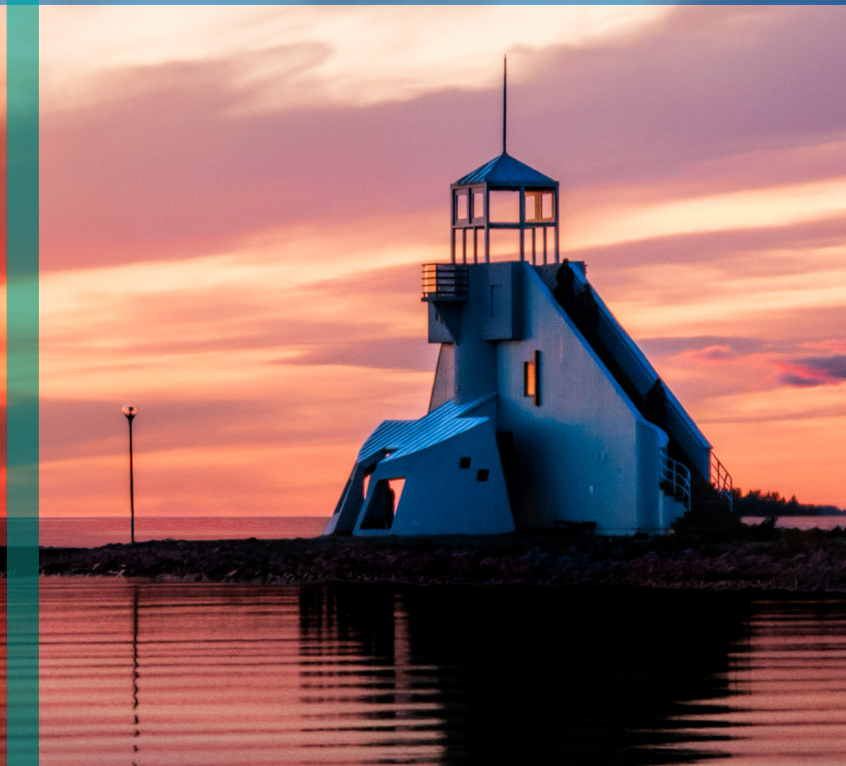


Outlook

MIDYEAR ISSUE JUNE 2019



Long-term
perspective on
markets and
economies



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2019 Midyear Outlook: Key takeaways

MACRO

The US expansion gets a second chance.

Recession? What a difference six months makes. The US Federal Reserve's policy pivot and lower-for-longer rates are extending the life of this economic cycle.

But late-cycle conditions are mounting. Rising wages will put pressure on profits, plus a flood of corporate debt could pose problems when the tide turns.

EQUITY

Stocks may have room to run, but be ready for a bumpy ride. Investors should expect more late-cycle volatility. It's not too early to prepare portfolios for rougher seas ahead.

Not all dividends are equal – or sustainable. Companies that binge on debt to cover share buybacks and dividends are susceptible to dividend cuts when times get tough.

If you think all the best stocks are in the US, think again. Over the last decade, most of the top 50 stocks were non-US, even though the US index did better overall. It's about selecting companies, not indices.

Look beyond the headlines in Japan and Europe. Solid consumer confidence and PMI data are supporting Europe's domestic economy, while structural changes are driving higher profitability in corporate Japan.

FIXED INCOME

Yield curve inversion – what should investors do? An inverted yield curve does not cause a recession, but is just another sign of a late economic cycle. So check portfolios are well diversified and core bond holdings limit excess risk.

Look beyond high yield for enhanced income. Right now, emerging markets debt offers a sweet spot for enhanced income.

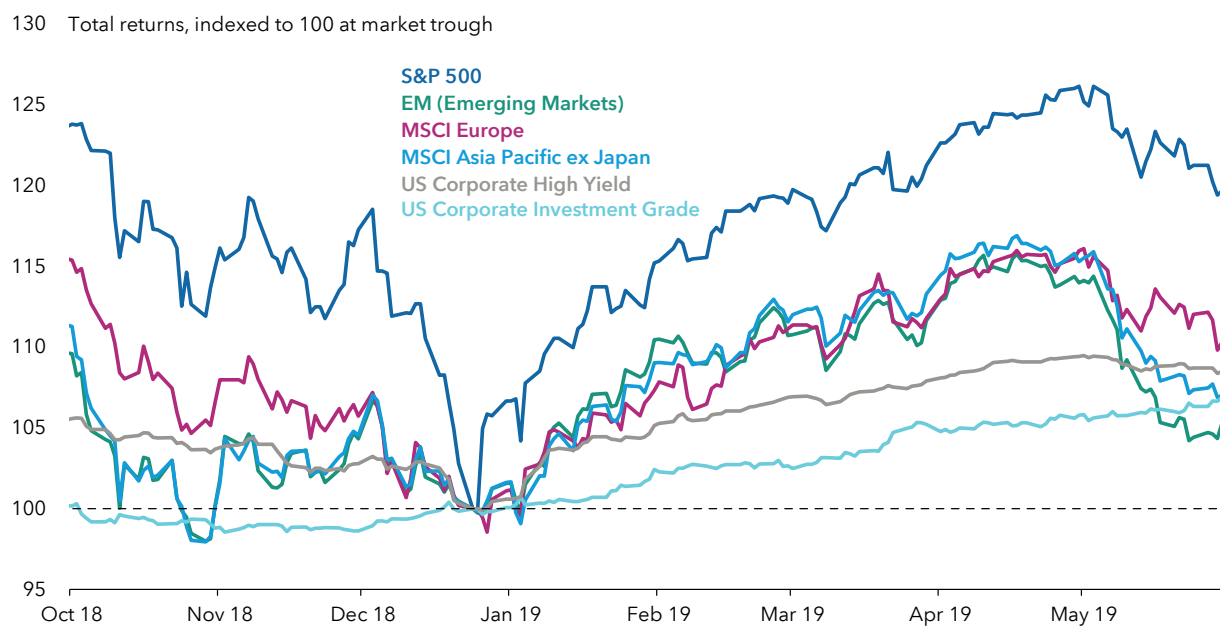
Pivot point: Central banks let markets fly higher.

What a difference six months makes. The most consequential change in the global financial markets since our last Outlook report was the US 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 US-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

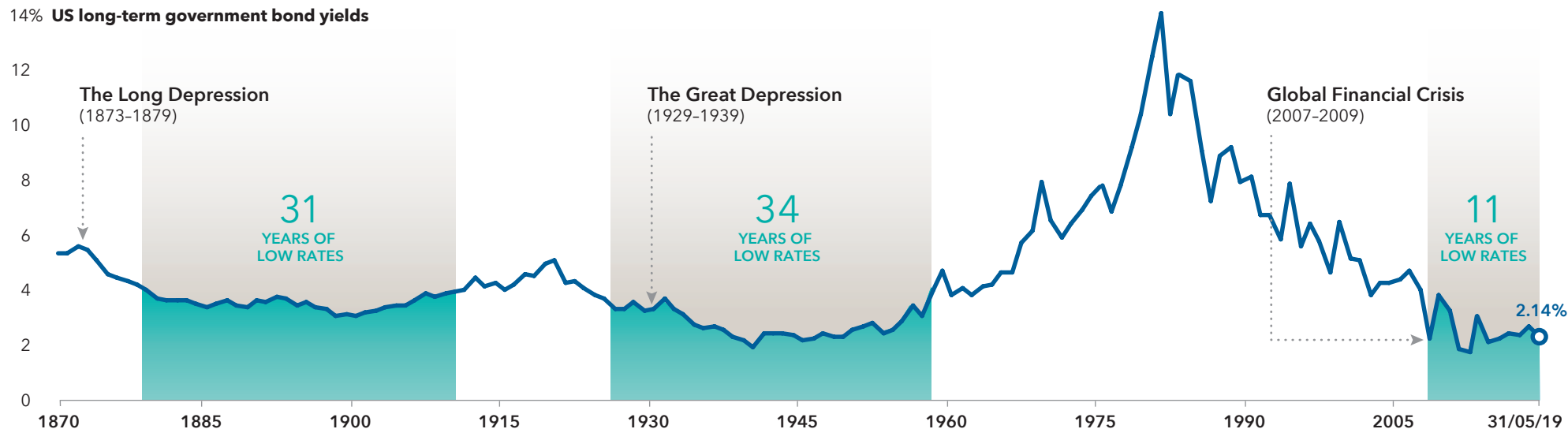


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Lower-for-longer rates extend the cycle.

History shows that US long-term rates can remain low for extended periods

14% US long-term government bond yields



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 demand for US Treasuries should weigh on long-term interest rates.

While inflation pressures are building in the US, 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.

For illustrative purposes only.

SOURCES: Federal Reserve, FactSet, Robert Shiller, Thomson Reuters. Data for 1871-1961 represents average monthly US long-term government bond yields compiled by Robert Shiller. Data for 1962-2018 represents 10-year Treasury yields as of 31 December each year within the period. 2019 data as of 31/05/19. Length of low rate periods above are consecutive years with rates below 4%.

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

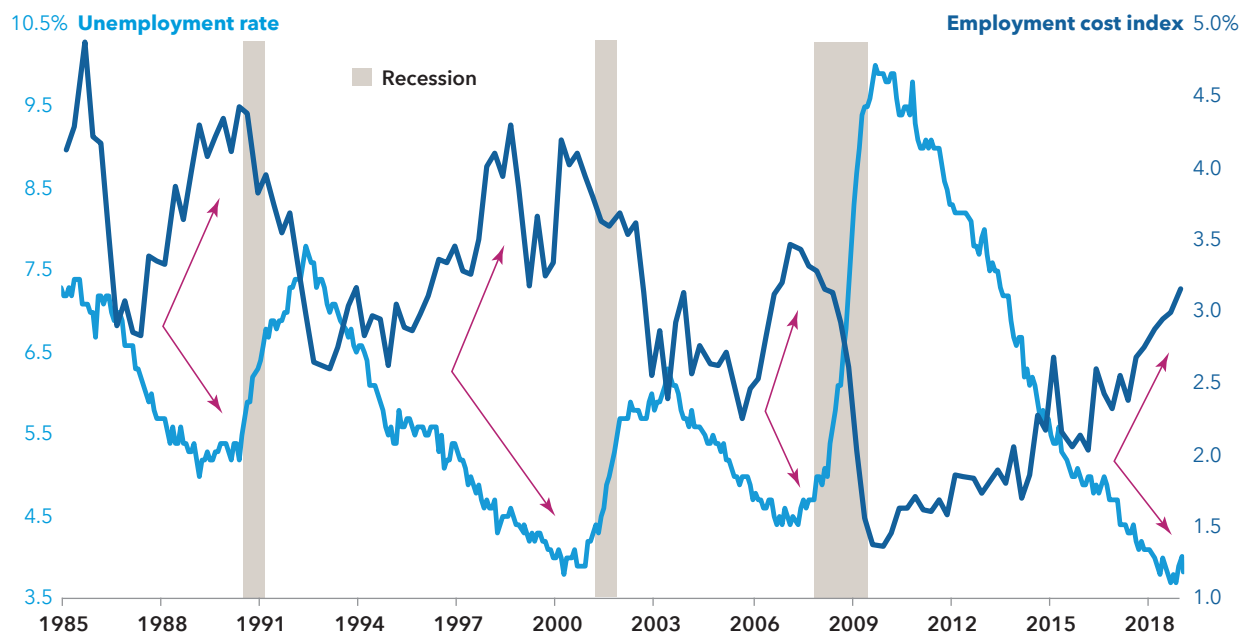
Easy Fed policy. Low rates. So, risk on? “An extended cycle suggests a longer runway for corporate earnings growth, so equities still have the potential to offer some modest appreciation in 2019,” says Capital Group US economist Darrell Spence. But investors would be well-advised to approach stock markets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

“Whether it’s rising wages or a tight labour 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 US 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 labour costs inevitably pressure profit margins and trigger market volatility. “And the potential for escalation of the US-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.

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



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SOURCES: Bureau of Labor Statistics, Thomson Reuters. Employment Cost Index uses quarterly data as of 31/03/19. Unemployment rate uses monthly data as of 30/04/19.

Beware of companies spending more than they earn.

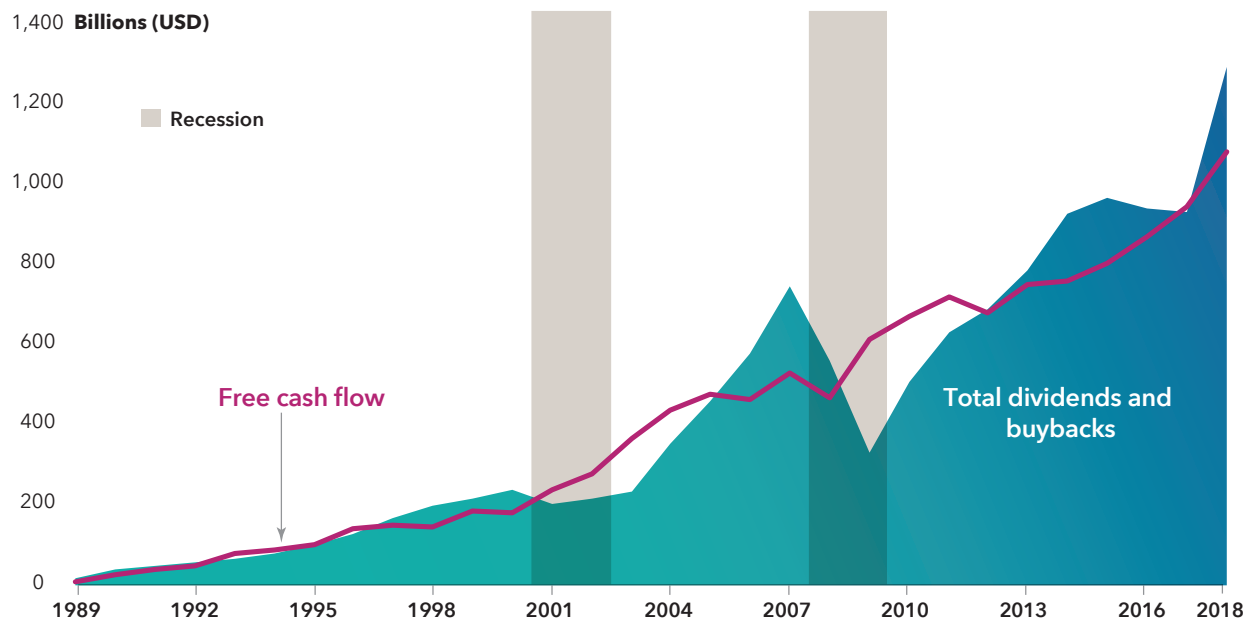
Where are the excesses today – and what are the risks? You might find them on the bloated balance sheets of companies that have been on a debt binge. In the US, non-financial corporate sector borrowing stood at 46.7% of GDP at the end of 2018, a record high.

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 US-based companies that represent more than 98% of the US public equity market. As of 31/12/18.

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 at Capital Group. “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+

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SOURCE: FactSet. Interest coverage ratio as of 31/12/18. Dividend yield and credit ratings as of 31/05/19. 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.

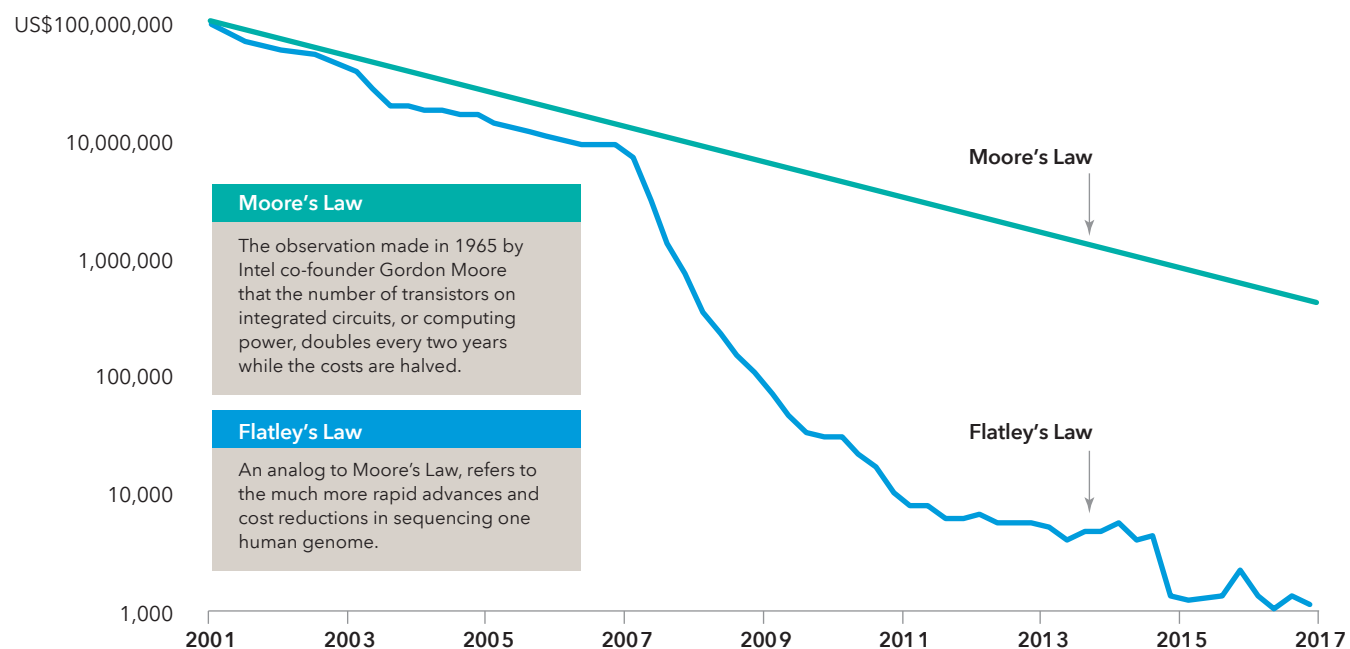
Innovation is a topic that gets Anne-Marie Peterson excited about coming to work every day. "Innovation improves people's lives and drives growth and opportunity for companies," says Peterson, a Capital Group portfolio manager.

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. US 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



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SOURCE: National Human Genome Research Institute. Data as of 31/07/17.

Think all the best stocks are in the US? Think again.

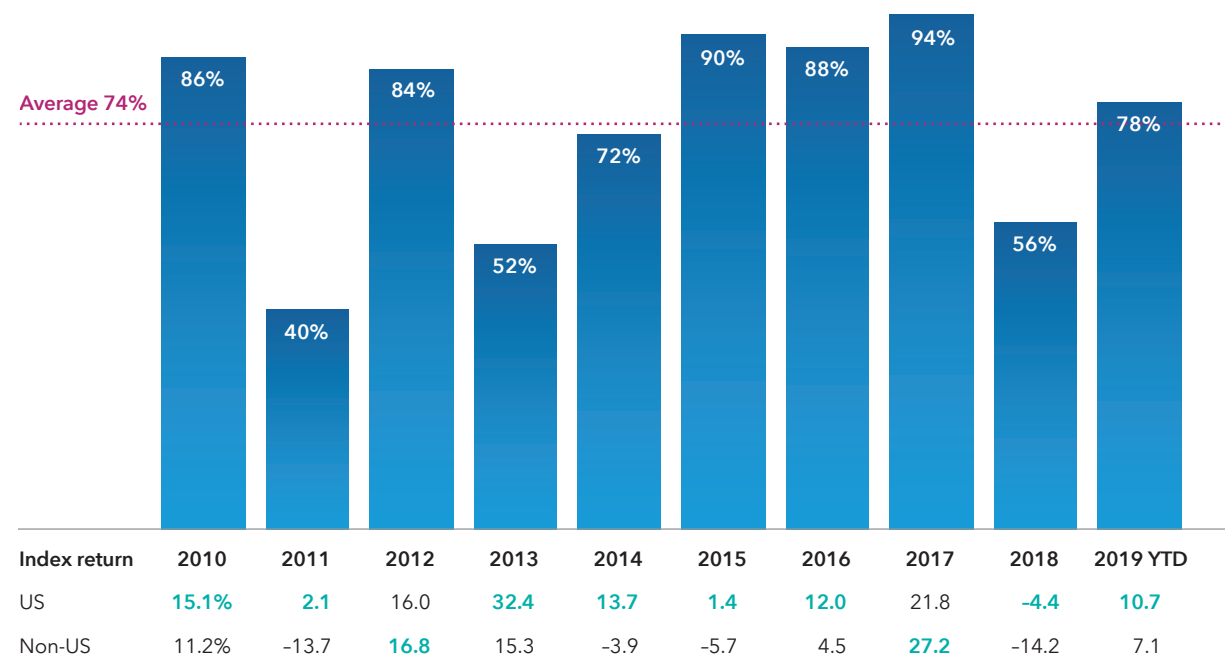
While it's true that most regional equity markets have lagged the US over the past decade, the index-based returns that most investors follow don't tell the whole story. On a company-by-company basis, the picture is significantly different than you may think.

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-US address.

In certain sectors, the US 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 US tend to offer higher yields. All reasons to consider maintaining a healthy allocation to global stocks, even if you think US markets will continue to lead the way.

What percentage of the top 50 stocks each year are non-US?



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SOURCES: RIMES, MSCI. Data as of 31/05/19. Returns in US dollars. S&P 500 Index and MSCI ACWI ex USA used for US and non-US returns.

Despite headwinds, Europe displays domestic resilience.

The European Central Bank allayed concerns of premature policy tightening by signalling interest rates will remain unchanged throughout 2019.

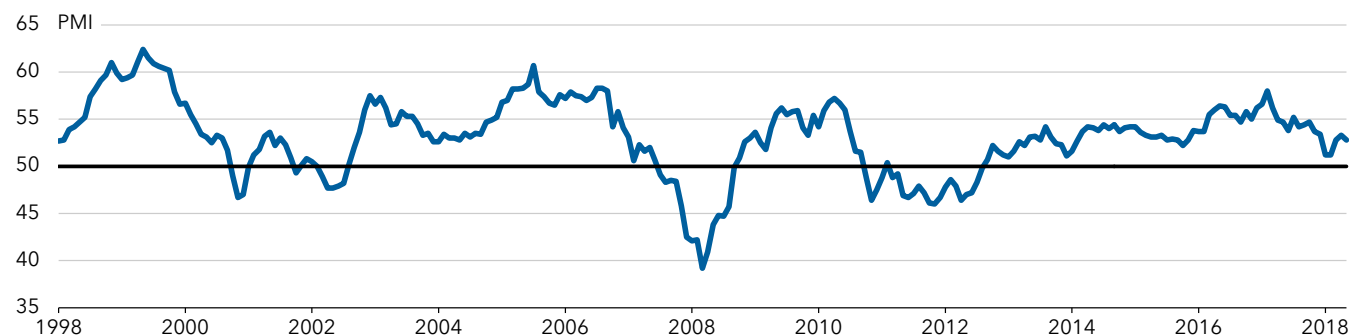
Alongside a more favourable outlook for rates, we have also seen some more encouraging signs for Europe. Manufacturing PMIs have stabilised, even in Germany and Italy. Activity has remained robust in services and construction.

In fact, the European domestic economy has shown surprising resilience: Unemployment has been falling in most economies – although Italy is an exception – and rising wages and lower headline inflation have boosted household real incomes. Governments have eased fiscal policy through tax cuts and increases in public spending. These factors have supported consumer spending. Business investment has also continued to grow. The result is that eurozone real GDP growth strengthened in Q1 2019.

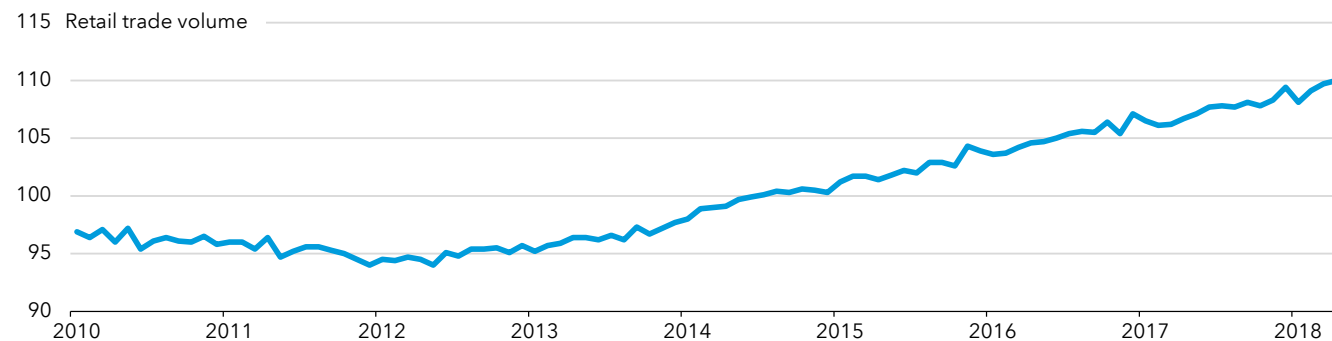
Political uncertainty within the region remains a key issue, as does the threat that the US could turn its trade fire on the EU. Despite these headwinds, there is some valuation support for European equities. The cyclically-adjusted P/E ratio on the MSCI US Index currently stands at 27x while it is 15x for MSCI Europe¹.

This valuation discount is evident across sectors; both compared against US peers, and when measured against long-term averages, providing ample opportunities for bottom-up, fundamental investors.

Europe's recovery has continued - Euro area services PMI survey



Consumer confidence has remained robust fuelled by rising retail trade volumes



Past results are not a guarantee of future results.

Top chart: PMI: Purchasing Managers Index. SOURCE: Thomson Reuters Datastream. As of 15/05/19.

Bottom chart: Retail trade volumes adjusted for price changes and seasonal effects. Data rebased to 100 in 2015.

SOURCE: Thomson Reuters Datastream. As of 15/03/19.

1. Data as of 31/05/19

Profitability on the rise in corporate Japan.

Although inflation and productivity have fallen short of expectations, Japan's economy grew by an unexpected 2.2% (annualised) in the first quarter of 2019. This is particularly impressive given the slowdown in China and trade frictions between Washington and Beijing.

The economic policies put into place by Prime Minister Shinzo Abe's administration have undeniably contributed to steady economic growth and record low unemployment. Recently, the government's focus has turned towards promoting a growth strategy aimed at increasing productivity, as well as boosting general corporate competitiveness.

Corporate governance and shareholder returns have been improving, as revised corporate governance and stewardship codes take effect.

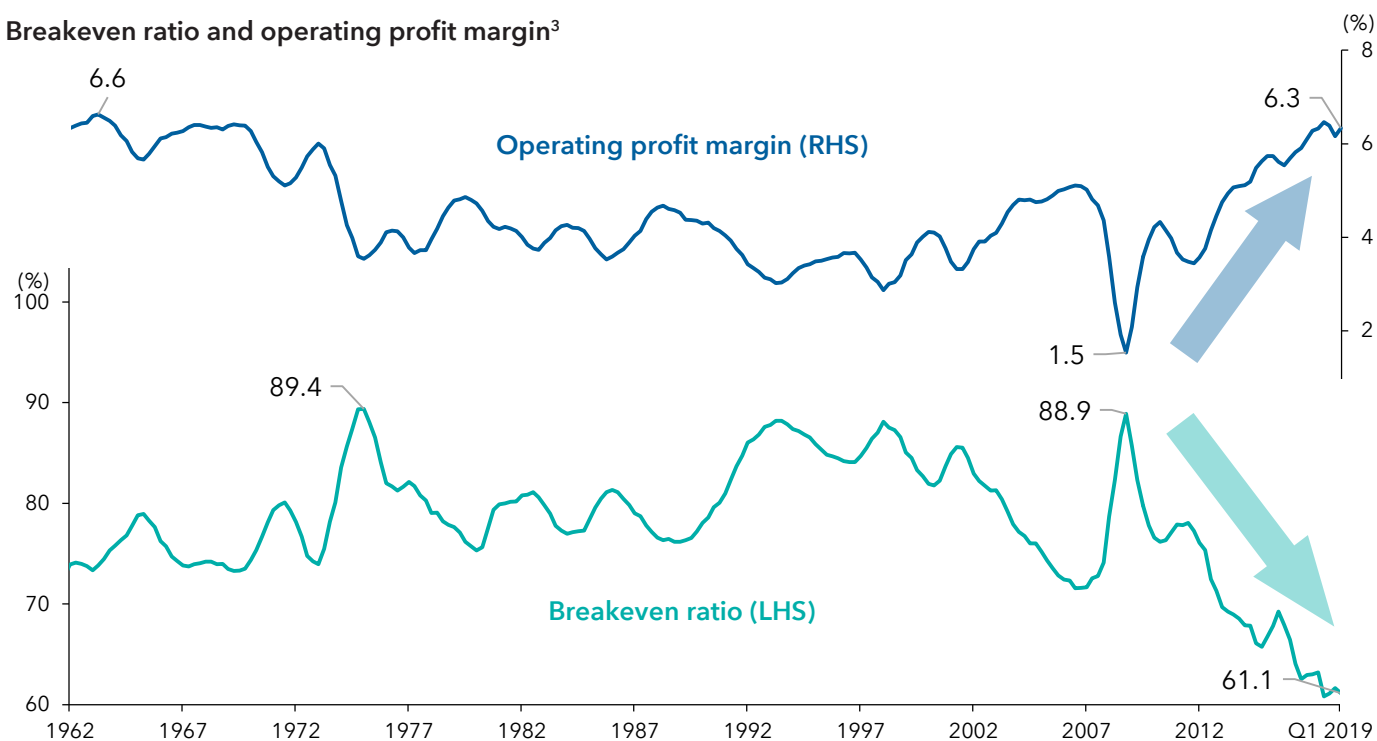
As a result of structural changes, many Japanese companies have become highly profitable. In 2018,¹ corporate Japan recorded its highest operating profit margin in decades, with a significant fall in the breakeven ratio. A large proportion of this has been driven by drastic cost-cutting undertaken since the global financial crisis in 2008.

Variable and fixed costs have come down by about 4% and 1% respectively, compared to 10 years ago.² A weaker yen should also prove supportive for the bottom line of both exporters and domestic firms.

Valuations look attractive from a historical and international perspective with ongoing earnings growth momentum. Continued strides in corporate governance and a stable macro environment could provide support for Japanese equities.

Historical paradigm shift in profitability of Japanese corporations

Breakeven ratio and operating profit margin³



Past results are not a guarantee of future results.

1. Data as at Q2 2018. Breakeven ratio is the point at which sales equal costs. SOURCE: Japanese Ministry of Finance
2. Data as at 31/03/19, Q4 2008 - Q1 2019 (4-quarter aggregate). SOURCE: Japanese Ministry of Finance
3. Data as at 31/03/19, Q4 1962 - Q1 2019 (4-quarter aggregate). Corporate statistics by Ministry of Finance. Non-financial and non-insurance companies with capital stock of more than 1 billion yen (5,045 companies for Q1 2019). CY: calendar year. SOURCES: Japanese Ministry of Finance, Capital Group

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

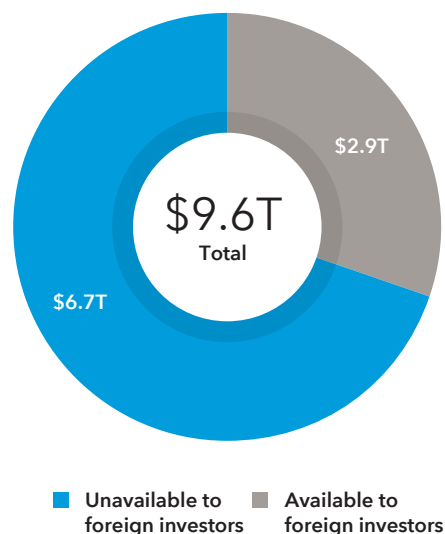
Investor worries about China are ubiquitous. What are the implications of China's slowing economy? Will a brewing trade war with the US derail a fragile recovery from the global financial crisis? Could internal political strife result in a reversal of China's ambitious reform efforts?

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.

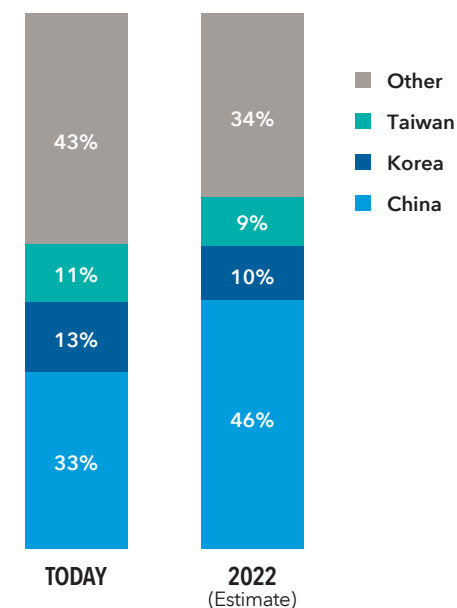
That is a stock picker's dream come true. Even if only a small fraction of those companies wind up being viewed as attractive investment opportunities, the extensive research needed to identify them should be well worth the effort. Imagine finding the next Alibaba, Baidu or Tencent in that mix. The implications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

Market value of Chinese equities



MSCI Emerging Markets Index country weights



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SOURCES: Capital Group, MSCI, RIMES. As of 31/03/19 in US dollar terms. 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.

Cyclical and structural drivers behind EM growth.

Country-specific economic and political issues, as well as trade tensions and slowing global growth, all contributed to a tough 2018 for emerging markets. However there are both cyclical and structural reasons for positivity around the asset class.

The relationship between emerging market returns and US dollar strength is still significant. However, as the US Federal Reserve takes a more cautious approach to interest rate hikes, there is potential for the dollar to moderate, and in turn rekindle appetite for emerging market assets.

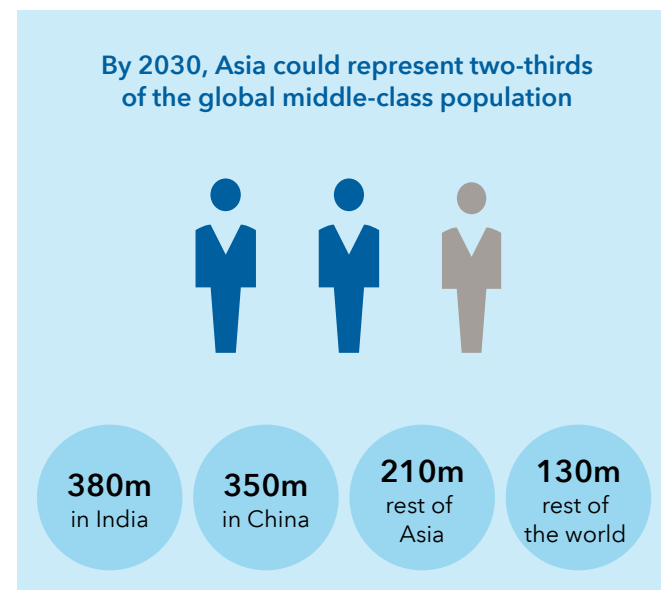
Moreover, economic indicators such as Markit's Purchasing Managers' Index show that activity remains in expansionary territory. Additionally, China has moved to stimulate growth through tax cuts and investment in infrastructure.

Looking longer term, there are compelling structural reasons behind a range of attractive investment opportunities in EM.

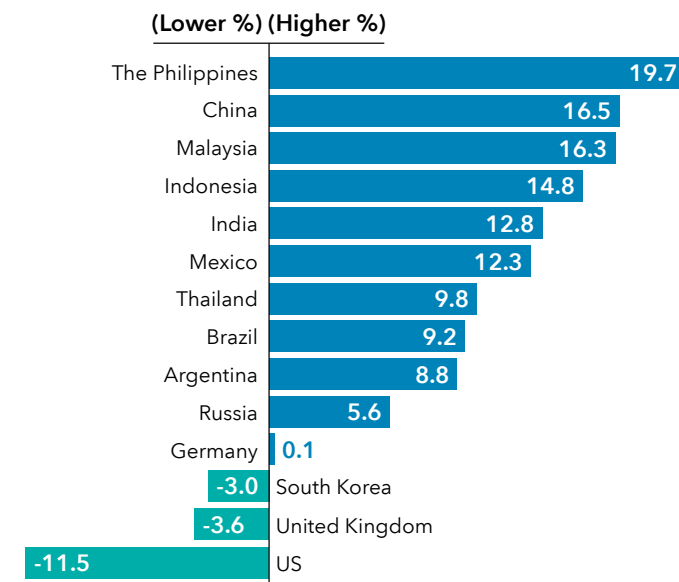
Contributing 70% to global GDP growth, emerging markets are the key driver of growth globally. A large portion of EM growth stems from a dynamic demographic profile, in particular the expansion of the middle class. Increasing household disposable income propels consumers to buy products and services across sectors like consumer durables, tourism, health, education and transport.

Emerging markets middle class is growing rapidly

88% of the next 1 billion entrants into the middle class are expected to be in Asia



Gross income of 25- to 29-year-olds vs. national average (2015)



For illustrative purposes only.

SOURCES: The unprecedented expansion of the global middle class: an update, Brookings Institute, February 2017.
Euromonitor International, 2016

Don't overreact to a yield curve inversion.

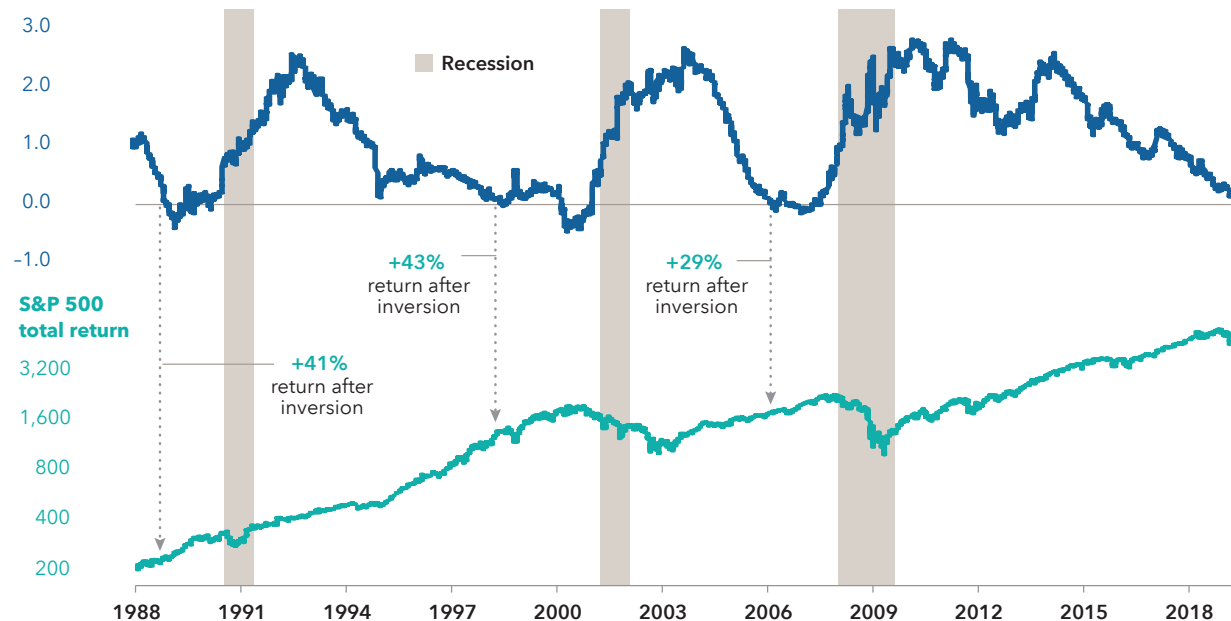
An inverted yield curve is one of the most widely cited recession indicators, but is it really cause for immediate concern? Probably not. While the measure's consistency can't be denied – an inversion has preceded every US recession over the past 50 years – its lead time has been significant. The 16-month 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 US Federal Reserve 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

Two-year/10-year spread



Past results are not a guarantee of future results.

SOURCES: National Bureau of Economic Research, Standard & Poor's, Thomson Reuters. As of 31/05/19. 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.

Emerging markets debt: Sweet spot for enhanced income.

Emerging markets debt is in the sweet spot for enhanced income. The asset class offers a nice balance of yield and modest equity correlation, even among higher quality issuers.

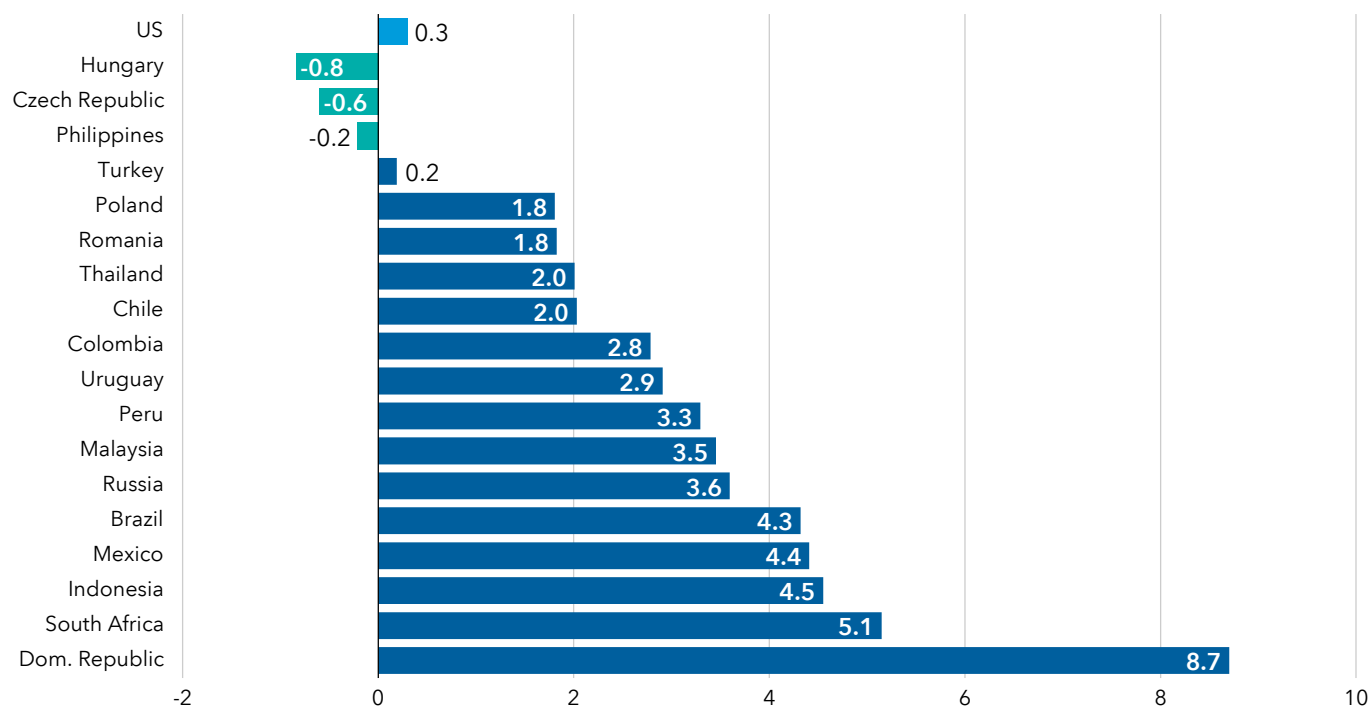
Fundamentals are also looking decent overall. EM countries are now generally less indebted than in the past (and those that still have high external debt will benefit from continued low developed market rates) and are less dependent on foreign inflows. EM countries are growing faster than developed markets, while inflation is relatively contained.

Select emerging markets currencies could appreciate against the US dollar as prospects for tighter monetary policy in the US and other developed markets recede.

This possibility, in combination with higher yields, suggests that local currency bonds should continue to offer fertile ground for selective investors in coming months.

However, there is a great deal of variation within emerging markets 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.

10-year bond yields minus core inflation (%)



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*Real yield for Uruguay is computed using nominal 5 year bond yields.
Excludes Argentina (real yield of -19%). Data as at 31/03/19. SOURCE: Bloomberg

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- **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.**
- **Depending on the strategy, risks may be associated with investing in fixed income, emerging markets and/or high-yield securities; emerging markets are volatile and may suffer from liquidity problems.**

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