AMERICAN CAPITAL MANAGEMENT

ECONOMIC & INVESTMENT OUTLOOK
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Investment Perspective

While Brexit will not impact the U.S. economy directly, the Federal Reserve may delay interest rate increases and the strengthening dollar will affect U.S. companies selling abroad

The U.K. decision to leave the European Union (EU) introduces economic and political uncertainty, but the U.S. investment environment continues to be favorable. The negative economic consequences will mostly affect Great Britain, but the political reverberations will be felt more broadly. Populism and protectionism appear on the rise. Global stock markets initially reacted negatively to a new uncertainty, but several major stock markets subsequently recovered. Interestingly, the FTSE 100, a major British equity benchmark, is up 5% since the decision whereas the STOXX 600, a European equity benchmark, is down 2%. The S&P 500 declined 6% over two days and then pushed to a new high. While Brexit will not impact the U.S. economy directly, the Federal Reserve may delay interest rate increases and the strengthening dollar will affect U.S. companies selling abroad. More broadly, investors are wrestling with the cross-currents facing the Fed – the domestic economy may warrant moderate tightening whereas global circumstances may dictate further accommodation. In the past, the Fed rarely gave much weight to overseas economic developments, but global issues are now influencing the decision-making process. A slower pace of Fed tightening has positive implications for equities, which remain attractive due to the combination of moderate growth, low interest rates and subdued inflation. A summary of index returns for the quarter ending June 30, 2016 is as follows:

Dow Jones Industrials	+4.3%	Russell 2500	+4.0%
MSCI EAFE	-4.4%	S&P 500	+3.8%
NASDAQ Composite	-2.7%	Wilshire 5000	+3.7%

GLOBAL ECONOMY

The moderate acceleration in global growth next year is more uncertain given the U.K.'s recent decision

World economic growth (ex. U.S.) should increase 3.3% in 2016, but the moderate acceleration in global growth next year is more uncertain given the U.K.'s recent decision. The consensus is that corporate decision-making will slow due to uncertainty and major economies will experience a moderate headwind with a drag of 0.3% in some economies and 1% in Great Britain. In general, Europe continues to experience slow growth and deflation that the European Central Bank (ECB) fights with negative interest rates and quantitative easing. Both are intended to force investors into riskier assets hoping for higher returns, but this approach may be counter-productive. China is slowing to 6.5% growth with downside risk as it transitions from an economy reliant on exports and infrastructure investment to one fueled by domestic consumption. In response to more difficult economic conditions, China has lowered interest rates, depreciated its currency and cut the required reserve ratio to stimulate lending.

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The strength in the consumer and housing sectors is supported by improving employment, moderate wage gains, low gasoline prices and low mortgage rates. This combination is favorable for households

The U.S. economy is expected to grow 1.9% in 2016 and 1.8% next year. Consumer spending remains the major engine of growth and is expected to increase 2.7% this year. Residential investment also continues to grow at a healthy 10% pace. The strength in the consumer and housing sectors is supported by improving employment, moderate wage gains, low gasoline prices and low mortgage rates. This combination is favorable for households. Average hourly earnings are up 2.5% year-over-year, private payroll growth is 1.8% and the unemployment rate is 4.7%. The manufacturing sector is mixed, but the Institute of Supply Management (ISM) purchasing managers index increased to 53.2 in June from 48.0 in December, signaling an accelerating pace of improvement. The report's leading indicators – e.g. new orders and production – suggest further progress ahead. In contrast, non-residential investment spending remains soft due to the downturn in energy expenditures and pressure from a strong dollar. Overall, most leading economic indicators point to solid growth across the economy with continued expansion.

BREXIT

The U.K. economy will bear the brunt of its decision with a major hit due to uncertainty

In a historic referendum on June 23, the U.K. voted to leave the European Union – a British exit from the EU or "Brexit." This was a vote against the loss of sovereignty and excessive globalization. The next major milestones include formalizing the request to leave the EU and negotiating the terms of separation and future engagement. This will be a complex and lengthy process that may take two to five years. The U.K. economy will bear the brunt of its decision with a major hit due to uncertainty. Business fixed investment remains the most vulnerable sector. Analysts estimate that GDP growth may decline from 2% to 1% and could tip into recession with the biggest impact in 2017. The negative impact on Europe's growth will be moderate. The U.S. will see minimal impact as the U.K. represents 4% of U.S. exports compared to 20% for Europe and 1% of revenue compared to 7% for Europe. The biggest risk is possible referendums by other nations to exit the EU, causing problems for financial institutions. Different from Great Britain, most European countries relinquished their currencies by joining the Eurozone; thus their departures would be more difficult and less likely. In addition, the potential for nationalistic trade wars will increase in the future. These developments would eventually have a modest negative impact on the U.S. economy.

HOUSING & REAL ESTATE

Longer-term, housing fundamentals remain attractive and balanced with little evidence of national excess

The housing sector is experiencing solid and healthy growth after the steep 2007-2010 downturn. This supports our economy with job growth and related household expenditures. Existing homes are selling at a 5.5 million annual rate, up 4.5% y/y. This is the best pace since prior to the Great Recession. In addition, the S&P/Case-Shiller Home Price Index is up 5.4% y/y. National home prices have been steadily rising at 4% or greater since 2012, a byproduct of improving incomes, low mortgage rates and tighter supply. Supply has tightened because new building has not kept pace with the pace of household formation and the shadow inventory from the foreclosure overhang has been absorbed. Housing starts are likely to be 1.18 million this year and improve to 1.32

million in 2017 – still modestly below the rate of household formation. For perspective, there were 1.5 million housing starts 20 years ago, illustrating the moderate pace of new building in response to the epic downturn nine years ago. Longer-term, housing fundamentals remain attractive and balanced with little evidence of national excess. Rising rents will continue to encourage prospective home owners to buy homes as housing affordability remains attractive. While there are no obvious signs of excess from a supply and demand perspective, certain metro areas appear expensive given the price increases in these "supply constrained" markets.

INFLATION & INTEREST RATES

The Fed initially raised interest rates in December, but has since indicated that the pace of tightening will slow in response to global growth concerns

In the wake of Brexit, the Federal Reserve will likely slow the process of raising interest rates. In addition, central bankers overseas are calling for a more coordinated approach to monetary policies to avoid currency pressure and potential trade wars. The Fed initially raised interest rates in December, but has since indicated that the pace of tightening will slow in response to global growth concerns. This results in a delicate balancing act as the domestic objectives of full employment and 2% inflation will likely be met in the near future. Headline inflation is 1% due to the decline in energy prices, but core inflation is 2.3% for the consumer price index and 1.6% for the personal consumption expenditure (PCE) price index – the Fed's preferred measure of inflation. While the pace of inflation is reasonable and attractive for investors, near-term risks are focused on deflation. The decline in 10-year Treasury yields from 2.5% to 1.5% over the last 12 months reflects the view that low growth and deflation remain a concern. Accordingly, future rate increases should be gradual, dependent on incoming data and below historical levels for some time.

INVESTMENT OUTLOOK

The S&P 500 dividend yield of 2.1% is competitive with both long-term Treasury yields and core inflation – another sign of the attractiveness of equities considering that dividends grow most years

The outlook for equities remains favorable based upon the combination of moderate earnings growth with low inflation and interest rates. The stock market is reasonably valued at 18.2x estimated 2016 S&P 500 operating earnings of $119 per share, especially considering a 10-year Treasury yield of 1.58% and core PCE inflation of 1.6%. Looking ahead, the market is trading at 16.8x next year's operating earnings estimate of $129. This multiple compares to the long-term average of 16.6x and over 19.0x during periods of low inflation and interest rates. In our opinion, there is upside to both the P/E multiple and earnings growth. Additionally, the S&P 500 dividend yield of 2.1% is competitive with both long-term Treasury yields and core inflation – another sign of the attractiveness of equities considering that dividends grow most years. In contrast, fixed income yields are experiencing unprecedented declines with all-time historic lows in 10 and 30-year Treasuries. The current period of global monetary accommodation may continue to depress yields and, in fact, the European Central Bank has begun buying corporate debt – an unprecedented move. When quantitative easing ends, large government buyers will no longer dominate the global bond market and yields may rise.

Technically, the equity market has been building a base over the past 18 months with improving breadth. Both the S&P 500 and Dow Jones Industrials are trading above their 50 and 200-day moving averages and hit new highs on July 11-12. In addition, the NYSE advance/decline ratio is making new highs confirming the secular uptrend. The market has been fluctuating in a 15% trading range since late 2014 with two 10% corrections in the last 12 months. This pattern of occasional downdrafts is normal and we view periodic corrections as buying opportunities given the favorable fundamentals. Interestingly, the CBOE Volatility Index (VIX), the fear gauge, fell 51% in the three weeks after Brexit for its largest decline since 1990. Investor sentiment is currently described as "skeptical", but this healthy skepticism enables the market to grind higher as key resistance levels are navigated without incident.

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The U.S. stock market began the year with significant volatility in response to several worries (China, oil, Fed hikes) and eventually rallied from its low on February 11. On June 23, investors capitulated after the Brexit decision as the market promptly declined 6% and then quickly recovered to new highs after 18 days as the worst fears subsided. Recently, the S&P 500 jumped 8% over the 10-day period ending July 12 – the biggest 10-day rally since December 2011. These episodes demonstrate that the stock market has an upward bias and is successfully climbing the "wall of worry." We believe U.S. equities, particularly small and medium-sized growth companies, remain attractive. A combination of earnings growth and multiple expansion appears likely given current valuations, low interest rates and tepid inflation. On July 12, the market hit a record high after a pause of 400 days. A new high after a pause over 300 days is rare and occurred only 23 times since 1929. Historically, this produced higher prices over the next year 91% of the time with an average gain of 16%. In addition, sell side indicators are at levels that produced gains over the next 12 months 97% of the time. These are bullish signals! But the market may experience a pause or correction after its recent strength. The key risks include: an economic downturn, Chinese hard landing, financial contagion from Brexit, Mideast conflict, terrorism or a sharp appreciation in the U.S. dollar.