Outlook

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CAPITAL GROUP℠

Long-term perspective on markets and economies

This material is a marketing communication

Rob Lovelace on the year ahead

Rob Lovelace
Vice Chairman
and President,
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As we head into a new year, it's clear in hindsight that the market downturn of 2020 was short-lived and entirely related to the COVID-19 outbreak. In my view, that means the powerful upswing in equity prices since then is simply a continuation of the bull market we've seen over the past decade. Market leadership today is essentially the same as it was before the pandemic. The largest gains are concentrated in a small number of companies – mostly US-based, internet-related businesses. Even outside the US, the winners primarily have been tech-focused companies benefiting from the same powerful tailwinds surrounding the growth of e-commerce, cloud computing and interactive media.

This continuation of pre-pandemic trends means investors should be mindful of the risks inherent in the latter days of a long bull market. In particular, the ongoing war between inflation and deflation could define markets in the years ahead. Looking ahead, the risks are clearly defined: Global economic growth is slowing, especially in China. Central bankers have started a gradual reduction in monetary stimulus measures. And valuations are elevated across the board, from stocks to bonds to real estate.

Against this challenging backdrop, however, we are optimistic about an environment that is ideally suited to selective investing grounded in bottom-up, fundamental research. Our equity and fixed income analysts around the world are uncovering many interesting new investment opportunities. In addition, our long-term investment horizon allows us to take advantage of market dislocations and invest in companies that we believe will prosper over a period of years.

With these thoughts in mind, I hope you enjoy reading and sharing our 2022 Outlook.

Expect strong but slowing economic growth in 2022

International Monetary Fund (IMF) and US Federal Reserve views	Capital Group views
Robust global growth should continue in 2022 The world economy should expand at a pace of 4.9%, according to forecasts[1], driven by an ongoing recovery from the COVID-19 pandemic, pent-up demand and strong corporate earnings. The IMF calls for 5.2% growth in the US and 4.3% in Europe.[1]	**US and European economies will likely grow at solid rates in 2022** "US economic growth should be solid, in the range of 2.5% to 3.0%, but hampered by emerging COVID variants, waning stimulus and inflationary headwinds," says Capital Group economist Darrell Spence. The major European economies may grow significantly faster, in the 4.0% to 5.0% range, as the eurozone enjoys a delayed but now strong COVID rebound, adds Capital's European economist Robert Lind.
China's economy to grow at a healthy rate The world's second largest economy is forecast to grow at an annualised rate of 5.6%[1], supported by increased global trade activity, renewed government stimulus measures and a recovery in the real estate sector.	**China's economy could markedly decelerate** "Investors should prepare for a rough patch," says Capital Group's Asia economist Stephen Green. "China's economy is slowing and credit is tightening in the real estate sector. I think GDP[2] growth will be considerably lower than the consensus forecast of 5.6%."
High inflation expected to fade over time Central bank officials expect high inflation rates, driven by COVID-related distortions, to ease in the coming quarters but they have become less certain on the timing. In the US, the Federal Reserve said in December it expects inflation to move closer to its 2% goal by 2023.	**High inflation may persist longer than expected** Inflation levels will likely remain elevated through late 2022, fuelled by labour shortages and broken supply chains. "Consumer prices will eventually return to normal, but that process may take longer than US Fed officials are expecting," says Capital Group fixed income portfolio manager Ritchie Tuazon.

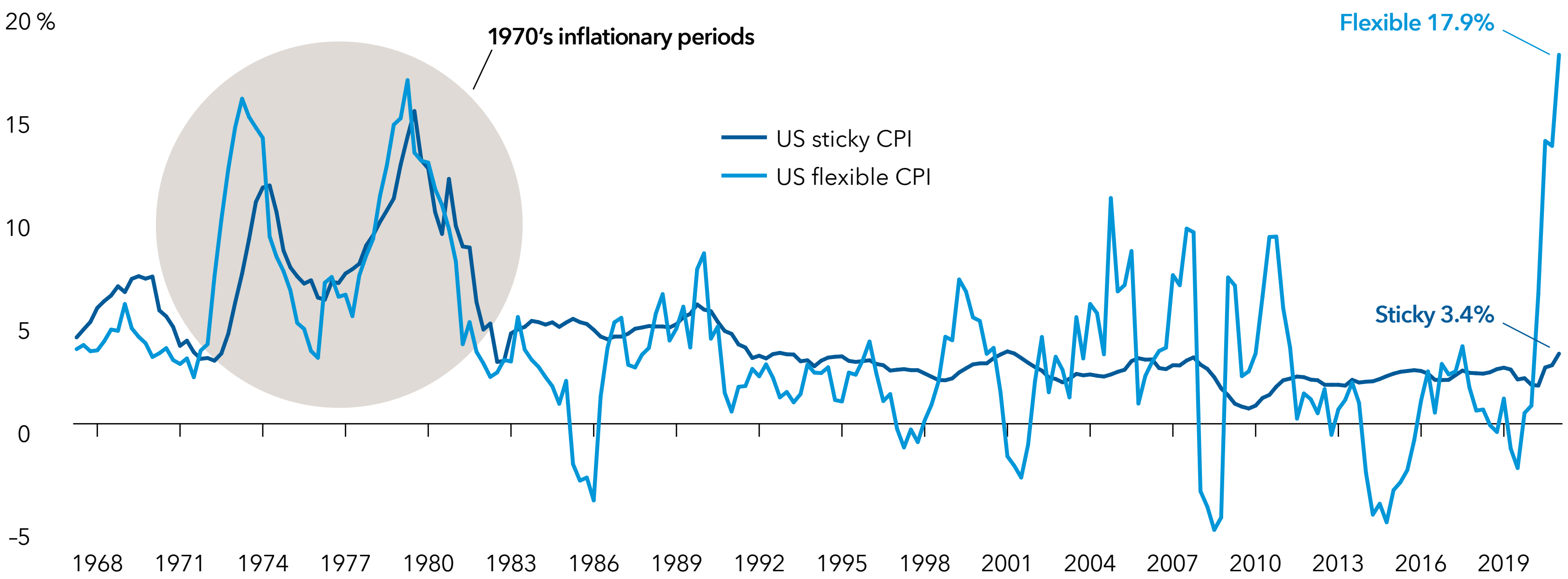
Forecasts shown for illustrative purposes only.

Sources: Capital Group, International Monetary Fund, US Federal Reserve, European Central Bank, Bank of England.

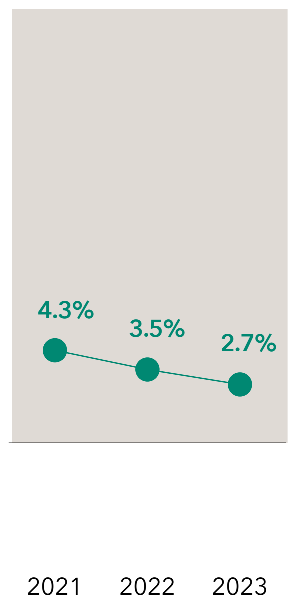
1. As at October 2021. Source International Monetary Fund
2. GDP is Gross domestic product

High inflation could persist in 2022, but we're not returning to the 1970s

Sticky and flexible US price inflation, YoY change (%)



US inflation projections



Inflation is like chewing gum. It's sticky and flexible, and you definitely don't want to step in it.

For the past 30 years, investors in developed markets haven't had to worry much about stepping in it. That changed last summer when COVID-related distortions caused prices for some consumer goods to skyrocket. Today, the biggest questions for investors are how high will it go and how long will it last?

Adding to the uncertainty is that there are two types of inflation. Sticky inflation tends to have longer staying power. Sticky categories include rent, insurance and medical expenses. Flexible inflation – affecting items such as food, energy and cars – has risen much faster in recent months but many believe it likely won't last.

"If we take US inflation as an example, the upside risk is in the sticky components," says fixed income portfolio manager Ritchie Tuazon. "Those are the categories that will drive inflation in 2022, so that's what investors need to keep an eye on."

While Tuazon expects inflation to eventually return to normal levels, he also thinks it makes sense to guard against the threat of sustained higher prices through investments in inflation-linked securities, dividend-paying stocks and companies with pricing power.

Those strategies may not fully shield investors from inflation, but they may help mitigate some of the impact.

Forecasts shown for illustrative purposes only.

Sources: Federal Reserve Bank of Atlanta, Refinitiv Datastream. Sticky and flexible prices reflect the Atlanta Federal Reserve sticky and flexible consumer price indexes (CPI). If price changes for a particular CPI component occur less than every 4.3 months, that component is a "sticky-price" good. Goods that change prices more frequently are "flexible-price" goods. Historic data as at 30 November 2021. Projections for 2021-23 are from IMF and as at October 2021.

Stocks and bonds have done well in various inflation environments

If you're worried that higher inflation is here to stay, keep three things in mind.

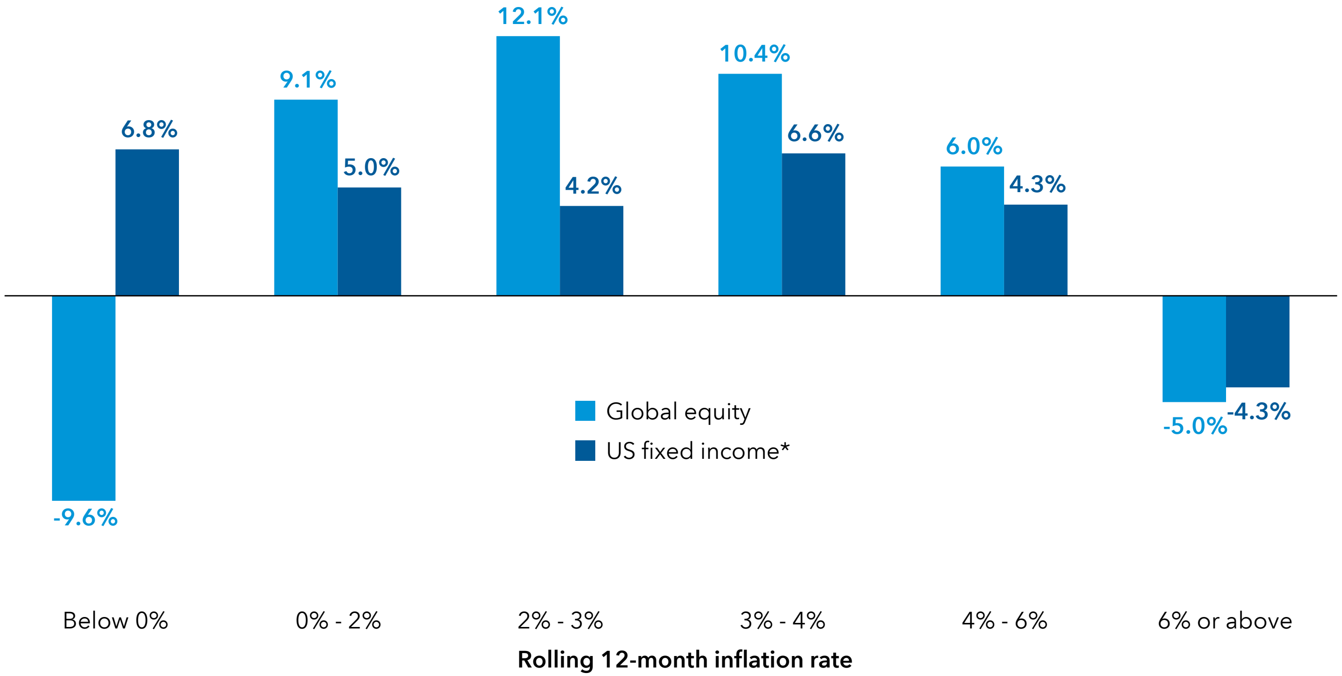
First, some inflation can be healthy for companies. It allows them to raise prices and enhance profitability in ways they may not have been able to do in recent years. It also helps banks and commodity-linked companies that have struggled in a low inflation, low interest rate world.

Second, even during times of higher inflation, stocks and bonds have generally provided solid returns as shown in the chart. It's mostly at the extremes – when inflation is above 6% or negative – that financial assets have tended to struggle.

Third, sustained periods of elevated inflation are rare. Some people may remember the ultra-high inflation of the 1970s. In hindsight, it's clear that was a unique period. Deflationary pressures have often been more difficult to tame, as students of the Great Depression will attest.

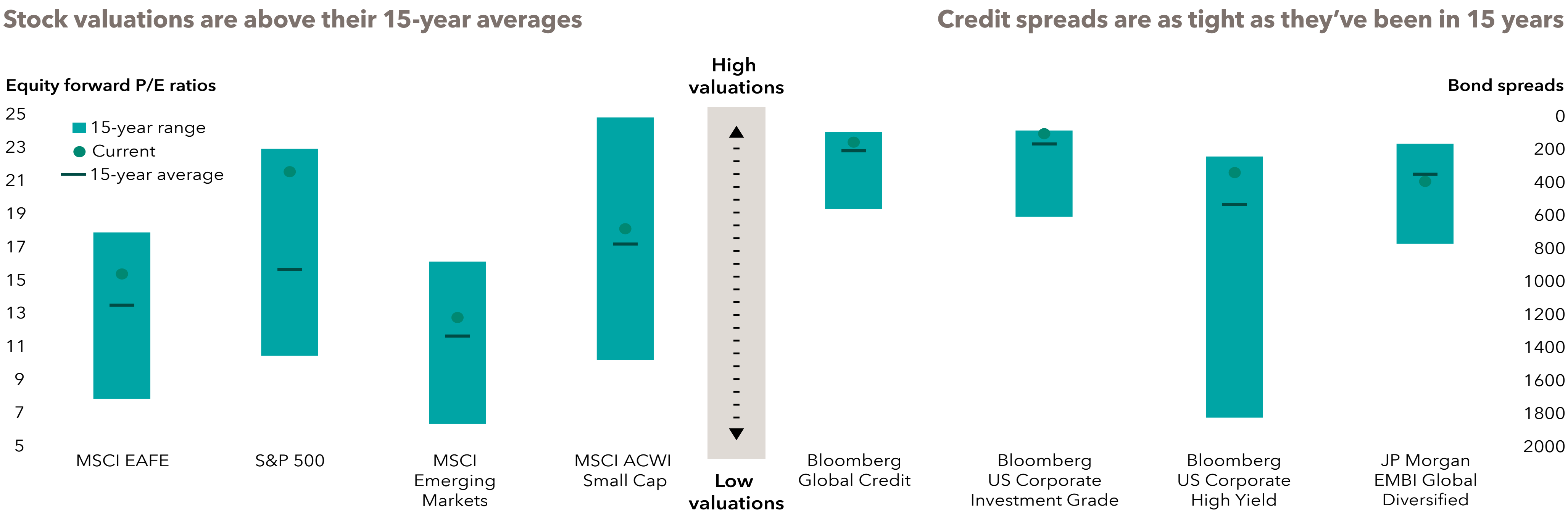
In the recent past, inflation in most developed markets has stayed below 5% the vast majority of the time. In the aftermath of the 2007–2009 financial crisis, US inflation has struggled to reach the Fed's 2% goal despite unprecedented stimulus measures and historically low interest rates.

Average annual real returns at different inflation rates (1970–2021)



Past results are not a guarantee of future results.
Sources: Capital Group, Bloomberg Index Services Ltd., Morningstar, Standard & Poor's. As at 30/11/21. All returns are inflation-adjusted real returns in USD. Global equity returns represented by MSCI All Country World Index from 30/09/2011; previously MSCI World Index. US fixed income represented by Ibbotson Associates SBBI US Intermediate-Term Government Bond Index from 1/1/1970–31/12/1975, and Bloomberg US Aggregate Bond Index from 1/1/1976–30/11/2021. Inflation rates are defined by the rolling 12-month returns of the Ibbotson Associates SBBI US Inflation Index.
* US fixed income used as proxy for global fixed income.

It's a good time for balance and bottom-up security selection



Whether you're in the market for steaks or stocks, today everything appears to be expensive. Thanks to low interest rates, accommodative central bank policy and the reopening of economies, most classes of stocks and bonds have become pricey.

Most equity markets around the world have been strong in the post-pandemic period. While company earnings have generally been solid, price-to-earnings ratios for developed and emerging markets were all above their 15-year averages as of 30 November 2021.

Similarly, in corporate bond markets, valuations have soared as investors' search for yield has driven credit spreads (the premium investors receive for taking on risk) to 15-year lows.

With growth slowing and cheap stocks and bonds hard to come by, security selection is more important than ever. "Given all the potential risks in today's environment, I am looking to strike a balance in my portfolios, seeking exposure to pricing power, sustainable growth and rising dividends," says equity portfolio manager Diana Wagner.

Fixed income portfolio manager Damien McCann agrees. "Because of the lack of screaming value out there, I am being highly selective in the investment grade and high-yield bond sectors and trying to balance appropriate risk with opportunity."

Past results are not a guarantee of future results.
Sources: Bloomberg Index Services Ltd., IBES, JP Morgan, MSCI, Refinitiv Datastream, RIMES, Standard & Poor's. As of 30/11/21. Bond spreads are the risk premium that investors receive for taking credit risk, and are calculated as the difference between bond yields and the risk-free rate. P/E is the price-to-earnings ratio which is the ratio of a company's share price to its earnings per share.

Be prepared for some volatility in the US this midterm election year

Capital Group political economist Matt Miller believes 2022 could be one of the more consequential midterm elections in US history.

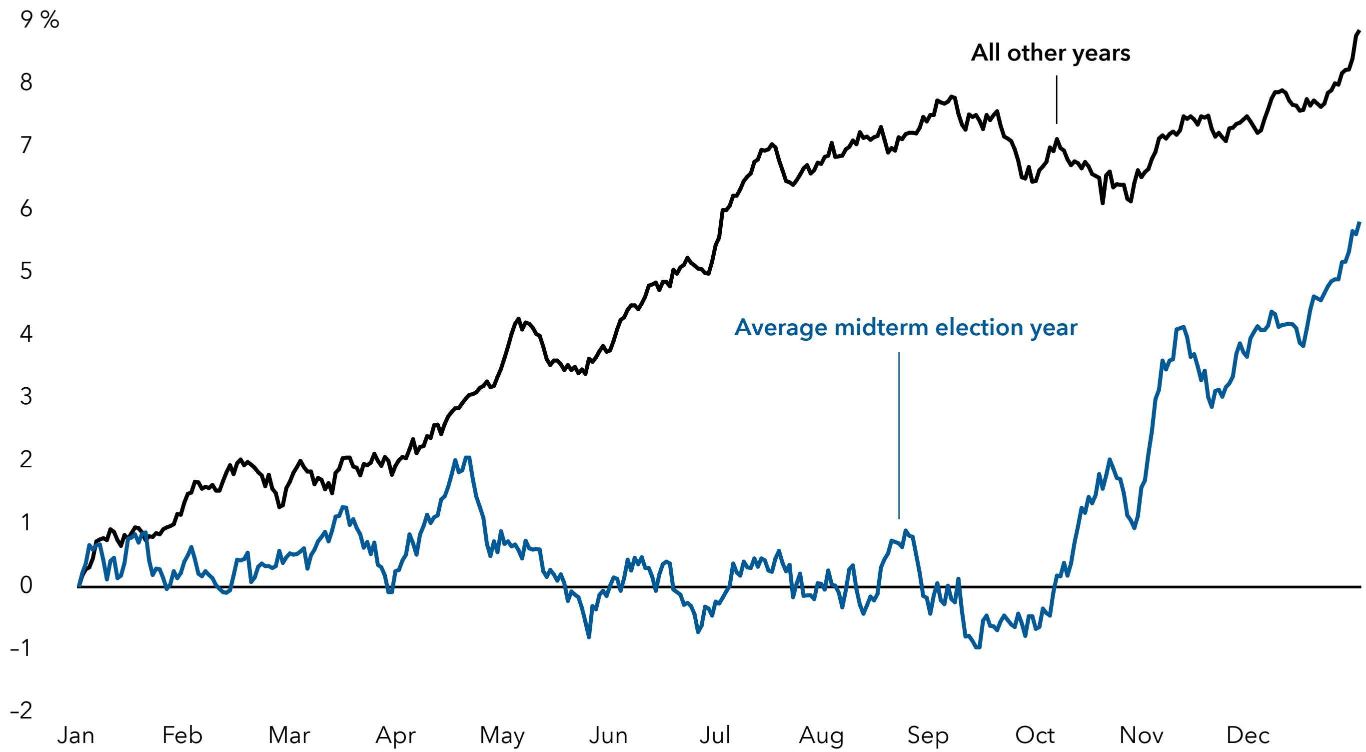
"While the election is still nearly a year away – and that's a lifetime in politics – history suggests we will see a backlash against the party in power that will result in Republicans taking back control of the House and potentially the Senate," Miller says.

This possibility isn't lost on Democrats. In the months ahead, they will likely continue to push for ambitious new spending programmes as well as higher taxes for corporations and wealthy individuals. However, expect these progressive goals to be tempered by the political reality of the party's slender majorities in the House and Senate.

Still, political uncertainty often has a noticeable short-term effect on markets. An analysis of more than 90 years of equity returns reveals that US stocks tend to have lower average returns and higher volatility for the first several months of midterm election years. As results at the polls become more predictable, this trend often reverses and markets have tended to return to their normal upward trajectory. But these are just averages, so investors shouldn't try to time an entry point into the market.

Elections – and politics as a whole – generate a lot of noise. Prudent investors would be wise to look past the short-term highs and lows and maintain a long-term focus.

S&P 500 Index average returns since 1931



Past results are not a guarantee of future results.
Sources: Capital Group, RIMES, Standard & Poor's. The chart shows the average trajectory of equity returns throughout midterm election years compared to non-midterm election years. Each point on the lines represents the average year-to-date return as of that particular month and day, and is calculated using daily price returns from 1/1/31–30/11/21. Returns in USD.

Europe's economy could see strong growth in 2022

Initially slow out of the COVID recovery gate, Europe is now expected to post an impressive GDP growth rate of 4-5% in 2022, according to Capital Group economist Robert Lind. That's nearly twice the rate Capital economists are estimating for the United States.

"Most of the major European economies are growing strongly," Lind explains, "driven by the release of pent-up demand, improving consumer sentiment and booming industrial activity."

Moreover, Lind doesn't see this as a temporary boom, but rather a significant shift in consumer behaviour and the political climate that could result in stronger European economic growth – as well as higher inflation – over the next few years.

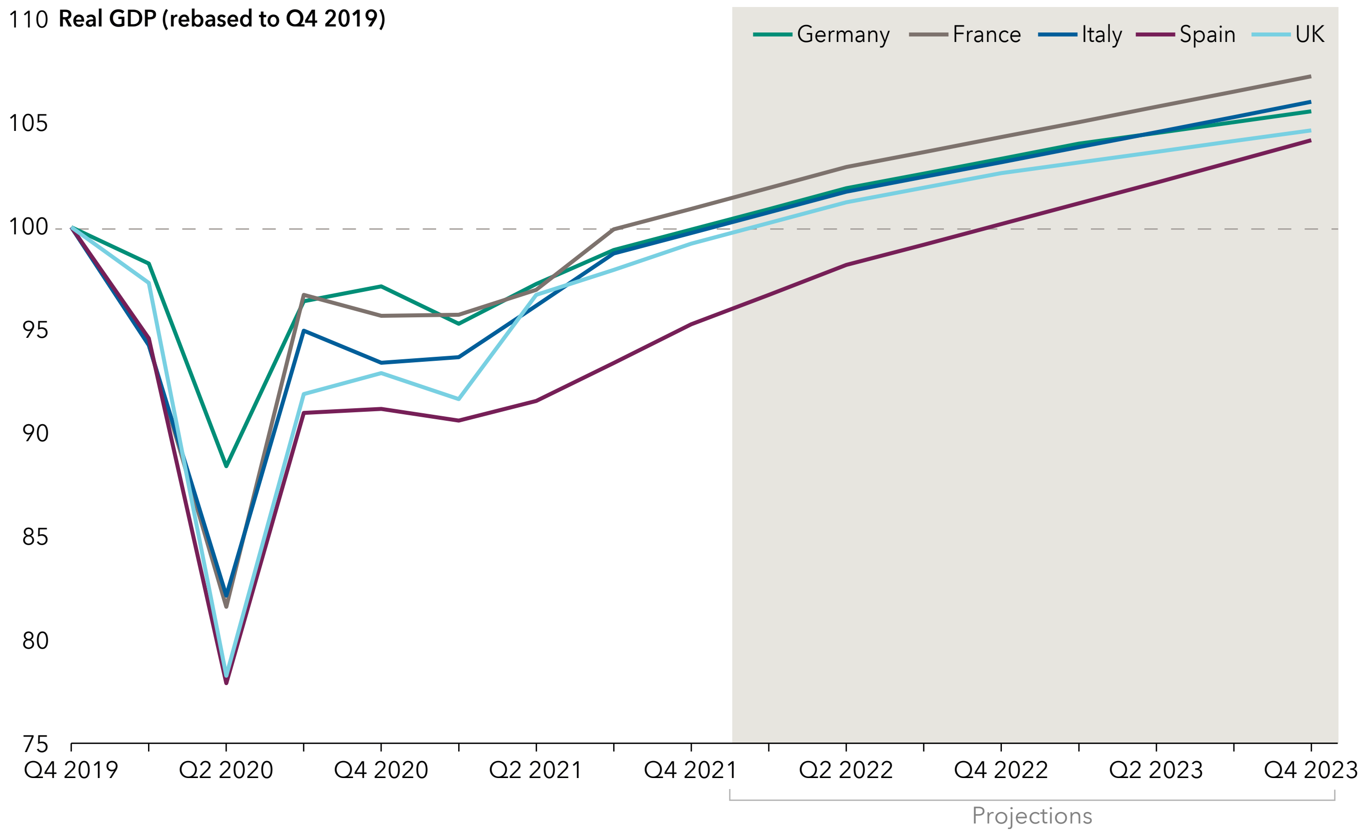
Despite these forecasts, we are in a highly uncertain economic environment and the rise of the Omicron COVID variant could mean we see a slowdown in growth during the early part of the year.

European equities could be an attractive area. They are trading lower valuations than their global and US peers. Price-earning (P/E) ratios for European equities are 15.3x (based on forward 12-month ratios) compared with 18.4x for MSCI ACWI and 21.5x for US equities.[1]

US companies have led the earnings recovery reflecting the strong economic rebound, but we are starting to see earning estimates now increasing strongly in the EU and the UK, driven by financials, energy and materials companies.

As earnings recover, European markets especially the UK have the potential to significantly outpace other regional markets.

Real GDP forecasts for major European economies show an encouraging recovery



Past results are not a guarantee of future results. For illustrative purposes only.

Sources: Capital Group forecasts, Bundesbank (Germany), National Institute of Statistics and Economic Studies (France), National Institute of Statistics (Italy), National Statistics Institute (Spain), Office for National Statistics (UK). Data as of 30/09/21.

1. P/E is the ratio of a company's share price to its earnings per share. Measured by MSCI Europe for European equities and S&P 500 for US equities. As at 30/11/21. Source: Refinitiv Eikon

Massive stimulus package a boon for Japan's economy

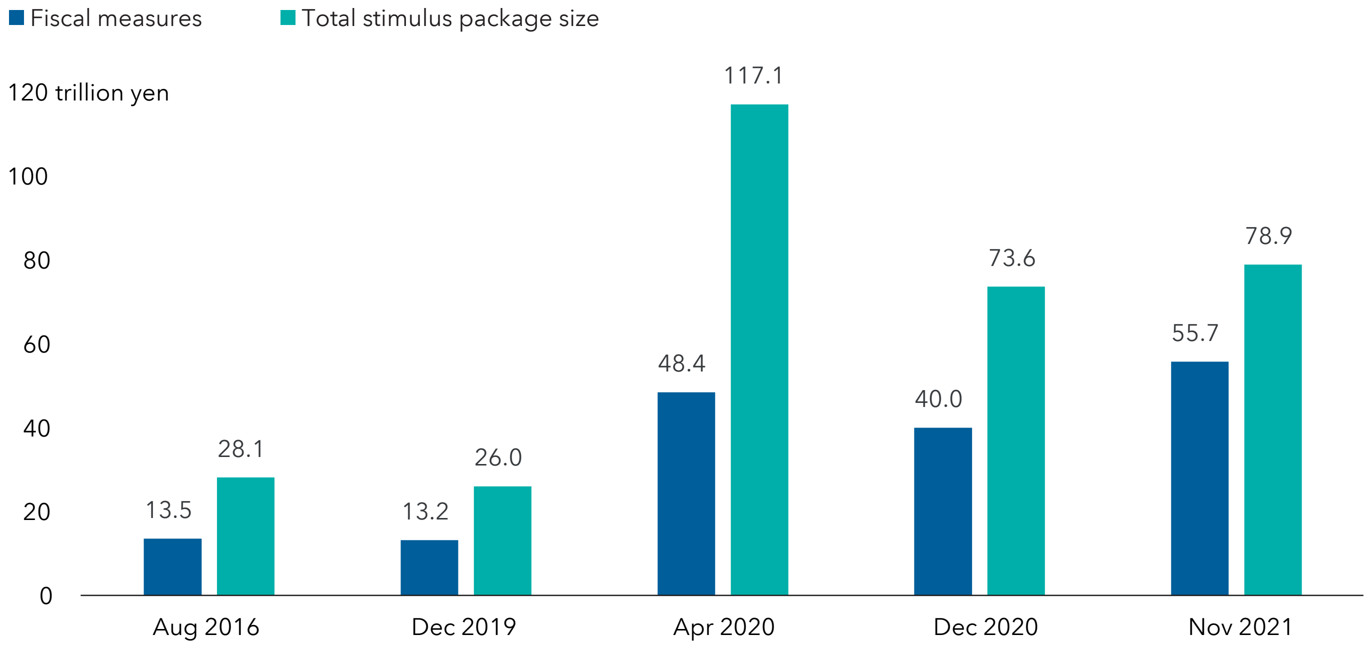
Just weeks after Japan's ruling party won the lower house election, new Prime Minister Fumio Kishida unveiled a larger-than-expected ¥55.7 trillion (about US$490 billion) stimulus package[1] to put the pandemic-battered economy back on track. While the economic stimulus may pack a punch in the near term, the easing of coronavirus restrictions, coupled with high vaccination rates, could pave the way for a rebound in consumer spending.

In a fresh step towards reopening its borders, Japan eased its entry rules for business travellers and students[2] but temporarily backtracked on its decisions following the discovery of the Omicron coronavirus variant. Despite the fears, more economic benefits may materialise in the future when Japan fully reopens to international visitors, who rose to a record 31.9 million in 2019; that year, the travel and tourism sector added US$359 billion to Japan's gross domestic product.[3]

In the long run, getting Japan onto a path of sustainable economic growth will require more than stimulus packages. Initiatives such as the digital garden city state concept and the clean energy strategy[4] can have a more lasting impact on the nation's economy and financial markets.

Overseeing a meaningful improvement in the economy would position Prime Minister Kishida well to clear the upper house election hurdle in July 2022 and offer him three years in which to govern free of elections. That is the potential inflection point to watch for.

The Japanese government expects the new stimulus package to boost the country's gross domestic product by around 5.6%



Forecasts shown for illustrative purposes only.

Chart: As at 19/11/21. Sources: Cabinet Office (Japan), Bloomberg, Capital Group

1. Japan's stimulus package consists of cash handouts to low-income households, aid to struggling businesses and subsidies for domestic travel. Including funds from the private sector, the overall package will likely amount to ¥78.9 trillion.
2. The Japanese government relaxed its entry rule in November 2021, capping the daily visitor numbers at 5,000 per day.
3. Sources: Japan Tourism Agency, Japan External Trade Organization
4. The Japanese government's digital garden city state concept involves advancing the roll out of 5G infrastructure and technologies such as telework and automated driving. It is also creating a clean energy strategy as it work towards reducing Japan's carbon emissions by 46% by 2030 (from 2013 levels) and achieving carbon neutrality by 2050.

Changing labour markets highlight the value of human capital

Tight labour markets, demand for new skills and changing employee preferences all underscore the value of companies' human capital. How companies manage people is increasingly a key driver of value creation.

Our investment analysts have identified three trends likely to be prevalent in 2022 and the years beyond:

- Concerns about inequality
- Workplace preferences
- Innovation and new skills

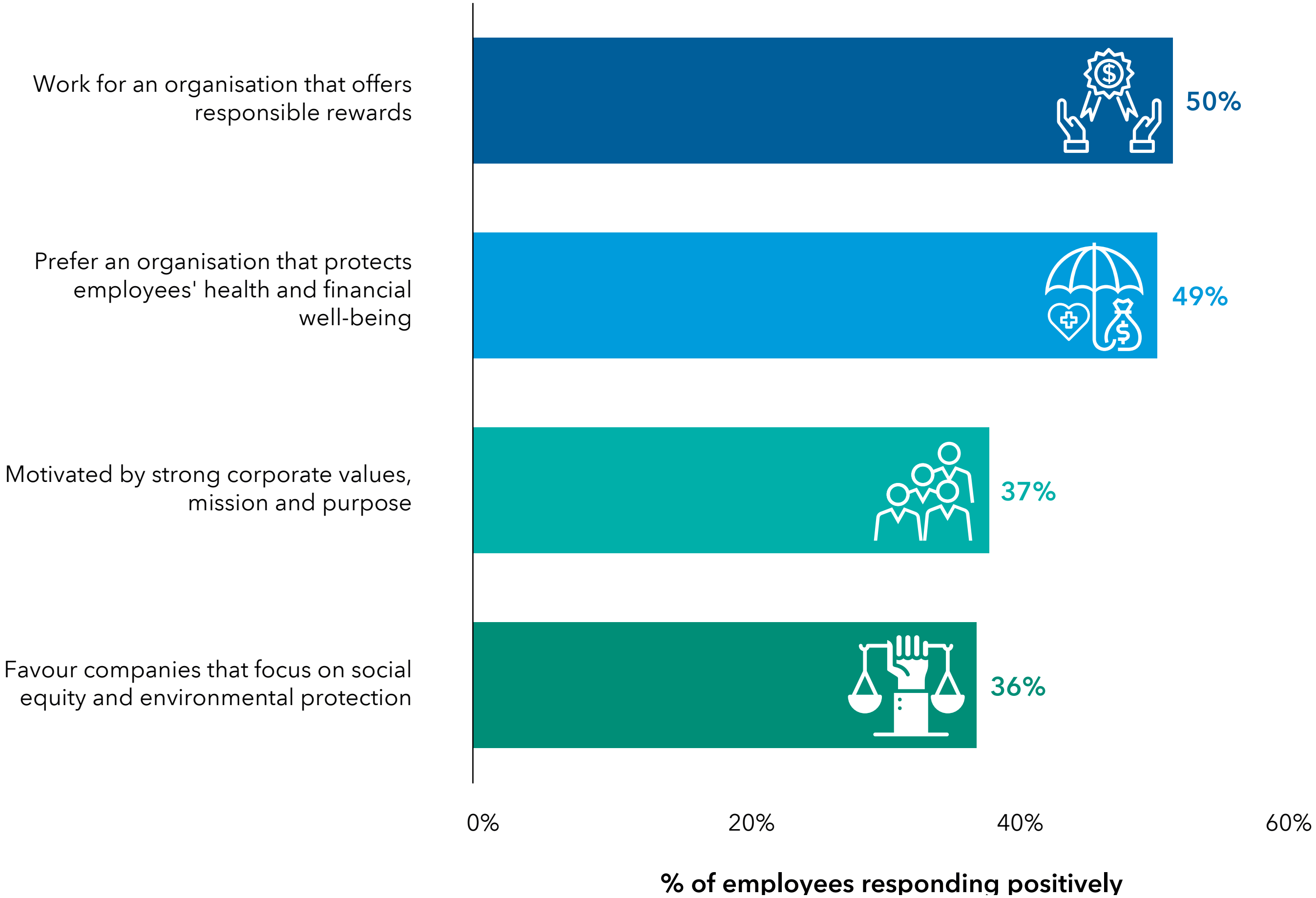
Persistent inequality could increase activism and work stoppages. Low wages and pay gaps are evident across many industries and regions. Employees are increasingly pushing for change with demands for higher wages and an end to racial and gender discrimination.

In the workplace, employees are looking for benefits beyond basic wages (after reaching minimum wage). These include work-life balance and a purpose-driven culture.[1] This is a distinct shift in attitudes from the same study in 2017, which reported fair and competitive pay and opportunity for promotion as the most wanted characteristics.[2]

Changes driven by digitalisation and the energy transition have increased the competition for talent. Some companies are retraining current workers but often the pace of technological change outstrips the rate at which workers can develop new skills.

Our ESG frameworks have identified human capital as a key driver of value creation and competitiveness. How companies respond to human capital issues will likely separate the winners from the losers.

Most wanted job characteristics in 2021[1]



1. Source: Mercer Global Talent Trends Study 2021
2. Source: Mercer Global Talent Trends Study 2017

Pricing power helps companies fight inflation

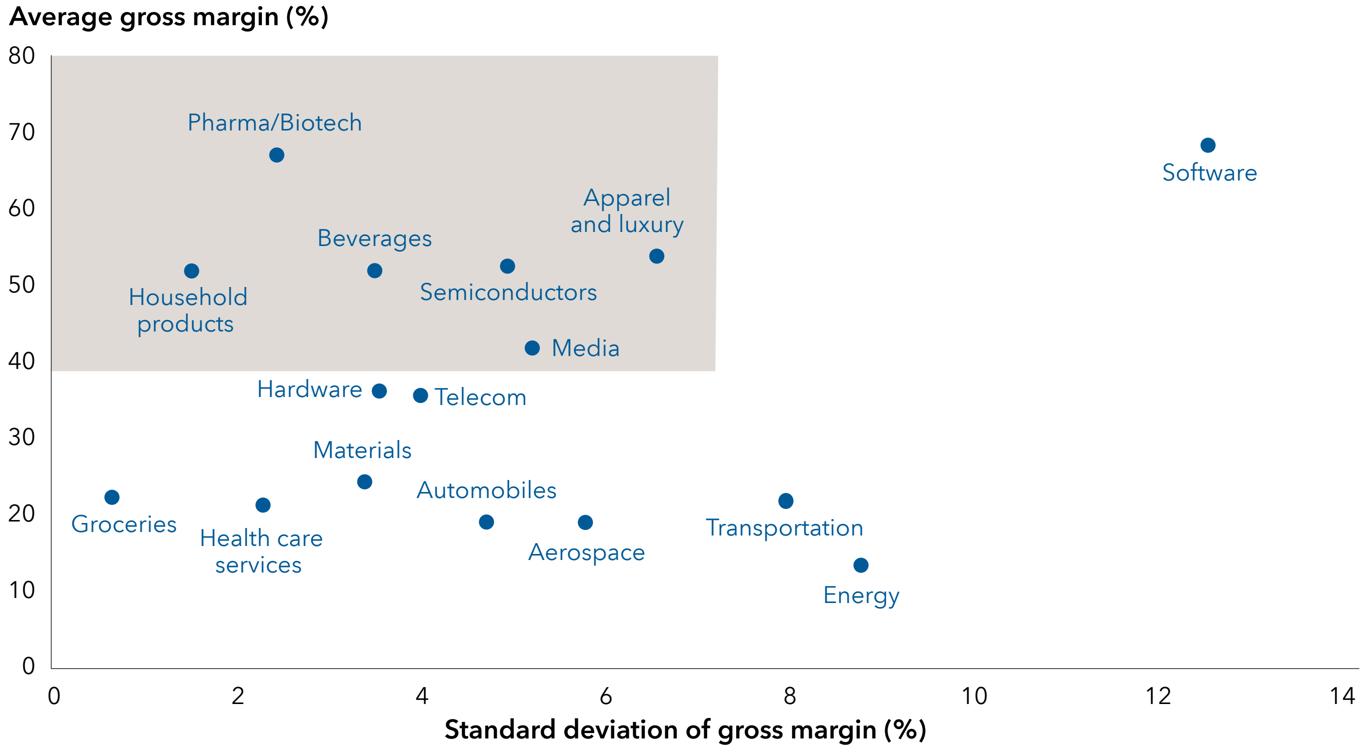
Inflation is so unsettling to investors because it can erode company profits and, ultimately, investor returns. But there are ways to fight it: Companies with pricing power can protect their profit margins by passing those costs along to customers.

"I'm not ready to believe we are headed into a period of sustained inflation," says equity portfolio manager Diana Wagner. "But I do believe rising costs will linger in the months ahead, making it the biggest risk investors face in 2022. That's why I am so focused on uncovering companies with pricing power."

Take Netflix. A string of hits like "Squid Game" and seemingly insatiable viewer demand have enabled the streaming giant to raise subscription fees four times over the past 10 years.[1]

High and stable margins can be an indication of pricing power. Companies with pricing power potential include businesses that provide essential services, like health care giants Pfizer and UnitedHealth Group; consumer businesses with strong brand recognition, like beverage maker Coca-Cola; companies in industries with favourable supply and demand dynamics, like semiconductor and chip equipment makers TSMC and ASML; and businesses serving customers who are relatively insensitive to changes in price, like luxury goods companies LVMH and Kering.

High and stable margins can be an indication of pricing power



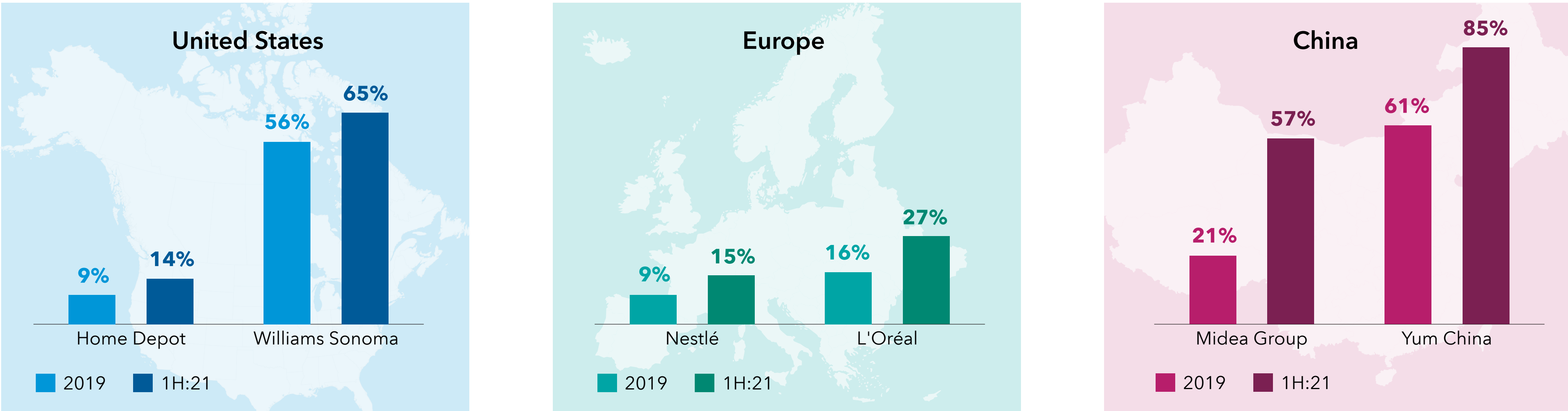
This information has been provided solely for informational purposes and is not an offer, or solicitation of an offer, or a recommendation to buy or sell any security or instrument listed herein.

Sources: Capital Group, FactSet, MSCI. Reflects select industries within the MSCI World Index. Average and standard deviation of gross margins are calculated for the five-year period ending 30/9/21.

1. As at 30/09/21. Based on standard subscription price in the US. Source: Netflix.

Beyond big tech: The digital revolution goes global

E-commerce as a % of total sales



The digital revolution has moved far beyond the turf of the US tech giants.

Across industries companies are adopting new technology to improve business, transform the way we live and create opportunity for investors. "I don't think these opportunities are yet fully understood by the market," says equity portfolio manager Greg Wendt.

Global spending on digital transformation is expected to rise from US$1.3 trillion in 2020 to US$2.4 trillion in 2024, according to Statista. Old economy companies across sectors are investing in technology to reinvent and revitalise their businesses through automation, cyber sales and machine learning.

Retailers like Home Depot and Williams Sonoma have integrated brick-and-mortar stores with their web presence, enabling customers to buy online and pick up at the store. Personal care companies like L'Oréal in France and appliance maker Midea Group in China have also ramped up their digital adoption.

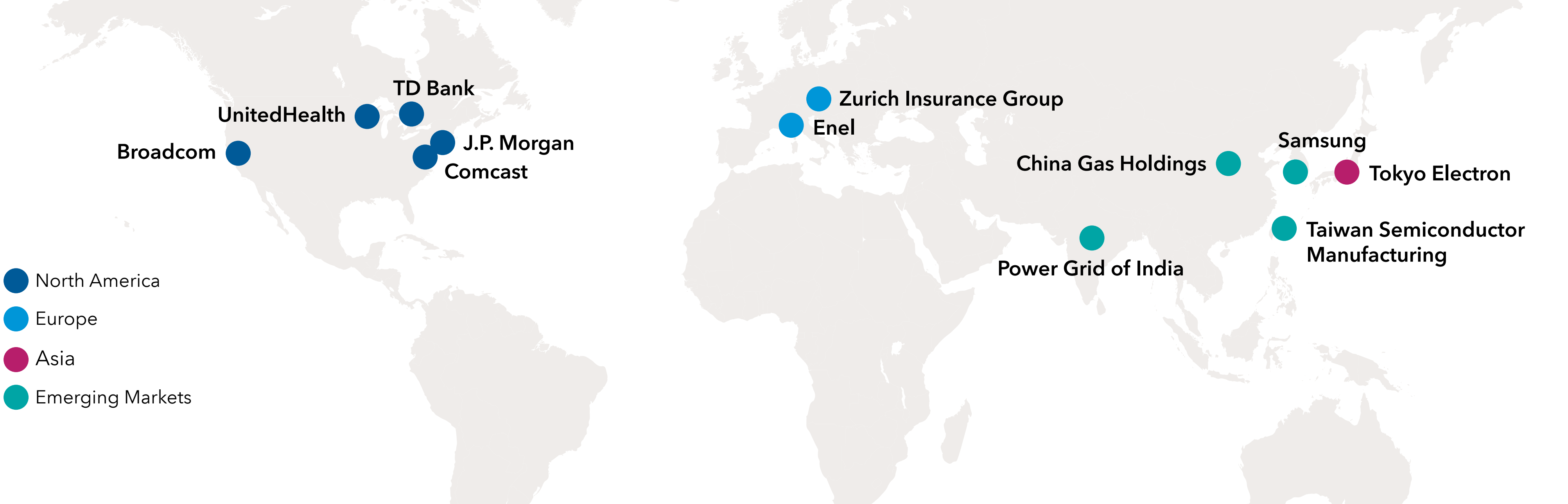
Not every company that embarks on a digital transformation will emerge as a long-term winner. The key, says Wendt, is to fully understand a company's digital strategy and its prospects for success.

"Some investors may think exclusively about consumer tech giants or cloud-based software providers," says Wendt, "but at Capital Group, we dig deeper across all industries to discover companies with the potential to benefit from a digital transformation."

Sources: Capital Group, company filings, company reports, FactSet. For Home Depot and Williams Sonoma, the full-year period refers to the 12 months ending on 30 January to align with company's fiscal year (i.e., 2017 = February 2017–January 2018); 1H:21 refers to the period between February 2021–July 2021. All other periods correspond with calendar years. As of 30/6/2021.

Dividends are staging a comeback of global proportions

Businesses across sectors and borders are raising their dividends



Many companies are shifting from dividend zeros to dividend heroes.

That's according to equity portfolio manager Caroline Randall. "These were companies that suspended dividends during the pandemic due to political pressure. And today many have surplus capital to be redeployed as regular and catch-up dividends."

With global economies coming back slowly and inflation rising, Randall is focusing not on the highest yielders, but on those companies with strong underlying earnings growth that have demonstrated a capacity and commitment to raise dividends over time.

Dividend growers historically have tended to generate greater returns than other dividend strategies, while also keeping up relatively well with the broader market. "Because it is reflective of stronger earnings, dividend growth can also offer a measure of resilience against interest rate hikes," Randall adds.

A broad range of companies with a history of paying meaningful and growing dividends can be found in markets around the world. Among these are semiconductor makers Broadcom and TSMC, financials such as Zurich Insurance Group and TD Bank, utilities such as electricity and gas provider Enel, and telecommunications conglomerate Comcast.

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.
Sources: Capital Group, FactSet, MSCI. 2021–2023 are estimates by FactSet. As of 30/9/21.

How to invest in China: Carefully and in select areas like pharmaceuticals

There's no way to sugarcoat it: Risks to investing in China have risen. Government intervention in the country's internet-related sectors, an everchanging regulatory environment and a slowing economy have investors on edge.

In truth, these changes serve as a helpful reminder that government and regulatory practice are quite different around the world. A strong understanding of the local environment is essential for investing successfully in global markets, including China.

While some companies and industries face heightened uncertainty in the near term, there remain plenty of attractive long-term opportunities on a stock-by-stock basis, especially in business areas more aligned with the government's strategic priorities.

The biopharma sector is one example. Party officials have sought to improve access to quality health care and foster an environment that will allow local firms to flourish. Regulatory reforms have drastically improved the landscape for both foreign and domestic companies and have helped China conform to global standards. This hasn't gone unnoticed. Health care has attracted a flood of venture capital in recent years. And many Chinese-born scientists have returned to the country after working at biotech firms and universities outside of China.

"Authorities have been pushing policies that encourage and incentivise domestic companies to compete with global companies. In that sense, biopharma is a little different than other industries in China that have been flagged as the next potential targets in line for heightened regulatory scrutiny," says investment analyst Laura Nelson Carney.

Multinationals partnering with local China firms

	Market cap (US$ billions)	**Revenue from China** (%)
AstraZeneca	$170	20%
Pfizer	$301	9%
Eli Lilly	$238	5%
Novartis	$196	5%

China firms partnering with multinationals

	Market cap (US$ billions)
BeiGene	$32
Zai Lab	$7
Legend Biotech	$7
HUTCHMED	$6

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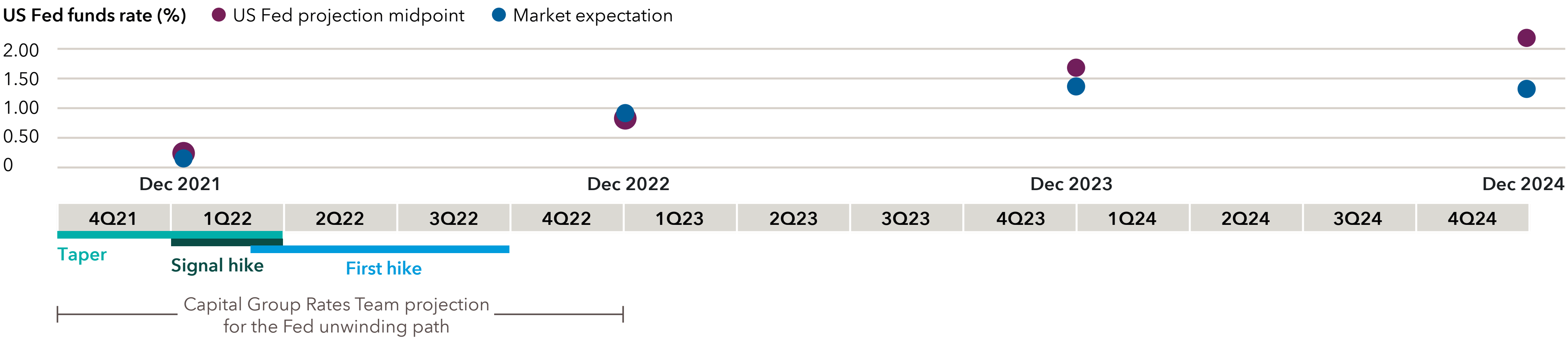
Sources: Capital Group, company filings, RIMES. Market value as of 30/11/21. Revenue from China are approximations based on most recently available company filings as of 30/6/21.

Interest rates: moving higher but at a measured pace



	Policy rate (30 Nov 2021)	1-year expectations	2-year expectations
Bank of Japan	-0.04	-0.04	-0.03
Bank of England	0.10	1.13	1.26
European Central Bank	-0.50	-0.46	-0.24

Strong inflation data has led central banks in many countries to indicate they want to normalise monetary policy. Markets are expecting major central banks to hike interest rates over the next two-to-three years.

In the US, the Federal Reserve (Fed) announced it would begin reducing its asset purchases, starting in November 2021. The sequencing of its actions - tapering its asset purchases before beginning rate hikes - has been well communicated, with the market expecting the first rate hike in 2022.

The European Central Bank (ECB) has held its main refinancing operations rate at zero since March 2016 and does not seem likely to raise rates in the foreseeable future. It did, however, begin slowing the pace at which it is buying bonds through its Pandemic Emergency Purchase Programme (PEPP) in September 2021 and this is expected to be completed by March 2022. That said, the ECB is likely to continue with other asset purchases beyond March.

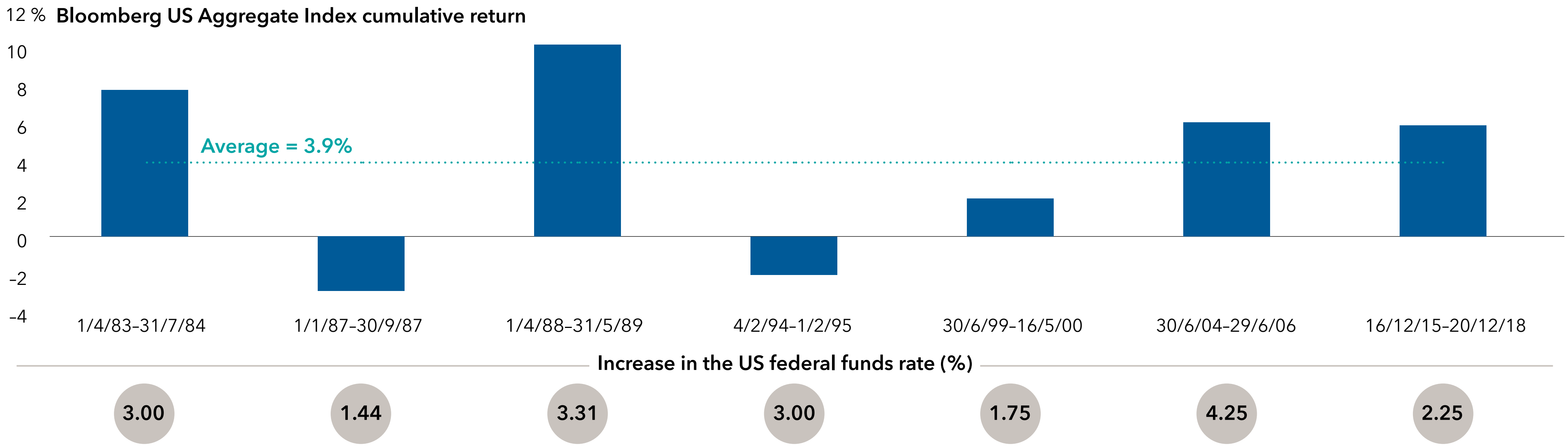
Other major central banks around the world also appear ready to tighten monetary policy in the coming year, so financial conditions are set to tighten from the very loose levels of 2021. Whatever actions the central banks take, they will be data dependent, relying on outcomes more than forecasts.

As always, the risks to this scenario include the extent to which the new Omicron variant evades vaccines and disrupts economic recovery, or a stronger-than-expected slowdown in China.

Forecasts shown for illustrative purposes only.

Sources: Capital Group, Bloomberg, Federal Reserve. Fed projections and Fed funds market expectations as of 15/12/21. Market expectations based on futures pricing data. Global policy rates and expectations as of 30/11/21.

Bonds can still do well in rising rate environments



Markets expect rate hikes to begin in 2022. That makes some investors nervous. However, the US Federal Reserve's communications and desire not to disrupt markets suggests a measured hiking approach, like last time around. Longer term bond yields are likely to rise at a modest pace, with persistent demand from sources such as non-US investors and pension funds.

But what do rising rates mean for bonds? Consider the last seven hiking periods. The Bloomberg US Aggregate Index declined in only two of those periods and averaged a nearly 4% return. Those two periods, with low single-digit losses, were also a far cry from the double-digit corrections stocks often experience.

Core bond funds provide a critical function in a balanced portfolio. First, they offer diversification from equities. That is especially important at a time when the stock market is hitting new highs. Uncertainties, such as slowing global growth, an unknown COVID trajectory and a weaker Chinese economy, could result in heightened volatility. Active core bond managers can work to identify bonds with maturities that could hold up relatively well should rates drift higher. They can also invest in inflation-linked securities to combat rising prices.

Past results are not a guarantee of future results.
Sources: Bloomberg Index Services Ltd., Morningstar. As of 30/11/21. Daily results for the index are not available prior to 1994. For those earlier periods, returns were calculated from the closest month-end to the day of the first hike through the closest month-end to the day of the final hike. Returns in USD.

With many bonds priced for perfection, selective investing across sectors is key

Income seekers could find opportunities across bond sectors

Sector	Fundamentals	Yield	Reasons to consider
US high-yield corporates	✓	4.7%	Improving credit quality trend, low near-term default rate expected
Emerging markets debt	–	5.2%	Provides non-dollar and/or developed market diversification
Global investment-grade corporates	✓	1.8%	Could provide some relative resilience in an equity correction

✓ positive

– neutral

Finding opportunities for value in today's bond markets isn't easy. Valuations are soaring. Persistently low yields have driven some investors to take on greater risk in search of income. Yet when looking for income across bond sectors, not all options are equally attractive. Even though credit spreads – the premium investors are paid for taking on credit risk over government bonds – are very tight, a research-driven approach can help differentiate among sectors and securities.

Take high-yield and investment-grade bonds. For an investor concerned with rising interest rates, high yield could appear a better choice: Its duration – a measure of sensitivity to interest rate risk – is lower than that of investment-grade corporates. The latter have seen their duration profile rise in recent years.

US high-yield corporate bonds have also improved in credit quality, with their highest quality BB-rated bond portion growing recently. This means that even with credit spreads approaching historically tight levels, there may be some upside for select bonds within the sector. Of course, high yield also contains more credit risk, broadly speaking, so it might not be appropriate for investors looking for diversification from equities.

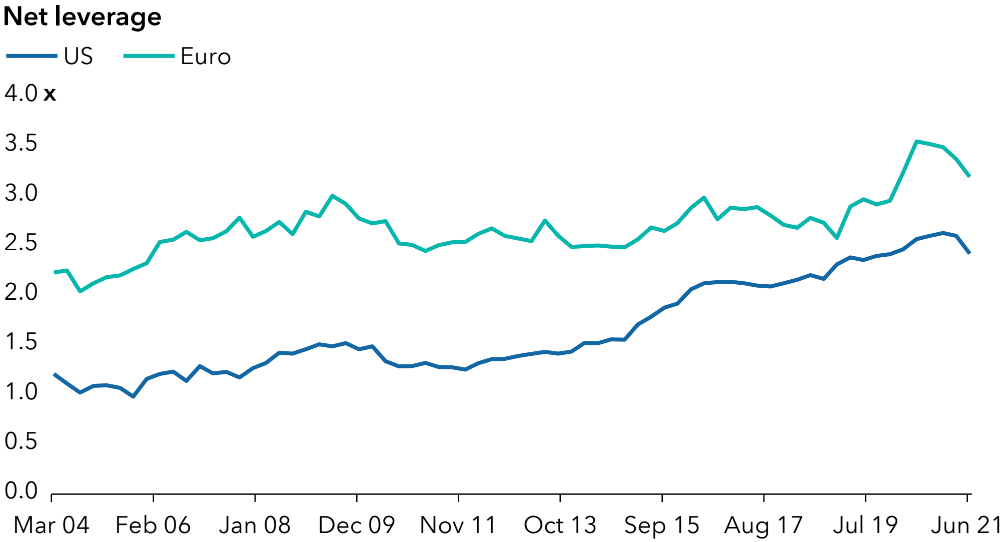
Considering all the varying attributes of income sectors and their specific bonds is necessary to achieve success in this environment. Flexibility to move from sector to sector when new opportunities arise is also key.

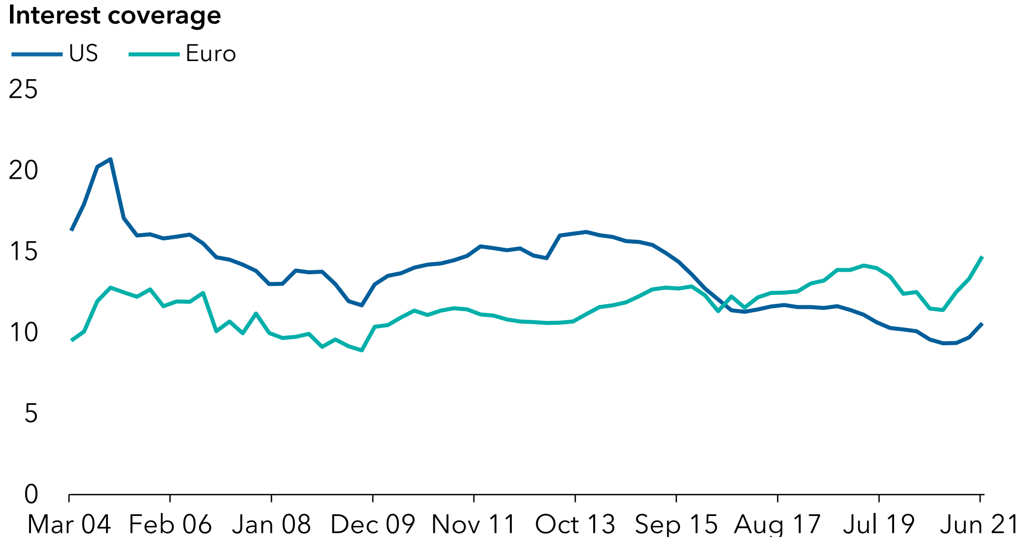
Past results are not a guarantee of future results. This information has been provided solely for informational purposes and is not an offer, or solicitation of an offer, or a recommendation to buy or sell any security or instrument listed herein.

Sources: Capital Group, Bloomberg Index Services Ltd., Morningstar. As of 30/11/21. Sectors represented by Bloomberg US Corporate High Yield 2% Issuer Capped Index, a 50%/50% blend of the JP Morgan EMBI Global/JP Morgan GBI-EM Global Diversified indexes and Bloomberg Global Aggregate Corporate Index. Yield shown is yield to worst.

Global investment-grade corporate bonds: a balanced approach and selectivity remain key

Key data points suggest improving fundamentals[1]





The balance of risks for the global corporate bond market continues to be finely poised. Rich valuations, high inflation and potentially slowing global growth need to be balanced against improving credit fundamentals, supportive supply and demand dynamics, and continued but potentially shrinking liquidity provision by central banks.

Spreads widened recently reflecting higher credit risks associated with market expectations for tighter monetary policy. Nevertheless, valuations are still rich following the strong recovery experienced following the peak of the crisis in March 2020.

The US Federal Reserve beginning to wind down its bond-buying programme and a move closer to a first interest rate hike in 2022 could add to market volatility. However, corporate fundamentals continue to gradually improve with leverage having peaked in 2020 and improved interest coverage. Flows into the asset class remain supportive of stable credit spreads, but investor flows can be transient and one must be mindful of a turn in sentiment should interest rates rise and financial conditions tighten. Inflation is another risk to sentiment should the current combination of supply chain bottlenecks and accelerating wage growth persist much longer than currently anticipated by most investors.

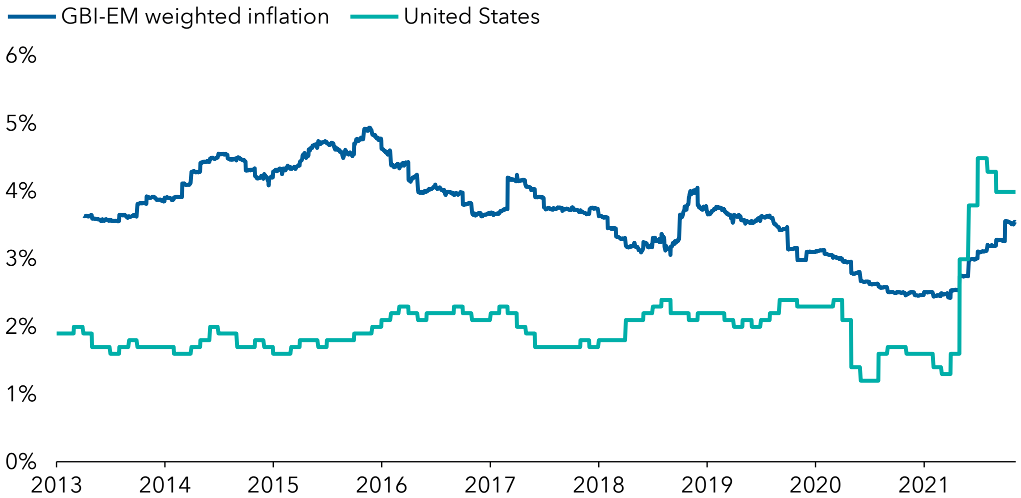
Now is not the time for complacency but rather selectivity and a cautious overall credit risk stance. There is still value to be found in certain areas and companies. This is where bottom-up, fundamentally driven research, and a diversified global approach can add value by identifying potentially attractive opportunities. Security and sector selection could be to be significant drivers of excess return going forward.

1. Data as at 30/06/21. Source: JPMorgan. Leverage ratios measure the ratio of a company's debt to earnings. Interest coverage is a measure of a company's ability to meet its required interest obligations.

Local currency emerging market debt could offer relative value

Increases in core inflation have been moderate for EM

Core inflation (% change, year on year)[1]



Local markets could offer relative value

Interest rate differentials (EM minus DM)[2]

Higher inflation and in some cases, rising inflation expectations, have been a key focus for investors over 2021, in emerging as well as developed markets.

A significant proportion of the shock to inflation in emerging markets (EM) can be attributed to volatile food and energy prices. Normalisation of supply chains and a higher base rate of inflation from the previous year could help going forward.

Exchange rate (FX) weakness has led to higher inflation in select emerging market countries, but many of these currencies are already structurally undervalued. This potentially limits further inflation from the FX channel.

Overall, emerging market inflation remains contained relative to developed market inflation. This is in part due to weaker economic conditions, muted domestic credit creation and proactive central banks.

Credit spreads are generally tight across the board within fixed income, including in US dollar-denominated EM debt. This means a lower premium for investors taking on credit risk. However, longer term nominal and real interest rates across emerging markets have substantially repriced and there is now a significant real rate premium compared with developed markets. We see the clearest valuation opportunities in EM local currency debt.

Our frameworks show EM currencies appear to be cheap on a fundamental basis. While some of this is warranted by deterioration in growth and fiscal conditions, it may be reasonable to expect the next decade to bring greater stability in EM foreign exchange markets.

Local bond markets in Malaysia, Mexico and Russia could appear especially attractive over a 12-24 month horizon.

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1. Source: Bloomberg. GBI-EM: JPMorgan GBI-EM Global Diversified Index (EM local currency index). Data as at 1/11/21.
2. Source: Bloomberg. As at 1/11/2021.

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