Investment Perspective

Leading indicators signal moderation over the medium term, yet the U.S. economy remains strong. There are growing uncertainties around the outlook combined with the expectation that the Federal Reserve will begin to gradually reduce its monetary stimulus. Offsetting these headwinds, corporate earnings are healthy and rising, balance sheets are excellent, and the economic recovery is broad based. Given the stock market's appreciation in the last 12 months, favorable news appears to be discounted, and investors may need to climb that "wall of worry" in the next few months. We believe a period of consolidation and base-building is likely. Growth-oriented equities, especially quality small and medium-sized growth companies, are well positioned for a scenario of moderately higher inflation because "good businesses" have both pricing power and volume growth. A summary of year-to-date index returns for the period ending September 30, 2021, is as follows:

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Index	Return	Index	Return
Dow Jones Industrials	12.1%	Russell 2500	13.8%
MSCI EAFE	8.8%	S&P 500	15.9%
NASDAQ Composite	12.7%	Wilshire 5000	15.6%

GLOBAL ECONOMY

Global economic growth (ex. U.S.) is likely to increase 5.8% this year and current estimates project 4.3% in 2022. Growth expectations have begun moderating after steadily increasing since the V-shaped bottom in mid-2020. It is noteworthy that the current rebound represents the strongest growth in over 30 years driven by the combination of unprecedented expansionary monetary policy, fiscal stimulus, vaccine deployment and massive pent-up demand. Factors dragging on the global rebound include supply chain bottlenecks, inflationary pressures, rising energy prices and China's efforts to deleverage its massive $5 trillion property debt level. China's expected 2021 GDP growth is comparatively strong versus other major countries but possesses the risk of deceleration since its property sector represents 29% of the economy. Among other major countries, projected economic growth in the U.K. is 6.9%, the U.S. is 5.9%, the Euro area is 4.8% and Japan is 2.1%. Broadly speaking, the global outlook is solid in the context of a global rebound from the pandemic recession, but growth rates are peaking and beginning to moderate. The risks are to the downside at present.

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The U.S. economy is expected to grow 5.9% this year with moderating growth over the next 24 months. The most powerful contributors to growth include robust consumer spending supported by $2 trillion in savings, pent-up demand, resurging capital equipment expenditures and a strong housing market. Demand for services is rebounding and will positively impact the expansion's duration. While demand for autos and capital goods is robust, supply shortages – especially semiconductors – have moderated production and sales. Supply shortages are an unfortunate consequence of an unevenly strong economy

575 Lexington Avenue / 30th Floor
New York, NY 10022
P 212.344.3300 / F 212.344.2045
americancapitalmanagement.com

caused by the Delta virus, manufacturing disruptions and transportation bottlenecks. It is important to note that the purchase of goods is often deferred whereas services are often skipped. Housing and renovations remain buoyant as families respond to work-from-home trends and new lifestyles. In September, continuing jobless claims reached the lowest level since the pandemic began and the unemployment rate declined to 4.8%. The job market is strong with 10 million openings and 3 million less workers looking for jobs. Almost 4.3 million people recently left the workforce in a move dubbed - The Great Resignation - driven by the pandemic and the desire for changes in personal and professional goals. The labor force participation rate is at a 40 year low with 5 million less workers since February 2020. There is a labor shortage today, but a strong economy will gradually attract more workers after reduced government financial support. In general, the economy is beginning to shift from a "rebounding growth" phase to a "sustainable growth" mode. It will take several quarters for this process to develop.

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INFLATION & MONETARY POLICY

Inflation is rising with a variety of transitory pricing issues applying upward pressure on the primary trend. The Federal Reserve and economists expect inflation to remain high for a few quarters and then decline to more moderate levels over the intermediate term. The Fed's preferred measure of inflation, the core personal consumption expenditure (PCE) price index, which excludes the impact of food and energy prices, is up 3.6% y/y. Headline inflation as measured by the consumer price index (CPI) is up 5.4% y/y - the largest increase since August 2008. Core inflation (CPI excluding food and energy) rose 4.0% y/y - the largest increase since November 1991. In addition, the producer price index (PPI) gained 8.6% over the past year. Reflecting the limited supply of autos due to the semiconductor chip shortage, used car prices increased 32% y/y and new vehicle prices increased 7.6% - the largest 12-month increase since June 1981. Energy, food, furniture, rent, transportation costs and wages are all increasing at above-average rates. We are in a perfect storm of rising prices.

Fed policy is targeting 2% core PCE inflation over the long term with tolerance for periods of inflation greater than 2% after a decade below its target. In line with the Fed's objectives, they recently noted increasing satisfaction with employment levels and indicated "tapering" would be the first step in removing accommodation. The Fed is expected to discuss tapering shortly and may begin reducing its $120 billion per month bond buying program before year-end with the first interest rate hike in 2022. The risk is that persistently high inflation might force the Fed to raise interest rates sooner and higher than expected. However, over the past four decades, it has been difficult sustaining above-average inflation for long periods, and it has averaged 2% in the past 20 years and even less in the past decade. It is important to note that massive fiscal spending to support the economy has increased the federal budget deficit to $2.8 trillion, or 13% of GDP. This will negatively impact future fiscal flexibility when interest rates rise, but the deficit will improve with reduced fiscal aid programs and increased tax collections. The risk is that the inflationary trends remain elevated after overcoming this "transitory" period.

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CORONAVIRUS UPDATE

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The risk of a future lock down in the U.S. due to the coronavirus is low. The downside has been limited by the deployment of vaccines, increased testing capacity and greater acceptance of precautionary measures. Most of the deaths in the last three months are from the unvaccinated. To date, 186 million people have been fully vaccinated representing 56% of the total U.S. population. Importantly, 84% of the population over 65 years old has been vaccinated. Vaccines are readily available for anyone over 12 years old and approval for children is expected shortly. Additionally, due to the abundance of vaccine supply, booster shot deployment has begun to increase protection. Clearly, the U.S. is making progress in administering vaccines, but progress has slowed as certain population segments are still resisting and the early adopters have already received two shots. Specifically, the U.S. experienced a Delta-variant surge from July to October. The average weekly case count jumped from 12,000 in late July to 160,000 in early September before declining. The Delta related increase in infections is now subsiding and the pandemic is waning in most developed countries with sufficiently vaccinated populations. Substantial progress has been made, but there are still risks as indicated by the Delta-plus variant recently spreading in Great Britain.

INVESTMENT OUTLOOK

There is a confluence of current tailwinds and potential headwinds buffeting the financial markets and the outlook for equities. Positively, fundamental factors, such as healthy earnings growth, an improving economy and low interest rates support the case for further appreciation ahead. But there are drags including higher inflation, rising energy prices and tighter monetary conditions. Investors remain optimistic, but perceptions could change and worries surface. We expect the equity market to start climbing a "wall of worry" resulting in a period of consolidation and moderate gains.

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The specific fundamentals supporting the investment outlook include strong economic and earnings growth combined with high liquidity and enthusiastic investor confidence. However, it is important to note that the accelerating phase of earnings growth has begun to recede. We expect S&P 500 (SPX) operating earnings of $200 per share this year, up significantly from the depressed levels in 2020. Looking ahead, $220 is possible in 2022. The SPX is valued at 20.7x estimated 2022 earnings, supported by a 10-year Treasury yield of 1.63%. Stock market valuations are higher than usual due to the favorable combination of exceptionally low interest rates, moderate underlying inflation, above-average growth and exceptional liquidity. It will be important to remain vigilant in identifying potential excesses in future years. There are many pluses, but irrational exuberance could upset the stock market.

The pandemic has created some unexpected and positive developments. These include a boom in capital raising, initial public offerings (IPOs), and merger activity. At the beginning of the pandemic, it was difficult to foresee a powerful surge in capital formation, but that is what happened. This is a pleasant surprise. U.S. merger & acquisition (M&A) activity totals $1.9 trillion on a year-to-date basis, up 157% from a year ago. IPOs in the U.S. are up

97% over the past 12 months with the most robust summer of underwriting since 2000. Private equity deals totaled $868 billion through September 30 – a new record. Special purpose acquisition companies (SPACs), accounted for 69% of all IPOs in the first quarter but have since moderated. Interestingly, follow-on offerings are down year-over-year because many companies issued equity last summer for fear that economic conditions would worsen. Investment grade corporate bond issuance is also down moderately compared to last year for similar reasons. Notably, junk bond issuance is increasing as private equity sponsors are completing more acquisitions and tapping into the available liquidity. This surge in capital raising has improved corporate balance sheets, created the firepower to engage in more M&A activity and strengthened investor confidence. We expect a continued period of robust corporate takeover activity due to healthy corporate liquidity. Also, new companies are entering the public markets, creating more opportunities for investors.

The SPX gained for seven consecutive months without a 5% correction in 12 months

From a technical perspective, the stock market is hitting new highs in late October following an oversold condition in September. The 5% correction from early September's peak reduced some excesses. Today, the percentage of stocks trading above their 50-day moving averages is 59%. This is positive for the historically favorable November-January period. Prior to September, the SPX gained for seven consecutive months without a 5% correction in 12 months. Since 1958, the market rose seven straight months 14 times and always increased over the next six months with an average gain of 9.04%. The consolidation within the stock market is also evident across a broader selection of stocks. The smaller capitalization growth indices recorded their 52-week highs in February whereas the SPX recently peaked in October. The market narrowed during the summer as evident in the sideways action of the advance/decline lines. Also, the VIX option volatility index increased sharply from 17 in late August to 26 in mid-September – coincident with the 5% correction – and recently declined to 15. Today, we expect that leadership may return to quality small and medium sized growth companies.

Massive global liquidity, strong fundamentals, above-average growth rates and improving asset flows into equities support the current environment. Investor expectations may fluctuate as new information is provided regarding the Fed's tapering plan. We see greater risk to stock market volatility resulting from changing expectations than any fundamental downgrades. The fundamental outlook is solid, but expectations include this favorable view. The key risks include Brexit, coronavirus contagion, cyber-attacks, disappointing earnings, excessive exuberance, military conflicts, social unrest, tapering too fast, tax rate increases and unexpected inflation. In our opinion, quality small and medium-sized growth companies remain likely to achieve above-average annual returns over the next few years.