AMERICAN
CAPITAL MANAGEMENT

ECONOMIC & INVESTMENT OUTLOOK
JULY 2023

Investment Perspective

The investment environment is better than feared. Expectations of a deep recessionary environment have diminished as economic data improved and investors adjusted to uncertainty. The recession obsession has become the un-recession. Crosscurrents confusing the outlook include moderating inflation (+), negative earnings growth (-), a healthy labor market (+) and an inverted yield curve. Positively, investors are looking through the earnings trough this year while focusing on accelerating earnings in 2024. Volatility has declined significantly from the tumultuous period last fall as the VIX has fallen to 14 versus 32 in October. The equity markets are moving higher as the worst fears have evaporated and good news fuels optimism. Today, the fear is FOMO -- Fear of Missing Out! We expect a period of consolidation with an upward bias in the months ahead. A summary of year-to-date index returns for the period ending June 30 is as follows:

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Dow Jones Industrials	4.9%	Russell 2500	8.8%
MSCI EAFE	12.1%	S&P 500	16.9%
NASDAQ Composite	32.3%	Wilshire 5000	16.3%

GLOBAL ECONOMY

Global growth expectations (ex. U.S.) for 2023 are gently increasing from a previously subdued pace. World GDP growth (ex. U.S.) is projected to be approximately 3.3% this year and 3.1% in 2024 after 4.0% last year. This partially reflects a drag from China, the engine of growth for a decade. China's economy is weak by historic standards with expectations of 5.0% growth this year. Sluggish growth signs include moderating consumer spending, lower exports and imports, low inflation, high youth unemployment and rising bankruptcies because of high debt levels. However, some additional government stimulus is being planned. Inflation has been the other global problem, but most major regions are currently experiencing disinflation except for the U.K. Japan is trying to boost inflation to defeat the deflationary forces that have troubled its economy since 1990. Overall, global growth is moderate and slowly improving relative to muted expectations. There are risks to the downside, but fears of a deep recessionary period are dissipating.

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The resilient U.S. economy is expected to grow 2.0% this year after the first half proved better than forecasts. Real GDP increased 2.0% and 2.4% in the first and second quarters, respectively. Consumer spending surprised to the upside as service-related expenditures grew faster than goods. The fully employed labor force and healthy job market are sustaining spending patterns among consumers as wages increase faster than inflation. Household wealth is $157 trillion -- a new high -- and cash in money market funds reached $5.5 trillion. Debt service as a percentage of disposable income remains historically low. However, the resumption in October of student debt repayments will impact consumer spending patterns. The Consumer Sentiment survey from the University of Michigan

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registered 72.6 in July, the most favorable reading since September 2021. Households continue to buy new vehicles due to pent-up demand given recent production shortages and the rising average age of vehicles. Vehicle sales are expected to grow almost 12% to 15.4 million units in 2023, still well below 2019 levels. Business spending on software and technology is also a source of growth with this component increasing 3.1% in the first quarter and 4.9% for the year. Investment in manufacturing facilities is beginning to strengthen.

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The primary drags on the economy are residential investment and business spending on capital equipment. The purchasing managers index (PMI) is confirming weakness in manufacturing with recent readings below 50. Specifically, the purchasing managers index (PMI) for manufacturing registered 46 in June, versus 53 last June, signaling a contraction. But, looking ahead, the Chips, Inflation Reduction and Infrastructure Investment Acts total a massive $2.2 trillion and should support a manufacturing renaissance over the next decade. The U.S. economy has experienced a series of rolling corrections over the last 24 months, but the labor market remains unaffected with the unemployment rate at 3.6%. Eventually, the labor market may weaken due to the cumulative effects of tighter monetary policy and a concerted effort by the Federal Reserve to hold interest rates "higher for longer." It is unprecedented to have fed funds rate increase over 500 basis points in 18 months and not negatively impact employment. Overall, the economy has strengths and weaknesses that indicate moderate progress. The risk remains that tighter monetary policy will eventually curtail growth more severely. We remain alert to developments that might change the outlook.

HOUSING AND REAL ESTATE

Housing is undergoing a moderate downturn in activity after its recent boom period, but a trough is near

The sales of existing homes declined 18.9% y/y in June to a 4.2 million annual rate while the median price declined 0.9%. Total housing starts are down 15.3% y/y in June with single family housing starts down 2.7% y/y and multi-family housing starts declining 33.1% y/y. The curtailment in home building has kept housing inventories low and the demand for new homes firm. For example, sales of new homes increased 23.8% y/y in May to a 697,000 annual rate. The S&P/Case-Shiller Home Price Index recently declined 0.2% y/y after increasing 41% cumulatively from June 2020 to June 2022. Housing is undergoing a moderate downturn in activity after its recent boom period, but a trough is near. The sharp rise in 30-year mortgage rates from 2.9% to 6.8% over the last 18 months has dampened the residential investment component of GDP which represents 3.8% of GDP, similar to its 50-year trendline. For context, this metric peaked at 6.5% in 2006 and plummeted to 2.5% in 2010 during the Great Financial Crisis. Several factors support the current environment including a strong job market, a generation of renters looking to buy, and the "golden handcuffs" of homeowners staying in their home after refinancing at exceptionally low mortgage rates. Separately, office-related commercial real estate is an area of weakness as work-from-home trends lessen the demand for large property footprints. Combined, the decline in commercial and residential construction are drags on GDP growth. This is consistent with the intended impact of tighter monetary policy, and it may take a few years for these sectors to recover.

INFLATION & TIGHTER MONETARY POLICY

The core measures are not decelerating fast enough for the Fed's satisfaction

We expect short-term interest rates will remain elevated

Inflation is clearly moderating, but more progress is necessary before the Federal Reserve will be satisfied with this disinflationary trend. The level of inflation remains too high but is retrenching. Reflecting the Federal Reserve's hawkish stance, the fed funds rate increased another 25 basis points in July to 5.25-5.50%, following a pause in June. However, the end of rate hikes is near, which suggests the financial markets will start anticipating the first interest rate cut. Headline inflation as measured by the consumer price index (CPI) was up 3.0% y/y in June, decelerating to the slowest pace since March 2021. The overall inflation rate has declined 12 consecutive months after it peaked in June 2022 at 9.1%. Core inflation (CPI excluding food and energy) rose 4.8% y/y in June and the Fed's preferred measure of inflation, the core personal consumption expenditure price index (PCE), excluding food and energy, increased 4.1% y/y in June. The core measures are not decelerating fast enough for the Fed's satisfaction. It is taking longer for the lagged effects of monetary policy to reduce inflation in services, shelter costs and wages. The Fed's long-term goal of 2% inflation appears at least a year away. Meanwhile, higher interest rates are creating a headwind for growth. For example, many of the most interest-rate-sensitive sectors of the economy, including commercial real estate, durable goods, freight volumes, housing, loan demand and regional bank liquidity are feeling the pressure from higher rates. We expect short-term interest rates will remain elevated and long-term rates may range between 3.50-4.25%. Recently, the 10-year Treasury yield has settled around 4.04% after hitting 2.95% this time last year. Furthermore, "quantitative tightening" (QT) which started in June 2022 is shrinking the Fed's balance sheet approximately $1 trillion per year. This pace is equivalent to 50 basis points of fed funds hikes, according to Federal Reserve research. Overall, monetary policy will remain restrictive for at least several more quarters.

RUSSIA/UKRAINE WAR

Ukraine recently began a counteroffensive which is making slow and steady progress against strong Russian defenses

This war is now in its 18th month with no end in sight. Fighting is intense with heavy casualties on both sides. NATO and the U.S. are providing Ukraine with advanced weapons systems while training its forces in combined arms tactics. As a result, Ukraine recently began a counteroffensive which is making slow and steady progress against strong Russian defenses. Russia recently moved tactical nuclear weapons into Belarus and the Wagner mercenary force is now in Belarus after attempting an insurrection. This force is beginning to train the Belarusian military which could threaten northern Ukraine and Poland. NATO also decided to transfer F-16 fighters to help them defend against Russian fighter and missile attacks. Pilots are being trained and the initial force may be operational this fall. Russia recently cancelled its pact ensuring safe passage for Ukraine's grain exports in the Black Sea and began attacking the port city of Odesa and its grain storage facilities. In response, Ukraine launched drone attacks on Crimea and Moscow. This war is expanding with attacks on Ukraine's industrial infrastructure and more countries supporting both combatants. NATO and the U.S. remain committed to supporting Ukraine for as long as it takes.

INVESTMENT OUTLOOK

Most major indices are producing double-digit returns as the economy is better than feared -- a pleasant surprise

The stock market is climbing that "wall of worry" this year. Investors have been bracing for a recession, which is not materializing. Most major indices are producing double-digit returns as the economy is better than feared -- a pleasant surprise. The technology sector is strong reflecting its durable growth theme and sensitivity to a better economy. However, the market is vulnerable to a correction given the recent strong rally against a backdrop of tight monetary policy, elevated inflation, moderate GDP growth and above-average equity valuations. At the same time, longer-term fundamentals appear more attractive than previously perceived. For example, we expect S&P 500 (SPX) operating earnings to decrease slightly this year to $218 per share, but investors are looking ahead to the potential of $245 in 2024 and higher again in 2025. Earnings should begin a transition to reacceleration in the fourth quarter. Also, the trade weighted dollar has weakened, which will increase earnings slightly for multinational corporations. The SPX is currently valued at 19.7x estimated next twelve months earnings versus its long-term average of 16.6x. Higher than average inflation and tighter monetary policy may dampen P/E multiples somewhat. However, it is important to note the SPX trades at 15x projected earnings, excluding the "Magnificent Seven" stocks which are Alphabet, Amazon, Apple, Meta Platforms, Microsoft, Nvidia and Tesla. These seven companies comprise approximately 29% of the $39 trillion market capitalization of the SPX -- a historically unique occurrence.

Given the strong advance in equities this year, we expect the market to experience a period of consolidation with modest gains as the year progresses

From a technical perspective, there is a narrowness to the YTD advance led by the largest companies in the SPX and the NASDAQ 100. The technology sector drove 73% of the SPX total return in the first half and the NASDAQ gained 32% -- its best first half return since 1983. Smaller capitalization indices and the Dow Jones Industrials have not yet fully participated in this rally. However, the SPX advance-decline line had an upside breakout in June and extended to new highs in July. This is positive if it continues. "Buy the dip" is reemerging as an operative strategy. Importantly, the third year of the Presidential Cycle is historically positive with an average gain of 20% for a president's first term in office after a down midterm year (2022). We are seeing that type of strength unfold in 2023.

Given the strong advance in equities this year, we expect the market to experience a period of consolidation with modest gains as the year progresses. However, a Fed "pivot" to easier monetary policy would ignite further investor enthusiasm. Patience will be important as we transition to better economic and earnings growth in 2024. We favor adding to equities during periods of individual issue or overall market weakness. The key risks include China's slowdown, cyber-attacks, disappointing earnings, global recession, the inverted yield curve, reduced bank lending, resurgence of inflation, Russian aggression, Taiwan and an unexpected credit crisis. Small and medium-sized growth companies are likely to achieve above-average annual returns over the next few years. Historically, this market segment benefits from investor rotation after a period in which mega-caps have dominated.