AMERICAN
CAPITAL MANAGEMENT

ECONOMIC & INVESTMENT OUTLOOK
JANUARY 2020

Investment Perspective

Investors were pleasantly surprised when the U.S. stock markets advanced in 2019. The late 2018 decline rattled confidence making the 30% increase an unforeseeable outcome. The S&P 500 index closed the year at an all-time high, returning 31.5% for the year. International equity markets were also strong. The stock market continues to confound those in doubt and reward those with patience. What can we expect in 2020 given the strong advance in stock prices? We are likely to experience a favorable environment as market momentum should be sustained by accelerating earnings growth. Additionally, presidential election years historically produce positive returns. When January is up in a presidential election year, the S&P 500 is always positive, with an average return of 16.6%. News associated with military conflicts, politics or trade policy may jostle the markets, but the fundamental underpinnings of the economy and corporate earnings are solid. Historically, the stock market increases most years despite periodic 5-15% corrections. We favor adding to equities during corrections because the combination of moderate earnings growth, mild inflation, low interest rates and reasonable valuations is favorable. A summary of index returns for last year ending December 31, 2019 is as follows:

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Dow Jones Industrials	25.3%	Russell 2500	27.8%
MSCI EAFE	22.0%	S&P 500	31.5%
NASDAQ Composite	36.7%	Wilshire 5000	30.2%

GLOBAL ECONOMY

World economic growth (ex. U.S.) should improve to a 3.5% pace in 2020 after 3.2% last year. The global outlook remains cautious, but evidence of a reacceleration is becoming more noticeable. The strongest tailwinds relate to expansionary monetary policy from the major central banks. Potential headwinds relate to uncertainty caused by tense trade discussions. China's economy is expected to decelerate to 5.6% from over 6%, but emergence of the coronavirus will likely worsen the slowdown. Japan is growing slowly — below 1% — and the Euro area is expected to grow about 1% this year after a similar rate in 2019. As Brexit approaches, western European economies may be impacted by the resulting turmoil. As an offset, European monetary policy remains accommodative with interest rates near zero or negative. There is no evidence of inflation in Europe. Germany just initiated a massive fiscal infrastructure spending program of 86 billion euros over 10 years that will improve rails and bridges, but more fiscal spending initiatives are needed in other countries. The synchronized monetary easing that started last year is helping the global outlook form a positive path forward and, as a result, confidence is improving.

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The U.S. economy is expected to advance 1.7% this year following 2.3% in 2019. There are no outsized drivers of growth, but there are moderate contributions across several sectors. Consumer confidence is strong and the consumer sector will continue to support the economy with 2.5% growth as it has for several years. Employment is healthy with payroll growth at

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1.4% and an unemployment rate of 3.5%. Average hourly earnings rose 2.9% y/y in December indicating a tighter labor market. Strong employment supports the expansion in several meaningful ways. Household debt-service payments as a percent of disposable income is at 9.7% — the lowest it has been in 30 years. The housing sector should gradually improve aided by low mortgage rates. Non-residential investment spending will provide modest growth with upside potential. Capital spending, which has been suppressed by the overhang of trade policy, will likely improve as uncertainty clears. Manufacturing has stabilized after a weak period and should gradually strengthen after a slow first quarter. Over the past 18 months, the ISM manufacturing index declined to 47.2 in December — the lowest level since 2009. Additionally, Boeing's 737 MAX production problems impact GDP by 0.5%, but both are expected to eventually improve. Government spending will be a modest contributor to growth as spending outpaces revenue, which means the federal budget deficit will grow to $1.1 trillion, the highest level since 2012. As a percent of GDP, the deficit will approach 5% — a manageable level given low interest rates. At this time, the odds of a fiscal infrastructure bill appear low, but the U.S. is poised to benefit from a refresh cycle if implemented. Overall, the economy is advancing in a balanced manner without risky excesses.

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FED POLICY, INFLATION & INTEREST RATES

The Federal Reserve reduced interest rates three times in 2019 and the federal funds rate is 1.75%, down from 2.50% in December 2018. The Fed pivoted to an accommodative stance as the risk of recession increased and trade-related uncertainties grew. This was an important shift and a preemptive strike that helped restore confidence in the financial markets. As a result, the 10-year Treasury yield declined from 2.68% to 1.92% and the stock market increased approximately 30%. Today, the Fed stands ready to act in either direction. It would prefer more forward momentum and will likely tolerate inflationary pressures above the 2% target before tightening again. Headline inflation as measured by the consumer price index (CPI) and core inflation (excluding food and energy) are both 2.3% y/y. The Fed's preferred inflation gauge, the core personal consumption expenditures (core PCE) price index, is up 1.6% y/y. Since last fall, the Fed has signaled that the federal funds rate may not change in 2020. It said that, "the current stance of monetary policy is appropriate to support sustained expansion of economic activity, strong labor market conditions and inflation near the Committee's symmetric 2% objective." If weakness emerges, the Fed will closely monitor the situation and ease further if needed. The Federal Reserve is successfully extending the expansion with these accommodative actions.

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TARIFFS & TRADE

Trade policy uncertainties muddied the waters for businesses and consumers over the last two years. These concerns created hesitancy which hurt demand for capital equipment and durable goods. Businesses will gradually expand production once these issues resolve and there is more visibility. Some of these uncertainties should diminish now that the U.S. and China have signed "phase one" of their trade accord. In fact, the S&P 500 is up 15% since the U.S.-China trade negotiations started in earnest on October 11 — a good sign. The U.S.-China deal stimulates the U.S. agriculture sector with $200 billion in purchases from China, regulates technology transfers to Chinese companies and opens doors for U.S. financial firms in China. In exchange, the U.S. will cancel any proposed tariff increases and reduce those on Chinese exports, but not until after the election. In addition, Congress passed a new version of NAFTA called the United States-Mexico-Canada Agreement (USMCA). The USMCA places greater emphasis on auto production within the North American region. It also increases access to Canadian dairy markets for American farmers and updates digital trade rules, among other provisions. At this time, the key benefit is less economic friction associated with trade policy uncertainties. Today, the financial markets are gaining confidence that tariffs and trade will be less of a drag going forward — at least until another round of negotiations starts. The administration wants to calm the markets and improve business confidence in advance of the November presidential election.

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INVESTMENT OUTLOOK

The stock market generated a Dow Theory buy signal on April 1, 2019 and the S&P 500 experienced a breakout on October 25 from a bullish triangle pattern. We are in a broad-based uptrend and this secular bull market will likely advance farther due to the favorable combination of moderate growth, low interest rates, tepid inflation, healthy skepticism and reasonable valuations. These ingredients have been powering the bull market and a continuation of these trends appears likely. The stock market is reasonably valued at 18.4x estimated S&P 500 operating earnings of $178 per share for this year, supported by a 10-year Treasury yield of 1.61% and core PCE inflation of 1.6%. Earnings are expected to increase 9% in 2020 after growing about 1% in 2019. Additionally, the S&P 500 dividend yield of 1.79% is competitive with both Treasury yields and core inflation.

Despite strong equity returns last year, there is continued skepticism regarding this bull market. Investors are concerned that the concept of "longest" expansion and bull market spells trouble — as if the expiration is, by definition, near. But bull markets do not die of old age, they die primarily from financial shock and severe recession. Why is this economic expansion aging so well (the longest expansion since 1854)? The moderate and balanced pace of growth has not created excesses or overheating. A lot of slack and overcapacity that resulted from the Great Recession has gradually dissipated without significant tightness in labor or goods. Also, the ongoing transition to a service-based economy removes the classic inventory cycles of yesteryear. Related, inflation has been tame globally (due to global overcapacity and aging demographics in key regions), which has given the major central banks the flexibility needed to stimulate their economies. Fear, lingering from the Great Recession, has dampened the traditional animal spirits that fuel a stampeding bull market as evidenced by the massive outflows from equities over the last 10 years. We have a stealth bull market, or as some have described, "the most hated bull market in history." We remain alert for developments that might change the investment landscape.

Technically, the stock market has improved significantly, although it may be overbought short-term. Breadth, price momentum and other confirmatory indicators suggest the advance is durable and sustainable. The NYSE advance/decline ratio is making new highs confirming the secular uptrend. The four-week moving average of the S&P put/call ratio is historically low which indicates less fear and more complacency. In addition, the VIX option volatility index is near 12.5 — among the lowest levels in the last 12 months. What about the January trend? The old stock market adage is "so goes the first day, week and month, so goes the year." This

January, the first five days were up 0.7%. Based on data from 1950, this leads to a positive annual return 82% of the time with an average gain of 13.6%. Last year's January increase (up 2.6% in the first five days) was a perfect indicator.

This is the Chinese "Year of the Metal Rat" — the first sign of the Chinese zodiac and a sign of good luck and wealth. It also signifies new beginnings, progress and success. The rat is adaptable, aggressive and creative. Since 1936, the S&P 500 increased 86% of the time during rat years with an average gain of 5%. Incumbent Presidents running for a second term have good success in rat years (1984 Reagan and 1996 Clinton).

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We look forward to above-average returns in the year ahead as the stock market continues to climb that "wall of worry." This low interest rate environment may persist longer than most expect. As a result, investors may be willing to pay a premium for high-quality growth equities during periods of below trend economic growth. In addition, higher valuations for stocks may result as the discount rate used by long-term investors trends down. A key issue will be accelerating corporate earnings after a broad-based slowdown due to the trade-related worries. The threat of lagged spillover effects appears contained at this stage, but they could emerge later. The key risks include Brexit, China's continuing slowdown, cyber attacks, disappointing earnings, European deflation, Hong Kong protests, military conflicts, political feuding in Washington (only three U.S. presidents in history have been impeached and none have been removed) and unexpected inflation. The odds favor higher prices this year due to the presidential election cycle. During the election year of a first term President, the S&P 500 gained 86% of the time with an average return of 11.7%. In our opinion, small and medium-sized growth companies remain likely to achieve above-average annual returns over the next few years. The future is brighter than some financial pundits and media are forecasting. Favorable fundamentals provide good reason to remain optimistic.

Appendix: Summary of Key Economic and Financial Measures

	Yearend 2018	Yearend 2019	Difference/ Change
Fed Funds Rate (%)	2.50	1.75	-75 bps
10 Yr. Treasury Yield (%)	2.68	1.92	-76 bps
Inflation (CPI y/y % ch.)	1.94	2.30	+36 bps
Gold ($/oz.)	$1,279	$1,523	+19%
Oil ($/barrel)	$45	$61	+36%
Euro per Dollar	0.87	0.89	+2%