Outlook

MID-YEAR ISSUE JUNE 2020

CAPITAL GROUP℠

Long-term perspective on markets and economies

FOR PROFESSIONAL / QUALIFIED INVESTORS ONLY
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2020 Mid-year 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. In US equities, the average recovery has delivered cumulative returns of 279% and lasted 72 months, compared to a decline of 33% and 14 months for bear markets.[1]

EQUITY

Companies will drive the next recovery.

The digitisation 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 in a low-rate world. For investors seeking dividend income, the combination of record dividend cuts and historically low interest rates emphasised the importance of being able to identify those companies that can sustain or quickly restart dividend payments.

It's a stock picker's market. A dramatic shift in the macroeconomic backdrop means fundamental research is more important than ever. Attractive long-term opportunities can be found across the US, Europe, Japan and emerging markets, but selectivity is critical.

FIXED INCOME

Fundamental research remains key.

Lower for longer. Low growth and inflation suggest that the low interest rate environment is likely to persist. Against that backdrop, a diversified approach and active fundamental research is imperative.

New opportunities in US credit markets. During a flight to quality, we are taking advantage of select opportunities in corporate credit.

Dislocation in emerging market debt. Historically, local currency debt yielded more than US dollar debt. This relationship has now completely reversed, creating opportunities where the sell-off has been more than fundamentals warrant.

Past results are not a guarantee of future results.

1. SOURCES: Capital Group, RIMES, Standard & Poor's. As at 31/5/20. Bear markets are peak-to-trough declines of at least 20% in the S&P 500. Bull markets are all other periods. 2020 bear market not included in calculations. Returns in USD.

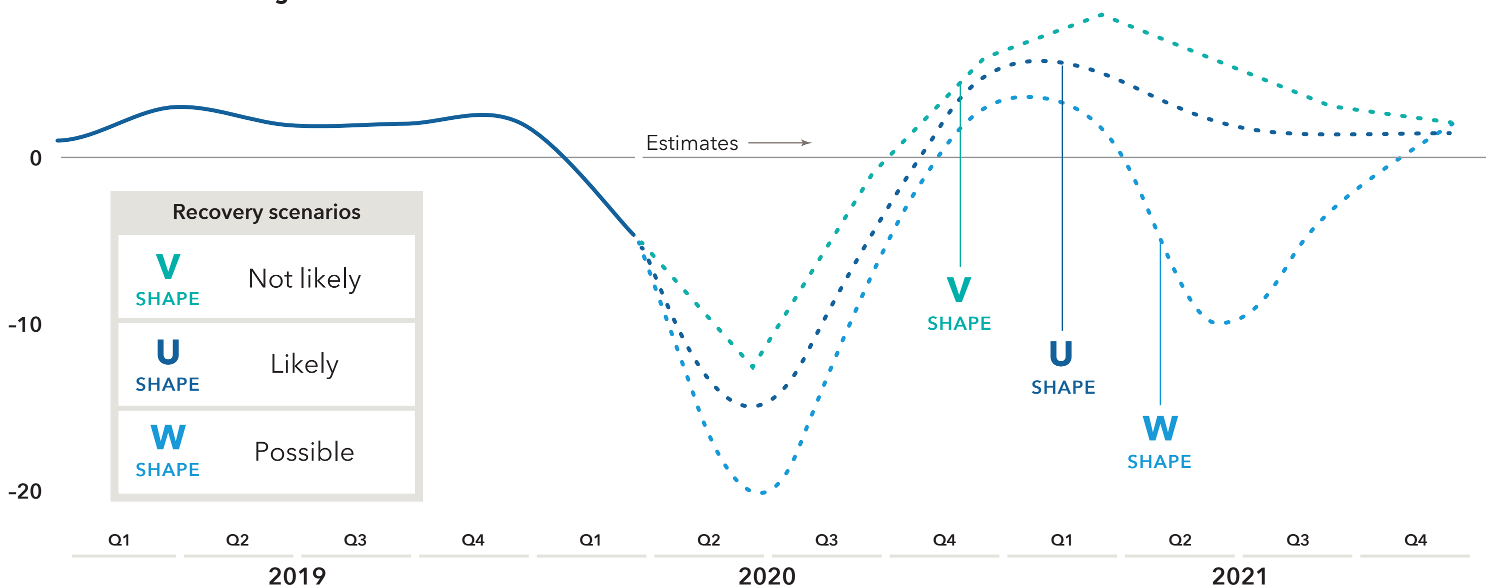
Expect peaks and valleys on the road to economic recovery

The decade-long global economic expansion did not end with a whimper. The coronavirus brought it to a screeching halt. US 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," US 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.

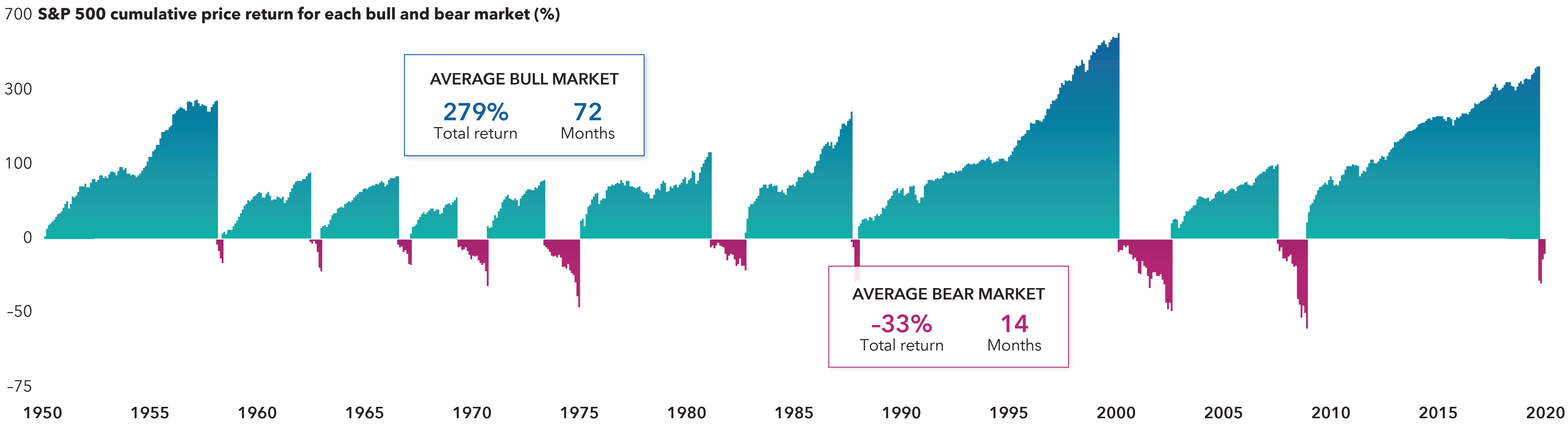
Though the shape and pace remain uncertain, a solid recovery is possible



For illustrative purposes only.

SOURCES: Capital Group, Bureau of Economic Analysis, Refinitiv Datastream. As at 31/05/20. Data for the three recovery scenarios are based on estimates from Capital Group economist Jared Franz. GDP: gross domestic product.

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 in the US 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 exceeded 279%.

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

Missing a bounceback 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.

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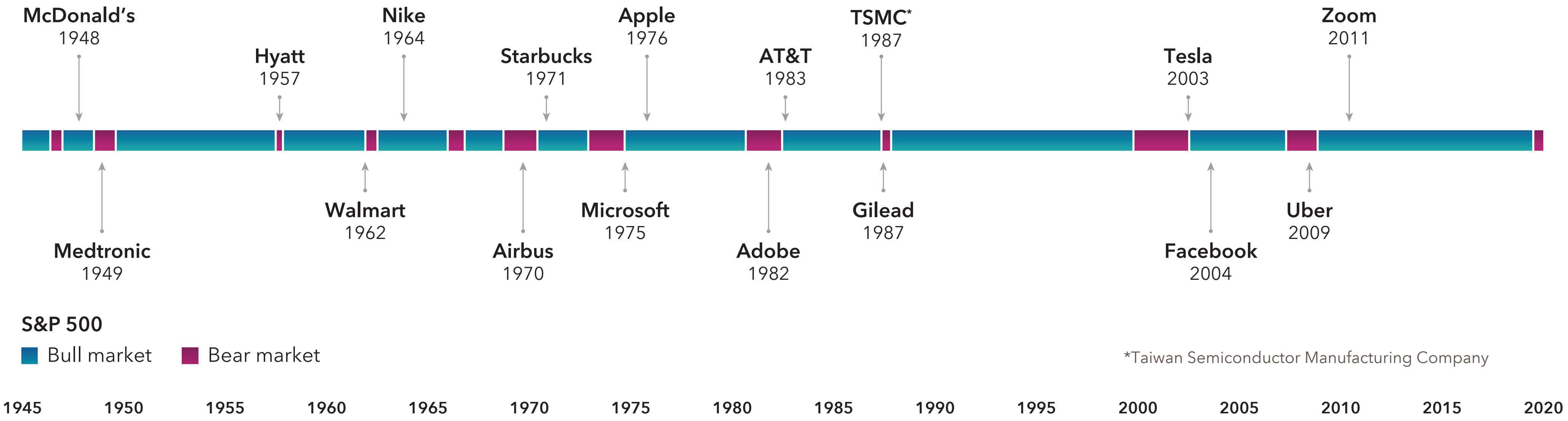
SOURCES: Capital Group, RIMES, Standard & Poor's. As at 31/5/20. The 2020 bear market is considered current as at 31/5/20 and is not included in the 'average bear market' calculations. All other bear market periods are peak-to-trough price declines of 20% or more in the S&P 500. Bull markets are all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

Tough times have created 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 US government's demobilisation 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 more than 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 US 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.

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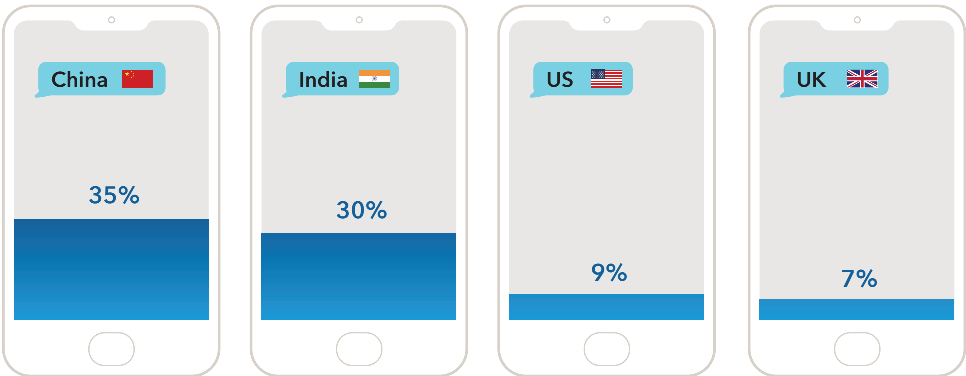
SOURCES: Capital Group, Standard & Poor's. As at 31/5/20. The 2020 bear market is considered current as at 31/5/20. All other bear market periods are peak-to-trough price declines of 20% or more in the S&P 500. Bull markets are all other periods.

Digitisation of daily life is here to stay

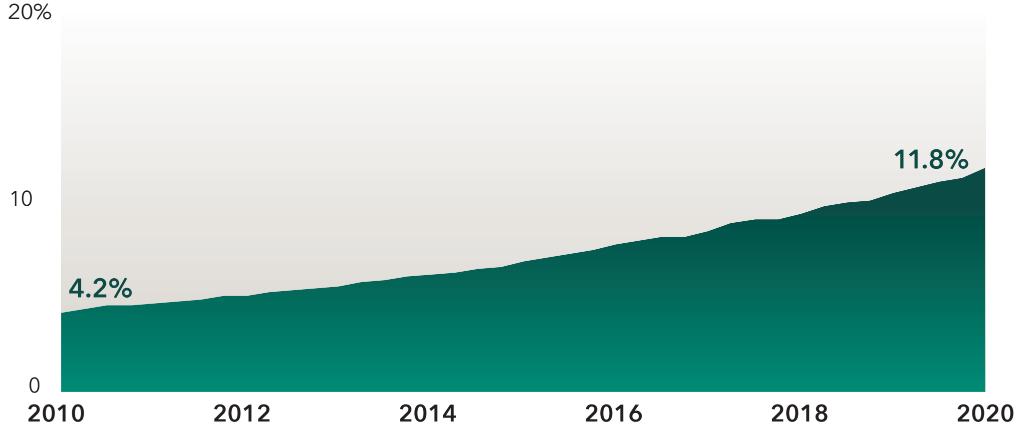
Low penetration rates indicate a long growth runway for mobile payments

Penetration rate of "mobile wallet" transactions



After strong growth, e-commerce is still a fraction of US retail sales

E-commerce as a percentage of total US 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 digitising 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 US 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."

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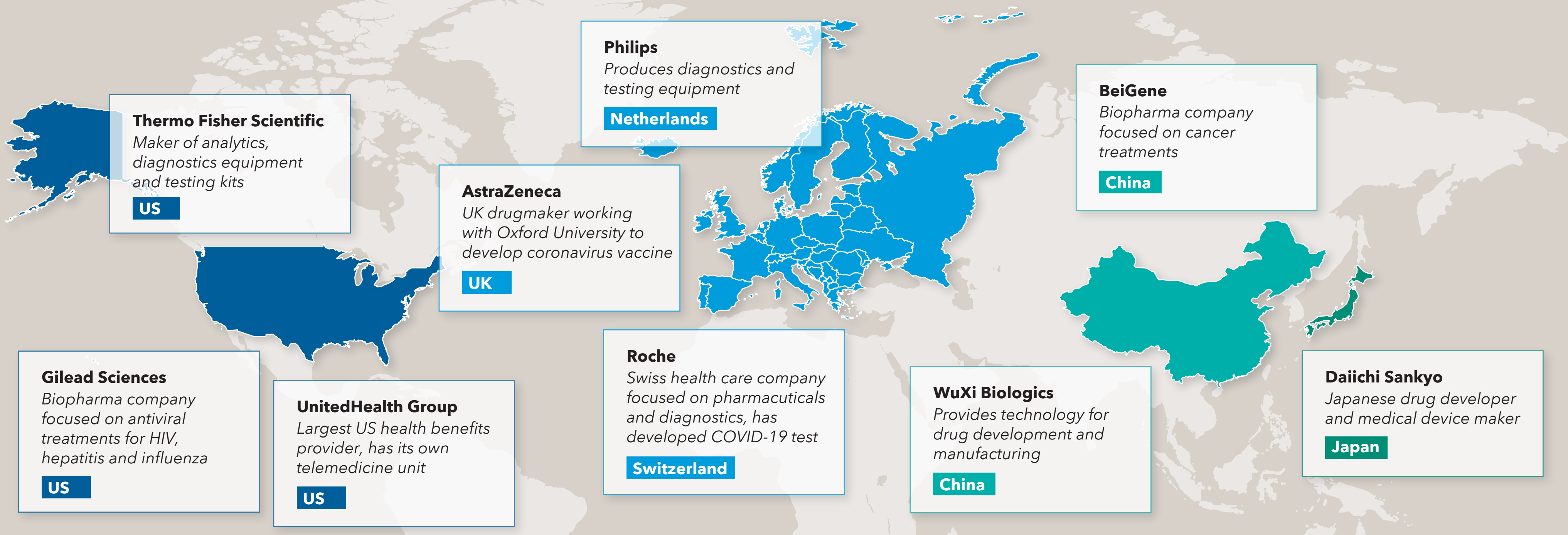
SOURCES: Statista, US Census Bureau. "Mobile wallet" transactions refer to transactions at point-of-sale that are processed via smartphone applications and are estimates as at 31/12/19. E-commerce data as at 31/3/20.

Health care innovation is changing the world



Before the COVID-19 outbreak, the health care sector faced significant swings in sentiment, primarily in the US, as a result of uncertainty around political pressure on drug pricing. A certain level of volatility was expected to continue as campaigning around the US presidential election in November intensified. However, sentiment has taken an abrupt turn as the world now rallies 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 12 September 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 behaviours shifting as patients adjust to the pandemic, US health benefits provider UnitedHealth could also see demand rise for its telemedicine services.

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SOURCE: Capital Group

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 global financial crisis, with much of the economy shut down and companies scrambling to preserve cash.

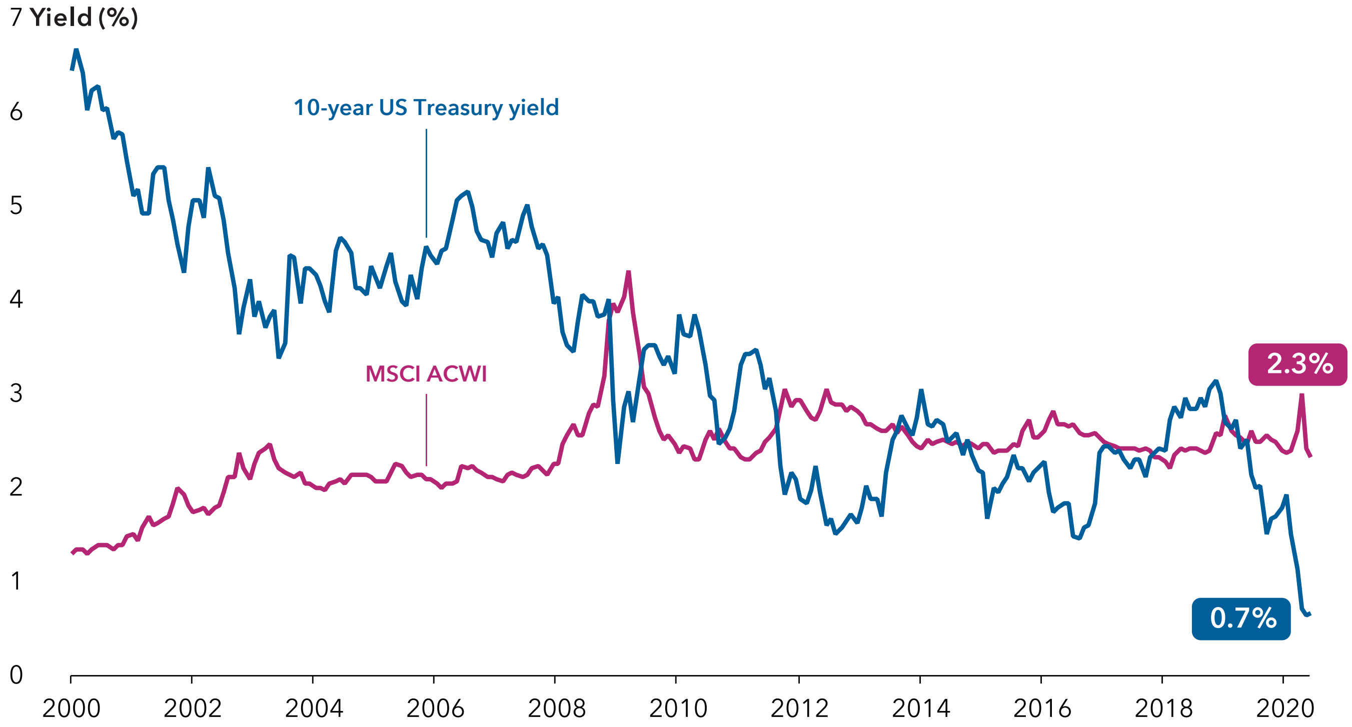
In past declines, sectors that traditionally pay dividends have tended to outpace the market. However, key dividend-paying sectors have lagged during the recent downturn. But with bond yields historically low, company dividends have become an increasingly important source of investment income.

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



Past results are not a guarantee of future results.

SOURCE: Refinitiv Datastream. As at 31/5/20. MSCI ACWI: MSCI All Country World Index.

US equities present opportunities for stock pickers

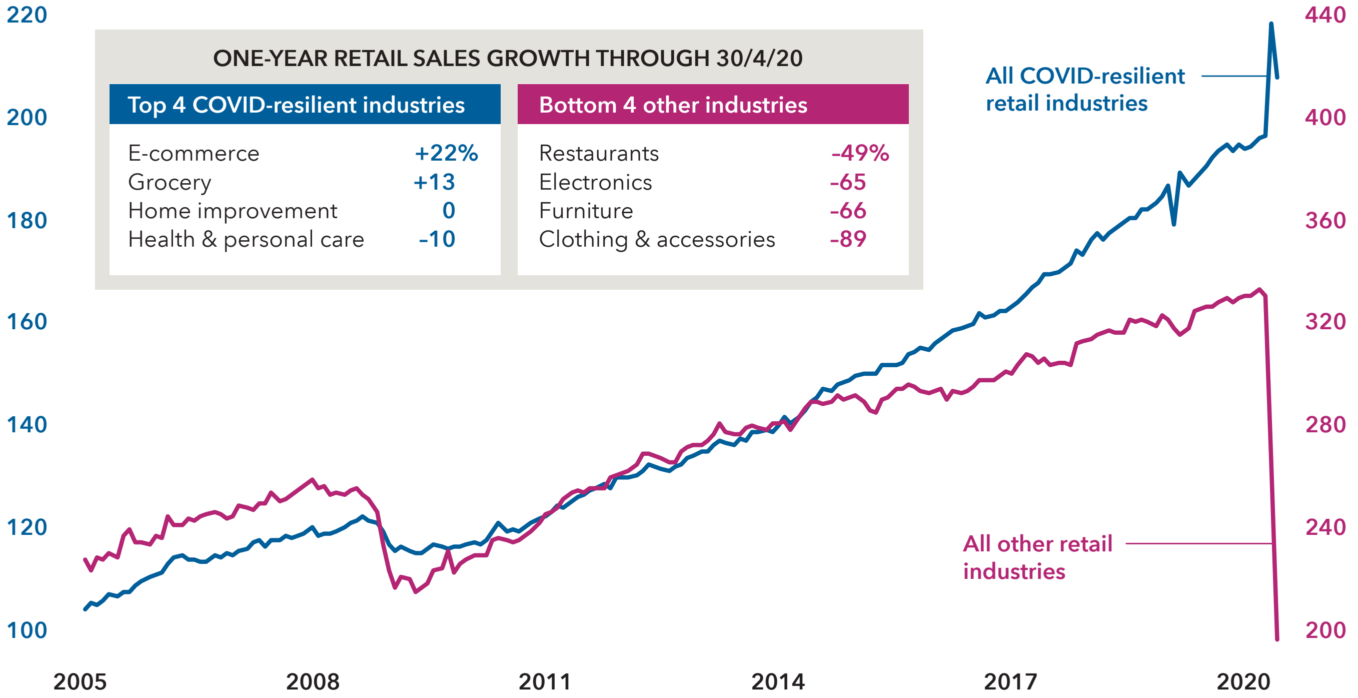
It's no surprise that business has been slow across wide swathes of the global economy. With many countries implementing strict lockdown measures, stores have shut and consumers have stayed at home. In the US, retail sales slid an unprecedented 16.4% in April, according to the US Commerce Department.

But that's not the whole story. A look beneath the surface of the US 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 behaviour," 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

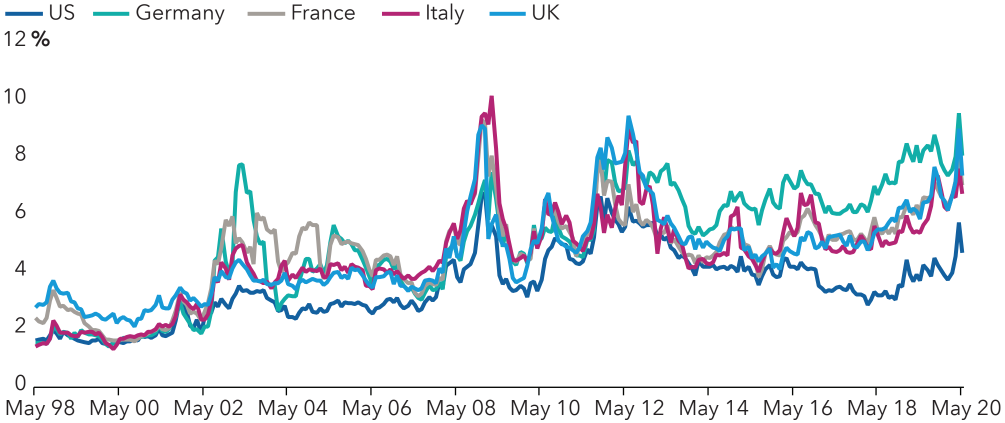
US retail sales (billions USD)



SOURCES: Refinitiv Datastream, US Census Bureau. As at 30/4/20. 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 30/4/20 sales growth, as at 31/5/20.

Europe faces a challenging backdrop

Equity risk premiums[1]



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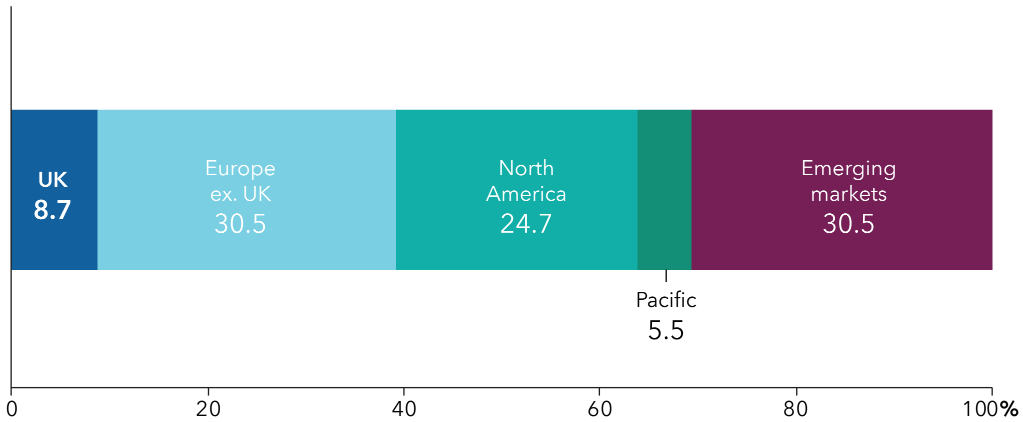
MSCI Europe – regional breakdown by revenue (%)[2]



Eurozone real GDP fell by 3.8%[3] in the 2020 first quarter, with notable weakness in France, Italy and Spain. Manufacturing activity is now as weak as it was following the global financial crisis. Services activity has dropped to historic lows.

With a partial reopening of the eurozone economy, most forecasters expect a recovery in the second half of 2020.

For illustrative purposes only.

1. SOURCES: ASR, Datastream. As at 1/5/2020.
2. SOURCE: MSCI. As at 31/5/2020.
3. SOURCE: Eurostat. As at 30/4/2020. GDP: gross domestic product.
4. SOURCE: DG ECFIN European Commission. Spring 2020 Economic Forecast, 6 May 2020.

Even so, we are unlikely to see a full return to pre-virus activity levels as forecasts show the eurozone's GDP shrinking by 8%-10% in 2020 before rising by 4%-6% in 2021[4].

For optimists, the huge economic shock of the coronavirus shutdown has exposed the limits of the eurozone's policymaking institutions and may force politicians to make changes, with the establishment of a fiscal union to support the monetary union. For pessimists, the scale of the economic shock could trigger an existential crisis for the eurozone and the wider EU, leading to fragmentation and perhaps even the collapse of the entire project.

Higher equity risk premiums in Europe suggest that investors are still wary of economic prospects and the potential stability of the eurozone. But a fading tail risk of fragmentation could help to reduce the equity risk premiums in Europe's main markets.

Despite this challenging backdrop, it is possible to find some interesting longer-term investment opportunities among European-listed equities. European stocks look cheap compared to other markets. Furthermore, many of these companies are not solely reliant on the health of the domestic European economy, with many having global businesses and diversified revenue streams.

The silver lining for Japanese equities

Japan's economy is being put to the test by a slew of challenges. Topping the list is the deadly virus COVID-19, which dragged the already weakened economy into recession and led to the postponement of the Tokyo Olympics to July 2021.

Amid the gloom, however, there are some bright spots. Among them are the high domestic savings (24.7% of GDP in 2018[1]) and the cash pile (¥506.4 trillion in 2019[2]) held by firms listed in Japan. The latter is a boon for Japanese firms compared to their global peers, where many face pressure to cut dividends.

Many Japanese companies today have globally competitive businesses, with some among the best in the world in areas such as automation, mechatronics and precision manufacturing.

Recently, the focus has turned to companies for the future, as Japan and the world adapt to a new normal – an environment of changed trade patterns triggered by disruptive technology and new consumer behaviours born out of the pandemic. The sudden increase in the need for remote work and telework has created strong demand for network, personal computer, tablet, software and cloud services. Japan offers competitive companies in those fields. One example is software developer OBIC Co.

Given the potential to identify individual companies with strong growth prospects despite the macroeconomic backdrop, Japan could be regarded as a classic example of a stock picker's market where bottom-up research can help to uncover opportunities.

Low broker coverage of Japanese equities means mispricing opportunities can be captured through deep research, particularly in the small- and mid-cap space

Industry	Company	Market capitalisation (US$ bn)[3]	Research coverage[4]
Automobile and transportation equipment	Toyota Motors	196.5	21
	Shimano	**13.3**	**6**
Electric appliances	Sony	75.0	24
	Hamamatsu Phonotics	**6.8**	**6**
	Obara Group	**0.4**	**0**
Precision instruments	Terumo	26.2	16
	Asahi Intecc	**6.5**	**14**
	Nakanishi	**1.3**	**2**

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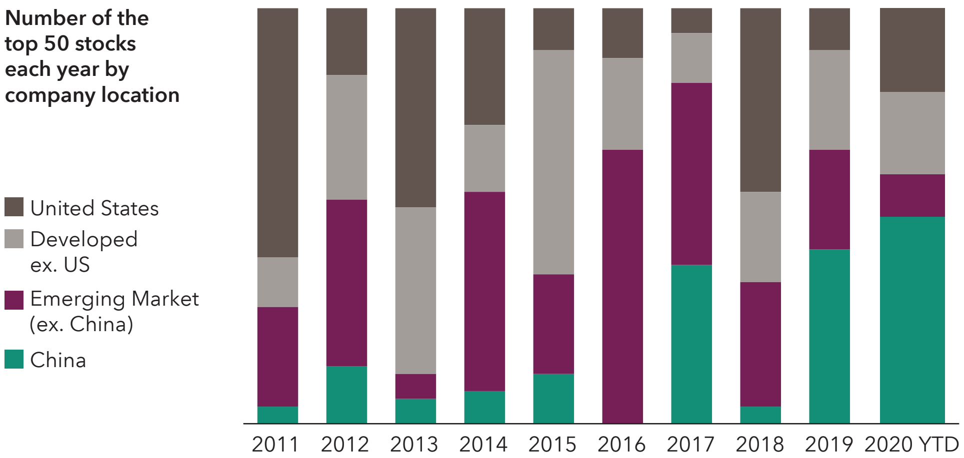
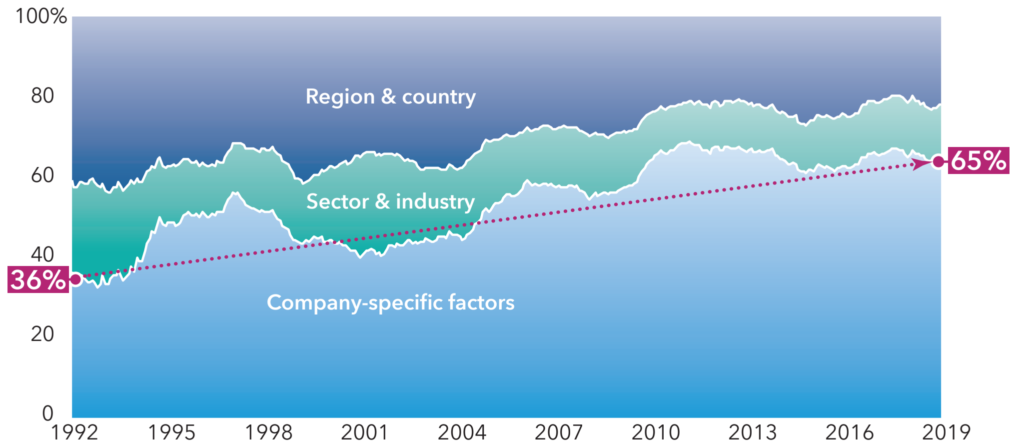
1. SOURCE: The World Bank. GDP: gross domestic product.
2. SOURCE: Bloomberg. As at 3/9/2019. Based on companies' latest filings compiled by Bloomberg.
3. SOURCE: Thomson Reuters Datastream. As at 31/3/2020.
4. SOURCE: Capital Group. As at 31/3/2020. Research coverage reflects the number of securities houses out of the major ones that officially rate stocks. Companies highlighted have relatively low levels of coverage.

Fundamentals are the key driver of emerging market returns

Almost half of the top stocks since 2011 have been based in emerging markets[1]



65% of emerging market returns can be attributed to fundamentals[2]



Market volatility has inevitably put pressure on emerging market (EM) returns. Commodity-exporting countries such as Brazil have suffered, but those successful in containing the COVID-19 outbreak, like China and Korea, have held up relatively well. In fact, China-based companies have dominated the list of strongest stocks in the MSCI ACWI index over the year-to-date period.

One explanation is that China was the first country hit by the pandemic and among the first to emerge from lockdown. However, over the past 10 years EM-domiciled stocks have accounted for 49% of MSCI ACWI's top 50 stocks. Over five years, that figure increases to 62%. So, while developed markets might have posted higher returns on an asset-weighted basis, on a company-by-company basis, emerging markets have proven to be fertile ground.

Helping propel some EM stocks is the role of fundamentals, which account for almost two-thirds of total EM returns. This means EM companies are less affected by the macro backdrop, and can tap into secular growth trends such as growing middle class wealth, faster digitalisation, and greater health care consumption. This could be particularly compelling in the current environment, where economic uncertainty has increased.

Past results are not a guarantee of future results. Emerging markets are volatile and may suffer from liquidity problems.

1. SOURCES: MSCI, RIMES. 2020 as at 31/5/20. Returns in US dollars. Top 50 stocks are the companies with the highest total return in the MSCI ACWI index each year.
2. SOURCE: Empirical Research Partners. As at 30/11/2019. Data shows the percentage of emerging markets' return that can be attributed to various factors over time, using regression analysis and a two-year smoothed average.

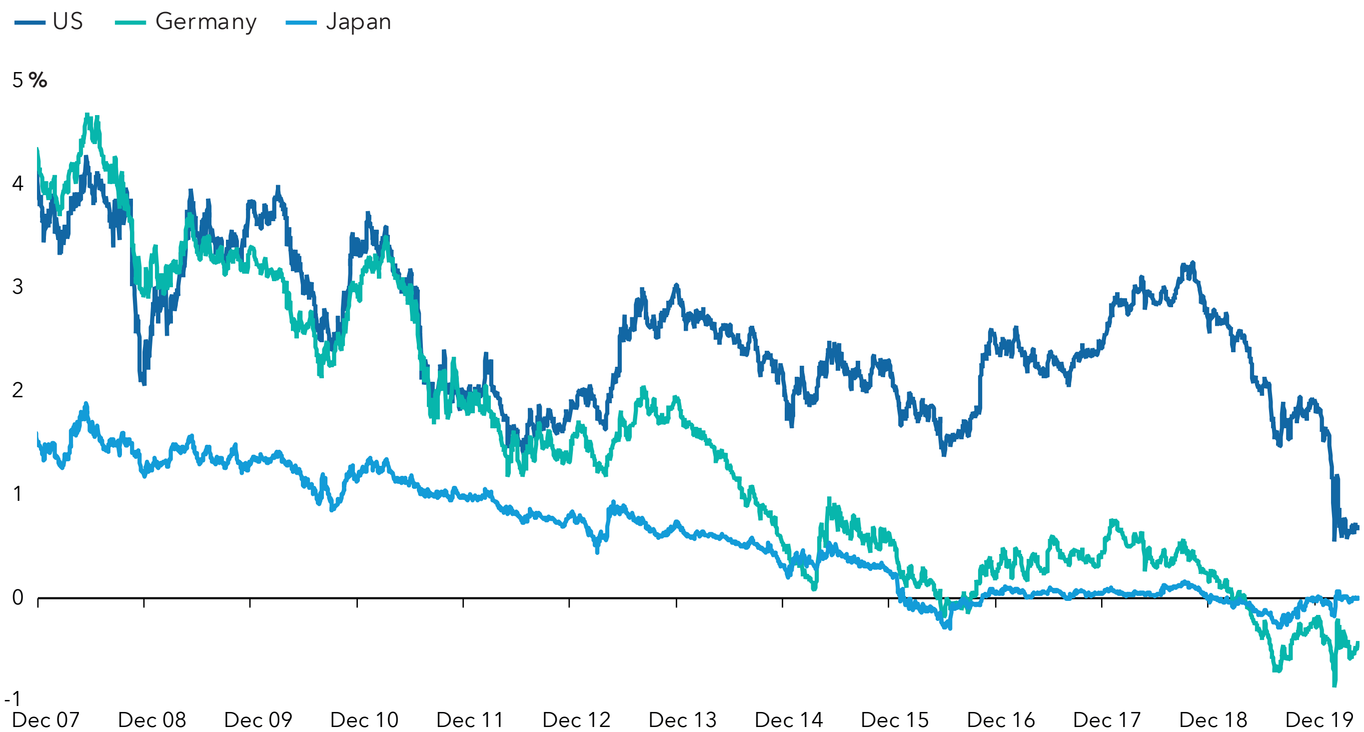
Lower for longer… still

Bond markets have stabilised following the extreme shock to markets in March, as governments and central banks stepped in to help alleviate market stress. Their responses have been relatively swift and extensive compared with past crises such as the global financial crisis. This has so far helped prevent an even greater economic decline, through interest rate cuts, bond buying, lending programmes and providing liquidity. But the temporary shutdown of the global economy is a unique event and it will be a long road to economic recovery, measured in years and not quarters.

Low growth and inflation prospects suggest that the low interest rate environment that has prevailed in recent years is probably here to stay for a while longer. Central banks will likely err on the side of being conservative and accommodative. For instance, the federal funds futures market, which represents market participants' expectations, is pricing the federal funds rate at 0–25 basis points well into 2023[1]. We can expect to see the balance sheets of the European Central Bank (ECB), Bank of Japan (BoJ) and US Federal Reserve (Fed) reaching a combined US$20–25 trillion[2]. There will likely also be many more announcements of fiscal stimulus programmes and extensions of expiring programmes.

While central banks can help shore up liquidity for companies that would otherwise have been solvent were it not for the economic shutdown, we would expect to see corporate earnings fall and defaults rise. Against that backdrop, we think it is imperative to maintain a diversified approach with a strong focus on active fundamental research.

10-year government bond yields: Treasury yields fell towards Bunds and JGBs[3]



Past results are not a guarantee of future results.

1. SOURCES: Bloomberg, Federal Reserve. As at 30/4/2020. Projection based on pricing in the futures markets.
2. SOURCES: Capital Group, Refinitiv Datastream. As at 31/3/2020.
3. SOURCE: Bloomberg. As at 31/5/2020. JGB: Japanese government bond.

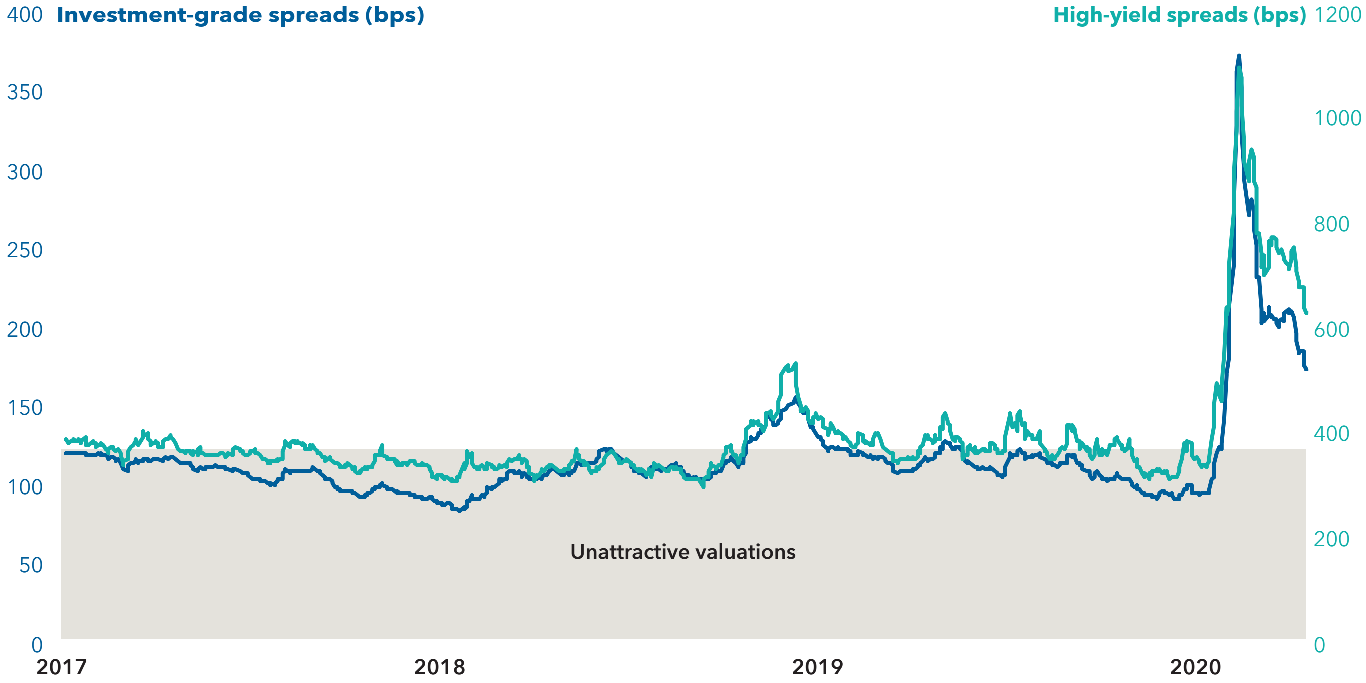
Selective opportunities are surfacing in US credit markets

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. US 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, US 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 US 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 US$350 billion in US bonds downgraded to high yield status this year. In this type of environment, fundamental research will be critical to avoiding those issuers most at risk.

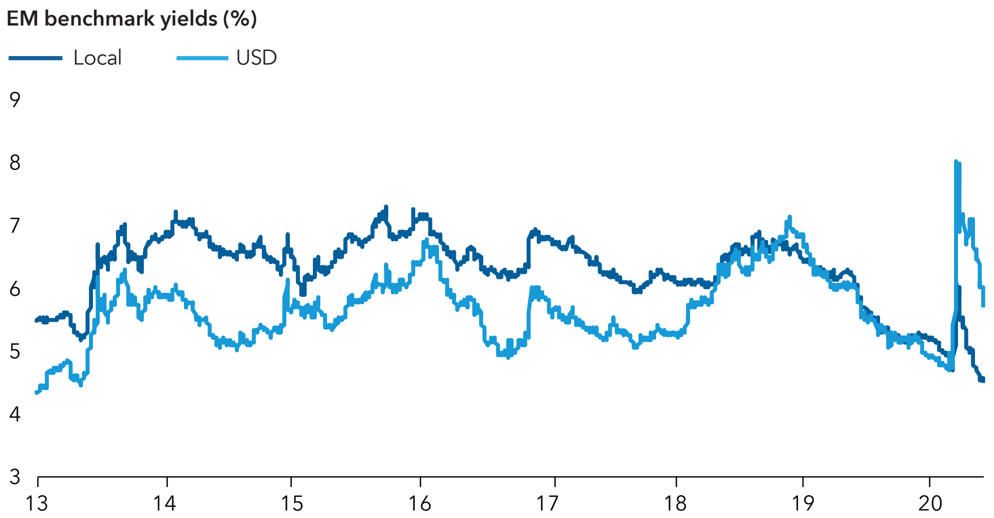
Credit spreads spiked in 2020 and remain elevated



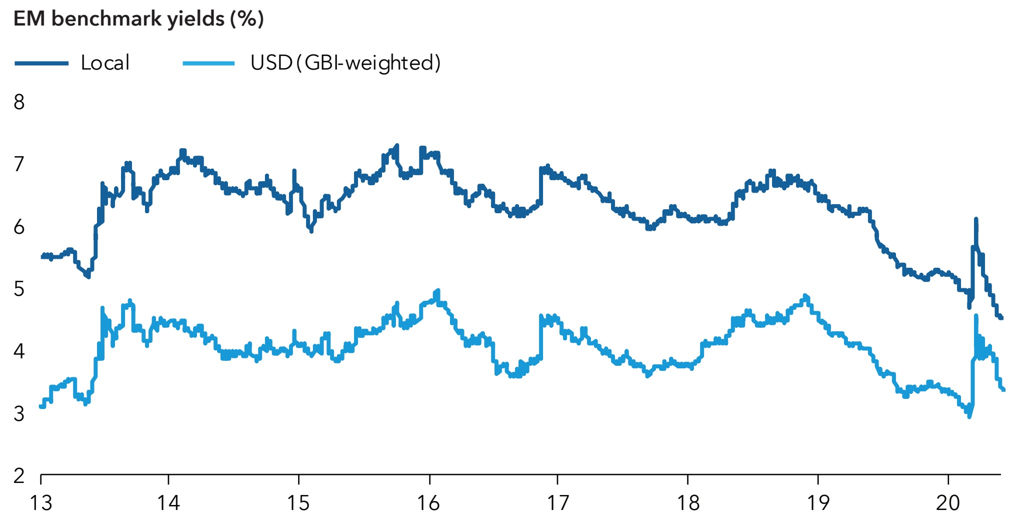
Past results are not a guarantee of future results.
SOURCES: Bloomberg Index Services Ltd., RIMES. As at 31/5/20. Investment-grade spreads are for Bloomberg Barclays US Corporate Investment Grade Index. High-yield spreads are for Bloomberg Barclays US Corporate High Yield Index.

Dislocation in higher yielding EM dollar debt may create opportunities

USD EM debt yields are now well above those of local EM debt[1]



But not after adjusting for local index country composition[2]



There has been a stark difference in the sell-off between emerging market (EM) hard and local currency debt since the start of the crisis. When the crisis hit EM in March, EM local currency debt was only down around 1% in local currency terms in March versus double digit losses for the US dollar-denominated portion of the asset class.

Historically, local currency debt yielded more than dollar debt. This has been changing over the past two years and has now completely reversed. Part of this reversal reflects the quality of local market issuers, which tend to be the higher quality, more developed issuers within the broader asset class. Meanwhile, we have seen more lower quality sovereigns come to the dollar market in recent years.

If you take the same issuers in the local currency benchmark, use their local currency index weights for the dollar bond index and measure their dollar market yields, they are actually lower than the same countries' local currency bond yields. It is the higher yielding US dollar denominated section of the asset class and particularly those related to oil that have sold off far more than the investment-grade credit. While this is justified, in some cases, the sell-off in higher yielding credit has been more than would be warranted by fundamentals.

Past results are not a guarantee of future results. Emerging markets are volatile and may suffer from liquidity problems.

SOURCE: Bloomberg. Data from 1/1/2013 to 31/5/2020.

1. USD EM debt: JPMorgan EMBI Global Diversified Index, Local EM debt: JPMorgan GBI EM Global Diversified Index.
2. USD (GBI-weighted) – EMBI Global Diversified adjusted for GBI EM country weightings.

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- **Past results are not a guide to future results.**
- **If the currency in which you invest strengthens against the currency in which the underlying investments of the fund are made, the value of your investment will decrease.**
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