composition of GDP: Disparities in economic strength among countries can also be attributed to divergences in fiscal and monetary policies along with variations in the composition of spending. Economies most heavily dependent upon *manufacturing and export trade* — such as Germany, Japan, and South Korea — have been most severely impacted by factory shutdowns and port closures. Conversely, service-oriented economies such as India and the US have been less impacted by supply chain disruptions. Surging energy prices have had a greater impact on Europe and Asia compared with the US, which became a ***net exporter*** of energy in 2019.

World GDP Forecast: *The desynchronized economic recovery is a manifestation of varying public health and government policy measures on a country-by-country basis*. The world economy is expected to expand by 4.5% in 2022 and 3.5% in 2023, slightly above its long-term trendline growth potential. By country and region, China's GDP should grow by 5.5% in 2022, followed by the eurozone and Japan, with GDP growth rates of 4% and 2.5%, respectively.

WORLD FINANCIAL MARKETS

World financial markets continue to respond to developments and events that shed light on the growth prospects for the global economy. The sharp slowdown in third quarter GDP prompted investors to seek safe-haven assets, including US stocks and the US dollar. An accelerating trend in consumer inflation resulted in rising volatility in the government bond market. Global asset prices over the next year will be governed by growth in GDP, inflation, company earnings, and central bank policies.

Fixed-Income Market: The recent uptick in US government bond yields is probably not the beginning of a sustained bear market in the US Treasury market. The level of bond yields remains exceptionally low in a historical context, suggesting that global investors continue to add to their portfolios, despite the reality of continued above-average inflation and a looming rate-tightening cycle by the Federal Reserve. Currently at 1.5%, market yields on ten-year Treasury bonds are likely to fluctuate within a range of 1.4% to 1.8% over the next three to six months.

- **Investor Psychology:** It is crucial to understand how bond investors perceive underlying economic conditions. The consensus view appears to be that the US and global economies are structurally weak and fragile and unable to tolerate higher interest rates. I vehemently disagree with this consensus view. *I believe that the US economy is fundamentally strong and capable of above-average growth throughout 2022, at a minimum*.

- **Are Rising Rates Self-Limiting?** *Consistent with this view, the consensus believes that rate-tightening cycles are self-limiting in that any increase in policy rates would undermine economic momentum, causing inflation to weaken and interest rates to roll over*. This ***flawed*** perception of the underlying fundamentals of the economy suggests that a sustained rise in interest rates is a low probability.

- **Sensitivity to Rising Rates:** I vehemently disagree with this point of view. In fact, I believe that the US economy is becoming ***less*** sensitive to rising interest rates, which I would attribute to several forces: The massive household sector deleveraging cycle of the past decade; cumulative fiscal stimulus of the past two years; a higher rate of inflation; and the powerful productivity cycle currently underway. *The crucial implication is that growth could remain surprisingly resilient in the face of rising rates, much to the surprise of the bond zealots*.

- **Bond Market Remains Vulnerable:** The result is that the bond market remains extremely overvalued and vulnerable to painful losses over the next several years. Adjusted for inflation, government bond yields are in deep negative territory, virtually guaranteeing ***real losses*** for bond investors in coming years. Currently at a yield of 1.5%, ten-year US Treasury bonds could reach 2% within the next six months, 2.5% by the fourth quarter of next year, and 3.5% in 2023. Both corporate bonds and mortgage-backed securities are also overvalued.

World Equity Markets: The direction of corporate earnings has generally been a reliable indicator of the ***direction*** of stock prices. However, the ***rate of increase*** in equity prices is dependent upon the trend in long-term interest rates, the thrust of Federal Reserve policy, and equity market valuations. My forecast for the next six to 12 months assumes the following: A slow-paced monetary tightening cycle that begins during the second half of next year and a gradual but steady rise in long-term interest rates. With respect to valuation, most segments of the equity market are expensive. *Pulling it all together, my forecast assumes positive equity returns during 2022, but only modest price appreciation*.

Equity Market Leadership: I continue to expect a shift in equity market leadership during 2022 in an environment of above-average GDP and corporate profit growth; above-average inflation; rising bond yields; and a gradual tightening in monetary conditions. In this environment, economically sensitive stocks and value managers tend to outperform defensive stocks and growth managers. A more synchronized global expansion accompanied by solid growth in world trade should favor international over domestic 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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