AMERICAN
CAPITAL MANAGEMENT

ECONOMIC & INVESTMENT OUTLOOK
FEBRUARY 2023

Investment Perspective

The Wall Street maxim that summarizes the past year is "Don't Fight the Fed." Returns on stocks and bonds were negative because of the historic pace of Fed tightening marking the first time both asset classes experienced a bear market simultaneously. Furthermore, stock prices had the sharpest decline since 2008 while bond investors recorded the worst year in over a century. In 2022, the 20-year Treasury bond index fund declined 31% - worse than most stock indices. In 2023, the stock market began positively with the S&P 500 (SPX) and Nasdaq Composite rising 6.2% and 10.7% respectively. The Nasdaq gain was its best January since 2001.

The outlook is complex and includes an economic slowdown, an uncertain earnings outlook, decelerating inflation and higher interest rates

The Federal Reserve raised short-term interest rates seven times in 2022 for a cumulative increase of 425 basis points (bps). The 10-year Treasury yield rose from 1.51% to 4.32% in October before declining to 3.52% today. In addition, the Fed started to shrink its balance sheet of bonds as a restrictive measure. The sudden tightening of financial conditions compressed the S&P 500 earnings multiple from 21.1x to 17.5x, and was the biggest detriment to stock returns in 2022 as earnings growth met expectations. Today, the outlook is complex and includes an economic slowdown, an uncertain earnings outlook, decelerating inflation and higher interest rates. There is a balancing act between favorable factors and negative headwinds. It is important to remain disciplined and patient with the likelihood of an improving environment in 2024. The market tends to look over the valley to the hills. A summary of index returns for the year ending December 31, 2022 is as follows:

Dow Jones Industrials	-6.9%	Russell 2500	-18.4%
MSCI EAFE	-14.0%	S&P 500	-18.1%
NASDAQ Composite	-32.5%	Wilshire 5000	-19.0%

GLOBAL ECONOMY

The era of ultra-stimulative policies is over, and the major developed economies are returning to more conventional monetary policies

World economic growth (ex. U.S.) is likely to decelerate to 2.9% this year after 3.8% in 2022. Restrictive monetary policy by the Federal Reserve, the European Central Bank (ECB), the Bank of England and other central banks is suppressing economic growth and inflation. The era of ultra-stimulative policies is over, and the major developed economies are returning to more conventional monetary policies. Fighting inflation remains a priority for central banks. As a result, economic growth will slow among the world's largest nations with the odds of recession rising in regions like the Eurozone and United Kingdom. Growth in China remains subdued due to its weakening property sector and a recent wave of covid infections related to China's pivot on its zero-covid policy. Even so, China's GDP should strengthen in 2023 by approximately 5% from the record low growth of 3.5% in 2022 as its re-opening is underway. Looking ahead, long-term growth may be negatively impacted

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

by a decline in its total and working age populations. The sustainability of global economic growth depends upon lower inflation enabling central banks to pause and ease their restrictive measures. The debate of a soft versus hard landing hinges on these factors.

The dominant factor suppressing growth is the sharp rise in short-term interest rates and the corresponding impact on overall demand and sentiment

The U.S. economy may experience a mild recession in 2023 after growth of 2.1% in 2022. Retail sales were weak in December and the personal savings rate has been rising since September. The dominant factor suppressing growth is the sharp rise in short-term interest rates and the corresponding impact on overall demand and sentiment. Economists project two or three quarters of negative GDP this year followed by a rebound in 2024. However, opinions vary regarding the depth and duration of this downturn. Some economists estimate a mild rolling growth recession whereas others forecast a deeper downturn. The housing sector is weakening significantly as 15 year high mortgage rates dampen buyer interest. Housing starts are projected to decline by 11% in 2023 to 1.39 million. Builders are purchasing less land for new construction and reducing staffing levels. The weakening housing market will eventually soften consumer spending for both goods and services.

Recently, the most powerful contributor to growth has been consumer spending on services, which may continue due to pent-up demand from the depths of the pandemic. Government spending, non-residential investment and software services are all expected to show modest gains. As an offset, the manufacturing purchasing managers index (PMI) declined to 48.5 in December – the lowest reading since May 2020 and a sign of contraction. However, there are several reasons to be optimistic. These include the reshoring of manufacturing and legislation such as the CHIPS and Science Act of 2022 -- a $280 billion package focused on expanding U.S-based semiconductor manufacturing capacity and research.

The most significant short-term question is the degree the Fed's tightening will slow the economy and inflation and impact employment

With the unemployment rate at 3.5% -- a 53 year low -- and reliable labor in short supply, wages are rising with average hourly earnings up 4.6% y/y. Job market strength is both a positive and negative from the Fed's perspective. The Fed has expressed concern over higher wages contributing to higher inflation. Some of the Fed's restrictive measures are intended to increase unemployment due to slowing demand. Today, the most significant short-term question is the degree the Fed's tightening will slow the economy and inflation and impact employment. Demand was healthy last year with constrained supply, but now supply has improved while demand is weakening. We foresee a mild recession without a deeper credit crisis, which will be a manageable scenario for businesses, consumers, and investors.

INFLATION & MONETARY POLICY

Inflation remains a top priority for the Federal Reserve. Its rapid rise peaked in June 2022 and has been gradually decelerating. However, more progress is necessary before the Fed believes that inflation is not a problem. On February 1, the Fed increased the fed funds rate 25 bps for the eighth increase since March 2022, for a total of 450 bps in 11 months. This was the fastest pace of tightening since the early 1980's, but positively the size of the recent increases has been incrementally smaller. The Fed is communicating a need for restrictive policy, which may include more increases before a midyear pause. In addition, it continues to execute quantitative tightening through the reduction of its bond holdings. The Fed balance sheet peaked at approximately $9 trillion last April and subsequently declined to $8.5 trillion. This modest reduction allows the marketplace to determine the yield more freely on Treasuries and mortgage-backed securities. Bond investors have a constructive view that inflation will decline to acceptable levels as the 10-year Treasury yield is now 3.52% versus 4.32% in mid-October and below the 6.5% rate of inflation.

There is evidence that price increases are decelerating for goods and commodities, although some important services, including shelter and rent components have not yet softened enough to give the Fed comfort

The monthly inflation report continues to play a dominant role in investor psychology. Investors are hunting for trends that suggest core inflation will return to the 2% range. December's overall consumer price index (CPI) was 6.5% y/y, with continuing signs that inflation peaked last year. Core inflation (CPI excluding food and energy) rose 5.7% y/y in December. 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 4.4% y/y in December - its slowest pace since October 2021. There is evidence that price increases are decelerating for goods and commodities, although some important services, including shelter and rent components have not yet softened enough to give the Fed comfort. The Fed is concerned that rising labor costs are feeding into services inflation. Wage rates and service prices tend to be sticky, whereas goods and commodities will decline with less demand or more supply. We expect relief over the intermediate term that will support a pause in the Fed's tightening and some easing may follow. The disinflationary process has started and we appear to be at the beginning of the end of the inflationary problem.

RUSSIA-UKRAINE WAR

Russia has continued to launch large missile attacks focused on destroying Ukraine's vital infrastructure and will to resist

The U.S and NATO continue to send financial aid and military supplies to support Ukraine's battle against Russia's invasion. To date, the U.S. has provided over $27 billion in military aid including a $2.5 billion package of Bradley and Stryker combat vehicles, munitions, and other supplies. NATO and the U.S. also agreed to supply battle tanks to Ukraine. Positively, the Ukrainian military is successfully using its sophisticated western training in deploying advanced weapons systems. They have also attacked Russian ammunition depots, command centers and supply lines including key targets inside Russia. It is estimated that Russia has lost 200,000 troops killed or wounded, over 3000 tanks and many other vehicles. Ukraine's losses are also heavy. Adding to Putin's challenges is low military recruitment because of the lowest birthrates in a century during the 1995-2005 period due to collapse of the former Soviet Union and emigration. There is a shortage of people in the prime warfighting years of their early 20s, which has resulted in the use of ethnic and foreign mercenaries. Additionally, Russia has continued to launch large missile attacks focused on destroying Ukraine's vital infrastructure and will to resist. This war continues to spread with Russia buying military equipment from Iran and North Korea and forming a joint military force with Belarus. In response, NATO's position has hardened and it is sending more advanced air defense systems and tanks to counter this threat. Unfortunately, the end of this conflict is not yet visible. Clearly, the global economic outlook would benefit and stock markets would rally if a peace agreement were reached.

INVESTMENT OUTLOOK

The financial markets are transitioning from a decade of above-average earnings growth, benign inflation, and low interest rates to a period in which these critical variables are temporarily in flux. Specifically, SPX earnings growth is slowing and may decline in 2023. Inflation is at the highest level since the early 1980s, but is on a moderating path. Lastly, short-term interest rates have increased over 450 bps in the last 12 months and the Fed has abandoned its zero-interest rate policy. These cyclical changes to the fundamental factors underpinning the stock market create dislocation, uncertainty and opportunity. The key question today is "When will the fundamentals improve?" We are in a transition year with 2024 offering a more bullish outlook. Inflation should decline, but short-term interest rates will remain elevated for a period as the Fed delivers on its "higher for longer" theme. Importantly, long-term interest rates are likely to stabilize around 4%. The financial markets will likely discount the eventual rate decline allowing stock prices to advance reflecting the prospects of improving fundamentals.

We are in a transition year with 2024 offering a more bullish outlook

Specifically, we expect SPX operating earnings per share to decline modestly in 2023 to approximately $210 after growing 6% last year to $220. This year's estimate is debatable and subject to considerable variability depending upon the degree of the economic slowdown. For example, earnings could grow this year if a recession is averted or, decline more if a harder landing occurs. In fact, SPX earnings estimates for this year range from $195 to $230, reflecting the various scenarios. It is prudent to maintain a conservative view until inflation has decelerated and earnings growth is more visible. Currently, the SPX is valued at 19.3x the mid-point of the 2023 earnings range 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.

The SPX is valued at 19.3x the mid-point of the 2023 earnings range versus its long-term average of 16.6x

From a technical perspective, the stock market is off to a strong start in 2023 given the uncertain outlook. It is difficult to determine if we are experiencing the beginning of another bull market or a bear market rally. Smaller companies, fallen angels, and cyclically exposed companies are performing best in January. Breadth indicators have improved as all styles and capitalizations are participating in the advance. For example, over 80% of stocks are trading above their 200-day moving average. Market leadership continues to evolve, and it is difficult to determine if the recent advances are durable and sustainable. The fear gauge – the VIX option volatility index – is at 18 indicating less risk and one of the lowest levels over the last year.

What about the January effect? January is a reasonably good predictor of the year based on SPX data since 1928. For example, when January rises, the year is up 79% of the time with an average return of 13%. The SPX gained 6.2% in January, which bodes well for the rest of the year. Also, this is the Chinese zodiac "Year of the Water Rabbit" which is a symbol of longevity, peace, and prosperity in Chinese culture. The S&P 500 was up 2.1% in the last rabbit year of 2011 and the past 10 rabbit years produced an average return of 21%. Closer to home, 2023 is year three of the Presidential cycle, which is the best year of the cycle with the SPX up 80% of the time after a down midterm year with an average gain of 18%. In addition, it appears that the bear market may have bottomed in mid-October. Since 1930, the market increased 90% of the time over the next 12 months after it bottomed with an average gain of 35%.

Investors are purchasing more equities in advance of a Fed "pause" or "pivot"

We expect the equity markets to experience periods of consolidation, modest gains and volatility as the year progresses. The uncertain earnings outlook and restrictive monetary policy will weigh on investor sentiment. Investors are purchasing more equities in advance of a Fed "pause" or "pivot." Heeding the "Don't Fight the Fed" mantra remains sound advice at this juncture. Patience will be important as we transition to another period of economic and earnings growth in the years ahead. It is important to remember that the SPX compounded at 9.7% over the last 20 years, but if you missed the 10 best days, the annualized return was only 5.5%. 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, global recession, resurgence of peak inflation, Russian aggression and an unexpected credit crisis. 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 that the bear market conditions prevailing during 2022 have receded and bull market spirits will foster a profitable environment in 2023 and 2024.

Appendix: Summary of Key Economic and Financial Measures

	Yearend 2021	Yearend 2022	Difference/ Change
Fed Funds Rate (%)	0.25	4.50	+425 bps
10 Yr. Treasury Yield (%)	1.51	3.88	+237 bps
Inflation (CPI y/y % ch.)	7.00	6.50	-50 bps
Gold ($/oz.)	$1,831	$1,826	-0.3%
Oil ($/barrel)	$75	$80	+6.7%
Euro per Dollar	0.88	0.93	+5.7%