Traditional equity market valuation techniques are the single most reliable variable in the determination of prospective rates of return over long time periods. However, in the short term, valuation has minimal predictive value: Short-term market behavior is typically governed by investor sentiment, momentum, economic and company earnings surprises, government policy announcements, and geopolitical shocks. The implication is that overvalued markets can become even more overvalued at cyclical peaks (1987, 2000), and that undervalued markets can become even more undervalued (2002, 2009, 2011, 2016) at cyclical troughs.

Summary and Major Conclusions:

- In spite of another sluggish US GDP report — with annual growth estimated at only 1.5% in the first quarter — high frequency incoming economic data are consistent with a strengthening economy. The most encouraging trends pertain to household spending, residential construction, manufacturing, services, and job creation.

- Global equity markets outperformed global bond markets once again in Q1, and by a wide margin. The total return on US equities of 6.1% in the quarter was the strongest since 2013. The market leaders of 2016 — small- and mid-cap stocks, value managers, and industrials — became laggards in the quarter. Foreign equities kept pace with domestic stocks following years of underperformance.

- Corporate earnings rose by an estimated 10% in the quarter — the fastest rate of growth since 2012 — on a 5% increase in revenues. The cyclical rebound in profits appears to be sustainable and should persist into 2018. My forecast assumes earnings growth of 10% to 15% this year and another 6% to 8% in 2018.

- As expected, the Federal Reserve raised its main policy rate to 1.0% at its March 15 FOMC meeting. The surprise was embodied in the FOMC's accompanying policy statement, which appeared to signal a more cautious assessment of current economic conditions, therein implying a slower pace of rate increases.

- The FOMC will likely proceed very cautiously in its stated mission of restoring interest rates to normal. The Fed is likely to deliberately lag the economic cycle to ensure sustained economic growth and rising employment. My forecast assumes a federal funds rate of 1.75% and 2.5% at yearend 2017 and 2018, respectively.

- The surge in world oil prices in the aftermath of last November's OPEC agreement to reduce output quotas appears unsustainable. Unsurprisingly, oil output from both OPEC and non-OPEC members of the cartel has already begun to exceed quotas; at the same time, the rebound in US shale output has greatly exceeded expectations. I predict that world oil prices will fluctuate within a range of $40 to $55 per barrel through yearend, much lower than previous market forecasts.

- My economic forecast includes the following assumptions: Real GDP growth of 3% over the next six quarters; core consumer inflation of 2% this year and 2.5% in 2018; average monthly nonfarm payroll growth of 185,000 this year and 150,000 in 2018; and an average unemployment rate of 4.5% through 2018.

- Global financial markets have benefitted enormously from the prolonged period of unprecedented monetary accommodation. Record low short-term interest rates worldwide have significantly lowered discount rates, thereby boosting market prices in virtually all asset classes.
Market valuations for government bonds, corporate bonds, corporate equities, and commercial real estate have risen to unsustainable highs, thereby effectively limiting prospective rates of return in coming years. It is becoming increasingly evident that world financial markets have entered a sustained era of low returns.

Fixed-income markets are likely to remain stagnant in coming years, with very disappointing performance results. Rising inflationary expectations, a gradual but steadily rising trend in policy rates, and growing public and private credit demand should conspire to push bond yields inexorably higher.

Total returns on both government and corporate bonds are likely to be near zero this year and in 2018. High-yield corporate bonds are expensive and are vulnerable to rising default rates in 2018, implying total returns of less than 5% annually over the next two years.

The US equity market has entered a more speculative phase, primarily the result of heightened valuations and growing domestic political risk. Equity valuations are at the highest level in a decade, while investor sentiment is the most exuberant since the years prior to the 2008 economic crisis.

The irony is that textbook economic conditions are highly favorable for equity investing: Accelerating growth in both GDP and corporate earnings; low and stable inflation; healthy credit conditions; and continued monetary accommodation by the Federal Reserve.

The US equity market is highly vulnerable to both political and fiscal policy shocks over the next six to nine months. Failure of the legislative and executive branches to reach a compromise on critical pro-growth legislative initiatives would likely trigger a sell-off in stocks. Conversely, meaningful legislation on tax reform, deregulation, and infrastructure spending would likely support a further rally in stock prices.

Taking into account the divergence between favorable business cycle-related factors and rich valuations, the path of least resistance for US equities will be modestly higher in 2017. The most likely scenario is that positive economic news and rising corporate profits will push an overvalued market into even more overvalued territory. However, such gains could prove to be unsustainable, and therefore place equities at even greater risk.

Stock selection — with an emphasis on regional markets and economic sectors — will likely drive portfolio performance in coming years. Technology, financials, industrials, and health care should perform best; utilities, telecom, energy, REITs, and consumer staples should be laggards. Select European and emerging Asian markets should perform best within the world equity market.

Underlying fundamentals for the commercial real estate market will likely become increasingly negative over the next two years. Borrowing costs will drift higher, demand for space will likely moderate, and vacancy rates will likely trend higher, implying downward pressure on market effective rents. With cap rates near all-time lows, property values are vulnerable to rising interest rates. Average annual returns are unlikely to exceed 5% in coming years.

International equity markets offer better valuations relative to those of the domestic market. Because they remain at significantly depressed levels, business profits for non-US companies are also likely to grow at a faster pace. In addition, monetary conditions are likely to remain more expansionary outside the US for a longer period.
ECONOMIC REVIEW

Despite another lackluster GDP report, evidence of a broad revival in domestic economic activity continues to build. Most notable are signs of strength in the manufacturing sector, continued moderate but steady growth in construction, and a sustained expansion in household spending. Most impressive is the continued strength in job creation and the surge in confidence. The key point is that weekly and monthly economic data continue to exceed analyst estimates, as depicted in the Citigroup Economic Surprise Index, which has risen to the highest level since 2011 (see chart 1).

- **First Quarter GDP:** US real GDP increased at an estimated annual rate of only 1.5% in the quarter, the result of persistent weakness in net exports, inventory investment, and government spending. However, *real final private domestic demand* — a measure of spending on consumer goods and services, business equipment, and construction — increased at a more respectable annual rate of nearly 3%. *Corporate sales and profits increased for the third consecutive quarter*, with earnings per share (EPS) for companies in the S&P 500 rising by an estimated 10%, the largest quarterly gain in more than three years.

**Labor Participation:** The US labor market has actually strengthened in most recent months, as measured by net job creation, initial jobless claims, nationwide job openings, and the labor participation rate. The participation rate rose to a cyclical high of 63%, implying resumed growth in the labor force and a greater amount of slack. The labor participation rate for the prime working-age population — aged 25 through 55 — has risen to 81.7%, the highest level in ten years (see chart 2).

**Federal Reserve Policy:** As widely expected, the Federal Reserve raised its target federal funds rate in mid-March to 1%, the highest level in nearly a decade. The current policy rate is still in “emergency” territory, reflecting the FOMC’s strong bias to remain accommodative for an extended period. The Federal Reserve is still behind the economic curve as it embraces a policy of deliberately lagging a strengthening domestic economy.

- **Consumer Inflation:** Wage and price inflation will be the primary drivers of the future thrust of Fed policy. Most recent data continue to depict an environment of price stability. Although both wages and prices are in an uptrend, the rate of growth is extremely mild. Core consumer inflation has stabilized in the vicinity of 1.75%, while wages are increasing at a modest 2.8% annual rate. *The bottom line is that wage and price inflation should remain in a rising trend over the next two years, but a breakout to the upside appears unlikely any time soon.*
FINANCIAL MARKET REVIEW

World equity markets powered ahead in the first quarter, registering their best three-month performance since 2015, while global bond markets languished. The S&P 500 Index posted a total return of 6.1% in the quarter; by comparison, the Barclays Capital Aggregate Bond Index registered an anemic return of 0.5%. High-yield corporate bonds, the darlings of the past several years — generated a total return of only 2.5% in Q1. International equity markets generally kept pace with the US with a total return of 7.1%, while emerging market equities jumped by more than 11% in the quarter.

**Equity Market Internals:** US equity market leadership shifted dramatically in the quarter: Large-cap stocks (+6.1%) easily outperformed both small-cap (+2.5%) and mid-caps (+4.1%), while growth stocks (+8.6%) outperformed value stocks (+3.1%) by a wide margin. Technology stocks performed best in the quarter with a total return of 10.2% as measured by the NASDAQ Composite Index. Measures of equity market volatility remained exceptionally tame in the quarter, inconsistent with heightened political and geopolitical tensions. Finally, when measured over the past five years, US large-cap stocks posted a compound annual return of 15.9%, well above the 2.3% annual total return for US investment-grade bonds.
ECONOMIC OUTLOOK

The economic outlook remains positive as incoming data continue to generally surprise on the upside. The Conference Board’s Leading Economic Index has a reliable track record of anticipating turning points in the economy and remains in a solid uptrend. The annualized increase in the index has accelerated to a rate of 4.7% over the past six months — up from an annual rate of 3.3% over the previous six months — signaling faster economic growth ahead (see chart 3).

**Sector Leadership:** Private consumption, residential construction, and manufacturing should be the main engines of growth over the next four to six quarters. A rebound in the lagging capital goods sector is also possible, following many years of weakness. Robust labor markets, surging consumer confidence, and favorable credit conditions should support continued strength in household spending, housing sales, and new construction. *The turnaround in manufacturing has been striking:* New orders have been in a rising trend for six consecutive quarters, and should contribute to — rather than detract from — GDP growth in future quarters (see chart 4).
Economic Perspective

Corporate Profits: The outlook for US corporate profits has improved markedly over the past six months. Following five consecutive quarterly declines, earnings per share (EPS) reversed course in the second half of last year, with year-over-year increases of 4% and 8% in the third and fourth quarters respectively. Quarterly EPS should expand at a double-digit pace over the next four to six quarters. My forecast assumes profit growth of 10% to 15% in 2017, followed by an additional gain of 6% to 8% in 2018.

Federal Reserve Policy: There is no change in my assumptions regarding the thrust of US monetary policy. In its traditional “balance of risk” analysis, the central bank continues to exhibit a greater concern for economic growth versus inflation. Consequently, I expect the FOMC to deliberately remain behind the economic curve until there is a sustained upward trend in inflation.

- Rate Normalization: Although determined to ultimately normalize interest rates, the Fed is likely to proceed at a glacial pace. My forecast assumes a gradual but steady rise in the federal funds rate from its current level of 1% to a level of 1.75% by the end of this year. Further rate tightening in 2018 should result in an estimated federal funds rate of 2.5% by the end of next year.

World Oil Prices: There is no change in my assumption that world oil prices will remain in a broad trading range of $40 to $65 per barrel over the next two years. However, current production trends within both OPEC and the US shale market strongly suggest that oil prices could be under downward pressure over the short to medium term. There are already preliminary signs of a breakdown in discipline within the OPEC-led coalition of oil producers to collectively reduce oil output in 2017. I expect cheating by cartel members to become increasingly widespread as the year unfolds, thereby adding to the glut in crude oil inventories, currently at record levels (see chart 5).

- Rebound in US Shale Output: In addition to OPEC output, the response of US shale producers to the previous rise in crude oil prices has been extraordinary. Drilling is becoming more robust at progressively lower market prices. Production costs continue to trend lower — courtesy of ongoing technological advances — sparking a steady decline in breakeven prices for shale producers, implying a larger volume of production at a given market price.

The bottom line is that oil prices are likely to languish at the lower end of the target range for much of 2017, as global supply remains at a level in excess of world consumption. Fluctuations in oil prices for the remainder of this year are likely to be defined by $40 per barrel on the downside and only $55 per barrel on the upper end of the trading range.
The outlook for the domestic economy is heavily dependent upon developments pertaining to the Trump legislative agenda. Business, consumer, and investor confidence have surged since the election on the expectation that pro-growth policies pertaining to taxes, spending, and deregulation will spark a period of robust growth. The surge in small business confidence is especially notable and reflects the unusually high sensitivity of small business owners to government regulation and taxes (see chart 6).

Trumponomics: It is virtually impossible for investors to accurately predict the future direction of economic policy under President Trump or to assess the ultimate economic outcome. Consequently, I have divided the most likely scenarios into three broad categories:

- **Favorable:** President Trump succeeds in his push for a pro-growth agenda of corporate tax reform, marginal tax rate reductions for the middle class, deregulation, and a sharp increase in infrastructure spending. The likely result would be an acceleration in real GDP growth to a range of 3% to 4%.
• **Neutral:** Because of political gridlock and an inability to reach compromises on critical pro-growth legislation, the legislative status quo remains intact. Under this policy scenario, the US economy would likely expand at an annual rate roughly equivalent to the 2% average of the past five years. Faster or slower growth would be predicated upon monetary policy, business confidence, business capital formation, market interest rates, and inflation.

• **Negative:** The Trump administration abandons key pro-growth policy initiatives in favor of anti-growth policies — trade protectionism, anti-globalization, and harsh immigration restrictions — with a decisively negative impact on both the US and global economies. Under this scenario, a contraction in US economic activity would be a high likelihood, possibly leading to a global recession.

While conviction levels regarding politics and policy are extremely low at this stage, *I am making the assumption that President Trump’s overarching goal is to promote faster economic growth and prosperity* — and that social, cultural, and ideological pursuits will diminish in importance over time. The critical issue then becomes the extent of cooperation and compromise between Congress and the White House. Assuming some degree of unity and cooperation from Congress, it seems plausible that many of these pro-growth fiscal initiatives will be passed, *although probably later than expected and in a far watered-down version*. However, a scenario of political gridlock should not be ruled out.

**RECESSION WATCH**

The most significant issue for investors is the inevitable winding down of the current business expansion cycle and onset of the next recession. I have developed a series of economic, financial, and policy-related indicators that have a very respectable track record in signaling the onset of recession. Historically, US recessions have almost always been preceded by the following economic, financial, and policy developments:

1. **Inflation:** Wage and price inflation is always in a significant rising trend in the year leading up to recession. Inflationary pressures are minimal at the present time, but should become more evident in 2018 and beyond (see chart 7).

2. **Monetary Policy:** The Federal Reserve always tightens monetary policy in an aggressive manner just prior to recessions. Currently, monetary policy remains ultra-accommodative, although a catch-up phase cannot be ruled out in 2018.
3. **Yield Curve:** An inversion of the Treasury yield curve typically results from a combination of unacceptably high inflation along with progressive monetary restraint. A decline in yields on long-term bonds to a level below short-term rates typically occurs with an **average lead time of 15 months in advance of recession**. The yield curve has actually steepened during the past six months and is far from inverted. A flattening process will begin once the Federal Reserve’s rate-tightening cycle shifts into high gear, most likely in 2018.

4. **Credit Conditions:** With a lead time of two years, credit conditions begin to deteriorate prior to recession, in the form of excess credit demand and rapidly rising credit problems — delinquent loans, charge-offs, and loan losses. While there are preliminary signs of credit problems in certain areas, financial conditions are generally favorable.

5. **Housing Market:** A downturn in housing construction typically leads the onset of recession by two years. **There has never been a recession while the housing market is in a rising trend.** Housing sales, starts, and prices remain in an uneven uptrend, while confidence among homebuilders is at a 12-year high (see chart 8).
6. **Confidence**: Business and consumer confidence tend to decline one year prior to recession. Surveys indicate that confidence levels among consumers, businesses, and small business owners are near all-time highs (see chart 9).

The bottom line is that there are only minor and scattered red flags that typically accompany the lead-up to recession. Consequently, the likelihood of recession during the next 12 months is extremely low. The probability of recession is virtually assured of rising during 2018 and 2019, as the US economy approaches full employment.

**Economic Forecast**: The basic assumptions in my forecast for the US economy in 2017 and 2018 can be summarized as follows:

- **Real GDP growth** of 3% for the remainder of 2017 and all of 2018
- **Core consumer inflation** of 2% this year and 2.5% in 2018
- **Corporate profit growth** of 12% this year and 7% in 2018
- **Annual growth in consumer spending** of 2.5% in both 2017 and 2018
- **Housing starts** of 1.35 million this year and 1.65 million in 2018
• Auto and light truck sales of 17.5 million in both years
• Growth in business investment of 3.5% this year and 7.5% in 2018
• A stable unemployment rate of 4.5% in both years
• Monthly job creation of 185,000 and 150,000 in 2017 and 2018, respectively

The Global Economy: Prospects for world economic growth appear to be the most propitious since 2010. World central banks continue to provide massive monetary stimulus; the index of global manufacturing remains in a solid uptrend; the eurozone appears to be in a moderate but sustained expansion cycle; and China’s economy is growing at a robust pace, at least for the time being.

- World Locomotive: Moreover, major exporting countries — such as Germany, Japan, China, and South Korea — should benefit greatly from strengthening domestic demand in the US, the world’s engine of economic growth. World GDP growth could approach 3% in both 2017 and 2018, compared with 2.2% last year and 2.5% in 2015.

FINANCIAL MARKETS: AN ERA OF LOW RETURNS

Global financial markets have benefitted in recent years from massive monetary ease from world central banks. Record low short-term interest rates in virtually all developed markets have boosted market prices in all major asset classes, courtesy of unprecedented lows in financial market discount rates. Risk assets in particular have been the major beneficiaries, including corporate equities, real estate equities, and high-yield corporate bonds.

However, the outlook for world financial markets is becoming increasingly complex and challenging because of several unknown variables:

- Growing uncertainty associated with domestic politics, legislation pertaining to tax reform and health care, and geopolitical risks
- A steady rise in market valuations to the highest levels in a decade
- The dramatic shift in investor sentiment from pessimism to optimism
- Prospects for rising interest rates in coming years, with negative implications for market discount rates
FIXED-INCOME MARKETS

Expected returns in global fixed-income markets are likely to be lackluster and could closely resemble the anemic returns of the past five years. Total returns on the Barclays Capital Aggregate Bond Index for the five years ending in 2016 were roughly 2%. High-grade corporate bonds registered annual gains of 3.5%, while the Treasury market returned only 1.2%. My forecast for the bond market assumes comparable rates of return for all categories of investment-grade bonds over the next several years.

Other Sectors: High-yield (speculative-grade) corporate bonds should perform only slightly better, with expected returns of 4% over the next two years. Sovereign debt in Europe and Japan should produce similar to slightly worse returns relative to the US Treasury market. Finally, emerging market (EM) sovereign debt should perform best, with compound annual returns of 6% through 2018.

US EQUITY MARKET: A COMPLEX PICTURE

The eight-year-old cyclical bull market in common stocks has entered a more speculative phase. Because of powerful crosscurrents currently in place, the outlook for US equity markets has become more complex and therefore a growing challenge for investors. There currently exist both compelling positive and negative factors regarding the outlook for equity investing. In the positive column, traditional economic factors appear extremely favorable for equities.

- US economic growth could accelerate over the next four years
- Classic recessionary conditions are currently imperceptible
- Corporate profits have entered a new cycle that could persist into 2018
- Credit conditions are favorable and supportive of growth
- Inflationary pressures appear to be limited and contained
- Monetary policy is expected to remain highly accommodative into 2018
- Pro-business policies appear likely to dominate the legislative agenda for the first time in a decade
- Corporate tax reform and deregulation are the two most important initiatives for economic growth and corporate profitability

The key point is that virtually all classic textbook variables pertaining to the equity market appear favorable for the next 12 months.
US Corporate Earnings: The most encouraging trend for investors is the sharp reversal in corporate earnings. Following a mild and temporary slump in 2014 and 2015, corporate profits reversed course in the second half of last year, rising by 5% on revenue growth of 3%. During the preceding five quarters, EPS declined by an average of 5% on a slight decline in revenues. My forecast assumes EPS will rise by 12% this year on a 5% gain in revenues. On a preliminary basis, EPS could expand by another 6% to 8% in 2018.

Equity Market Headwinds: However, equity investors face equally powerful negative issues, mainly in the realms of valuation, investor sentiment, and domestic and global political and policy issues:

- Traditional measures of valuation are at the highest levels in a decade
- Domestic political risks are elevated and involve polarization both within Congress and between Congress and the White House
- The thrust of the Trump legislative agenda is far from certain, to the extent that widely expected pro-growth initiatives could be hijacked by anti-growth policies
- Investor sentiment has shifted dramatically from caution to euphoria, a reliable contrarian indicator

EQUITY MARKET VALUATION

Over long periods of time, traditional equity market valuation techniques are the single most reliable variable in the determination of prospective rates of return. However, in the short term, valuation has literally zero predictive value: Short-term market behavior is driven by sentiment, momentum, economic and company earnings surprises, government policy announcements, and geopolitical shocks.

Market Overshoots: The implication is that overvalued markets can become even more overvalued at cyclical peaks (1987, 2000), and that undervalued markets can become even more undervalued (2002, 2009, 2011, 2016) at cyclical troughs. The key word is overshoot: History clearly reveals that equity markets are notorious for overshooting theoretical fair value both on the upside and on the downside (see chart 10).

- Risk/Reward Ratio: Although valuation tools have proven to have minimal reliability as short-term market indicators, overvalued markets tend to be at greater risk of a consolidation or correction phase that could occur at any time and without warning. More importantly, valuation models have proven to be excellent predictors of longer-term rates of return.
• **Market Entry Levels:** History clearly reveals that market starting points — price entry levels — are the principal determinant of subsequent rates of return over five- and ten-year time horizons. It is not surprising that subsequent multi-year returns were well above average from a starting point of very depressed valuations in 1933, 1941, 1982, 2009, and 2011 — while returns were extremely disappointing from starting points of overvaluation near market peaks in 1929, 1972, 1987, 1999, and 2007.

**Five-Year Returns:** The key point is that valuation is currently a legitimate headwind for long-term equity investors. *The risk/reward ratio for equity investing has turned negative for the first time since the onset of the bull market in early 2009.* Accordingly, from current levels of overvaluation, investors should expect compound average annual rates of return of no greater than 5% over a five-year holding period. This would be approximately one-third the 14.6% average annual return for the S&P 500 Index over the previous five years beginning at yearend 2011, and half the very long-term average of 10.1% dating back to 1985.
Sector and Region Selection: Although expected returns for the overall domestic equity market should be disappointing in coming years from current levels, stock selection by economic sector and geographic region could generate somewhat greater rates of return. The best-performing economic sectors within the S&P 500 Index over the next several years are likely to include health care, industrials, technology, and financials. Conversely, utilities, telecom, energy, consumer staples, and REITs should generate the worst performances.

Commercial Real Estate: Similar to corporate equities and high-yield corporate bonds, commercial real estate is faced with a more challenging environment over the next several years when compared with the previous five years. Developer borrowing costs are expected to drift steadily higher; the demand for space should soften as employment growth slows; and lending standards for real estate should become more stringent over time.

- Depressed Cap Rates: Most importantly, there are signs of overbuilding in commercial offices, retail stores, and apartment buildings, which implies a rising trend in vacancies and less pricing power for developers. Cap (capitalization) rates in the mid-single digits are currently at unprecedented lows, which means that property values could be increasingly vulnerable as interest rates trend higher. Total rates of return should average no better than 5% annually over the next five years.

International Equity Markets: Many foreign equity markets offer better valuations relative to those of the domestic market. Because they are significantly depressed relative to normal, business profits are also likely to grow at a faster pace. Generally weak currencies relative to the US dollar should also benefit leading world exporters. Finally, monetary conditions are likely to remain more expansionary outside the US for a longer period. Equity markets in Europe and emerging Asia appear best positioned to generate positive returns (see chart 11).

- Global Equity Correlations: Can non-US equities continue to rally in the absence of a concurrent rise in US equities? A study of history suggests that the likelihood of this scenario is low — and in particular, highly unlikely in the specific case of European equities. During the past 50 years, there has not been a single instance during which European equities rose while the US equity market was simultaneously in a correction phase.

The converse is not true: History shows that US equities can rise while euro equities are falling. A similar relationship also exists between US and emerging market equities: There are no instances in which EM equities were in a rising trend while US equities were declining. The message is clear: The US is the trend-setting market, especially on the upside.
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