

Outlook

MIDYEAR ISSUE 2023



Long-term
perspective on
markets and
economies

Marketing communication



The new reality for investors



Martin Romo
President, Capital
Research Company

As we reach the midpoint of 2023, it's clear we are facing tremendous uncertainty and change. We are moving through a period of transition in the global economy, the financial markets and individual sectors. What had been a binary market – a market that was either/or – is now more balanced.

Previously, you could focus on a handful of large internet-related companies and disregard everything else. You could borrow at nearly zero percent and not worry about the consequences of free money, the threat of inflation, or the possibility that central banks might raise interest rates. Times have changed.

From an investor's point of view, that's good news. The market is no longer going in just one direction and that presents a more compelling, target-rich environment. The opportunity set has grown to include US companies and international companies, growth stocks and value stocks, the technology sector and health care, industrials and energy, short-term and long-term bonds, Treasuries and corporates. We're living in a world where there are both cyclical and secular opportunities for investors willing to do their homework.

It's important to note, we are also searching for opportunities where the baby has been thrown out with the bathwater – that is, companies left humbled by the sell-off of 2022, but still worth our attention because business models remain intact, earnings are holding up and the potential for stock price appreciation remains strong. So far this year we've seen companies in the tech and consumer sectors demonstrate the ability to bounce back impressively.

The risks have also grown. Not just market and economic, but policy risks. Where does the US stand in relation to China? Will the war in Ukraine escalate? How will regulators respond to a crisis of confidence in the banking sector? These are all issues to be considered as we evaluate potential investments. And we must be willing to embrace short-term discomfort for long-term benefit.

The reality is, it's a great time to be an active investor. It's more important than ever to look for opportunities on a global scale, but also to keep an eye on growing risks in the markets, the economy and the world. Given the uncertainty, there's a lot of cash on the sidelines these days. Now may be the time to consider putting it to work.

Growth stocks are stocks that are expected to grow at an above-average rate compared to their industry or the broader market.

Value stocks are undervalued stocks based on fundamental analysis.

In investing, 'secular' refers to market activities that unfold over long time horizons, or that aren't influenced by short-term factors.

Cash on the sidelines can be a bullish signal

Investors have anointed cash as king, shifting assets out of stock and bond investments and driving US money market totals to a record US\$5.4 trillion as at 31 May 2023.

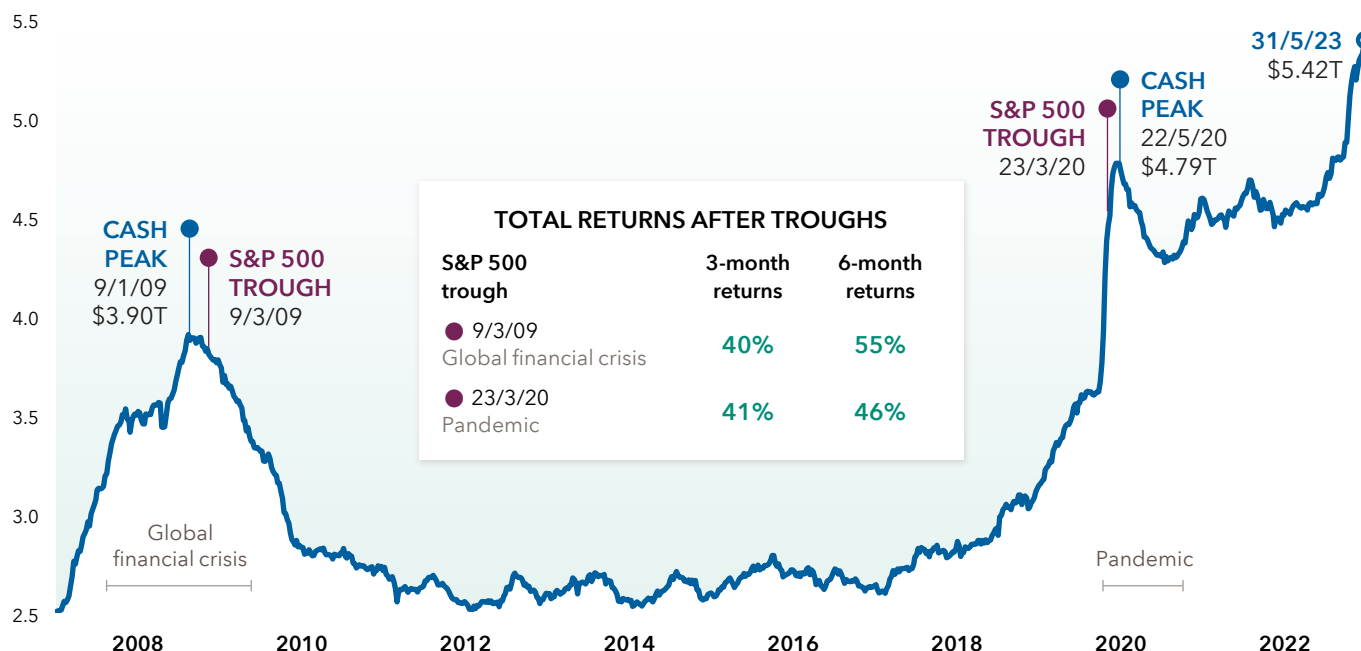
This flight to cash and cash alternatives (such as money market funds and short-term Treasuries) is understandable following last year's tandem decline of stocks and bonds in the face of rising interest rates, inflation and slowing economic growth. Many investors moved deposits from banks to money markets amid ongoing volatility and relatively high yields on cash instruments.

But conditions have shifted thus far in 2023, and long-term investors may want to rethink their approach. Levels of cash peaked near two recent market troughs. During the global financial crisis, for example, money market fund assets peaked two months before the S&P 500 Index reached a bottom on 9 March 2009. The stock market recorded a 40% return over the subsequent three months and a 55% return over the following six months. Similarly, during the pandemic, money market fund levels reached a high weeks after the S&P 500 reached its trough in March 2020.

After the painful losses of 2022, more risk-averse investors might consider allocating some cash to dividend-paying stocks, which provide income and capital appreciation potential, and select short- and intermediate-term bonds, which have been offering higher yields than in 2022.*

Investors' flight to cash has surpassed that of the pandemic and financial crisis

ICI Money Market Fund Assets (USD trillions)



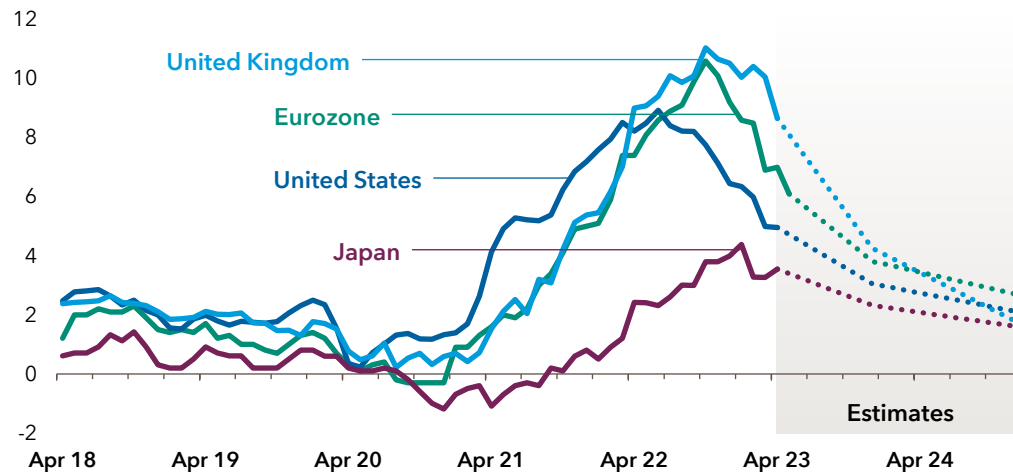
Past results are not a guarantee of future results.

As at 31 May 2023. In the chart, "cash peak" refers to peak money market fund assets. Unlike cash, which may be insured or guaranteed by the Federal Deposit Insurance Corporation, dividend-paying stocks, short- and intermediate-term bonds are not guaranteed and are subject to loss. A money market fund is a type of mutual fund that invests in high-quality, short-term debt instruments, cash, and cash equivalents. Yield is the income returned on an investment, such as the interest or dividends received from holding an asset. Treasury refers to Treasury securities - including Treasury bills, notes and bonds - which are debt obligations issued by the US Department of the Treasury. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value. The "bottom" of the market refers to its trough, or lowest point. It's the turning point when stocks stop falling and start rising again. * The 2 and 10-year US Treasury yield increased by 185 basis points and 80 basis points between May 2022 to May 2023. Basis points are a unit of measure used in finance to describe the percentage change in the value of financial instruments or the rate change in an index or other benchmark. SOURCES: Capital Group, Bloomberg Index Services Ltd., Investment Company Institute (ICI), Standard & Poor's

Inflation has eased as rate-hiking cycle nears an end

Inflation, still elevated, is less fierce

Annual consumer price index (%)



It may not feel like it at the supermarket, but inflation is on a downward trajectory in the US, Europe and many other markets. That's largely due to lower energy prices, fewer supply chain disruptions and a steady series of interest rate hikes by central banks.

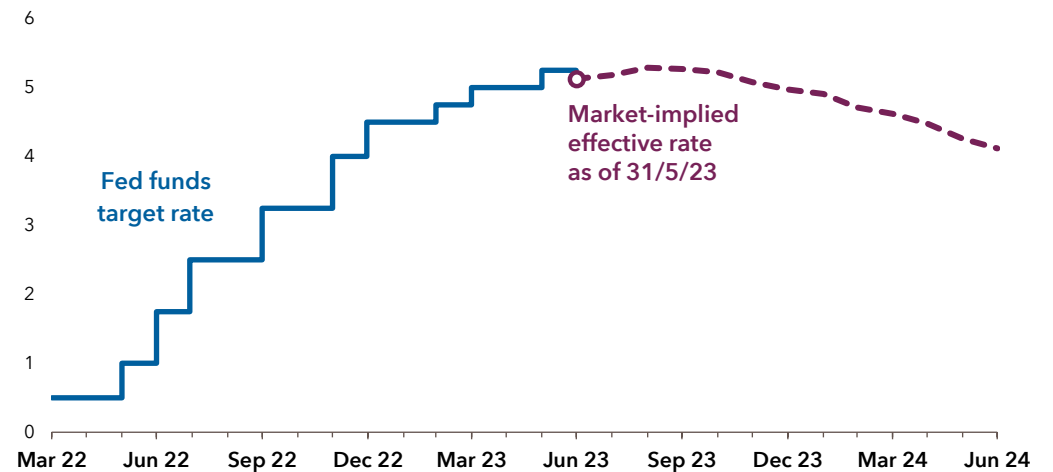
Interest rate-sensitive industries such as housing are already feeling the effects, with home prices falling in some formerly hot markets. Inflation still remains well above the US Federal

Reserve's (Fed) 2% target, but monetary policy often works with long lags, so the full impact of interest rate hikes should spread through the rest of the economy over time.

The recent US banking turmoil could also help slow economic growth as some banks may become more cautious and reduce their lending activities. Taken together, these factors have significantly changed the interest rate outlook.

Markets expect a decline in interest rates over the next year

Federal funds rate - Actual vs. market-implied (%)



"We knew there would be consequences to one of the most aggressive tightening campaigns in history," says fixed income portfolio manager Pramod Atluri. "The dislocations we are seeing in the financial markets signal a painful new phase for the Fed. It has clearly exposed some vulnerabilities and, as a result, I believe we are nearing the end of this rate-hiking cycle."

Forecasts shown for illustrative purposes only.

FOR LEFT CHART: Data as at 5 June 2023. SOURCES: Capital Group, FactSet, Bureau of Labor Statistics, Eurostat, UK Office for National Statistics, Japanese Statistics Bureau & Statistics Center, International Monetary Fund. Consumer price indexes for each region provide a measure of the average change over time in the prices paid for a basket of consumer goods and services. FOR RIGHT CHART: Data as at 31 May 2023. Fed funds target rate reflects the upper bound of the Federal Open Markets Committee's (FOMC) target range for overnight lending among US banks. SOURCES: Capital Group, Bloomberg Index Services Ltd., Refinitiv Datastream, US Federal Reserve

US recession is likely, but the recovery could be stronger than expected

This may be the most widely anticipated recession in history. The question is: What comes after?

"When an insight is widely held, such as the likelihood of recession before the end of the year, it may already be priced into the market," US economist Jared Franz says. "Investors may be better served by preparing for what I expect will be a stronger than usual recovery."

Franz cites three reasons the next recovery could be more robust than prior cycles. First, companies are expecting economic weakness and taking action, cleaning up inventories and balance sheets.

Second, the US consumer is in relatively good shape. Consumer debt is low relative to levels during the global financial crisis and other more typical recessions.

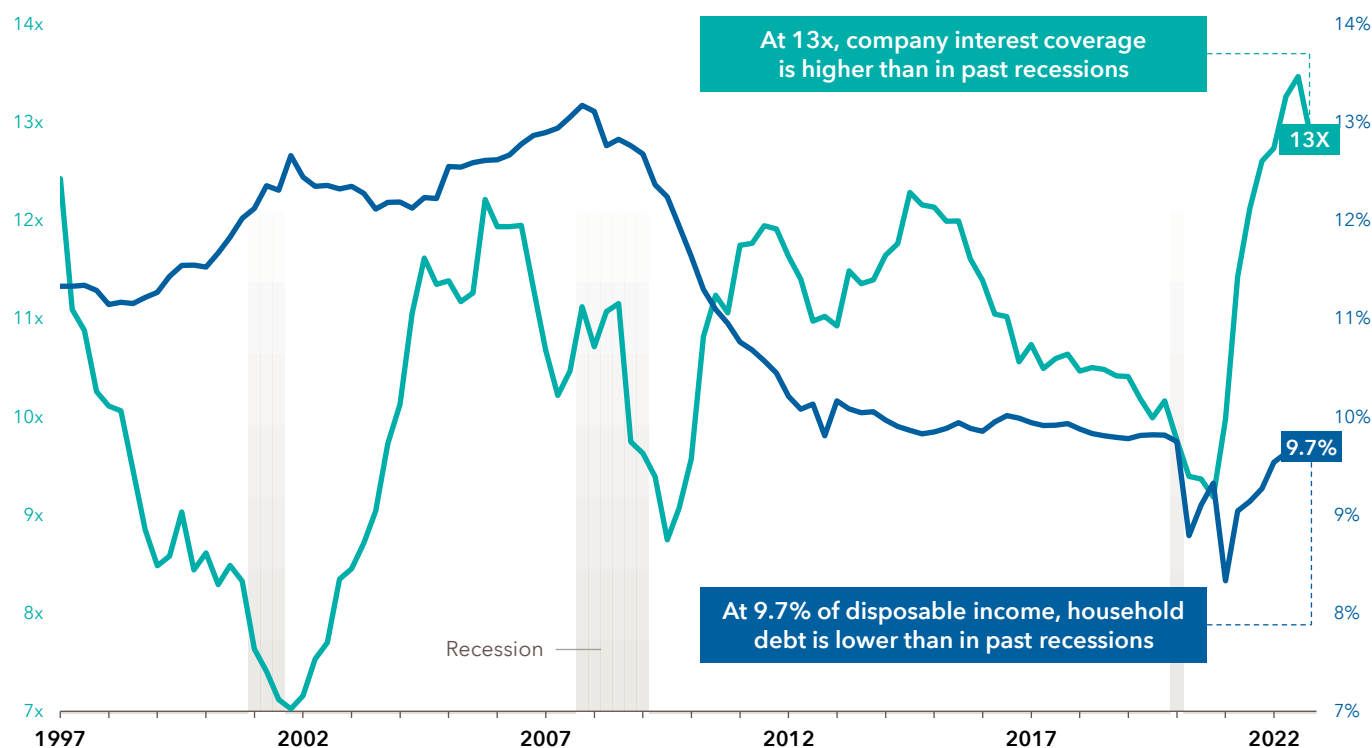
Third, Franz expects moderating inflation to support consumer strength. "While it will take some time for the Federal Reserve to get inflation down to its 2.0% target, I believe it will be contained near 3.0%, which can feel like a real wage boost," Franz says.

Strong consumer spending could boost a range of industries, including travel and leisure. What's more, some signs suggest the housing market, which has already been in recession, may be recovering, providing a tailwind for spending on construction and durable goods such as household appliances.

Consumers put their houses in order as companies cleaned up balance sheets

US investment-grade issuers
median interest coverage

US household debt service payments
as % of disposable income



Forecasts shown for illustrative purposes only.

Data as at 31 December 2022. Interest coverage reflects the ratio between earnings before interest and taxes (EBIT) and interest expense. Shaded bars represent US recessions as defined by the National Bureau of Economic Research. SOURCES: Capital Group, Federal Reserve Bank of St. Louis, Morgan Stanley, National Bureau of Economic Research

Could now be the time to move out of cash?

Market volatility hastened a flight to cash for many investors. While understandable, this response effectively placed investment objectives on hold and relinquished long-term return potential.

“I believe many investors have become disbelievers in balanced strategies at the wrong time. Going forward, balanced portfolios - whether they are a 60/40 split or 65/35 - may continue to be a successful approach,” says portfolio manager Hilda Applbaum.

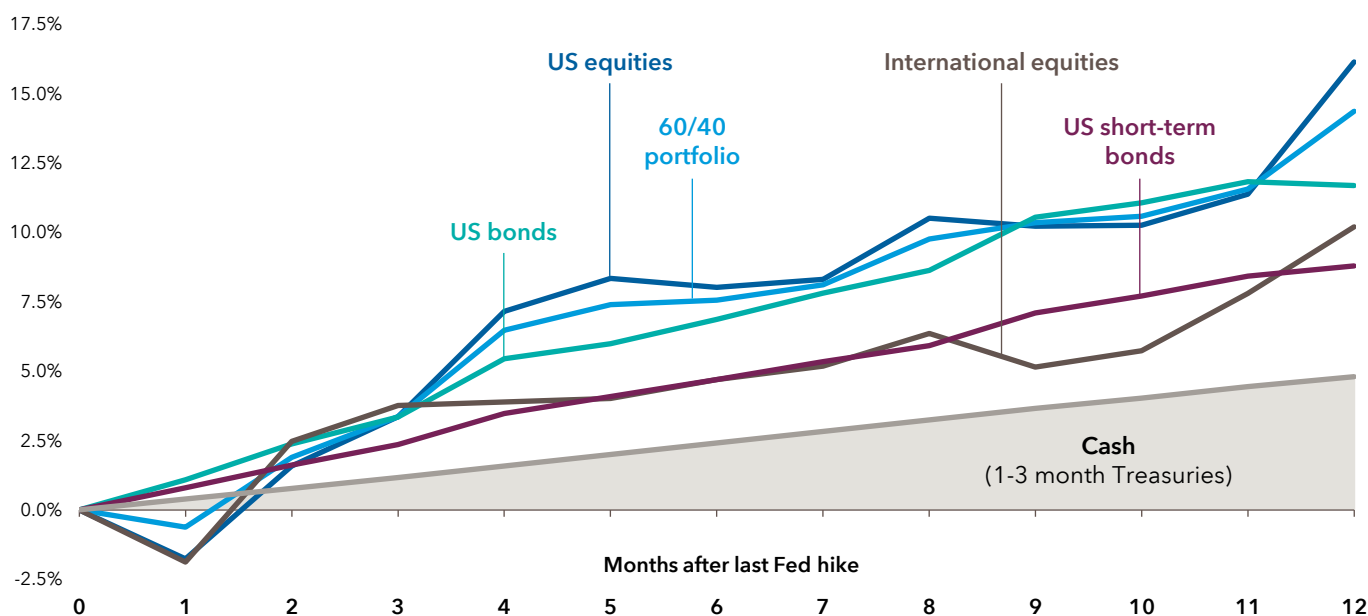
The 60% equities and 40% fixed income portfolio aims to generate attractive returns while reducing risk. Investors were hit hard in 2022 as the Fed started raising interest rates and both stocks and bonds posted losses.

With inflation inching toward normal and the Fed taking a pause, now may be an opportune time for investors to consider moving back into a balanced strategy. Valuations across a range of stocks are more attractive, and bonds are now offering more income and higher return potential.

Over the last four hiking cycles since 1995, investing after the last Fed rate increase has generated strong returns for both stocks and bonds. What’s more, the best returns occurred in the first 12 months after the last rate hike.

Stocks and bonds have outpaced cash after a Fed hiking cycle

Average returns following the last Fed hike - Prior four hiking cycles



Past results are not a guarantee of future results. This information is not intended to provide investment advice or be considered a personal recommendation.

As at 31 May 2023. Returns reflect the average cumulative return over each of the first 12 months immediately following the last increase in the target US federal funds rate (“last Fed hike”) over the prior four hiking cycles. The specific start months for the periods included in the average calculations are: February 1995, May 2000, June 2006, and December 2018. US bonds are represented by the total return of the Bloomberg US Aggregate Index; US equities are represented by the total return for the S&P 500 Index; the 60/40 portfolio is represented as the weighted average return using 60% of the total return for the S&P 500 Index and 40% of the total return in US dollars for the Bloomberg US Aggregate Index, with no rebalancing for the first 12 months. International equities are represented by the total return in US dollars for the MSCI EAFE Index; US short-term bonds are represented by the total return for the Bloomberg 1-3 Year US Government/Credit Index; cash is represented by change in the Bloomberg US Treasury Bills 1-3 Months Index. SOURCES: Capital Group, Bloomberg Index Services Ltd. MSCI, Refinitiv Datastream, Standard & Poor’s

A stronger long-range investment outlook across asset classes

After a tumultuous 2022, the future appears brighter across a range of asset classes. Many investors who fled to cash may now opt to revisit their asset allocation.

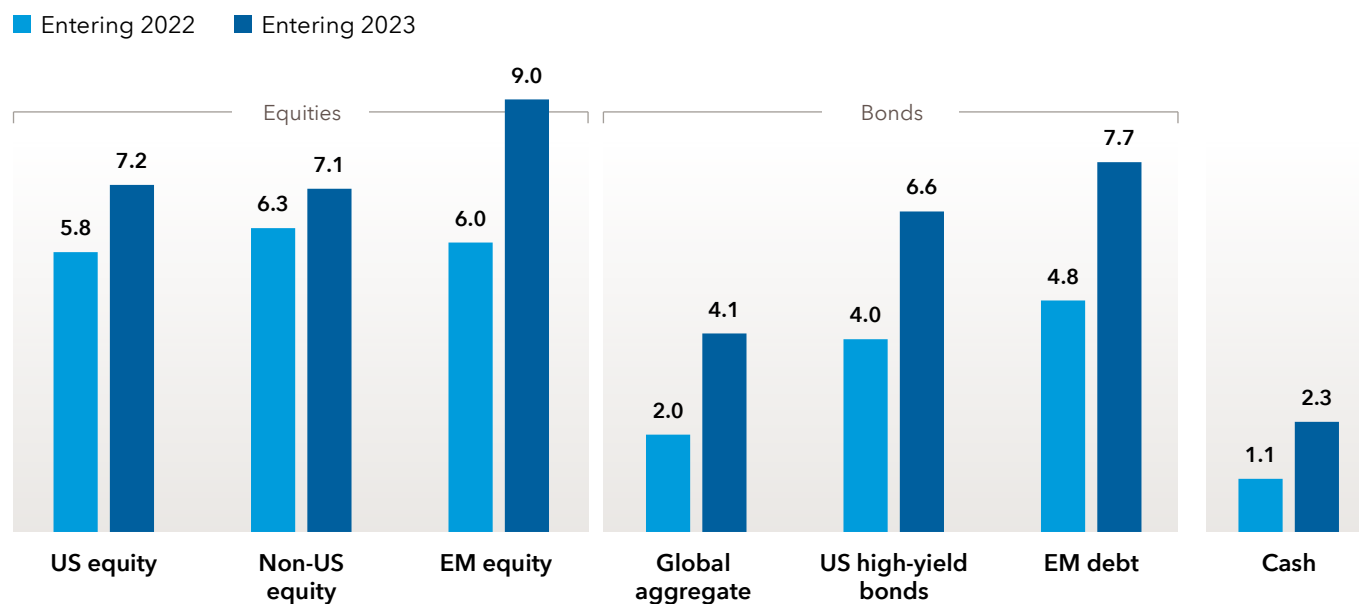
“Entering 2023, our long-term capital markets return assumptions show a more appealing investment environment,” says solutions portfolio manager Michelle Black. “We see better corporate fundamentals and a currency tailwind more than offsetting potentially slower global economic growth, most notably in China.”

Following the sharp decline in US equities, valuations are more reasonable. “We are also optimistic on non-US equities, which should be propelled by a combination of higher dividend yields, multiple expansion and a weaker dollar,” notes Black.

US fixed income returns should improve in large part from a higher starting point in yields, but also may benefit from price appreciation and declining yields. From a total return perspective, the solutions team finds emerging markets debt to be attractive. Yields are higher than in other areas of fixed income, and the US dollar could be a tailwind for local currency debt returns.

Many asset classes offer better long-term potential than cash

Capital Group’s capital market assumptions – Forward 20-year annualised expected returns across asset classes (%)



Forecasts shown for illustrative purposes only. Past results are not a guarantee of future results.

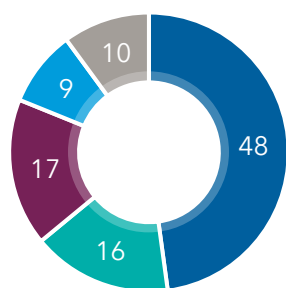
All asset classes reflect asset class proxy benchmarks used in Capital Market Assumptions (CMAs). All assumptions are for market asset classes only and are reviewed at least annually. These figures represent the views of a small group of investment professionals based on their individual research and are approved by the Capital Market Assumptions Oversight Committee. They should not be interpreted as the view of Capital Group as a whole. As Capital Group employs The Capital System™, the views of other individual analysts and portfolio managers may differ from those presented here. They are provided for informational purposes only and are not intended to provide any assurance or promise of actual returns. They reflect long-term projections of asset class returns and are based on the respective benchmark indices, or other proxies, and therefore do not include any outperformance gain or loss that may result from active portfolio management. Note that the actual results will be affected by any adjustments to the mix of asset classes. All market forecasts are subject to a wide margin of error. EM = emerging markets. EM debt is a blend of 50% emerging markets debt denominated in US dollars and 50% emerging markets debt denominated in domestic currency. For full list of benchmarks used, please see the disclosures page. A high-yield bond is one with a lower credit rating than an investment-grade bond. High-yield bonds typically offer a higher rate of interest because of a greater risk of default. SOURCE: Capital Group

Global champions in Europe are navigating the new reality

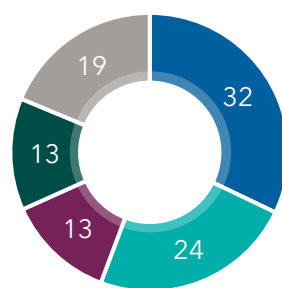
Leading European companies are operating in markets around the world

Revenue by region across top MSCI Europe Index constituents (%)

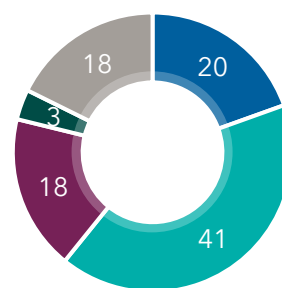
■ United States ■ Europe ■ Asia Pacific ■ Latin America ■ Africa & Middle East ■ Others



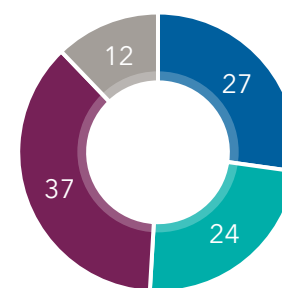
Novo Nordisk
(Denmark)



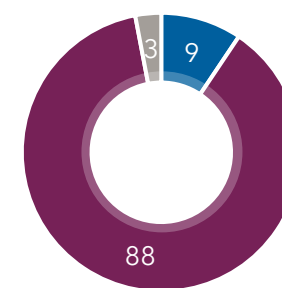
Nestlé S.A.
(Switzerland)



Airbus
(France)



LVMH
(France)



ASML
(Netherlands)

Europe's economy has proved resilient despite the war in Ukraine, high inflation and rising interest rates. Consumers have continued to spend, travel and tourism have picked up and European companies are benefitting from a combination of modest domestic growth and international opportunities, including the reopening of China's economy.

In fact, some of Europe's most successful multinational companies are highly adept at tapping into external revenue streams from Asia to Latin America to the United States.

For example, Novo Nordisk's weight-loss drug Wegovy has seen enormous worldwide demand, prompting the Denmark-based company to nearly double its sales guidance compared to 2019.

"In Europe, select companies can thrive even in a tough economic environment," says equity portfolio manager Lara Pellini, stressing the importance of bottom-up, fundamental research.

In the luxury goods industry, many of the world's elite brands are based in Europe, but their customers live all over the world. French luxury giant LVMH reported record-high revenue of US\$86 billion for 2022, driven largely by strong demand from the US and Japan.

"One reason these companies have the potential to outpace domestic peers is because they are subject to global competitive forces, which can spur innovation," Pellini adds. "The expertise they develop is difficult to replicate."

Company examples shown for illustrative purposes only. This information has been provided solely for informational purposes and is not an offer, or solicitation of an offer, or a recommendation to buy or sell any security or instrument listed herein.

Data as at 31 May 2023. Companies above are among the top 25 largest constituents within the MSCI Europe Index by market cap across a range of industries. Revenue by region is estimated by FactSet based on most recently reported figures. SOURCES: Capital Group, FactSet

New growth opportunities emerge

Big Tech is back. Many of the names that led the last bull market are leading a nascent recovery, including Amazon, Apple, Microsoft, Meta and Nvidia - the top five contributors to the rise of the S&P 500 Index this year, as at 31 May.

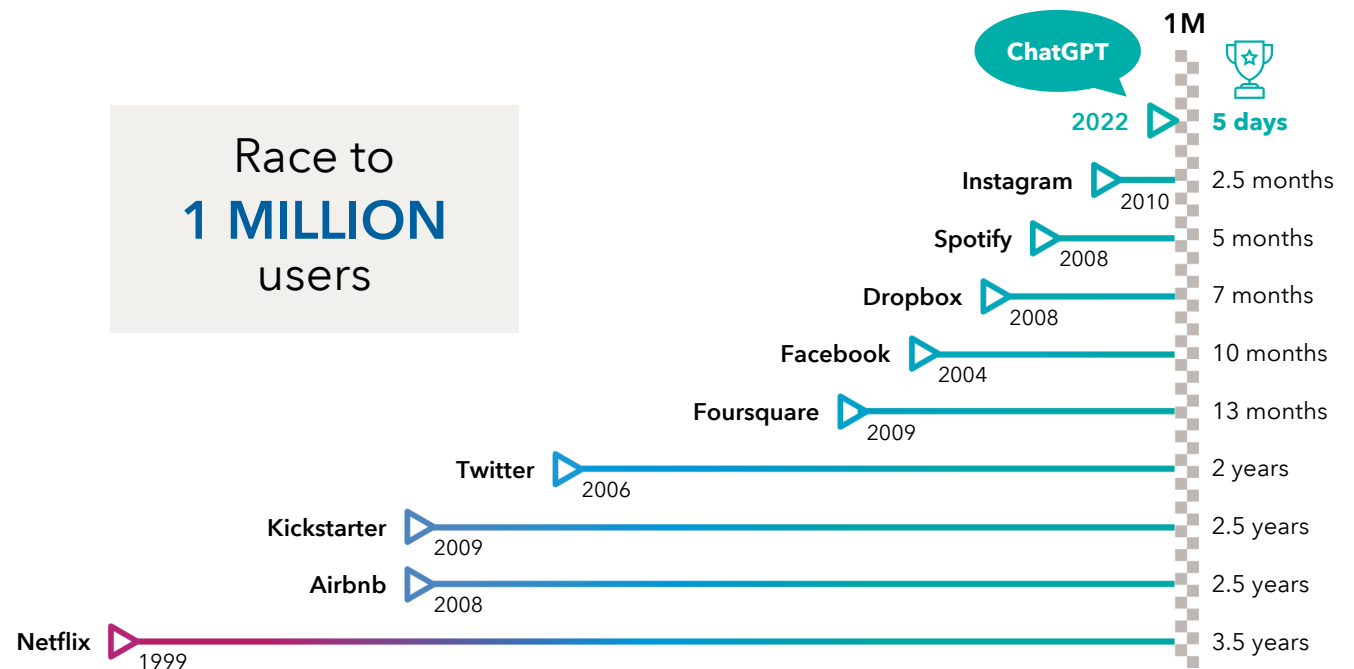
Whether this advance will continue remains an open question, but so far this year the tech-heavy Nasdaq Composite Index has gained about double the return of the S&P.

The difference today is that tech stocks are no longer the only game in town. Over the past year, market opportunities have broadened to include energy, health care and industrials, as well as traditional value-oriented and dividend-paying stocks. Returns have been less dominated by a handful of US companies and more evenly distributed around the world. Market breadth has increased sharply since the end of 2021, in contrast to the prior six years.

"There are many strong, long-term secular themes in sectors beyond technology," says equity portfolio manager Jody Jonsson. "I, for one, am encouraged by all the opportunities emerging in various parts of the market."

The adoption rate of new technologies is accelerating

Time for selected online services to reach one million users

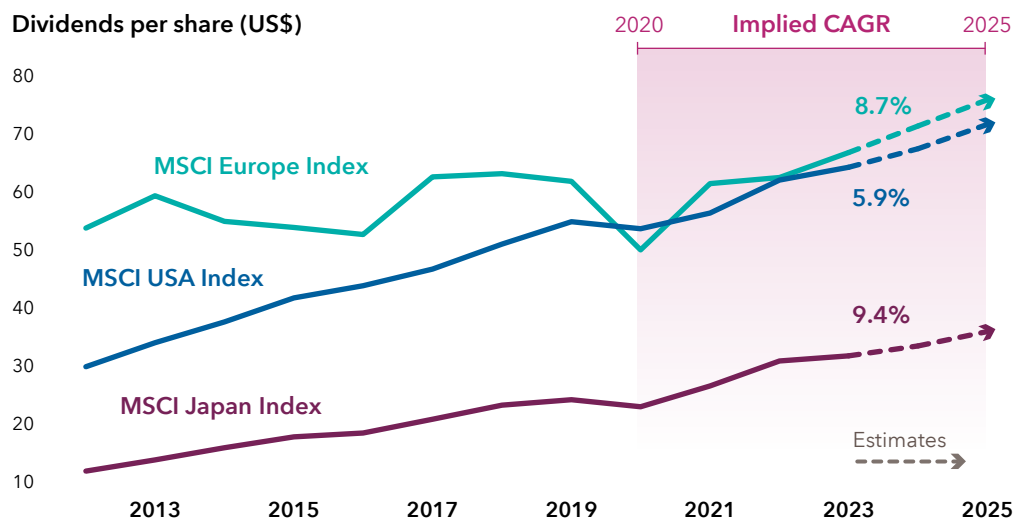


This information has been provided solely for informational purposes and is not an offer, or solicitation of an offer, or a recommendation to buy or sell any security or instrument listed herein.

As at 31 May 2023. A bull market is a financial market in which prices are increasing, especially over a long period of time. Kickstarter refers to number of backers. Airbnb refers to number of nights booked. Foursquare and Instagram refer to number of downloads. SOURCE: Statista

Dividends have reached new heights

Dividends projected to grow through 2025



When growth slows and market volatility rises, the role of dividends takes on greater prominence in investment portfolios.

Since the start of 2022, dividend contributions to total returns have increased, as have total payments to investors. Global companies distributed more than US\$2.0 trillion in dividend payments for the 12 months ended 31 May 2023, an 12.3% increase from the previous 12 months (source: FactSet).

"I expect dividends to rise in importance this year and beyond," equity portfolio manager Caroline Randall says. "But in a period of relative instability and rising debt costs, it is essential to focus on the quality of dividend payers."

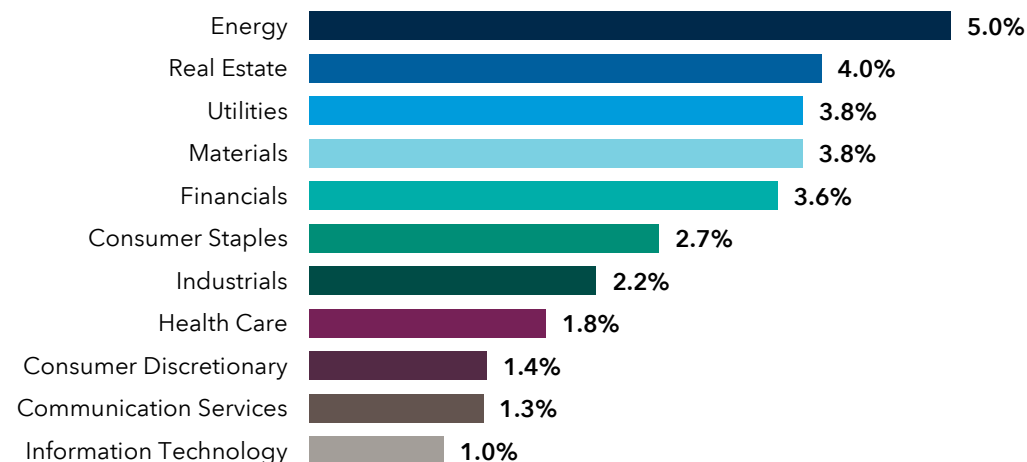
For Randall, that means closely scrutinising company balance sheets, credit ratings and interest costs. This has guided her to select companies across pharmaceutical and medical device firms, utilities, energy producers and some industrials.

"It is critical to track what management says about dividends, and equally critical to follow what they do," notes Randall. "If you are going to rely more on dividends, you must be confident the companies will pay them. That's where we can add value as active managers."

For example, Abbott Laboratories has increased its dividend payout for 50 consecutive years. European beverage maker Diageo has done so for 20 straight years.

Attractive yields can be found across a range of sectors

Dividend yield by sector in the MSCI All Country World Index



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FOR LEFT CHART: Data for 2023-2025 is based on consensus estimates as at 31 May 2023. The compound annual growth rate (CAGR) is the rate of return (RoR) that would be required for an investment to grow from its beginning balance to its ending balance, assuming the profits were reinvested at the end of each period of the investment's life span. SOURCES: FactSet. FOR RIGHT CHART: Data as at 31 May 2023. SOURCES: Capital Group, MSCI, Refinitiv Datastream, Refinitiv Eikon

Wage growth is finally coming to Japan amid higher inflation

There's no question Japan's demographic backdrop has been challenging over the last decade. Things could be changing, however, as a post-pandemic inflation surge has forced Japanese companies to act.

In a nation where pay hikes are rare, nearly 30% of Japan's industry leading companies have announced increases this year. For example: Nintendo and Hitachi announced increases of 10% and almost 4%, respectively. Fast Retailing agreed to increase employee wages by as much as 40%.

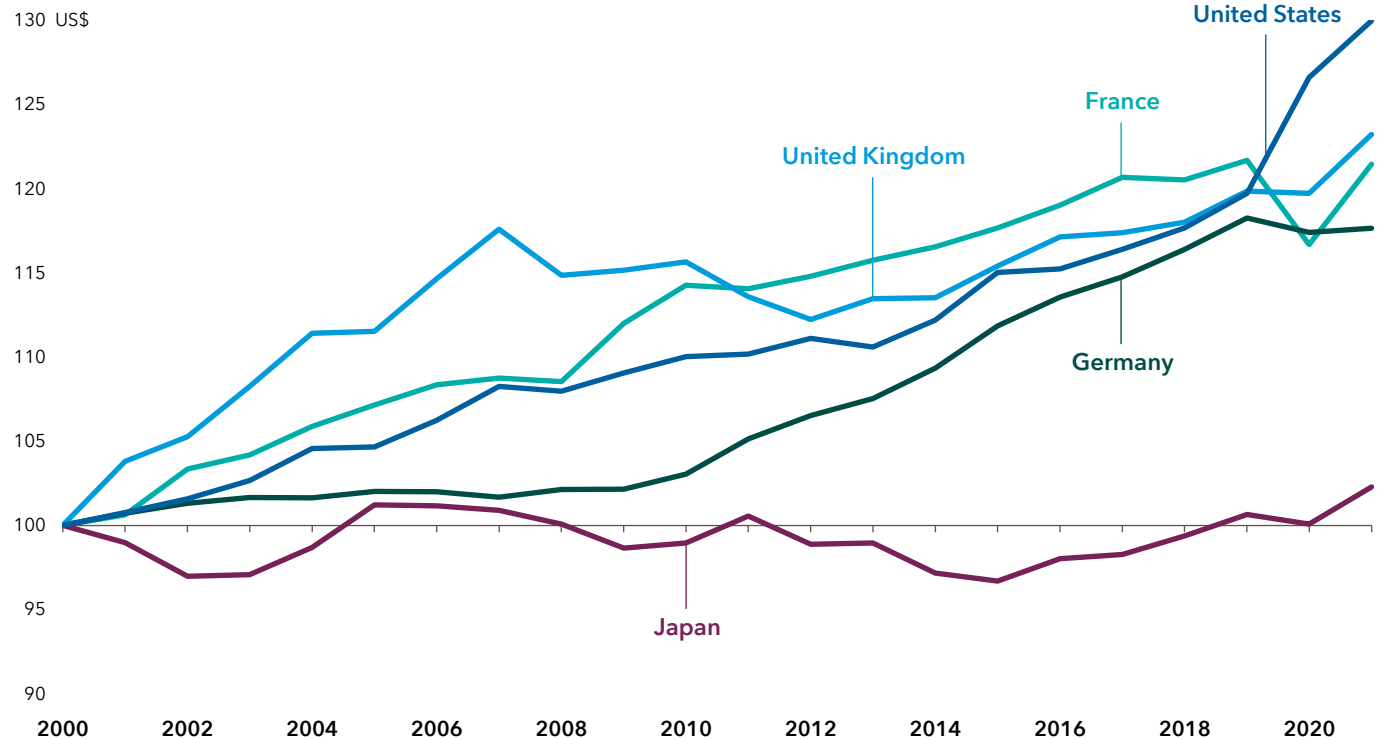
"Hefty pay increases will be a headwind for corporate profits," says Capital Group economist Anne Vandenaabeele, "but profit margins are at multi-decade highs, so many Japanese companies can afford to share the wealth."

Japan's government officials and labour unions agree. They've been pushing for across-the-board pay increases of around 3.8% this year, roughly matching core inflation, which has risen to a 41-year high (source: Statistics Bureau of Japan).

Companies' willingness to grant wage hikes is well correlated with their expectations for demand growth three years out, Vandenaabeele says. "This trend could bode well for consumer spending in the future."

Japan is looking to catch up with global peers in wage growth

Cumulative average wage growth



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Figures through 2021 reflect most recently available data as at 31 May 2023. Average wage growth reflects constant prices at 2021 US dollar purchasing power parity (PPP), indexed to 100 as at 2000. PPP is a measurement of the price of specific goods in different countries and is used to compare the absolute purchasing power of the countries' currencies. SOURCES: Capital Group, Organisation for Economic Co-operation and Development (OECD)

As China reopens, equity valuations are attractive but caution is warranted

When it comes to investing in China, there are clear challenges. Geopolitical tensions are elevated, medium- to long-term growth will likely moderate from the rate of prior decades, and the property sector is mired in debt. That said, China has not relinquished its title as the world's second-largest economy, providing opportunities to selectively invest despite the risks.

"There are great entrepreneurs in China, and the large addressable markets have not disappeared despite geopolitical worries and restrictions imposed on the private sector," says portfolio manager Chris Thomsen.

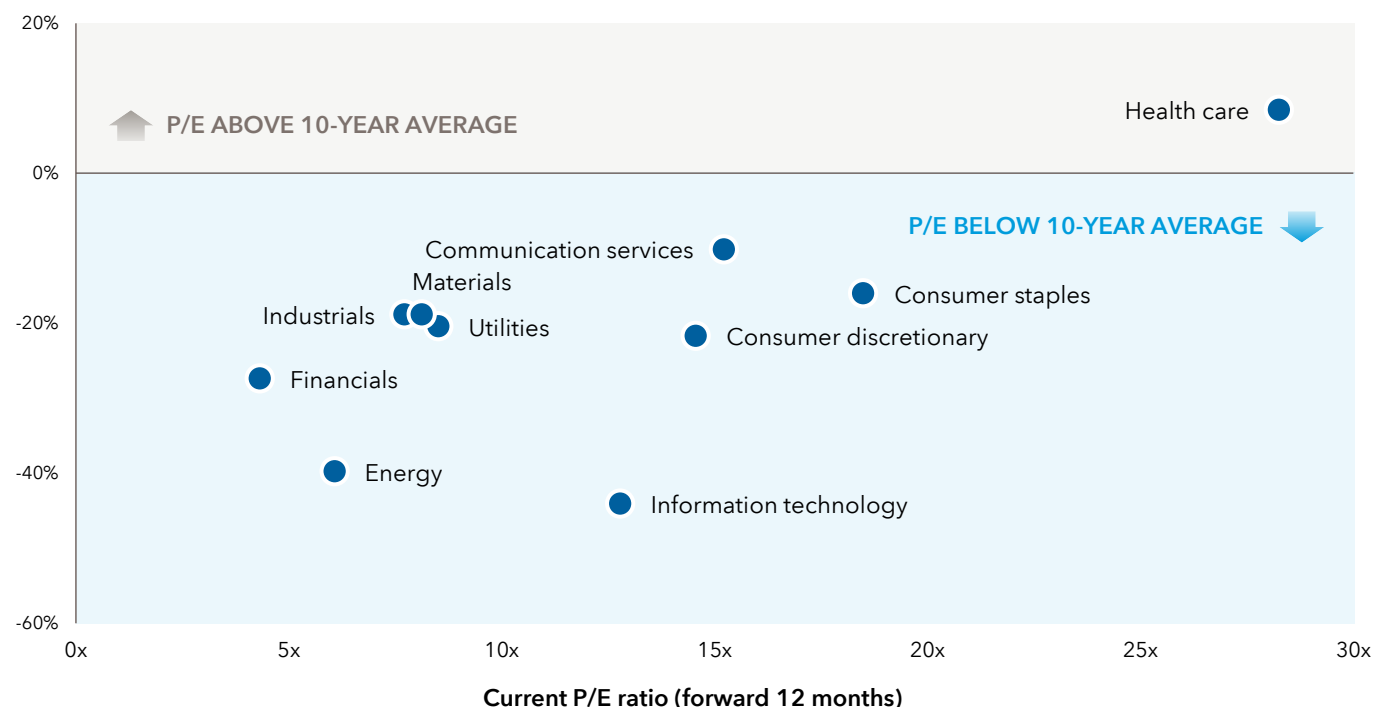
China's economy looks to be improving after the government lifted COVID restrictions in late 2022 and reprioritised growth. Airports are busy. Cinemas and restaurants are packed. And Chinese tourists are flocking to their favourite Asian destinations.

Thomsen says both multinationals and domestic firms could benefit from the country's reopening. Luxury goods giant LVMH has seen demand in China surge. Starbucks and McDonald's are planning to open additional stores. Meanwhile, domestic consumer goods makers, hotels and Macau casino operators could thrive as the economy recovers.

But caution is warranted. While valuations for Chinese equities remain depressed against their long-term averages, "it becomes a question of the risk premium you apply to stocks, which impacts the multiple you are willing to pay for them," Thomsen adds.

Valuations across several sectors are below historical averages

MSCI China Index - Price-to-earnings ratios vs. 10-year average



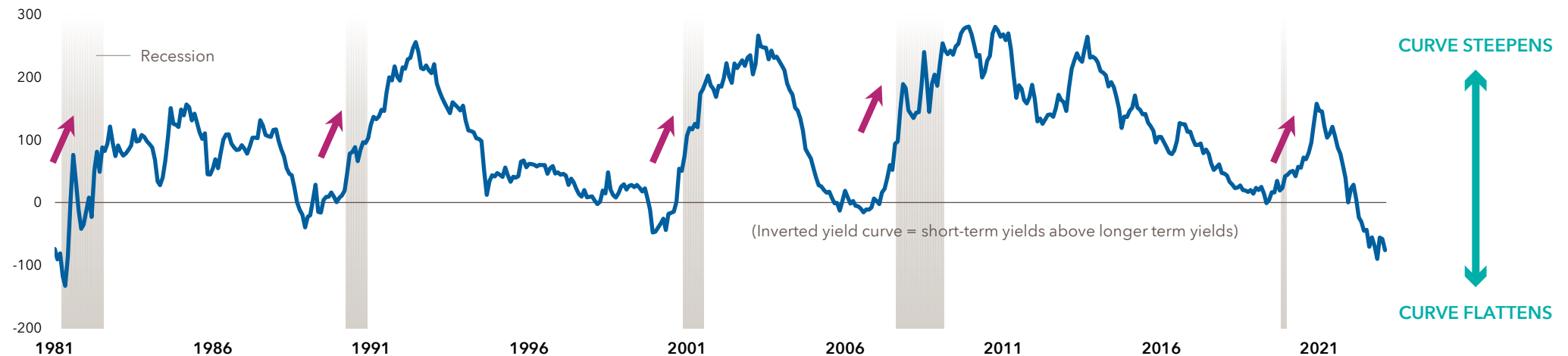
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Data as at 31 May 2023. The price-to-earnings (P/E) ratio is the ratio for valuing a company that measures its current share price relative to its earnings per share (EPS). Forward price-to-earnings (forward P/E) is a version of the ratio of P/E that uses forecasted earnings for the P/E calculation. While the earnings used in this formula are just an estimate and not as reliable as current or historical earnings data, there are still benefits to estimated P/E analysis. Forward P/E ratios reflect the current share price relative to the consensus estimate for EPS on a forward 12-month basis. SOURCES: Capital Group, MSCI, RIMES

As Fed pauses, value can be found in rates market

A more balanced view amid risk of recession could present opportunities in yield curve positioning

Spread between two-year and 10-year Treasury yields (basis points)



After 10 consecutive interest rate increases totalling 500 basis points, the Fed finally took a breather.

“The Fed is confronting a lot at once: persistent inflation, a resilient labour market and stresses in the banking sector. Pausing gives them time to see how things play out, though I do think the risk of a recession is higher,” says Tim Ng, portfolio manager.

Fed hikes have lifted yields across fixed income, with the Bloomberg US Aggregate Index yielding 4.59% on 31 May 2023 (source: Bloomberg).

“Exposure to interest rates now may provide portfolios a meaningful return potential,” according to portfolio manager Ritchie Tuazon. “It also offers a potential upside – and diversification – should the Fed cut rates to support growth, as bonds would experience price appreciation.”

If the economy continues to weaken, short-term Treasury yields may drift lower, particularly if Fed rate cuts are more likely. Meanwhile, longer term Treasury yields could be more anchored or even rise. These movements would cause the yield curve to steepen from being so deeply inverted.

“We favour positioning portfolios to benefit from a steepening of the Treasury yield curve. The position could work well in a slowing economy or outright recession and is compelling from a valuation perspective,” adds Tuazon.

Past results are not a guarantee of future results.

As at 31 May 2023. In investing, the spread generally refers to the difference or gap that exists between two prices, rates, or yields. Treasury refers to Treasury securities, which are debt obligations issued by the US Department of the Treasury. The yield is usually expressed as an annual percentage rate based on the investment’s cost, current market value, or face value. A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. The yield curve reflects the difference between longer-and shorter-term Treasury yields. SOURCES: Capital Group, Bloomberg Index Services Ltd., National Bureau of Economic Research, Refinitiv Datastream

US corporate bonds can likely weather an economic slowdown

A weaker economy equals weaker credit markets. That's been the traditional wisdom. But this cycle may be a little different.

Corporate bonds have come under some selling pressure in the wake of banking sector turmoil, since financials hold a large place in the investment-grade (rated BBB/Baa and above) bond universe. But overall, the sector has held some ground, with yields hovering around 5% and spreads over Treasuries expanding to approximately 130 basis points. Credit markets could decline further if the economy slows materially and corporate profitability decreases.

However, according to portfolio manager Scott Sykes, two factors are helping to counteract this possibility in the current market environment. Corporations with investment-grade ratings generally have strong balance sheets with sufficient cash to fund their operating and expansion needs. Additionally, most corporate bonds are trading at a discount to their issuance price, which provides a valuation cushion as investors are likely to get fully paid when the debt comes due.

"Current starting yields look compelling. Historically, when investment-grade bonds yielded in the range of 3.8% or higher, two-year forward returns averaged 6.5% or more."

Sector selection is also important, says portfolio manager Robert Caldwell. In a slowing economy, companies in non-cyclical areas such as pharmaceuticals and telecommunications tend to look more appealing than those in cyclical areas such as autos, metals and mining.

Higher starting yields have led to better returns for investment-grade bonds

Bloomberg US Investment Grade Corporate Bond Index - yield-to-worst (%)



Past results are not a guarantee of future results.

As at 31 May 2023. Average forward two-year returns are annualised, based on each quartile of starting yield-to-worst. A quartile describes a division of observations into four defined intervals based on the values of the data and how they compare to the entire set of observations. Yield-to-worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting. A bond is trading at a discount when its market price is below its face value (the amount the issuer pays to the investor at maturity). The terms cyclical and non-cyclical refer to how closely correlated a company's share price is to the fluctuations of the economy. Cyclical stocks and their companies have a direct relationship to the economy, while non-cyclical stocks repeatedly outperform the market when economic growth slows. SOURCES: Capital Group, Bloomberg Index Services Ltd

Patience could reward investors in US high-yield bonds

Owning high-yield bonds ahead of a potential recession might make some investors uneasy. But for those with a time horizon beyond one year, investing in bonds with current yields of around 8% has historically offered solid returns.

“You can’t have financial conditions tighten substantially and not have repercussions in the real economy,” says portfolio manager Tara Torrens, who expects a slowdown.

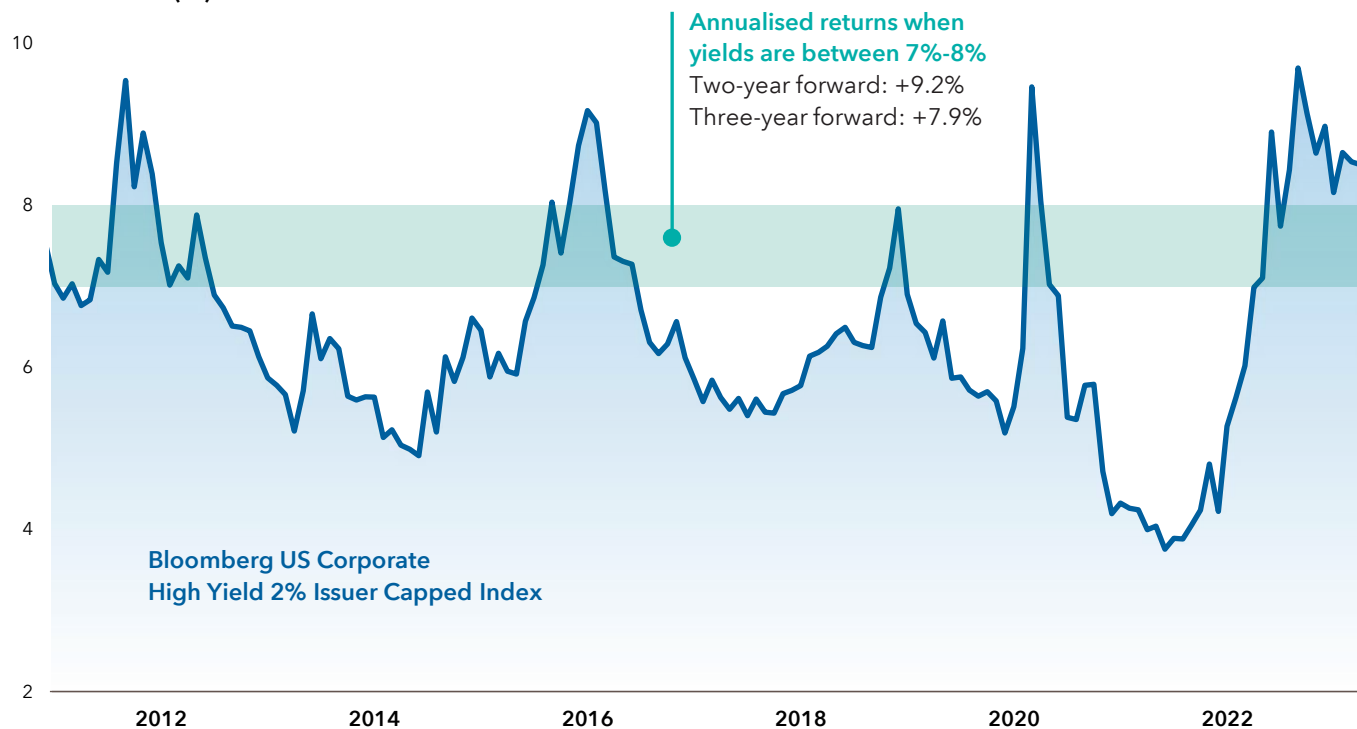
Fundamentals are especially important as corporate profitability comes under pressure in the face of rising costs and higher interest rates. “Fundamental credit analysis helps identify which companies can pay their debts,” portfolio manager David Daigle adds. “For example, although oil prices often decline as growth slows, there are energy companies that can comfortably navigate a downturn.”

The quality of the high-yield universe has improved, with nearly half the market carrying the highest rating (BB/Ba). One reason is that many companies with riskier financial profiles have opted to raise funds in the private credit and leveraged loan markets.

Taken together, defaults will likely increase but remain low relative to prior recessions – current valuations reflect this scenario. And while spreads could widen in a recession, investors waiting for better entry points may not see them given the improved credit profile of high yield.

Current yields offered strong two- and three-year returns

Yield-to-worst (%)



Past results are not a guarantee of future results.

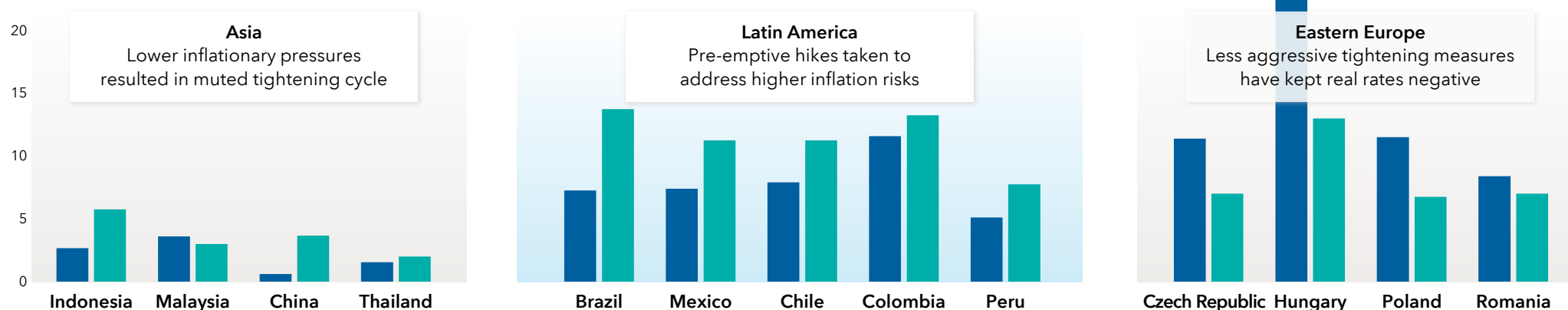
As at 31 May 2023. Yield-to-worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting. The real economy refers to all non-financial elements of an economy. Lower rated bonds are subject to greater fluctuations in value and risk of loss of income and principal than higher rated bonds. A high-yield bond is one with a lower credit rating than an investment-grade bond. High-yield bonds typically offer a higher rate of interest because of a greater risk of default. A leveraged loan is a type of loan that is extended to companies or individuals that already have considerable amounts of debt or poor credit history. SOURCE: Bloomberg Index Services Ltd

Some emerging markets have benefitted from attractive rates, moderating inflation

Countries across Latin America have been more aggressive in tackling inflation

Inflation and interest rates of select emerging market countries

25% ■ Core inflation ■ Policy rate



Inflation is trending lower in many emerging markets, providing central banks the room to taper interest rates and provide monetary stimulus. Many developing economies have been ahead of the developed world, raising interest rates earlier and more aggressively to address inflation.

There is some regional divergence, with inflation lower in Asia, moderate in Latin America and high in Central/Eastern Europe.

Decent overall fundamentals, coupled with attractive nominal rates and positive real rates across many developing economies, indicate a reasonably constructive view of emerging market debt overall, according to portfolio manager Kirstie Spence.

That said, selectivity will be key given the divergence in policy and inflation dynamics across countries, as well as varying relative and absolute valuations across issuers. On balance, Spence favours a modest tilt toward local currency

issuers compared to hard currency credits.

Spence sees potential value in Latin American local currency bonds given the combination of attractive nominal and positive real rates, moderate inflation, proactive behaviour on the part of central banks and a reasonable growth outlook. "Central and Eastern Europe are still struggling to curb inflation - and real rates remain negative - but at some point I believe that region will potentially become more attractive," Spence says.

Core inflation is represented by the year-over-year change in consumer price index (CPI) excluding food and energy across countries. Inflation rate as at April 2023 for Romania and Malaysia and as at May 2023 for other regions. Policy rate as at 5 June 2023. Real interest rates reflect the true cost of funds to a borrower. Nominal interest rates equal the real interest rate plus the rate of inflation. SOURCES: Capital Group, Bloomberg Index Services Ltd

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