AMERICAN CAPITAL MANAGEMENT

ECONOMIC & INVESTMENT OUTLOOK
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Investment Perspective

Despite much skepticism, the stock market is advancing this year on moderately improving fundamentals

Despite much skepticism, the stock market is advancing this year on moderately improving fundamentals. Today, the key question is "Will the investment outlook change based upon the election results in November and a possible Federal Reserve interest rate hike in December?" We doubt it. The fundamentals that support equities – a combination of moderate growth, mild inflation and low interest rates – remain in place. Interestingly, this powerful multi-year advance has not created investor euphoria and valuations are reasonable. We remain encouraged by the opportunity to earn attractive returns by investing in small and medium-sized growth companies. However, unexpected developments may increase uncertainty and volatility. A summary of year-to-date index returns for the quarter ending September 30, 2016 is as follows:

Dow Jones Industrials	+7.2%	Russell 2500	+10.8%
MSCI EAFE	+1.7%	S&P 500	+7.8%
NASDAQ Composite	+7.1%	Wilshire 5000	+8.4%

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GLOBAL ECONOMY

World economic growth (ex. U.S.) should increase 3.3% this year and improve to 3.8% in 2017. A consensus is emerging that the reflationary actions of central banks are boosting global growth and sentiment is improving. However, growth expectations of 1% in Europe and Japan remain low compared to other regions. Both are dealing with an aging population that hinders growth. The European Central Bank continues to battle sluggishness with negative interest rates and quantitative easing. Japan is increasing fiscal stimulus and adopting yield-targeting to break a multi-decade deflationary conundrum. Yield-targeting is a new concept to help steepen the yield curve – a pro-growth indicator and a beneficial move for the Japanese banks. China is growing 6.7% with downside risk as it transitions from an economy reliant on short-term stimulus measures to one fueled by domestic consumption and private investment. Brexit in Europe is moving slowly and this may be boosting sentiment.

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The U.S. economy is expected to grow 1.6% in 2016 and 2.1% next year. Growth in the second half of the year is expected to accelerate after growth of 1.1% through June 30 and this momentum should carry into 2017. Consumer spending remains a major growth driver and is forecast to increase 2.6% this year and next. This spending strength is evident in the healthy pace of vehicle sales at a 17.8 million annual rate – a robust level fueled by easy credit that may pleateau over the near-term. Consumer spending is supported by improving employment, moderate wage gains and low energy prices. Existing homes are selling at a 5.5 million annual rate, up 1.0% y/y, and the S&P/Case-Shiller Home Price Index is up 5.1% y/y. However, a pause is emerging in the growth

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rate of new single-family housing starts. The manufacturing sector has been a headwind to growth. The combination of a stronger dollar, which makes U.S. goods more expensive abroad, and energy weakness has subdued spending and investment. The Institute of Supply Management (ISM) purchasing managers index declined slightly in the third quarter, but the September reading improved 4.2% to 51.5 from August – suggesting a possible inflection. Importantly, the survey is above 50 which indicates an expansionary mode. The ISM non-manufacturing survey also gained 11% to 57.1 – the highest reading since last October. Overall, several leading economic indicators point to moderate growth across the economy with continued expansion.

We are experiencing a "normalizing" of earnings growth and a pause in progress as tailwinds offset a few headwinds

CORPORATE PROFITS

We expect S&P 500 operating earnings of $119 per share this year followed by an increase to $129 in 2017. Next year will be the first meaningful increase in earnings in three years after doubling from $60 to $118 between 2009 - 2014. We are experiencing a "normalizing" of earnings growth and a pause in progress as tailwinds offset a few headwinds. The issues that have hindered EPS growth are similar to those affecting the manufacturing sector – a stronger U.S. dollar and lower energy prices. However, better earnings growth should emerge in the quarters ahead on a resumption in revenue growth, improving margins and strong stock repurchase activity. Additionally, mergers and acquisitions (M&A) are accelerating after a slow start to the year and could be an important market driver. Domestic M&A volume is $1.3 billion through September with 8,882 deals announced. We are seeing increasing acquisition interest in small and medium-sized growth companies in response to the combination of challenging growth prospects, attractive borrowing costs and lack of pricing power. There is an "urge to merge" to achieve economies of scale, consolidate buying and pricing power and strengthen market positions in growing markets. Outside of M&A, businesses could also benefit from a boost in U.S. government spending associated with infrastructure projects which is long overdue.

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MONETARY POLICY

The Federal Reserve is likely to raise interest rates more slowly and less steeply compared to the historical experience of past tightening cycles. The next increase may occur in December with the consensus expecting one or two increases per year for the next two years. The peak in the federal funds rate might reach 2% to 3% versus prior peaks of 4% to 6%. This approach is supported by low worldwide economic growth and the accompanying risk of deflation. The Fed has been waiting for clear signs of 2% inflation to increase rates and we are approaching this level. Headline inflation is 1.5% due to the decline in energy prices, but core inflation is 2.2% for the consumer price index and 1.7% for the personal consumption expenditure (PCE) price index – the Fed's preferred measure of inflation. In addition, market-based measures of inflation, such as the five year forward inflation rate, suggest declining deflation fears and rising inflationary expectations. This measure bottomed in July 2016 at 1.35% and is now 1.78%. Future rate increases should be gradual, dependent on incoming data and slower than historical precedent. In addition, there has also been increasing discussion among central bankers regarding tolerance for overshooting inflation targets.

INVESTMENT OUTLOOK

In general, the outlook for equities remains positive based upon the combination of moderate earnings growth with low inflation and interest rates

In general, the outlook for equities remains positive based upon the combination of moderate earnings growth with low inflation and interest rates. But investors are wrestling with the cross-currents facing the Fed. Delays in the tightening process have kept rates lower for longer which positively impacts equity valuations, but also adds to concern regarding the strength of underlying growth. Conversely, as the growth outlook improves, the odds of Fed action increases and valuation improvements may moderate.

The stock market is reasonably valued at 16.6x estimated 2017 S&P 500 operating earnings of $129 per share, especially considering a 10-year Treasury yield of 1.76% and core PCE inflation of 1.7%. This multiple compares to the long-term average of 16.6x and over 19.0x during periods of low inflation and interest rates. Interestingly, the multiple premium of quality small and medium sized growth companies relative to the market is at its average level of the past 40 years. After five quarters of declining earnings, there is room for improvement in both the P/E multiple and earnings growth. Furthermore, the S&P 500 dividend yield of 2.15% is competitive with both long-term Treasury yields and core inflation – another sign of the attractiveness of equities. When S&P 500 dividends are combined with buybacks, the total "yield" to investors is 4.7% – which compares favorably to the yield on fixed income instruments. Supply and demand fundamentals in equities are favorable as M&A and repurchase activity shrinks the equity base while new supply from initial-public-offerings (IPO) remains subdued. Global M&A volumes are down 22% year-to-date, but activity started to rebound in the third quarter. IPOs are running at the slowest pace since the financial crisis as companies raised billions from venture and private capital. It is healthy for the stock market to be rising without the exuberance that often accompanies a bull-market environment.

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The technical aspects of the market are improving with increasing breadth, momentum and other confirmatory signals. The NYSE advance/decline ratio is making new highs which confirms the secular uptrend. Both the S&P 500 and Dow Jones Industrials are trading above their 200-day moving averages and hit new highs on August 15. Dow Theory has turned bullish with Dow Transports now confirming the July breakout. A broader index, like the Russell 2500, confirmed this bullish strength with a 52-week high on September 7. Bullish sentiment from the Investor's Intelligence poll increased to 46.7% from 45.2% in September. Additionally, the two 10% market corrections over the last 18 months helped eliminate weak holders and provide a refreshed base for the latest advance. 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 should support appreciation consistent with historic trends. Although we anticipate cross-currents and

The market is advancing despite poor money flows

volatility ahead, we believe the path of least resistance leads to higher equity prices. A positive contrarian indicator is the outflow of money from active domestic equity funds. Over $220 billion has left active domestic mutual funds in the past year with some of this money going to passive index funds. It is prudent to invest in the opposite direction of these fund flows as selling creates inefficiencies in the marketplace. The market is advancing despite poor money flows – which highlights the opportunity for further gains as cash on the sidelines commits to equities. Investor cash rose to 5.8% in October – the highest level in 15 years and just before Brexit. In addition, we are entering the favorable seasonal November – April period which has produced positive returns 71% of the time with an average gain of 5.02% since 1928. The key risks include: an unexpected economic downturn, Chinese hard landing, cyber-attacks, financial contagion from the European banking sector, military conflicts, protectionism, terrorism or sharply higher interest rates.