# Outlook

MIDYEAR ISSUE JUNE 2020

## Long-term perspective on markets and economies

# 2020 Midyear Outlook key takeaways:

MACRO

## Recoveries have been longer and stronger than downturns.

**Expect peaks and valleys on the road to economic recovery,** according to veteran portfolio manager Rob Lovelace. There will be ups and downs, but Rob feels it's a matter of when, not if, we make it across this valley.

**Market recoveries have been powerful after large declines.** The average recovery has delivered 279% cumulative returns and lasted 72 months, compared to a decline of 33% and 14 months for bear markets.

EQUITY

## Companies will drive the next recovery.

**The digitization of daily life is here to stay.** Even with rapid increases in e-commerce, digital payments and media consumption, there are still long runways for growth and years of potential opportunities on the horizon.

**Dividends can be even more important for investors seeking income in a low-rate world.** The combination of record dividend cuts and historically low rates emphasized the importance of being able to identify those companies that can sustain or quickly restart dividend payments.

**If you think all the best stocks are in the U.S., think again.** This year has been a good reminder that most of the best-performing stocks were outside the U.S. It's about companies – not countries or indexes.

FIXED INCOME

## Core strength matters.

**Strong core bond allocations are still a smart strategy.** The fastest equity decline in history showed how important it is to continue to hold mostly higher quality bonds that can withstand stock market volatility.

**We see new opportunities in credit and muni markets.** During this flight to quality, we are taking advantage of select opportunities in corporate credit and municipal bonds.

**Cash is not king.** The recent investor stampede into cash is understandable. But liquid strategies, like short-term bond funds, may help investors seeking more income and diversification from equities.

### CE credit available

As part of our Capital Ideas™ webinar series, earn one hour of CE credit from CFP and CIMA by watching our 2020 Midyear Outlook webinar and completing a short quiz at the following link:

**volatility2020.com**

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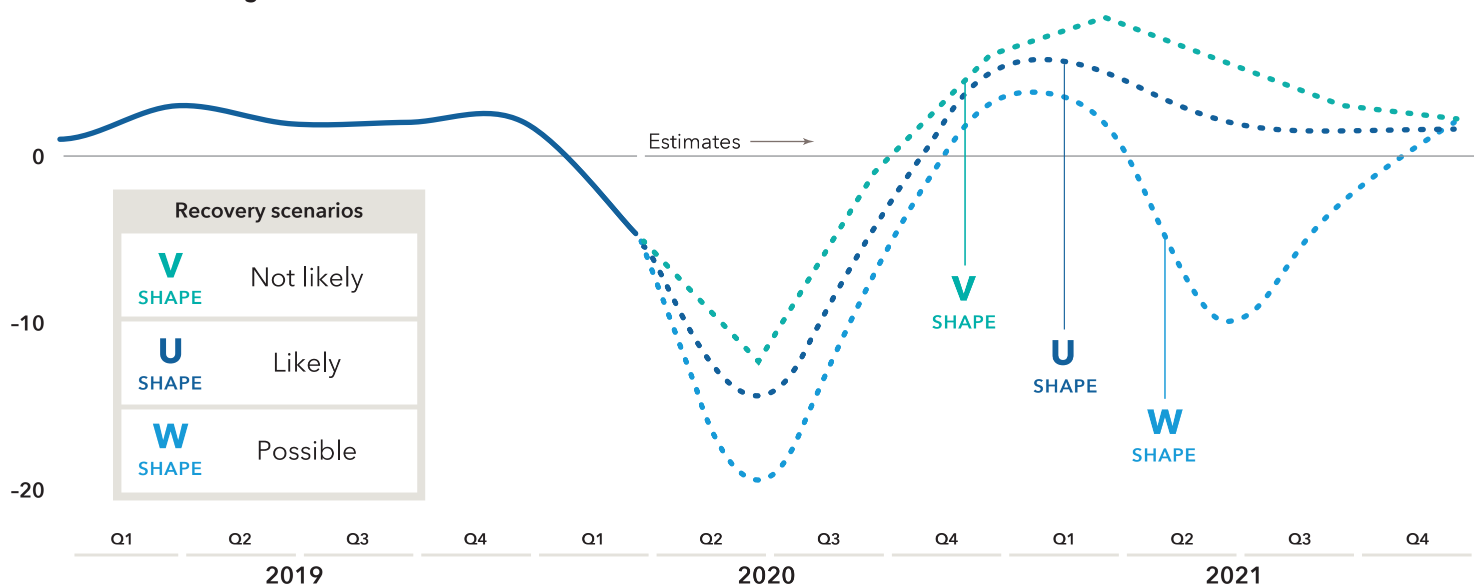
# Expect peaks and valleys on the road to economic recovery

The decade-long economic expansion did not end with a whimper. The coronavirus brought it to a screeching halt. U.S. GDP fell 5.0% in the first quarter, and a steeper decline is likely in the second quarter.

More bad news lies ahead in the short term, starting with the tragic human cost. Historic unemployment will likely have a lasting impact on the economy, and many businesses are failing. The path to economic recovery will depend on the course of the virus and public health response. "I expect a more gradual U-shaped recovery with bumps along the way," U.S. economist Jared Franz explains. "But, as the economy begins to open more broadly, there will likely be a V-shape in some industries like travel and dining."

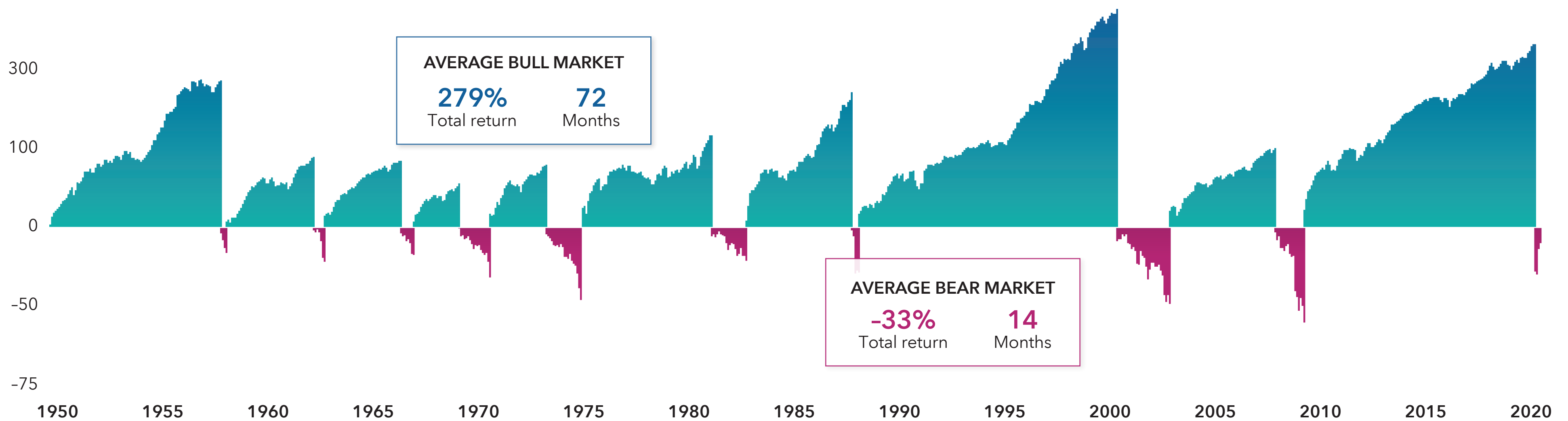
Longer term, there is a silver lining: Because the slowdown was the result of government policy – underlying economic fundamentals were reasonably healthy – a solid recovery is possible, according to Rob Lovelace, vice chairman of Capital Group and an equity portfolio manager. "We can see the other side of the valley, what recovery can look like when policies are relaxed, and that to me is reassuring," Lovelace says.

## Though the shape and pace remain uncertain, a solid recovery is possible




SOURCES: Capital Group, Bureau of Economic Analysis, Refinitiv Datastream. As of 5/31/20. Data for the three recovery scenarios are based on estimates from Capital Group U.S. economist Jared Franz.

# Market recoveries have been longer and stronger than downturns




Bear markets are painful, no doubt about it. And when you're in the middle of one, it feels like it's never going to end. But it's important to remember that during the post-World War II era, bull markets have been far more robust than bear markets, and they've lasted considerably longer as well.

While every market decline is unique, over the past 70 years the average bear market has lasted 14 months and resulted in an average loss of 33%. By contrast, the average bull market has run for 72 months – or more than five times longer – and the average gain has been 279%.

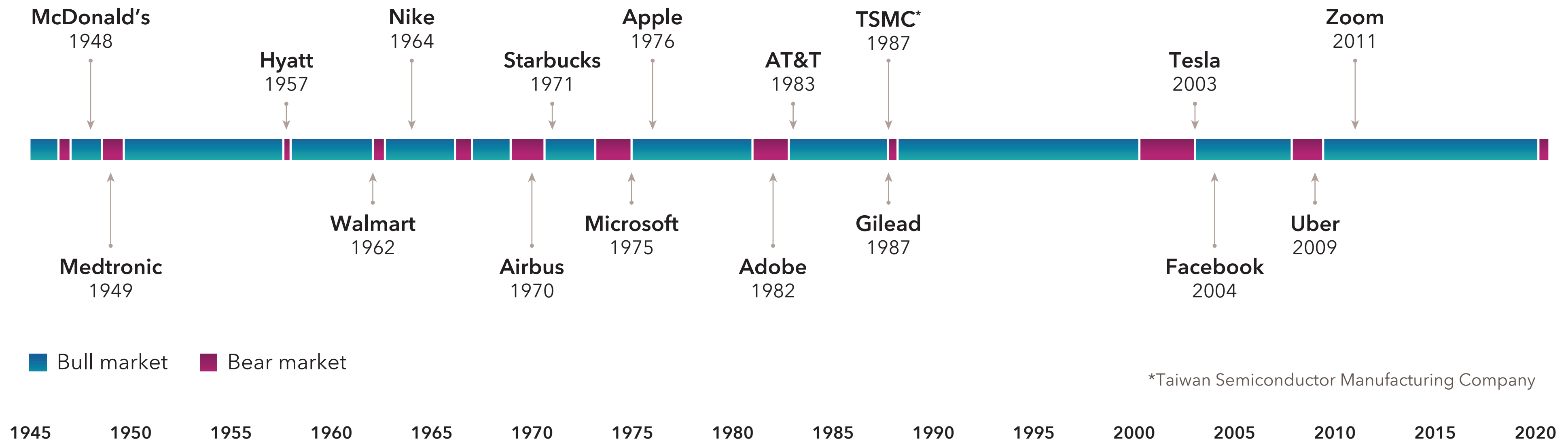
Moreover, returns have often been strongest right after the market bottoms, as investors learned in the last severe downturn. After the carnage of 2008, U.S. stocks finished 2009 with a 23% gain.

Missing a bounce back can cost you a lot, which is why it's important to consider staying invested through even the most difficult periods.

The long-term power of bull markets is hard to understate. Recoveries are rarely a smooth ride, but investors who can look past the short-term volatility and remain focused on the long-term picture have often been rewarded for their patience.

SOURCES: Capital Group, RIMES, Standard & Poor's. As of 5/31/20. The 2020 bear market is considered current as of 5/31/20 and is not included in the "average bear market" calculations. In all other periods, bear markets are peak-to-trough price declines of 20% or more in the S&P 500. Bull markets are all other periods. Returns shown on a logarithmic scale. Returns in USD.

# Tough times have birthed some of the world's leading companies




Tough companies are often started in tough times. The list of examples is lengthy and impressive.

To highlight just a few: McDonald's emerged in 1948 following a downturn caused by the U.S. government's demobilization from a wartime economy. Walmart came along 14 years later, around the time of the "Flash Crash of 1962" — a period when the Standard & Poor's 500 Composite Index declined 27%.

Airbus, Microsoft and Starbucks were founded during the stagflation era of the 1970s, a decade marked by two recessions and one of the worst bear markets in U.S. history. Not long after that, Steve Jobs walked into his garage and started a small company called Apple.

History has shown that strong businesses find a way to survive, and even thrive, in volatile markets and difficult economic conditions. Companies that are able to adapt and grow in tough times often present attractive long-term investment opportunities. Bottom-up, fundamental research is the key to separating these resilient companies from those likely to be left behind.

Which companies will emerge as market leaders after the COVID-19 crisis? Only time, and solid research, will tell.

SOURCES: Capital Group, Standard & Poor's. As of 5/31/20. The 2020 bear market is considered current as of 5/31/20. In all other periods, bear markets are peak-to-trough declines of at least 20%. Bull markets are all other periods.

# Post-COVID market presents opportunity for stock pickers

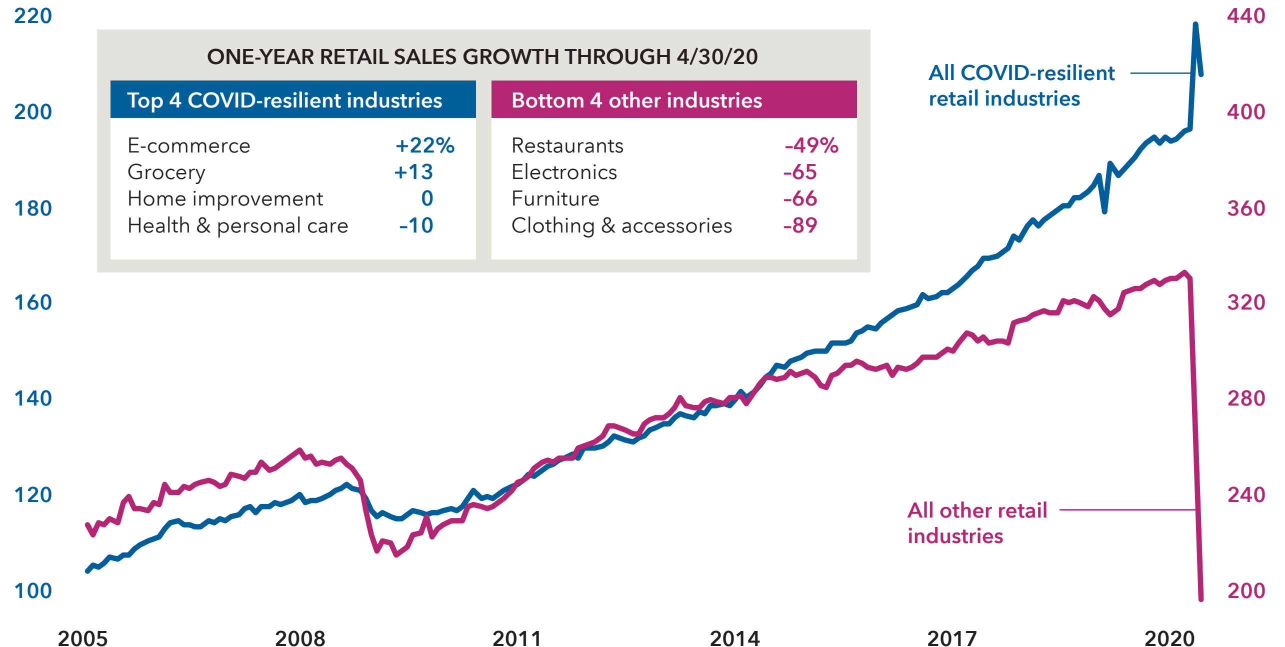
It's no surprise that business has been slow across wide swaths of the American economy. With stores shuttered and consumers mostly sheltering at home, U.S. retail sales slid an unprecedented 16.4% in April, according to the U.S. Commerce Department.

But that's not the whole story. A look beneath the surface of the U.S. stock market shows there has been a stark divide between winners and losers in this era of limited mobility. Not surprisingly, online retailers and grocers have enjoyed strong sales growth as consumers eat in and do their shopping in front of a screen. Providers of broadband, health care, home improvement materials and educational services have also benefited from healthy demand. Conversely, restaurants, travel and leisure companies, and aerospace companies have seen sales evaporate.

"Some of this activity reflects an acceleration of existing trends, some is temporary and some represents fundamental shifts in behavior," says Rob Lovelace, Capital Group equity portfolio manager, so selective investing will be critical going forward. "Our job as active investors is to seek to identify the long-term winners and losers," he says.

## A great divide has opened between winners and losers

**Retail sales (billions USD)**

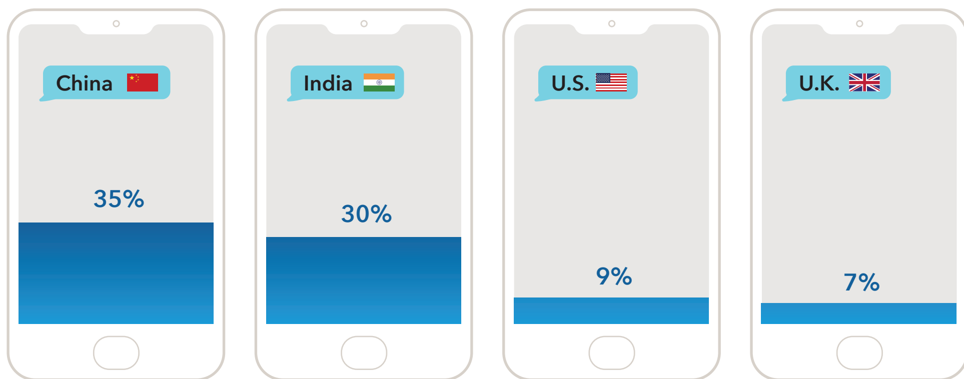



SOURCES: Refinitiv Datastream, U.S. Census Bureau. As of 4/30/20. COVID-resilient retail includes e-commerce, health & personal care, grocery, alcohol and home improvement. Top and bottom retail industries do not include those that had not reported 4/30/20 sales growth, as of 5/31/20.

# Digitization of daily life is here to stay

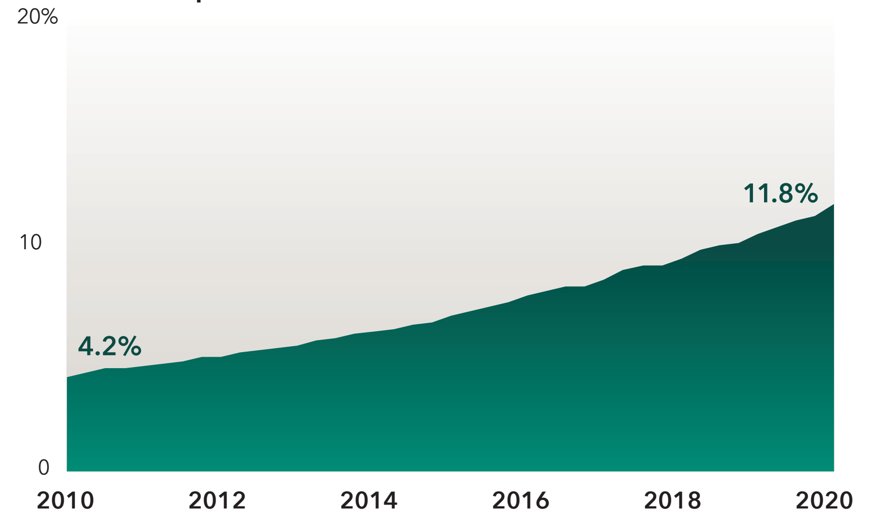
## U.S. mobile payments have a long runway relative to other markets

**Penetration rate of "mobile wallet" transactions**




## After strong growth, e-commerce is still a fraction of U.S. retail sales

**E-commerce as a percent of total U.S. retail sales**




Cloud demand is sky-high. That was true before the COVID-19 outbreak, but the events of 2020 have kicked that theme into overdrive. In the stay-at-home era, e-commerce, mobile payments and video streaming services have soared in popularity, occasionally pushing the limits of technology.

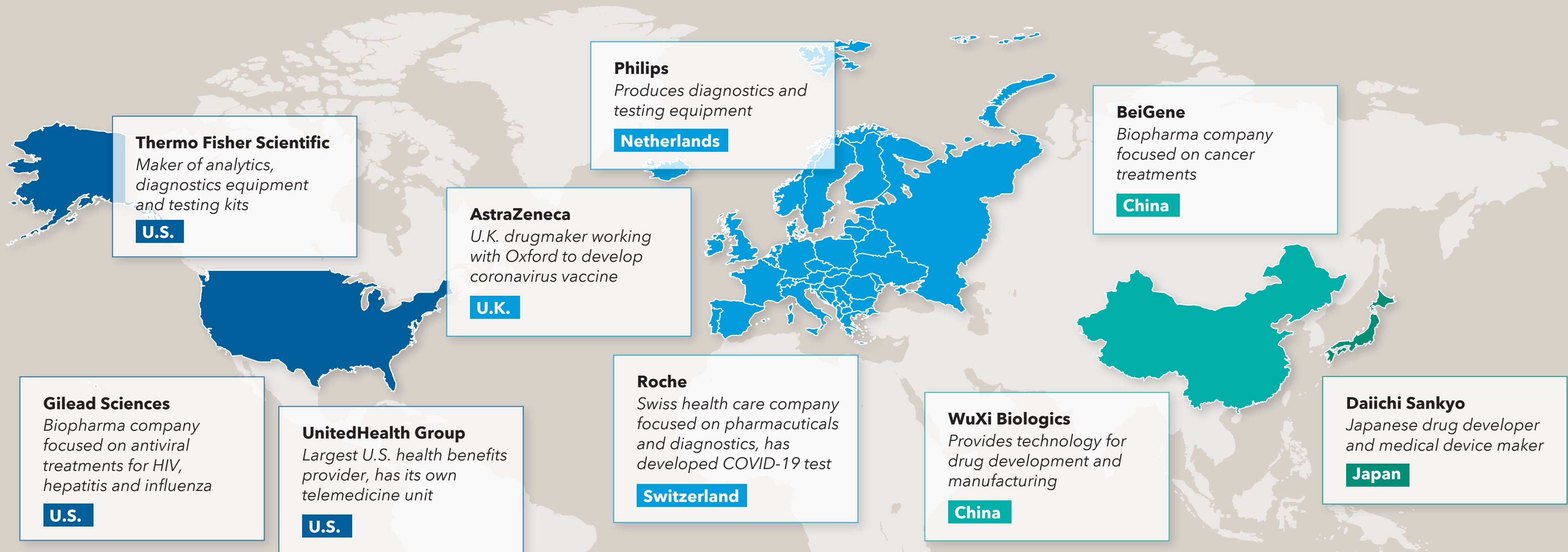
Reacting to unprecedented demand, Amazon, Netflix, YouTube and other streaming platforms had to reduce video quality in some regions to avoid literally breaking the internet. These levels of online activity are likely to moderate, but the pandemic could be a catalyst for even stronger e-commerce growth in the years ahead.

"The response to the COVID-19 crisis – keeping everyone at home – has accelerated this powerful trend of digitizing the world," explains Capital Group portfolio manager Mark Casey. "Services that were already useful have in some cases become almost essential. Many people feel compelled to try grocery delivery for the first time, for example, and subscriptions to Netflix have skyrocketed."

There's also room to advance, Casey adds. While e-commerce has grown in popularity, it still represented only about 11% of U.S. retail sales last year, and mobile payments stood at similarly low levels. "Given where we are now in the consumer technology space, the growth potential is truly exciting."

SOURCES: Statista, U.S. Census Bureau. "Mobile wallet" transactions refer to transactions at point-of-sale that are processed via smartphone applications and are estimates as of 12/31/19. E-commerce data as of 3/31/20.

# Health care innovation is changing the world




Remember when drug pricing figured to be in the political crosshairs in 2020, placing pressure on the health care sector? Those days seem far away as the world finds itself rallying around efforts to test for and treat COVID-19.

As drugmakers across the globe race to develop a vaccine in record time, attitudes toward the health care sector are already softening among individuals and governments. What's more, the pandemic has shed light on a potential deficiency in personal and national security, uncovering shortages in critical medical equipment and supplies. "Health care today is like the defense sector on September 12, 2001," says Rich Wolf, a Capital Group health care analyst, "and demands on suppliers are likely to grow."

A broad range of companies are engaged in activities that could address this rising demand. Among them are pharmaceutical giants Roche and AstraZeneca in Europe and Daiichi Sankyo in Japan; biopharma companies Gilead Sciences and BeiGene; and drug manufacturing, diagnostic and testing equipment makers Thermo Fisher Scientific, Philips and WuXi Biologics. With behaviors shifting as patients adjust to the pandemic, U.S. health benefits provider UnitedHealth could also see demand rise for its telemedicine services.

SOURCE: Capital Group.

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

You've heard this message before, but it's worth repeating. Just because U.S. indexes showed greater returns than international indexes over the past decade doesn't mean all the best stocks are in the U.S. In fact, on a company-by-company basis, it's the opposite: The stocks with the best annual returns have been overwhelmingly located in non-U.S. markets.

That trend was even more pronounced in the year-to-date period through May 31. The list of investable companies with the best returns was dominated by Chinese firms. Not surprising, given that China was the first country to get hit by the COVID-19 outbreak, and among the first to emerge from lockdown. While the YTD period is a very short time frame, the trend has generally played out over other years as well.

Why? It's all about opportunity set. There are roughly three times as many foreign stocks as domestic. So why fish in a smaller pond when there are great companies all over the world? When markets are uncertain, it's important to have flexibility. Consider selecting global funds that give managers the ability to choose from among the best companies, no matter where they are located.

## 75% of the top stocks since 2011 have been based outside the U.S.

**Number of the top 50 stocks each year by company location**

| Index return | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | 2019 | 2020 YTD |
|---|---|---|---|---|---|---|---|---|---|---|
| U.S. | 2.1% | 16.0 | 32.4 | 13.7 | 1.4 | 12.0 | 21.8 | –4.4 | 31.5 | –5.0 |
| Non-U.S. | –13.7% | 16.8 | 15.3 | –3.9 | –5.7 | 4.5 | 27.2 | –14.2 | 21.5 | –14.8 |

SOURCES: MSCI, RIMES. 2020 as of 5/31/20. Returns in U.S. dollars. Top 50 stocks are the companies with the highest total return in the MSCI ACWI each year. Returns table uses S&P 500 and MSCI ACWI ex USA indexes for U.S. and non-U.S., respectively.

# In a low-rate world, dividends are more important than ever

There's no way to sugarcoat it: Dividend cuts and suspensions have soared to levels not seen since the Great Recession, with much of the economy shut down and companies scrambling to preserve cash.

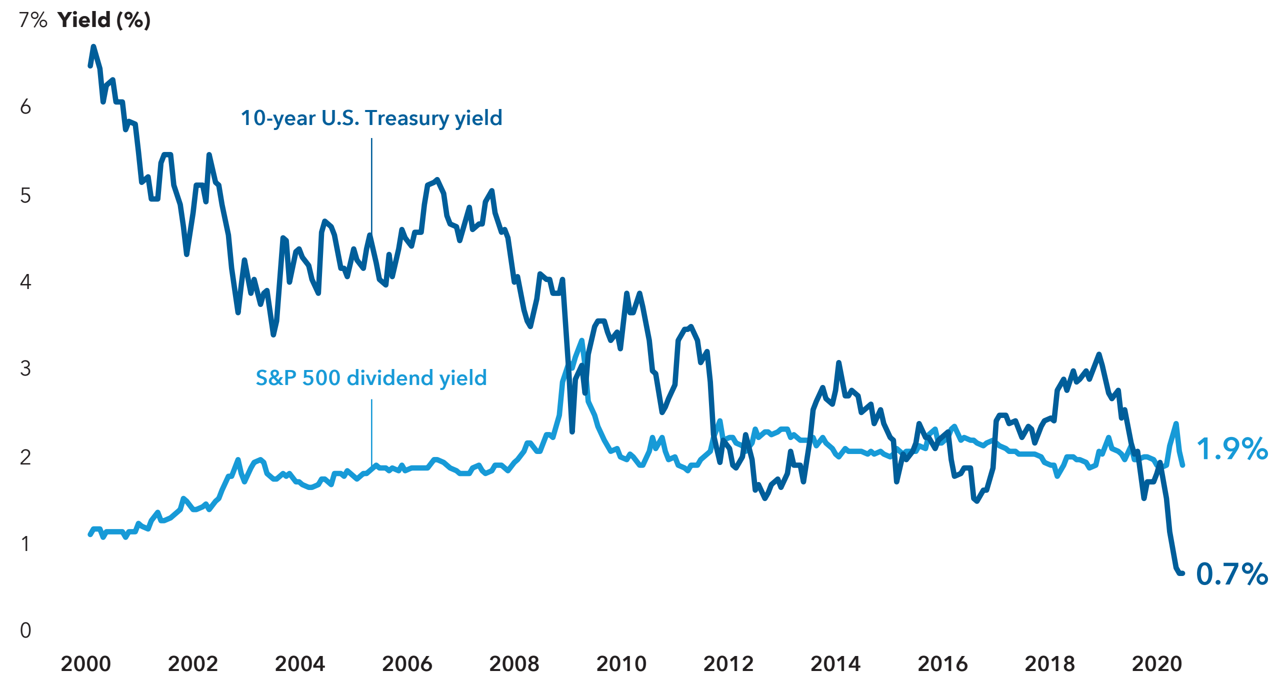
In past declines, sectors that traditionally pay dividends have tended to outpace the market. However, key dividend-paying sectors have lagged during the recent downturn. But with bond yields historically low, company dividends have become an increasingly important source of investment income.

So where can investors with income needs turn for dividends they can count on?

"We're likely to see more cuts, so we are working hard to try to anticipate them," says equity portfolio manager Joyce Gordon. "Some companies are cutting out of an abundance of caution to weather this extreme environment; others may be under pressure from rating agencies to cut or face a credit rating downgrade."

Despite the challenges, many companies remain committed to sustaining and even increasing their dividends. "Our equity analysts work closely with our bond analysts," says Gordon, "so they dig deep into both sides of the balance sheet to evaluate dividend sustainability." She adds, "The key is to be really selective in this period."

**Dividend-paying companies remain an important source of income for investors**




SOURCES: Refinitiv Datastream, Standard & Poor's. As of 5/31/20.

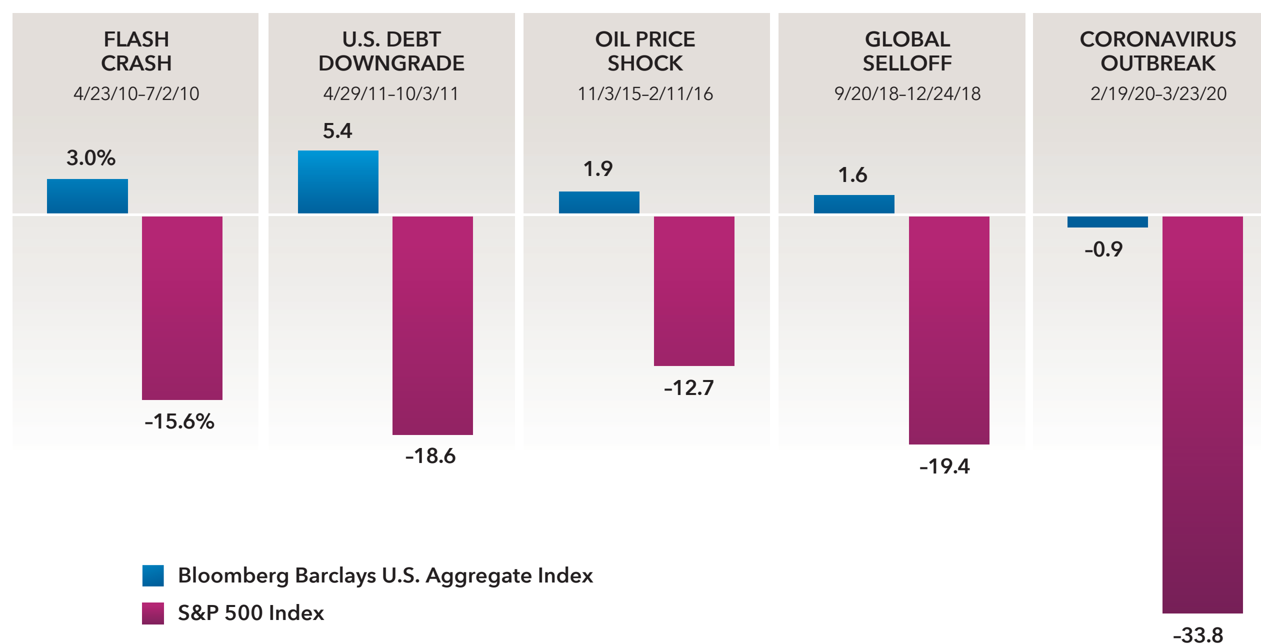
# Does your fixed income need an upgrade?

How has your fixed income been holding up? If you owned a core bond fund that provided diversification from equities and capital preservation when the stock market tanked in the first quarter, then you probably feel pretty good about your portfolio's balance. From peak to trough, equities were down more than 30%, while core bond fund returns, as measured by the Bloomberg Barclays U.S. Aggregate Index, were close to flat. In contrast, many widely used funds in the core plus and multisector bond categories, which often rely more heavily on higher risk bonds, didn't perform these critical roles. If you didn't own strong core fixed income, you might think it's too late to upgrade. It isn't.

Even though yields have fallen sharply, markets expect them to remain low. Looking two years out, investors don't see yields approaching levels of even a year ago. Easy monetary policy and low growth and inflation prospects also imply that rates rising significantly isn't a major risk today.

In addition, the potential shock absorption that a quality-oriented core fund can provide still matters. Equity volatility may not be over. While everyone expects the global economy will eventually see the end of this turmoil, the time to recovery remains unknown. A balanced portfolio remains vital.

## Cumulative returns during the five largest equity market declines since 2009




SOURCE: Morningstar. Dates shown are representative of the five largest equity market declines (with dividends reinvested) in the unmanaged S&P 500 with at least 50% recovery persisting for more than one business day between declines. The returns are based on total returns in USD. As of 5/31/20.

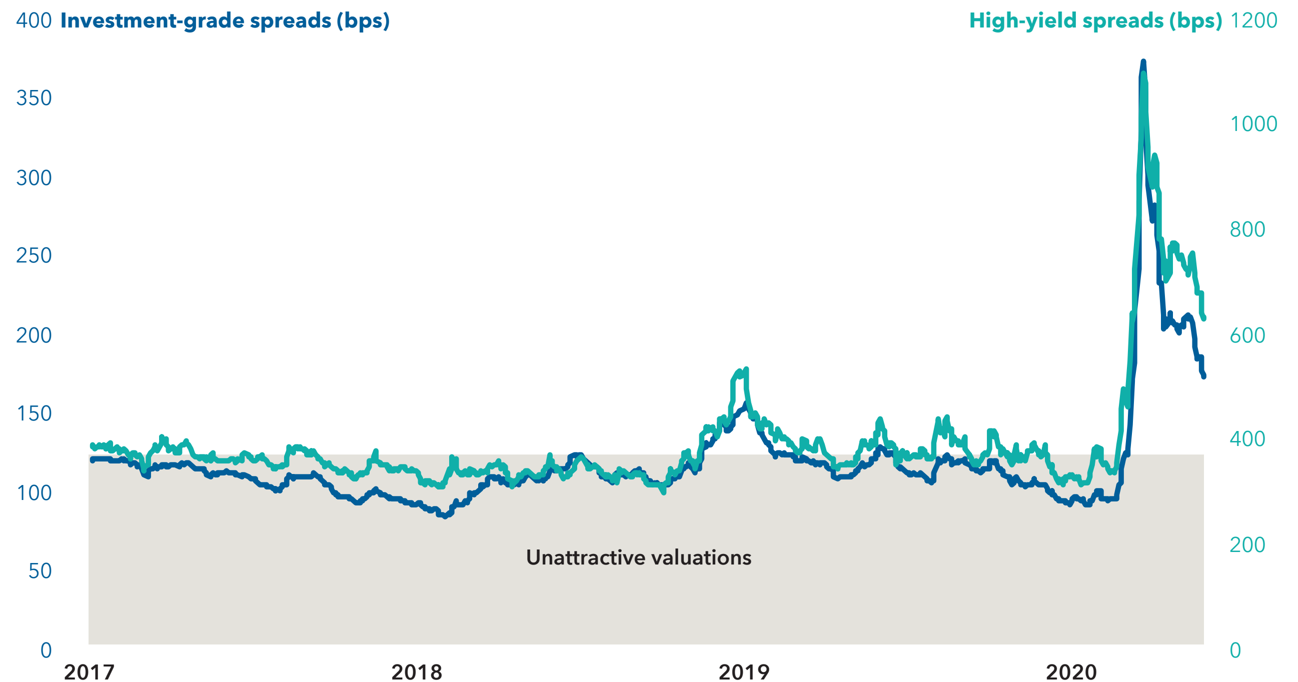
# Selective opportunities are surfacing in credit markets

Anyone who owned a bond fund heavily invested in credit during the recent bout of equity volatility learned the hard way that not all fixed income will provide protection from sinking stocks. Credit spreads – the risk premium that investors receive for taking credit risk – widened sharply to levels not seen since the financial crisis. This led to losses in both investment-grade and high-yield bond sectors.

Prior to that volatility, credit valuations were approaching some of the most expensive levels in history. Corporate bonds look much more attractive today. More reasonable valuations created opportunities to buy debt of issuers with the potential to endure present economic challenges.

However, selectivity is critical. Although many companies have tools to withstand the current climate, some do not. Over the past decade, the BBB-rated portion of the investment-grade universe – those companies at the low end of the investment-grade spectrum – rose from 35% to 50%. Using history as a guide, the market could see as much as $350 billion in bonds downgraded to junk status this year. In this type of environment, fundamental research will be critical to avoiding those issuers most at risk.

## Credit spreads spiked in 2020 and remain elevated

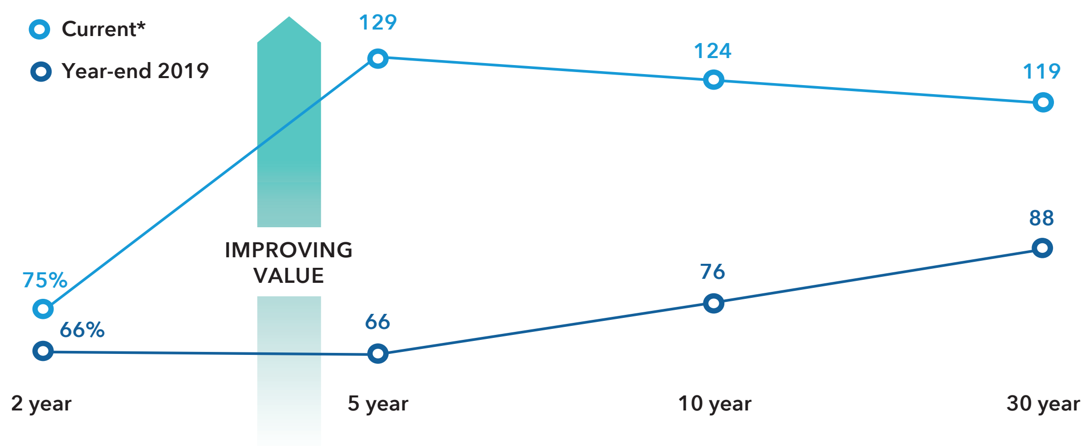



SOURCES: Bloomberg Index Services Ltd., RIMES. As of 5/31/20. Investment-grade spreads are for Bloomberg Barclays U.S. Corporate Investment Grade Index. High-yield spreads are for Bloomberg Barclays U.S. Corporate High Yield Index.

# Municipal bonds can offer compelling value

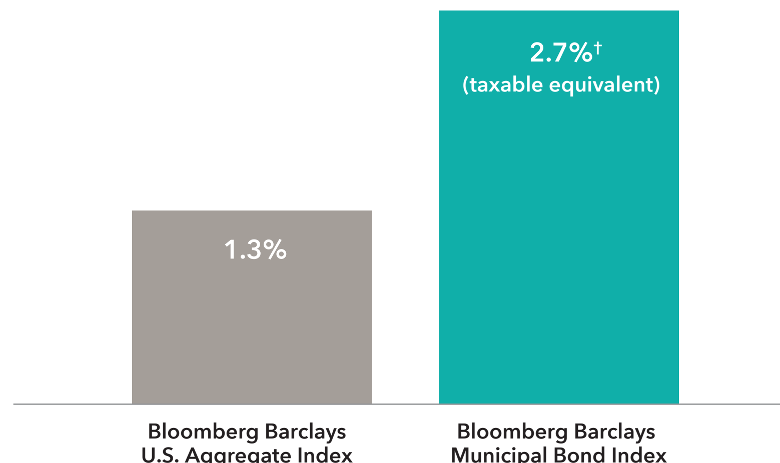
## Higher ratios across maturities signal compelling value

**Ratio of pretax muni yields to Treasury yields (%)***




## Tax-equivalent municipal yields are about double those of taxables

**Taxable and municipal bond yields**




Election years and municipal bonds: It's a combination that has often spelled volatility. 2020 is no exception. But for once the culprit isn't uncertainty over how tax policies will evolve — it's fallout from the pandemic and future uncertainty around municipal finances.

Looking forward, even if the government and Federal Reserve step up support for municipalities and states, recession may expose vulnerable finances. The rout in oil prices is also pressuring energy-producing regions.

Investor sentiment has shifted — ending a 60-week period of inflows into municipal bond funds as of March 2020. Bonds with lower ratings or from economically sensitive sectors have been hit hard.

For income seekers, however, there's a silver lining: The market now includes many pockets of great value. For example, the yield advantage of BBB-rated over AAA-rated munis has climbed from below 1% to over 2%. Relative value compared to U.S. Treasuries (measured by the muni to Treasury ratio) has significantly improved. The ratio shows municipal yields as a percentage of yields for U.S. Treasuries. Owning muni bonds can benefit investor portfolios in another way: The asset class has offered a source of equity diversification over time. Given the likelihood of continuing headwinds, a selective investment approach is crucial, using bond-by-bond research to assess the trade-off between risk and return potential.

SOURCES: Capital Group, Bloomberg Index Services Ltd.

*The muni ratio, as of 5/31/20, expresses the pretax muni bond yield as a percentage of yields for U.S. Treasuries (for example: 100% indicates equal pretax yields).

†Taxable-equivalent rate assumptions are based on a federal marginal tax rate of 37%, the top 2020 rate. In addition, we have applied the 3.8% Medicare tax. As of 5/31/20.

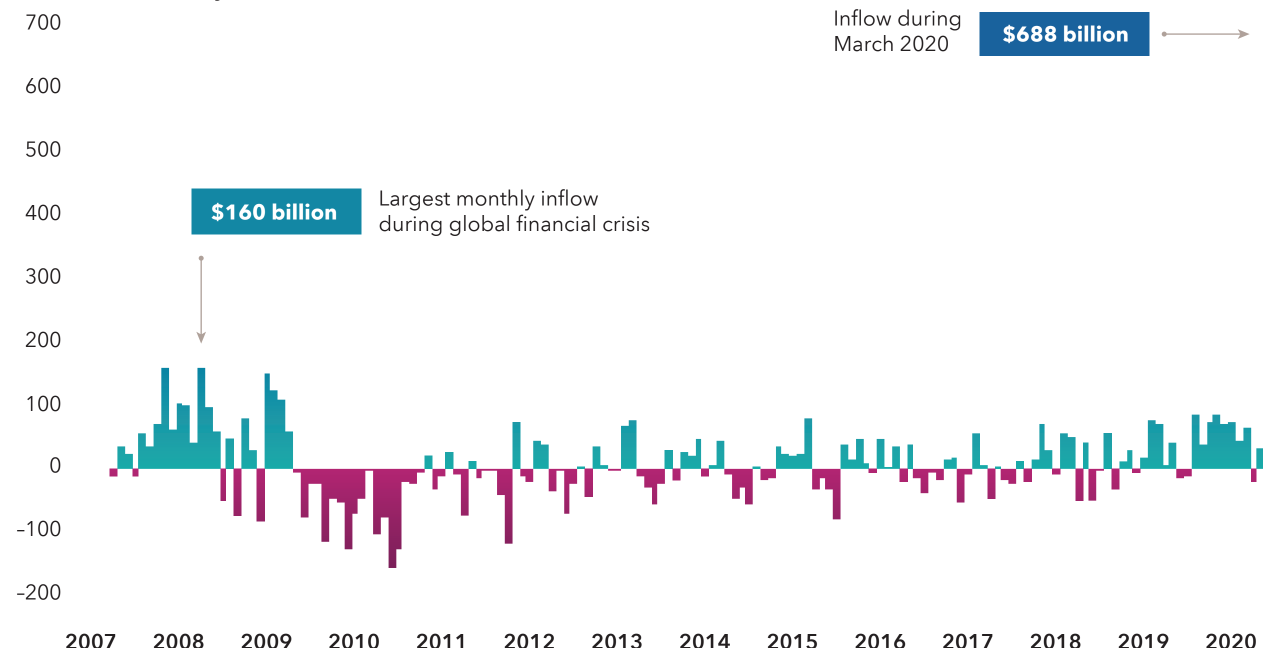
# Cash is not king: Consider short-term bond funds

Fight or flight. That's a natural response to a crisis. Indeed, the flight to cash (money market funds) from both bond and equity funds during this period is even more of a stampede than during the global financial crisis. While it's a completely understandable reaction to turbulent markets, holding cash carries its own risk. Investors are missing out on potential income and investment growth.

Instead investors should consider some alternatives that may leave them better positioned to reach their goals. Strategies that are liquid and have demonstrated relative historical stability may help investors who want higher returns compared to cash. That includes short-term bond funds that maintain a cautious investment approach designed to maintain stability, while offering a measure of income and diversification from equity markets.

Just how much could you stand to gain? Compare these two options as of May 31. A money market fund yielded less than 0.1%, using Morningstar's U.S. Fund Money Market – Taxable Category average as a proxy, while a short-term bond fund yielded around 1% using the Bloomberg Barclays U.S. Intermediate Aggregate Bond Index benchmark as a proxy. Then there's the equity diversification. That benchmark had a three-year correlation to the S&P 500 Index of –0.1. Low or negative correlation suggests that when the stock market is down, short-term bond funds could be a source of resilience. While a short-term bond fund can produce a negative return, many are focused on capital preservation and contain only high quality fixed income.

## Investors' flight to cash in March far surpassed that of the financial crisis




SOURCES: Investment Company Institute, Refinitiv Datastream. As of 4/30/20. Data in USD. Bloomberg Barclays U.S. Intermediate Aggregate Bond Index is an unmanaged index that consists of 1–10 year governments, 1–10 year corporates, all mortgage and all asset-backed securities within the Aggregate Index. Morningstar's U.S. Fund Money Market – Taxable Category contains funds that invest in short-term money market securities in order to provide a level of current income that is consistent with the preservation of capital. These funds do not designate themselves as Prime in Form N-MFP.

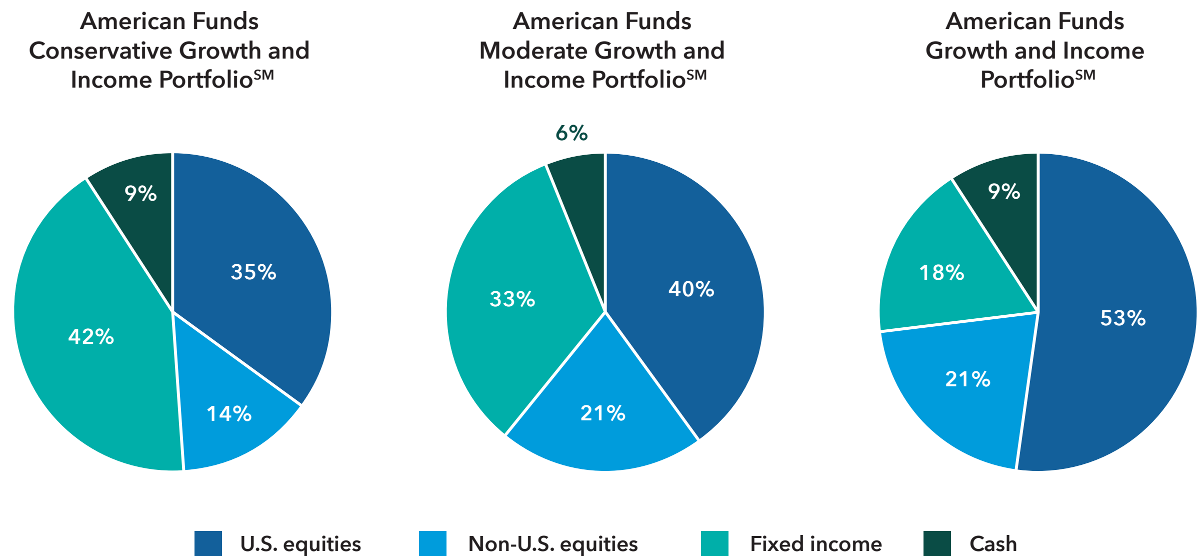
# What's the best portfolio allocation for your objectives?

If you're feeling nervous about the coronavirus and market fallout, you're not alone. Uneasy investors moved $688 billion into money market mutual funds in March 2020, according to the Investment Company Institute, far exceeding the largest weekly total during the global financial crisis.

By giving in to emotions, investors run the risk of derailing their long-term investment plans. After all, history has shown that periods of market turmoil have proven to be among the best times to invest. Rather than moving to cash, financial professionals should work with investors to ensure that their investments are still aligned with their personal goals. Whether investors are looking to build or preserve wealth, it's not just about the allocation to stocks and bonds – but also the types of stocks and bonds that matter. Here are three courses of action to consider:

- **Cautious investors:** Consider a conservative portfolio that includes core bond strategies that seek to offer capital preservation and dividend-paying companies with solid balance sheets that can sustain or quickly restart dividend payments.
- **Balanced investors:** It may be time to revisit stock and bond allocations. Look for flexible equity mandates that can pursue stable growth opportunities in markets around the world.
- **Opportunistic investors:** Seek opportunities to invest in durable growth trends, like e-commerce, digital payments and select innovative health care companies from around the globe.

## Sample portfolio allocations




SOURCE: Capital Group. As of 3/31/20. Check with home office for product availability.

# 2020 Midyear Outlook: Positioning portfolios for recovery

| Themes | U.S. equity | Global/International equity | Taxable fixed income | Tax-exempt fixed income |
|---|---|---|---|---|
| | **Recoveries have been longer and stronger than downturns** | **If you think all the best companies are in the U.S., think again** | **Does your fixed income need an upgrade?** | **Municipal bonds offer selective investors compelling value** |
| **Investment implications** | Given the potential for a gradual recovery, focus on long-term growth opportunities, such as e-commerce and digital payments companies, in addition to well-capitalized companies that can sustain or quickly restart dividends. | Global growth may remain weak, but many of the world's top companies are in non-U.S. markets. It's about companies, not economies. | Rates have fallen and are expected to stay lower for even longer. Select credit opportunities look more attractive. This underscores why investors should seek a high-quality core bond fund to provide diversification from equity volatility and capital preservation. | After-tax income potential for munis far exceeds what's typical among similarly rated taxables. Even so, economic headwinds mean it's crucial that fundamental research is used when choosing bonds. |
| **Select investments to consider** | **The Growth Fund of America®**<br>A – AGTHX; F-2 – GFFFX; F-3 – GAFFX; R-6 – RGAGX<br>**American Mutual Fund®**<br>A – AMRMX; F-2 – AMRFX; F-3 – AFMFX; R-6 – RMFGX<br>**Washington Mutual Investors Fund℠**<br>A – AWSHX; F-2 – WMFFX; F-3 – FWMIX; R-6 – RWMGX | **New Perspective Fund®**<br>A – ANWPX; F-2 – ANWFX; F-3 – FNPFX; R-6 – RNPGX<br>**New World Fund®**<br>A – NEWFX; F-2 – NFFFX; F-3 – FNWFX; R-6 – RNWGX<br>**American Funds International Vantage Fund℠**<br>A – AIVBX; F-2 – AIVFX; F-3 – AIVGX; R-6 – RIVGX | **Intermediate Bond Fund of America®**<br>A – AIBAX; F-2 – IBAFX; F-3 – IFBFX; R-6 – RBOGX<br>**The Bond Fund of America®**<br>A – ABNDX; F-2 – ABNFX; F-3 – BFFAX; R-6 – RBFGX<br>**American Funds Strategic Bond Fund℠**<br>A – ANBAX; F-2 – ANBFX; F-3 – ANBGX; R-6 – RANGX | **Limited Term Tax-Exempt Bond Fund of America®**<br>A – LTEBX; F-2 – LTEFX; F-3 – FLTEX<br>**The Tax-Exempt Bond Fund of America®**<br>A – AFTEX; F-2 – TEAFX; F-3 – TFEBX<br>**American High-Income Municipal Bond Fund®**<br>A – AMHIX; F-2 – AHMFX; F-3 – HIMFX |

**For high net worth investors, consider our separately managed account (SMA) strategies, which include our Capital Group U.S. Income and Growth℠ offering (which pursues a similar objective as American Mutual Fund), Capital Group Global Growth℠ (which pursues a similar strategy to New Perspective Fund) and Capital Group International Equity℠ (similar to American Funds International Vantage Fund).**

**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.**

Investing outside the United States involves risks, such as currency fluctuations, periods of illiquidity and price volatility, as more fully described in the prospectus. Small company stocks entail additional risks, and they can fluctuate in price more than larger company stocks. The return of principal for bond funds and for funds with significant underlying bond holdings is not guaranteed. Fund shares are subject to the same interest rate, inflation and credit risks associated with the underlying bond holdings. Lower rated bonds are subject to greater fluctuations in value and risk of loss of income and principal than higher rated bonds. Income from municipal bonds may be subject to state or local income taxes and/or the federal alternative minimum tax. Also, certain other income (such as distributions from gains on the sale of certain bonds purchased at less than par value, for The Tax-Exempt Bond Fund of America), as well as capital gains distributions, may be taxable. Bond ratings, which typically range from AAA/Aaa (highest) to D (lowest), are assigned by credit rating agencies such as Standard & Poor's, Moody's and/or Fitch, as an indication of an issuer's creditworthiness. If agency ratings differ, the security will be considered to have received the highest of those ratings, consistent with the fund's investment policies.

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