Outlook

2023 EDITION

CAPITAL GROUP™

Long-term perspective on markets and economies

Marketing communication

A new reality for investors

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Portfolio Manager

There's a new reality taking shape in global markets.

Many commentators are focusing on the rotation from growth to value, but I think that view is too simplistic. Some investors may be hoping for a return to normal after central banks stop raising interest rates and inflation subsides. In my view that's not the path forward due to several seismic shifts that will likely define the next decade of investing.

From falling rates to rising rates: Inflation is at its highest levels since the early 1980s and, until recently, we've had 40 years of declining interest rates. As rate cycles reverse, the process often takes much longer than anticipated, which leads me to believe that some inflation will likely persist. Consequently, I'm wary of highly leveraged companies. Money isn't free anymore, so a larger slice of earnings will go to service debt. And companies able to fund their own growth will remain particularly attractive.

From narrow to broad market leadership: The last decade of investing was dominated by a handful of internet-related companies. This overshadowed the fact that you can't build a new economy without older industries. While digital-first companies are not going away, I think investors will start to place greater emphasis on producers of physical assets. Moreover, I expect broader market leadership to emerge among a variety of companies, which should provide a positive backdrop for stock pickers over indexers.

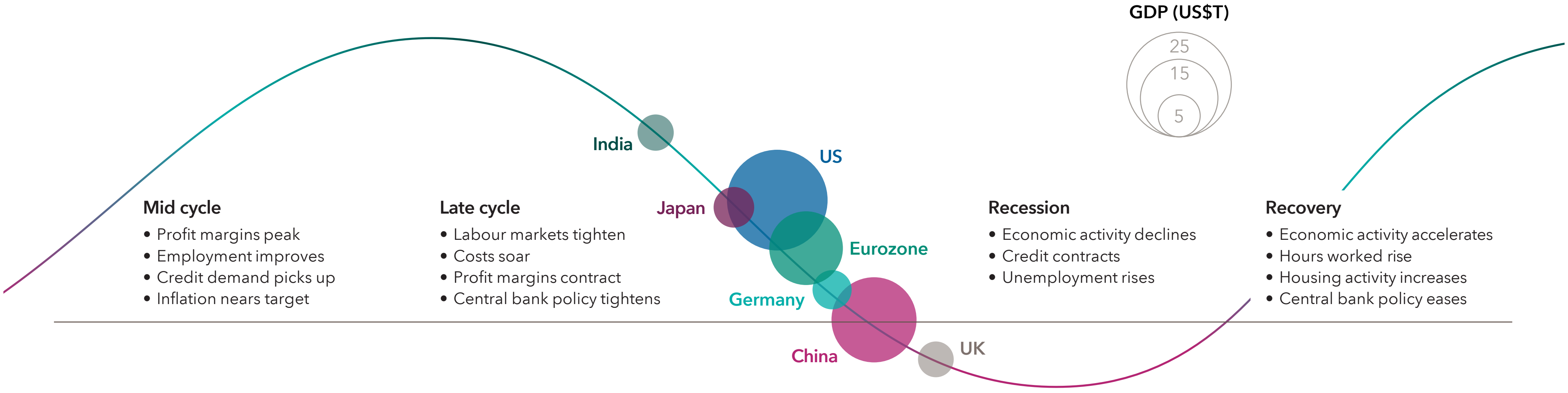
From global to regional supply chains: The globalisation of supply chains is another multi-decade trend adjusting course. For a generation, companies moved manufacturing overseas to cut costs. But the limitations of placing efficiency over resilience are now clear. Growing geopolitical tensions and pandemic-induced disruptions have prompted companies to create supply chain redundancies so that a single breakdown won't derail an entire operation. Such capital investments may help inspire a renaissance among smartly managed industrial companies.

I could describe additional shifts rocking the economy and markets, but suffice to say we are living through a historic period of change. The outlook has evolved from a decade of sunny skies to darker clouds. That may sound like a pessimistic view, but I see it as an exciting time to be a fundamental, bottom-up investor – unrestricted by geographies, sectors or style boxes – and better equipped to adjust to this new reality of investing.

Growth investing is a stock-buying strategy that looks for companies that are expected to grow at an above-average rate compared to their industry or the broader market.
Value investing is a strategy for identifying undervalued stocks based on fundamental analysis.
Bottom-up investing is an investment approach that focuses on the analysis of individual securities before subsequently considering economic and market cycles.
Leverage is an investment strategy of using debt (borrowed funds) to increase the potential return of an investment.
'Stock pickers' refers to investors who seek to determine what stocks to buy or sell, and when to buy or sell. 'Indexers' describes investors who seeks to replicate the returns of a benchmark index.

Recessions are inevitable, but the pain won't last forever

Most of the world's major economies are in or near recession



Recessions are painful, no doubt about it. But they are necessary to clean out the excesses of prior growth periods, especially the more or less uninterrupted growth investors have enjoyed over the past decade.

"You can't have such a sustained period of growth without an occasional downturn to balance things out," Capital Group vice chair Rob Lovelace noted at midyear. "It's normal. It's expected. It's healthy."

The global economy certainly appears headed in that direction. Europe is likely already in a recession, exacerbated by the war in Ukraine. China's growth has decelerated essentially to zero, pressured by rolling COVID-19 lockdowns. And the US economy, while stronger than most, appears headed for a significant downturn as elevated inflation and higher interest rates take their toll.

Capital Group economist Jared Franz expects the US economy to contract by about 2% in 2023 – worse than the post-tech and telecom bubble recession of the early 2000s, but not nearly as bad as the 2008-09 financial crisis. The important thing to remember, Franz stresses, is that recessions set the stage for the next period of growth.

"Today, the stock market is reflecting a more realistic view that a recession is looming," Franz adds. "But, historically speaking, stocks also tend to anticipate a brighter future ahead, long before it becomes clear in the economic data.

Forecasts shown for illustrative purposes only.

Gross domestic product (GDP) data are in USD and are the latest available through 30 September 2022. Country positions within the business cycle are forward-looking estimates by Capital Group economists as at November 2022. Sources: Capital Group, FactSet

Stocks typically recover before recessions end

Everyone wants to know when the next recession will start and how long it will last. While each recession is painful in its own way, one potential bright spot is that they don't historically last very long. Our analysis of 11 US cycles since 1950 shows that recessions have ranged from two to 18 months, with the average lasting about 10 months.

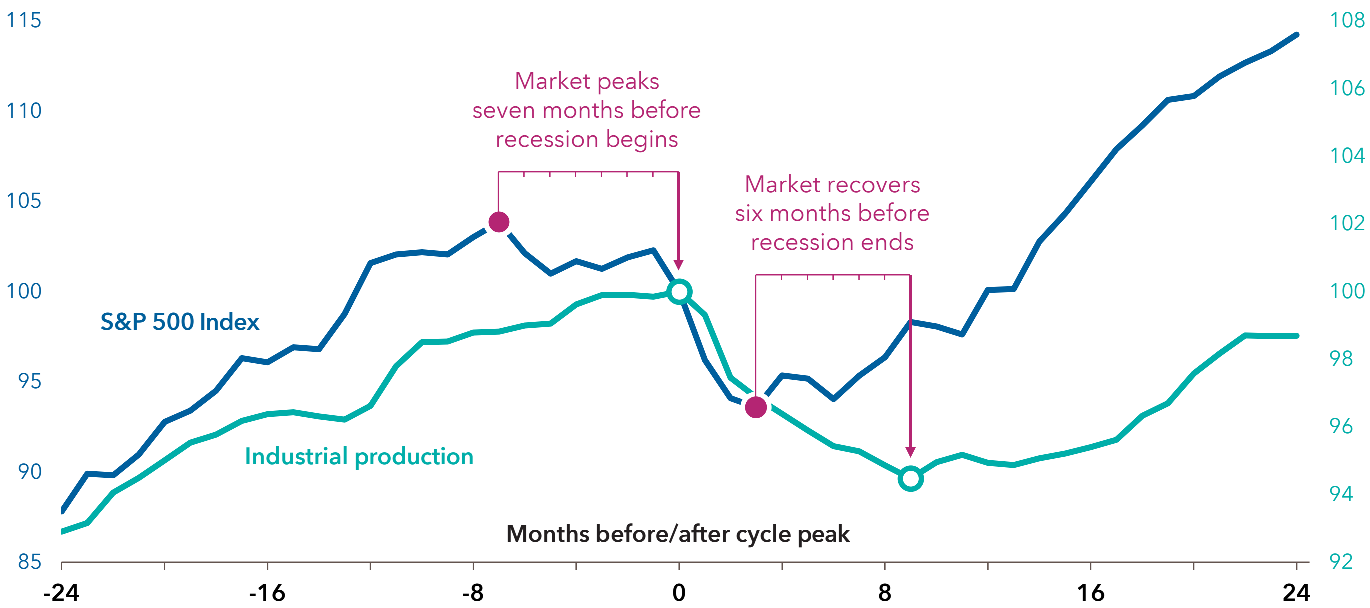
What's more, stock markets usually start to recover before a recession ends. Stocks have already led the economy on the way down in this cycle, with nearly all major equity markets entering bear market territory by mid-2022. And if history is a guide, they will rebound about six months before the economy does.

The benefits of capturing a full market recovery can be powerful. In all cycles since 1950, bull markets had an average return of 265%, compared to a loss of 33% for bear markets.

The strongest gains can often occur immediately after a bottom. Therefore, waiting on the sidelines for an economic turnaround is not a recommended strategy.

"It's been a difficult year, and the pain may continue," says Capital Group economist Darrell Spence. "But it's important to keep in mind: One thing all past recessions and bear markets had in common was that they eventually ended. Ultimately, the economy and the markets will right themselves."

Stocks have typically been a leading indicator of the economy



	RECESSION	vs.	EXPANSION
Duration (months)	10		69
GDP growth	-2.5%		24.6%
Corporate earnings	-22%		96%
Net jobs added	-3.9M		12M

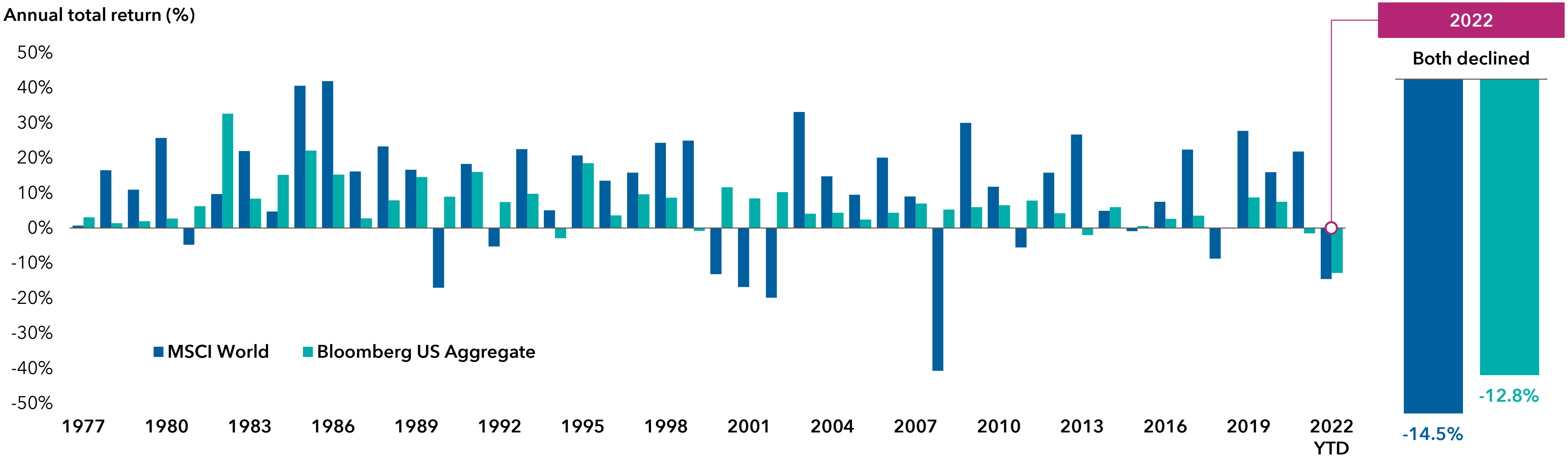
	BEAR MARKET	vs.	BULL MARKET
Duration (months)	13		67
Total return	-33%		265%

Past results are not a guarantee of future results.

Data reflects the average of completed cycles in the US from 1950 to 2021, indexed to 100 at each cycle peak. Corporate earnings calculated by Strategas for all completed cycles from 1/1/1928 to 31/10/2022. Other data includes all completed cycles from 1/1/1950 to 31/10/2022. Industrial production measures the change in output produced by manufacturers, mines and utilities and is used here as a proxy for the economic cycle. 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. A bear market is a financial market in which prices are falling, especially over a long period of time. A bull market is a financial market in which prices are increasing, especially over a long period of time. Total return is the overall actual rate of return of an investment over a given evaluation period. Sources: Capital Group, Federal Reserve Board, Haver Analytics, National Bureau of Economic Research, RIMES, Standard and Poor's

Bonds should once again offer diversification from equities

2022 was the only year in 45 years where stocks and bonds declined in tandem



The numbers are ugly – 2022 will go down in history as one of the worst periods for bond returns on record. Big losses have caused investors to question the long-held principle that bonds offer relative safety when stocks fall.

Stocks and bonds rarely decline in tandem in a calendar year, and 2022 was the only exception in the 45-year period dating back to 1977. That's because the US Federal Reserve (Fed), and central banks globally, hiked interest rates aggressively to quell high inflation at a time when rates were near zero.

That should change in 2023. Lower inflation reports coupled with growth concerns could allow the Fed to slow down.

"I believe we are close to that point," says Pramod Atluri, fixed income portfolio manager. "Once the Fed eases, high-quality bonds should again offer relative stability and greater income."

Bonds could offer some relief from volatile equity markets as recession concerns take centre stage. "I am seeing more opportunities now that bonds have repriced lower," says Atluri. "Valuations are attractive so I am selectively adding mortgages and corporate bonds. Even if prices fall further, bonds now offer a much healthier income stream, which should help offset any price declines."

Past results are not a guarantee of future results.

As at 30 November 2022. Returns above reflect annual total returns in USD for all years except 2022, which reflects the year-to-date total return for both indexes. Sources: Capital Group, Bloomberg Index Services Ltd., MSCI

In battle to tame inflation, prepare for a range of possible outcomes

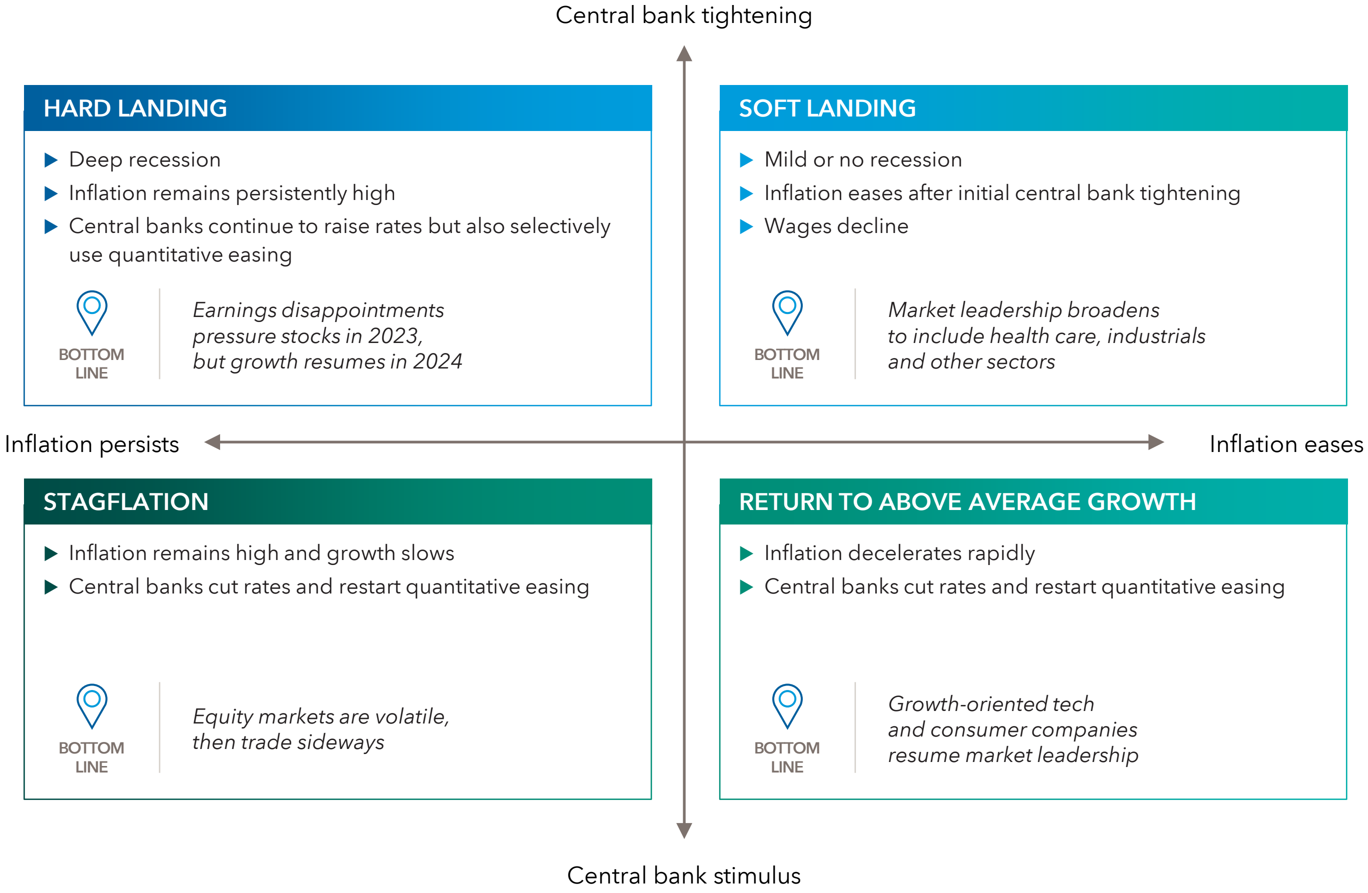
How persistent will inflation be? And where are interest rates headed?

"These are complicated questions that depend on many variables, including investor psychology," says US economist Jared Franz, who advocates scenario planning in periods of extreme uncertainty. "With central banks around the world following differing paths, we are weighing a range of outcomes rather than committing to a single answer."

Markets appear to have priced in expectations for a soft landing, but that may be too optimistic. After the Fed announced its fourth consecutive rate increase of 75 basis points in November, Fed Chairman Jerome Powell warned that "the ultimate level of interest rates will be higher than expected." While the Fed moderated its approach with a 50 basis point rate rise in December, officials underscored that hiking will continue in 2023 and the ultimate level could be above 5%.

Higher rates and nagging inflation may tip the US economy into a recession in 2023, adds Franz. "Inflation likely has peaked, but it should remain elevated above the Fed's target level of 2% for an extended period. That means corporate earnings are likely to decline in 2023 as much as 15% to 20%."

Europe, which may already be in a recession, should see conditions deteriorate further under pressure from energy shortages and the ongoing war, according to Franz. With respect to China, Capital Group economists expect growth to slow sharply before a stimulus-induced rebound in the second half of 2023.

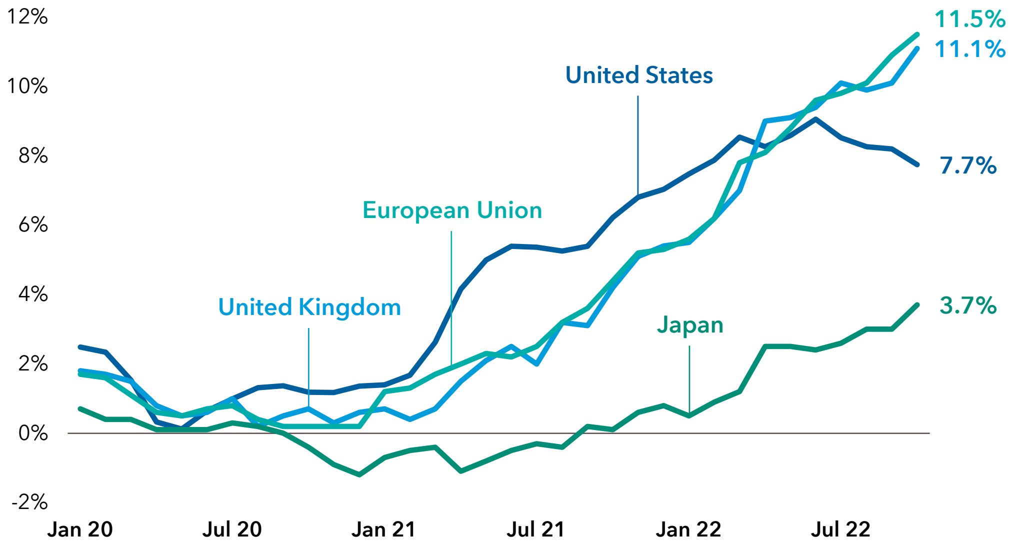


Scenarios reflect analysis of Capital Group's Night Watch team as at October 2022, and are not predictive of future outcomes. 'Tightening' monetary policy is a measure undertaken by a central bank, such as the Federal Reserve, to slow down overheated economic growth. Quantitative easing refers to strategies a central bank can use to increase the domestic money supply via asset purchases. 'Stimulus' refers to a central bank's efforts to use monetary policy or fiscal policy to stimulate the economy. It can also refer to monetary policies such as lowering interest rates and quantitative easing. Source: Capital Group

US inflation reached a peak, but the market may be too optimistic on progress

Inflation remains high in most economies

Annual consumer price index (%)



Inflation expectations have fallen

US inflation expectations (%)

Uncertainty has a name: inflation. Soaring prices have threatened economies globally, with growth for the United States, Europe and Japan expected to stall or contract. As central banks struggle to keep four-decade high inflation under control, demand for items that quickly absorb rate increases, such as housing, has already fallen.

Other pockets of the economy will take more time to cool.

"The impact of rate hikes will unfold over the next several months in the form of higher unemployment, lower job openings and declining retail sales," says fixed income portfolio manager Ritchie Tuazon. "The Federal Reserve is likely to slow the pace of rate hikes as the US economy shows signs of weakening, but it also runs the risk of overcorrecting. My concern is that the Fed may have tightened by too much."

There is evidence that inflation has peaked in the US but will remain high. While most of the pandemic-era supply shocks that drove price increases have resolved, the market may be underestimating geopolitical risks and the continuing trend of passing price increases on to consumers, according to Timothy Ng, fixed income portfolio manager. "It's difficult to see inflation dropping to the Fed's 2% target in 2023 unless we get a deep recession."

Forecasts shown for illustrative purposes only.

Left chart as at 31 October 2022 and right chart as at 30 November 2022. Inflation expectations are measured by TIPS (Treasury Inflation-Protected Securities) breakeven rates. The consumer price index (CPI), a commonly used measure of inflation, measures the average change over time in the prices paid by consumers for a basket of goods and services. Sources: Bloomberg, Refinitiv Datastream

Leadership picture and COVID backdrop continue to set agenda for China

"China's zero-COVID policy has weighed on the country's equity market, and recent shifts toward local policymaking signal a move in the right direction" says portfolio manager Steve Watson. "The key will be to watch for these changes at the margin as a precursor to policy relaxation and eventual reopening", he adds. Worsening protests against Beijing's COVID policy highlight how important this has become and the government is facing tough choices.

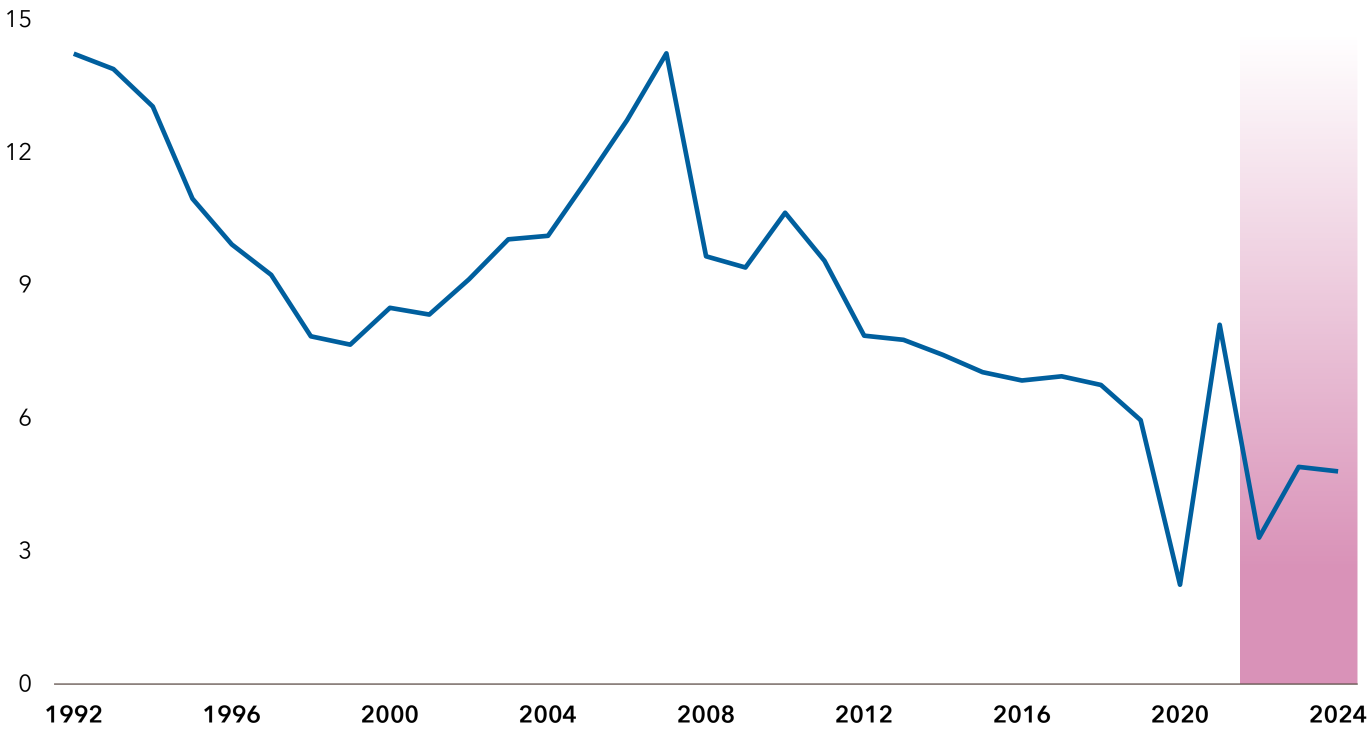
Ramifications from October's 20th Communist Party Congress also continue to set the agenda for markets. Xi Jinping has embarked on a third term as President and promoted four new members to the Politburo Standing Committee. Some may worry about the lack of checks and balances but this set-up also implies more cohesive leadership at the highest level.

Key areas of focus at the event included moving toward self-reliance and secure supply chains, modernisation and Common Prosperity. The latter has faced the greatest scrutiny, with concerns around how a policy to rebalance income distribution is compatible with corporate profitability and innovation.

From a market perspective, there remain sectors with obvious tailwinds and headwinds: 'Security' in areas as diverse as technology, energy, food and defence stood out as a key theme at the Congress. Elsewhere, the emphasis on ideological work and fostering a healthy online environment means sentiment around internet stocks will likely remain volatile. The Congress also reiterated that the housing market is not for speculation, but authorities later announced sweeping measures to rescue the struggling property sector amid the current slowdown and worsening liquidity backdrop.

Can China return to growth in the coming years?

China GDP growth (annual %)



As at 31 October 2022. Source: World Bank, Bloomberg. Figures for 2022 onwards are estimates based on median forecasts from the October 2022 Bloomberg economist survey. Liquidity describes the degree to which an asset or security can be quickly converted into cash without a significant concession in price.

Energy demand outlook could spell milder recession for Europe

Energy security quickly became the central issue for Europe when Russia attacked Ukraine in February, and it continues to dominate investor attention. The continent is teetering on the edge of recession, but economist Robert Lind says shifts in energy demand could mean the downturn will be less damaging than feared.

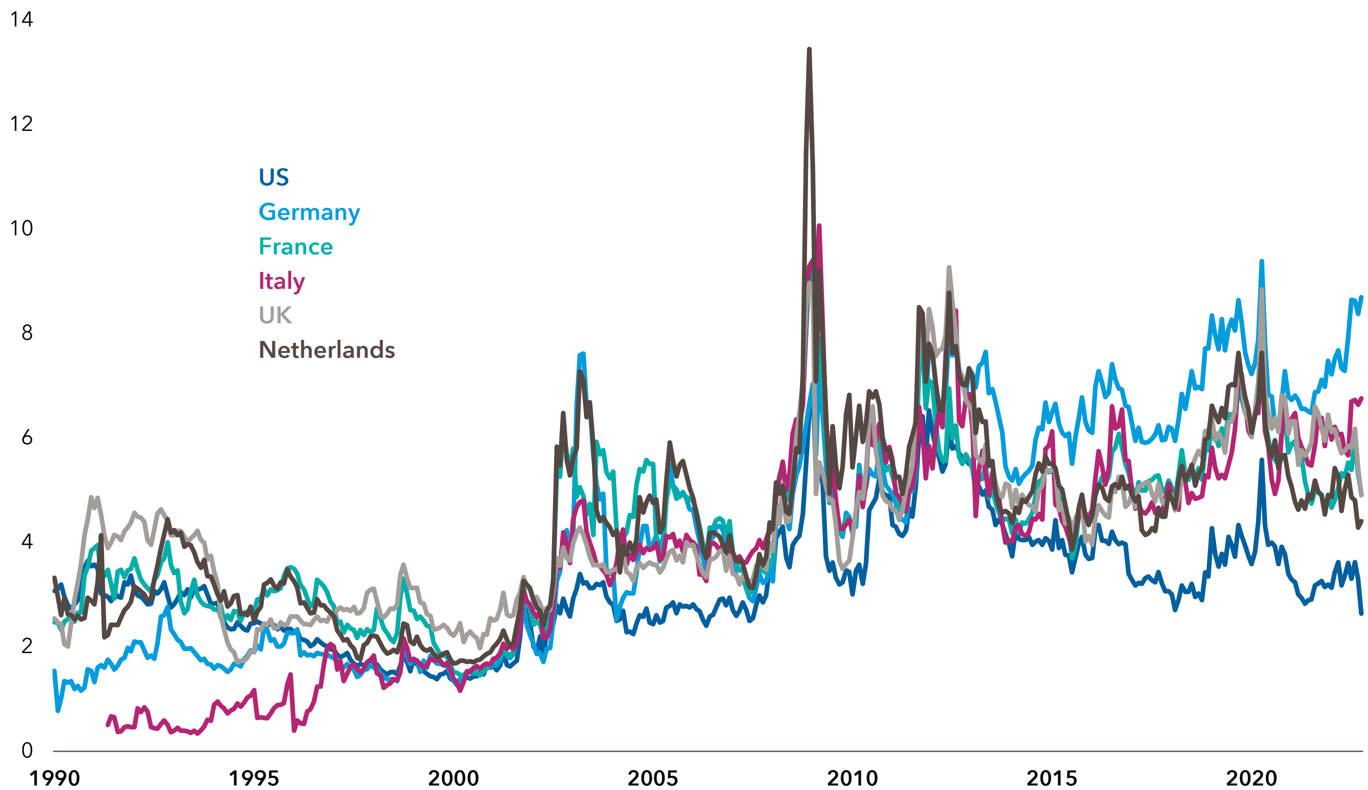
In the early stages of the war, analysts (including the International Monetary Fund) estimated the loss of Russian energy might depress eurozone gross domestic product (GDP) by around 2-3%.* But the macro impact of supply disruptions and price spikes looks modest so far. Lind currently expects GDP to decline by around 1% in 2023.

Europe has successfully replaced Russian oil and gas with other energy sources in many areas, reducing the need for significant cuts in output or energy demand destruction. Heavy industry has been particularly successful in finding new energy sources, which should translate into a lesser hit to GDP.

A milder recession could unlock further value in European equities, which remain at a significant valuation discount to the US. A clear peak in headline CPI that would enable the European Central Bank and Bank of England to stop monetary policy tightening could also provide a major boost. This is unlikely over the next few months, but if inflation drops off in early 2023, central banks should stop hiking, with policy interest rates peaking well below current expectations.

Is there scope for European equities to reprice versus the US?

Implied equity risk premiums (%)



Forecasts shown for illustrative purposes only.

Data as at 31 October 2022. Sources: Absolute Strategy Research, Refinitiv Datastream

* As at 19 July 2022. Source: IMF

A repricing opportunity is a change in the market environment that allows for a reassessment of the value of an investment. An equity risk premium is an excess return earned by an investor when they invest in the stock market over a risk-free rate.

Japan's strength in automation is an advantage amid supply chain shifts

Enhancing the resilience of supply chains has become a top priority for governments as they look to secure their economic lifelines amid a rise in geopolitical uncertainty. In Japan, the passage of the Economic Security Promotion Act gives the government more oversight of companies that rely on foreign suppliers for critical input and services. Economist Anne Vandenabeele believes this could be a milestone that kicks off a significant restructuring of supply chains in the coming years.

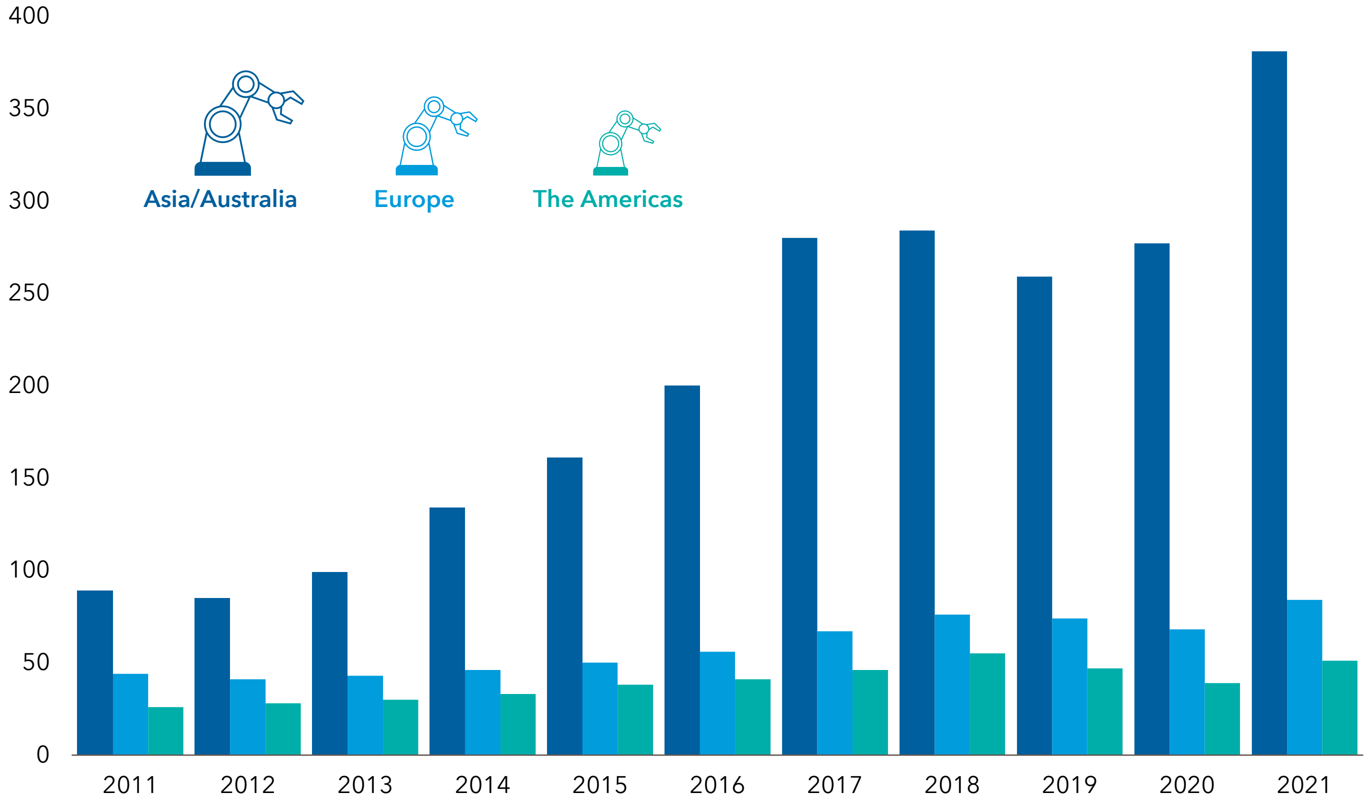
"The key for investors is to identify companies that do not depend on a single market for most of their growth or resources," says equity portfolio manager Harry Gunji.

Innovation is crucial to untangling the kinks in supply chains. Long known for its strength in automation, Japan's technology could grow in importance as companies turn to industrial robots to mitigate costs.

It may be difficult for export-dependent Japan to avoid a recession in the event of a significant global economic slowdown, but its world-class companies in industries including semiconductors, precision manufacturing and automation may benefit from major trends such as digital and green transitions. Attractive stock market valuations and robust corporate earnings compared to the US and Europe also cast Japan in a positive light.

Industrial robot installations surged to a record high in 2021

Annual installations of industrial robots (in thousands)

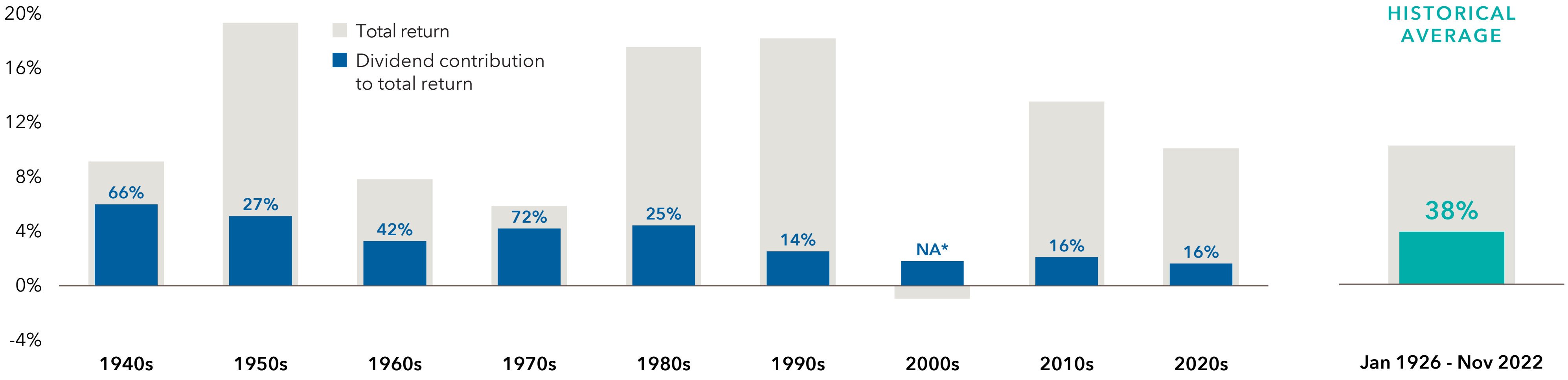


Five countries accounted for 78% of global robot installations in 2021: China (52%), Japan (9%), US (7%), South Korea (6%) and Germany (5%). Totals may not reconcile due to rounding. Sources: World Robotics 2022, International Federation of Robotics

Look for dividends to account for a larger portion of total returns

Dividend contributions to returns by decade

S&P 500 Index annualised total return (%)



Over the past decade, many investors spent little time thinking about dividends. With US tech and consumer companies generating double-digit returns and dominating the lion's share of total market return, dividends appeared downright boring.

Today boring is beautiful, according to equity portfolio manager Caroline Randall. "With growth slowing, the cost of capital is rising and valuations for less profitable tech companies is declining. I expect dividends to be a more significant and stable contributor to total returns," Randall says.

While dividends accounted for a slim 16% of total return for the S&P 500 Index in the 2010s, historically they have contributed an average 38%. In the inflationary 1970s they climbed to more than 70%. "When you expect growth in the single digits, dividends can give you a head start," Randall adds. "They may also offer a measure of downside protection when volatility rises, but it is essential to understand the sustainability of those dividends."

Companies that have paid steady and above-market dividends can be found across the financials, energy, materials and health care sectors, among others. Examples include Zurich Insurance, metals and mining multinational Rio Tinto, biopharmaceutical giant AbbVie and personal care company Kimberly-Clark.

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.

2020s data is from 1/1/1926 to 30/11/2022 in USD terms. Sources: S&P Dow Jones Indices LLC. * Total return for the S&P 500 Index was negative for the 2000s, so dividend contribution cannot be calculated.

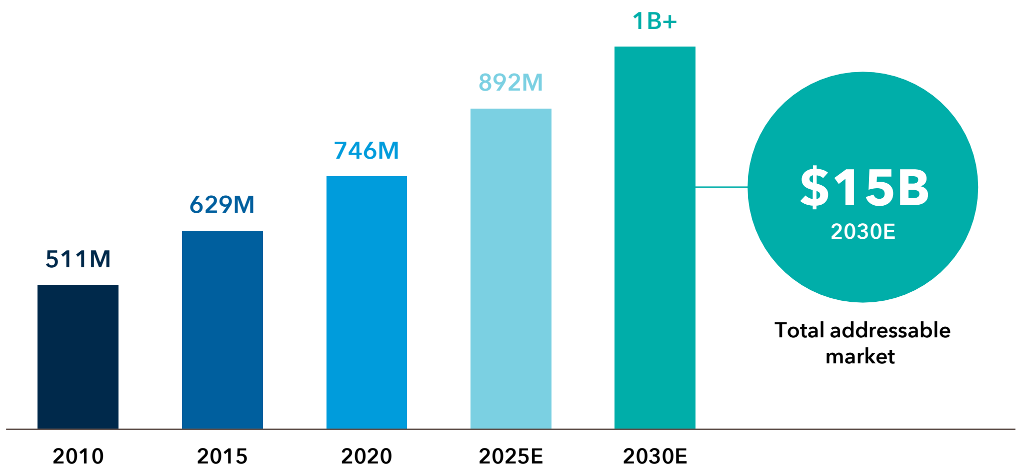
Health care may lead the next bull market

Large drug makers are positioned to fund their own growth

Total cash on balance sheets for global pharmaceutical companies (USD billions)

New therapies address the growing obesity problem

Global obesity (number of people)



New market leadership often emerges at the end of a bear market. With the cost of capital soaring, companies with strong, reliable cash flows are favourably positioned to lead the next recovery.

Consider the health care sector, which features innovative pharmaceutical companies that are well capitalised and hold pricing power. Select drug makers can use near-term profitability to fund acquisitions and other growth strategies. That's especially important when rising rates may limit a company's ability to fuel their growth with debt.

"I don't know for certain that the health care sector will lead the next bull market," equity portfolio manager Diana Wagner explains. "But the best managed of these companies could emerge as market leaders."

Recent investments in drug discovery are resulting in new ways to tackle major problems like obesity. By 2030 it is estimated that over one billion people worldwide will suffer from obesity, which is linked to cardiovascular disease, diabetes and kidney failure. Companies like Novo Nordisk and Eli Lilly have invested heavily in therapies with the potential to reduce a patient's body weight by as much as 20% to 25%.

"We have entered a golden age of drug development that may vastly improve quality of life for people," adds Wagner. "This is an exciting time to invest in health care. Not all drugs will achieve blockbuster success, however, so selective investing is crucial."

For left chart: Figures above represent the aggregated value in US dollars of cash and short-term investments across MSCI World Pharmaceuticals constituents. Data as at 30 September 2022. For right chart: Figures for 2015 are based on the averages of 2010 and 2020 figures. Total addressable market is the estimated size for obesity medication in 2030, per Capital Group estimates. 'E' refers to estimate. As at March 2022. Sources: Capital Group, FactSet, MSCI, Refinitiv Datastream, Refinitiv Eikon, World Obesity Atlas 2022, UN Population Division and World Obesity Federation projections

Capital spending super-cycle could power an industrial renaissance

Today's biggest challenges may have a silver lining: They appear to be setting the stage for a capital investment super-cycle that could drive opportunity for capital equipment companies, lower US energy costs and help revive American manufacturing.

Years of globalisation have led to underinvestment in machinery, plants and other capital projects. "You have an ageing factory footprint behind the manufacturing sectors of most developed markets," says Gigi Pardasani, an equity investment analyst who covers US large-cap industrials.

In addition, the transition to renewable energy and greater energy security is generating opportunities for companies that invest aggressively.

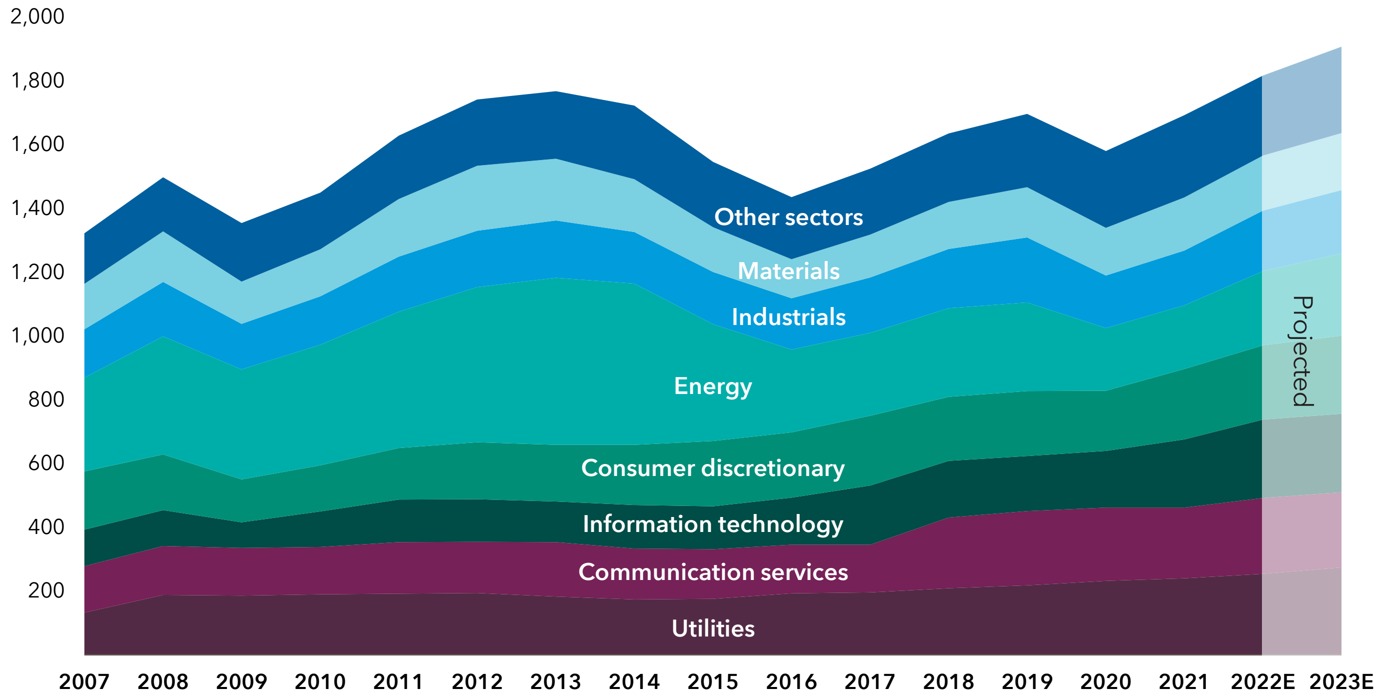
"Capital spending has traditionally been looked at negatively," Pardasani says. "But investments today to modernise the power grid, make buildings and factories more efficient and develop battery technology could boost long-term earnings growth for nimble, well-managed companies."

This billions of dollars in spending also reflects revenue growth potential for a range of capital equipment leaders such as Rockwell Automation; battery and energy storage developers like Lockheed Martin and Tesla; electrical equipment makers like Siemens, ABB and Schneider Electric; and equipment providers to the energy and mining industries like Caterpillar and Baker Hughes.

"This investment cycle can have broader benefits for US manufacturing as significantly lower energy costs over the long term can give American manufacturers a competitive edge, notes Pardasani. "I can see 'Made in the USA' becoming a byword for growth again."

Rising capital spending across sectors can benefit capital equipment companies

Capital expenditures across MSCI ACWI sectors (USD billions)



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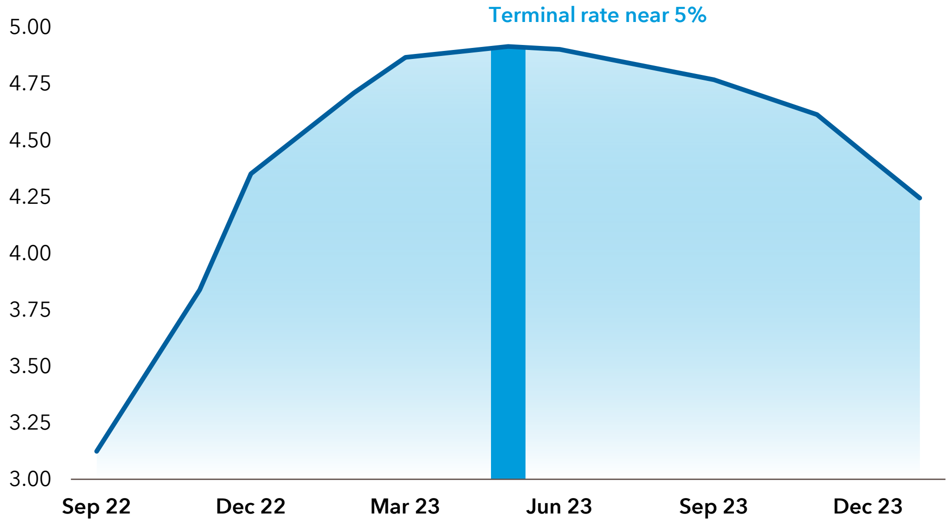
In current US dollars. All figures represent estimates from FactSet, including projected figures for 2022 and 2023. Data as at 30 November 2022. 'E' refers to estimate. Sources: Capital Group, FactSet, MSCI

MSCI ACWI is a free float-adjusted market capitalisation-weighted index designed to measure equity market results of developed and emerging markets. A large cap (sometimes called "big cap") refers to a company with a market capitalisation value of more than US$10 billion.

Bond investing before rates peak can provide strong returns

Markets predict Fed funds peak in June 2023

Market-implied federal funds rate (%)



Investing prior to final rate hike provided strong returns

BLOOMBERG US AGGREGATE INDEX
(Investment six months prior to final rate hike)

Last hike	First 12 months return (dollar cost average)	Annualised total return over 5 years
6/2006	**4.5%**	**5.9%**
5/2000	**5.3%**	**7.2%**
2/1995	**7.7%**	**6.8%**
2/1989	**10.2%**	**10.6%**
9/1987	**7.0%**	**9.6%**
5/1981	**3.3%**	**15.6%**

Interest rate turmoil hit bonds hard in 2022. But with the Fed expected to end its hiking cycle in mid-2023, investors are faced with two options: sit on the sidelines or invest.

"I think we will get peak interest rates of around 5%, so the Fed is now close to the end of its tightening cycle," says fixed income portfolio manager Pramod Atluri.

Historically, investing prior to the final rate hike has paid off. In the last 40 years, there were six hiking cycles. Purchasing bonds regularly for a year starting six months prior to the last Fed rate hike in each of those cycles would have returned a range of 3.3% to 10.2% in the first 12 months. Longer term, that year-long investment boasts a five-year annualised total return that spanned from 5.9% to 15.6%.

"As active managers, we aim to purchase bonds with good prospects using fundamental research while also accounting for macroeconomic conditions," says Atluri. "Markets move fast. I'd rather be early than late when it comes to positioning portfolios I manage."

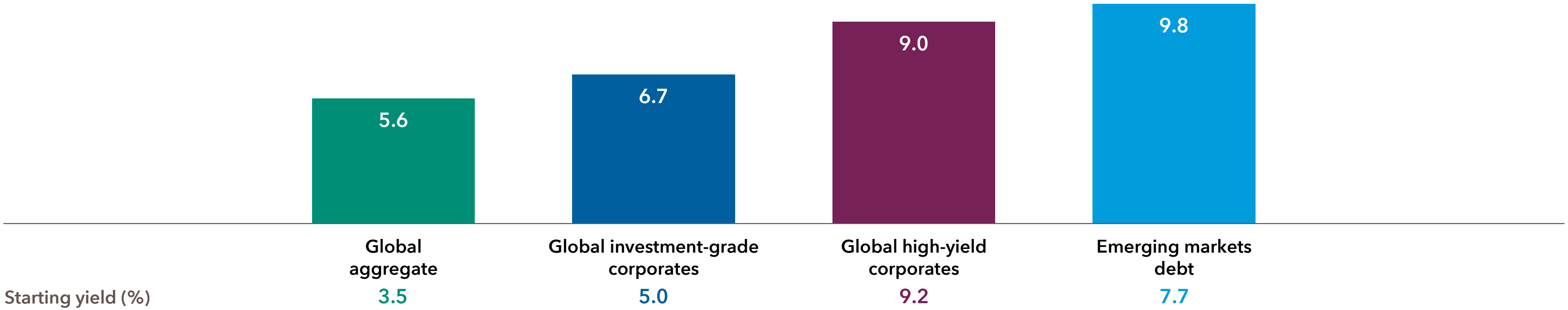
That's why a consistent investing plan can help investors avoid missing out on attractive bond income opportunities.

Past results are not a guarantee of future results. Forecasts shown for illustrative purposes only.
Market-implied Fed funds rates are as at 30 November 2022. Monthly returns as at 30 September 2022. Left chart based on futures markets pricing. Right chart shows date as at the last hike in all Fed hiking periods since 1980, excluding the 2018 peak, which does not yet have five years of data. 12-month dollar cost average return is the total return for a level monthly investment for 12 months starting six months prior to each last rate hike. The five-year return annualises the total return for that first 12 months plus four more years, assuming no additional investment after that first year. Regular investing does not ensure a profit or protect against loss. Investors should consider their willingness to keep investing when share prices are declining. Sources: Capital Group, Bloomberg
The federal funds rate is the target interest rate set by the Federal Open Market Committee. Active management of a portfolio or a fund requires a professional money manager or team to regularly make buy, hold, and sell decisions. Dollar cost averaging is a strategy of investing equal dollar amounts in a security at regular intervals. This method reduces investment risk but is also less likely to result in outsized returns.

Income is back in fixed income

Investing at current yields has provided attractive returns

Average five-year forward returns at recent yield levels (%)



High inflation and hefty rate hikes by the Fed provided a challenging backdrop for bond markets. While painful to endure in the moment, these losses can set the stage for higher income down the road. The yield on 10-year US Treasury bonds climbed to 4.27% in October, the highest level since June 2008. Yields, which rise when bond prices fall, have soared across sectors. Over time, income levels should increase since the total return of a bond is made up of price changes and interest paid – and the interest component is now much higher.

The return of income in fixed income has brought a renewed focus toward the asset class. "Investing in fixed income during a time of high inflation and rising rates can seem worrisome. However, today's starting yields offer an attractive entry point for investors," writes Mike Gitlin, Head of Fixed Income.

As indicated in the chart, which shows average annualised five-year returns when yields were at similar levels to those available today, at current yields history would suggest higher total returns over the next few years.

Overall higher yields mean that investors now have the potential to earn more income from bonds. Over time, this could provide more of a cushion for total returns, even if price movements remain volatile. For an active manager, the market could present compelling opportunities to find value, though selectivity is still crucial in the current environment.

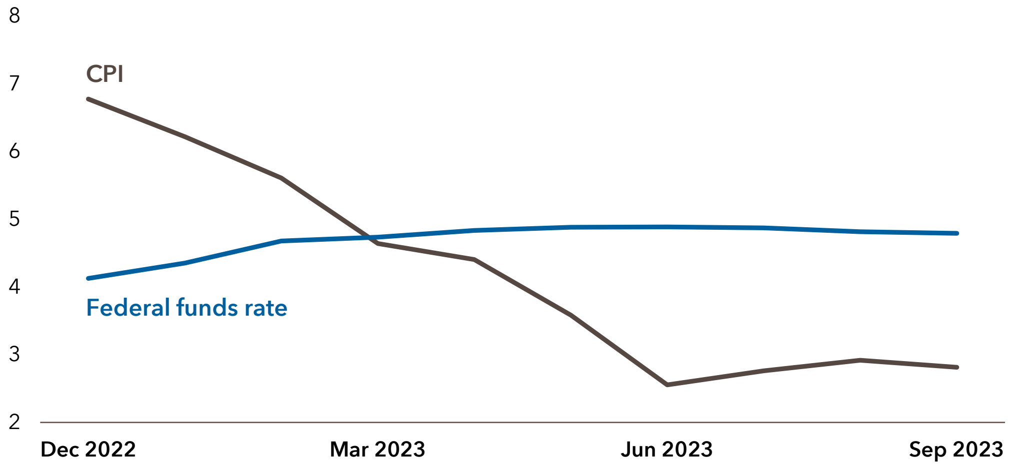
Past results are not a guarantee of future results. Forecasts shown for illustrative purposes only.

Yields and monthly return data as at 30 November 2022, going back to January 2000 for all sectors except for emerging markets debt, which goes back to January 2003. Based on average monthly returns in USD for each sector when in a +/–0.30% range of yield-to-worst shown. Sector yields above include Bloomberg Global Aggregate Index, Bloomberg Global Investment Grade Corporates Index, Bloomberg Global Corporate High Yield Index, 50% JPMorgan EMBI Global Diversified Index / 50% JPMorgan GBI-EM Global Diversified Index blend. Yield is 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.

Fed uncertainty looms over rates markets

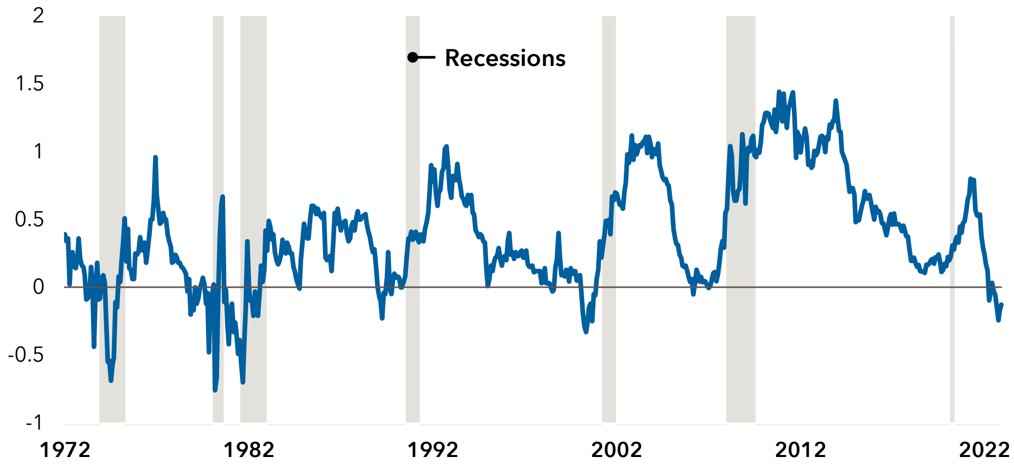
Markets appear confident in Fed's ability to curb inflation

Forecasted year-over-year CPI vs. federal funds rate



Extended periods of heavily inverted yield curves are rare

US Treasury yield curve (10y - 5y)



With financial conditions deteriorating and labour markets softening, the Federal Reserve's tightening cycle will likely slow down soon. Market pricing shows investors are confident in the Fed's ability to lower inflation to its 2% target over the next few years, with expectations for the Federal funds rate to decline after peaking at around 5%.

But that view may be overly optimistic. Fixed income portfolio manager Richie Tuazon expects consumer price index (CPI) inflation to slow to 4% by mid-2023 but believes risks to this forecast are skewed to the upside.

While our rates team is neutral on duration, members expect the curve to steepen should the Fed underdeliver on rate hikes. Most believe yield curve steepeners (which profit when long-term yields move higher than short-term yields) are at an attractive entry point while the curve is significantly inverted.

Market conditions also create a strong case for Treasury Inflation-Protected Securities (TIPS) despite headwinds created by investor outflows. "Real yields have become attractive while the market is expecting benign inflation in the coming years," says Tuazon. The rates team expects pairing TIPS with steepeners could fare well in multiple scenarios.

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

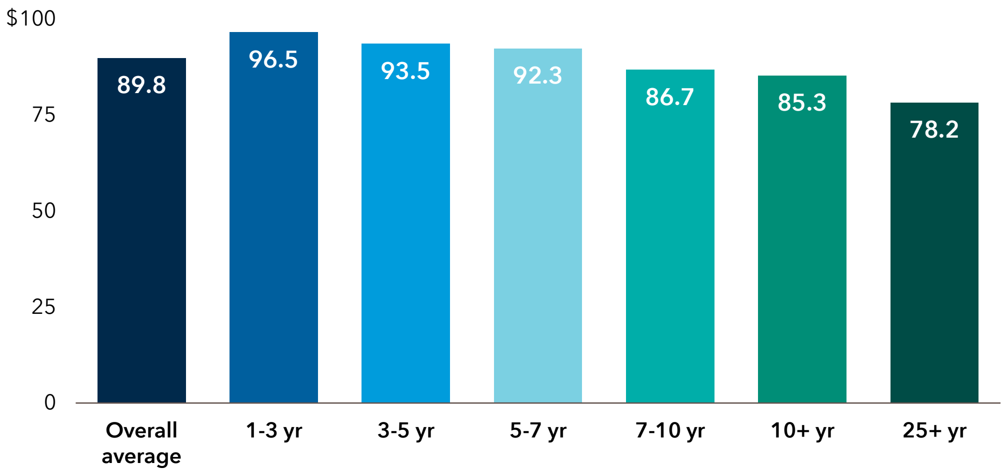
Sources (left chart): Capital Group, FactSet, RiskVal as at 31 December 2022. Sources (right chart): Capital Group, FactSet, as at 30 November 2022. Shaded areas represent recessions. The yield curve reflects the difference between longer- and shorter-term Treasury yields. An inverted yield curve occurs when short-term rates are higher than long-term rates. Duration is a measure of a bond price's sensitivity to changes in interest rates. Real yields are calculated by subtracting the inflation rate from nominal yields.

A yield curve is a line that plots yields (interest rates) of bonds having equal credit quality but differing maturity dates. A yield curve steepener is a trade that favours short-term bonds over long-term bonds.

Investment-grade credit is supported by fundamentals and strong demand

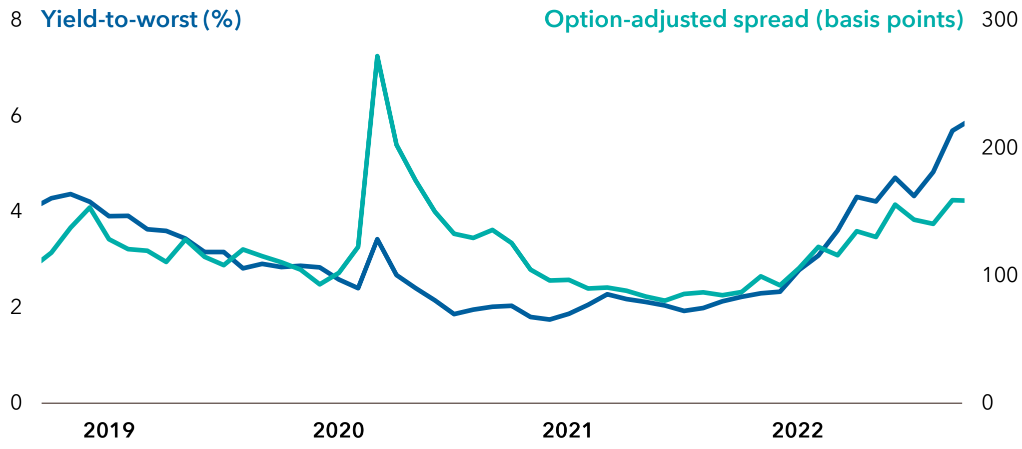
Corporate bonds are trading at discounted prices

Corporate bond dollar price by maturity



Volatility for investment-grade corporates will likely continue

Investment-grade corporate bond yields and spreads



After a significant sell-off earlier in 2022, starting yields in US investment-grade credit may be at an attractive entry point. These assets may decline further in a slower growth, recessionary environment – possibly creating an opportunity to purchase investment-grade (IG) credits at more compelling valuations.

IG credit has traded in line with equities and may continue to suffer if the backdrop for risk assets weakens further. Additional interest rate hikes could also impact the sector, as the average duration of IG corporate bonds is higher than the duration of the Bloomberg US Aggregate Index.

But IG has a captive buyer base, which can underpin support. Crossover buyers also tend to invest in these assets as prices become more appealing.

The average dollar price of the IG index also looks attractive at around US$85, and many bonds are trading in an even more appealing range of US$60 – US$70."Many low-cost high-quality IG bonds offer an attractive risk profile. This portion of the market has been, and could remain, a source of strength," says portfolio manager Scott Sykes.

Financials represent about a quarter of the IG universe and are the most frequent issuers. Overall, they're in good shape heading into a downturn, given the regulatory structure in place since the 2007-2008 global financial crisis.

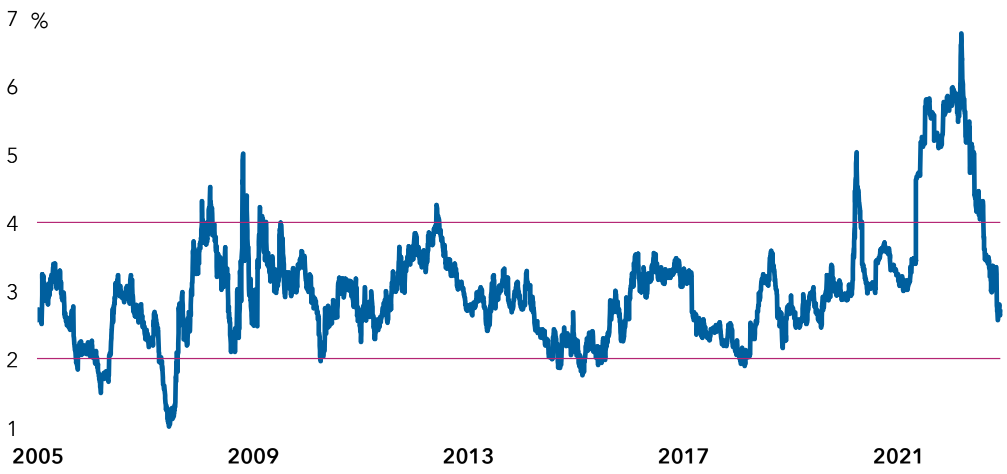
Past results are not a guarantee of future results.

Source (left chart): Bloomberg Index Services Ltd. Pricing shown for bonds in the Bloomberg US Corporate Bonds Index as at 30 November 2022. Source (right chart): Bloomberg Index Service Ltd. as at 30 November 2022. Investment-grade (IG) is represented by the Bloomberg US Corporate Investment Grade Index. 'IG credit' and 'IG corporate bonds' refer to bonds issued by a corporation that has been awarded a 'Baa3' or higher credit rating by Moody's, or 'BBB-' or higher credit rating by Standard & Poor's or Fitch. 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 option-adjusted spread (OAS) is the difference between a fixed income security rate and the risk-free rate of return, which is then adjusted for an embedded option. Embedded options are provisions included with some fixed income securities that allow the investor or the issuer to do specific actions, such as calling back the issue.

Emerging markets offer positive real yields

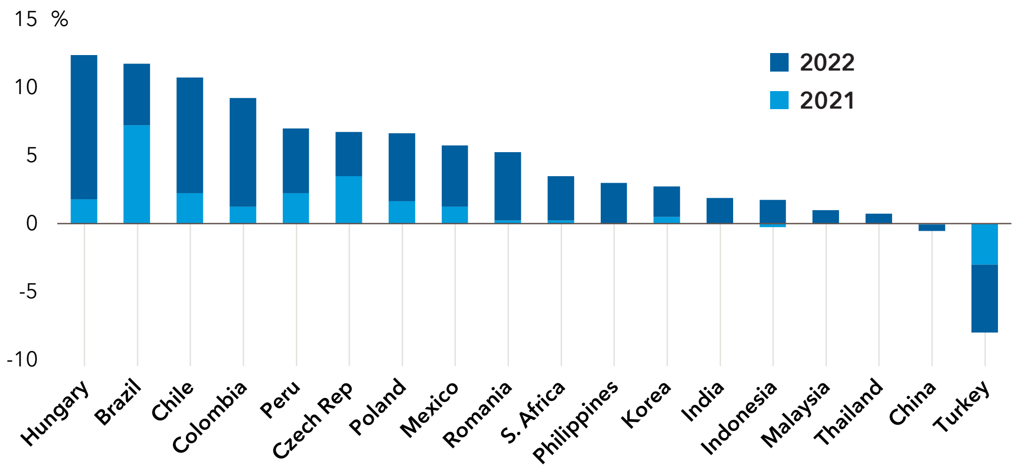
EM debt has offered a pick-up over US real yields

EM real yields minus US real yields



Latin America and Central Europe ahead in the rate hiking cycle

Policy rate changes



The global backdrop has been the main driver of emerging markets (EM) debt returns in 2022. This looks likely to continue in 2023, with US financial conditions, the dollar, global growth and geopolitical concerns at the forefront. While these factors will likely continue to weigh on the asset class, there is more yield on offer both in nominal and real terms, and the high starting yields can offset subsequent price volatility.

The difference in real interest rates offered by emerging markets compared to developed markets has been somewhat eroded, but it remains positive and attractive relative to other asset classes, while EM exchange rates remain highly undervalued given the continued strength of the dollar.

"We currently see the most value in Latin American countries that raised interest rates early such as Brazil, Mexico and Colombia. This has helped keep inflation under control and support exchange rates," says fixed income portfolio manager Kirstie Spence. Latin America has also benefitted from higher commodity prices and has been less exposed to the Ukraine war.

"Opportunities in Central Europe may be on the horizon," notes Spence. "The low interest rate environment that we have seen in Europe for years is coming to an end. Central banks across the region have been aggressively hiking rates to tame inflation. Both the Czech Republic and Poland have kept interest rates on hold recently and may have now reached the end of their hiking cycles."

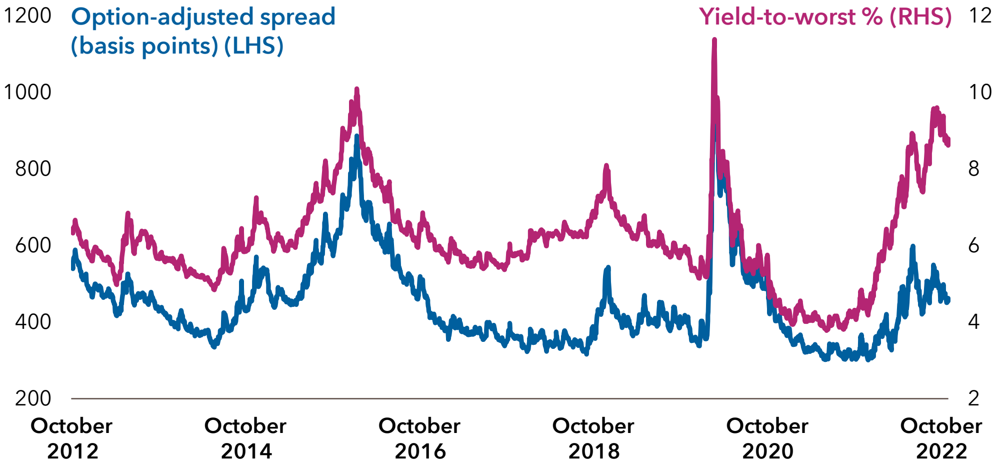
Past results are not a guarantee of future results.

Source (left chart): Bloomberg Index Services Ltd. as at 24 November 2022. EM real yields minus US real yields (10-year). The real interest rate is the nominal interest rate minus inflation. A nominal interest rate refers to the interest rate before taking inflation into account. Sources (right chart): CEIC, Refinitiv. As at 30 November 2022.

High yield – light at the end of the tunnel

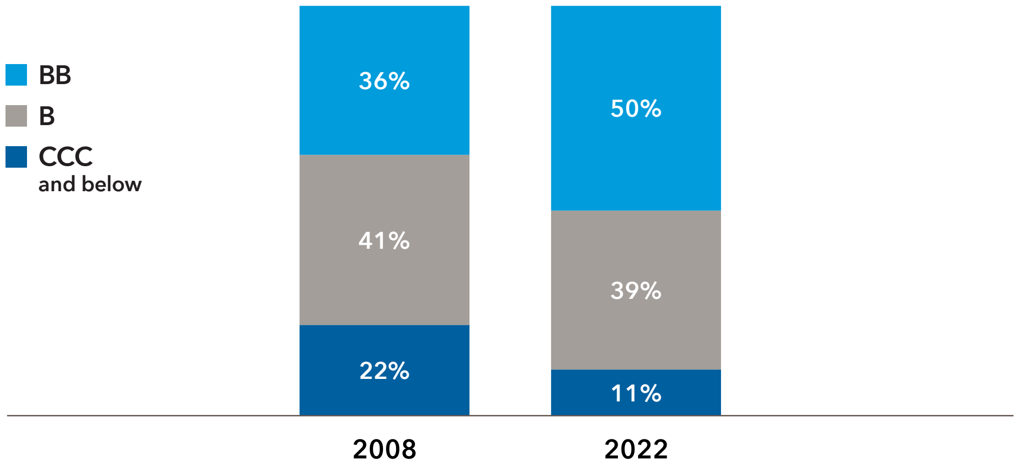
High yield has become high yielding

Higher spreads and yields



Half of the index is now rated BB

Bloomberg US Corporate High Yield Index weight by credit quality



After a challenging period, there is light at the end of the tunnel for high yield.

"The US high yield market appears healthier and more stable than it has been for many years," notes fixed income portfolio manager Shannon Ward.

At the beginning of the 2022, US high yield credit spreads were close to all time lows at around 300 basis points (bps). Yields were just 4.3%. By early November, spreads had increased to around 500 bps and yields more than doubled to over 9%. In short, high yield has become higher yielding.

Fundamentals have also improved. Many high-yield companies took advantage of ultra-low interest rates of recent years to term out their debt. During the pandemic a lot of the weaker high yield issuers defaulted. The companies that have survived are typically much stronger. This shake-out of the weaker credits has helped increase the overall credit quality of the index. As the above chart shows, 50% of the US High Yield Index is now rated BB (the highest credit quality for high yield).

Looking ahead, while macroeconomic headwinds could mean that default rates rise from their current low levels, it does not seem likely they will spike sharply higher.

There are still challenges ahead, and the potential for near-term volatility remains. But the higher yields as a result of this year's sell-off should provide a buffer against further weakness.

As ever, security selection and rigorous due diligence will remain key to success.

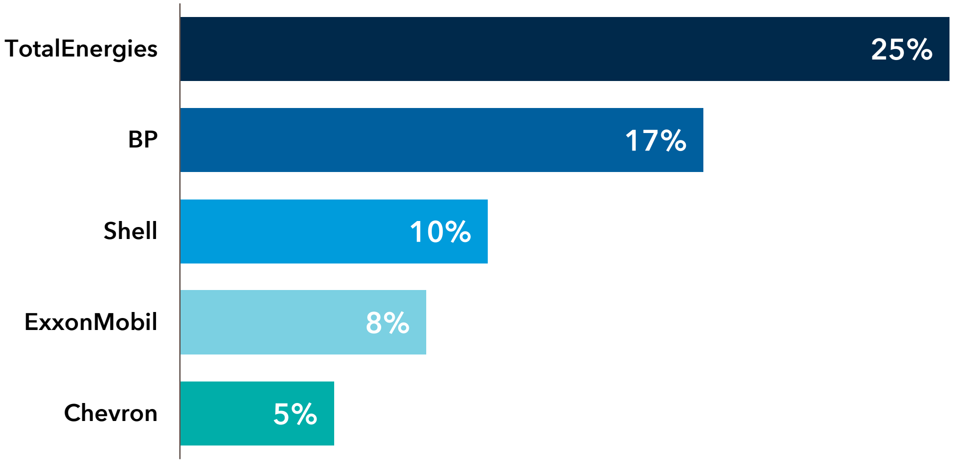
Past results are not a guarantee of future results.

Left chart: Data as at 30 November 2022. Index ICE BofA US High Yield. Right chart: As at 30 November 2022. Sources: Capital Group, Bloomberg, Bloomberg Index Services Ltd., JPMorgan
Credit 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.

Both energy security and energy transition are fuelling opportunities

Decarbonisation prominent in European supermajors' spending

Projected low carbon investments (% of overall 2022 capital expenditure)



Governments are helping drive the clean energy transition

Inflation Reduction Act

- **US$369B** clean energy spending
- Purchase incentives for households for clean energy technologies

REPowerEU

- Estimated **€210B** in new investments toward clean energy
- Eliminates EU dependance on Russian fossil fuels by 2030

GX Plan

- Estimated **¥150T** public and private decarbonisation investments
- Nuclear capacity is core to the plan

Energy security is a strategic priority for many countries in the wake of the Russia-Ukraine war. For investors, upheaval in the global energy complex is having a similarly profound impact.

Some oil companies, for example, generated hefty profits as the price of crude oil climbed to multi-year highs. Brent crude prices seem likely to remain elevated (the U.S. Energy Information Administration has forecast US$97 a barrel at year-end 2023). Supermajors have also been helped by sky-high European natural gas prices after Russia turned off its supply.

Despite the dash for fossil fuels and corresponding boost to profits, we are in a pivotal period when demand for fossil fuels is peaking* and the clean energy transition accelerates. Recently passed legislation across the world will help direct the equivalent of hundreds of billions of dollars of capital toward clean energy in coming years.[1]

"Though renewables are a lower return business today, there is a clear risk that failure to invest in infrastructure now results in them being disrupted and abandoned by some of their investor base," says Matthew Wolf, an equity investment analyst. And renewables opportunity goes beyond solar and wind.

Government incentives should also help advance clean hydrogen, sparking disruptive innovation across industries. "Decisions that energy firms are now making in regard to hydrogen and other renewables will shape their prospects in the coming decades," adds Wolf.

Source (left chart): InfluenceMap, September 2022. Sources (right chart): Cabinet Public Affairs, Japan; European Union; US Congress

* US Energy Information Administration forecast from its November 2022 Short Term Energy Outlook.

1. Forecasts based on the IEA's 2022 World Energy Outlook Stated Policies Scenario.

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