AMERICAN
CAPITAL MANAGEMENT

ECONOMIC & INVESTMENT OUTLOOK
OCTOBER 2022

Investment Perspective

This has been one of the most challenging times for equity investors in the last 80 years of stock market history. After tumbling 22.3% through June 17, the S&P 500 (SPX) gained 19.3% in two months and then weakened again concluding with a 9.2% loss in September. As a result, the SPX declined 23.9% through September 30 for the worst first nine months performance since 2002. Most of the decline reflects compression in valuation multiples due to higher-than-expected inflation and interest rates. In addition, the risks of recession and slower earnings growth are suppressing investor confidence. The Federal Reserve has been rapidly tightening monetary policy to slow demand and reduce inflation. It hopes to engineer a "soft landing," but investors are worried that higher rates may generate a "hard landing." We believe the fear of a deep recessionary environment appears overblown, but the odds of a mild economic contraction are high. It is important to note that recessions are temporary, and the U.S. economy always recovers. In fact, the U.S. experienced two quarters of negative GDP growth in the first half of the year while the second half is expected to be positive. Longer term, investors need a strong central bank with tough inflation fighting credentials to foster healthy financial markets. This year's Fed actions can be viewed as "short-term pain for long-term gain." We believe the current headwinds will abate and the equity markets will rebound significantly as the worst fears dissipate and good news fuels optimism. Until then, we expect a period of consolidation with continued volatility. A summary of year-to-date index returns for the period ending September 30 is as follows:

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Dow Jones Industrials	-19.7%	Russell 2500	-24.0%
MSCI EAFE	-26.8%	S&P 500	-23.9%
NASDAQ Composite	-32.0%	Wilshire 5000	-24.4%

GLOBAL ECONOMY

Worldwide growth expectations (ex. U.S.) in 2022 and 2023 continue to slow as all major regions are experiencing downward revisions. Global GDP growth (ex. U.S.) is expected to approximate 2.9% this year with lower growth in 2023. Inflation remains a global problem and most major central banks (except Japan) are tightening monetary policy to dampen inflationary forces. In addition, the strong U.S dollar and production cuts by OPEC are making oil more expensive for regions like Europe and Japan. Western Europe is further challenged by a shortage of natural gas due to its over reliance on Russia. In contrast to other G8 countries, Japan continues to stimulate to end deflation by generating reflation – an interesting and different approach from Western central banks. China is also struggling due to severe coronavirus lockdowns, weakening exports and the need to address high debt levels in the bloated real estate sector. OPEC's decision to reduce oil production to support higher energy prices is an example of the risks. Overall, worldwide growth is slowing, and the risks are to the downside.

Japan continues to stimulate to end deflation by generating reflation – an interesting and different approach from Western central banks

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The U.S. economy is expected to grow 1.7% this year and 1.0% in 2023. After sequential GDP declines in the first half of the year, modest growth is forecast to resume in the second half. Today, the focus is on the economic impact of rising interest rates, higher inflation, and the Federal Reserve's tighter monetary policy. Housing is one major casualty as the sector has been hard hit by higher mortgage rates. The fallout is visible in declining mortgage applications, a slowdown in housing starts and building permits and declining home prices. Existing home sales fell for an eighth straight month in September, the longest streak in 15 years. As residential investment represents 3% of GDP, these headwinds will moderately suppress future growth. Beyond that, the decline in home prices and the stock market may diminish the "wealth effect" and dampen consumer spending. Currently, consumer spending, nonresidential investment in equipment and investment in software technology are contributing to GDP growth. The Social Security 8.7% cost of living adjustment will also be helpful for senior citizens. These factors will continue to demonstrate modest growth during this phase of the slowdown as the most interest rate sensitive sectors (residential) create the biggest drags on growth. The purchasing managers index (PMI) for manufacturing registered 50.9 in September, which is the lowest reading for this year – any figure above 50 indicates growth as opposed to contraction. The economy is experiencing an uneven series of rolling slowdowns while the job market is strengthening. Wages are rising approximately 5.0% y/y with the unemployment rate at 3.5% and reliable labor is in short supply. The positive strength in employment supports healthy consumer spending but makes the Fed's job difficult as it battles inflation. At the same time, supply chain and pricing pressures that have created bottlenecks and ignited inflation are abating.

Housing is one major casualty as the sector has been hard hit by higher mortgage rates

FEDERAL RESERVE POLICY & INFLATION

Inflation remains a critical factor for the investment outlook. The Federal Reserve needs to fight inflation more vigorously to prevent an increase in long-term inflationary expectations. In September, the Fed increased the fed funds rate another 75 basis points (bps) after 25 bps in March, 50 bps in May and 75 bps in June and July for a total of 300 bps since March – the fastest pace of increases since the early 1980's. The Fed is tightening monetary policy to a restrictive stance and forecasters expect another 125-150 bps of increases by year end. If more restrictive policy is needed, the fed funds rate might increase to 4.75% or higher in mid-2023. Given the inflation worries, bond vigilantes have repriced the 10-year Treasury yield to 3.94% from 2.60% in mid-July. In addition, the Fed's "quantitative tightening" (QT) program is shrinking the Fed's balance sheet at a rate of approximately $1 trillion per year. This pace is considered implicitly equivalent to 50 bps worth of fed funds hikes.

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At this stage, investors view the monthly inflation report as the most important economic data release. Investors need to see a decelerating pattern of inflation and evidence that the core inflation and its stickier components are easing. September's overall consumer price index (CPI) was 8.2% y/y, and there are now clearer signs that inflation may have peaked. Core inflation (CPI excluding food and energy) rose 6.6% y/y in September, slightly above recent reports. 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 4.9% y/y in August. This represents a modest decline over the last few months. The Producer Price Index (PPI) increased 8.5% y/y in September, which was slightly lower than the peak figure in March. There is broad evidence that inflation may have peaked, although some of the shelter and rent components have not yet softened. We expect relief over the intermediate term that will support a pause in the Fed's tightening process. The futures market indicates that inflation should decline significantly in 2023. We appear to be at the beginning of the end of the inflationary problem.

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RUSSIAN CONFLICT

The global geo-political situation is tense due to the Russian invasion of Ukraine. The U.S and NATO have continued to support Ukraine with financial aid and military equipment to help it repulse the invasion. Russia recently conducted a sham annexation of four eastern provinces that it claimed voted to leave Ukraine, but the United Nations rejected this action. Positively, the Ukrainian military launched a counteroffensive that has successfully reclaimed parts of the country. They have also attacked ammunition depots, command centers and the supply lines that support the Russian offensive, including bombing a key bridge to Crimea. The Ukrainian military is gradually pushing back the Russian army on the battlefield. It is estimated that Russia has lost 80,000 troops killed or wounded and substantial numbers of aircraft and equipment. As a result, Russia has responded by launching large missile attacks focused on destroying vital infrastructure before winter designed to intimidate the population into capitulating. In September, President Putin declared a draft to conscript over 300,000 additional reservists and civilians into the army. Intelligence reports suggest new recruits are arriving on the front lines with little training. Unfortunately, the end of this conflict is not yet visible. The U.S. and NATO have committed to support Ukraine for as long as it takes. Russia said its special operation will not end until its objectives are met. This war is indirectly spreading as Iran agreed to sell attack drones and missiles to Russia. In addition, Belarus and Russia are forming a joint military force and strategists are concerned about another attack from Belarus. In response, the west is sending more advanced air defense systems to counter this threat. President Putin has also threatened to use tactical nuclear weapons if Russian territory is threatened. This invasion is causing a shortage of and higher prices for energy, grain and other products. The economic sanctions directed toward Russia have hurt global trade and increased inflationary pressures.

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INVESTMENT OUTLOOK

The outlook for stocks and bonds is evolving to a new chapter. Due to higher interest rates, the TINA effect (there is no alternative) is giving way to a range of investment options. The "Great Rotation" from bonds to equities has ended. Short-term government bonds yield 4.3% and investment grade corporate bonds yield 5.5%. Rising interest rates have depressed bond prices and produced one of the worst performing bond markets in decades. As a result, higher yields will start to attract investors. Despite the changing environment, stocks remain the asset class of choice for long-term capital appreciation. The current volatility in equities is clearly uncomfortable, but it is important to remain patient and disciplined as equity prices may already reflect the risks ahead. Yes, it can be

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SPX is valued at 17.0x the mid-point range of 2023 earnings versus its long-term average of 16.6x

frustrating, but "time in the market is more important than timing the market." For example, the SPX compounded annual return over the past 20 years was 9.7%, but it was only 5.5% if you missed the market's 10 best days. Currently, the stock market appears to be in a bottoming process and offers attractive opportunities. It is important to stay invested and potentially add incrementally during periods of high volatility. Specifically, the SPX has risen the year after every midterm election since WWII with an average increase of almost 15%. Also, since 1971, the worst nine month returns similar to today for the Wilshire 5000 produced one and three year total returns of 28% and 59%, respectively. These statistics strengthen the probability of significant returns over the next two years.

We expect SPX operating earnings to increase 6% this year to $220 per share after last year's gain of 48% to $208. The estimate for this year is affected by slowing economic growth and the adverse translation effects of the strong dollar. The earnings outlook for 2023 is highly variable and uncertain, which is dampening investor sentiment. The stock market appears to be bracing for a modest decline in earnings next year due to rising interest rates, a softer demand environment and a margin squeeze from higher costs. In fact, SPX earnings estimates for next year range from $212 to $240, which is unusually wide but reflective of various scenarios. It is prudent to maintain a fundamentally conservative view until inflation has clearly decelerated and a peak in interest rates is visible. Currently, the SPX is valued at 17.0x the mid-point range of 2023 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 market. Given the recent inflation news, the SPX declined to new lows on October 11, which undercut the prior low and left the index down 26% from the all-time high on January 4. The technical conditions for a cyclical bear market have been met with a decline of greater than 25%. The fear gauge -- the VIX option volatility index – has increased to 33 – a level similar to the June 17 low.

We believe the stock market is positioned for a strong rebound given the preponderance of pessimism and maturity of the bottoming process, but it is difficult to time. In challenging periods, fundamental factors, such as, growth, profitability, positive cash flow, a strong balance sheet and quality businesses prove valuable. We focus on such investments and believe that ACM's strategy of owning quality small and medium-sized growth companies will produce above-average returns in the years ahead. We are amidst a difficult market. But, unlike the Great Financial Crisis in 2008, the banking system is strong today and a credit crunch is unlikely. This period will eventually transition to another leg of positive returns due to the dynamic long-term opportunities available in the U.S. economy.