AMERICAN
CAPITAL MANAGEMENT

ECONOMIC & INVESTMENT OUTLOOK
OCTOBER 2018

Investment Perspective

The major U.S. stock indices produced strong returns and record highs during the third quarter. The broadest U.S. equity benchmarks generated 10% year-to-date returns through September while foreign benchmarks were negative. Additionally, smaller growth companies in the mid and small-cap indices have outperformed — especially healthcare stocks. These segments increased over 25% through September because they are growth oriented, beneficiaries of tax reform, able to reach global markets and less likely to be negatively impacted by protectionism.

We see this corrective action as a healthy development that will squeeze out excesses and exuberance. The overall outlook remains constructive with solid fundamentals

However, October has been different. During the first three weeks of October, the market declined approximately 11% on concerns about rising interest rates and economic weakness abroad. Sectors with the greatest momentum during the summer corrected the most. Volatility and anxiety spiked. We see this corrective action as a healthy development that will squeeze out excesses and exuberance. The overall outlook remains constructive with solid fundamentals. However, there is growing debate on the peaking of growth rates and impact of higher interest rates on valuations. A summary of index returns for the year-to-date ending September 30, 2018 is as follows:

Dow Jones Industrials	+8.8%	Russell 2500	+10.4%
MSCI EAFE	-1.4%	S&P 500	+10.6%
NASDAQ Composite	+17.5%	Wilshire 5000	+10.7%

GLOBAL ECONOMY

The economic tone is positive in developed markets, especially in America and Europe, but there are headwinds in China and other developing regions

World economic growth (ex. U.S.) is expected to be 4.0% in 2018 with a similar projection for next year. The economic tone is positive in developed markets, especially in America and Europe, but there are headwinds in China and other developing regions. The Euro area is growing moderately at 1.9% and Japan is shuffling along at a 1.1% pace. Economic performance in the emerging markets remains uneven due to slumping currencies, higher inflation and rising rates in places like Argentina, Indonesia and Turkey. China remains a strong influence on the world's economy with 6.6% growth, but the pace may slow if China's export sector is negatively impacted by rising tariffs. Estimates suggest that the China-U.S. tariff war might clip Chinese growth by up to 1% if retaliations spiral. Although the current impact from tariffs appears regional and small, the robust global environment may moderate if tariffs escalate and retaliatory behavior disrupts trading patterns. Accommodative measures from the European and Japanese central banks continue to provide support for these regions and world growth. It is too draconian to expect a global recession in the near term.

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The U.S. economy accelerated during the middle part of this year – with GDP growth of 4.2% and 3.5% in the second and third quarters, respectively. This is the fastest rate of growth that the U.S. has experienced since mid-2014. Not only is this pace impressive, but the economic drivers are balanced. The consumer sector is growing 2.4%, non-residential capex at 7.4% and the government at 1.8%. Positively, there are no major economic drags. The slowest sector is housing due to a combination of multi-year home price appreciation, rising mortgage rates, buyer fatigue and changing demographics. There are few excesses in the housing sector and better growth will likely resume after this period of digestion. The need for new housing stock is significant due to the slower rate of home construction since the Great Recession. Construction employment is rising twice as fast as overall employment, yet most contractors are struggling to fill skilled positions. Additionally, the Conference Board consumer confidence index hit an expansion high of 138.4 in August. The manufacturing sector remains healthy with the Institute of Supply Management manufacturing survey rising to an expansion high of 61.3 in August.

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Government spending is accelerating for the first time in years supporting GDP growth. However, this spending spree is financed with deficit spending. Government outlays recently grew 6.7% y/y while receipts were up only 1.0% y/y. As a result, the budget deficit may increase to 3.8% of GDP in FY2018 and 4.2% in FY2019. Overall, the economic environment is healthy and the odds favor a continuation of this positive momentum with some cyclicality. We do not foresee a recession in the near future. More importantly, Fed Chairman, Jerome Powell, highlighted that we are in “extraordinary times” of steady growth and low inflation.

INFLATION, INTEREST RATES & MONETARY POLICY

Almost all inflation measures are in the Fed’s target range of 2%, which suggests future policy actions will be taken to keep inflation in the range

Inflation trends in the U.S. are favorable with some indications of pricing power. Almost all inflation measures are in the Fed’s target range of 2%, which suggests future policy actions will be aimed at keeping inflation in the range. The consumer price index (CPI) is up 2.3% y/y, but core inflation (excluding food and energy) is 2.2% y/y. The Fed’s preferred inflation gauge, the core personal consumption expenditures (i.e. core PCE) price index, is up 2.0% y/y. Additionally, market-based measures indicate inflation in the 2.1% region. For example, the 10-year breakeven inflation rate is 2.15% – this is a daily indicator measuring inflationary expectations. Furthermore, the Fed’s 5-year, 5-year forward inflation expectation rate is 2.25% -- this indicator projects inflation over a five-year period that begins five years from today. The benefit of these market-based indicators is that they measure inflationary expectations in real-time, whereas the conventional indices, such as CPI and PCE, measure inflation on a historical basis. Positively, the real-time indicators suggest inflationary expectations remain subdued.

The Federal Reserve is successfully engineering an expansion with low inflation and full employment. The unemployment rate recently declined to 3.7%, which is the lowest it has been since 1969. Monetary policy remains in a tightening mode with the recent 25-basis point increase in September bringing the federal funds rate to 2.25% — the eighth hike since December 2015. The Fed is likely to continue raising rates through 2019 depending upon financial market conditions. Directionally, the Fed is tightening as it moves to "neutral" from "accommodative." Today, policy is not restrictive, but may become so within the next two years. The central bank also continues to taper its $4 trillion balance sheet by letting bonds mature without fully reinvesting the proceeds. The pace of tapering accelerates this month as the monthly cap on reinvestment increases from $30 to $50 billion per month. The net effect is that the Federal Reserve will buy fewer bonds and institutional buyers will increasingly set pricing. Currently, the yield on the 10-year Treasury is 3.11% -- the highest level since 2011 and up from 2.41% in January. It will take time before interest rates are high enough on a "real" (inflation-adjusted) basis to suppress economic growth.

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INVESTMENT OUTLOOK

The favorable fundamentals supporting equities propelled the U.S. stock markets to new highs in September. The environment has been particularly advantageous for small and medium-sized company growth stocks. They benefited from a perfect combination of moderate GDP growth, above-average earnings gains, mild inflation and low interest rates. This is often called "nirvana" as captured in the cumulative results over the past 10 years. The S&P 500 gained 333% from the market low in March 2009. If measured against the prior bull market peak in October 2007, the index is up 84% -- still an attractive return. Investors could have bought at the top of the last bull market and earned a good return by remaining patient! This has been a productive period for long-term investors. However, some caution is warranted because the favorable economic conditions may begin to moderate. Also, investor expectations may have turbo-charged valuations in certain market sectors. We see a favorable set of fundamentals, but price gains may be tempered over the near term.

Corporations are repurchasing stock at a record pace – breaking the 2007 record. This year's buying is approximately 40% greater than last year and likely to return $750 billion

Operating earnings after taxes for the S&P 500 are expected to increase 22% in 2018 to $163 per share and likely 8-10% in 2019. A key contributor to this strength is projected revenue growth of 8% and 5%, respectively. The resurgence in sales growth provides visibility to further above-average earnings gains over the intermediate term. In the short term, tax cuts are boosting earnings. Approximately half of the 22% earnings growth in 2018 is related to tax reform, with sales growth, margin expansion and buybacks contributing the balance. The S&P 500 is currently valued at 16.0x forward earnings almost equal to its long-term average since 1926 according to Merrill Lynch. However, during periods of low inflation and interest rates, like today, the forward P/E tends to be higher. Hence, valuations are reasonable.

Speaking of buybacks, corporations are repurchasing stock at a record pace – breaking the 2007 record. This year's buying is approximately 40% greater than last year and likely to return $750 billion. The sum of dividends and buybacks will approximate $1.2 trillion. This process of shrinking the equity base in the U.S. stock market continues, which helps long-term investors benefit from higher prices as greater demand chases a shrinking supply. For example, there were 8,884 companies listed on the U.S. exchanges in 1997 versus approximately 3,600 today. Meanwhile, the value of the stock market has more than tripled during the same period benefiting long-term investors.

From a technical perspective, the secular bull market is alive and well, but the October correction has interrupted the trends. Positive trends are evident in the 200-day-moving-average indicators with the Dow Jones Average reaching a new high on October 3 and the S&P 500 on September 21. In addition, Dow Theory recently confirmed the bull market with new highs in the industrials and transports. However, the October declines have weakened breadth. Buyer exhaustion is evident with signs of rotation and correction in technology shares. Smaller growth companies, especially healthcare and software companies, have demonstrated the greatest leadership year-to-date, but have been losing momentum. The recent 15% correction in the frothier segments is healthy and will help cleanse built-up excesses. The VIX (CBOE Volatility Index) jumped to 25 in October after subsiding during the summer months to the 11-15 range. In general, we expect investors to "buy the dip" to deploy some of the large cash reserves on the sidelines.

The third year of the Presidential cycle is the strongest year for stocks and the quarter of midterm elections begins the best three quarter span of the four-year election cycle

Positively, we are entering a favorable period for stock market returns from a historical and seasonal perspective. The third year of the Presidential cycle is the strongest year for stocks and the quarter of midterm elections begins the best three quarter span of the four-year election cycle. Since 1949, this period has produced an average gain of 21.1% for the S&P 500. We believe the odds favor new highs in the year ahead, but caution is warranted if higher inflation, rising interest rates and protectionism create negative headwinds. Another "taper tantrum" might occur as investors debate the trade-off between higher interest rates, future growth and valuations.

The risks primarily relate to politics and trade relations. For example, the Khashoggi affair created an international uproar that may cause unfavorable developments between allies in a volatile region. Other risks include a Chinese slowdown, cyber-attacks, military conflicts and terrorism. Importantly, the experience since the collapse of Lehman Brothers in September 2008 illustrates the importance of maintaining a disciplined investment approach that views market events from a long-term perspective. Investors who react emotionally to short-term movements risk making ill-timed decisions that compromise long-term performance. We favor quality small and medium-sized growth companies because they are best positioned for success in most market environments.