AMERICAN
CAPITAL MANAGEMENT

ECONOMIC & INVESTMENT OUTLOOK
JULY 2020

Investment Perspective

The second quarter was also one of the strongest quarters for capital raising in recent memory

This is a peculiar time for investors. Despite the pandemic's global spread, financial market conditions have improved significantly since March due to massive fiscal and monetary stimulus. The S&P 500 (SPX) increased 21% in the second quarter — the best quarter in over 20 years — and the NASDAQ gained 31% reflecting its technology and heath care bias. Furthermore, the SPX is only 5% below its all-time high of 3394 on February 19. Since the end of WW II, there have been eight quarters where the SPX increased at least 15%. In the subsequent quarter, it gained nearly 10% in all cases. The second quarter was also one of the strongest quarters for capital raising in recent memory. Companies issued equities, convertible bonds and regular bonds in record amounts. On the other hand, "Main Street" was hurting due to business closures and social distancing guidelines. Unemployment spiked to record levels and many small businesses suffered. Covid-19 has been severely disruptive to the consumer related sectors. We are fighting an invisible enemy for an indeterminate period with limited visibility.

Each major region is suffering a dramatic decline in growth during 2020 except for China which may grow 2.0% this year as a result of draconian measures to contain the virus

Stock markets have recovered as investors gained confidence that the virus's impact is not as bad as originally feared and some normal activities can resume. We expect the market to consolidate with an upward bias after its powerful breadth thrust over the last three months. So far, the SPX has gained 47% from its intraday low on March 23 and retesting that low appears unlikely. We expect continued above-average volatility due to the various uncertainties associated with Covid-19, the economy and trajectory of corporate earnings. Due to higher levels of uncertainty, it is important to maintain a consistent and disciplined investment strategy that emphasizes quality growth companies with strong cash flows and healthy balance sheets. A summary of year-to-date index returns for the quarter ending June 30, 2020 is as follows:

Dow Jones Industrials	-8.4%	Russell 2500	-11.1%
MSCI EAFE	-11.3%	S&P 500	-3.1%
NASDAQ Composite	+12.7%	Wilshire 5000	-2.9%

GLOBAL ECONOMY

The global economy is in a deep recession with GDP (ex. U.S.) expected to decline 4% this year due to the Great Virus Crisis. Economists expect a rebound in growth of 6% in 2021. The positive inflection point will likely occur during the current quarter. Each major region is suffering a dramatic decline in growth during 2020 except for China which may grow 2.0% this year as a result of draconian measures that were implemented to contain the virus. The annual economic data hides the intra-year volatility of the second and third quarters. Shockingly, U.S. GDP is expected to decline sequentially at a 35% annual rate in the second quarter and then rebound at a 20% annual rate in third quarter — this is record setting volatility for the largest economy in the world. We expect the decline in U.S.

551 Madison Avenue / Suite 902
New York, NY 10022
P 212.344.3300 / F 212.344.2045
americancapitalmanagement.com

economic activity to stabilize later this year followed by a recovery of 3.4% in 2021 in response to strong fiscal and monetary support. Positively, despite the sudden drop in demand and spike in unemployment, many businesses and consumers are resuming activity as the environment appears safe enough to restart. Working remotely has also demonstrated to be a viable solution with many industries experiencing productivity increases. The U.S. unemployment rate soared to 15% in April and improved to 11% in June — a sizeable change from last fall when the jobless rate of 3.5% was the best in 50 years. Covid-19 will have a severe negative impact on the many service-oriented segments of the economy (e.g. gyms, restaurants, theatres, travel-related businesses) but other areas like home improvement, legal work, mortgage refinancing, online commerce and software consulting are booming. In addition, the overwhelming demand for RVs, bicycles and outdoor products has created supply shortages. The strongest sectors of the economy are healthcare, residential investment and technology. Strength in housing is acting as a counter-cyclical piston of growth after being a drag over the past two years. Mortgage applications are rising with the 30-year rate under 3%. Next year, we expect all cylinders to fire positively as our recovery broadens and we reap the benefits of rebounding growth. Importantly, the virus has not destroyed infrastructure and the economic means of production are ready and waiting to resume growth. The worst appears behind us, but we expect a bumpy ride ahead. The risk is a double-dip recession caused by a surging virus and a second round of business shutdowns.

The strongest sectors of the economy are healthcare, residential investment and technology. Strength in housing is acting as a counter-cyclical piston of growth after being a drag over the past two years

CORONAVIRUS UPDATE

The U.S. continues to suffer the contagious spread of the coronavirus at approximately a 1.5% daily case growth. Regionally, the country is experiencing different infection growth rates with the northeast growing slowly (e.g. NY growth 0.2%) and the southern and western regions growing faster. Cumulatively, the U.S. has conducted over 50 million tests with approximately 4.2 million positive cases. Testing capacity is growing rapidly with the capability to test larger segments of our population, unlike in April when testing was reserved primarily for the symptomatic and essential workers. Now, increased testing will yield more cases given the nature of this virus and its community spread. The U.S. represents 25% of global cases and approximately 22% of the world's 650,000 deaths. For context, there were 50 million global deaths during the 1918-19 Spanish influenza pandemic and approximately 1.5% of those deaths occurred in the U.S. By comparison, this pandemic is not yet as lethal, but Covid-19's impact on the U.S. is proportionally higher. Today, the key issues are the rate of infection, health care capacity in the hot spots and the lack of uniform containment measures across the nation. At present, most local health care systems are not overwhelmed, and fatalities are growing more slowly than the infection rate, so a repeat of the New York-New Jersey experience in April has not occurred. However, the situation is fluid and warrants attention. The explanation for recent lower fatality rates is unclear, but many experts believe it is because the virus is now more pervasive among the younger, healthier population and treatment modalities have improved. In addition, the most vulnerable segments are taking greater precautions due to increased awareness and knowledge. For example, nursing home deaths accounted for

The key issues are the pace of the infection growth, health care capacity in the hot spots and the lack of uniform containment measures across the nation a much higher percentage of total deaths in April than in June. At the same time, there is progress on drug treatment and vaccine development with increasing optimism that mortality rates could significantly improve in the next 12 months. Negatively, virus infections have been rising since mid-June and we need the population to adopt common sense preventative measures. In general, we are muddling through a pandemic with an inconsistent national approach that could still negatively impact the country.

FISCAL & MONETARY POLICY

Looking ahead, the Fed has indicated that it will pivot monetary policy from a mode of stabilization to accommodation by supporting a full recovery in employment and returning inflation to its 2% objective

The Federal Reserve and Treasury Department said that they will do "whatever it takes" to soften the cyclical downturn caused by this pandemic and they responded with massive stimulus. The Federal Reserve acted forcefully to stabilize the economy with large and significant measures to provide the banking system and financial markets with capital and liquidity. The Fed is employing unconventional tools in its vast arsenal to stabilize the economy. Its three major initiatives include reducing short-term interest rates to near zero, buying more bonds in the open market to reduce long-term interest rates, and backstopping numerous credit facilities to reduce credit spreads and ensure appropriate access to liquidity. With the restoration of smooth market functioning and credit flows, the Fed's emergency facilities are appropriately moving into the background, providing confidence that they remain available as an insurance policy if storm clouds move in again. Looking ahead, the Fed has indicated that it will pivot monetary policy from a mode of stabilization to accommodation by supporting a full recovery in employment and returning inflation to its 2% objective. Inflation has receded further reflecting weaker demand. The core PCE inflation measure has weakened to 1% y/y in May from 2% in February. Measures of inflation expectations are mixed while market-based indicators move lower and surveys remain relatively stable within their recent historical ranges. Nonetheless, with inflation below the Fed's 2% objective for many years, the risk that inflation expectations could drift lower complicates the task of monetary policy. We expect interest rates to remain unusually low for the foreseeable future.

From a fiscal perspective, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) provided enhanced unemployment benefits and subsidized payroll loans for businesses. This $2.2 trillion stimulus bill is the largest stimulus package in U.S. history and represents approximately 11% of GDP. The stimulus softened hardships associated with widespread closures that disrupted society, but benefits were temporary. Today, Congress is discussing another plan to add more fiscal aid to the mix, but there will likely be more economic hardships. Fiscal and monetary stimulus currently equal over $7 trillion with another $1.2 trillion expected shortly. All major economies in the world are primed with massive reflationary measures.

INVESTMENT OUTLOOK

We will survive this pandemic, overcome the global recession and stock prices will eventually surpass the prior all-time highs. However, Covid-19 is a major disruption that is identifying winners and losers. The business environment has changed significantly with expectations of a "new normal." The interruptions are becoming disruptions that accelerate permanent change. Interestingly, the initial fixation was on those sectors experiencing the most difficulty such as the restaurant, retail and travel related industries. But heath care service providers and software firms are sustaining positive change as society enhances solutions to adapt to this "new normal." Digital technologies are receiving increasing attention. The coronavirus lives in the physical world, but technology allows us to adopt a virtual world that minimizes exposure to the contagious elements. This is a positive dynamic that is enabling a resumption of growth faster than what was initially imagined.

The coronavirus lives in the physical world, but technology allows us to adopt a virtual world that minimizes exposure to the contagious elements. This is a positive dynamic that is enabling a resumption of growth faster than what was initially imagine

We assume SPX operating earnings will likely decline 20-25% in 2020 to approximately $125 per share, but it is too early for a reliable forecast. The second quarter earnings cycle will help focus that forecast with initial reports that are better than expected. Today, the key question is the magnitude and timing of a recovery in 2021 as investors look over the valley. It is plausible that earnings in 2021 will match the levels of 2019. Positively, the massive cuts to earnings estimates have abated and most analysts/companies are revising their forecasts higher to remove the worst-case scenarios. Assuming SPX operating earnings of $163 next year, the stock market is selling at 19.7x earnings – an above-average but fair valuation considering the 10-year Treasury yield at 0.59% with inflation at 1.0%. A moderate risk to equities is an upward drift in interest rates which may occur as economic activity strengthens and the Fed begins to remove some of its massive monetary accommodation.

Today, the key question is the magnitude and timing of a recovery in 2021 as investors look over the valley. It is plausible that earnings in 2021 will match the levels of 2019

Given the significant rebound in stock prices, the key question is this: How much good news is implied at current market levels? This is not an easy question to answer. Stock prices have recovered as the worst fears have not been realized and investors are confident that the Federal Reserve and Treasury attacked the problem with abundant capital, liquidity and support. The capital raising activities of the global investment banks have been record-setting on top of strong central bank measures. The focus will soon shift to the corporate fundamentals driving equities. Admittedly, the business metrics supporting equities remain weak, but stock prices typically rebound well in advance of the earnings recovery. What is the political risk and impact of a change in government leadership in November? Historically, the market performs somewhat better under Democratic administrations. Since 1951, in the 18 cases when the Democratic party controlled both the White House and Congress, the market increased 83% of the time with an average annual gain of 13.2%.

Technically, the financial markets appear to be consolidating after a bullish breakout from the March 23 lows. We experienced a breadth thrust from April through July with solid confirmation in measures of breadth, momentum and volume. This triggered an upside breakout for the SPX advance/decline line — a potential bullish leading indicator.

Today, we expect a period of consolidation of the recent gains with an upward bias

On July 9, the market also experienced a Golden Cross (GC) — when the 50-day moving average (MA) crossed above the 200-day MA. Since the late 1920s, a GC during recessions produced a rising market 92% of the time with an average gain of 21% over the next nine months. Today, we expect a period of consolidation of the recent gains with an upward bias. Investors have little prior experience with a global pandemic of this scale which adds to the confusion. Positive surprises may emerge with the development of drugs and vaccines to treat and prevent the virus and reduce mortality. However, fear of additional quarantines, a second wave of infections, and lingering long-term side-effects from the infection create concern. We remain alert for developments that might improve or worsen the investment landscape. However, the probabilities favor higher stock prices over the intermediate term. We continue to believe the current market environment will prove to be an outstanding opportunity to accumulate quality investments for above-average returns in the years ahead.