

# Outlook

MIDYEAR ISSUE JUNE 2024



## Long-term perspective on markets and economies

Marketing communication



# The new reality of investing

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**Jody Jonsson**

Vice Chair and  
Portfolio Manager  
Capital Group

Over the past 40 years, essentially the entire length of my career, investors have become accustomed to an environment characterised by generally declining interest rates, low inflation and the rapid advance of globalisation. Since the end of the Cold War, we've also enjoyed long periods of relative geopolitical stability.

All of that is changing. Interest rates in the US stand at a 23-year high. Inflation is falling but stalling, and it remains uncomfortably elevated. We are seeing signs of deglobalisation amid rising tariffs and growing trade wars. The relationship between the world's two largest economies, the US and China, has taken a step backward. And, tragically, we have ongoing conflicts in Ukraine and the Middle East, in addition to other flash points around the world.

Borrowing a phrase from the Harvard Business Review, publicly traded companies operating in this environment need a foreign policy. They must think more strategically about global supply chains and the sensitivities of doing business in a more challenging geopolitical landscape. As investors in these companies, we must consider scenarios we haven't had to think much about over the past four decades.

What does this mean for the market outlook? Over the next few years, I think we are less likely to see a narrow group of highly valued companies dominating returns. I believe US markets will continue to do well, but they won't be the only source of superior returns. Bonds, too, have become more attractive as income returns to the fixed income markets. And despite what sounds like a more pessimistic environment, I think it presents an opportunity for individual stock selection to make a profound difference in portfolios.

Along with this monumental change comes uncertainty. We are moving from a period of relatively low volatility to what could be much higher volatility in the years ahead. And that's OK. That's what Capital Group is built for. We are here to help tune out the short-term noise and invest for the long term. There are still so many exciting industries, companies and investment themes to explore. It's prime time for active investing.

With that in mind, I invite you to read and share our 2024 Midyear Outlook report.

A glossary of technical terms can be found on page 19, with some definitions on individual pages.

Some of the information in this material may include forecasts, hypothetical data, company examples and segments, which are shown for illustrative purposes only.

# US economy continues to power global growth

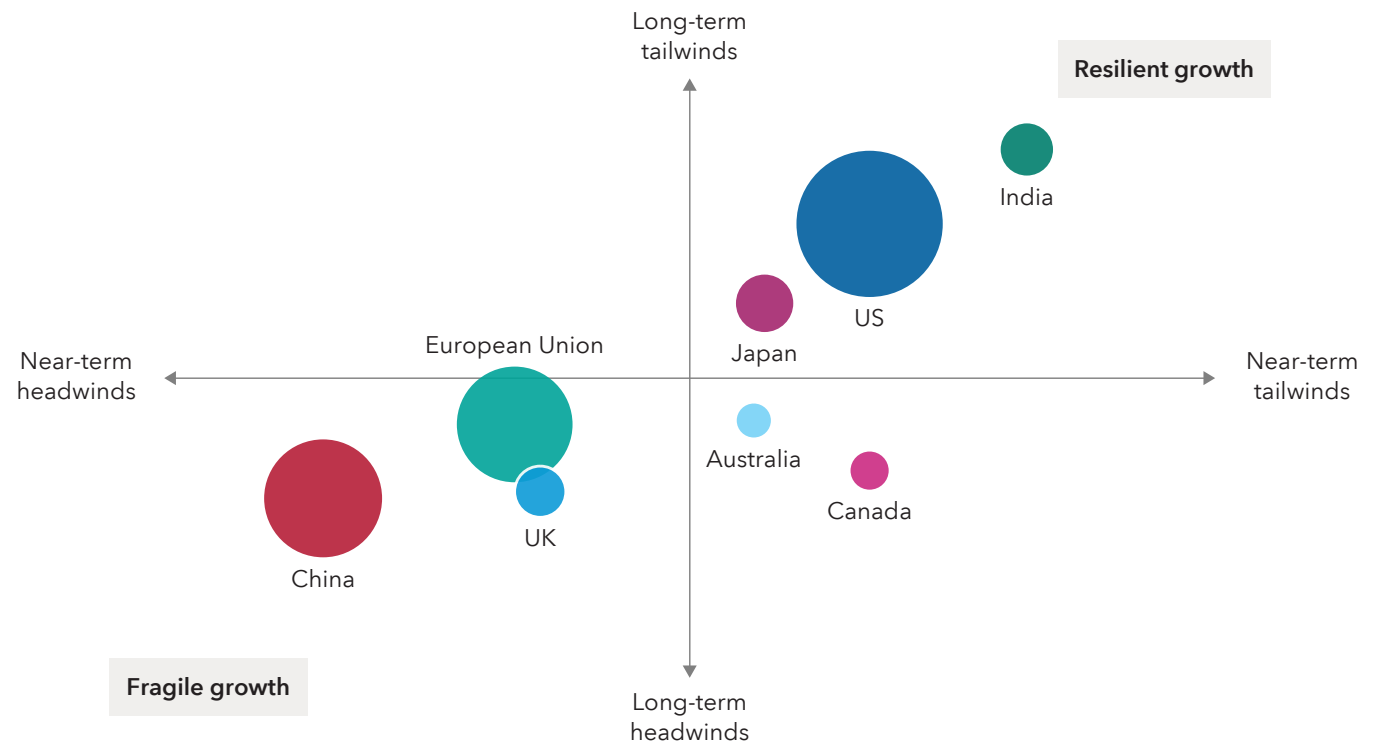
The United States, flexing its muscles as the world's largest economy, is once again serving the critical role of global growth engine. As Europe and China struggle with weak economic activity, the US, India and Japan are showing signs of resilience.

Despite higher interest rates and elevated inflation, the International Monetary Fund is predicting the US economy will expand this year at more than twice the rate of other major developed countries. The IMF recently raised its forecast for US growth to 2.7%, compared to 0.8% for Europe. Moreover, the power of America's consumer-driven economy is helping to support growth in the rest of the world.

"People used to say if the US sneezes, the rest of the world catches a cold. The opposite can also be true," says Capital Group economist Darrell Spence. "When it's firing on all cylinders, the US can help other export-oriented economies."

Spence believes the US will grow at a rate closer to 3.0% this year as consumers continue to spend, the labour market remains tight, and manufacturers invest in newly diversified supply chains. Among emerging markets, India is a major beneficiary of these changing dynamics. In a post-pandemic world, many companies are looking to India as an additional source of manufacturing capacity as China's economy matures.

## A resilient US is counterbalancing weakness in Europe and China

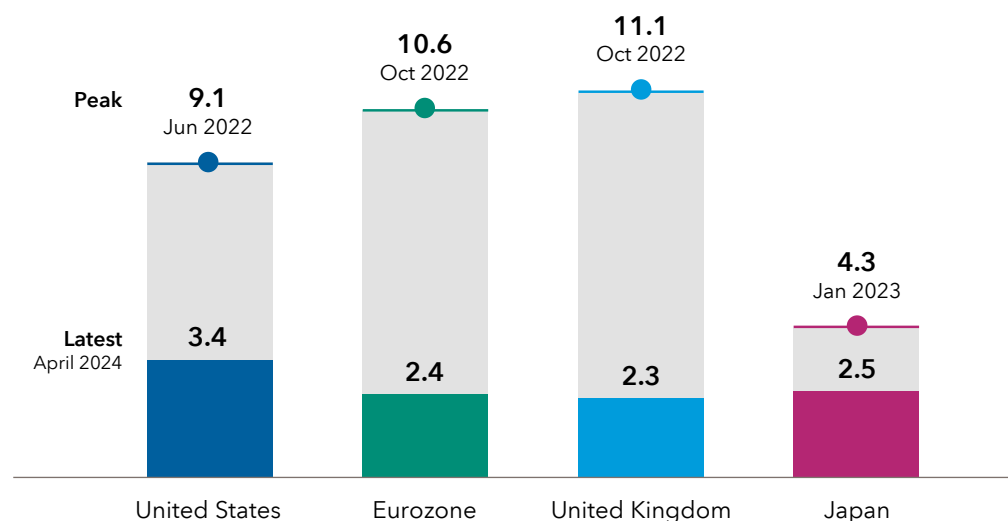


Source: Capital Group. Country positions are forward-looking estimates by Capital Group economists as of May 2024 and include a mix of quantitative and qualitative characteristics (in USD). Long-term tailwinds and headwinds are based on structural factors such as debt, demographics and innovation. Near-term tailwinds and headwinds are based on cyclical factors such as labour, housing, spending, investment and financial stability. Circles represent individual economies. Circle sizes approximate the relative value of each economy and are used for illustrative purposes only.

# Fed rate path to mirror inflation's slow descent

## Inflation: Falling but stalling

Inflation (annual % change)



Despite elevated inflation and the highest Federal Reserve policy rate in 23 years, the US economy has shown remarkable resilience. Labour markets have been robust, consumer spending strong and corporate fundamentals healthy.

"While growth continues to slow, the US economy has largely adapted to this new rate environment, and I expect growth to remain above a healthy 2% in 2024," says portfolio manager Pramod Atluri. This broader resilience has forced investors to

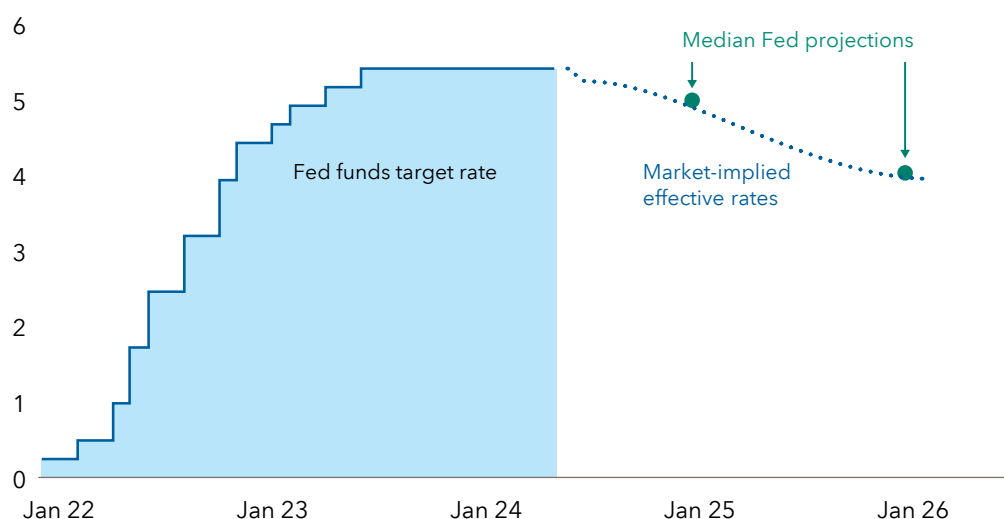
shift expectations for Fed policy rate changes. Even though Atluri believes the case for rate cuts is less clear, the central bank appears biased toward cutting.

Fed Chair Jerome Powell cited two paths to rate cuts: unexpected weakness in the labour market or inflation sustainably down to 2%. Inflation declined in 2023 but stalled above 3% in early 2024. Atluri is optimistic that price increases will fall closer to the Fed's target by year-end.

Sources: Capital Group, Bureau of Labor Statistics, Eurostat, FactSet, Japanese Statistics Bureau & Statistics Center, UK Office for National Statistics. Inflation data as of 30 April 2024. Peak values reflect the highest inflation rate between January 2018 and April 2024.

## Rate cuts are on the horizon

Federal funds rate – actual vs. projections (%)



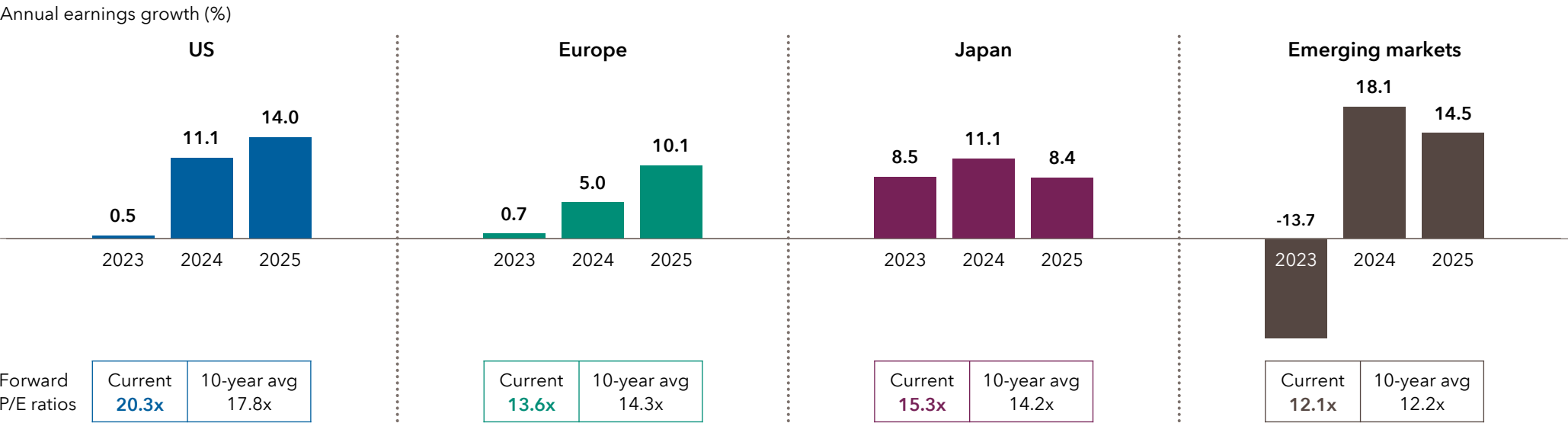
That's largely because rent increases – a major reason the Core Consumer Price Index remains elevated – continue to modestly improve. Additionally, the higher inflation we saw for certain goods and services earlier this year may be reflecting some seasonal adjustment distortions.

Elsewhere in the world, growth and inflation expectations are weaker than the US, and central banks are generally expected to cut interest rates more rapidly.

Sources: Capital Group, Bloomberg, Federal Reserve. Fed funds target rate reflects the upper bound of the Federal Open Market Committee's (FOMC) target range for overnight lending among US banks. Median Fed projections are as of 12 June 2024. Latest data available as of 12 June 2024.

# Earnings expected to strengthen further in 2024 and beyond

## Accelerating earnings growth can provide support for equity valuations



The sunny picture for corporate earnings appears to be brightening further. This bodes well for equity investors, as profit growth is a primary driver of returns.

In the US, Wall Street analysts expect earnings for companies in the S&P 500 Index to grow more than 10% in the second half of the year, with further acceleration in 2025. “Underlying conditions appear supportive of solid revenue growth and steady margins,” says US economist

Jared Franz. “I think we’ll see US earnings growth in a range of 10% to 15% this year.”

What’s more, equity market valuations don’t appear to be particularly stretched, even after market rallies. Price-to-earnings ratios for most markets were near or modestly above their 10-year averages as of 31 May 2024. Profit growth is anticipated to be more muted in Europe, albeit still positive.

In emerging markets, economists are calling for a strong rebound in profits after the decline of the prior year. Even in China, where a slow economy has cast a long shadow, there are early signs of a turnaround in some industries.

Of course, the risks to these rosy estimates are that inflation stalls, oil prices skyrocket, geopolitical tensions trigger escalated trade wars, or other unforeseen events.

**Past results are not a guarantee of future results.**  
Sources: FactSet, MSCI, Standard & Poor’s. Estimated annual earnings growth is represented by the mean consensus earnings per share estimates for the years ending December 2024 and December 2025, respectfully, across the S&P 500 Index (US), MSCI Europe Index (Europe), MSCI Japan Index (Japan) and MSCI Emerging Markets Index (emerging markets). Estimates are as of 31 May 2024. **The price-to-earnings ratio (P/E)** is a measure for valuing a company and is computed by dividing the price of a company’s stock by its annual earnings per share.



# US elections: How they could impact markets

The rematch is on. With incumbent President Joe Biden and former President Donald Trump set to square off in November, the 2024 US election could produce a significant shift in political leadership, potentially leading to policy changes that are likely to affect the investment environment.

Much depends on whether the winning presidential candidate can muster enough support to propel other candidates in his party to victory, taking control of the US Senate and the House of Representatives in a red wave or blue wave scenario. Otherwise, a gridlock scenario could prevail, with little change expected. However it plays out, investors should expect occasional bouts of market volatility in the months leading up to Election Day.

A Republican sweep, or red wave, could benefit banks, health care providers, and oil and gas companies, primarily through deregulation, according to Capital Group's Night Watch team, a group of economists, analysts and portfolio managers who track such issues. A Democratic sweep, or blue wave, could provide a boost to renewable energy initiatives, industrial stimulus spending and telecommunications projects through additional funding for nationwide broadband access.

As for the presidential election, it remains too close to call. "We're still a few months away," says Capital Group political economist Matt Miller. "And that's a lifetime in politics."

## Potential beneficiaries of red or blue wave outcomes

### Potential beneficiaries of a red wave



#### **Banks/Financials**

Weaker regulation, lower capital requirements for banks.



#### **Aerospace/Defense**

Proposed increase in spending.



#### **Healthcare**

Proposed deregulation promotes competition and efficiency; however, this could lower prices/profits.



#### **Oil and gas**

Domestic drilling and mining will be encouraged and deregulated but could result in lower price per barrel.

### Potential beneficiaries of a blue wave



#### **Renewable energy/ Electric vehicles**

Increased protection of Inflation Reduction Act (IRA). Stronger environmental regulations.



#### **Telecommunication**

Expansion of broadband funding.



#### **Homebuilders/Industrials**

Increased immigration should keep wage inflation low.



#### **Tech/Manufacturing**

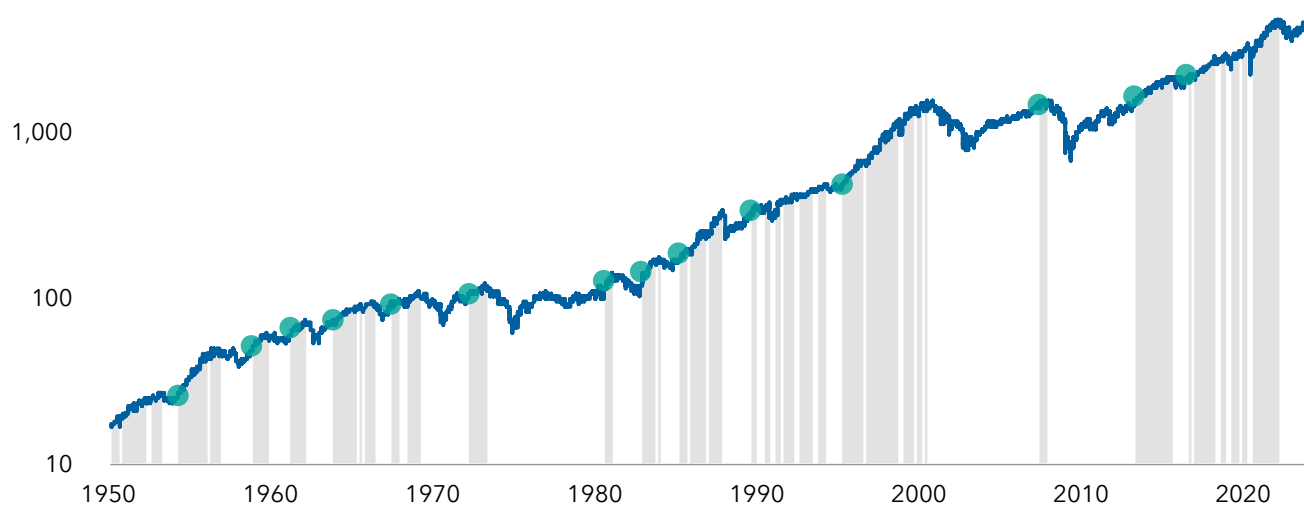
Continued stimulus support from IRA and CHIPS act.

Source: Capital Group. **IRA** is the US Inflation Reduction Act which enhanced or created tax incentives for clean energy and manufacturing. **CHIPS Act** refers to the Creating Helpful Incentives to Produce Semiconductors Act, passed by US lawmakers in 2022 to encourage domestic manufacturing of computer chips.

# All-time highs can be bullish for stock markets

## Stock markets have advanced more often than they've retreated

10,000 S&P 500 Index



■ Since 1950, the S&P 500 Index has reached **1,434 new all-time highs**

● When the S&P 500 Index reached its first new high in more than a year:

Positive returns in  
**13 out of 14 periods**

Average return over the following year  
**17.1%**

Stock market highs can feel like a mixed blessing.

When stocks reach record highs, investors may conclude the market has peaked and they've missed the boat. That couldn't be further from the truth. Over long periods, markets have trended higher and peaked multiple times in prior cycles.

Of course, market declines are also inevitable, and stocks can fall at any time. But history has shown that fresh highs have often been a good entry point for long-term investors.

Since 1950, each time the S&P 500 Index hit its first all-time high in at least a year, stocks then delivered a 17.1% average return for the subsequent 12 months. An investor would have had gains in each of these periods except the start of the global financial crisis in 2007.

"That's why I focus on themes like globalisation, productivity and innovation that are just incredibly powerful forces for growth," says equity portfolio manager Martin Jacobs.

"We're going to have downturns, but that doesn't change the long-term trajectory. That's why I generally am positively positioned for market appreciation."

So what's the bottom line? Historically, bull markets (prices rising) have been much longer than bear markets (prices falling), leading to new highs within each cycle.

### Past results are not a guarantee of future results.

Sources: Capital Group, RIMES, Standard & Poor's. Includes all daily periods between 1 January 1950, and 31 May 2024. Chart shown on a logarithmic scale (a method used to display numerical data that spans a broad range of values). Markers include periods in which the S&P 500 Index hit its first all-time high in at least a year. The S&P 500 Index also reached its first all-time high in at least a year on 19 January 2024. This period has been excluded from the chart because a full year since that date has not been completed. Returns are in USD.

# AI opportunity is stacking up across tech and utilities

The artificial intelligence arms race has kicked into high gear.

With its open-ended potential to transform industries and how people do their work, generative AI represents compelling investment opportunity.

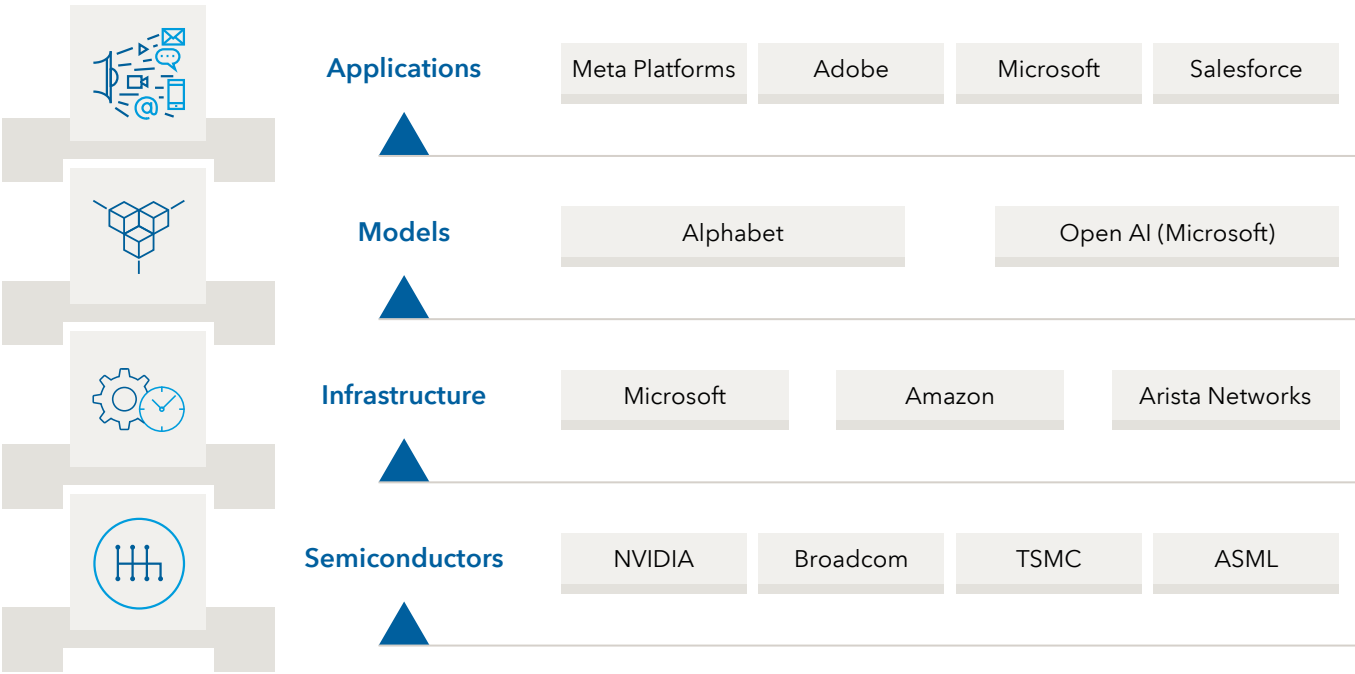
For investors, key to success will be understanding the AI “stack” – four layers of technology that enable AI to operate. Companies are jockeying for position at each layer: semiconductors, infrastructure, applications and the AI models themselves.

Alphabet, Meta and Microsoft are investing tens of billions of dollars to dominate multiple layers of the stack. While the big three are spending money on their own processors, leading chipmakers like NVIDIA, Broadcom and Micron could continue to maintain their market share dominance for years.

“We are studying each layer of the stack to determine which companies have the best chance of being winners,” says equity portfolio manager Mark Casey. “At certain layers, like semiconductors, this is relatively straightforward because it appears few companies have the technical and financial wherewithal to compete successfully.”

Because AI data centres require vast amounts of electricity, the build-out will drive demand for a range of energy sources, including nuclear. In June 2023, Microsoft struck a deal with Constellation Energy to supply one of its data centres with nuclear power.

## The AI stack consists of four essential layers



Source: Capital Group interpretation of technology stack that enables AI to operate. Companies listed are examples of businesses that are among leaders of market share in each segment.



# Myth: Tech companies do not pay dividends

The dividend market is no longer what you might expect.

Long regarded as the domain of mature industries with slowing growth prospects, dividends are gaining favour among information technology giants. Meta, Alphabet and Salesforce all introduced dividends in the first half of 2024, and those announcements appear to be shifting the narrative.

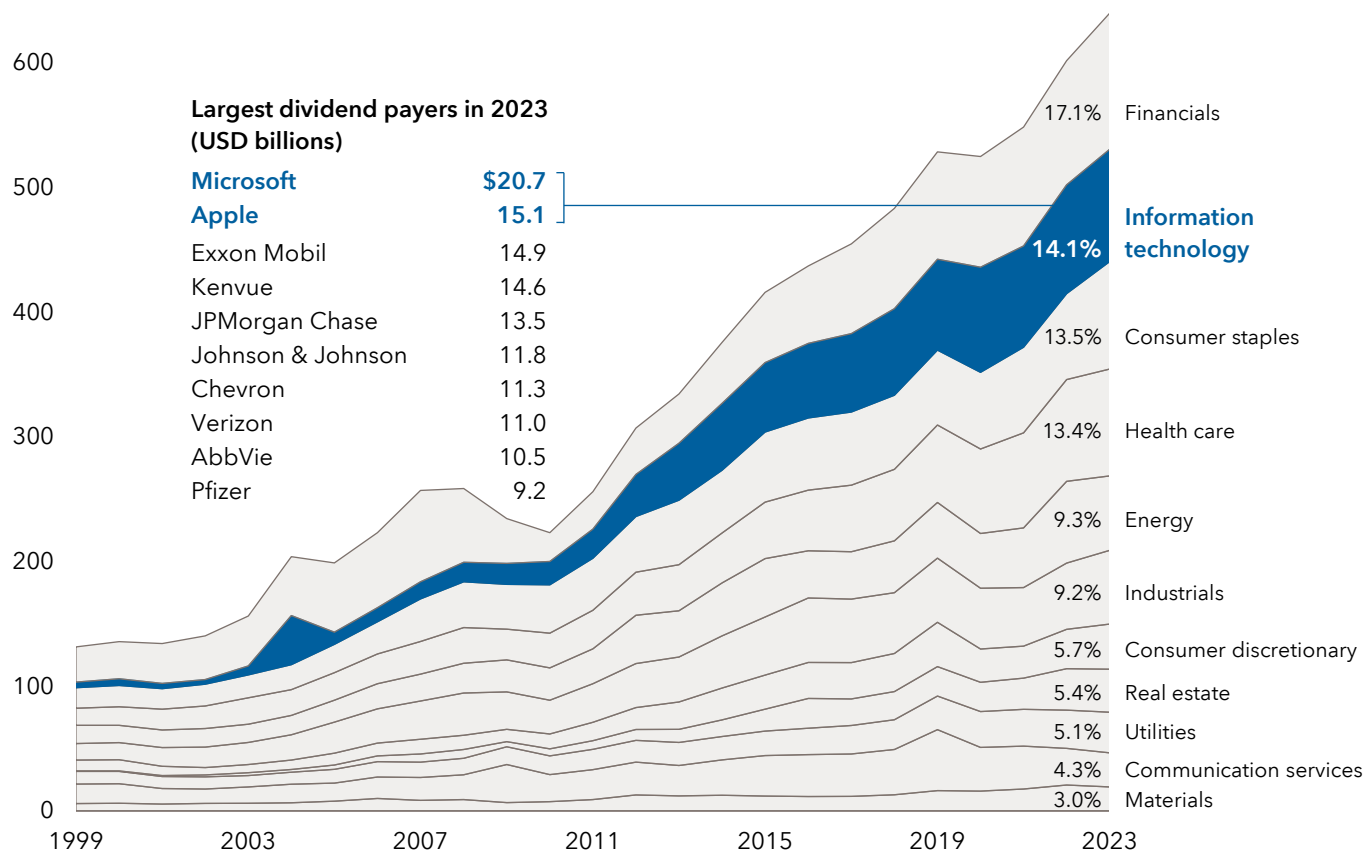
"Meta and Alphabet's dividend can be viewed as a signal of capital discipline among tech innovators and a commitment to shareholder returns," says equity portfolio manager Chris Buchbinder. Tech companies accounted for 14.1% of total cash dividends paid by S&P 500 companies in 2023, making them the second largest contributor by sector in dollar terms.

"While dividend yields for many tech firms are modest, the dollar amounts are massive, and I expect continued strong earnings growth both this year and in 2025," adds Buchbinder. "Going forward, a broadening market should create an opportunity for dividend-oriented strategies to generate income and to participate more fully in market appreciation."

For investors seeking current income, technology and aerospace companies have been introducing or increasing dividends. Semiconductor makers Broadcom and Texas Instruments, and conglomerate General Electric, which makes and services jet engines, all boosted their dividends since the end of 2023.

## The tech sector ranks second in cash dividend payments

Value of total cash dividends paid by S&P 500 companies (USD billions)



**Past results are not a guarantee of future results.**

Sources: Capital Group, FactSet, Standard & Poor's. As of 31 December 2023.

# Europe's aerospace industry is flying high

If you're gearing up for a holiday, it may come as no surprise air travel has returned to pre-pandemic levels. Growing passenger numbers, coupled with constraints on supply chains, could mean the aerospace industry is on the verge of a super-cycle.

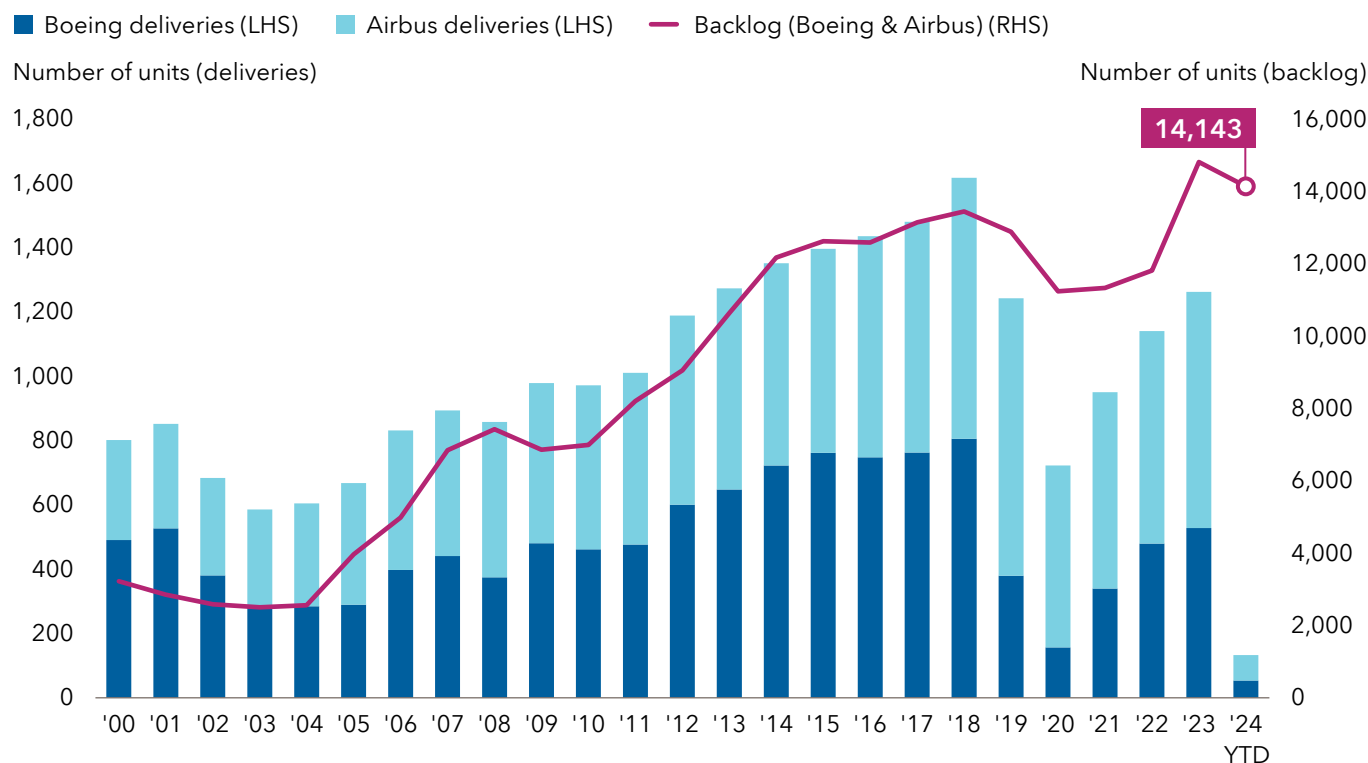
While we expect another few years of above-average demand growth, perhaps the most compelling driver is on the supply side, with the backlog for new aircraft extending to 2030. Markets like India and China are adding to order books as air travel expands in response to their growing middle classes. In an industry dominated by two manufacturers – Boeing and Airbus – the resulting pricing power is difficult to overlook.

But there is another effect from the growing order backlog; existing aircraft are flying for longer, which require more servicing. Almost 70% of in-service commercial aircraft are more than five years old and 32% are over 12 years.

This dynamic provides a further boost to companies servicing the aftermarket, already an attractive high-margin business. Component suppliers like Safran and Melrose Industries derive significant value from recurring revenue generated by their existing products. Often more money is made on replacement parts than the initial sale as aircraft components are serviced multiple times over a plane's lifespan. Durable attributes like this provide solid foundations for long-term investment potential.

## At current delivery rates, it would take 10+ years to fill all current orders

The sale of an aircraft is a one-time transaction, but each plane sold creates a multi-decade servicing opportunity

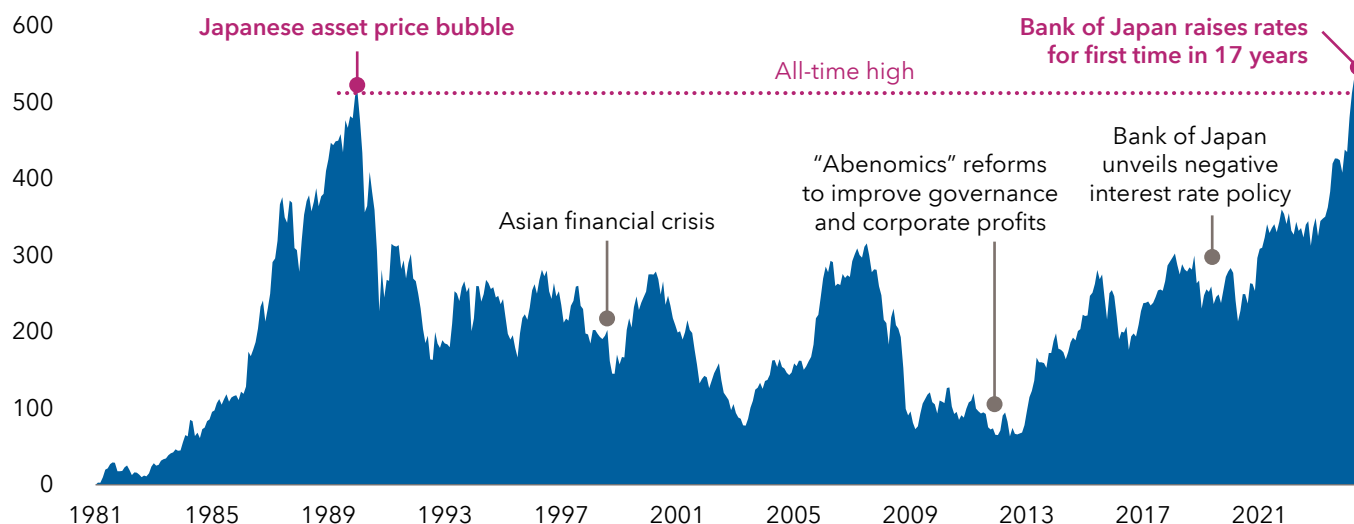


Sources: Airbus, Boeing, Goldman Sachs. Data as of 29 February 2024.

# Digital revolution gathering pace in Japan

## The Japanese market has reached levels not seen since 1989

MSCI Japan Index cumulative price return (%)

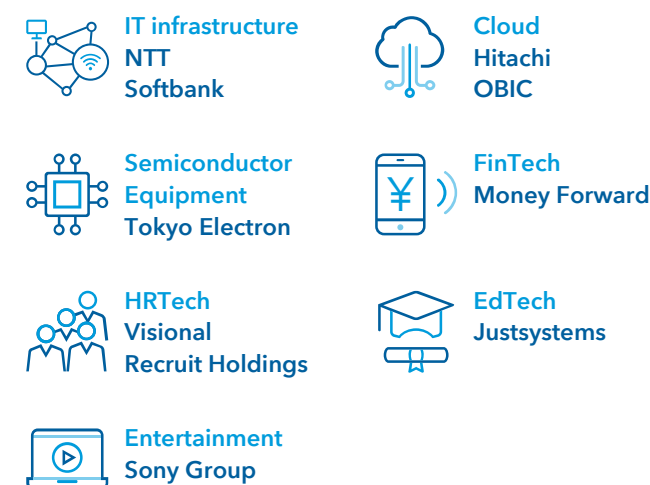


Winds of change are blowing through Japan, with corporate reform, wage growth and a digital revolution helping end decades of deflation and driving the market to highs not seen since 1989. Just as policymakers are pushing companies to prioritise shareholders, the government has established a digital agency to close the innovation gap with global competitors.

Digitisation is key to overcoming demographic challenges and boosting productivity, and this focus is driving demand for products from businesses such as software solutions firm OBIC and distance learning specialist JustSystems.

Meanwhile, the cheap cost of doing business in Japan is attracting foreign direct investment (FDI). The country's semiconductor industry continues to revive; despite not offering advanced manufacturers or global foundries, businesses such as Tokyo Electron produce materials

## A range of digitisation opportunities



essential to the supply chain. Meanwhile, global companies are establishing manufacturing in Japan, such as TSMC's Kumamoto plant.

Portfolio manager Akira Horiguchi highlights returning capex and FDI as reflationary. "The recent opening of TSMC's Kumamoto factory is considered successful due to availability of engineering resources, whereas its Arizona opening suffered from high costs, including engineers," he says. "This indicates a bright future for FDI into Japan."

### Past results are not a guarantee of future results.

Left-hand side: Sources: Capital Group, MSCI, RIMES. Cumulative price returns shown from 31 December 1980 to 31 May 2024. Returns shown in Japanese yen. The cumulative return is the total change in the investment price over a set time. RHS: Source: Capital Group. EdTech: educational technology. HR Tech: human resources technology. FinTech: financial technology.

# Could this be India's decade to shine?

This decade is likely to be different for emerging markets – and so are the opportunities. Once characterised by China's rapid ascent in the global economy and that country's predominance in the MSCI Emerging Markets Index, emerging markets are undergoing a shift as global supply chains are rewired. India, which is becoming a viable alternative to China to make mobile phones and home appliances, provides one such example.

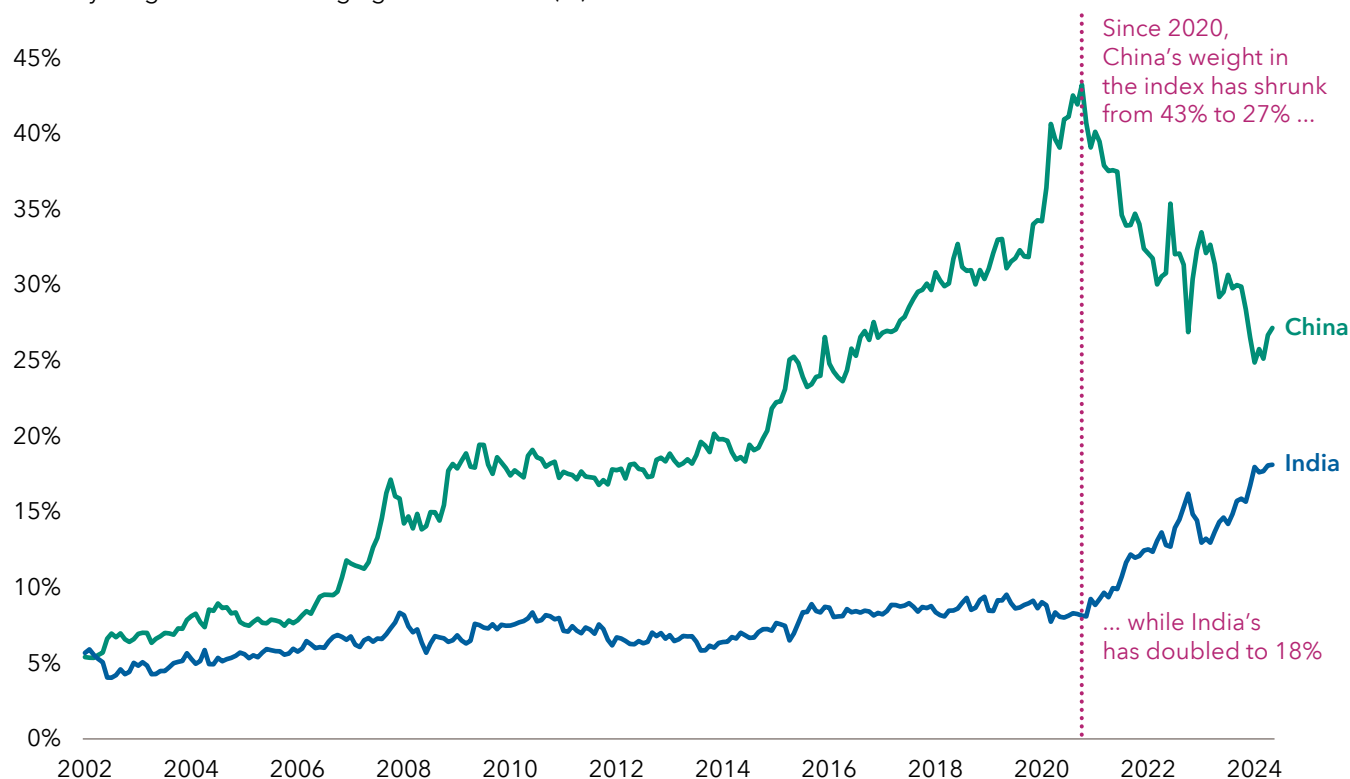
India's rise speaks to a larger trend, however. Infrastructure growth is accelerating, new manufacturing hubs are boosting regional economies, and the world's energy transition is driving foreign investment into a broader mix of developing countries for manufacturing and natural resource needs.

"The setup for emerging markets is attractive," says portfolio manager Brad Freer. "As multinationals diversify their supply chains, this is an exciting opportunity for countries such as India, Mexico and Indonesia because it broadens the investable options for manufacturers in the US and Europe. Meanwhile, the deep selloff in China has created opportunities to selectively invest in companies with strong cash flows and dominant market shares, including some of the technology giants."

On top of that, most emerging markets are trading at their cheapest valuations in 10 years on a price-to-earnings basis, and central banks in many of those countries have ample room to cut interest rates.

## India and China: A tale of two evolving stock markets

Country weight in MSCI Emerging Markets Index (%)



Sources: MSCI, RIMES. Data reflects 31 January 2002 to 31 May 2024.

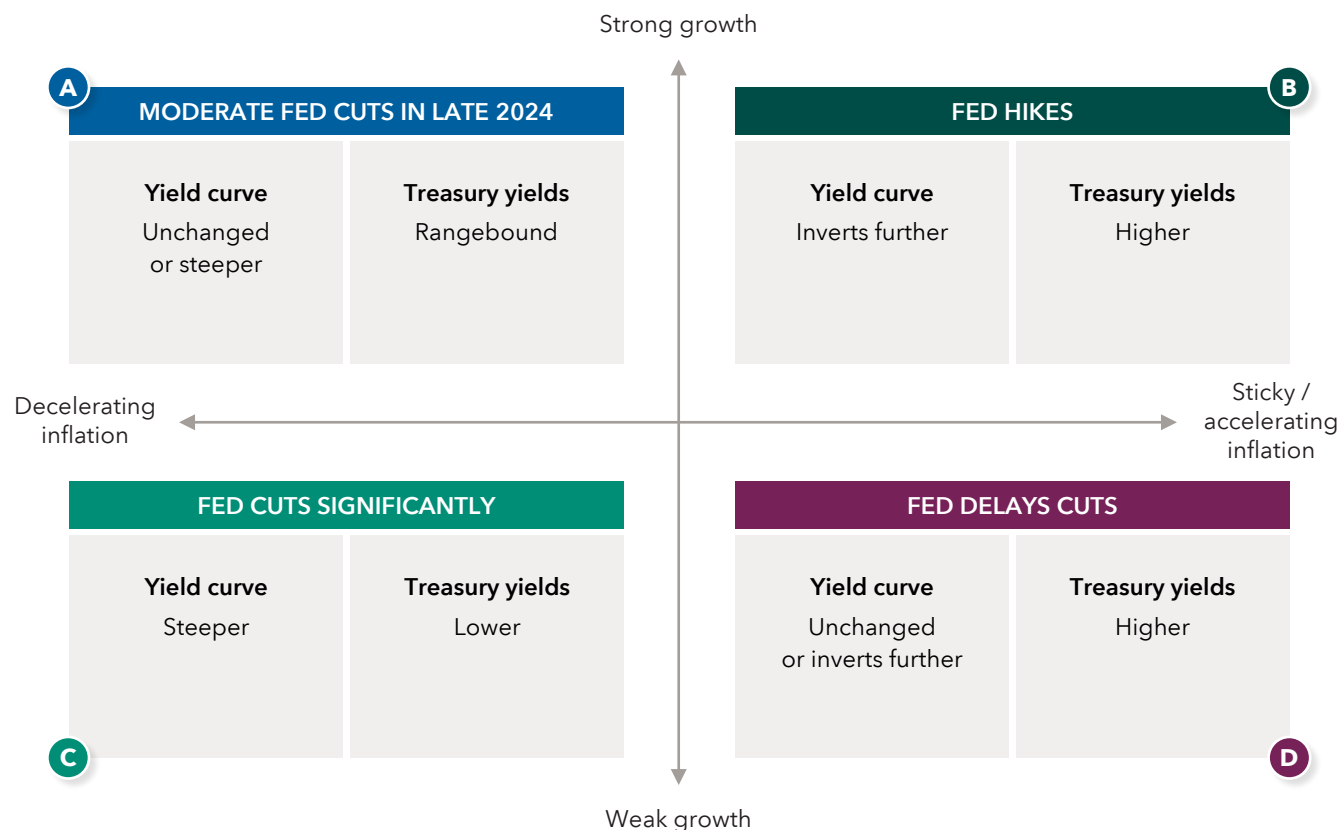
# Fed pause or pivot: Bonds offer options to deal with uncertainty

Preparing bond portfolios for a range of outcomes may be prudent this year, as high yields and a likely end to the Federal Reserve's rate-hiking cycle are bringing investors back to fixed income. The Fed's commitment to data dependence could create uncertainty, meaning investors may want to remain flexible and invest selectively.

Despite continued volatility, US Treasury yields are likely to remain rangebound, given the robust economy and elevated deficit offset by the Fed's bias to cut rates. What could break rates out of their current range is a sharp economic slowdown prompting deeper cuts or, conversely, a dramatic upswing in inflation forcing a pivot back to hikes by the Fed.

"It appears likely that we will get fewer rate cuts this year than the Fed had forecast in March. However, there seems to be a high bar for rate hikes so there is a limit to how high yields could rise. Conversely, there is plenty of room to come down if the economy hits a rough patch," says fixed income portfolio manager Tim Ng.

Within rates, positioning for a steeper yield curve – a scenario where long-term Treasury yields increase more or fall less in relation to short-term yields – is a high conviction view of many members of the fixed income team.



Source: Capital Group. As of 31 May 2024.

# Bond opportunities in a higher rate world

Bond markets have navigated rough terrain in recent years as the Fed raised rates and yields moved higher.

Nevertheless, credit assets ranging from investment-grade corporate bonds to mortgage-backed securities (MBS) offer potential value.

As the economy has chugged along and demand from investors has remained strong, the spread, or yield differential, between credit assets and US Treasuries has narrowed significantly. As such, the greatest potential for these bonds comes not from possible spread tightening, but a decline in interest rates.

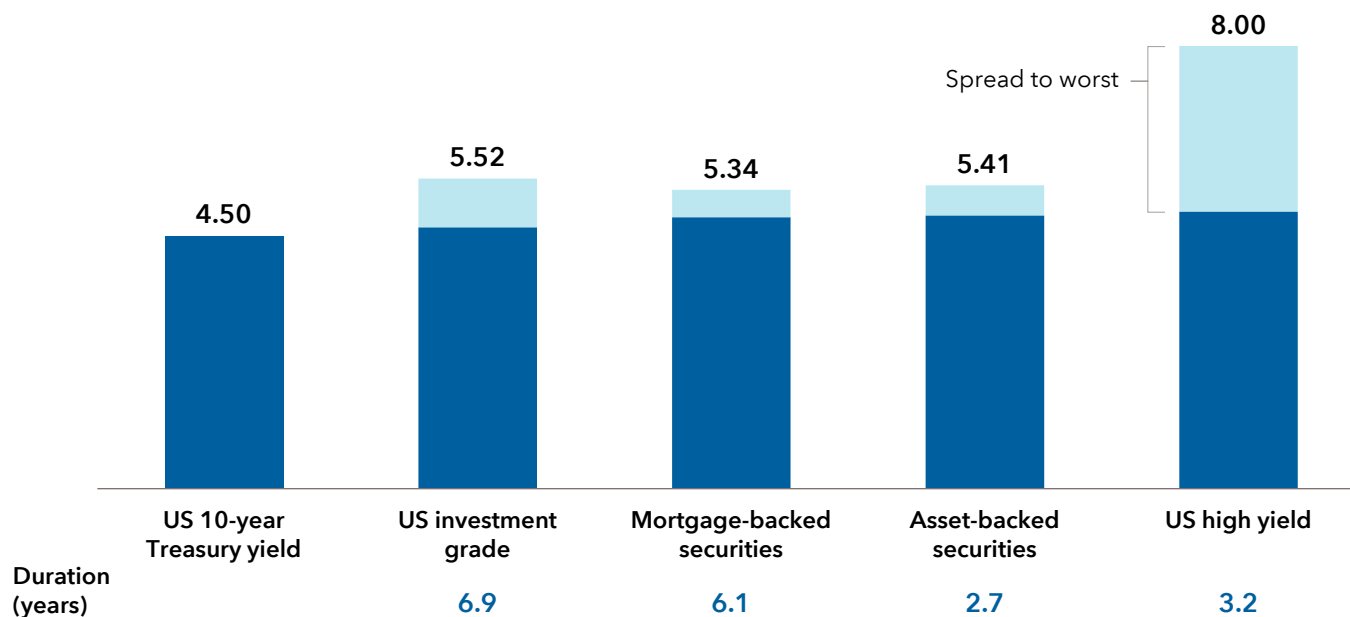
"Given the recent rally in corporate bond spreads, we are seeing better opportunities in higher quality sectors with attractive yields such as securitised credit and agency MBS," says portfolio manager Vince Gonzales.

Investment-grade bonds and MBS are well positioned. Within MBS, quality, high-coupon bonds such as agency mortgage securities are attractive. These bonds are unlikely to get refinanced ahead of their maturity given prevailing mortgage rates. Supply dynamics also work in MBS's favour. Namely, home sales have slowed as homeowners choose to stay put to hold on to their pandemic-era mortgage rates.

"Exposure to agency MBS can help investors maintain a balanced portfolio alongside credit opportunities," says Gonzales. History has shown that credit spreads can stay at these levels for a long time, especially if the economic outlook points toward continued growth.

## Resilient economy has supported tight credit spreads over US Treasuries

Yield to worst (%)



### Past results are not a guarantee of future results.

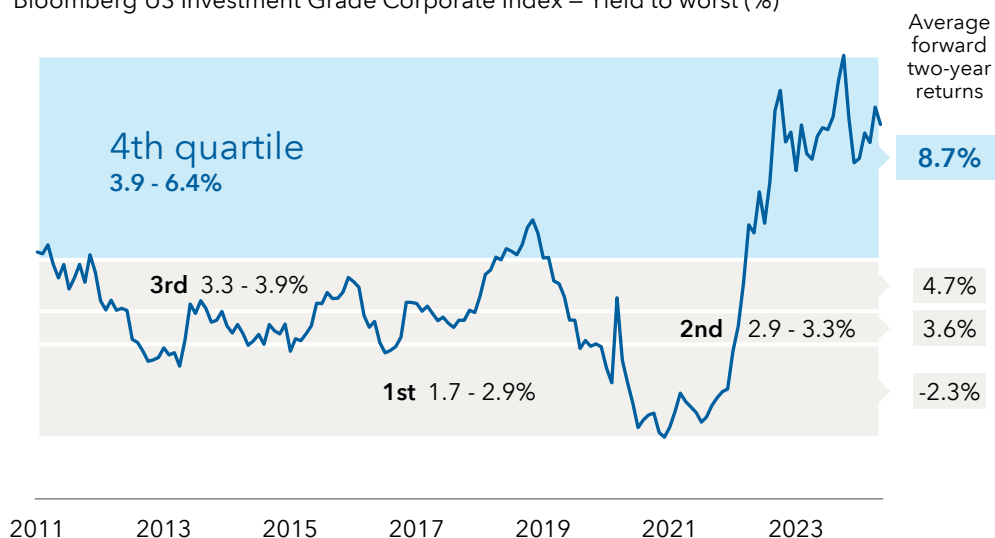
Sources: Capital Group, Bloomberg Index Services Ltd. **Yield to worst** is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting. **Spread to worst** is the difference between the yield to worst of a bond and yield to worst of its benchmark yield curve. Indexes used are the Bloomberg US Corporate Investment Grade Index (US investment grade), Bloomberg US Mortgage-Backed Securities (MBS) Index (mortgage-backed securities), Bloomberg US Asset-Backed Securities Index (asset-backed securities) and the Bloomberg US Corporate High Yield Index (US high yield). As of 31 May 2024.



# Healthy fundamentals support corporate bonds

## History suggests strong return potential given current starting yields for investment-grade and high-yield bonds

Bloomberg US Investment Grade Corporate Index – Yield to worst (%)



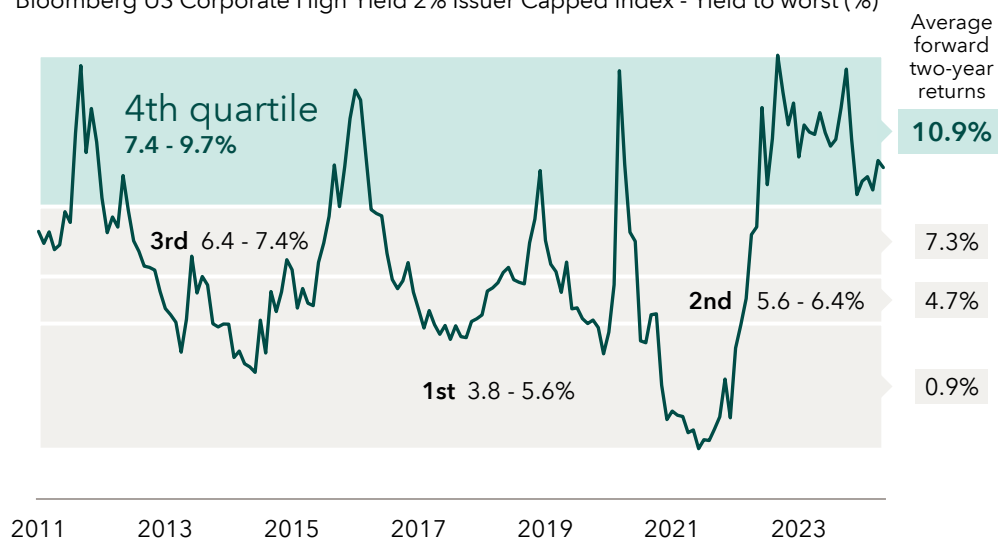
Steady consumer spending and economic growth translate to solid income potential for corporate investment-grade (credit rating of BBB/Baa and above) and high-yield bonds in 2024.

Corporate issuers have largely avoided the impact of high financing costs because most refinanced their debt during the pandemic when rates were near zero. A strong consumer also enabled businesses to increase prices for goods and services. Earnings growth will likely continue to remain positive through 2024 and 2025.

But so long as the yield on the 10-year US Treasury stays near 5%, risks remain that economic cracks could develop. This is especially true if companies are forced to renew their debt at higher costs, a process expected to begin over the next two years.

Risks tied to high rates warrant a cautious approach, especially when it comes to lower rated bonds. "In high yield, there are attractive opportunities in certain defensive sectors such as energy, which have strong balance sheets

Bloomberg US Corporate High Yield 2% Issuer Capped Index - Yield to worst (%)



and can withstand higher rates and weaker economic growth," says portfolio manager David Daigle.

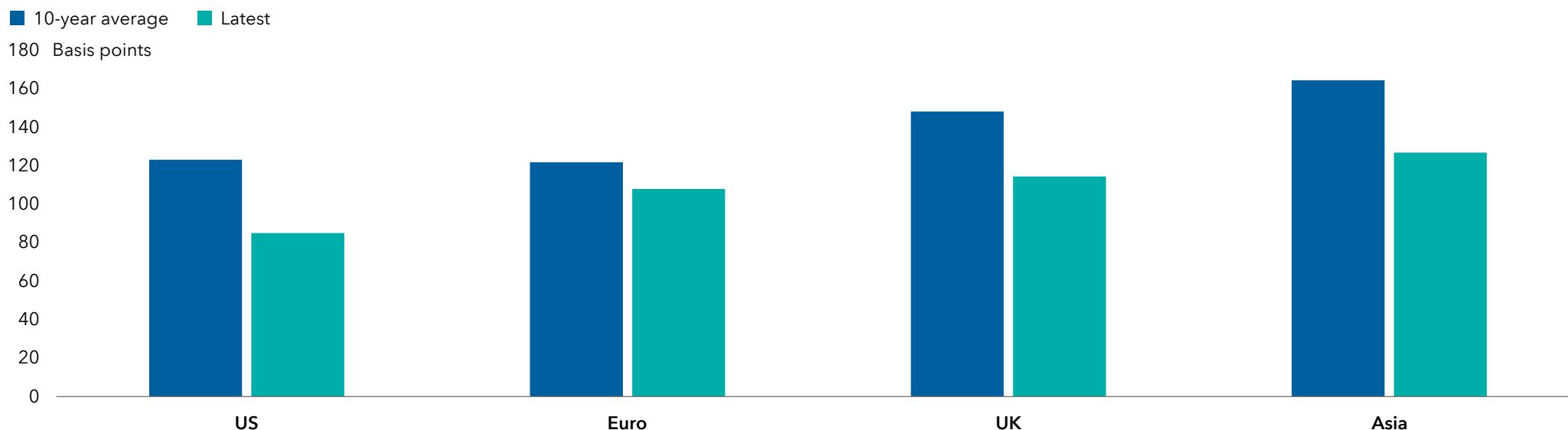
Bonds now offer the highest income potential in 23 years, which might explain why spreads remain so narrow. "Starting bond yields are a good indicator of future annualised return, and today's levels are attractive by long-term standards," Daigle concludes.

### Past results are not a guarantee of future results.

Sources: Capital Group, Bloomberg Index Services Ltd. Data as of 31 May 2024. Average forward two-year returns are annualized, based on each quartile of starting yield to worst.

# Not all bonds are the same: increasing dispersion across regions and sectors

## Regional comparison of option-adjusted spreads (OAS)\* for investment grade credit



The return of income to bond markets has led to a surge in demand for the asset class. In turn, this has led to a narrowing of investment grade (IG) credit spreads. But this tightening has not happened at the same pace for all bonds, leading to valuation dispersion.

One notable area where this has occurred is between regions. Spreads in Europe and Asia are close to or below historical averages but still off their lows, whereas in the US, they are nearing minimum levels.

We also continue to see dispersion between sectors: credit spreads for financials are wider than industrials, for example. This is unusual, particularly in the US, and we would expect the gap to narrow as conditions normalise.

This ongoing sector and regional dispersion highlights that the opportunity set within investment grade has become increasingly company specific. It requires a dedicated, experienced, bottom-up research capability to help understand where companies offer potential value, while

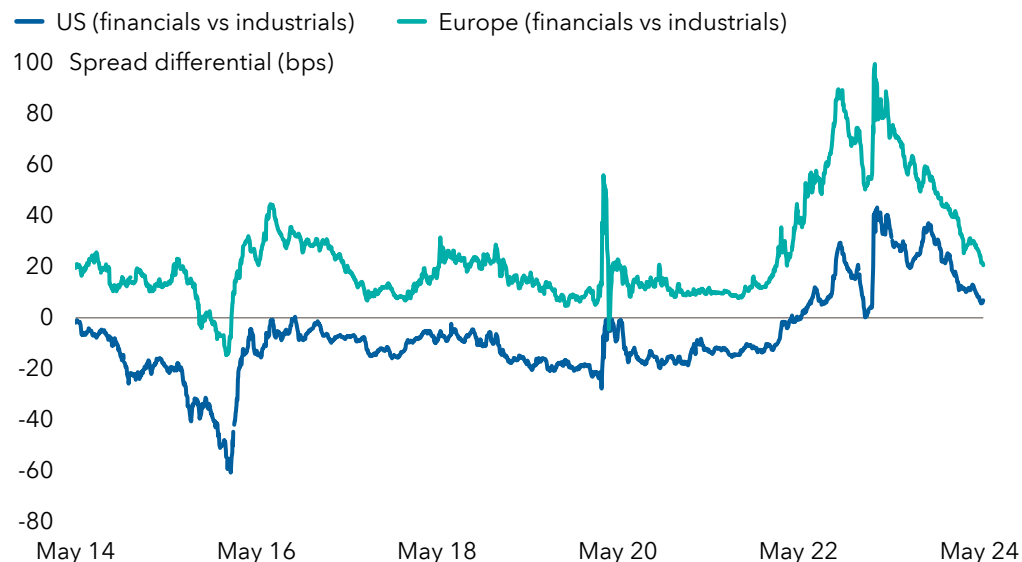
also avoiding companies where spreads could be too tight compared to fundamentals.

Furthermore, by shifting focus from the macro to the company-specific, we believe investors reduce their dependency on one particular economic outcome and can maximise unprecedented opportunities still available within IG credit.

Sources: Bloomberg, Barclays Live. As of 31 May 2024. Bloomberg US IG Corporate Bond Index (US), Bloomberg Euro IG Corporate Bond Index (Europe), Bloomberg Sterling Corporate Bond Index (UK), JPMorgan JACI Investment Grade Index (Asia). **\*OAS:** The difference in yield between a bond with an embedded option and the yield on Treasuries. **Embedded option:** a feature of a financial instrument that allows either the issuer or the holder to take specific actions against the other party at some point in the future.

# Investment grade credit: more than meets eye

## US financials vs industrials, option-adjusted spreads



On the surface, global investment grade credit spreads are at historically tight levels. But dig a little deeper and it is possible to find pockets of opportunity where spreads are wider and do not necessarily reflect underlying fundamentals.

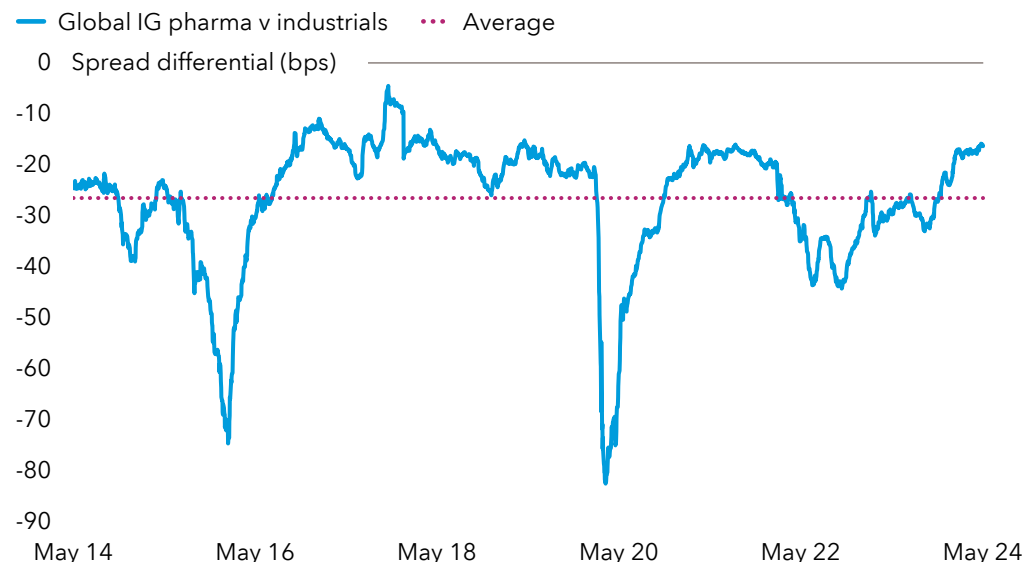
For example, the banking sector has been out of favour due to high issuance volumes (high supply), ongoing concerns over the US regional bank crisis in early 2023, and uncertainty about future economic growth. Outside of US regional banks, however, fundamentals within the banking

sector are the strongest they have been in decades. In addition, central banks increasing interest rates has been broadly beneficial.

By using fundamental research, it is possible to identify mispriced credit and capture attractive investment opportunities.

Pharmaceuticals is another area where selective bottom-up opportunities can be uncovered. This tends to be a defensive sector and lagged the broader market earlier in the year

## Pharmaceuticals vs industrials, option-adjusted spreads



when yields fell on signs the hiking cycle might have peaked. In addition to its defensive nature, this was due to expected large supply coming to market, higher M&A risk and concerns around patent cliffs. We think these headwinds are fading and profitability increasing, and alongside new drug discovery, this is providing room for spread compression.

Tighter credit spreads over recent months do not mean opportunities in investment-grade credit have disappeared, only that they are increasingly company specific.

Sources: Bloomberg, Barclays Live. As at 31 May 2024. Indices: Bloomberg US Corporate Index, Bloomberg Euro Aggregate Corporate Index, Bloomberg Global Aggregate Corporate Index. M&A: mergers and acquisitions.

# US high yield: remain focused on credit quality

With inflation rates falling less than many anticipated, and the timing of any interest rates cut more uncertain, fixed income investors may find it difficult to navigate the noise. However, the US high yield market – with higher yields and lower duration – is an area less driven by rates and more impacted by a deterioration in growth and credit quality.

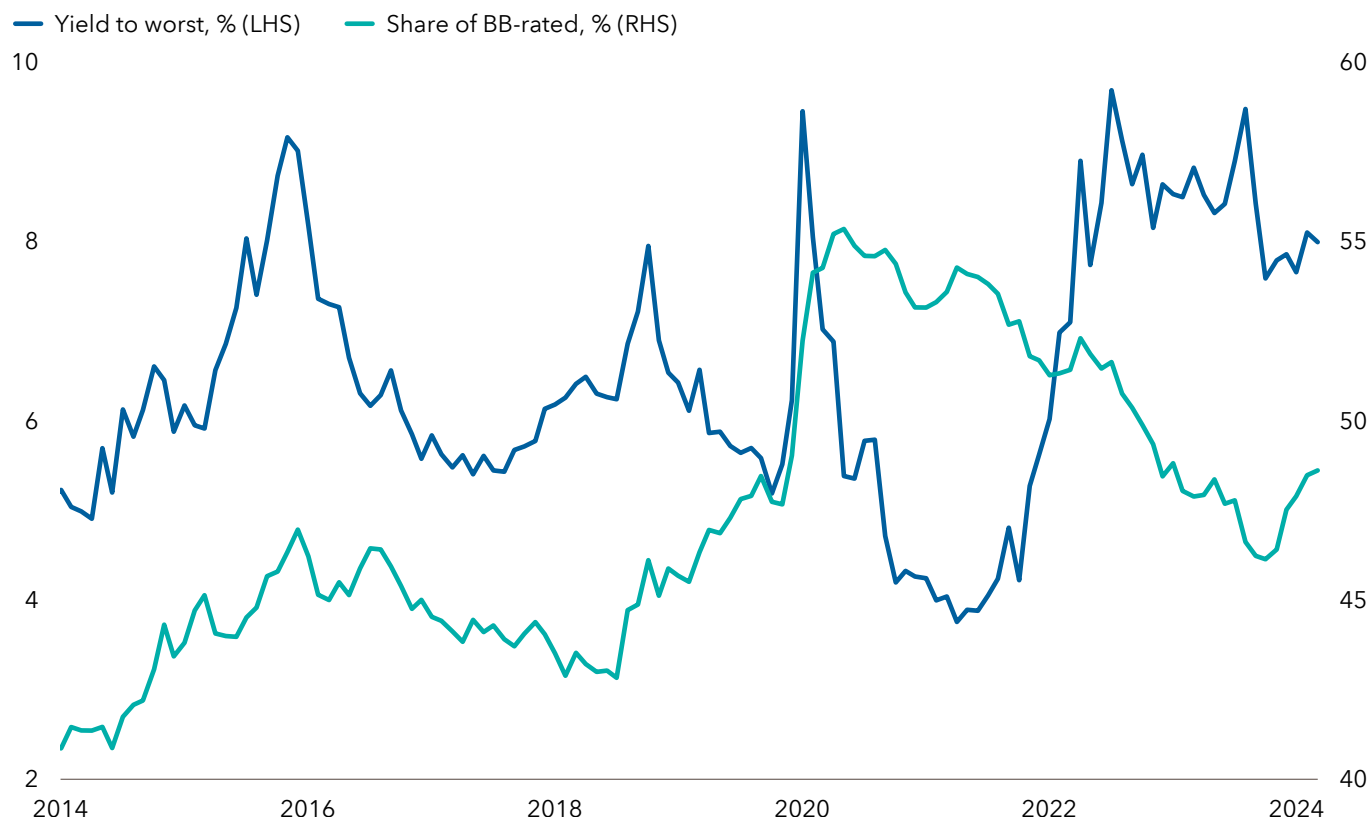
The good news today for US high yield investors is that the overall credit quality of the market has increased significantly in recent years. BB-rated issuers accounted for around 50% of the entire market compared to less than 40% 10 years ago, partly due to riskier issuers moving to the private credit market for funding.

From a high point in 2020, credit quality in the high yield space has deteriorated somewhat as companies have been upgraded to BBB, but despite this trend, default rates have been exceptionally low at around 1%-2%.

Consideration of the economic backdrop is also essential. Leveraged companies typically need a healthy level of growth to generate cashflow to service their debt. As we enter a period of economic uncertainty, understanding how an issuer might navigate different environments helps paint a clearer picture of the risk-reward dynamics of each investment.

But with yields close to 8%, better credit quality and low default rates, there is an opportunity to invest in good quality credits and lock in healthy income, with added potential for prices to rise if and when rates do come down. However, a focus on security selection is vital as spreads remain relatively tight.

## Security selection critical as average credit quality deteriorates



**Past results are not a guarantee of future results.**

Source: Bloomberg. As of 31 May 2024. Index: Bloomberg US High Yield 2% Issuer Capped Index.

# Emerging market monetary policies vary but yields remain attractive

While headline inflation has ticked up in several emerging markets recently, core inflation remains muted. This is thanks to aggressive actions by central banks early in their inflation cycles.

Many emerging economies shifted toward easier monetary policies when inflation softened, but there are regional differences. While most Asian economies are not yet ready to reduce rates, with Indonesia recently raising rates, several Latin American and Eastern European countries are well into their easing cycles. In fact, Brazil has already eased rates significantly and is now expected to keep rates on hold for the foreseeable future or hike.

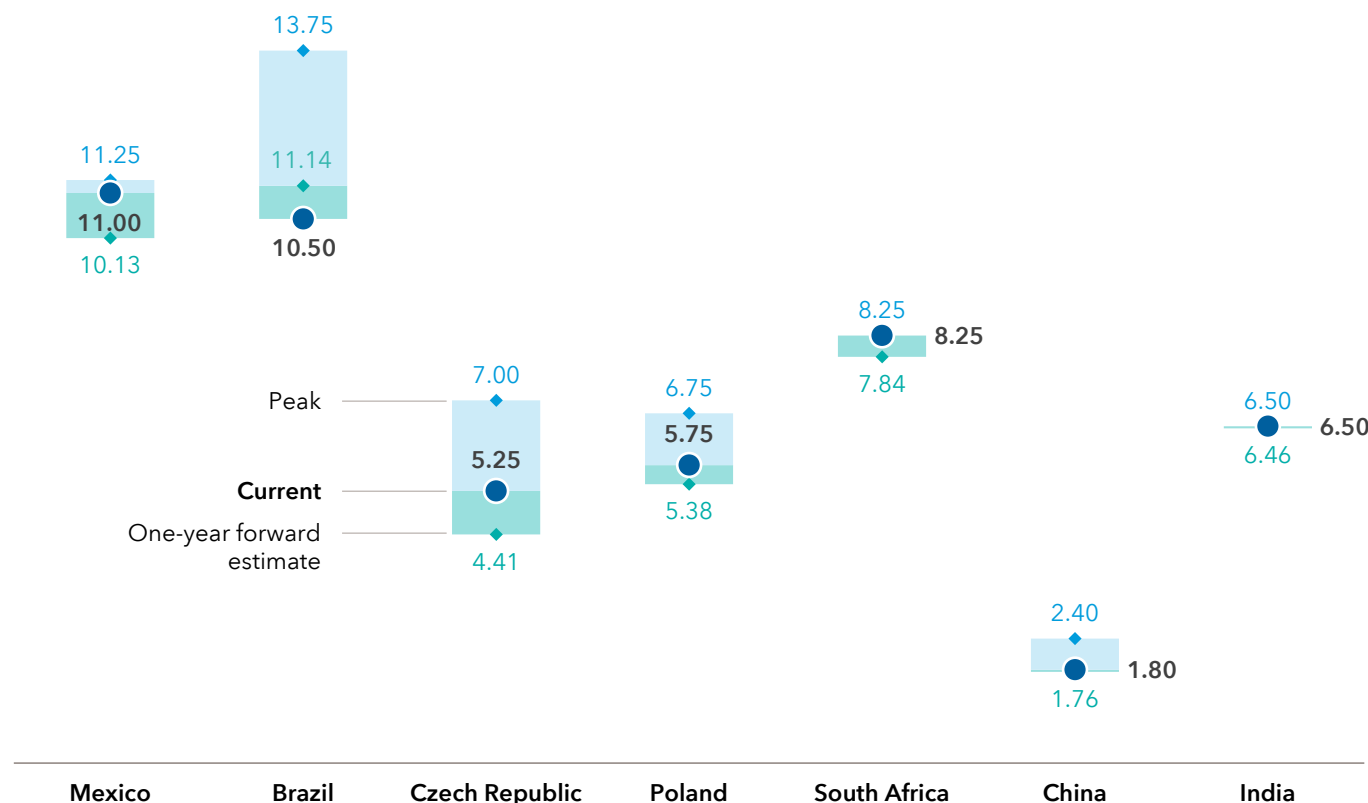
That said, sustained US dollar strength and expectations of fewer interest rate cuts by the Federal Reserve this year have diminished the scope for further monetary easing. On the positive side, an improving global growth outlook is helping offset the impact from higher US Treasury yields.

Economic growth rates for several developing economies continue to outpace their developed market counterparts, with largely similar fiscal deficits and mostly lower sovereign debt levels.

We remain largely constructive on emerging markets debt. "Valuations are reasonably attractive in local currency markets with high real rates," says portfolio manager Kirstie Spence. "In US dollar-denominated debt there are opportunities in some higher yielding credits where wider spreads offer a valuation cushion. Select EM corporate bonds add diversification as well."

## Policy variations across emerging markets can create investment opportunities

Policy rates (%)



Source: Bloomberg. As of 31 May 2024. One-year forward estimates based on market implied policy rates. Peak policy rate is highest since January 2020. The policy rate referenced for China is the PBoC 7-day reverse repo rate

# Glossary

**Agency Mortgage-Backed Securities (MBS)** – These are pools of securitised residential mortgage loans that are issued and guaranteed by US government agencies.

**Capital expenditure (capex)** – The money a company spends to acquire, upgrade and maintain fixed assets such as equipment, property and buildings.

**Core inflation** – The rise in the prices of goods and services in a basket of goods that excludes food and energy. Commodities like food and energy tend to be more volatile, price movements for these goods are captured in headline inflation.

**Coupon** – The regular interest payment on a bond. It is usually expressed as a percentage of the face value and it is paid from issue date until maturity.

**Credit rating** – Typically ranging from AAA/Aaa (highest) to D (lowest), these are assigned by credit rating agencies such as Standard & Poor's, Moody's and/or Fitch, as an indication of an issuer's creditworthiness.

**Credit spreads** – The difference between the yield (return) of two different debt instruments with the same maturity but different credit ratings. Spreads tighten/compress when that difference narrows and widen when it gets larger.

**Default rate** – A bond is considered in default if the issuer misses a coupon interest payment or cannot repay the principal amount at maturity. The default rate measures the percentage of issuers in each fixed income asset class that failed to make either of these payments in the prior 12 months.

**Cumulative price return** – The accumulated gain or loss of a stock (excluding dividends) over time, independent of the amount of time involved.

**Deflation** – A decrease in the prices of goods and services in an economy.

**Dividend** – A sum of money paid regularly by a company to its shareholders out of its profits (or reserves).

**Duration** – A measure of the approximate sensitivity of a bond portfolio's value to interest rate changes.

**Earnings per share** – Calculated as a company's profit divided by the outstanding shares of its common stock. The resulting number serves as an indicator of a company's profitability.

**Federal (Fed) Funds Rate** – The target rate reflects the upper bound of the Federal Open Markets Committee's (FOMC) target range for overnight lending among US banks.

**Fiscal deficit** – The difference between government spending a government's spending and the income it receives from taxes and other revenues.

**Foundries** – A factory that produces metal castings.

**Gross domestic product (GDP)** – Measures the monetary value of final goods and services – that is, those that are bought by the final user, produced in a country in a given period (for example over a quarter or a year). Real GDP takes inflation into account.

**Headline inflation** – The rise in the prices of goods and services of a basket of goods that includes commodities like food and energy, which tend to be volatile (see comparison with core inflation).

**High yield 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.

**Investment-grade bonds** – These bonds are considered higher quality bonds. They have a credit rating of BBB/Baa and above.

**Local currency bonds** – Government or corporate debt that is issued in the local currency of the country of the participating organisations.

**Maturity** – The date when the principal of a fixed income security is due to be repaid.

**Mean consensus earnings** – The average of the combined projected earnings based on estimates from professional analysts that cover the stock.

**Monetary policy** – A set of tools used by a central bank to manage the country's money supply and promote economic growth. A central bank may adopt an accommodative (easier) monetary policy to boost the economy by measures such as lowering interest rate and purchasing securities. When inflation is high, a central bank may adopt a contractionary (tighter) policy by increasing interest rates to slow growth and decrease inflation.

**Mortgage-backed securities (MBS)** – An investment similar to a bond that consists of a bundle of loans (usually home loans) bought from the banks that issued them.

**Policy rates** – The central bank policy interest rate determines the level of the rest of the interest rates in the economy, since it is the price at which private agents (mostly private banks) obtain money from the central bank.

**Price-to-earnings (P/E)** – The ratio for valuing a company that measures its current share price relative to its earnings per share (EPS).

**Private credit** – Investments in private, non-publicly traded debt instruments.

**Real rates** – Interest rates after factoring in inflation

**Recession** – A significant decline in economic activity, usually defined as when GDP falls for two consecutive quarters.

**Reflation** – A return to inflation (an overall increase in prices), from a state of deflation (an overall decrease in prices).

**Sovereign debt** – A debt security issued by a national government to raise money for financing government programmes, paying interest on current debt and any other government spending needs.

**US Treasury** – Debt instruments (bonds) issued by the US government.

**Yield** – The income returned on an investment, such as the interest or dividends received from holding an asset. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market.

**Yield-to-worst** – The lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaulting.



All data as at 31 May 2024, unless otherwise specified.

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