QUARTERLY ECONOMIC OUTLOOK

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My projections for GDP growth over the next two years are well in excess of the economy's potential long-term growth rate of 2%. In other words, spending and output over the next two years are likely to exceed the economy's capacity for sustained noninflationary growth estimated at 2%. The central long-term issue for equity investors involves an assessment of the risks of an overheating economy once it reaches full employment and once surplus resources and economic slack are fully absorbed.

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Summary and Major Conclusions:

- The US economy gathered momentum during the first quarter, as reflected in accelerating growth in household income, retail sales, building permits, factory orders, and business investment in equipment and software.

- Real GDP expanded at an estimated 6% annual rate in the quarter, 50% faster than the growth rate in Q4 of last year. The absolute level of real GDP has returned to its 2019 peak in only five quarters, the fastest recovery from any recession since 1950.

- Despite continued monetary easing by the Federal Reserve, long-term interest rates soared in the quarter. From a low of 0.92% at the end of last year, the ten-year US Treasury bond doubled to an interim peak of 1.75% in late March, an 18-month high.

- Corporate profitability benefitted enormously from the boom in economic output. Operating earnings per share (EPS) for the companies in the S&P 500 increased by an estimated 25% in Q1 versus the year-ago quarter.

- The central theme in my outlook is that the US economy is entering a period of very rapid growth that could persist through most of 2022. I expect quarterly GDP growth rates to rival those of the economic booms following World War II — when growth exceeded 12% — and during the mid-1980s, when real GDP growth exceeded 8%.

- The overarching long-term issue for investors involves an assessment of the risks of an overheating economy once it reaches full employment and once economic slack and surplus resources are fully absorbed.

- There currently exists a confluence of forces — pertaining to COVID-19 vaccines, pent-up demand, and government stimulus — that are forming a perfect storm, supporting the case for an outright economic boom.

- News on the pandemic front appears to be trending in the right direction. Public health officials project that the country will reach herd immunity during the summer months, which implies a full reopening of the economy during the third and fourth quarters.

- The economic rebound will be magnified by massive pent-up demand. At nearly $4 trillion, household savings are double the normal level, providing massive firepower for consumer spending this year and in 2022.

- The forthcoming new round of fiscal stimulus will supercharge the US economy over the next two years. President Biden's $1.9 trillion American Rescue Act is the equivalent of 7% of GDP.

- My forecast assumes GDP growth of 7% for this year, within a range of 6% to 8%, followed by growth of 4% to 6% in 2022. If so, the next two years would be the strongest consecutive years of economic growth since 1983 and 1984.
- Earnings per share for the companies in the S&P 500 could increase by 30% this year, the fastest yearly increase since 2010. Operating profit margins could reach 16% this year, up from less than 14% in 2020, a result of operating leverage and tight cost containment by business firms.
- The long-term outlook for inflation is the major variable in the outlook. Although inflation remains under good control, the long-range outlook is highly uncertain. Currently at 1.5%, core consumer inflation could average 2% for all of this year, rising to 2.5% in 2022 and 3.5% or higher in 2023.
- The combination of rapid economic growth and rising inflationary expectations should exert steady upward pressure on long-term interest rates over the next two years. Currently at 1.6%, government bond yields could rise to 2% by the end of this year and to 3% by yearend 2022.
- With the notable exception of China, the global economy is lagging the recovery in the US. Following a slow start to the year, most regional economies should be on a sustained recovery path during the second half of this year and in 2022. World GDP could expand at a 6% rate this year followed by 5% growth in 2022.
- Along with the US, China will be at the forefront of world economic growth this year, with GDP expanding by 8%. Eurozone GDP could grow by 3% to 4% both this year and in 2022, led by manufacturing and business investment spending.
- The primary risks to the outlook pertain to central bank policy and the potential for higher inflation and interest rates. While inflation is a lagging indicator, expectations of future inflation is a leading indicator and currently on a steep incline.
- Another risk is a surge in COVID-19 infections during the next several months as the more transmissible UK B.1.1.7 variant of the coronavirus becomes the increasingly dominant strain in the US, lifting the number of cases and hospitalizations. Investors should view the next several months as a race between vaccinations and coronavirus variants.

ECONOMIC REVIEW

The US economy gathered momentum during the first quarter, as manifested in accelerating growth in household income, retail sales, automobile production, building permits, factory orders, and business investment in equipment and software. Residential construction continues to be the fastest-growing sector within the domestic economy. February data were adversely affected by severe weather, but economic data in March and April should resemble an economic boom. Consumer confidence remains depressed but is in an improving trend and reached the highest level of the pandemic in March (see chart 1).

Chart 1: US Manufacturing Sector Enjoying Solid Growth
Monthly Survey of Manufacturers, New Orders Index
Source: The Institute for Supply Management (ISM)

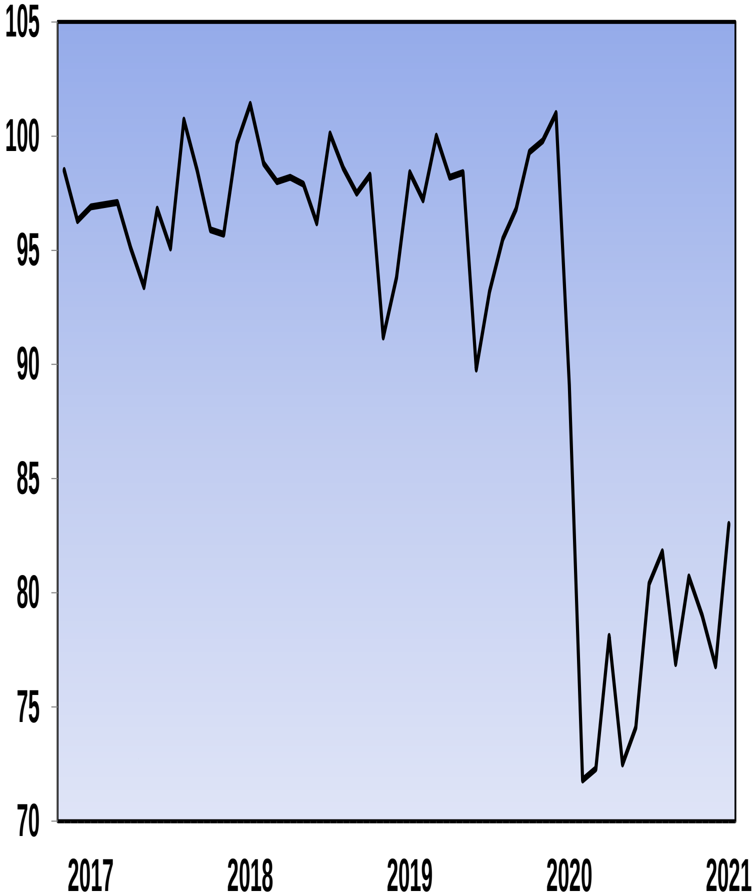
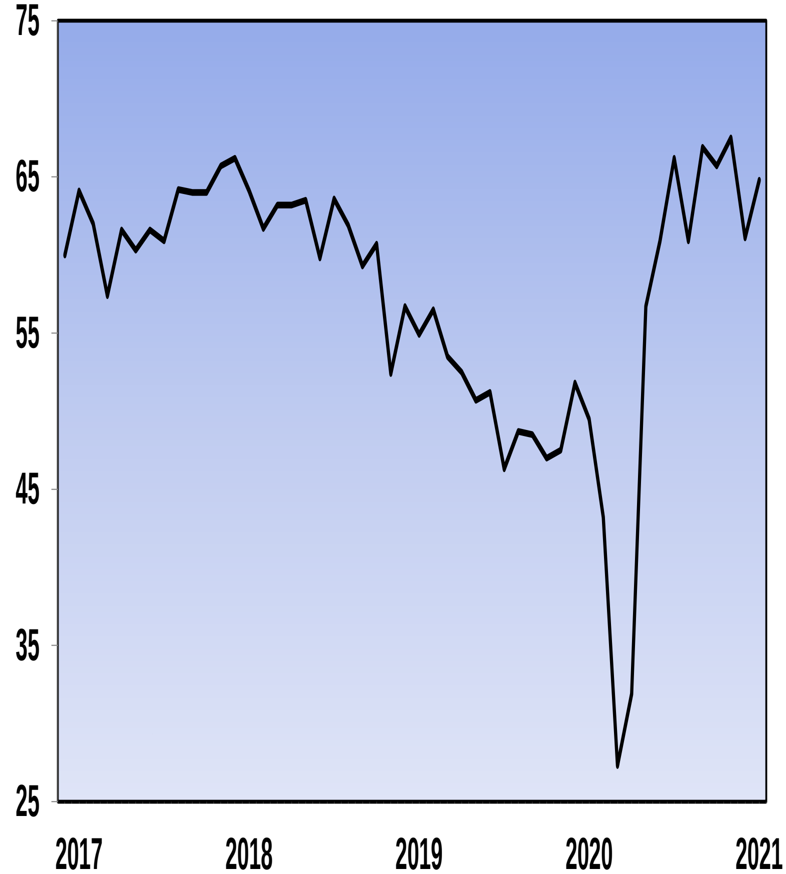


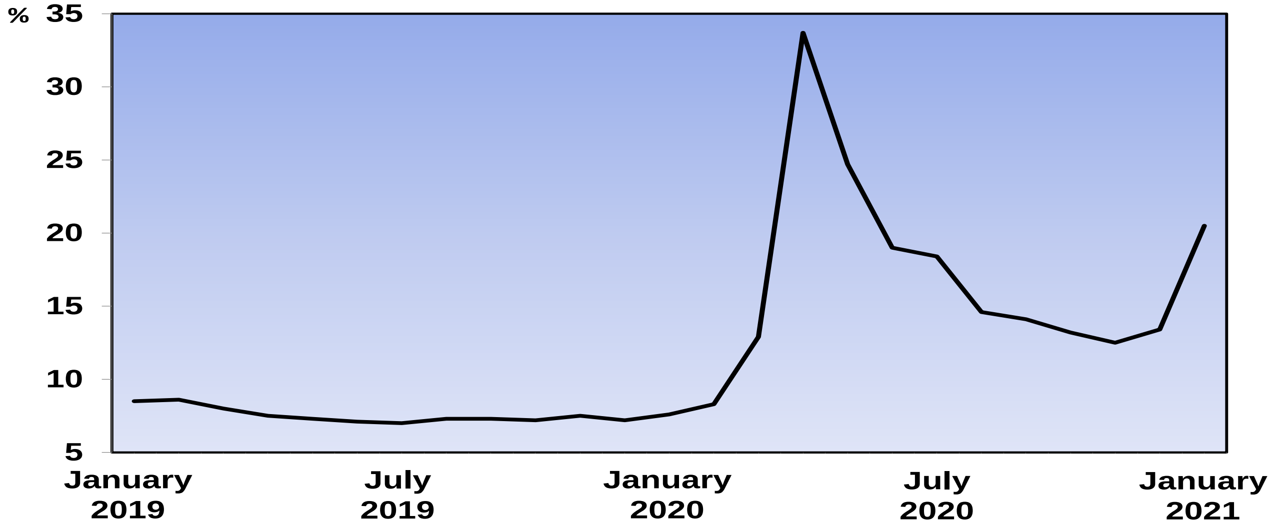
Chart 2: Inflationary Expectations on the Rise
Market-Implied Future Inflation Rate in Five Years
Treasury Inflation-Protected Securities (TIPS)
Source: Federal Reserve



Gross Domestic Product: Real GDP expanded at an estimated **6%** annual rate in the quarter, 50% faster than the growth rate in Q4 of last year. *Excluding the artificial rebound in the third quarter of last year, this would be the fastest quarterly growth rate since 2003*. The absolute level of real GDP has returned to its pre-pandemic peak reached in late 2019 in the space of only five quarters, the fastest recovery from any recession since 1950. Real GDP following the 2008 financial crisis did not return to its previous peak for 12 quarters.

Company Earnings: Corporate profitability benefitted enormously from the boom in economic output. Operating earnings per share (EPS) for the companies in the S&P 500 increased by an estimated 25% in Q1, with revenue growth of 5%. Profit margins widened significantly as a result of ***operating leverage*** along with rigorous cost containment. Because of manufacturing businesses comprise more than 40% of the S&P 500, profit growth tends to respond to the strength in factory orders (see chart 2).

Chart 3: Exceptionally Elevated Personal Savings Will Boost Spending
The US Personal Savings Rate (%)
Personal Savings as a Percent of Disposable Personal Income
Source: Bureau of Economic Analysis



Public Health: Developments pertaining to the pandemic were mostly positive in the quarter, as the number of coronavirus infections and hospitalizations declined precipitously and as vaccination programs gathered momentum. The Biden administration announced that there will be sufficient vaccine supply to inoculate all adults by Memorial Day. *However, while the worst of the pandemic appears to be behind us, risks remain*.

- **Reversal in March:** Daily infections bottomed in February, followed by a worrisome upturn in March, as the new highly infectious UK B.1.1.7 variant became the dominant strain in the US. The potential magnitude of the current outbreak is unknown and is a wild card in the near-term outlook. *The ongoing race between vaccinations and variants will eventually be won by science, but perhaps not until the summer months*.

Economic Policy: Government policy remained decidedly expansionary in the quarter, as the Federal Reserve continued to inject massive amounts of liquidity into the financial system. Even more dramatic is the thrust of fiscal policy. The strong economic rebound in the quarter was reinforced by the $900 billion COVID relief package signed into law late last year. Beyond that, the economy will be invigorated during the final three quarters of this year by President Biden's landmark $1.9 trillion American Rescue Plan Act.

- **Transfer Payments:** The power of fiscal stimulus can be seen in monthly data on personal income and savings. Real disposable income rose at an annual rate of 14% in January, fueled by government payments associated with COVID relief legislation. Excluding transfer payments, personal income actually declined. Because most of these payments were not spent, the savings rate jumped from 13% in December to 21% in January (see chart 3).

Chart 4: US Service Inflation at the Lowest Level in a Decade
Consumer Price Index, Services, Annual % Growth
Source: Bureau of Labor Statistics

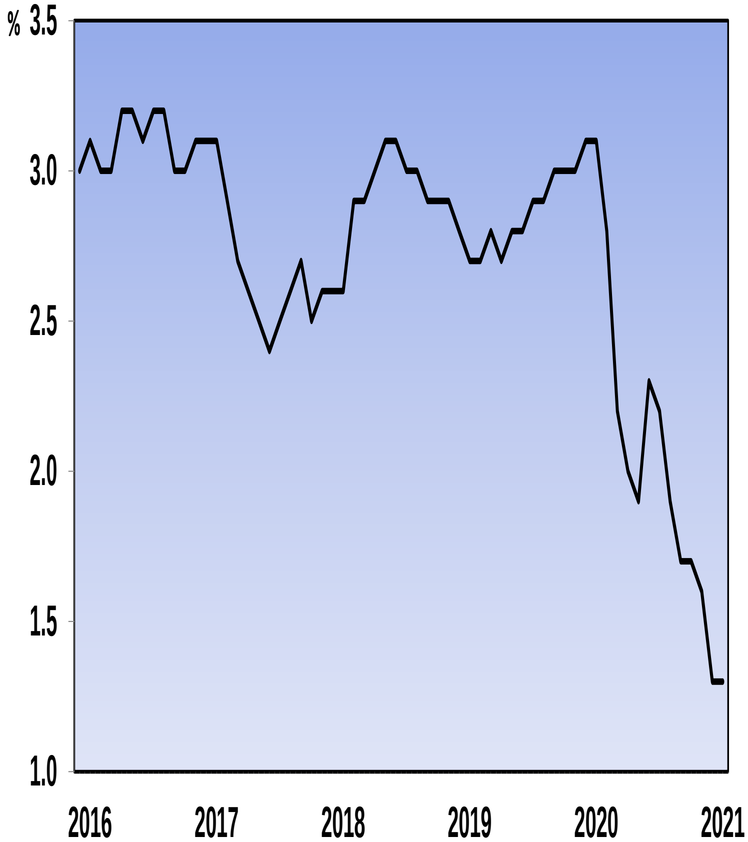
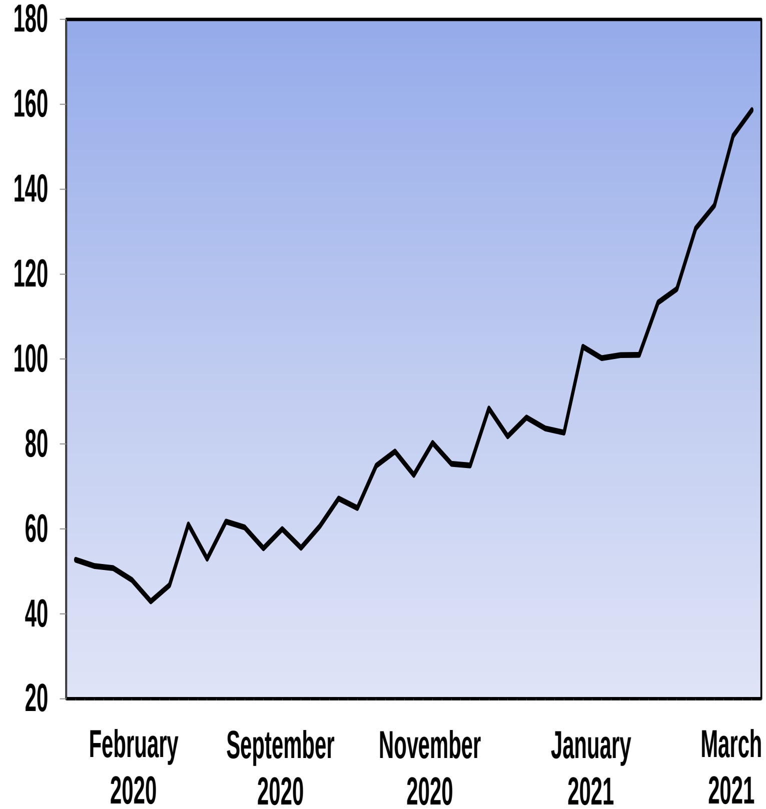


Chart 5: Pronounced Steepening of the Yield Curve Underway
Yield on Ten-Year Treasury Bonds Minus
Yield on Three-Month Treasury Bills (Basis Points)
Source: Federal Reserve



Inflation and Employment: As two classic lagging economic indicators, both new hiring and inflation remained depressed in the quarter. The core consumer inflation rate has stabilized around 1.5%, while the inflation rate for ***consumer services*** fell to 1.3%, the lowest level in more than a decade. Inflation will likely lag the economic recovery until the labor market begins to approach full employment later next year (see chart 4).

Long-Term Interest Rates: Despite continued monetary easing by the Federal Reserve, long-term interest rates soared in the quarter. From a low of 0.92% at the end of last year, the ten-year US Treasury bond doubled to a yield of 1.75% in late March, an 18-month high. With short-term rates pinned at zero, *the Treasury yield curve steepened to the highest level since 2017, a signal of market expectations for rapid economic growth and rising inflation ahead* (see chart 5).

The World Economy: The global economic recovery continues to lag that of the US and China, as COVID-19 containment measures continue to shape regional activity. Europe and the UK are in double-dip recessions, while partial recoveries in Japan, India, Canada, and Brazil have recently slowed. The Asia-Pacific region is leading the global recovery, led by China, Taiwan, and Vietnam, with India and South Korea slightly behind.

ECONOMIC OUTLOOK

The central theme of my economic outlook is that the US is entering a period of very rapid growth that could persist through most of 2022. I expect GDP growth rates to rival those of the economic booms following World War II — when growth exceeded 12% — and during the mid-1980s, when real GDP growth exceeded 8%. My forecast assumes GDP growth of 6% to 8% this year followed by another 4% to 6% growth in 2022. By way of perspective, the normal pace of GDP growth during periods of economic expansion has typically been within a range of 3% to 3.5%.

Potential Growth: These projected growth rates are well in excess of the economy's potential growth rate of 2%, based upon estimates for productivity and labor force growth. In other words, spending and output over the next two years are likely to exceed the economy's capacity for sustained noninflationary growth of 2%. ***The central long-term issue for equity investors involves an assessment of the risks of an overheating economy once it reaches full employment and once surplus resources are fully absorbed***. This issue is discussed more fully below.

A PERFECT STORM

Whereas the long-term direction of the economy remains in doubt, it appears highly likely that a period of healthy noninflationary economic growth lies immediately ahead. *There currently exists a confluence of forces that are forming a perfect storm, supporting the case for an outright economic boom*. These fall within the category of favorable developments in the realms of public health, government policy, and underlying economic and financial conditions.

- **Economy Reopening:** News on the pandemic front appears to be trending in the right direction. Public health officials estimate that the country will reach herd immunity during the early summer months, which implies a full reopening of the economy during the third and fourth quarters. Increased mobility will result in accelerating growth in spending, output, employment, and capital formation.

- **Credit Conditions:** Unlike the aftermath of the world financial crisis in 2008, economic and financial conditions are healthy, and therefore supportive of robust growth. Household balance sheets are the strongest in several decades and the financial system is in good health. The default rate is in a declining trend. In short, impediments to economic growth in the form of credit-related problems are minimal.

- **Pent-Up Demand:** The massive accumulation of pent-up demand can be attributed to the steep economic downturn last year along with generous government payments to households. At nearly $4 trillion, household savings are nearly ***fourfold*** pre-pandemic levels, providing powerful firepower for consumer spending this year and in 2022. Business inventories are also below normal, thereby providing additional support for the manufacturing sector.

- **Monetary Policy:** My forecast assumes no changes in monetary policy this year, implying a continuation of very favorable financial conditions. Beyond that, the thrust in monetary policy is likely to change in two respects: (1) The Fed should begin to reduce the volume of government bond purchases within the next year, currently at a monthly rate of $110 billion; and (2) The Fed will begin to gradually lift its policy rate beginning later next year.

- **Fiscal Stimulus:** The forthcoming new round of fiscal stimulus will supercharge the US economy over the next two years. President Biden's $1.9 trillion American Rescue Plan Act is the equivalent of 7% of GDP. When added to the $900 billion COVID relief package from very early this year, total fiscal stimulus for this year will be the equivalent of 12% of GDP. When nearly $2.5 trillion in fiscal stimulus from 2020 is included, the total rises to more than $5 trillion, an unprecedented 25% of GDP.

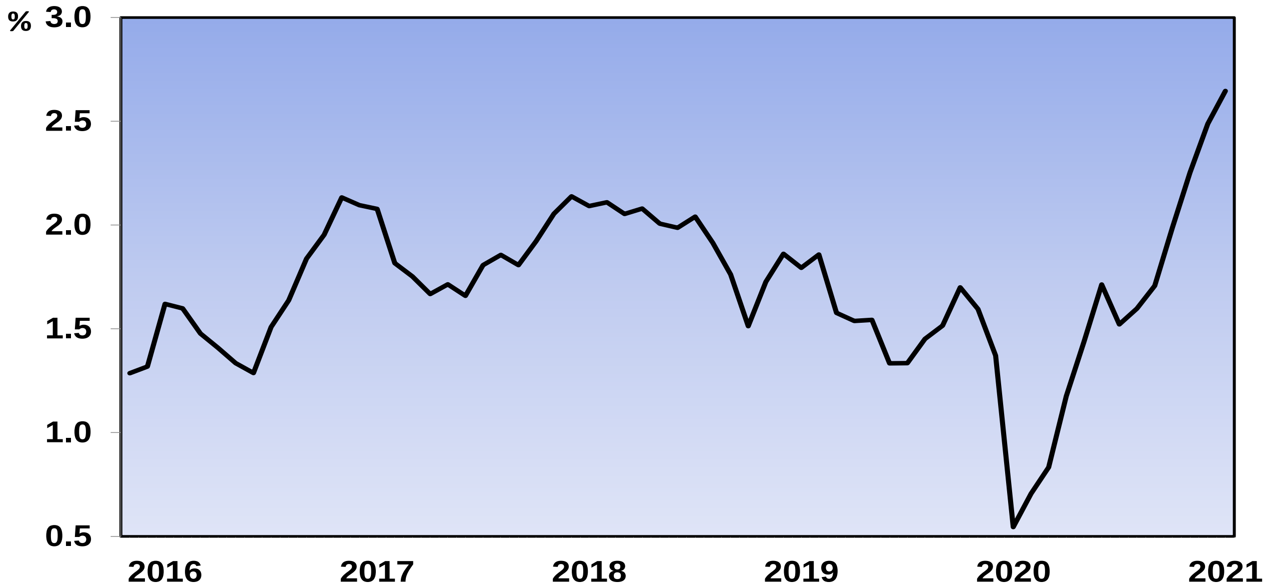
ECONOMIC FORECAST

The US economy will soon be firing on all cylinders in response to improving public health conditions and massive fiscal policy stimulus. Consumer purchases of autos and household durable goods, business investment in equipment and software, and residential construction should be at the leading edge of the rebound in aggregate spending. My GDP forecast for this year assumes 6% growth in consumer spending and 15% growth each for business investment and residential construction.

Factory Output: The outlook for manufacturing is also positive, as companies lift production to meet the surge in current demand and rebuild depleted inventories. I expect manufacturing production to increase by 5% both this year and in 2022. Net exports and government purchases should lag the recovery in overall GDP.

GDP Growth: My forecast assumes real GDP growth of 7% for this year, within a range of 6% to 8%, followed by growth of 4% to 6% in 2022. *If so, the next two years would be the strongest consecutive years of economic growth since 1983 and 1984*, when real GDP increased by an average of 6.8% over a period of six quarters. Nominal (current dollar) GDP could increase by nearly 10% this year.

Chart 6: Inflationary Expectations on the Rise
Market-Implied Future Inflation Rate in Five Years
Treasury Inflation-Protected Securities (TIPS)
Source: Federal Reserve

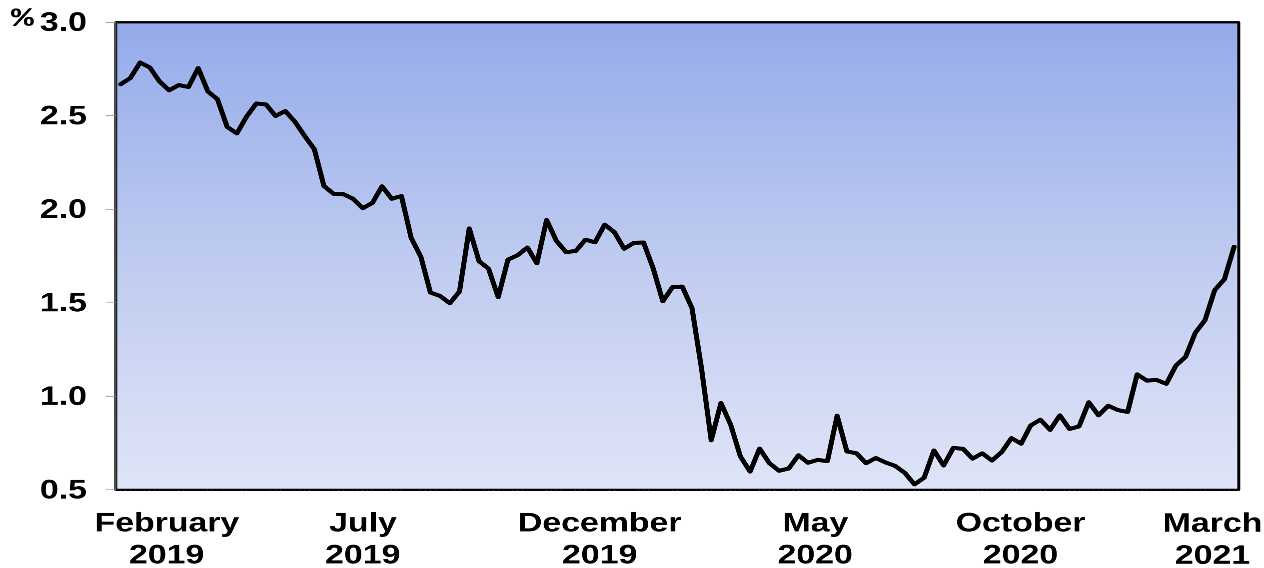


Corporate Earnings: Company revenues should match the expected 10% growth in nominal GDP this year — the fastest yearly growth rate since the 1980s — followed by growth of 8% in 2022. *Operating profit margins could reach 16% this year, up from less than 14% in 2020*, a result of operating leverage and tight cost containment by business firms. EPS for the companies in the S&P 500 could increase by 30% this year — the biggest yearly increase since 2010 — and by another 20% in 2022.

Employment: The US labor market should reach an inflection point within the next six months, at which point the pace of job creation could accelerate sharply. Compared with average monthly increases of 275,000 so far this year, nonfarm payrolls could grow at a monthly rate of 400,000 for the remainder of this year and during all of 2022. Currently at 6.2%, the unemployment rate could decline to 5.5% by the fourth quarter of this year and to 4.5% by yearend 2022.

Consumer Inflation: Although the long-range outlook is highly uncertain, inflation is likely to remain depressed over the next 12 months, at a minimum. Wages and prices should remain stable until the economy reaches a higher level of resource utilization and the labor market is at full employment. Currently at 1.5%, core consumer inflation could average 2% for all of this year, rising to 2.5% in 2022. The inflation rate could approach 3% later next year and possibly exceeding 3.5% during 2023. Measures of inflationary expectations are already flashing red (see chart 6).

Chart 7: Steady Rise in Long-Term Interest Rates
Market % Yield, Ten-Year US Treasury Bond
Source: Federal Reserve



Long-Term Interest Rates: The combination of rapid economic growth and rising inflationary expectations should exert steadily increasing upward pressure on long-term interest rates over the next two years. I expect government bond yields to rise in waves, followed by periods of consolidation. In terms of levels, the ten-year US Treasury bond, currently at 1.6%, could rise to 2% by the end of this year and approach 3% by yearend 2022. The yield curve has already steepened to a four-year high and should remain in a steadily steepening trend throughout 2022 (see chart 7).

THE WORLD ECONOMY

With the exception of China, the global economy is lagging the economic recovery in the US. Following a slow start to the year, most regional economies should be on a recovery path during the second half of this year, as coronavirus containment measures are gradually lifted along with a steady increase in vaccine availability. World GDP could expand at a 6% rate this year followed by 5% growth in 2022.

Along with the US, China will be at the forefront of world economic growth this year, with GDP expanding by 7.5%. Economic recovery in Europe will be supported by strong exports to China and the US, while domestic demand should benefit from continued large-scale government stimulus and an accelerating pace of vaccinations.

Eurozone GDP could grow by 3% to 4% both this year and in 2022, led by manufacturing and business investment spending. Impeded by powerful structural economic headwinds, growth in Japanese GDP will likely be within a range of 2% to 3% in both 2021 and 2022. Emerging Asian economies appear poised for very rapid growth, projected at 7% to 8% both this year and in 2022.

RISKS TO THE OUTLOOK

The major risks to the outlook pertain to central bank policy and the potential for higher inflation and interest rates. *Whereas monthly government data on inflation are notorious lagging indicators, inflationary expectations are a leading indicator*. A further increase in inflationary psychology would become embedded in valuations of both fixed-income and equity assets. Consequently, the most immediate risk to the economy and financial markets is a sharp rise in long-term interest rates, which could restrain spending, investment, employment, and asset prices.

Another significant risk is a surge in COVID-19 infections during the next several months as the more transmissible strains of the coronavirus gain traction in the US, lifting the number of cases and hospitalizations. I view the next several months as a race between infections of the new UK B.1.1.7 variant and vaccinations.

The emergence of new variants from Brazil, South Africa, New York, and California is also a concern. My assumption is that scientists will persistently gain the upper hand on future mutations as they emerge — albeit with a time lag — but that these potential outbreaks could be very disruptive to commerce, mobility, and consumer and business confidence in the interim.

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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