Outlook

MIDYEAR ISSUE JUNE 2019

CAPITAL GROUP®

Long-term perspective on markets and economies

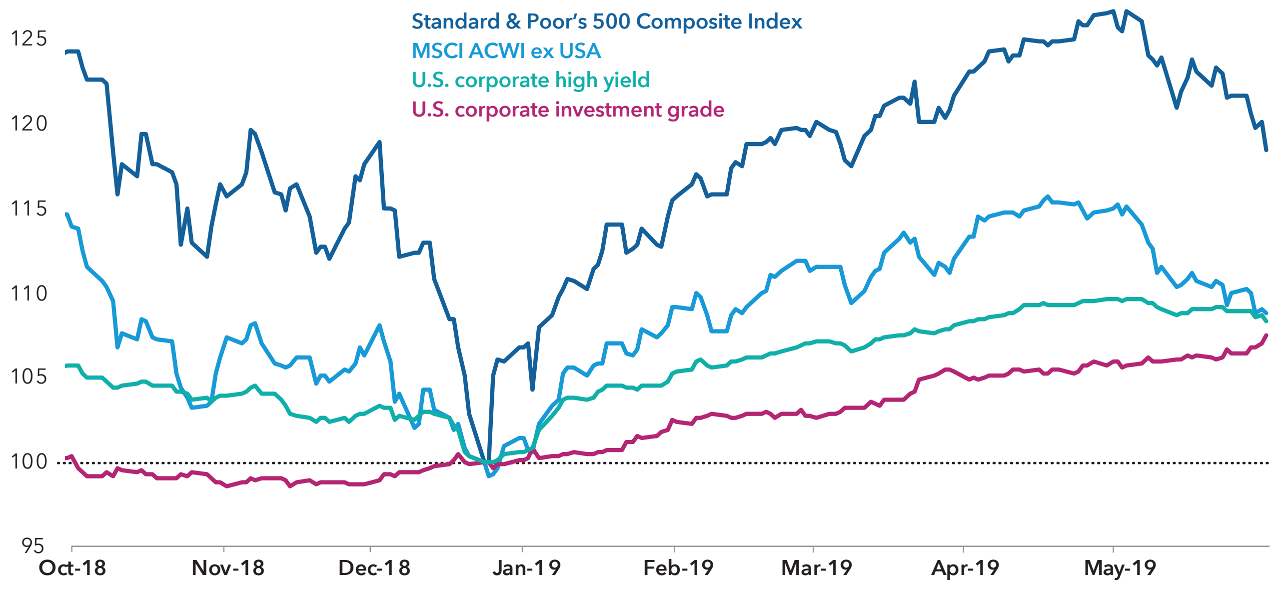
Pivot point: Central banks let markets fly higher.

What a difference six months makes. The most consequential change in the global financial markets since our last Outlook report was the U.S. Federal Reserve's decision to stop raising interest rates. In a major policy shift, Fed officials hit the pause button in January, prompting investors to conclude that the central bank will keep rates steady this year.

Other central banks around the world have echoed that dovish tone. The European Central Bank revived a previously halted stimulus plan and indicated that negative interest rates would remain in place through the end of 2019. China ramped up its stimulus efforts. And Japan, the world champion of quantitative easing, forged ahead with its massive and long-running asset purchase program.

These moves helped to fuel a powerful first-quarter rally in global equities. Technology and consumer tech stocks led the way, including Apple, Microsoft and Amazon. A setback in U.S.-China trade talks tempered equity gains somewhat, but from a monetary policy standpoint, the stage has been set for potentially solid returns ahead. At the very least, central banks aren't expected to get in the way.

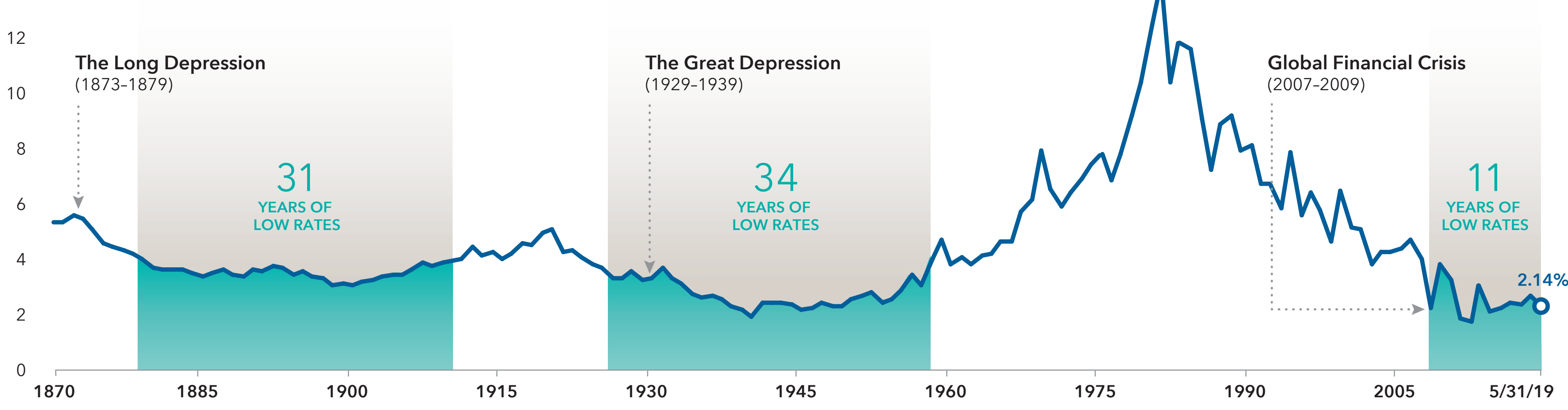
Markets abruptly changed direction amid major shift in global monetary policy



SOURCES: MSCI, RIMES, Standard & Poor's. As of 5/31/19. Total returns indexed to 100 at the S&P 500 market trough on 12/24/18.

Lower-for-longer rates extend the cycle.

History shows that U.S. long-term rates can remain low for extended periods



Turns out, fears that rising rates would soon put an end to the cycle were greatly exaggerated. After climbing in the fourth quarter of 2018, longer term interest rates have declined, thanks in part to the Federal Reserve's policy turnaround.

Rates are low by historical standards and could remain so, even if the Fed resumes its hikes later this year.

That's because muted global growth, low government bond yields abroad and international trade disputes should weigh on long-term interest rates.

While inflation pressures are building in the U.S., inflation on the whole remains mild. This means the 10-year-old expansion seems likely to continue into 2020.

Lower rates also are supportive of earnings growth, suggesting stocks could appreciate in the second half of the year. However, given elevated valuations, ongoing trade disputes and rising volatility, investors may want to approach equity markets with caution. With respect to bonds, focus more on credit risk than rates. Reaching for yield late in the cycle may prevent bond portfolios from providing stability when the next downturn occurs.

SOURCES: Federal Reserve, FactSet, Robert Shiller, Thomson Reuters. Data for 1871–1961 represents average monthly U.S. long-term government bond yields compiled by Robert Shiller. Data for 1962–2018 represents 10-year Treasury yields as of December 31 each year within the period. 2019 data as of 5/31/19. Length of low rate periods above are consecutive years with rates below 4%.

But make no mistake, late-cycle conditions are mounting.

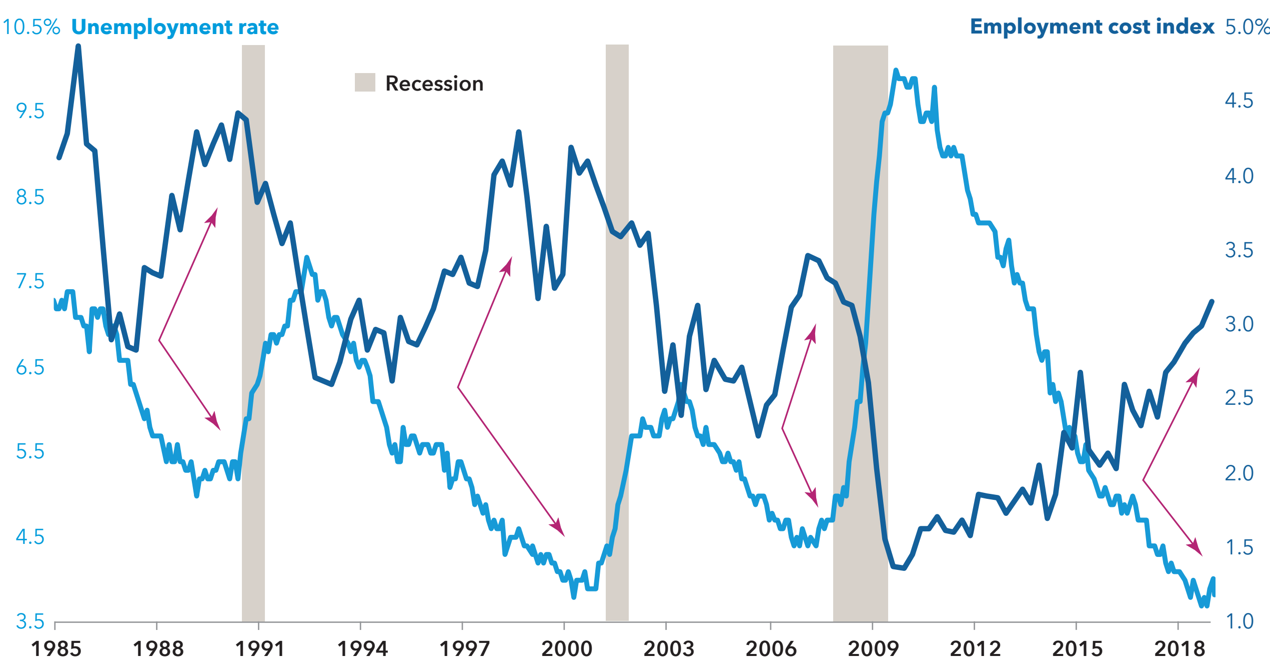
Easy Fed policy. Low rates. So, risk on? "An extended cycle suggests a longer runway for corporate earnings growth, so equities still have the potential to offer some modest appreciation in 2019," says U.S. economist Darrell Spence. But investors would be well-advised to approach stock markets with a measure of caution.

"Whether it's rising wages or a tight labor market, the economy continues to exhibit late-cycle characteristics," adds Spence. These are likely to become more pronounced, placing stress on companies and the economy. The unemployment rate stood at 3.6% in April, a number not seen since December 1969. Such low unemployment typically translates into rising wages.

But while higher wages tend to encourage stronger consumer spending, rising labor costs inevitably pressure profit margins and trigger market volatility. "And the potential for escalation of the U.S.-China trade dispute is a clear risk to growth," adds Spence.

Under the circumstances, the Fed's about-face and the ensuing stock market rebound may be regarded as an opportunity to position for a tougher environment down the road.

Labor costs are finally rising, placing added pressure on corporate profits



SOURCES: Bureau of Labor Statistics, Thomson Reuters. Employment Cost Index uses quarterly data as of 3/31/19. Unemployment rate uses monthly data as of 4/30/19.

Beware of companies spending more than they earn.

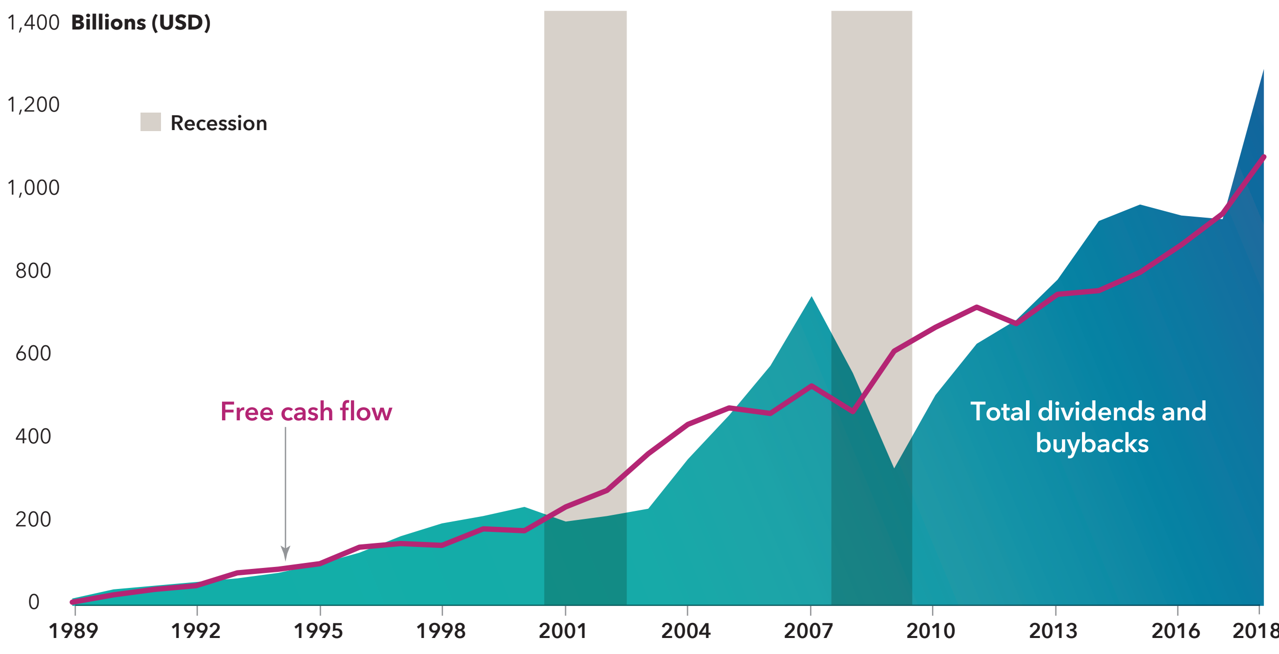
Where are the excesses today – and what are the risks? You might find them on the bloated balance sheets of companies that have been on a debt binge. At the close of 2018, non-financial corporate sector borrowing stood at 46.7% of GDP, a record high.

Much of this cheap debt has been used to fund dividends, share buybacks, and mergers and acquisitions. Since 2013, dividends and buybacks have generally exceeded free cash flow levels. Debt issuance has covered the shortfall. In many cases, this strategy has artificially inflated earnings per share growth, driving up stock prices.

Such financial engineering cannot continue indefinitely. Many companies will need to go on a debt diet – either because of rising rates or tighter credit conditions – and dividends, buybacks and M&A will need to be reduced. This will pressure stock valuations and potentially trigger a wave of debt write-offs.

But without a catalyst such as higher interest rates or slower economic growth, these excesses will continue to build, leading to elevated market volatility down the road.

Dividends and buybacks have exceeded free cash flow levels since 2013



SOURCE: Capital Group. Universe is made up of 2,902 non-financial U.S.-based companies that represent more than 98% of the U.S. public equity market. As of 12/31/18.

Not all dividend payers are equal – or sustainable.

After 40 years investing in dividend-paying companies, Joyce Gordon knows a thing or two about identifying those most likely to sustain their payments in a downturn.

"One lesson I learned is to pay close attention to companies with too much debt," says Gordon, a portfolio manager for American Mutual Fund®. "Those with significant debt face numerous challenges. For example, they may feel pressure to cut their dividend to maintain an investment-grade credit rating."

When you look at pairs of companies across different industries you can see those with a lower credit rating and lower interest coverage ratio might be more likely to cut their dividends when times get tough.

For example, Nestlé, with a manageable debt burden, hasn't done so in decades. Conversely, more highly leveraged Kraft Heinz recently cut its dividend. "That's why it's so important to look beyond simple dividend yield and do the research on whether companies can sustain them," Gordon says. "The longer this expansion goes on, the more attention I pay to company debt."

Companies with manageable debt may be more able to maintain dividends

Company	Dividend yield	Interest coverage ratio	Credit rating
Daimler	7.0%	14.2x	A
Ford Motor	6.3	2.5	BBB
Nestlé	2.5	18.9	AA-
Kraft Heinz	5.8	4.5	BBB
ExxonMobil	4.9	15.2	AA+
Valero Energy	5.1	8.4	BBB
Procter & Gamble	2.9	29.2	AA-
Clorox	2.6	14.2	BBB+

SOURCE: FactSet. Interest coverage ratio as of 12/31/18. Dividend yield and credit ratings as of 5/31/19. If credit ratings between Moody's and S&P credit rating agencies differ, the more conservative measure has been used. The interest coverage ratio is used to determine how easily a company can pay their interest expenses on outstanding debt. The ratio is calculated by dividing a company's earnings before interest and taxes by the company's interest expenses for the same period.

Health care has innovation in its DNA.

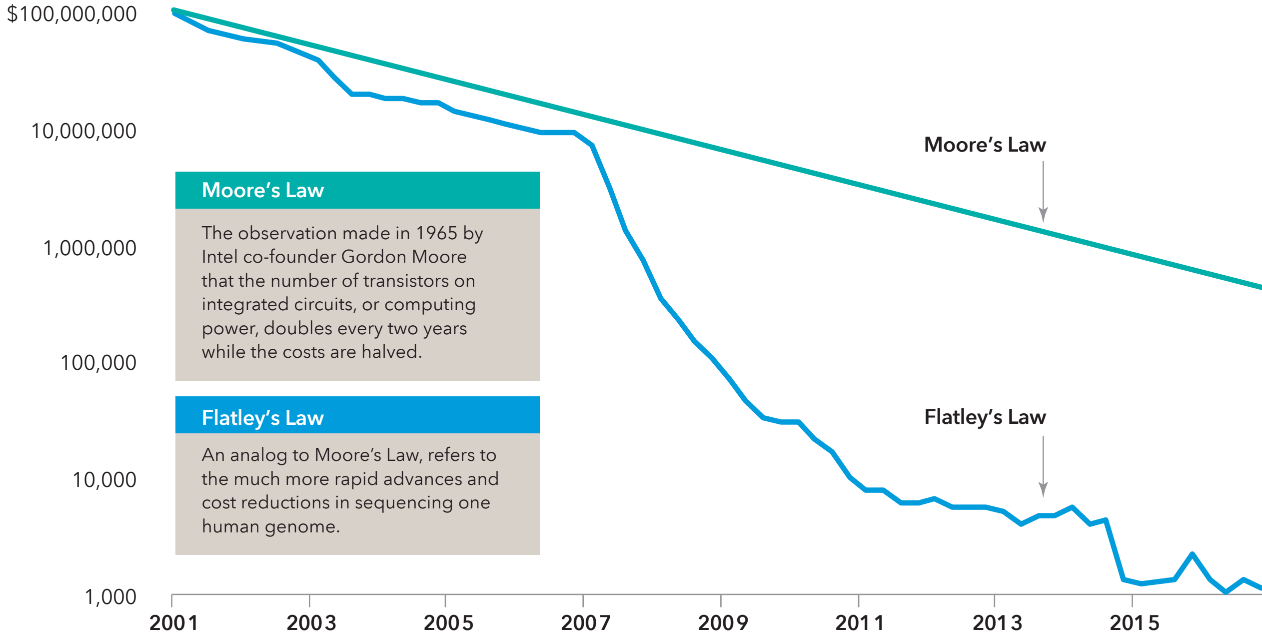
Innovation is a topic that gets Anne-Marie Peterson excited about coming to work every day. "Innovation improves people's lives and drives growth and opportunity for companies," says Peterson, a portfolio manager with The Growth Fund of America®.

Consider, for example, rapid innovation in health care. Advances in genomics have decreased the cost of sequencing a set of human genes from $100 million in 2006 to about $1,000 today.

Therapies derived from genetic testing have the potential to extend lives and generate billions of dollars in revenue. U.S. drugmakers AbbVie and Merck, the maker of blockbuster immunotherapy treatment Keytruda, have invested millions of dollars to develop genetic-based treatments for various cancers.

It's not just the drugmakers making advances. "I am interested in companies that are arms dealers to the pharmaceutical industry, providing manufacturing and research," says Peterson. Genetic testing equipment maker Illumina is a leader in sequencing technology, while Thermo Fisher Scientific provides research and manufacturing resources to a host of drug developers. Of course there are risks, such as the steep cost of research and development and public debate over drug pricing, so selective investing is essential.

Gene sequencing costs have fallen far quicker than the pace set by Moore's Law



SOURCE: National Human Genome Research Institute. Data as of 7/31/17.

Think all the best stocks are in the U.S.? Think again.

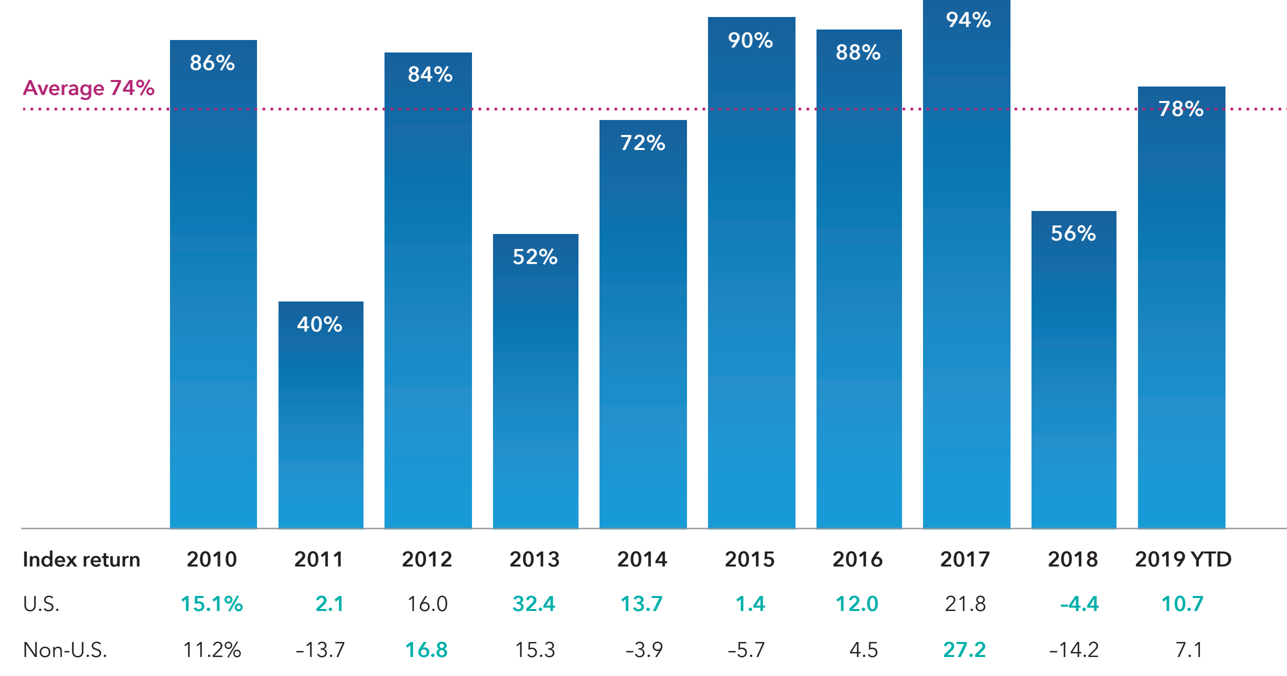
While it's true that international equities have lagged U.S. markets over the past decade, the index-based returns that most investors follow don't tell the whole story. On a company-by-company basis, the picture is significantly different than you may think.

Since 2009, the top 50 companies with the best annual returns were overwhelmingly based outside the United States. In many of those years, 80% to 90% carried a non-U.S. address. That means if you had decided to ignore international equities, you would have missed a shot at many of the best opportunities.

In certain sectors, the U.S. is not the most dominant player. Many premiere luxury goods companies, such as LVMH and Kering, are found in Europe. (Think Louis Vuitton, Fendi and Gucci.) Japan is home to a number of cutting-edge robotics firms, including Murata and Fanuc. Big pharma has no shortage of innovative drug companies in Europe: AstraZeneca, Novartis, Novo Nordisk.

In addition, dividend-paying companies outside the U.S. tend to offer higher yields. All reasons to consider maintaining a healthy allocation to international stocks, even if you think U.S. markets will continue to lead the way.

What percentage of the top 50 stocks each year are non-U.S.?



Index return	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019 YTD
U.S.	15.1%	2.1	16.0	32.4	13.7	1.4	12.0	21.8	–4.4	10.7
Non-U.S.	11.2%	–13.7	16.8	15.3	–3.9	–5.7	4.5	27.2	–14.2	7.1

SOURCES: RIMES, MSCI. 2019 as of 5/31/19. Returns in U.S. dollars. S&P 500 Index and MSCI ACWI ex USA used for U.S. and non-U.S. returns.

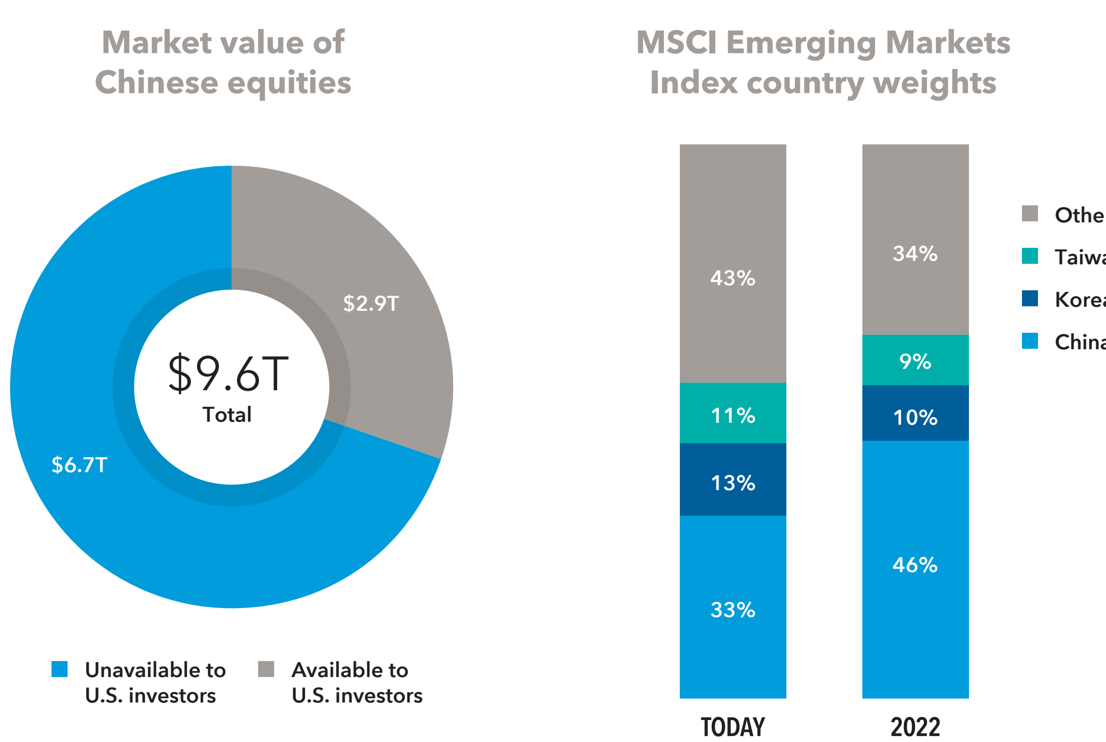
Look past trade: China's stock market is opening up.

Investor worries about China are ubiquitous. What are the implications of China's slowing economy? Will a brewing trade war with the U.S. derail a fragile recovery from the global financial crisis? Could internal political strife result in a reversal of China's ambitious reform efforts?

While those are important questions, there is a more relevant story unfolding for long-term investors. Trade disputes aside, the veil is lifting on China's domestic stock market. More than 800 companies previously off limits to foreign ownership are expected to become available to investors outside of China during the next few years.

That is a stock picker's dream come true. Even if only a small fraction of those companies wind up being viewed as attractive investment opportunities, the extensive research needed to identify them should be well worth the effort. Imagine finding the next Alibaba, Baidu or Tencent in that mix. The implications for investors are profound.

Despite sometimes daunting headlines, China's stock market will continue to be driven by foreign capital inflows. Participating in this rapidly growing market will be paramount for investors seeking broad diversification and long-term growth of capital.



SOURCES: Capital Group, MSCI, RIMES. As of 3/31/19. Currently available investments include MSCI China IMI and MSCI China A Index. Currently unavailable investments include all other publicly traded Chinese equities, which are generally restricted to foreign investment. 2022 estimate of country weights assumes that A-share mid caps are added to the index, and A-share inclusion is increased to 100% by 2022.

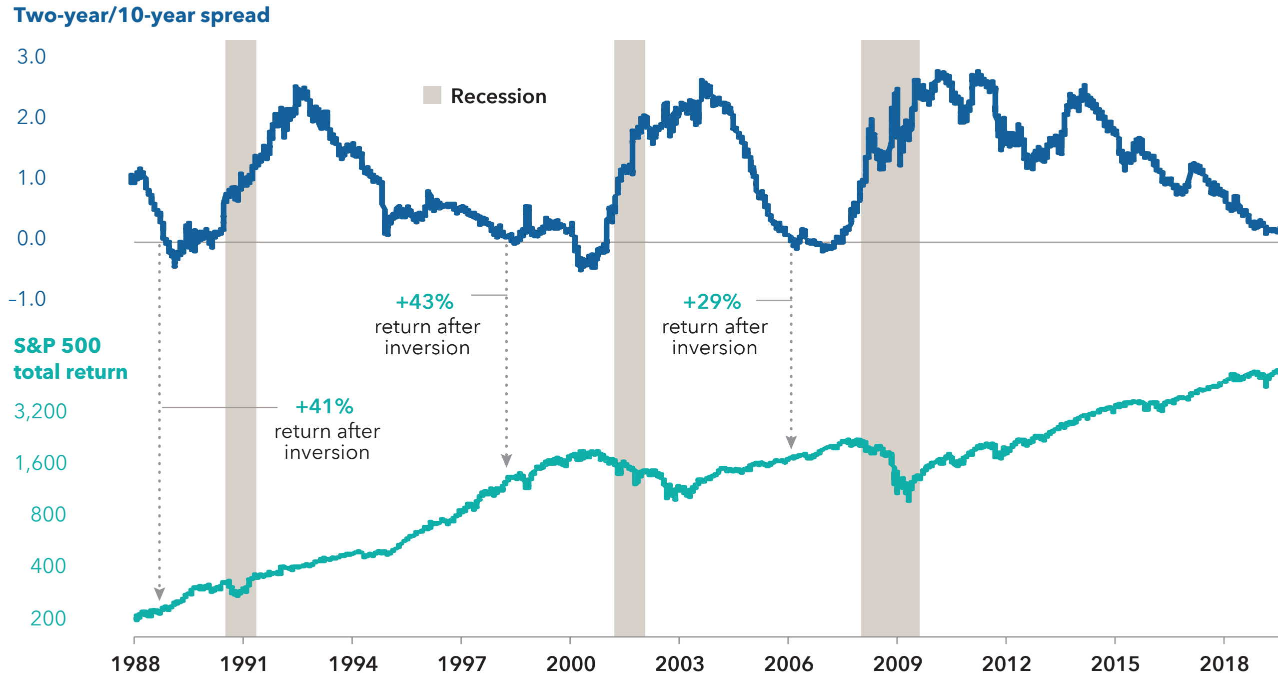
Don't overreact to a yield curve inversion.

An inverted yield curve is one of the most widely cited recession indicators, but is it really cause for immediate concern? Probably not. While the measure's consistency can't be denied – an inversion has preceded every U.S. recession over the past 50 years – its lead time has been significant. The 16-month average between inversion and the onset of a recession has left time for equity markets to continue their rally. Over the last three cycles, stocks averaged a 37% return from the point of inversion until the subsequent market peak.

The closely watched two-year/10-year curve hasn't inverted yet, and as the Fed takes a more dovish tone it may not for some time.

The takeaway for investors? An inverted yield curve does not cause a recession, but is just another sign of a late economic cycle. So instead of using it as a reason to panic, investors should think of it as a gentle reminder to check that their portfolios are well diversified and their core bond holdings limit excess risk. During a late cycle it is especially critical to determine if the type of bonds within one's portfolio are providing diversification from equities and the right level of balance.

Markets have continued to rally after previous yield curve inversions



SOURCES: National Bureau of Economic Research, Standard & Poor's, Thomson Reuters. As of 5/31/19. S&P 500 chart shown on a logarithmic scale. Returns after inversion are the total return from inversion until the S&P 500 pre-recession peak during each cycle.

$1.6T bond category shake-up: Morningstar splits out the core.

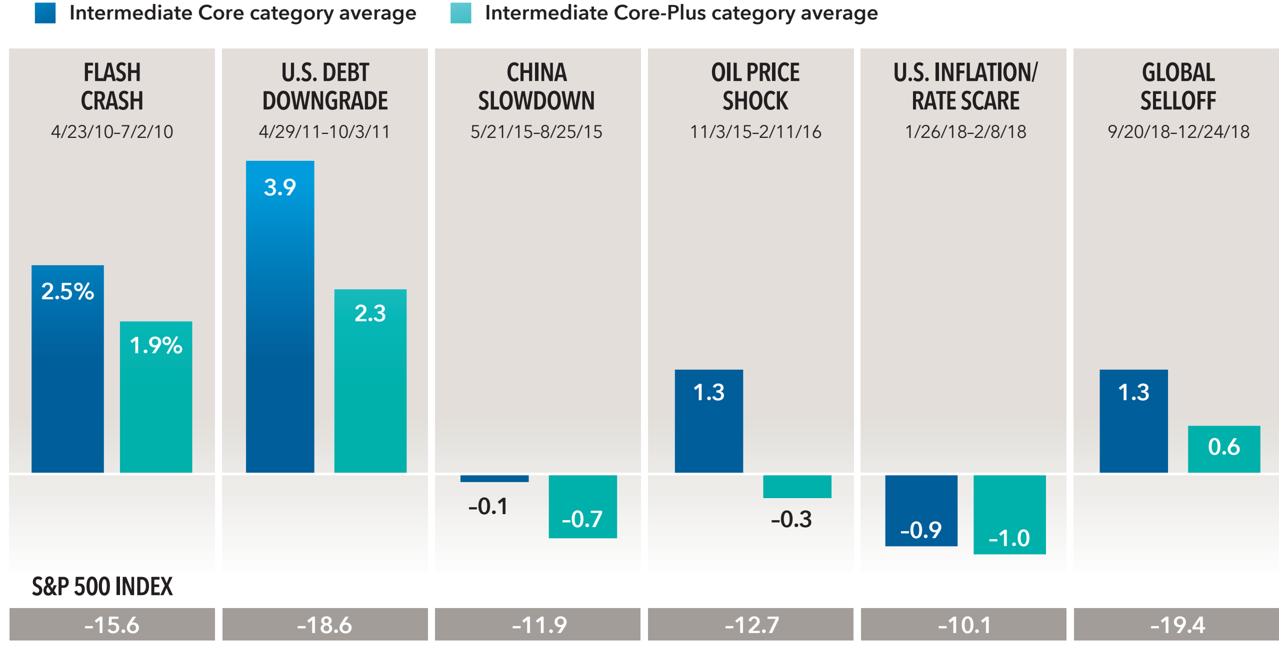
The hunt for yield has led to an uncomfortable truth: Many strategies regarded as core fixed income are not what they seem.

For years, we've cautioned investors to ensure their core bond fund isn't overemphasizing income at the expense of equity diversification. Turns out we weren't the only ones concerned by unintentional risk in core.

On April 30, Morningstar split its $1.6 trillion Intermediate-Term bond category – home to most funds chosen for core fixed income allocations – in two. Going forward, funds from the defunct category with less than 5% of their portfolio rated below investment grade move into the new Intermediate Core category. The new Intermediate Core-Plus category will be home to most of the other funds, many of which seek higher income and show high equity correlation due to greater exposure to high yield.

Morningstar's decision should help investors more easily distinguish strategies that may be vulnerable in stock market declines from those which offer a balance of the four key roles of fixed income: diversification from equities, income, capital preservation and inflation protection. Arguably, core should be the largest fixed income allocation in a balanced portfolio for many investors. Greater clarity around core is, therefore, a real win for investors – especially in a late-cycle environment.

When you need core most: cumulative returns (%) during recent market corrections*



*Dates shown for market corrections are based on price declines of 10% or more (without dividends reinvested) in the S&P 500 with at least 50% recovery between declines.

SOURCES: Capital Group, Bloomberg Index Services Ltd., Morningstar, Standard & Poor's.

High income is not all about high yield. Think EM and munis.

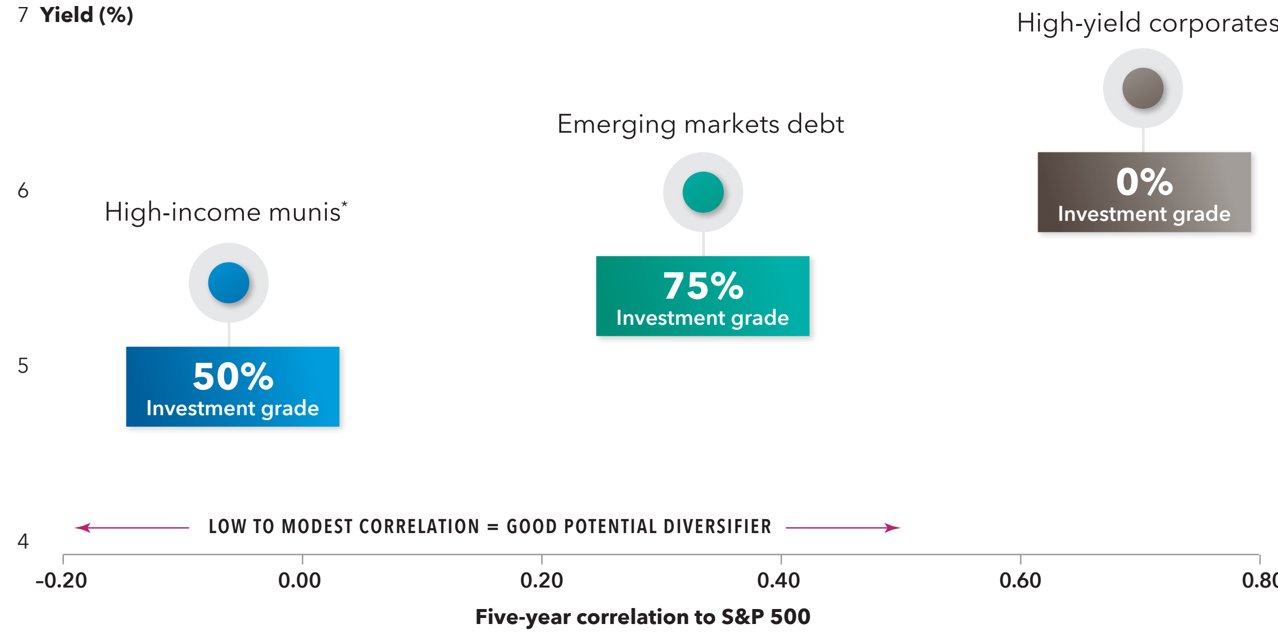
U.S. corporate high yield has been on a tear so far in 2019. Fundamentals remain broadly supportive of the near-term outlook. But amid elevated valuations, this may not be the best time to add exposure.

In comparison to high yield, emerging markets and high-income muni bonds (see page 13 for more on munis) have offered similar yields – with the bonus of better equity diversification.

Emerging markets debt offers a nice balance of yield and modest equity correlation, even among higher quality issuers. For investors, the trade-off here comes in the shape of greater potential volatility due to currency and interest rate moves. And – as underscored by unrest in Venezuela and Argentina – political, fiscal and monetary policy developments can quickly unsettle markets.

With that in mind, a laser focus on country fundamentals is critical. Select emerging markets currencies could appreciate against the U.S. dollar as prospects for tighter monetary policy in the U.S. and other developed markets recede. This possibility, in combination with higher yields, suggest local currency bonds should continue to offer fertile ground for selective investors in coming months.

EM debt and high-income munis balance quality, yield and diversification potential



*Tax equivalent yield: Based on the top federal marginal tax rate for 2019 of 37%. In addition, we have applied the 3.8% Medicare tax. This comes to a combined 40.8% marginal tax rate on investment income for taxpayers in the highest tax bracket.

SOURCES: Bloomberg Index Services Ltd., J.P. Morgan, RIMES, Standard & Poor's, Thomson Reuters. As of 5/31/19. Market proxies: Bloomberg Barclays U.S. High Yield 2% Issuer Capped Index (high yield), blend of 50% Bloomberg Barclays Municipal Bond Index and 50% Bloomberg Barclays High Yield Municipal Bond Index (high-income munis), and blend of 50% J.P. Morgan GBI-EM Global Diversified Index and 50% J.P. Morgan EMBI Global Diversified Index (emerging markets bonds).

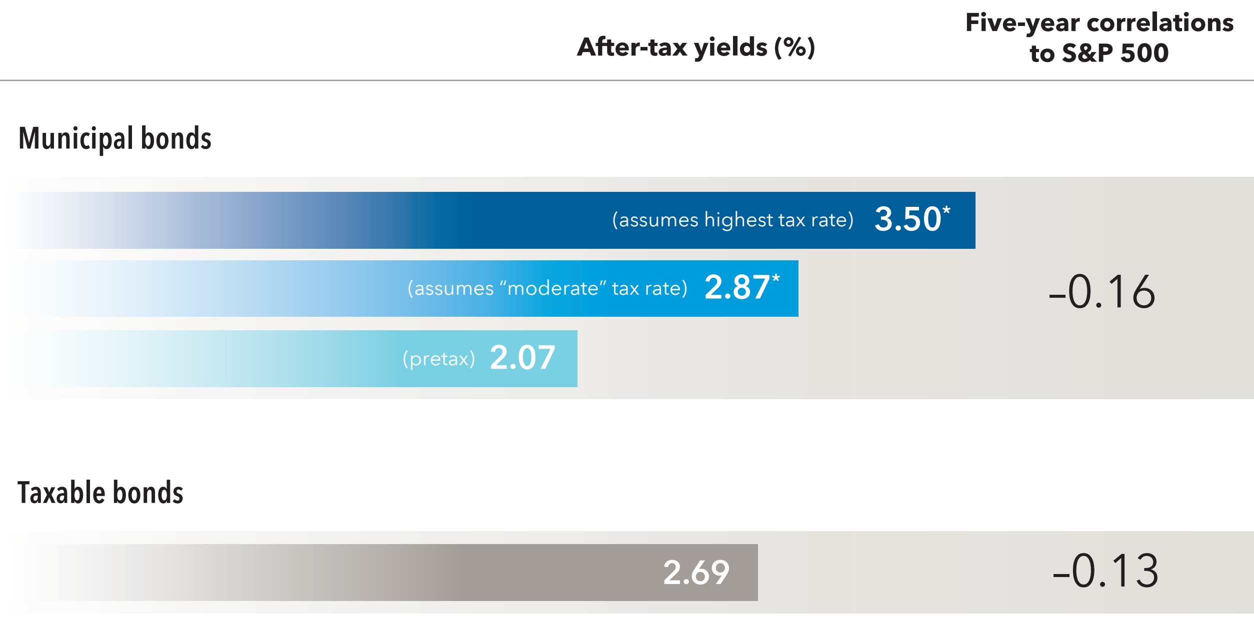
Muni bonds are not just for the wealthiest.

So far, so good for municipal bond returns in 2019. At a time of moderate bond issuance, there's rarely been such demand: By April, muni funds had raked in more investor money than they typically do in a year. With tobacco settlement bonds a notable exception, fundamentals are broadly solid. The asset class has enjoyed a season in the sun.

And yet, the myth that a permanent muni allocation only makes sense for the wealthy persists. Truth is, this perception is seldom correct. Lately, after-tax yields for munis have outpaced taxables for anyone whose marginal tax rate is 24% and above. Indeed, in recent years, this breakeven tax rate (indicating when the muni tax advantage "pays off") has averaged under 15% – well below the top tax rate.

But there's so much more to today's muni opportunity than tax-advantaged income. With the stock market unsettled, munis also offer a vital potential source of equity diversification. Amid high valuations, emphasizing higher quality munis may make sense. Investors looking to add exposure in the coming months should consider waiting for market setbacks to offer more attractive entry points.

Even outside the top income tax bracket, the muni tax advantage can "pay off"

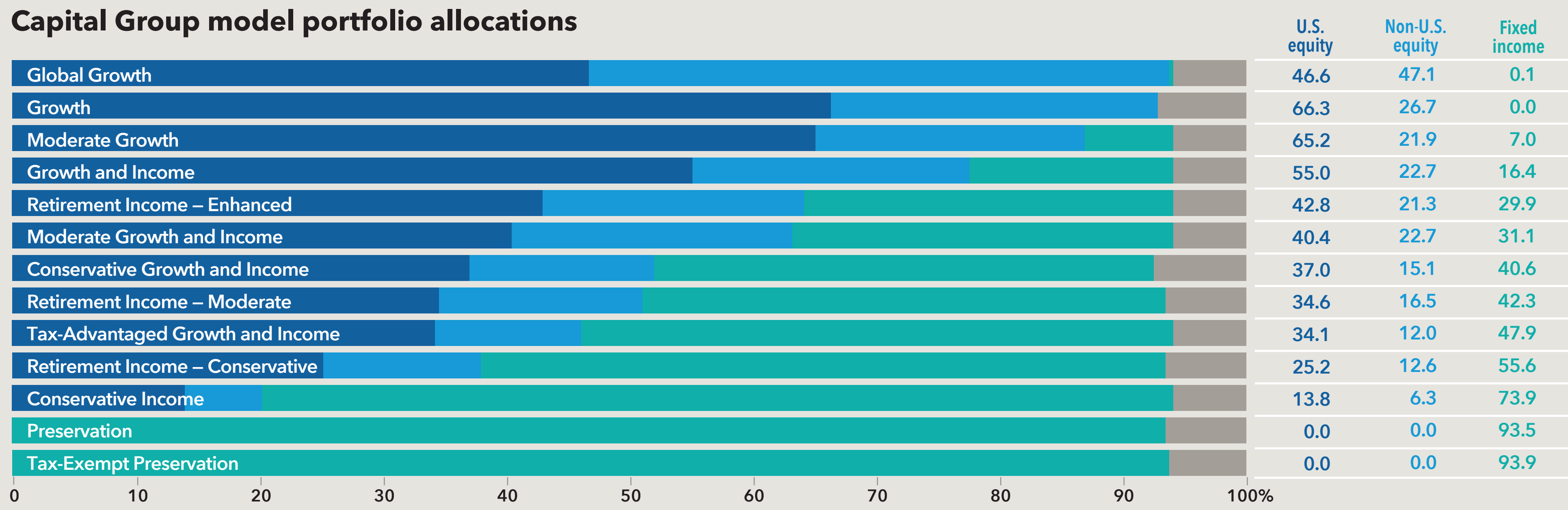


*Tax-equivalent yield: Highest tax rate assumes the 3.8% Medicare tax and the top federal marginal tax rate for 2019 of 37%; "moderate" tax rate assumes the 3.8% Medicare tax and the 24% federal marginal tax rate.

SOURCES: Bloomberg Index Services Ltd., Morningstar, RIMES, Thomson Reuters. As of 5/31/19. Market proxies: Bloomberg Barclays U.S. Aggregate Index (taxable bonds) and Bloomberg Barclays Municipal Bond Index (municipal bonds).

What's the best portfolio allocation for your objectives?

Capital Group model portfolio allocations



	U.S. equity	Non-U.S. equity	Fixed income
Global Growth	46.6	47.1	0.1
Growth	66.3	26.7	0.0
Moderate Growth	65.2	21.9	7.0
Growth and Income	55.0	22.7	16.4
Retirement Income – Enhanced	42.8	21.3	29.9
Moderate Growth and Income	40.4	22.7	31.1
Conservative Growth and Income	37.0	15.1	40.6
Retirement Income – Moderate	34.6	16.5	42.3
Tax-Advantaged Growth and Income	34.1	12.0	47.9
Retirement Income – Conservative	25.2	12.6	55.6
Conservative Income	13.8	6.3	73.9
Preservation	0.0	0.0	93.5
Tax-Exempt Preservation	0.0	0.0	93.9

Make sure your portfolio has the right balance: The first-quarter rally in global equities serves as a stark reminder of how quickly and powerfully markets can react to economic and political events. Rather than trying to time the business cycle, investors should ensure portfolios are broadly diversified with a mix of global stocks and bonds in pursuit of investment success across cycles.

Consider upgrading your equity portfolio: Stocks may have room to run, but it's not too early to prepare for rougher seas ahead. Maintain a balance of growth and dividend-oriented equity strategies, with a focus on companies that have avoided the worst debt excesses of the decade-long expansion. Geographic flexibility is essential, given that most of the top stocks over the last 10 years have been non-U.S. companies.

It's time to revisit your bond allocation: Morningstar split the Intermediate-Term bond category into Core and Core-Plus. Chances are you have too much of the latter category and need to rebalance. Also, consider emerging markets debt and high-income municipal bonds for enhanced income opportunities.

SOURCE: Capital Group. As of 3/31/19. After accounting for U.S. equities, non-U.S. equities and fixed income, the remaining assets are allocated to cash.

2019 Midyear Outlook

ACCUMULATE WEALTH — SPEND WEALTH — PRESERVE WEALTH

U.S. EQUITY The expansion gets extra innings, but it's not too soon to consider upgrading portfolios.	**The Growth Fund of America®** A – AGTHX F-2 – GFFFX F-3 – GAFFX R-6 – RGAGX	**AMCAP Fund®** A – AMCPX F-2 – AMCFX F-3 – FMACX R-6 – RAFGX	**American Mutual Fund®** A – AMRMX F-2 – AMRFX F-3 – AFMFX R-6 – RMFGX	**American Balanced Fund®** A – ABALX F-2 – AMBFX F-3 – AFMBX R-6 – RLBGX	
GLOBAL/INTERNATIONAL EQUITY Think all the best stocks are in the U.S.? Think again. Select companies around the world are creating value.	**New World Fund®** A – NEWFX F-2 – NFFFX F-3 – FNWFX R-6 – RNWGX	**EuroPacific Growth Fund®** A – AEPGX F-2 – AEPFX F-3 – FEUPX R-6 – RERGX	**New Perspective Fund®** A – ANWPX F-2 – ANWFX F-3 – FNPFX R-6 – RNPGX	**Capital Income Builder®** A – CAIBX F-2 – CAIFX F-3 – CFIHX R-6 – RIRGX	
TAXABLE FIXED INCOME To achieve the right risk-reward approach, it's essential to know what you own in core bond portfolios.				**American Funds Emerging Markets Bond Fund®** A – EBNAX F-2 – EBNFX F-3 – EBNGX R-6 – REGGX	**The Bond Fund of America®** A – ABNDX F-2 – ABNFX F-3 – BFFAX R-6 – RBFGX
TAX-EXEMPT FIXED INCOME Municipal bonds aren't just for the wealthiest investors – offering attractive after-tax yield potential and strong equity diversification.				**American High-Income Municipal Bond Fund®** A – AMHIX F-2 – AHMFX F-3 – HIMFX	**The Tax-Exempt Bond Fund of America®** A – AFTEX F-2 – TEAFX F-3 – TFEBX

For high net worth investors, consider our separately managed account strategies, which include our Capital Group U.S. Core℠ offering (which pursues a similar objective as The Investment Company of America®), Capital Group Global Equity℠ and Capital Group International Equity℠.

Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing.

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Market indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index.

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