AMERICAN CAPITAL MANAGEMENT

ECONOMIC & INVESTMENT OUTLOOK
WINTER 2024

Investment Perspective

We are experiencing a "pause that refreshes" which is a favorable outcome given the Federal Reserve's historic tightening cycle

The stock market rebounded in 2023 after declining in 2022. The S&P 500 (SPX) was propelled by the Magnificent Seven which represented 28% of its market capitalization at year end. The unweighted SPX only gained 13.9% for the year. Today, the investment outlook is improving and the list of uncertainties is narrowing. Recession fears have faded as employment has remained strong and credit conditions are stable. Earnings growth slowed over the last two years as many economic indicators flashed warning signs of recession but earnings are now forecast to accelerate. We are experiencing a "pause that refreshes" which is a favorable outcome given the Federal Reserve's historic tightening cycle. To validate this renewed investor enthusiasm, the major market indices recently hit record highs surpassing the previous highs in early 2022. Today, the combination of improved earnings growth, moderating inflation and the forecast of monetary easing by the Fed is increasing investor confidence. Almost nine trillion dollars of cash on the sidelines and improving trends in merger and acquisition activity add further conviction. A summary of index returns for the year ending December 31, 2023 is as follows:

Dow Jones Industrials	16.2%	Russell 2500	17.4%
MSCI EAFE	18.9%	S&P 500	26.3%
NASDAQ Composite	44.6%	Wilshire 5000	26.1%

GLOBAL ECONOMY

World economic growth will soften to 2.3% this year after a year of better-than-expected growth in 2023. Last year was supposed to be a "recession year" followed by a "recovery year" in 2024, but the script reversed. Softness is now expected through mid-year with strength thereafter as monetary easing helps support growth. From a regional perspective, the U.S. remains one of the most vibrant economies while Europe and Japan are experiencing slow growth with the Eurozone at 0.4%, the U.K. 0.3% and Japan 0.7%. China is expected to grow over 4%, which is above average versus other regions. However, its downshift from higher growth has been a drag on its trading partners, especially Germany and United States. China is wrestling with deflation, moderating consumer spending, real estate debt problems and a slowdown in manufacturing. At the same time, it is trying to reduce its dependence on property development-led growth that fueled much of its historic success with targeted stimulus measures. The path of global economic growth is dependent upon lower inflation allowing the major central banks to reduce interest rates. This inflection point is near.

Softness is now expected through mid-year with strength thereafter as monetary easing helps support growth

The U.S. economy is performing significantly better-than-expected primarily due to consumer spending and a tight labor market. GDP growth surprised to the upside in the second half of last year with gains of 4.9% and 5.3%, respectively, in the third and fourth quarters. This was shockingly strong compared to the consensus call for recession. For

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

Economic activity in the services sector expanded in January for the 13th consecutive month as the purchasing managers index (PMI) for services registered 53.4

2024, estimated GDP growth is 2.0% after a gain of 2.5% last year. Consumer expenditures will have another year of growth due to the combination of gains in disposable personal income and the wealth effects of rising home and stock prices. Residential investment, which has been weak due to rising interest rates, has recently rebounded. Non-residential construction is benefiting from federal legislation, such as, the CHIPS and Inflation Reduction Acts, to promote infrastructure development and semiconductor plant construction. Spending on software and technology continues to contribute to growth as does government spending. Economic activity in the services sector expanded in January for the 13th consecutive month as the purchasing managers index (PMI) for services registered 53.4. With the unemployment rate at 3.7% in January, wages are rising with average hourly earnings up 4.5% y/y. However, a risk to the outlook is the possibility of a slowdown in consumer spending after an elongated period of healthy consumption. From a manufacturing perspective, activity levels are soft, but not dire. The manufacturing PMI registered 49.1 in December, up two percentage points from the prior month. On balance, the overall economy is growing although there have been minor weaknesses impacting certain sectors such as banking, digital ad spending, durable goods, real estate, and transportation. None of these weaknesses have spilled over to create wider economic contagion, which is a testament to the broad-based strength of the economy. Overall, the U.S. economy is demonstrating enough resilience to produce a "soft landing" which is positive for consumers and investors.

INTEREST RATES & INFLATION

The messaging around monetary policy suggests a significant inflection point is near and the financial markets are cheering this pivot

We expect two or three reductions in the fed funds rate this year, which will help reduce interest rates across the maturity spectrum. The Federal Reserve will remain data dependent and will reduce interest rates only after gaining greater confidence that inflation is moving sustainably toward 2%. Most recently, the Fed left the fed funds rate unchanged at its meeting on January 31. It said that the risks to achieving its employment and inflation goals are moving into better balance. It last increased the fed funds rate by 25 basis points on July 26, 2023 to 5.50% -- the longest stretch of no action since the central bank began increasing rates in March 2022. In addition, it continues to evaluate quantitative tightening and may moderate its balance sheet reduction process, which would be a stimulative measure. The messaging around monetary policy suggests a significant inflection point is near and the financial markets are cheering this pivot.

The monthly inflation report continues to play a dominant role in investor psychology. Investors are searching for indications that confirm core inflation will return to the 2% range. The consumer price index (CPI) in December was 3.4% y/y and core inflation (CPI excluding food and energy) rose 3.9% y/y. 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 2.9% y/y in December. We expect further relief over the intermediate term that will support Fed easing, especially as the long lags of softer housing rents work their way into the CPI statistics. For example, the shelter component of CPI, which comprises 35% of the index, was up 6.3% y/y in December due to the various techniques for measuring housing costs. In contrast, an analysis of real-time market-based data indicates housing inflation is decelerating. Overall, bond investors have a constructive view that inflation will decline to acceptable levels as the 10-year Treasury yield is now 4.25% versus 5.00% in mid-October. Investors are beginning to price in positive real interest rates after an extended period of negative rates. This is another example of the return to a normal trend.

DEGLOBALIZATION & GEOPOLITICAL TENSIONS

These tensions divide the world and disrupt the multi-decadal trend of globalization that goes back to the end of the Cold War

The military, political and economic environments are becoming more fractured. The war between Russia/Ukraine and Israel/Gaza are continuing. In addition, the Houthis in Yemen are attacking shipping and western naval vessels in the Red Sea and Gulf of Aden. Iranian backed militia groups are also attacking U.S. troops in Jordan and Syria with recent casualties. The U.S. is retaliating, and these conflicts could trigger a major escalation. In addition, the Mideast is dealing with an underlying struggle for regional influence between Shia and Sunni ideologies, which is also highlighted geographically by Arabian and Persian influences battling for regional power. As a result, there are multiple geopolitical hotspots. Meanwhile, North Korea remains a volatile wildcard. These tensions divide the world and disrupt the multi-decadal trend of globalization that goes back to the end of the Cold War. Today, security is a priority. This includes national security first along with biological, cyber, energy, food, and semiconductor security. The "peace dividend" of past years is gone and significant U.S. resources are being allocated to address the inadequate supply of domestically produced military equipment, semiconductors, and technology. Deglobalization and reshoring themes are replacing globalization as a dominant trend. It is important to note that U.S. energy security has dramatically improved since 2001 with the U.S. production of oil and gas significantly greater than the early 1970s. In contrast, Europe is heavily dependent on imported oil and gas, especially Russian gas. From an investment viewpoint, rising geopolitical tensions increase fear and decrease confidence. Today's military conflicts add concern to the world's global growth prospects.

Deglobalization and reshoring themes are replacing globalization as a dominant trend

INVESTMENT OUTLOOK

The financial markets are entering a period of normalization after four years of extraordinary events. These included the pandemic, massive stimulus, a sharp rise in asset prices followed by a major correction in 2022, the steepest Fed tightening cycle in history, the highest inflation since 1980 and the lowest unemployment rate since 1969. Considering these factors, the investment environment is transitioning to a more normal operating profile of low GDP growth, moderating inflation, and double-digit earnings gains. Furthermore, the yield curve is likely to normalize after being inverted for nearly two years. Investors are already discounting this normalization by pushing the S&P 500 (SPX) and Dow Jones Industrials (DJIA) to record highs.

The yield curve is likely to normalize after being inverted for nearly two years

We expect SPX operating earnings per share to grow 12% in 2024 to $246. This follows no growth last year as earnings plateaued for two years (2022 & 2023) at the $220 level. However, it is important to note that earnings were expected to decline last year. Flat earnings beat expectations and positively influenced investor sentiment. This year's increase is supported by above-average revenue growth coupled with productivity led margin improvement. There is evidence that companies are using AI (artificial intelligence) based solutions and improving productivity. Furthermore, interest sensitive sectors should rebound from the negative impact of higher interest rates. Currently, the SPX is valued at 20.2x earnings versus its long-term average of 16.6x. The current environment supporting above-average valuations remains dependent upon moderating inflation and long-term interest rates in the 3.50-5.00% range. For example, when the 10-year Treasury yield hit 5% on October 19th, the SPX was 15% lower than current prices, which highlights the importance of decelerating inflation.

Looking ahead, we expect a broadening of the stock market associated with the reduction in interest rates

From a technical perspective, there are two important trends to monitor. First, the broader stock market lacks breadth as investors have narrowed their focus on mega capitalization companies, such as the Magnificent Seven. This is contributing to a two-tiered stock market with equally weighted and smaller capitalization indices underperforming. Looking ahead, we expect a broadening of the stock market associated with the reduction in interest rates. Second, there is almost nine trillion dollars in cash on the sidelines. Cash is king as money market funds offer 5% yields for the first time in over 15 years. However, investor investment may shift to cash is trash as interest rates decline fueling market strength. As the soft landing becomes a reality, we expect investor rotation into quality small and medium sized growth companies.

There is an old saying, "as January goes, so goes the year." Since WWII, whenever January rises, the year is up 85% of the time with an average return of 16%. The SPX gained 1.7% in January. This is also a presidential election year and for the nine election years with positive January returns, the SPX gained an average 15.6% and rose 100% of the time. Finally, this is the "Year of the Wood Dragon" according to Chinese tradition, which is a symbol of ambition, excitement, and strength. The SPX was up 15.9% in the last dragon year of 2012 and the past eight dragon years produced an average return of 14.4%. These are bullish signs for the stock market in 2024.

This constructive stance is evidenced by new record highs for the SPX and DJIA supported by the likelihood of a soft landing

The stock market environment is improving as investors position ahead of the Fed's pivot to a more accommodative monetary policy. This constructive stance is evidenced by new record highs for the SPX and DJIA supported by the likelihood of a soft landing. About 18 months ago, it seemed likely that a recession would occur given the sharp rise in interest rates, but it is becoming clearer that the economy may have experienced a series of rolling mini-recessions in 2022 and 2023 that caused a slowdown, but not a decline. This may have been the "pause that refreshes." It is important to remain alert and cautious for signs of a re-ignition of inflation as that would change the market's outlook on interest rates and valuations. The key risks include China's slowdown, cyber-attacks, disappointing earnings, geo-political conflicts, higher inflation, recession, 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. This market segment is better positioned than usual given the upcoming monetary easing cycle. We are cautiously optimistic that the recent new highs confirm the bull market cycle that began on October 12, 2022 and a favorable environment for stock prices in the years ahead.

Appendix: Summary of Key Economic and Financial Measures

	Yearend 2022	Yearend 2023	Difference/ Change
Fed Funds Rate (%)	4.50	5.50	+100 bps
10 Yr. Treasury Yield (%)	3.88	3.88	0 bps
Inflation (CPI y/y % ch.)	6.50	3.40	-310 bps
Gold ($/oz.)	$1,826	$2,063	+13.0%
Oil ($/barrel)	$80	$72	-10.0%
Euro per Dollar	0.93	0.91	-2.2%