AMERICAN
CAPITAL MANAGEMENT

ECONOMIC & INVESTMENT OUTLOOK
APRIL 2021

Investment Perspective

The Roaring '20s are back again! The Covid-19 vaccination process is underway and we are likely to experience a strong rebound in consumer spending as people gradually return to normal activities and consumer confidence increases. In the investment community, there is little debate regarding the strength of the economic outlook. It is a matter of how strong! Tailwinds include powerful economic and earnings growth, low inflation and interest rates and robust capital market liquidity. Aiding these pillars of support is reduced stock market volatility. Investors appear more confident about the power and durability of the expansion. Stock market valuations remain above historic norms, which is a moderate risk to the outlook given the sensitivity of total returns to valuation and sentiment. We are in a favorable environment for equity investors. A summary of year-to-date index returns for the period ending March 31, 2021 is as follows:

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Index	Return	Index	Return
Dow Jones Industrials	8.3%	Russell 2500	10.9%
MSCI EAFE	3.5%	S&P 500	6.2%
NASDAQ Composite	3.0%	Wilshire 5000	6.2%

GLOBAL ECONOMY

Global economic growth (ex. U.S.) is likely to increase 5.6% in 2021 after a decline of 3.1% last year because of the Covid-19 pandemic. The combination of unprecedented expansionary monetary policy, strong fiscal stimulus, vaccine deployment and massive pent-up demand will drive the world economy. It is becoming clearer that the coronavirus pandemic was a temporary economic setback and GDP growth will rebound in a powerful cyclical manner. Some industries are experiencing a secular tailwind due to the occurrence of the pandemic. This experience is a classic example of how disruption can create opportunity. Among major countries, the U.K. experienced the sharpest downturn in growth last year with GDP contracting 9.9% accompanied by declines of 4.9% in Japan and 3.5% in the U.S. In contrast, China grew 2.3% last year and just announced 18.7% growth for the first quarter of 2021. China impressively contained the spread of the virus while limiting the economic damage to the first half of last year. Overall, the global outlook continues to improve as the level of uncertainty diminishes.

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The U.S. economy is expected to grow 7% this year. In the first quarter, GDP increased 6.4% with a 41% gain in durable goods. Consumer spending, housing and capital equipment expenditures will provide the most powerful support. Consumer demand will be underpinned by enormous quantities of fiscal stimulus. The housing sector continues to grow supported by a combination of factors including rising family formations, work-from-home trends and the desire for a different lifestyle. Capital spending and business equipment investment are growing in response to pent-up demand that developed during

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the slowdown when many businesses were negatively impacted by government mandated shutdowns. Looking ahead, the next opportunity is re-employing the available labor, increasing the employed tax base and reducing the sizable government deficits. Rising employment will provide sustainability to the economic expansion in 2022 with greater disposable income, more tax revenue and less government stimulus. Clearly, the outlook is positive as evidenced by the dramatically improving surveys of consumer confidence and manufacturing. In fact, the Conference Board consumer confidence index surged to 109 in March – the largest one-month gain in 18 years — and rose to 122 in April. The Institute for Supply Management (ISM) manufacturing index also jumped to the highest level in 38 years – a clear sign of economic optimism. Also, Fed Chairman Powell recently said that the Federal Reserve is committed to using its full range of tools to support the economy with its goals of maximum employment and 2% inflation over the long term.

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AUTOS & HOUSING

U.S. auto sales surged to an annualized rate of 17.8 million in March compared to 8.8 million last April during the depths of the pandemic. Auto sales will likely remain strong driven by the urban exodus, stimulus checks and improving employment. However, the global shortage of semiconductors is currently suppressing auto production and therefore sales. Inventories at new car dealers are low, resulting in increased demand for used cars. Because of the new demand, prices are rising at a record pace. For example, used vehicle prices rose by a record 11.2% q/q in the first quarter — the fastest gain on record. Increased prices are beneficial for auto manufacturers, retailers and rental firms. The auto manufacturers will also benefit as their finance companies record gains on the sale of lease return vehicles.

Key factors underpinning the housing industry are favorable and will continue to buttress the economy for the foreseeable future. Existing home sales have increased to a 6.3 million annualized rate – the highest level in five years. Median prices of existing homes are up 16% y/y and inventory of available homes for sale is low. The powerful combination of record sales levels and higher prices is making the housing sector a bright spot in the economy. As expected, new building permits are being issued at a record pace to meet demand and replenish low inventory. Given the modest level of housing starts over the last 10 years, the current acceleration is likely to be sustainable for a few years. Also, mortgage rates remain historically attractive and buying power has been boosted by the rising stock market and high savings rate. Overall, the demand for "big ticket" items like cars and homes is a visible source of economic growth.

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CORONAVIRUS UPDATE

The world is in a constant flux between rising Covid-19 infections and vaccinations to control the pandemic. Globally, new cases are rising and have reached over 5.2 million recently — a new record. Cases are surging in India, Pakistan, the Philippines and South America. New variants are more contagious. In the U.S., the infection rate has

decreased 75% from its peak of 250,000 cases per day on January 8 to 63,000 now. But cases are climbing in the Northwest due to pandemic fatigue, relaxed prevention efforts, loosened restrictions and new variants. The New York Times reported that 64% of the U.S population lives in counties with high risk of exposure to Covid-19. The future challenge will be managing the rolling series of outbreaks. Approximately 2.3 million vaccinations occur per day and we are on track to vaccinate the nation's adult population by the third quarter. To date, 107 million people have been fully vaccinated representing 41% of the population over 18 years old. Further news is pending regarding vaccinations for children under 16. The pace of deaths has declined by 75% from the post-Christmas spike of approximately 3,400 per day. Since the beginning of the pandemic, a total of 32 million Americans contacted the virus with approximately 575,000 deaths or 1.8%. While seasonal infection strength creates future risk, the fear of overwhelming the healthcare system and suffering another state-mandated lockdown has dramatically decreased. Despite 20% of adults refusing the vaccine, there is light at the end of the tunnel and the Centers for Disease Control and Prevention (CDC) recently started easing its guidelines.

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INVESTMENT OUTLOOK

The worldwide demand for equities is strong. For example, flows into global equity funds totaled $602 billion over the past five months versus a combined total of $452 billion in the past 12 years. The fundamentals supporting a robust investment outlook include strong economic growth, accelerating earnings momentum and rising investor confidence. Additionally, the combination of low interest rates, moderate inflation and ample liquidity in capital markets is creating a solid foundation for stock market gains, initial public offerings (IPOs) and mergers & acquisitions (M&As). There are many positives, but exuberance and overconfidence could upset the stock market. It is important to remain vigilant in identifying potential excesses as the market could get ahead of itself and borrow from tomorrow's return. A new risk is rising tax rates that would reduce corporate earnings. In 2018, investors responded favorably to tax reform that significantly lowered U.S. corporate and individual taxes and boosted earnings. The opposite may occur with increased tax rates proposed by the Biden administration.

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We expect S&P 500 operating earnings of $186 per share this year, up significantly from the depressed levels in 2020 and slightly above the 2019 levels. Looking ahead, $212 is possible in 2022. The S&P 500 is valued at 22.5x estimated 2021 earnings, supported by a 10-year Treasury yield of 1.64% and core PCE inflation of 1.4%. The S&P 500 forward earnings multiple is higher than its long-term average of 16.6x and somewhat above its average of 21x during periods of low inflation and interest rates. The reasons for this premium include extraordinary stimulus measures, above-average growth, improving confidence and the relative attractiveness of equities compared to fixed income or real estate. Core CPI inflation is 1.6%, but the overall CPI inflation measure is 2.6% due to the recent rebound in energy prices. The S&P 500 dividend yield of 1.39% is competitive with both Treasury yields and core inflation.

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The window at the capital markets desk is wide open! M&A deals announced in the first quarter surged past $1.1 trillion for the highest annual start since 1998. Several investment banks have announced impressive results tied to their advisory businesses. In addition, more than 330 SPACs (special acquisition companies or blank-check firms) have listed in 2021, mostly in the U.S., representing over a third of global IPO activity. This follows 300 SPACs listed last year. Goldman Sachs estimates that SPACs currently have $128 billion, seeking new opportunities. We expect M&A activity to remain robust with small and medium-sized companies likely to benefit given the unspent capital sitting in SPACs. In addition, corporate bond underwriting remains strong. U.S. leveraged loan sales are off to their fastest start in at least eight years. The fear of a credit crisis was excessive and many companies are now accessing the debt markets to take advantage of low interest rates.

From a technical perspective, the stock market is healthy, although some sectors or strategies may be overbought on a near-term basis. Conversely, rotation away from technology and growth companies in the first quarter left them lacking price momentum. Momentum shifted to the commodity, financial and industrial based companies — beneficiaries of rising interest rates and energy prices. We expect a series of mini rotations this year driving the market higher while benefiting some sectors over others. For example, growth company investments experienced renewed strength in April. Breadth, price momentum and other confirmatory indicators suggest the advance is durable and sustainable. Positively, the VIX option volatility index declined from a reading of 30 in January to under 20 in April. A lower VIX reading in the context of a rising stock market is a positive development.

We expect above-average returns for the stock market in the year ahead. Massive global liquidity, strong fundamentals, above-average growth rates and improving asset flows for equities suggest a continuation of the current trends. It is important to note that momentum trends can be sustained for longer than expected. The presidential cycle is also positive. Since 1920, the first year of a new Democratic administration gained 77% of the time with an average increase of 13.3%. We favor adding to equities during periods of individual issue or overall market weakness. The key risks include Brexit, coronavirus contagion, cyber-attacks, disappointing earnings, excessive exuberance, military conflicts, social unrest, tax rate increases, unexpected inflation and vaccine failure. In our opinion, quality small and medium-sized growth companies remain likely to achieve above-average annual returns over the next few years. We continue to remain optimistic given the current investment climate.