THE YEAR IN REVIEW: AN ANALYSIS OF THE WORLD ECONOMY AND MARKETS IN 2021

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The economic recovery during 2021 is a testament to the unparalleled scientific prowess of the US healthcare system; the unique expertise of business firms in transforming themselves and coping effectively with extraordinary challenges; and the ability of the federal government to respond quickly to an unprecedented economic emergency. Assuming further improvement on the medical front, 2022 should be another year of solid economic growth and positive equity market returns.

Summary and Major Conclusions:

- Economic historians will describe 2021 as a year of unprecedented turmoil with respect to public health conditions, economic growth, government policy, and financial markets, each of which generated heightened uncertainty and enormous economic and financial market volatility.

- One of the highlights of 2021 was the rapid distribution of vaccines for COVID-19 in the US and to a lesser extent in the world. As of December 17, nearly 73% of American adults had received at least one dose of a coronavirus vaccine while more than 62% had been fully vaccinated.

- Widespread distribution of vaccines early in the year provided a significant lift to economic confidence well into the spring, only to be thwarted in the third quarter by a surge in infections caused by the Delta variant of SARS-CoV-2.

- GDP growth plunged from an impressive 6.5% annual rate during the first half of the year to close to zero in Q3. Widespread disruptions to global supply chains caused shortages of vital goods, triggering the most serious inflation problem in decades. Full-year real GDP expanded by an estimated 5.5%.

- The failure of output to keep pace with exuberant spending resulted in huge bottlenecks and a surge in prices for consumer goods, which rose by more than 8% over the course of 2021. Including services, which rose by 3.5%, overall core inflation rose at an estimated 5% during the year.

- Although most of the acceleration in inflation can be attributed to temporary factors pertaining to disrupted supply chains, there was also evidence of a more permanent buildup of long-term inflationary pressures emanating from the unprecedented fiscal and monetary stimulus of the past two years.

- The US labor market was buffeted by powerful structural forces during 2021 and behaved erratically during much of the year. Both workers and employers were forced to cope with powerful disruptions to normal behavior, which had significant effects on economic output, inflation, and company profits.

- The tightening of the labor market over the course of 2021 was unprecedented. For a variety of reasons, an unusually large number of workers exited the labor market, resulting in a severe labor shortage. The result was a sharp increase in wages to an annual rate of nearly 5% by yearend.

- Despite the sharp increase in labor compensation, the corporate sector enjoyed spectacular growth in earnings, with a full-year gain of nearly 50% on revenue growth of 18%. Companies were successful in offsetting cost increases through selling price increases.

- As expected, Federal Reserve policy was extremely accommodative throughout 2021. Through its ongoing program of government bond purchases, the Fed injected $1.3 trillion of liquidity into the economy during the year. More importantly, the Fed maintained its short-term policy rate at zero for all of 2021.

- Through December 10, the total return for investment-grade bonds was a *negative* 1.75%, as measured by the Bloomberg US Aggregate Bond Index. High-yield corporate bonds did slightly better with a total return of 3.3%. US Treasury securities with long maturities lost 4% in value over this same period.

- Stock markets across the globe rose in 2021, led by large-cap growth stocks in the US. The total return on the S&P 500 Index was 25% through December 10, topping the 18.5% total return in 2020. Since the COVID-19 panic bottom on March 23, 2020, the S&P 500 has generated a total return of nearly 110%.

- Non-US stocks lagged the domestic market with a total return of only 10%, as earnings growth failed to keep pace with that in the US. Strength in the US dollar was a huge headwind for the international equity portfolios of US investors.

- Outside the US, European equities performed best, with a total return of 20% in local currencies — although the weak euro reduced returns to only 10% when translated into dollars. Equity returns in the Asia/Pacific region were slightly positive in local currencies but negative in US dollars, led by profound weakness in Chinese stocks.

- The past year was unprecedented in many respects and could mark a significant inflection point with respect to various long-term economic and investment trends. Perhaps most importantly was the gargantuan ascendancy of the federal government as an influence on economic activity.

- The greatest economic and investment risks involve inflation. Unprecedented monetary and fiscal stimulus may have sown the seeds of rapid inflation in coming years. Historically, large amounts of excess liquidity have resulted in excess spending and sustained increases in the general price level.

Economic historians will describe 2021 as a year of unprecedented economic, policy, and investment developments, characterized by heightened uncertainty and enormous economic and financial market volatility. Widespread distribution of vaccines early in the year provided a significant boost to economic confidence, only to be thwarted during the middle of the year by a surge in infections nationwide caused by the highly transmissible Delta variant of COVID-19.

GDP growth plunged from a 6% annual rate during the first half of the year to close to zero in Q3. Widespread disruptions to global supply chains caused bottlenecks and shortages of vital goods, more than offsetting strong underlying demand. These logjams triggered the most serious inflation problem in several decades.

Long-term interest rates spiked early in the year but declined sharply in the second quarter and at yearend. The equity market experienced four 4% corrections during the year — in January, February, September, and late November — but rose by 25% for the year through December 10, led by growth stocks. Commodity prices spiked during the year, and the US dollar strengthened. Congress passed several massive spending bills during the year, which will boost spending and output in 2022 and beyond.

MAJOR DEVELOPMENTS

The past year will be remembered for developments in a wide range of areas that could leave a permanent legacy for future years. The most notable developments of 2021 include the following:

1. The rapid distribution of vaccines for the SARS-CoV-2 virus in the US was one of the major economic forces during the past year. As of December 17, nearly 73% of American adults had received at least one dose of the vaccine, while more than 62% had been fully vaccinated. As a result, schools, restaurants, and businesses returned to some semblance of normalcy, while air travel more than doubled over the course of the year.

2. Beyond the initial vaccines approved roughly one year ago, the pharmaceutical industry achieved numerous major breakthroughs, including vaccines for adolescents and young children along with revolutionary oral antiviral medications that work by blocking the ability of the virus to replicate.

3. In combination with unprecedented monetary and fiscal stimulus, these scientific breakthroughs contributed to a strong, albeit uneven and imbalanced, economic recovery over the past year. The extraordinary display of resourcefulness, resilience, and innovation exhibited by the private sector was also instrumental in the solid recovery in economic output and spending.

4. Real GDP was in a strong recovery mode for most of the year, faltering only in the third quarter in response to the sudden surge in infections caused by the Delta variant. Following exceptional growth of 6.5% during the first half of the year, real GDP weakened abruptly in Q3, increasing by only 2%. Growth accelerated later in the year, with estimated GDP growth of 5% in Q4. For the full year, real GDP increased by 5.5%, led by consumer spending.

5. Although 2021 was a year of impressive growth it was also a year of economic chaos, distortions, and instability caused by the Delta variant. The rebound in spending far outpaced the recovery in the output side of the economy, causing massive shortages as global supply chains and the distribution network disintegrated.

6. The failure of output to keep pace with exuberant spending on durable goods created huge bottlenecks and a surge in prices for consumer goods, which rose by more than 8% over the course of 2021. Including services, overall core inflation rose at an estimated 5% during the year.

7. Although most of the surge in inflation can be attributed to temporary factors pertaining to disrupted supply chains, there was also evidence of a more permanent buildup of long-term inflationary pressures, most likely the result of unprecedented fiscal and monetary stimulus.

8. The US labor market was buffeted by powerful structural forces during 2021 and behaved erratically during much of the year. Both workers and employers were forced to cope with daunting crosscurrents, which had significant effects on economic output, inflation, and company profits. For a variety of reasons, workers exited the labor market, resulting in a severe shortage of labor, with inflationary implications for both prices and wages.

9. The tightening of the labor market over the course of 2021 was unprecedented. The private sector generated six million net new jobs during the year, one of the strongest calendar years on record. The unemployment rate plunged from nearly 7% late last year to 4.2% in November. Initial jobless claims plummeted from a high of more than 900 thousand in January to less than 200 thousand at yearend, the lowest level since 1968. The unsurprising result was a rapid increase in wage growth to 4.8% during the second half of the year, a trend that should persist in 2022 and 2023.

10. Despite the sharp increase in labor compensation, the corporate sector enjoyed spectacular growth in earnings, with a full-year gain of nearly 50%, on revenue growth of 18%. Faced with sharp increases in labor, raw materials, and components, companies raised selling prices aggressively, pushing operating margins to all-time highs.

11. As expected, Federal Reserve policy was extremely accommodative throughout the year. Through its ongoing program of asset purchases — generally referred to as quantitative easing — the Fed injected $1.3 trillion of liquidity into the economy during the year, augmenting its approximately $3.1 trillion asset purchases during 2020. The Fed maintained its policy rate at zero for all of 2021.

12. The bond market performed poorly in 2021. Interest rates — as measured by the benchmark US Treasury note — fluctuated within a range of 0.92% and 1.75% during the year. Through November 30, the total return for investment-grade bonds was a ***negative*** 1.15%, as measured by the Bloomberg US Aggregate Bond Index. Speculative-grade corporate bonds did slightly better with a total return of 3.3%. US Treasury securities with long maturities **lost** 4% in value over this same period.

13. Equity markets across the globe rose in 2021, led by US large-capitalization stocks. The total return on the S&P 500 Index was 27% through Friday December 10, easily topping its 2020 return of 18.5%. Since the COVID-19 bottom on March 23, 2020, the S&P 500 has generated a cumulative total return of nearly 110%.

14. Although the major domestic indexes avoided more than a 5% correction during the year, an examination of market trends beneath the surface reveal that individual stocks and sectors experienced sizeable declines. *The equity market suffered rolling declines as investors rotated frenetically among sectors*. The Russell 2000 Index of small-cap stocks declined by 12% in November; the technology-heavy NASDAQ declined by more than 10% in March; and the Russell 3000 Value Stock Index lost nearly 7% in value during Q3.

15. International stocks lagged the domestic market by a wide margin with a total return of only 7.5%. Strength in the US dollar was a huge headwind for US investors in foreign stocks. Returns on European equities approximated 20% in local currencies but only 10% when translated into dollars. Equity returns in the Asia Pacific region were slightly positive in local currencies but negative in US dollars, led by profound weakness in Chinese stocks. The total return on the MSCI Japan Index was 13%.

THE ECONOMIC AND INVESTMENT LEGACY OF 2021

How might the extraordinary events and developments of 2021 shape the economic and financial market landscape in future years? The past year was unprecedented in many respects and could mark a significant inflection point with respect to various long-term economic and investment trends. Economic historians will likely highlight the following factors when looking back at 2021:

- The sudden economic slowdown during the second half of the year could smooth the pace of spending over time. Most spending and output were deferred, not lost, thereby *extending the life of the expansion cycle* by shifting growth from 2021 into future years. The equity and bond markets could benefit from a prolonged expansion cycle.

- Supply chain disruptions could undermine *globalization* but could be the catalyst for incremental business investment spending in future years as new distribution networks are created to ensure reliability of supply.

- The past year reinforced numerous changes in *consumer behavior*, such as e-commerce, work from home, and telehealth, each of which could persist for an indefinite period, improving both quality of life and economic efficiency.

- The growing prevalence of remote work triggered a large *migration of the population* from large metro areas in the Northeast and West Coast to small cities and suburbs in the rapidly growing low-tax states in the South, Southeast, and Southwest. This migration phenomenon is expected to persist for the foreseeable future, with significant implications for residential and commercial real estate.

- A combination of post-pandemic catalysts, worker shortages, global supply glitches, and large infrastructure spending programs could spark a powerful *capital goods cycle* in future years. Several years of strong growth in capital formation could be the catalyst for a strong rebound in productivity.

- Massive intervention into the economy by the federal government could unleash a period of *big government* for many years to come. In theory, sustained high levels of government regulation and spending tend to undermine the dynamism and efficiency of the private sector.

- Unrivaled federal spending programs imply a sustained increase in *budget deficits* over the next several years. High levels of government borrowing could crowd out private sector borrowing and exert upward pressure on long-term interest rates.

- Unprecedented monetary stimulus may have sown the seeds of rapid *inflation* in coming years. Historically, large amounts of excess liquidity have resulted in excess spending and sharp increases in the general price level.

- The COVID-19 pandemic could be the catalyst for rapid *technological innovation* for years to come, as businesses and individuals use high-tech equipment and software to solve problems created by interruptions to commerce, personal interface, and mobility.

- An extremely depressed cost of capital has spawned *bubbles* in some sectors of the economy and notable pockets of the financial markets. These imbalances could exacerbate economic distortions that inevitably emerge as the business cycle matures.

CONCLUSION

The past year was a far better year for the economy and financial markets than had been predicted only one year ago. The growth rate in both real GDP and corporate earnings exceeded expectations by a wide margin, culminating in very strong equity market returns. The growth in jobs and wages and the decline in the unemployment rate exceeded even the most optimistic forecasts. Finally, according to estimates by both the Urban Institute and Columbia University, the US poverty rate plunged in 2021 to a record low of approximately 8%, well below the official US Census Bureau rate of 12.8% only three years earlier.

The ability of the economy to adjust to and ultimately overcome the numerous challenges presented by the pandemic was impressive. Each new wave of the pandemic has proven to be progressively less disruptive to the healthcare system and the economy than the previous one. While the Delta variant has proven to be a deadly pathogen, it revealed the inherent resiliency of the US economy and its ability to transcend even the most severe exogenous shocks.

The economic recovery is a testament to the unparalleled scientific prowess of the US healthcare system; the unique expertise of business firms in transforming themselves and coping effectively with extraordinary challenges; and the ability of the federal government to respond quickly to an unprecedented economic emergency. Assuming my growth and employment forecasts for 2022 are accurate, it will have taken less than three years for the economy to return to pre-recession levels, far less than the nearly ten years following the 2008 global financial crisis. Assuming further improvement on the medical front, 2022 should be another year of solid economic growth and positive equity market returns.

Note to Readers: This week's report is the final *Economic Perspective* for 2021. The next report, to be distributed during the week of January 3, 2022, will be the *Annual Economic Outlook*. The Prudential Retirement Economics Team would like to take this opportunity to extend to our readers all good wishes for a happy holiday season and a New Year filled with joy, peace, and good health.

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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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