

# Outlook

MIDYEAR ISSUE JULY 2017



The global economic picture brightens

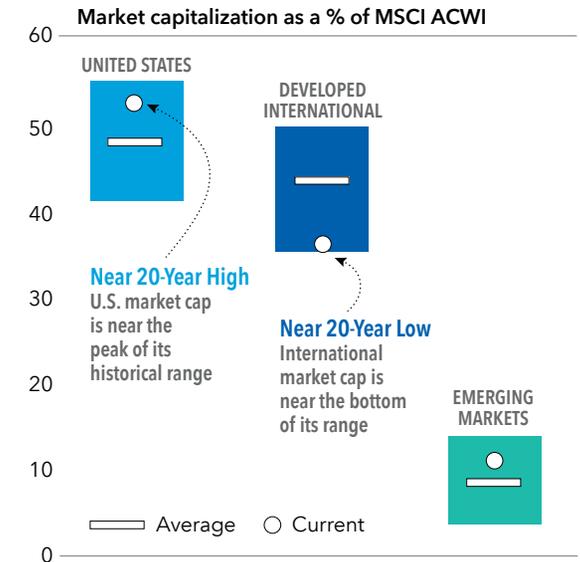
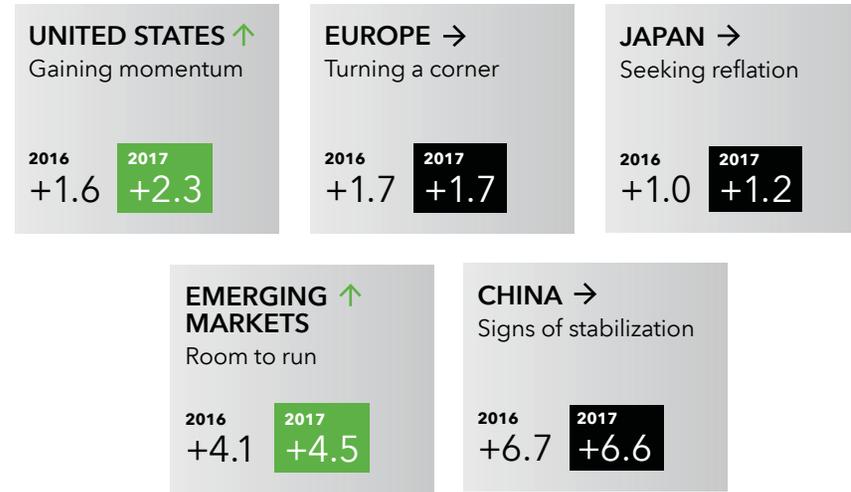
# Across the globe, momentum builds

Most economies are growing, but market levels suggest it may be time to rebalance

“The world has shifted and today global growth is in ascendance. But with that comes higher valuations, especially in the United States. In my portfolios, I am finding it easier to identify attractively valued companies abroad.”

**STEVE WATSON**  
PORTFOLIO MANAGER

## The U.S. and emerging economies, with growth accelerating, are standouts in an improving landscape



SOURCES: International Monetary Fund, World Economic Outlook Database, April 2017; MSCI; RIMES; Thomson Reuters. 2017 GDP figures are estimates. Market capitalization ranges represent each region's percentage of the total market capitalization for the MSCI All Country World Index for the 20 years ended 5/31/17.

For the first time in years, the world's major economies all appear to be on the road to recovery. Heading into the second half of the year, clarity is improving on many fronts. But questions remain: Can U.S. markets sustain their winning streak? Will Europe finally turn the corner? What will rising rates mean for investors? And will politics upend everything?

Nowhere is economic momentum more evident than in the U.S., where the economy is firing on more cylinders. Since the end of the Great Recession, the U.S. recovery was largely driven by a resilient consumer. But more recently, manufacturing has turned around. This should be supportive of equity markets barring any unexpected shocks or policy missteps.

That said, a look at the world's market capitalization levels shows the U.S., at 53%, nearing the top of its historical range while overseas markets are near lows. Europe appears to have turned a corner and is poised to play catch-up. With China stabilizing, emerging markets are roaring ahead and appear to have more room to run. Given the relatively wide chasm in valuation between U.S. and international stocks, it may be time to rebalance portfolios toward markets outside the U.S.

Investments are not FDIC-insured, nor are they deposits of or guaranteed by a bank or any other entity, so they may lose value. Past results are not predictive of results in future periods.

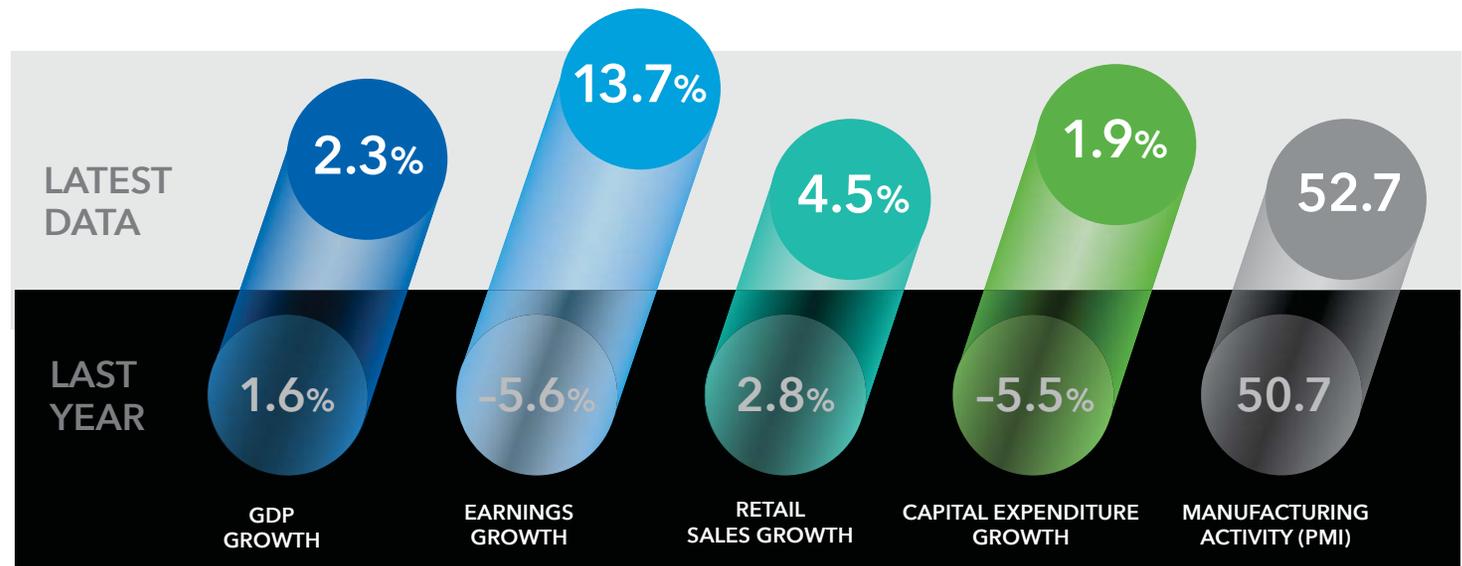
# The U.S. is firing on more cylinders

Rebounding earnings and manufacturing activity point to higher octane expansion

"I start by looking for businesses with robust top-line growth. Today this includes companies focused on cloud computing and online retailing. Valuations for many of these companies have gotten stretched. But I can get comfortable investing in them if I have multiple years of visibility into the business model and can determine the robust growth is sustainable."

**ALAN WILSON**  
PORTFOLIO MANAGER

**Built to go the distance: Manufacturing, capital spending and earnings are all strengthening**



SOURCES: Bureau of Economic Analysis, Bureau of Labor Statistics, FactSet, International Monetary Fund, Thomson Reuters. GDP is the actual 2016 and estimated 2017 GDP growth, as reported by the IMF. Earnings growth is year-over-year S&P 500 earnings growth in 1Q16 and 1Q17, as reported by FactSet. Retail sales is year-over-year change on 4/30/16 and 4/30/17. Capital expenditure growth is the year-over-year growth of U.S. manufacturing non-defense shipments, excluding aircrafts, on 4/30/16 and 4/30/17. Manufacturing PMI is the manufacturing component of the 5/31/16 and 5/31/17 PMI reports.

Revved up: The American economy has found a new gear. For more than seven years the recovery proceeded at a lackluster pace, propped up mainly by a resilient consumer. More recently, business- and industrial-focused areas have provided positive momentum to the overall growth picture.

The Purchasing Managers' Index (PMI), a measure of manufacturing activity, recently rose to 52.7, indicating expansionary conditions. In addition, corporate profits, which came under pressure in

2015 and 2016, have rebounded, surging more than 13% in the first quarter. Taken in combination with strengthening wage growth and retail sales, these conditions point to accelerating growth in the second half.

On the policy front, easing regulations, combined with prospective tax reform, could provide a further boost to growth. That said, policy remains fluid and any missteps with regard to trade policy could have an adverse impact on the overall economy.

With valuations stretched in many areas, look for companies with a proven record of generating top-line growth, such as firms that support cloud computing. For example, Microsoft has achieved solid growth from its Azure cloud computing business and Amazon remains a leading provider of cloud services to businesses. Semiconductor-maker Intel is a leader in the design and development of equipment that runs data centers on which cloud computing relies.

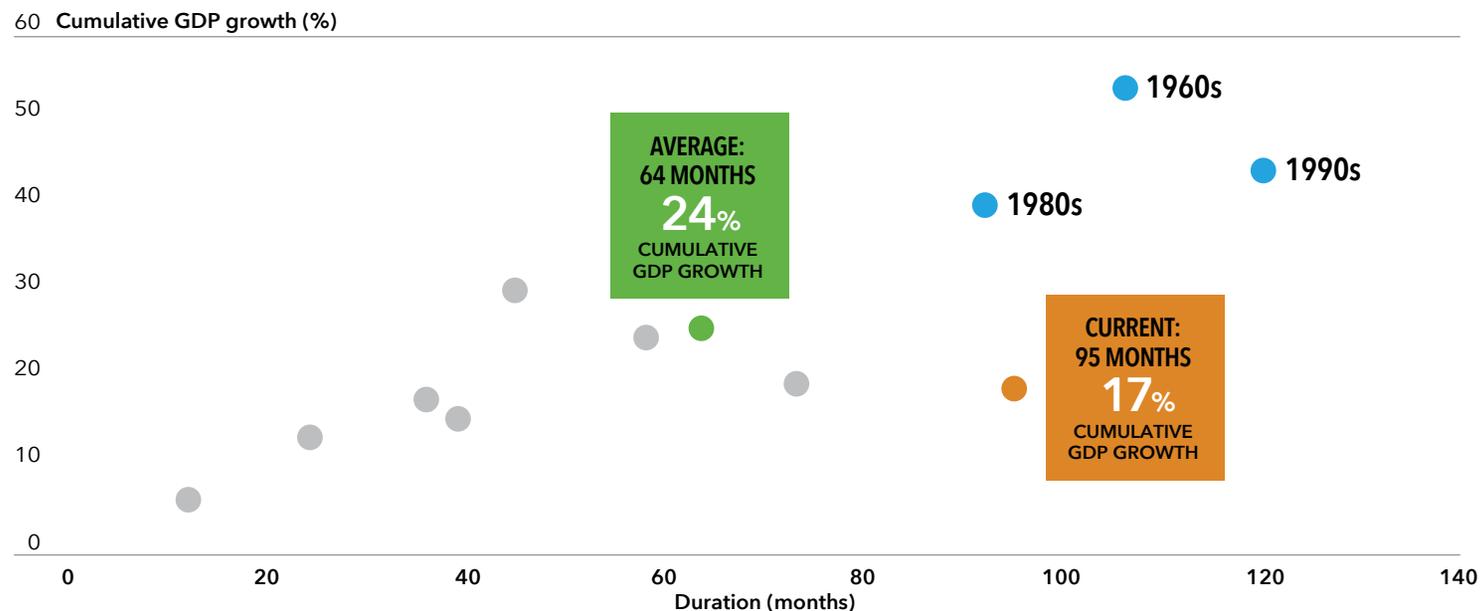
# The U.S. expansion is old ... but age is just a number

A low growth rate and lack of clear imbalances indicate the recovery still has fuel in the tank

“Right now everything seems to be pointing up in the U.S. Some parts of the economy may feel late in the cycle, but many others – like housing and hourly wages – do not. We don’t have the excesses you would normally see at the end of an economic cycle. That is why I think this will go on longer than a lot of people think.”

**ALAN BERRO**  
PORTFOLIO MANAGER

The current growth cycle is longer than average, but the growth rate has been lower than average



SOURCES: National Bureau of Economic Research, U.S. Bureau of Economic Analysis. Expansion duration uses monthly data through 5/31/17, as reported by NBER. Cumulative GDP Growth uses quarterly data through 3/31/17.

It’s indisputable. The current growth cycle has been around for a long time, a fact that has raised questions about how much longer it can continue.

Since World War II, the average U.S. expansion has lasted 64 months, producing 24% cumulative GDP growth. At 95 months, the current expansion is longer than average. But its 17% cumulative GDP growth rate is lower than average. Three growth cycles have spanned at least 90 months and have been stronger.

But history has shown that expansions don’t just die of old age. Recessions

generally are the result of a buildup of imbalances in the economy, such as high inflation, a buildup in inventory, or a stock or housing bubble.

There are no obvious imbalances in the economy today, and given the relatively modest pace of growth thus far in the cycle, it could take some time for any to build up.

To be sure, unexpected policy shifts, such as unfavorable trade negotiations, or external shocks could still trigger a recession.

With household balance sheets healthy and corporate interest expenses relatively low, conditions appear supportive of credit growth. Rising interest rates, along with the prospect of a less restrictive regulatory environment, could help boost profit margins for banks. Regional bank PNC Financial Services and conglomerates JPMorgan Chase and Wells Fargo are examples of companies that have strong credit card and commercial banking divisions.

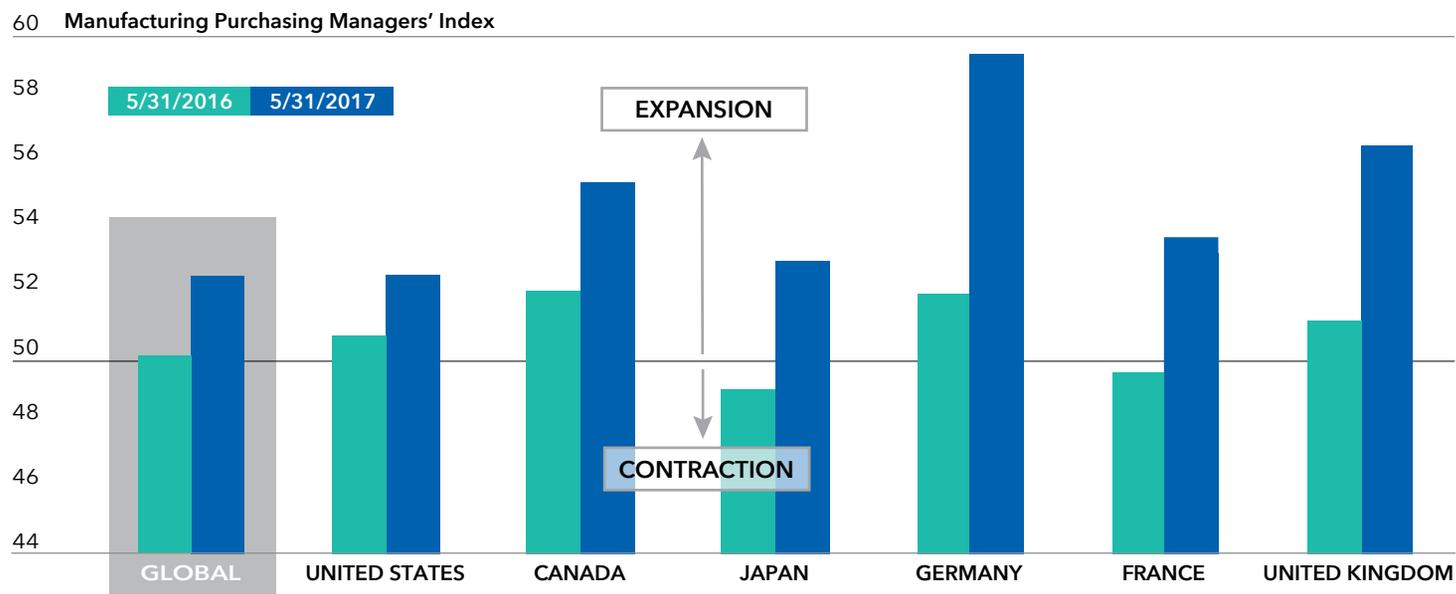
# Manufacturing a synchronized global recovery

After a lengthy slump, factory output around the world is ramping up

“The global economy is doing well and investor sentiment is improving, which is quite a departure from last year when everyone was worried about China, Brexit and negative interest rates. It’s not just the U.S. anymore, it’s Japan, Europe and a number of emerging markets where we are seeing better economic growth, rising consumer spending and signs of higher inflation.”

**LISA THOMPSON**  
PORTFOLIO MANAGER

## Industrial strength recovery: Survey points to expanding manufacturing activity all over the world



SOURCE: FactSet as of 5/31/17. The Purchasing Managers' Index is an indication of whether business conditions for a number of variables in the manufacturing sector have improved, deteriorated or stayed the same compared to the previous month. An index reading above 50 indicates an expansion in manufacturing, whereas a reading below 50 indicates a contraction.

Once the missing link in the global recovery story, the industrial sector has bounced back this year, powered by improvements in the U.S., Germany, France, the U.K. and China. Increasing demand and a gradually weakening dollar have acted as tailwinds for global manufacturing activity, while consumer spending has remained strong in many regions.

Threats to world trade and geopolitical stability are showing signs of diminishing. That trend was exemplified by France's presidential election, which could prove to be a turning point in the European recovery story. French voters' overwhelming rejection of populist, anti-EU candidates bodes well for European unity and could mark a key moment in time in Europe's ongoing recovery.

The improving macroeconomic environment should support growth for manufacturing companies across a range of industries. For example, Murata Manufacturing, a Japanese maker of electronic components, stands to benefit from rising demand for smartphones with faster data speeds. And European commercial aircraftmaker Airbus will likely see greater demand for its planes as air-travel volumes improve.

# International investing with an American accent

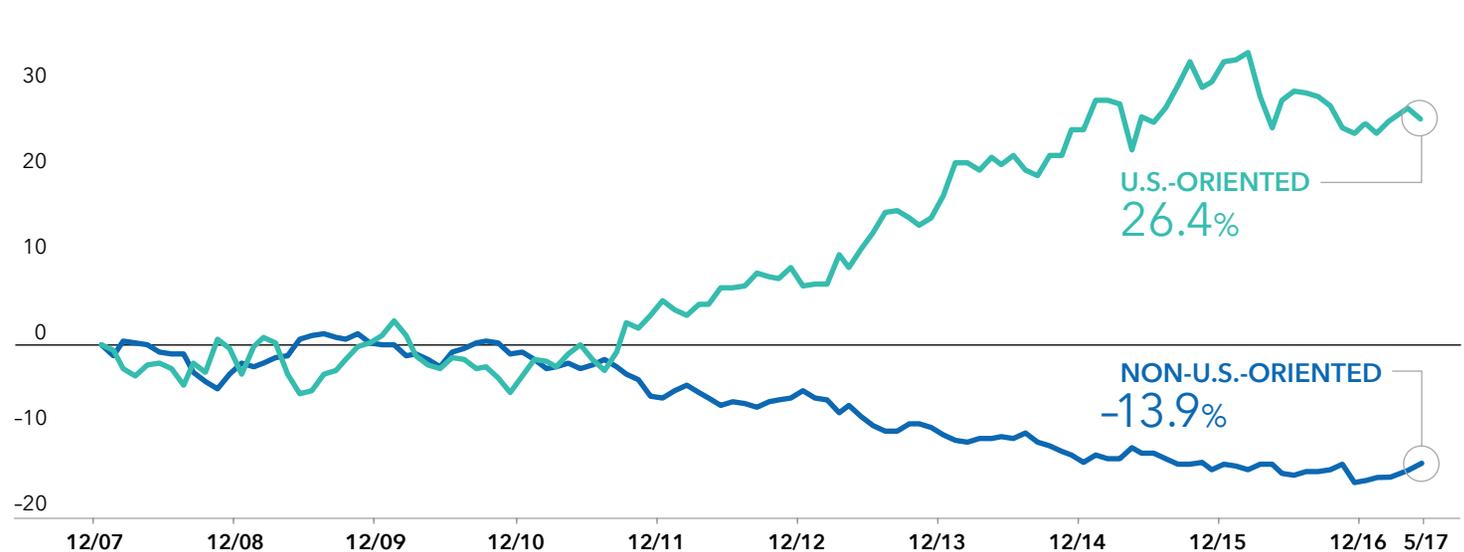
Exposure to the U.S. economy has boosted returns for many non-U.S. companies

“Fading political uncertainty in continental Europe has enabled investors to concentrate on what’s important: the underlying fundamentals. Companies in the euro zone are seeing a significant improvement in earnings growth, which reflects a stronger macroeconomic environment. After a protracted period of underperformance, there is scope for further relative gains in euro-zone stocks.”

**ROBERT LIND**  
ECONOMIST

## The divergence in returns shows that investing in companies is not the same as investing in economies

40% Cumulative relative return of non-U.S. companies vs. MSCI ACWI



SOURCES: Capital Group, FactSet, MSCI. Data represents cumulative relative returns of each category of non-U.S. companies to the MSCI ACWI since 12/31/07. “U.S.-oriented” includes all companies that generate over 40% of their revenues in the U.S. “Non-U.S.-oriented” includes all companies that generate less than 40% of their revenues in the U.S. Non-U.S. companies also exclude Canada. Returns are in USD as of 5/31/17.

Smart companies go where the growth is. Nowhere is this more evident than in Europe, where a number of agile global businesses have shifted their focus to the American consumer. Since 2008, shares of non-U.S. companies with significant exposure to the U.S. economy have done notably well. Challenges remain in Europe and Japan, but select companies may get a further lift as growth forecasts in both regions improve and consumer spending and manufacturing activity picks up.

Amid these signs of better economic growth and diminished political instability, there are a number of other reasons why international equities look more attractive. A gradually weakening U.S. dollar is helping to boost international investment returns for dollar-based investors. In addition, European equity valuations are appealing, particularly in relation to U.S. stocks, which have outpaced their European counterparts for more than eight years.

A number of leading companies abroad have managed to succeed on a global basis, despite difficulties in their home market. Examples of large international companies that have outpaced the global equity market since 2008 include Swiss foodmaker Nestlé, pharmaceutical companies Novartis and Roche, Japanese automaker Toyota, British American Tobacco and Anheuser-Busch InBev.

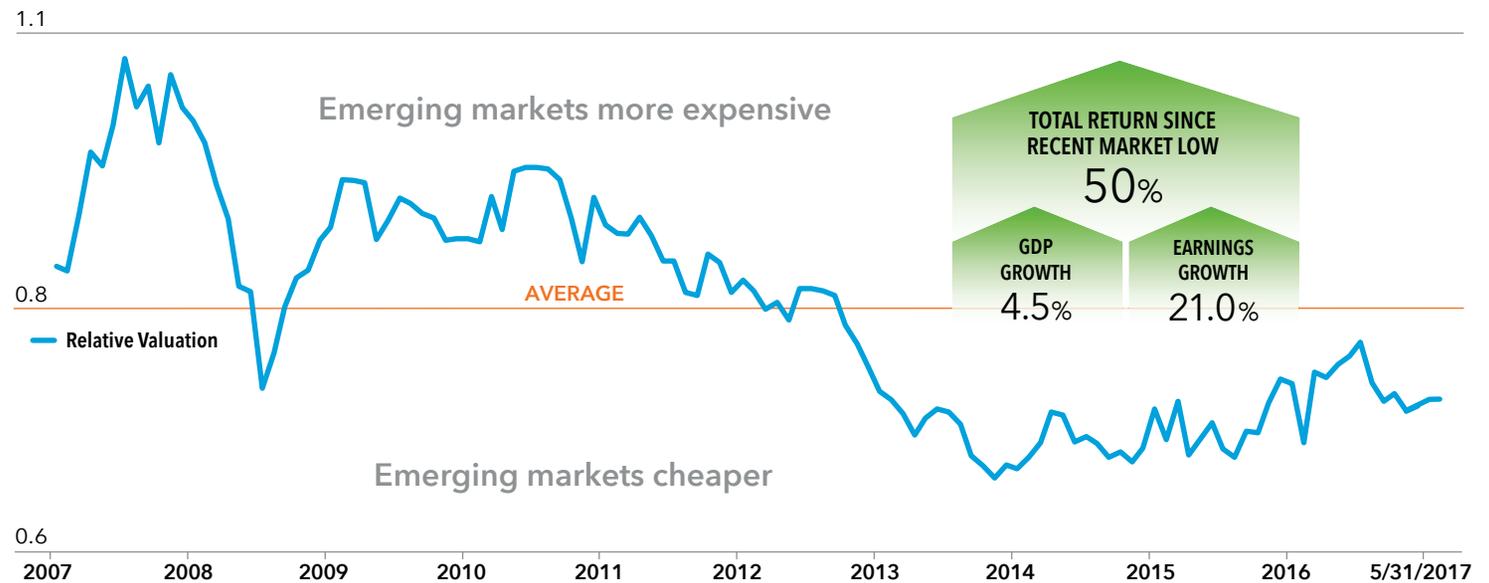
# After solid rebound, there may be room to run in EM

Valuations appear relatively attractive amid earnings turnaround and reform drive

“The country I am most excited about is India, where Prime Minister Narendra Modi is driving through numerous reforms, supporting technological innovations, tackling black money and introducing deep anticorruption efforts. Recent success for his party in India’s state elections demonstrates broad support for reform and that is encouraging.”

**CHRIS THOMSEN**  
PORTFOLIO MANAGER

## Emerging markets have soared since January 2016, but valuations remain relatively attractive



SOURCES: FactSet; International Monetary Fund, World Economic Outlook Database, April 2017; MSCI; RIMES. Relative Valuation compares the forward 12-month price-earnings ratio of the MSCI World and MSCI Emerging Markets indexes as of 5/31/17. Estimated EPS Growth is as of 5/14/17. Total Return is from 1/21/16-5/31/17. GDP Growth is the estimated 2017 GDP Growth, as reported by the IMF.

Emerging market equities have surged 50% since a trough in early 2016, supported by a sustained stimulus program in China, demand for a range of commodities and a more stable U.S. dollar. But after such a strong run, has EM reached a peak?

Don’t count on it. Even after the recent rally, EM has only averaged a 4.5% return over the last five years, compared to 15.4% in the U.S. Overall valuations also remain attractive compared to developed markets. For instance, Brazil and

China look like relative bargains, trading for less than 13 times projected earnings over the next year.

Corporate profits are picking up too, and historically that’s been good for share prices. In aggregate, earnings for companies in emerging markets are estimated to increase 21% in 2017 – the best growth since 2010 if achieved. Strong earnings are expected from the technology sector, while companies domiciled in India, China and Brazil are projected to see stable growth through 2018 following several uneven years.

What companies could thrive in this environment? Some examples include Tencent and Alibaba, innovative Chinese internet service providers benefiting from rapid growth in mobile commerce; Samsung, Taiwan Semiconductor and Hon Hai Precision, Asian electronics-component manufacturers boosted by increased content in mobile devices; and privately run Indian banks HDFC and Kotak Mahindra, which may be aided by the country’s pace of growth.

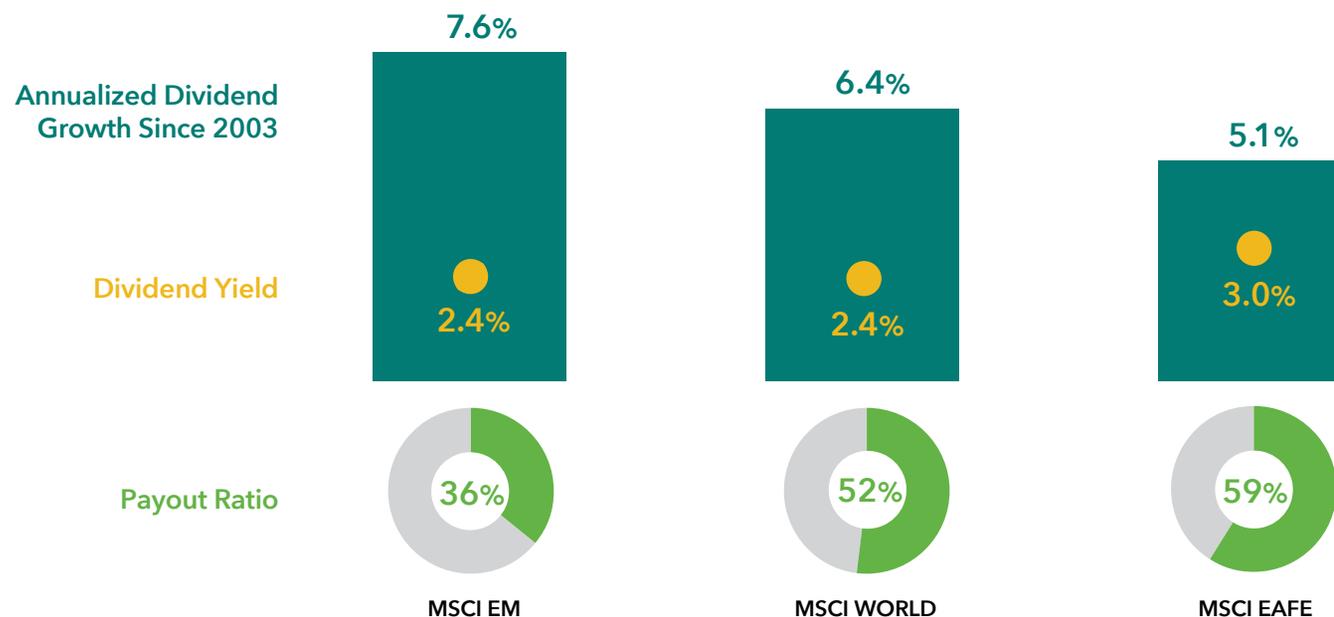
# In emerging markets, dividends are growing in importance

Relatively low payout ratios leave room for further potential dividend growth

“Dividend income is every bit as important to long-term returns in emerging markets as it is in developed countries. Over the years, we have found that emerging market companies that pay dividends quite often turn out to be superior investments. As these companies mature, we expect dividends to play a more prominent role in total returns.”

**SHAW WAGENER**  
PORTFOLIO MANAGER

Dividends are becoming an increasingly additive component of total return for emerging markets stocks



SOURCES: MSCI, RIMES as of 5/31/17. Annualized dividend growth is from 12/31/03 to 5/31/17.

When considering reasons to invest in emerging markets, dividends may not be near the top of the list – but perhaps they should be. Since 2003, emerging markets have grown dividends by an average of 7.6% per year, faster than in developed non-U.S. markets and comparable to the U.S. But unlike the U.S. and other developed markets, emerging markets payout ratios are relatively low, so there may be more room for growth as earnings rise and cash flows improve.

The reasons for investing in dividend-paying companies in emerging markets mirror those for developed markets: Dividends can be an indicator of effective corporate governance and point to the presence of a successful management team focused on the best interests of shareholders. They also imply that a company is confident in its balance sheet as well as in its expectation to grow earnings and cash flows to support future payments.

Got dividends? When seeking income potential, long-term investors should cast a wider net outside of the U.S. and focus on companies with reputations as dividend payers. The range of dividend payers in developing markets is broad. For example, Taiwan Semiconductor and African grocer Shoprite Holdings both have consistently increased their dividend payouts over the years.

# Don't bail on bonds in a rising rate environment

Yes, U.S. rates have risen, but they should remain relatively low

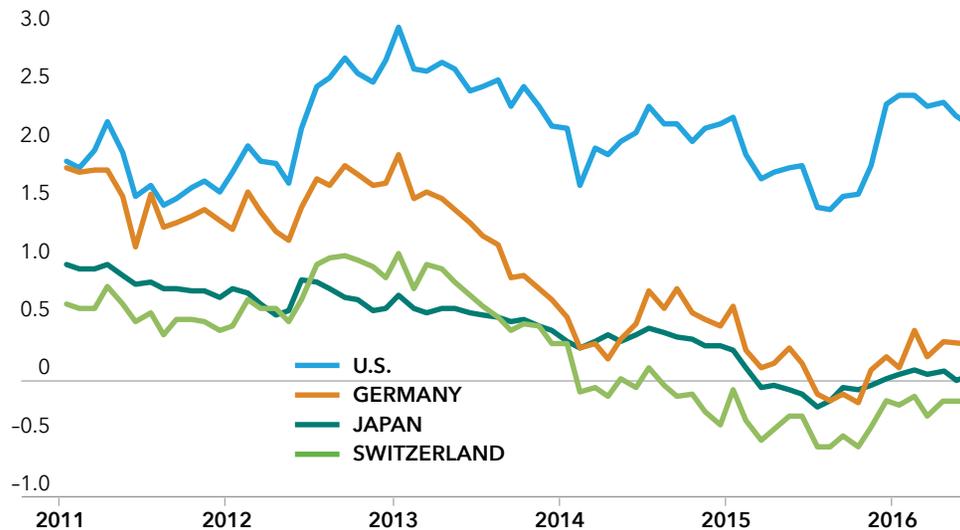
“Three-year Treasury yields have doubled over the past year, and the 10-year yield is up half a percentage point since the election. These rising rates reflect improving economic expectations. While policy changes may justify some optimism, growth should remain fairly slow. This view, coupled with relatively less attractive yields in other developed markets, should keep any increase in U.S. yields somewhat in check.”

**DAVID HOAG**  
PORTFOLIO MANAGER

SOURCE: Thomson Reuters. As of 5/31/17. Table calculations assume 5-year duration bonds, which would incur 5% capital losses for every 1% that rates rise.

## External factors point to gradually rising rates in the U.S. ...

3.5 10-year government bond yields (%)



The Federal Reserve finally appears to be following through with its effort to move short-term rates higher. Policy expectations coming out of U.S. election results paired with improving economies overseas have helped brighten growth expectations, which have also helped to push yields higher.

Despite this backdrop, rates face an uphill battle. Policy changes may turn out more modest than the market's best-case scenario and take longer to materialize. The Fed also remains very cautious in its

tightening, as a sharp global shock could knock it off of its planned path. Add in continued robust demand from global and domestic investors for bonds, and yields may remain in a relatively low range.

However, even if rates do rise more than these factors suggest, as long as they rise gradually bond funds could absorb associated price declines. And an offset from higher yields can help to prevent losses in fixed income.

## ... So, what do you stand to lose when rates rise?

### IMPACT OF RISING YIELDS

Consider a 1% increase in yields over two years.

	Capital Loss	+ Yield	= Total Return
Year 1	-2.50%	2.50%	0.00%
Year 2	-2.50	3.00	0.50
After two years		<b>3.50</b>	<b>0.50</b>

From a global standpoint, U.S. bond yields look very attractive. Although the negative rates experiment may be over, yields in other developed countries remain much lower than what can be found in the U.S. market.

Bond math shows that as rates rise gradually, additional interest income could more than cover associated price declines to keep total return positive.

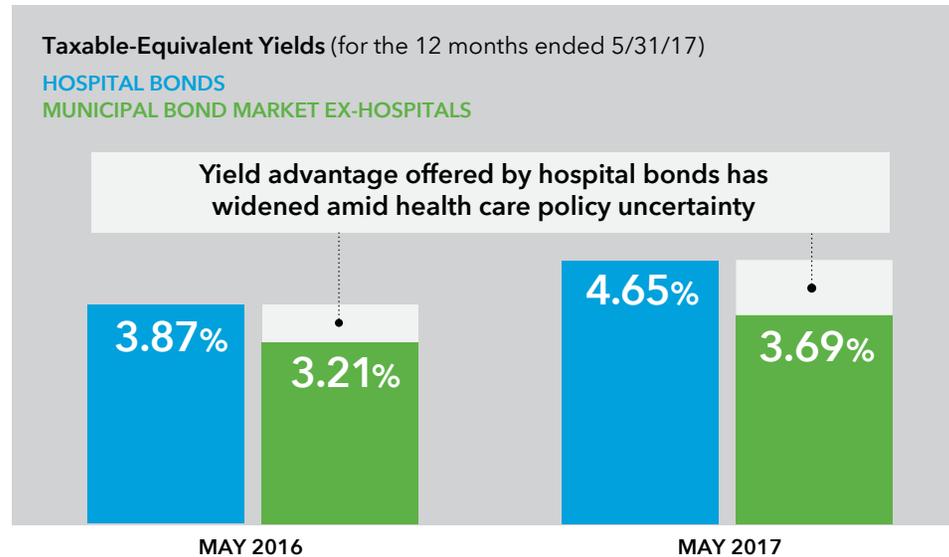
# Munis: Healthy prognosis for hospital bonds and beyond

Look through near-term uncertainty to find compelling income potential

“Research allows us to be selective. Fiscal distress can create good opportunities to invest in projects and nonprofit organizations without taking governmental repayment risk. In states and municipalities, as well as territories like Puerto Rico, we have often found relative value by investing around specific trouble spots.”

**KARL ZEILE**  
PORTFOLIO MANAGER

## Not-for-profit hospitals offer relative value opportunities amid a wave of consolidation



Despite the rise of health care megasystems, there are **>3,900** outstanding hospital bonds.



Typically, those bonds carry an **A RATING** and offer an after-tax yield **>5%**

SOURCE: Bloomberg Index Services Ltd. Taxable-equivalent yields are as of 5/31/16 and 5/31/17.

Income from municipal bonds may be subject to state or local income taxes and/or the federal alternative minimum tax. Certain other income, as well as capital gain distributions, may be taxable. Methodology for calculation of taxable-equivalent yield: Based on 2016 federal tax rates. For the year 2016, there will be an Unearned Income Medicare Contribution Tax of 3.8% that applies to net investment income for taxpayers whose modified adjusted gross income exceeds \$200,000 (for single filers) and \$250,000 (for married filing jointly). Thus taxpayers in the highest tax bracket will face a combined 43.4% marginal tax rate on their investment income. The federal rates do not include an adjustment for the loss of personal exemptions and the phase-out of itemized deductions that are applicable to certain taxable income levels. Index proxies for muni market is Bloomberg Barclays Municipal Bond Index. The indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in indexes.

Puerto Rico. Higher interest rates. Health care and tax reform proposals. These are a few of the reasons behind some commentators' predictions of muni market mayhem in 2017. So far, so wrong. Broad returns have been solid and, for the most part, the market has digested these developments with barely a hiccup. That said, municipal bond yields do remain above average 2016 levels and relative value has emerged in various revenue bond sectors.

Revenue bonds – such as those linked to hospitals, schools or toll roads – account for more than two-thirds of the investable universe. For this type of muni bond, the credit fundamentals of the corporate or nongovernmental issuer are what really matters. Furthermore, volatility centered on specific issuers such as Puerto Rico, or broader factors like a Fed rate hike, can have a silver lining – creating attractive entry points for selective investors.

For income-seeking investors, munis remain hard to ignore. Investors comfortable with more volatility should consider high-yield munis as they've tended to be less correlated to stocks than taxable bonds – making them a great source of diversification and income potential (taxable-equivalent yields have been over 10% in 2017).

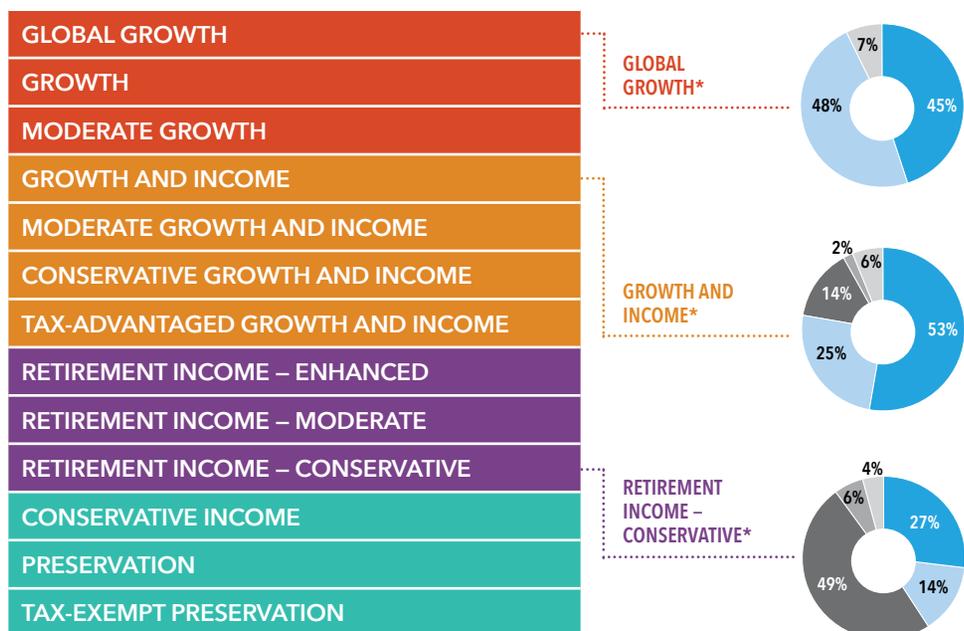
# Portfolio implementation

Capital Group has developed 13 model portfolios that pursue a wide variety of investment goals. These portfolios offer exposure to many of the themes and takeaways outlined here. Each portfolio, built with several of the American Funds, is conceived and managed according to the following principles:

- Objective-based strategies designed to pursue concrete outcomes like appreciation, income and preservation.
- A flexible bottom-up approach to asset allocation.

## 13 Objective-Based Portfolios

With the American Funds as their building blocks, these portfolios take a flexible, risk-sensitive approach to crucial investor goals.



As of 3/31/17.

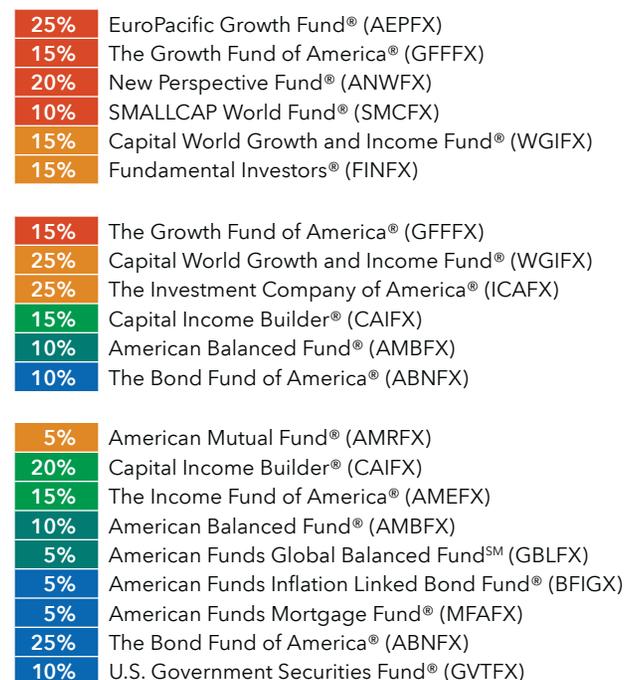
\*Holdings are weighted averages of each model portfolio's underlying funds. The underlying funds are managed, so holdings will change. Cash and equivalents includes short-term securities, accrued income and other assets less liabilities.

### Asset Mix

- U.S. equities
- Non-U.S. equities
- U.S. bonds
- Non-U.S. bonds
- Cash & equivalents

## Model Portfolios for Every Investor

Here are three model portfolios for investors to consider depending on their time horizon and risk tolerance.



### Underlying Fund Allocation (F-2 Ticker)

- Growth
- Growth and Income
- Equity Income
- Balanced
- Bond
- Tax-Exempt Bond

# 2017 Midyear Outlook: Global Economic Picture Brightens

	U.S.	Global/International	Emerging Markets	Municipal Bonds	Taxable Bonds
<b>Headwinds</b>	<ul style="list-style-type: none"> <li>Equity valuations remain stretched</li> <li>Possibility of inflation picking up</li> <li>Risk of external shocks, such as slowdown in China</li> </ul>	<ul style="list-style-type: none"> <li>Persistently high unemployment</li> <li>Soaring government debt levels</li> <li>Potential for disruption from any unforeseen external shock</li> </ul>	<ul style="list-style-type: none"> <li>Uncertainty over global trade agreements</li> <li>Geopolitical risk, particularly as a result of strife in Syria, Korea and Brazil</li> <li>Lack of clarity over direction of China policy beyond October central planning meeting</li> </ul>	<ul style="list-style-type: none"> <li>Tax-policy changes may disrupt balance of supply and demand</li> <li>Abrupt rise in Treasury yields could trigger volatility</li> <li>Pension liabilities weigh on state, local governments</li> </ul>	<ul style="list-style-type: none"> <li>Fed tightening is now well under way, with more action likely later this year</li> <li>Bonds could struggle as investors show preference for equities</li> <li>A rise in global yields could impact U.S. bonds</li> </ul>
<b>Tailwinds</b>	<ul style="list-style-type: none"> <li>The industrial sector is recovering, in some cases robustly</li> <li>Corporate profits have picked up</li> <li>Inventories are at healthy levels</li> <li>Consumer balance sheets are healthy</li> <li>Housing cycle still going strong</li> </ul>	<ul style="list-style-type: none"> <li>Attractive valuations relative to the U.S.</li> <li>Surprisingly upbeat growth, particularly in Europe</li> <li>With election of Macron in France, political risk receding</li> <li>U.S. dollar headwind has eased</li> </ul>	<ul style="list-style-type: none"> <li>Ongoing China stimulus</li> <li>Stable commodity prices</li> <li>Easing of U.S. dollar strength</li> <li>Improving current account balances</li> <li>Broadly positive global growth picture</li> </ul>	<ul style="list-style-type: none"> <li>Lower-for-longer scenario still supportive of bond prices</li> <li>Yield advantage prized by U.S., international investors</li> <li>Volatility could create attractive entry points</li> </ul>	<ul style="list-style-type: none"> <li>A steady, gradual rise in yields could boost demand for bonds</li> <li>Companies appear well positioned to refinance or deleverage as the economy strengthens</li> <li>Emerging markets appear stable</li> </ul>
<b>Key takeaways</b>	The U.S. is firing on more cylinders, but with valuations stretched in many areas of the market, selective investing is critical.	The European economy has turned a corner and equity valuations remain relatively attractive.	A number of emerging markets have roared back to life since early last year, but company valuations and earnings growth suggest there may be room to run.	Diverse and attractive yield opportunities remain, though return potential may moderate and volatility could rise.	Rates are clearly rising, albeit at a slow pace, and bonds continue to play an important risk-dampening role in portfolios.
<b>Investments to consider</b>	<b>The Investment Company of America®</b> A – AIVSX; C – AICCX; F-2 – ICAFX; R-3 – RICCX; R-6 – RICGX	<b>Capital Income Builder®</b> A – CAIBX; C – CIBCX; F-2 – CAIFX; R-3 – RIRCX; R-6 – RIRGX	<b>New World Fund®</b> A – NEWFX; C – NEWCX; F-2 – NFFF; X; R-3 – RNWCX; R-6 – RNWGX	<b>American High-Income Municipal Bond Fund®</b> A – AMHIX; C – AHICX; F-2 – AHMFX	<b>The Bond Fund of America®</b> A – ABNDX; C – BFACX; F-2 – ABNFX; R-3 – RBFXX; R-6 – RBFXX
Ticker symbols	<b>The Growth Fund of America®</b> A – AGTHX; C – GFACX; F-2 – GFFF; X; R-3 – RGACX; R-6 – RGAGX	<b>EuroPacific Growth Fund®</b> A – AEPGX; C – AEPXX; F-2 – AEPFX; R-3 – RERXX; R-6 – RERGX		<b>The Tax-Exempt Bond Fund of America®</b> A – AFTEX; C – TEBXX; F-2 – TEAFX	<b>American Funds Emerging Markets Bond Fund®</b> A – EBNAX; C – EBNCX; F-2 – EBNFX; R-3 – REGXX; R-6 – REGGX
	<b>American Mutual Fund®</b> A – AMRMX; C – AMFCX; F-2 – AMRFX; R-3 – RMFCX; R-6 – RMFGX	<b>New Perspective Fund®</b> A – ANWPX; C – NPFCX; F-2 – ANWFX; R-3 – RNPCX; R-6 – RNPGX			<b>American Funds Strategic Bond Fund<sup>SM</sup></b> A – ANBAX; C – ANBCX; F-2 – ANBFX; R-3 – RANXX; R-6 – RANGX
	<b>American Balanced Fund®</b> A – ABALX; C – BALCX; F-2 – AMBFX; R-3 – RLBCX; R-6 – RLBGX				
	In addition to the above funds, we also offer 13 American Funds model portfolios and a number of Separately Managed Account strategies, including the <b>Capital Group International Equity SMA, Global Equity SMA and World Dividend Growers SMA</b> , available through select broker-dealers.				

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