

# Outlook

MIDYEAR ISSUE JULY 2018

A photograph of a lighthouse at dusk, with the sky transitioning from deep blue to a soft orange glow near the horizon. The lighthouse is illuminated from within, and its structure is silhouetted against the sky. The foreground shows the dark, rocky shore of the sea.

Long-term  
perspective on  
markets and  
economies

# 2018 Midyear Outlook summary

Midway through 2018, virtually all countries find themselves in the midst of an economic upswing. But the specter of tighter monetary policy, trade skirmishes, rising volatility and rich valuations may leave investors wondering, “What’s next?” The following three insights and seven actions can help investors navigate through these challenges toward long-term investment success.

	INSIGHTS	IMPLICATIONS	ACTIONS
Macro perspectives	<p><b>The tide is turning from QE to QT.</b></p> <p>Expect more volatility as monetary policy shifts from quantitative easing (QE) to quantitative tightening (QT).</p>	<p>Synchronized global growth is supportive of equities in the near term, but expensive markets and higher volatility mean it’s time to be broadly balanced and diversified.</p>	<ul style="list-style-type: none"> <li>❑ Evaluate portfolios to ensure broad diversification this late in the cycle.</li> <li>❑ Check correlations between equity and fixed income portfolios. Lower correlations (closer to 0) provide greater diversification.</li> </ul>
Equity opportunities	<p><b>The world is smaller than you think.</b></p> <p>Structural changes in international markets and trade dynamics are driving the need to access a global opportunity set.</p>	<p>Solid growth, attractive relative valuations, rising consumption and a potential currency tailwind continue to support the case for investing outside the U.S.</p>	<ul style="list-style-type: none"> <li>❑ Rightsize your international equity allocations. Many of our model portfolios are above 24% non-U.S.</li> <li>❑ Combine a dedicated international holding with a flexible global strategy for a broader opportunity set.</li> </ul>
Fixed income opportunities	<p><b>It’s time to upgrade bond portfolios.</b></p> <p>Amid unsettled equity markets, bond strategies need to provide a balance of income and diversification from equities.</p>	<p>Emphasize higher quality in core allocations, and be mindful that significant exposure to U.S. high-yield corporates may leave portfolios vulnerable.</p>	<ul style="list-style-type: none"> <li>❑ Favor true core strategies, and be alert to unintended credit exposure.</li> <li>❑ Rethink high yield with emerging markets and municipal bonds.</li> <li>❑ With inflation rising, consider adding inflation protection.</li> </ul>

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Past results are not predictive of results in future periods.

# Synchronized global growth should continue into 2019

Many of the world's economies are contributing to the highest global growth since 2011

## Gross domestic product growth, 2009 to 2019 (estimate)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018E	2019E
<b>Developed markets</b>											
United States	-2.8	2.5	1.6	2.2	1.7	2.6	2.9	1.5	2.3	2.9	2.7
Eurozone	-4.5	2.1	1.6	-0.9	-0.2	1.3	2.1	1.8	2.3	2.4	2.0
Japan	-5.4	4.2	-0.1	1.5	2.0	0.4	1.4	0.9	1.7	1.2	0.9
Germany	-5.6	3.9	3.7	0.7	0.6	1.9	1.5	1.9	2.5	2.5	2.0
United Kingdom	-4.2	1.7	1.5	1.5	2.1	3.1	2.3	1.9	1.8	1.6	1.5
Canada	-3.0	3.1	3.1	1.7	2.5	2.9	1.0	1.4	3.0	2.1	2.0
<b>Emerging markets</b>											
China	9.2	10.6	9.5	7.9	7.8	7.3	6.9	6.7	6.9	6.6	6.4
India	8.5	10.3	6.6	5.5	6.4	7.4	8.2	7.1	6.7	7.4	7.8
Brazil	-0.1	7.5	4.0	1.9	3.0	0.5	-3.6	-3.5	1.0	2.3	2.5
South Korea	0.7	6.5	3.7	2.3	2.9	3.3	2.8	2.8	3.1	3.0	2.9
Russia	-7.8	4.5	5.1	3.7	1.8	0.7	-2.5	-0.2	1.5	1.7	1.5
Mexico	-5.3	5.1	3.7	3.6	1.4	2.8	3.3	2.9	2.0	2.3	3.0
<b>Developed markets</b>											
	-3.4	3.0	1.7	1.2	1.3	2.1	2.3	1.7	2.3	2.5	2.2
<b>Emerging markets</b>											
	2.8	7.4	6.4	5.4	5.1	4.7	4.3	4.4	4.8	4.9	5.1
<b>World</b>											
	-0.2	5.4	4.3	3.5	3.5	3.6	3.5	3.2	3.8	3.9	3.9

**GDP growth** ■ <0% ■ 0% to 1% ■ 1% to 2% (developed); 1% to 4% (emerging) ■ 2% and above (developed); 4% and above (emerging)

SOURCE: International Monetary Fund, World Economic Outlook Database, April 2018.

From the United States to the eurozone, the world's economy is experiencing a synchronized and multidimensional pickup in growth. With manufacturing, trade, consumer sentiment and other indicators mostly on the upswing, expansion is gaining traction in many of the countries driving global growth. Although some countries, such as Japan, are showing signs of slowing, the global economy remains broadly healthy and on pace to advance.

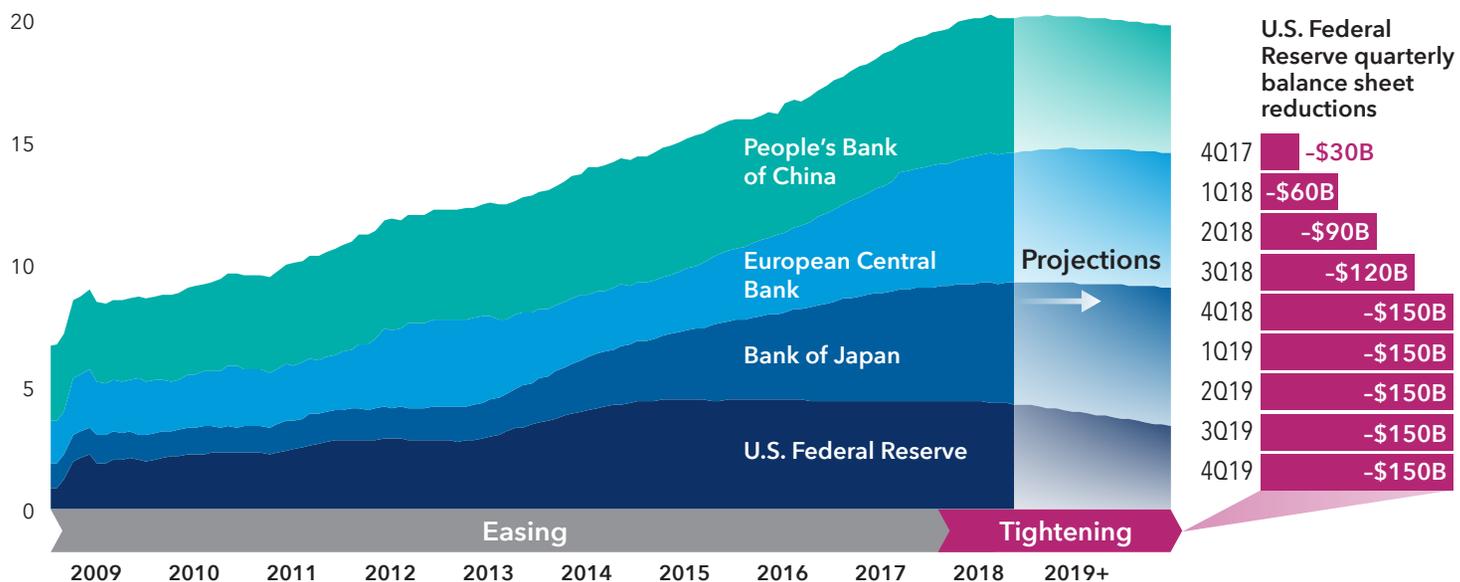
Overall, the International Monetary Fund expects global GDP growth to hit 3.9% in 2018 – the fastest rate since 2011. Moreover, the IMF says the global recovery now underway is the broadest in seven years, with growth picking up in countries accounting for three-quarters of world output. Global growth is supported by strong momentum, favorable market sentiment, accommodative financial conditions, and the domestic and international repercussions of expansionary fiscal policy in the United States.

From construction to computer chips, the growing world economy provides opportunities for select companies. Increased building and infrastructure spending, for example, is boosting demand for heavy-duty equipment from Caterpillar, the world's largest machinery company. At the other end of the spectrum, global demand for chips is driving growth for companies such as Intel and Samsung Electronics.

# Not-so-easy money: The tide is turning from QE to QT

Expect more volatility as the Fed unwinds its massive balance sheet

Central bank assets (USD trillions)



SOURCES: Capital Group, Federal Reserve, Thomson Reuters. People's Bank of China assets are as of 4/30/18. Other data and projections are as of 5/31/18.

For nearly a decade, the world's major central banks have given new meaning to the term "accommodative." In the wake of the Global Financial Crisis, central banks around the world lowered interest rates to pump liquidity into a global economy on the brink of depression. The U.S. Federal Reserve was the first to take rates to zero, and when that was insufficient to spur growth, the Fed started making massive asset purchases to provide more economic stimulus.

The chart shows that central banks have reached an inflection point. The Fed began raising rates in 2015, and began selling assets in 2017. The European Central Bank and Bank of Japan are reining in asset purchases, although neither has begun raising rates or reducing assets on their balance sheets. The assets of those three central banks still total about \$15 trillion. The Bank of England hiked rates for the first time in a decade in November 2017.

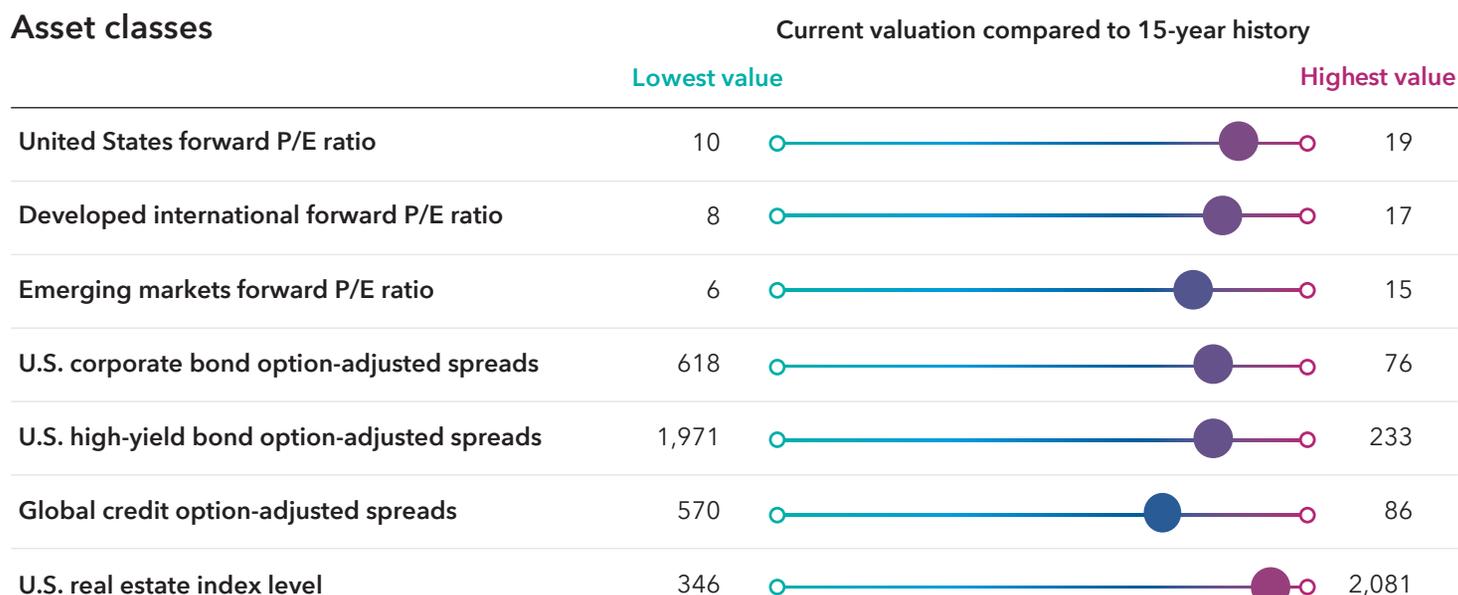
Accommodative policy has provided a significant tailwind to asset prices. Now, policy is tightening. This is uncharted territory for the global economy. How much of a headwind will assets face amid less supportive policy? That question is likely to influence markets for years as central banks begin to unwind the unprecedented monetary stimulus that has played a critical role in shaping the global markets since 2009.

# The QE tide lifted most boats, raising asset prices

At these levels, investors need to manage expectations for future returns

“The silver lining is that in a challenging investment environment, when valuations are high and there are periods of volatility, the markets give us an opportunity to do what we do best and use our fundamental research to invest selectively in companies that have the greatest potential for reward.”

**HILDA APPLBAUM**  
PORTFOLIO MANAGER



SOURCES: Bloomberg Index Services, Ltd., IBES, MSCI, Standard & Poor's, Thomson Reuters. Benchmarks used are the S&P 500 Index, MSCI World ex USA Index, MSCI Emerging Markets Index, Bloomberg Barclays U.S. Aggregate Corporate Index, Bloomberg Barclays U.S. High Yield 2% Issuer Cap Index, Bloomberg Barclays Global Aggregate Corporate Index, and MSCI US REIT Index. Real estate figure is based on the total return index levels. Scale represents the minimum/maximum value for each respective index for the 15-year period ended 5/31/18.

If you feel like everything's expensive, you're not alone. From real estate to fine art, prices seem elevated. So it is with the markets. Fueled by years of accommodative monetary policy, prices of stocks, bonds, houses and just about every other asset have soared. U.S. stocks were at their most expensive in 15 years recently before the P/E ratio retreated as earnings got a boost from the corporate tax cut. Bond valuations have also been stretched, leaving credit spreads at their tightest levels in years.

Now, as the Federal Reserve begins to unwind its balance sheet, a variety of asset classes that have benefited from unprecedented easy money may be in for a rougher ride. Investors should also be prepared for bouts of volatility. In fact, at the same time that the Fed is unwinding its \$4 trillion balance sheet, it is also increasing interest rates. The Bank of Japan and European Central Bank are likely to follow the Fed's tightening lead.

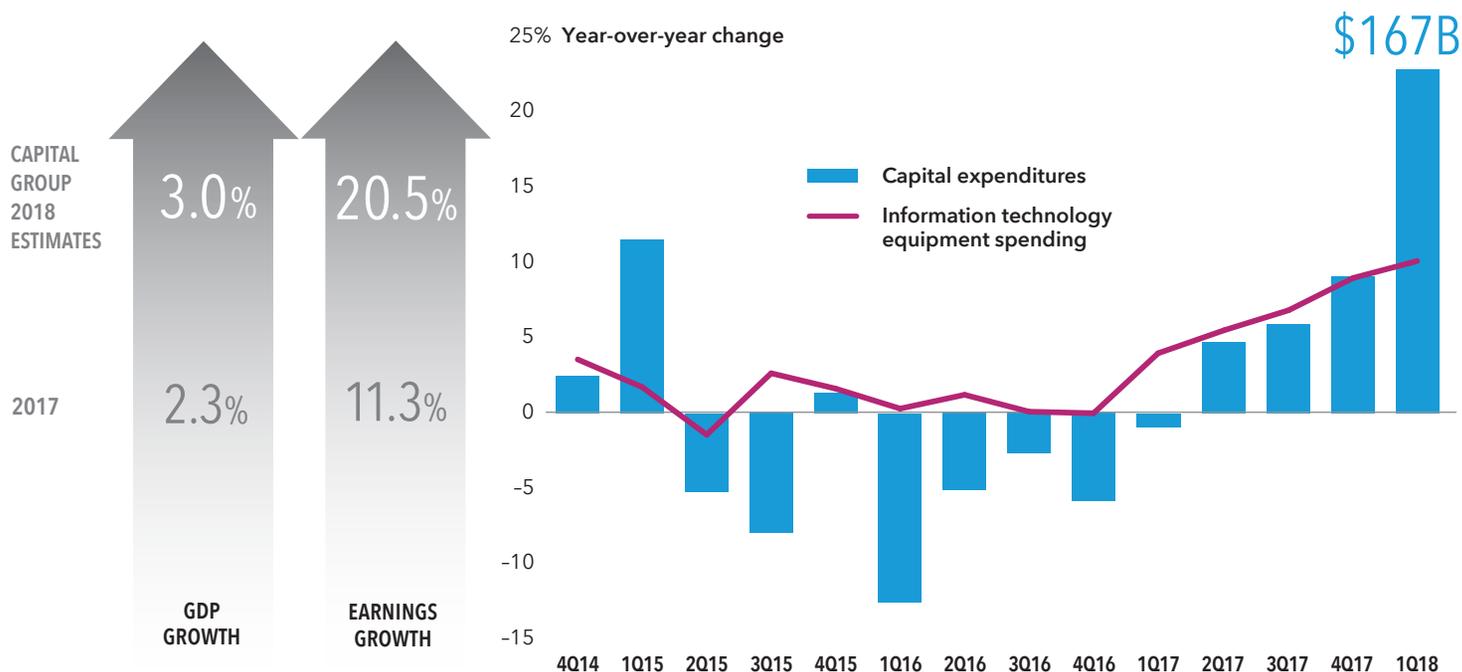
The strengthening economy is one reason the U.S. stock market has soared since the end of the Global Financial Crisis. In such an environment, some companies and sectors of the market may be relatively expensive, making selectivity especially important. Bottom-up fundamental research can help identify future investments as well as test current investment theses.

# Performance-enhancing policies give U.S. economy a boost

Capital spending has soared in 2018, setting a first-quarter record

“The tax bill is likely to stimulate U.S. economic growth in 2018 and 2019 through higher consumer and business spending. I expect to see GDP growth of about 3% this year.”

**JARED FRANZ**  
ECONOMIST



SOURCES: Capital Group; Bureau of Economic Analysis; FactSet; International Monetary Fund, World Economic Outlook Database, April 2018; Thomson Reuters. Capital expenditures data is as of 3/31/18.

Talk about an inflection point. Passage of the Tax Cuts and Jobs Act of 2017 has put more cash in companies' coffers, and they have been ramping up spending on their businesses at the fastest pace in years. Capital expenditures – such as spending on factories, equipment and other capital goods – by S&P 500 companies totaled about \$167 billion in the first quarter, the fastest pace in seven years and a record for a year's first quarter.

Higher spending on technology, equipment and facilities could ease worries that S&P 500 companies have reached a peak in their profit growth. The spending could also give the U.S. economy a fresh set of legs, and help extend an expansion now in its tenth year. In addition to capital spending, a solid jobs market, rising corporate profits and healthy industrial production point to the U.S. economy continuing to grow through this year and possibly beyond.

Technology companies are among the big spenders and big winners in the capital spending surge. Google topped the list for capital spending during the first quarter at \$7.3 billion, while Apple and Microsoft were among the top 10. They're also benefiting from companies upgrading their technology infrastructure. Corporate spending on tech this year has reached its highest level since 2010.

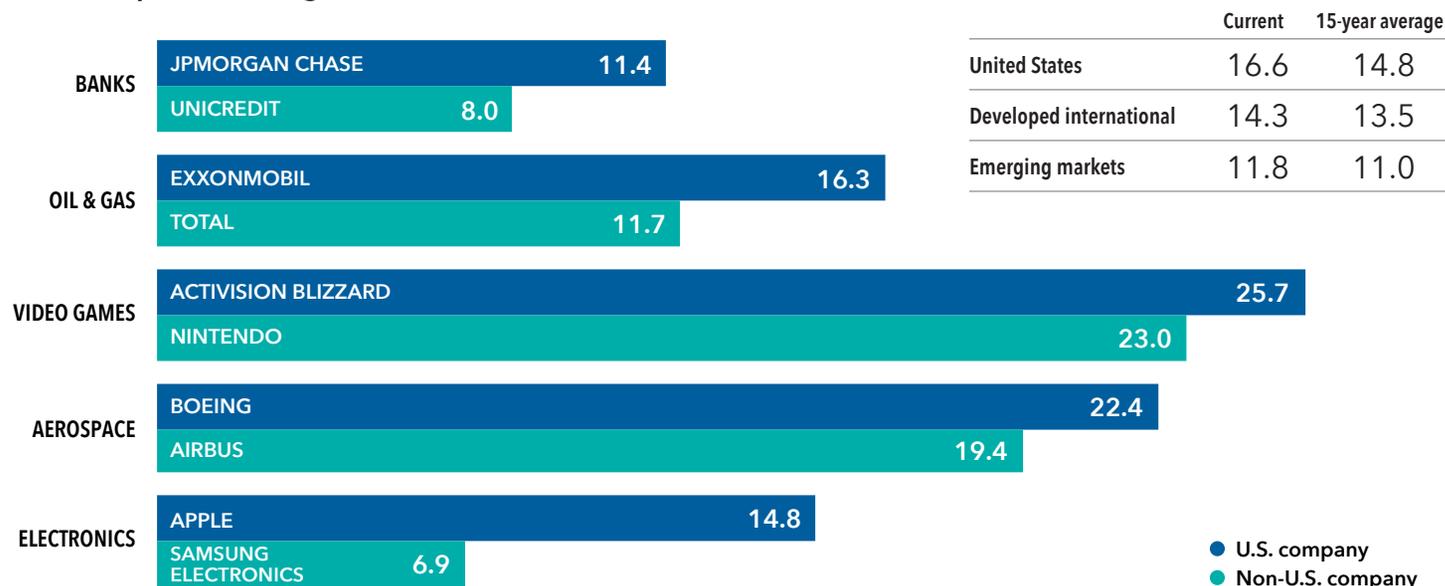
# Attractive valuations abound in international equities

Many non-U.S. companies trade at significant discounts to their U.S. counterparts

“The key question is, can international equities do well without the U.S. leading the way? I believe they can, on a relative basis, given the more attractive valuations we are seeing in many non-U.S. markets.”

**LISA THOMPSON**  
EQUITY PORTFOLIO MANAGER

## Forward price-earnings ratios



SOURCES: IBES, MSCI, Standard & Poor's, Thomson Reuters. As of 5/31/18. Forward price-earnings ratios are for the S&P 500, MSCI World ex USA, and MSCI Emerging Markets indexes.

International equities remain attractive, given steady economic growth in Europe and Japan, central bank stimulus measures and lower valuations compared to U.S. equities. In addition, political stability is returning to the European Union in the wake of last year's elections. Investor sentiment may continue to improve as French President Emmanuel Macron and German Chancellor Angela Merkel solidify a power base that should dominate the EU after the United Kingdom's planned exit in March 2019.

Crisis-era monetary policy remains active in Europe and Japan, despite some recent steps toward normalization. The European Central Bank plans to wind down its stimulus program later this year, but it isn't expected to raise rates until mid- to late 2019, and the Bank of Japan has no such timetable. That means the era of "easy money" should last longer in non-U.S. markets. Moreover, recent signs of a slowdown in both economies could result in renewed stimulus measures down the road.

The European financials sector offers a number of potentially attractive valuation stories. Many eurozone banks have struggled in recent years with strict regulations and a low-interest-rate environment. But economic growth and the prospect of higher interest rates next year mean select banks look relatively attractive, including Barclays, Credit Suisse and UniCredit.

# Changing shape of global trade presents new opportunities

Structural shifts are transforming trade channels from the old economy to the digital age

“Shifts in economic and trade regimes and turning points in markets provide managers like us the opportunity to capitalize on short-term distortions in asset prices and invest in attractive companies that we view to be winners in the long term.”

**ROB LOVELACE**

EQUITY PORTFOLIO MANAGER



SOURCES: Capital Group white paper, “Shifting global trade patterns bring new opportunities,” May 2017.

Global trade issues are once again headline news amid growing U.S.-China trade tensions, talk of renegotiating the North American Free Trade Agreement, and the United Kingdom’s attempt to break away from the European Union. That’s a lot of potential change on the horizon, and the outcome remains uncertain. However, over the past two decades, much bigger shifts have completely reshaped the global trade environment in powerful and likely irreversible ways.

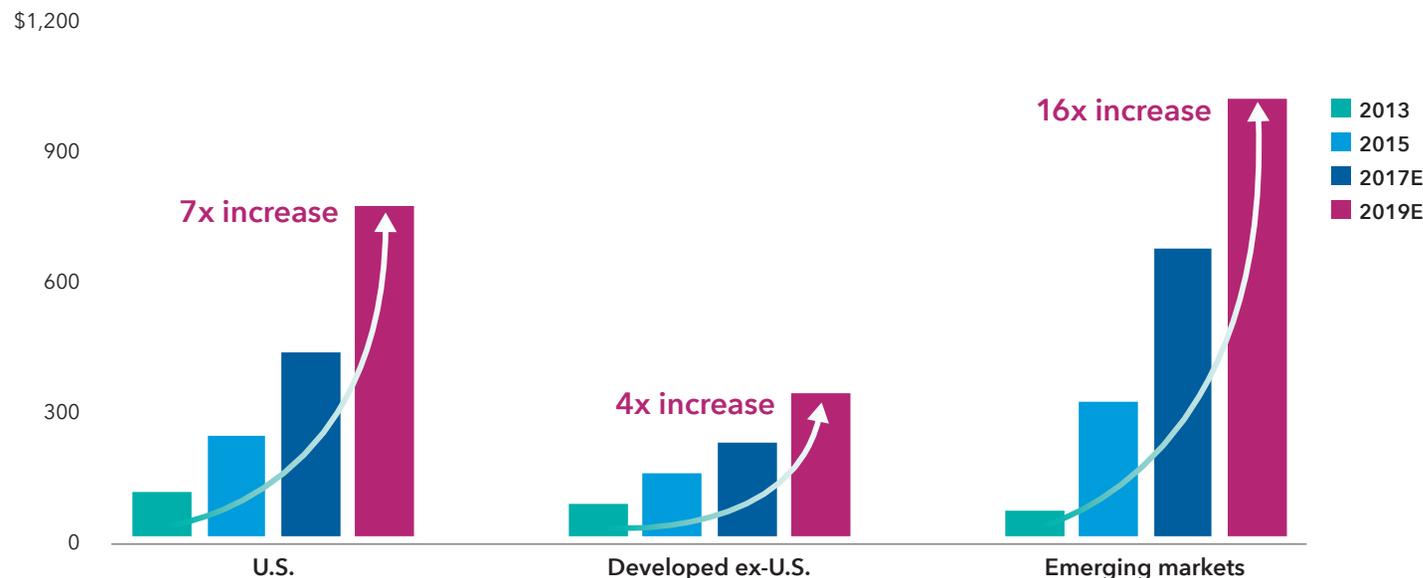
If the 20th century was defined by a phenomenal rise in the transfer of goods and industrial commodities, the 21st century is being characterized by the rapid digitization of services. Innovative technology platforms are facilitating this digital trade, also known as the knowledge economy. Moreover, the movement is not easily captured in traditional trade metrics or controlled by government regulations. Thus, the flow of data and capital over digital networks can’t be easily thwarted.

Examples of companies that are thriving in the era of digital trade include Alphabet (Google), which, along with Facebook, dominates the online advertising space; Amazon, which is radically disrupting both the retail shopping and cloud-based hosting services industries; and Priceline, the largest online travel agency in the world. In their own market, several Chinese internet companies are just as dominant, including Alibaba and Tencent.

# Emerging consumers are leapfrogging the developed world

Select companies are gaining from rising smartphone adoption and mobile commerce

Total value of goods purchased on mobile devices (USD billions)



SOURCES: Capital Group, Euromonitor.  
As of 9/30/17.

The rapid adoption of mobile devices – including smartphones, tablets and other internet-connected gadgets – is driving consumption trends around the world, but even more so in fast-growing emerging markets such as China, India and Brazil. To underscore that point, consumers in many developing countries are surpassing their developed-market counterparts when it comes to the growth of e-commerce purchases and use of other online services.

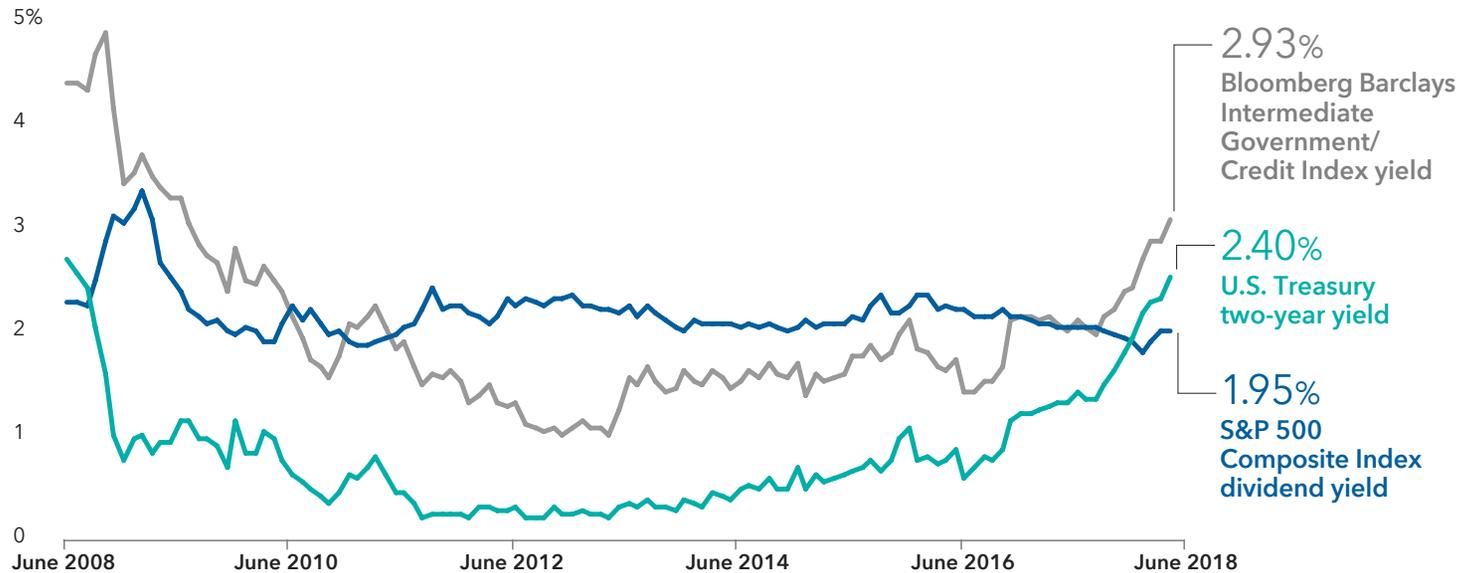
In certain areas, such as mobile payment platforms, Chinese tech companies are building massive scale and leapfrogging Silicon Valley in advancements. Meanwhile, venture capital investments are surging throughout Asia as investors search for “the next big thing.” India, for instance, has become a prime battleground for U.S. and Chinese internet giants seeking share of mind in e-commerce, financial services and ride-hailing.

Emerging markets investing isn't just about commodities anymore. Technology corporations based in emerging markets are now among the largest companies by market capitalization in the developing world. Examples of EM companies capitalizing on mobile device trends include South Korea's Samsung Electronics, India's Reliance Industries and China's Ctrip, among others.

# The income comeback is here

Shorter term bonds lead the way for the first time in nearly a decade

## Two-year U.S. Treasury yields have moved above the S&P 500's dividend yield



SOURCES: Bloomberg Index Services Ltd., Thomson Reuters. As of 5/31/18.

Welcome back, income. In late 2017, the two-year U.S. Treasury yield rose above the S&P 500 Composite Index dividend yield for the first time in almost a decade. So far in 2018, shorter term bond yields have continued to trend higher as the Federal Reserve has forged ahead with gradual interest rate hikes.

For income investors, this is a sea change. Years of ultra-low bond yields had led investors to turn to equities for income. Now, rising interest rates are shaking things up. Relatively attractive opportunities in higher quality bonds can supplement income from equities, where dividend yields have been fairly flat overall.

Higher bond yields make this a great time for investors to reconsider bonds for income. Balanced funds are worth a closer look, as are shorter term core bond strategies. They're focused on higher quality bonds of shorter maturity and can offer an attractive complement to equities.

# Unintentional risks lurk in bond strategies and markets

Knowing what you own is critical

“The changing direction of global monetary policy naturally centers a lot of attention on interest rates. But we’re also later in the cycle. I think bond investors should, therefore, be just as focused on credit risk – both in strategies and in markets.”

**MIKE GITLIN**  
HEAD OF FIXED INCOME

**89% of top-quartile funds in Morningstar’s Short-Term Bond category have had returns over time that you may not expect**



SOURCES: Morningstar. As of 3/31/18.

\*According to Morningstar’s Best Fit Index, applied to Morningstar Short-Term Bond category. Funds examined are the top quartile for trailing three-year average annual returns. Morningstar’s Best Fit Index definition: The market index that shows the highest correlation with a fund’s excess returns over the most recent 36 months. For example, this analysis indicates that 33% of top-quartile short-term bond funds were most highly correlated to the high-yield bond market (not short-term bonds).

Naturally, all eyes are on interest rates. The 10-year Treasury note yield topping 3% only increased that focus. Short-term bond funds have tended to be less sensitive to changes in rates, and have become a popular choice for de-risking. But there’s a snag: some funds may not behave as expected. That’s because credit risk is lurking. For example, in short-term bond strategies – which should emphasize capital preservation and diversification from equities – credit fund-like behavior is surprisingly common.\*

Later in the cycle, credit risk in bonds should also be front-and-center. Although Corporate America is prospering, debt burdens are rising. Moody’s estimates that nonfinancial corporate leverage has reached a record high of just over 45% of U.S. GDP. And with short-term rates now higher than they’ve been for years (page 9), there’s no need to stretch for yield. Shorter term funds that emphasize high-quality bonds can now offer solid income potential without taking excessive credit risk.

Some bond strategies may be vulnerable amid stock market declines. Investors should ensure their bond investments are appropriately aligned with the four primary roles of fixed income in a balanced portfolio: diversification from equities, capital preservation, income, and inflation protection.

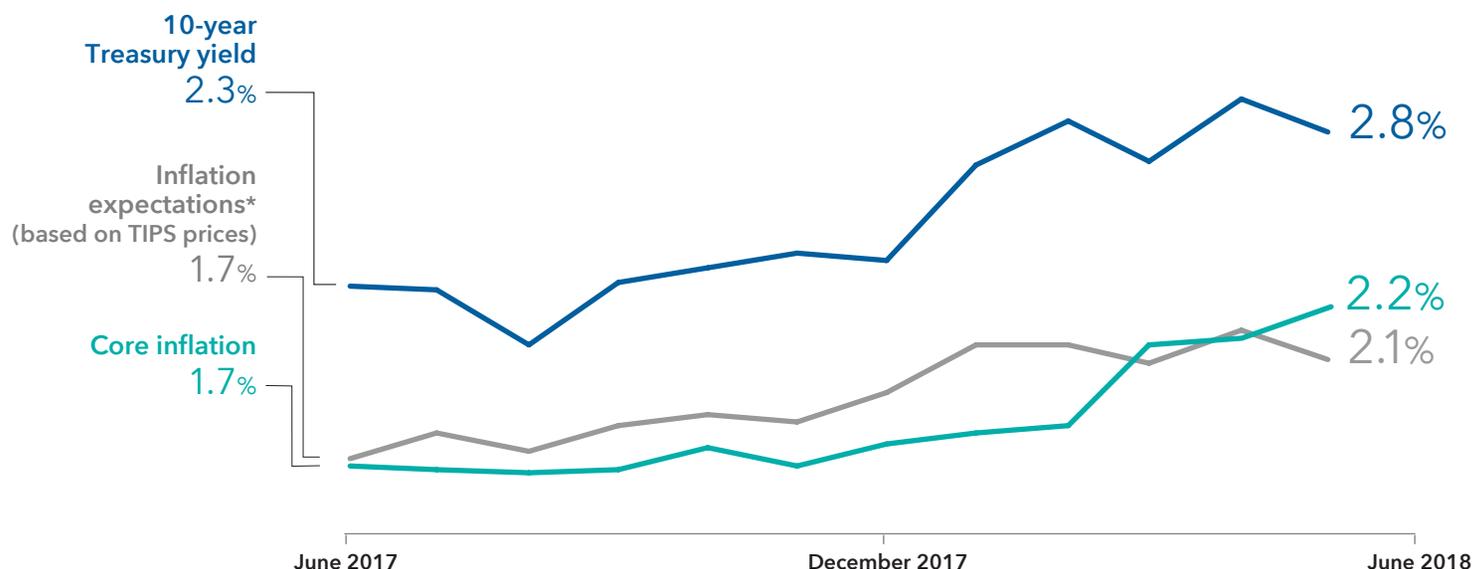
# Inflation is on the rise and may exceed what's expected

Investors should consider adding some inflation protection

"There's a good chance that core inflation could be up to 2.5% this year, which is more than the market has been anticipating. Against that backdrop, Treasury Inflation-Protected Securities (TIPS) valuations appear to offer some good upside potential."

**RITCHIE TUAZON**  
PORTFOLIO MANAGER

## Inflation and inflation expectations have trended higher



SOURCES: Federal Reserve Economic Data, Thomson Reuters. As of 5/31/18. Core inflation measured by percentage change from a year ago for Consumer Price Index for All Urban Consumers: All Items Less Food and Energy.

\*Expectations based on the TIPS break-even, which reflects the average annual inflation rate that would need to occur over a 10-year period for Treasuries and TIPS to notch the same returns.

Inflation has been on the rise. Core inflation – the measure that strips out volatile energy and food prices – was up 2.2% in May compared to 12 months earlier. Looking forward, signs point to inflation that is stable to higher from here. Key supportive factors include tighter labor markets, higher energy prices, the global manufacturing recovery and the lagged impact of past dollar weakness on import costs.

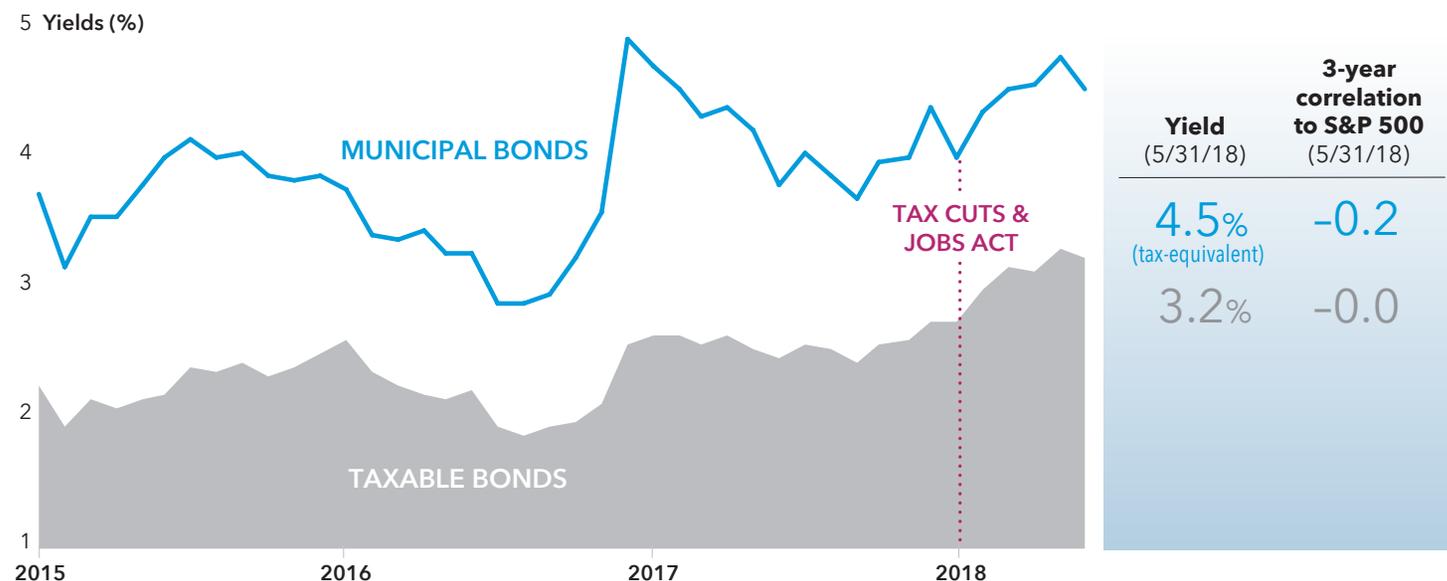
Preserving purchasing power is critical for investors who rely on income, such as those who are in or close to retirement. But the question remains: what kind of inflation hedging strategy should you consider? After all, some invest in high-yield bonds, others in equities or commodities. It's only strategies that focus on TIPS, however, that offer a potential source of explicit inflation protection.

Although TIPS are often held in core bond funds, TIPS-focused strategies are worth closer consideration. In addition to offering the potential for explicit inflation protection, TIPS can complement other bond investments – such as those that may not hold up well amid higher inflation or provide diversification to equities.

# Munis offer tax-advantaged income and more

Post-tax reform, the after-tax income and diversification potential of the asset class still shines

## Higher after-tax yields have further burnished the core credentials of munis



SOURCES: Bloomberg Index Services Ltd. Market proxies: Municipals (Bloomberg Barclays Municipal Bond Index); Taxable (Bloomberg Barclays U.S. Aggregate Bond Index). Three-year correlations between returns for Standard & Poor's 500 Composite Index and respective bond indexes. Taxable-equivalent yield: Based on a federal marginal tax rate of 37%, the top 2018 rate. In addition, we have applied the 3.8% Medicare tax. This comes to a combined 40.8% marginal tax rate on investment income for taxpayers in the highest tax bracket (in 2017, pre-tax reform, the rate was 43.4%). Assumed tax rates in tax-equivalent yield calculations prior to 2017 are 43.4% (2015-2016).

Expect the more challenging bond market environment to continue as the Fed proceeds with gradual rate hikes. That means investors should prepare for mixed returns and further volatility. Following the glut of issuance that occurred ahead of tax reform, bond issuance was weak earlier in 2018. Supply is likely to pick up for the remainder of the year, which could put some downward pressure on valuations.

While broader interest rate moves may prompt volatility in munis, credit fundamentals are solid across most sectors. Consolidation among not-for-profit hospitals remains fertile ground for selective investors. Conversely, caution around tobacco-settlement bonds seems appropriate. Despite recent gains, tighter regulation and smoking's dwindling popularity create structural headwinds.

The after-tax income potential of munis has reached multiyear highs. In mixed market conditions, greater emphasis on bonds of higher quality may help cushion investors amid volatility. High-yield muni bonds are still worth considering; they've often offered average after-tax yields comparable to high-yield corporates, but with significantly less correlation to equities.

# Rethink high yield without giving up income

High-income munis and emerging markets debt can complement high-yield corporate exposure

**Munis and emerging markets debt: favorable yields, diversification and quality (but, higher rates sensitivity)**

	U.S. HIGH YIELD	HIGH-INCOME MUNIS	EMERGING MARKETS DEBT
Yield (%)	6.4	6.3 <sup>1</sup>	6.3
Correlation <sup>2</sup> to S&P 500	0.64	-0.02	0.42
Investment grade (%)	0	50	75
Duration (years) <sup>3</sup>	4.0	6.7	5.9

SOURCES: Capital Group, Bloomberg Index Services Ltd., J.P. Morgan, RIMES, Standard & Poor's and Thomson Reuters. Market proxies: Bloomberg Barclays U.S. High Yield 2% Issuer Capped Index (high yield), blend of 50% Bloomberg Barclays Municipal Bond Index and 50% Bloomberg Barclays High Yield Municipal Index (high-income munis) and blend of 50% J.P. Morgan GBI-EM Global Diversified index and 50% J.P. Morgan EMBI Global Diversified index (emerging markets bonds). Data as of 5/31/18.

<sup>1</sup> Tax-equivalent yield to worst assuming the top federal marginal tax rate for 2018 of 37%, plus the 3.8% Medicare tax.

<sup>2</sup> Three-year correlations between returns for Standard & Poor's 500 Composite Index and respective market proxies as of 5/31/18.

<sup>3</sup> Duration measures sensitivity to changes in the prevailing level of interest rates: the higher the number, the greater the potential index decline when rates rise.

U.S. corporate high yield has benefited from strong demand from investors and modest net issuance. Default rates have moderated and many issuers that are sensitive to commodities have strengthened balance sheets. All that said, debt burdens remain heavy, and an extended rally has left valuations elevated. In comparison, high-income munis and emerging markets bonds have offered comparable yields – even among higher quality issuers.

Fundamentals for many emerging markets appear more favorable than in developed nations, with higher commodity prices providing a boost to exporters. Valuations have eased lately, and volatility around Turkey and Argentina – as well as a bout of U.S. dollar strength – underscores the need to invest selectively. High-income munis have also seen volatility. With valuations elevated, bond-by-bond research is an especially critical aspect of uncovering favorable tax-advantaged opportunities.

Further increases in U.S. Treasury yields may cause setbacks for emerging markets debt and high-income munis. Developments such as Brazil's October election, or negative news around certain troubled muni issuers are possible sources of volatility. Market wobbles could present attractive entry points for investors considering a reallocation of some high-yield corporate exposure.



# 2018 Outlook: Time for balance and flexibility

Themes	Big picture	U.S. equity	International equity	Taxable fixed income	Tax-exempt fixed income
	Market levels call for balance and flexibility.	The U.S. economy is strong, but markets are relatively expensive.	There may be room to run in markets outside the U.S.	It's time to upgrade bond portfolios.	Municipal bonds offer attractive opportunities.
<b>Key takeaways</b>	The global expansion is gaining momentum as the U.S. forges ahead and conditions improve in Europe. Relatively low rates and mild inflation across the globe further contribute to a benign economic environment. But volatility is back and valuations remain high.	Consumer optimism and rising wages have provided a further boost to a strengthening U.S. economy. Valuations are near multiyear highs across a number of asset classes. But a deeper look beyond market averages reveals opportunity for selective investors.	After outpacing U.S. equity markets in 2017, European and emerging markets continue to offer relatively attractive valuations in select areas. Improving economic conditions, a weaker U.S. dollar and rising profit growth all contribute to an encouraging outlook for investing in non-U.S. markets.	Fixed income asset valuations remain elevated, but income potential in shorter term U.S. bonds has improved. The Fed's gradual approach to rate hikes remains likely amid modest inflation and growth. Expect more volatility as the Fed unwinds its massive balance sheet.	After broad gains in 2017, municipal bond valuations are relatively high. After-tax income potential has improved, but investors should prepare for greater volatility and more mixed returns.
<b>Investment implications</b>	At this stage of the cycle, make sure portfolios are well-diversified, with the flexibility to pivot to select areas of opportunity.	Maintain a core allocation of U.S. equities but be selective and consider rebalancing toward international and emerging markets equities.	Seek meaningful exposure to Europe's improving health and rising consumer purchasing power in emerging markets.	Upgrade bond portfolios with three actions: favor core strategies that offer solid income and capital preservation, and can diversify from equities; rethink enhanced income by considering alternatives to high-yield corporates; consider adding inflation protection.	Consider shifting a portion of core bond portfolios to municipals and explore high-income muni bonds as an option for enhanced income.

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