Investment Perspective

The financial markets are now caught between higher-than-expected inflation and recessionary risks

The investment environment changed considerably in the last nine months. Following a massive post–Covid rally, the worldwide stock and bond markets declined sharply in the first half of 2022. The U.S suffered its worst first half since 1970. In addition, digital currency assets collapsed. The financial markets are now caught between higher-than-expected inflation and recessionary risks. Today, the fear of high inflation prevails, and the Federal Reserve is tightening monetary policy to slow demand. While the Fed's objective is a "soft landing," investors are worried the medicine might generate more economic weakness then necessary. Bottom line, investors need price stability because high inflation destroys the long-term purchasing power of money. The fear of a deep recessionary environment appears overblown while investors are becoming more comfortable with the uncomfortable. The stock market appears to be in a bottoming process and has firmed in July. Volatility continues as investors digest the crosscurrents from an economic slowdown, global energy crisis, higher inflation, and the Russia-Ukraine war. Eventually, the equity markets will rally significantly as the worst fears dissipate and good news fuels a surge of optimism. Until then, we expect a period of consolidation with an upward bias. A summary of year-to-date index returns for the period ending June 30 is as follows:

Index	Return	Index	Return
Dow Jones Industrials	-14.4%	Russell 2500	-21.8%
MSCI EAFE	-19.3%	S&P 500	-20.0%
NASDAQ Composite	-29.2%	Wilshire 5000	-20.9%

GLOBAL ECONOMY

Inflation is a global problem and most of the major central banks are finally tightening monetary policy to reign in inflationary forces

Global growth expectations (ex. U.S.) in 2022 and 2023 are suddenly slowing as all major regions are experiencing downward revisions to growth. Global GDP growth (ex. U.S.) is now expected to be approximately 2.8% for this year and next. Inflation is a global problem and most of the major central banks are finally tightening monetary policy to reign in inflationary forces. For example, Canada recently and unexpectedly increased short-term rates 100 basis points. Additionally, the war in Ukraine has exacerbated a global energy crisis. Europe, China, Japan, and India are overly dependent on imported fossil fuels and renewable energy sources are not yet ready to carry the economic workload of these nations. The deemphasis of nuclear energy after the 2011 tsunami disaster in Japan has compounded the problem and the world is caught amidst several crosscurrents. In addition, the fossil fuel industry has underinvested in energy production over the last seven years due to an oil price collapse (2015-2017) and a strong movement to minimize the carbon footprint of energy production. Europe's dependence on Russian energy is a major policy weakness. Fortunately, the U.S. has achieved energy independence after spending more than 40 years dependent on foreign oil. Overall, worldwide growth is slowing, and the risks continue to the downside.

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

The U.S. economy is now expected to grow minimally this year and next. The recently reported second quarter real GDP growth declined 0.9% at an annualized rate and the first quarter declined 1.6%. Two quarters of negative does not necessarily make a recession according to the National Bureau of Economic Research (NBER), but near-term growth needs to accelerate in the second half of the year to produce annual growth. Consumer spending is decelerating due to the "inflation tax" primarily from rising energy and food prices. But consumers are in good shape with net worth of $14 trillion -- up 115% from 2012. Corporate America is also strong with over $4 trillion in cash compared to the financial crisis in 2008. Clearly, a mild recession is impacting parts of the economy. The bigger question is the depth and duration of the downturn. The recent key to U.S. economic growth has been balance among the major drivers, but the mix is changing. Consumer spending, capital expenditures, nonresidential investment and software technology might lead overall growth, while the slowdown in residential investment and net exports because of the strong dollar will be a negative impact. In general, service industries should show more relative strength compared to hard goods, manufacturing, and retail. The purchasing managers index (PMI) for manufacturing registered 53.0 in June, down from 56.1 in May – any figure above 50 indicates an expansionary environment. Some economists believe the manufacturing PMI might dip into the 40s, but it has not yet. With the unemployment rate at 3.6% compared to 5.4% last summer, reliable labor is in short supply and wages are rising approximately 5.1% y/y. Labor force participation continues to improve slowly from the pandemic lows, but jobless claims are beginning to rise. A greater pool of available labor is needed to suppress wage inflation. Recently, the sharp rise in mortgage rates to over 5% is slowing the previously robust housing market. Existing home sales, new construction and permits are all declining. Prices have risen sharply over the last few years and the Case-Shiller Home Price Index is up 19.7% y/y. The major economic negatives include excessive inflation, higher energy prices, labor shortages and rising interest rates.

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INFLATION & INTEREST RATES

Inflation has quickly become a major concern for the investment outlook. The Federal Reserve is behind the curve in fighting inflation and is pivoting to a tighter monetary stance. June's headline inflation was 9.1% y/y, but there are now signs that it may have peaked. The Fed's preferred measure of inflation, the core personal consumption expenditure (PCE) price index, which excludes the impact of food and energy prices, rose 4.7% y/y in May. Core PCE inflation has been modestly declining the last few months, which is positive. Similarly, core inflation (CPI excluding food and energy) rose 5.9% y/y in June, which is down from the 6.5% peak in March. It is constructive to have the core inflationary measures decelerating from their peak pace. The Producer Price Index (PPI) increased 11.2% y/y in June, which is slightly lower than the peak figure in March. Copper, gasoline, gold, lumber, shipping containers, wheat and other similarly traded commodities are down significantly from their recent highs. There is broad evidence that inflation has probably peaked, but the headline data does not yet support that view. We expect some relief in the months ahead.

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Inflation is uncomfortably above the Fed's 2% target and the Fed is concerned that longer-term inflation expectations are becoming unanchored. The Fed has responded by raising rates 225 basis points (bps) in four moves -- 25 in March, 50 in May and 75 in June and July. The Fed is transitioning from a stimulative monetary stance to a neutral position and Fed watchers expect another 50-100 bps of increases this year. As a result, the fed funds rate may finish the year near 3.0-3.5%, which is considered a neutral level. If more restrictive policy is needed, the fed funds rate may rise further in 2023. Reflecting this concern, bond vigilantes have adjusted the long end of the curve as the 10-year Treasury yield has risen to 2.68% from 1.43% in early December. In addition, "quantitative tightening" (QT) started in June and is expected to shrink the Fed's balance sheet by approximately $1 trillion per year over the next few years. This pace is considered equivalent to 50 bps worth of fed funds hikes.

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RUSSIA – UKRAINE WAR

President Putin's goal to "demilitarize" Ukraine and take its sovereignty continues. Russia expected the same Ukrainian military they faced in 2014, but Ukraine resisted this invasion with surprising resilience and strength. This was primarily due to the extensive western military training that started in 2015 after Russia's takeover of Crimea and recent NATO support. It demonstrates the benefit of western military training compared to the Soviet doctrine previously employed. The U.S. Department of Defense asserts that Ukraine's ability to prevent Russia from gaining air superiority has proved a critical factor in its successful resistance. After the first advance to topple Kyiv failed, Russia has focused on securing the Donbas and Crimean regions. Casualties have been heavy on both sides and Russia lost a significant amount of equipment. At this stage, there is no easy exit for President Putin as Ukraine has proven its determination to fight for independence. Clearly, the U.S. and NATO will continue to support Ukraine for the foreseeable future. Furthermore, Russia has become a pariah state and its integration into the global economy has been significantly weakened by sanctions, except for supplying various key global commodities.

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PANDEMIC TO ENDEMIC

For most of the developed world, the coronavirus infection has shifted to an endemic phase, with high prevalence and low severity. The latest variant, BA.5, represents 80% of infections and is more contagious and spreading rapidly worldwide. There is a high risk of infection, but mortality of 300 per day has normalized to levels typically associated with bad influenza seasons. The disease does not present a major risk to death rates or the health care system. The pandemic is also effectively ending in the minds of investors. In Asia, China is pursuing a zero Covid policy and its actions of periodic lockdowns reflect a pandemic mind-set. This is disrupting supply chain normalization and adding to the global inflation problem. In the U.S., approximately 223 million are fully vaccinated representing 67% of the population and over 91% of people aged 65 or older are fully vaccinated. Recently, the pace of vaccinations has slowed while infections have declined precipitously from 800,000 per day in mid-January to 130,000 in late July. However, daily infections are probably significantly

higher because of unreported home testing. Average weekly deaths and the mortality rate are near the lows of the pandemic. Economically speaking, the coronavirus is a minor risk compared to the other issues on the horizon, but newer variants are constantly emerging and could change this assessment.

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INVESTMENT OUTLOOK

The outlook for stocks and bonds is heavily influenced by the threat of higher interest rates to combat inflation and a possible recession that would reduce corporate earnings. Investor sentiment is growing more cautious because of two primary threats caused by higher interest rates. These threats are lower valuations for stock prices and slower earnings growth due to demand destruction. Positively, the sharp correction in equity prices may already appropriately reflect the risk inherent in the short-term outlook. The stock market is climbing the "wall of worry", essentially discounting repeatedly the same types of risk. The market appears to be in a bottoming process, but it is difficult to determine the duration. We believe it is plausible to experience a rebound in upward momentum with some positive news.

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The fundamentals supporting the investment outlook include continued earnings gains, healthy corporate buybacks and positive asset flows into equities. We expect S&P 500 (SPX) operating earnings to increase 5% this year to $218 per share following last year's explosive growth of 49% to $208. The estimate for 2022 was recently reduced reflecting slower economic growth and the translation effects of the strong dollar. Frankly, the earnings environment is fluid and results could improve if recession risks are minimized. Additionally, SPX revenue growth could be boosted by rising prices whereas earnings growth might be clipped by margin pressures associated with inflation. This is a tough environment for corporate management because supply bottlenecks and wage demands add costs, it is challenging to increase selling prices frequently to maintain margins and there is the risk of declining demand. Furthermore, multi-national companies will face some short-term challenges associated with a strong dollar. For example, the dollar is up 16% versus the euro on a year-to-date basis and this will reduce the translated effect of revenue earned overseas. The SPX is now valued at 18.4x estimated 2022 earnings versus its long-term average of 16.6x. Higher than average inflation and interest rates might pressure P/E multiples further, which highlights the importance of reducing inflation.

From a technical perspective, the stock market is in a cyclical bear correction within a secular bull market. Since the SPX low on June 17, the market has rallied 11% and appears to have started a bottoming process. Market breadth has also been gradually improving. Traders are looking for the "capitulation day" before becoming more aggressive. Most contrarian indicators provide positive reassurance while momentum indicators have a negative bias. "Sell the rip" has replaced "buy the dip." Leadership continues to change with a tug of war between inflation and recession risks and growth versus value. The fear gauge -- the VIX option volatility index -- is 23 in late-July and has gyrated between a year-to-date low of 17 and high of 36 in early March. Positively, the VIX is establishing a

sequence of lower highs as the market bounces around this summer. We believe the stock market is ready for a strong rebound given the preponderance of pessimism and the maturity of the bottoming process.

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We are amidst a challenging environment. It is likely that 2022 will be remembered as a difficult year in the financial markets similar to 2008, 2002, 1987 and 1974. The SPX decline in the first half was the largest in a secular bull market since 1962. Historically, this results in positive returns in the second half 90% of the time with an average return of 9.2%. It is critically important to remain invested and avoid market timing at this juncture. We are confident that equities offer attractive returns on a multi-year basis and believe that ACM's strategy of owning quality small and medium-sized growth companies can produce above-average returns in the years ahead. Unlike 2008, the financial system is strong and this period will eventually transition to another leg of growth due to the dynamic long-term opportunities available in the U.S. economy. Specifically, we are optimistic regarding the growth of the healthcare and technology industries that are a major emphasis of ACM's investment strategy.