AMERICAN
CAPITAL MANAGEMENT

ECONOMIC & INVESTMENT OUTLOOK
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Investment Perspective

Higher inflation and low unemployment have prompted the Federal Reserve to pivot, leading to expectations of higher short-term interest rates and the tapering of QE

Investors always find something to worry about and 2022 begins with more challenges than usual. The stock market is correcting sharply year-to-date while the NASDAQ and growth indices have been under pressure since November. The Federal Reserve is taking a more aggressive approach to fighting inflation, shifting from its extraordinarily accommodative policies of recent years to a neutral position by raising interest rates. Although the zero-interest-rate-policy (ZIRP) and quantitative easing (QE) were stimulative measures necessary to survive the pandemic, higher inflation and low unemployment have prompted the Federal Reserve to pivot, leading to expectations of higher short-term interest rates and the tapering of QE. This anticipated tightening may increase long-term interest rates and dampen the enthusiasm for equities. More recently, the potential Russian invasion of Ukraine is creating additional uncertainty. We expect a period of continued volatility as stock market forecasts and valuations reset. Positively, demand remains solid with above-average growth expected for GDP and corporate earnings. These important fundamental demand factors will eventually serve as favorable offsets to the negative headwinds. A summary of index returns for the year ending December 31, 2021 is as follows:

Dow Jones Industrials	21.0%	Russell 2500	18.2%
MSCI EAFE	11.8%	S&P 500	28.7%
NASDAQ Composite	22.2%	Wilshire 5000	26.7%

GLOBAL ECONOMY

Demand remains solid with above-average growth expected for GDP and corporate earnings

World economic growth (ex. U.S.) is likely to increase 4.5% this year after 6.0% in 2021. This represents the strongest growth in over 30 years. The combination of accommodative monetary policy, government stimulus, vaccine deployment and pent-up demand is driving the global economy. This post-pandemic expansion is historically powerful as the 'return to normal' is fueling a cyclical rebound. However, the emergence of the Omicron variant and supply related constraints are modestly dampening demand. Among major countries, China continues to grow faster than most of the developed world, but its rate of growth is slowing to an expected 4.8% rate in 2022 -- the slowest in four decades. China's modest growth will have a suppressing impact on the world economy in future years. The U.K. is expected to grow 4.0%, the U.S. 3.6%, the Euro area 3.6% and Japan 3.8% in 2022. The durability of the global economic outlook continues to improve albeit at a more moderate pace than the early stages of the recovery.

The U.S. economy is expected to grow 3.6% this year and 2.0% in 2023 after 5.7% growth in 2021. The most powerful contributors to growth include healthy consumer spending, a robust housing market, inventory rebuilding and improving capital equipment expenditures. Growth in retail sales jumped 19.3% y/y last year in response to direct relief via government

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checks, pent-up demand, reallocation away from services and improving employment. With the unemployment rate at 3.9% and reliable labor in short supply, wages are rising with average hourly earnings up 4.7% y/y. Labor force participation continues to rise from pandemic lows, but improvement is needed to address escalating wages and labor shortages with 11 million job openings. Consumer spending should remain strong due to $2.7 trillion in savings and deferred spending. But COVID-19 is a temporary drag with 9 million home sick. The demand for autos and housing is high, but supply is constrained. Auto sales are 12.9 million vehicles annualized but could be over 17 million without semiconductor shortages. Demand for housing remains buoyant as families respond to work-from-home trends and the desire for new lifestyles. However, supply is constrained as many homeowners are not selling, and builders cannot accelerate new home construction. Also, state funds have an extra $113 billion available for projects. Bottom line, demand is solid, manufacturing backlogs are growing, consumers are spending, and the job market is strong. Despite the dampening effect of higher prices, the demand side of the equation looks sustainable. The biggest issues with the economy have been on the supply side, including bottlenecks, labor shortages and accelerating inflation.

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CORONAVIRUS PANDEMIC

The world continues to grapple with COVID-19 variants after 380 million infections and 5.7 million deaths. Beta, Delta and Gamma all came and went, and now there is Omicron. This latest variant is highly transmissible even among those vaccinated, making it harder to contain. As a result, infections are exploding around the world. Omicron may accelerate herd immunity due to its highly contagious yet milder profile, a potential positive in a challenging pandemic environment. Approximately 64% (212 million) of the U.S. population is vaccinated, but the country is experiencing a surge in infection cases above year ago levels with 600,000 infections daily, but weekly deaths are 33% lower. For example, last year in mid-January there were 24,000 weekly deaths in the U.S. versus 16,000 today. Since the beginning of the pandemic, a total of almost 75 million Americans caught the virus with approximately 885,000 deaths. The pace of fatalities has increased since the summer lows but is lower than the peak levels of January 2021. The combination of vaccines, better medical practices, helpful therapies and a milder variant are suppressing the fatality rate. Nearly all of today's infections are from Omicron. There is hope that the combination of increasing vaccinations and a milder variant will create greater herd immunity. Improving trends and current predictions indicate a slowing rate of infections in the near term.

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INFLATION & MONETARY POLICY

Today, inflation is different than one year ago. It is high due to many factors including rising commodity, labor and transport costs combined with higher rents, used car prices and supply bottlenecks. In addition, food and energy costs are spiking but they are considered non-core and more transitory as natural commodities. Nevertheless, energy costs increased 29.3% y/y. The Federal Reserve and economists expect inflation to remain elevated in the near term and then decline to more moderate levels later this year and next.

Economists predict core PCE inflation of 3.8% this year and 2.6% in 2023 versus 4.9% today. Estimates indicate that 50% of today's inflation is related to supply bottlenecks. Adding credence to this view, the market pricing of bonds and inflation-protected securities implies an expectation of lower inflation 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 4.9% y/y. Headline inflation as measured by the consumer price index (CPI) is up 7.0% y/y - the fastest pace since June 1982. Core inflation (CPI excluding food and energy) rose 5.5% y/y - the largest increase since February 1991. In addition, the producer price index (PPI) gained 9.6% over the past year. Oddly, gold prices declined in 2021 despite gold's traditional reputation as an inflation hedge.

Inflation has suddenly become a wildcard in the investment outlook

Inflation has suddenly become a wildcard in the investment outlook as Fed policy is targeting 2% core PCE inflation over the long term with tolerance for periods of inflation greater than 2%. At this juncture, inflation is significantly above the Fed's tolerance. In response, the Fed is pivoting to a more hawkish stance with fed funds futures indicating several interest rate hikes this year beginning in March. The federal funds rate is currently 0-25 basis points and may finish the year at 100-125 basis points, still a relatively modest level. In addition, the tapering process may accelerate, and quantitative tightening is possible by late 2022. The Fed started tapering in December 2021 and recently indicated that it will conclude by March 2022, which effectively means no new bonds will be purchased. Quantitative tightening occurs when the Federal Reserve's $9 trillion balance sheet shrinks. Short-term interest rates are determined by central bank policies whereas long-term rates are driven by both market-based inflationary expectations and the Fed's QE program. The 10-year Treasury yield has recently risen to 1.78% from 1.43% in early December - the beginning of tapering. However, the yield remains substantially below the rate of inflation. We expect both short and long-term interest rates to rise this year. The risk is that persistently high inflation might force the Fed to tighten more aggressively than indicated.

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INVESTMENT OUTLOOK

The outlook for equities and the financial markets is being impacted by a "tug of war" between increasing earnings, inflation and interest rates. Positively, fundamental factors, such as strong earnings growth, a solid economy and historically low interest rates support a favorable investment environment. Negatively, the drags include higher inflation, rising energy prices and tighter monetary conditions. Investor sentiment is more cautious. It is important to note that market expectations are changing faster than the fundamentals because the Fed is planning to tighten faster than previously anticipated. As a result, some investors are adjusting their investment strategies. We expect the equity markets to experience periods of consolidation, volatility and modest gains as the year progresses. Historically, the stock market gains during rising interest rate cycles. For example, the S&P 500(SPX) experienced an average annual increase of 9% during the 12 Fed hiking cycles since the mid 1950's and rose 92% of the time.

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The specific fundamentals supporting the investment outlook include strong economic and earnings growth combined with high liquidity and strong asset flows. We expect an S&P 500 operating earnings increase of 9% this year to $225 per share. Earnings gains will be more normal after last year's explosive growth. In 2021, earnings grew more than expected and rose around 46%--a banner year. Investors initially expected $174 per share, but the estimate was continually increased to approximately $206 due to stronger economic growth and conservative forecasting. Over the past five years, earnings reported by S&P 500 companies exceeded estimated earnings by 8.6% on average. During this period, 76% of companies in the SPX reported actual EPS above the mean estimate. We expect our investments to report favorable December quarterly earnings and 2022 forecasts. The SPX is valued at 20.1x estimated 2022 earnings, supported by a 10-year Treasury yield of 1.78%. The long-term average is 16.6x. But valuations are a concern for the first time in 20 years because of accelerating inflation and rising interest rates. The lack of yield in fixed income has created the TINA (there is no alternative) effect for equities. Equities have been the right to place to be.

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From a technical perspective, the stock market is off to a weak start, but may be oversold on a near-term basis. Breadth indicators are offering mixed signals as rotation helps certain sectors and hurts others. The S&P 500 entered 2022 on a new high, but the NASDAQ Composite, NYSE Composite and Russell 2000 have been declining since November. Negatively, 40% of NASDAQ companies have declined over 50% from their 52-week highs. Leadership is changing and it is difficult to determine if the changes are durable and sustainable. The fear gauge – the VIX option volatility index -- is at 25 indicating moderately high risk. The stock market is experiencing a cyclical correction.

What about the January effect? January is a reasonably good predictor of the year based on S&P 500 data since 1928. For example, when January rises, the year is up 79% of the time with an average return of 13%. But when January declines, the SPX gains only 47% of the time with an average return of -0.20%. Also, this is the Chinese zodiac "Year of the Water Tiger" whose signs are bravery and competitiveness with traits of authority, leadership and strength. The tiger is known as the king of all beasts in China.

We expect a more challenging year in the stock market that will gradually climb a "wall of worry." Monetary policy will weigh on investor sentiment and create a cautious environment. The year will be marked by consolidation and volatility with an upward bias. Positives include tremendous global liquidity, strong earnings fundamentals, decade high asset flows and moderate interest rates. Also, the stock market increases most years (82% of the time since 1989) despite periodic 5-15% intra-year corrections. We favor adding to equities during periods of individual issue or overall market weakness. The key risks include China's slowdown, coronavirus variants, cyber-attacks, disappointing earnings, military conflicts (especially Ukraine), social unrest, and rapidly rising interest rates. In our opinion, quality small and medium-sized growth companies remain likely to achieve above-average annual returns over the next few years. We are cautiously optimistic and remain alert to take advantage of stock market opportunities as they arise.

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Appendix: Summary of Key Economic and Financial Measures

	Yearend 2020	Yearend 2021	Difference/ Change
Fed Funds Rate (%)	0.25	0.25	0 bps
10 Yr. Treasury Yield (%)	0.93	1.51	+58 bps
Inflation (CPI y/y % ch.)	1.29	7.00	+571 bps
Gold ($/oz.)	$1,891	$1,831	-3.2%
Oil ($/barrel)	$48	$75	+56.3%
Euro per Dollar	0.81	0.88	+8.6%