Outlook

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CAPITAL GROUP®

Long-term perspective on markets and economies

2021 Outlook: Turning points on the road to recovery

We may one day look back at 2021 as a major turning point for the global economy, public health, politics, and how we live and work in the digital age. Here are the key takeaways from Capital Group's 2021 Outlook.

MACRO

The world is turning the corner toward recovery.

Economic growth is making a comeback. The International Monetary Fund (IMF) estimates that global GDP will climb 5.2% in 2021. But risks to recovery remain, chief among them a resurgence of COVID-19.

Low rates continue to support asset prices. With interest rates seemingly "lower forever," equity markets may move higher if investors flock to stocks in search of better returns than those offered by other asset classes.

EQUITY

The future is here, and it's digital.

Digital leaders across industries are leaping ahead of the competition. Companies with fast and efficient online business models are soaring above the terrestrial competition, disrupting the status quo.

Not all experiences can be digitized. Pent-up demand is poised to fuel a comeback in travel and other hard hit sectors as people yearn to go on their next vacation or simply go out to dinner.

Think all innovation is in the U.S.? Think again. Europe and Asia lead the world in some of tomorrow's technology, from renewable energy to digital payments.

FIXED INCOME

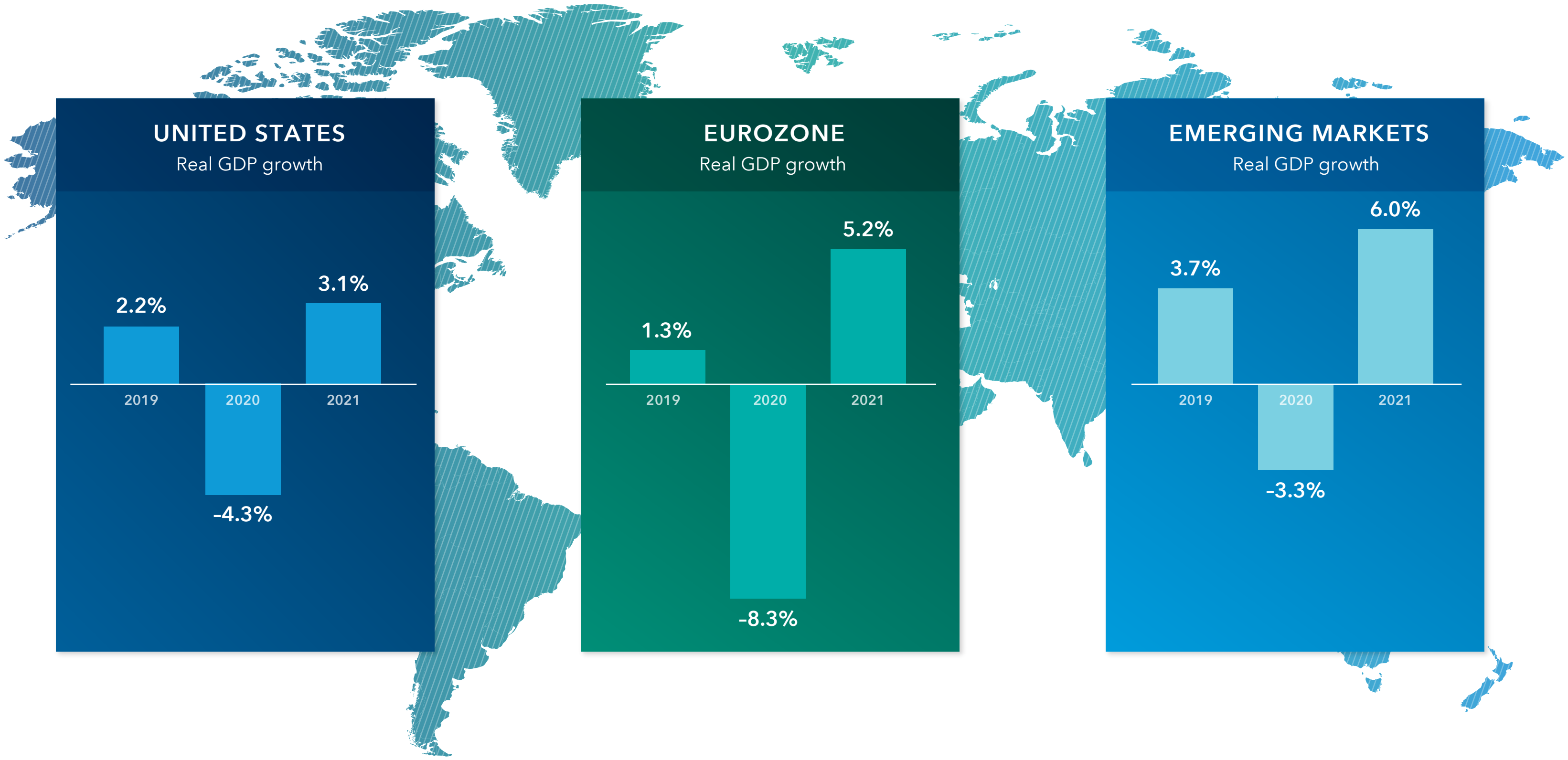
Core strength matters when life is uncertain.

Strong core bond allocations remain a smart strategy. 2020's fastest equity decline in history showed how important it is to continue to hold high-quality bonds as a buffer to market volatility.

After big inflows into corporate bonds, it's time to be selective. Investors are rushing into corporate bonds in search of higher income, so beware of taking on too much risk.

Municipal bonds continue to look attractive, offering favorable levels of tax-advantaged income and more diverse opportunities.

The world is turning the corner toward recovery



The global economy is experiencing a serious case of whiplash. The pandemic-induced shutdown of 2020 — which caused the worst recession since the Great Depression — is expected to be followed by solid growth in 2021 across major economies, according to the International Monetary Fund (IMF).

The recovery in China, which has largely contained the pandemic and opened its economy, has been surprisingly swift. The world's second-largest economy was expected to grow in both 2020 and 2021.

In the U.S., which enjoyed a record 33.1% annualized GDP growth in the third quarter of 2020, the IMF anticipates the economy will expand 3.1% in 2021. That follows an expected decline of 4.3% for 2020 overall.

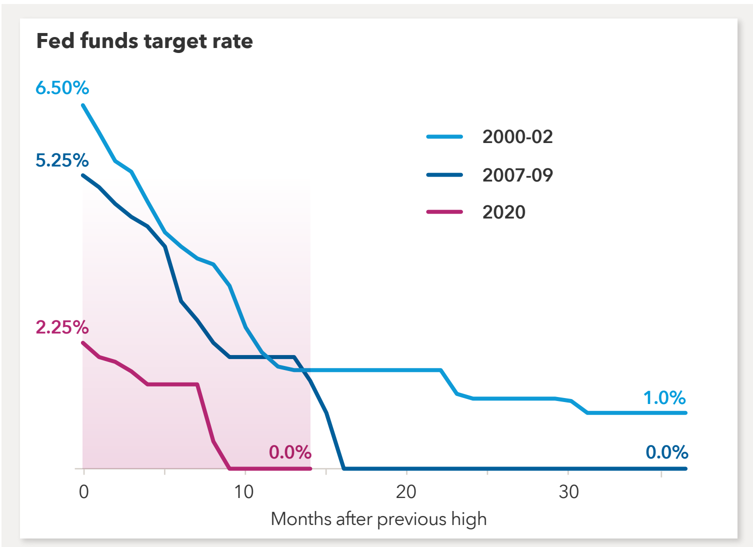
"All economic growth forecasts depend on the trajectory of the vaccines," says Capital Group U.S. economist Jared Franz. Indeed, risks to a sustained recovery remain — chief among them a resurgence of COVID-19.

When will vaccines be widely available? "We've already seen some promising data from Pfizer, Moderna and other companies' trials," says equity portfolio manager Rich Wolf. "Granted, it will take time for a vaccine to be made widely available and to convince people to take it. That said, as of late November it appeared we would have two vaccines available under emergency use authorization by the end of 2020. I expect there will be at least four vaccines widely available by midyear 2021."

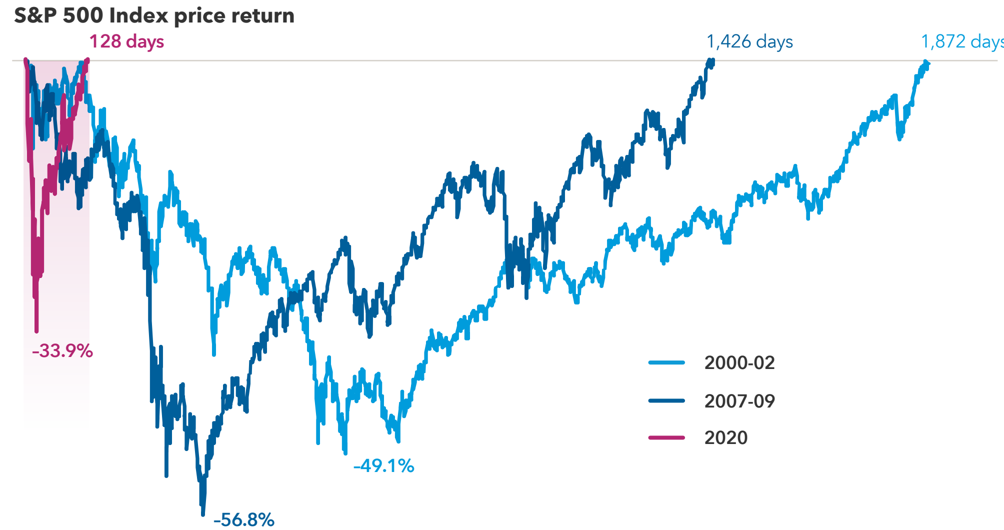
SOURCE: International Monetary Fund, *World Economic Outlook*, October 2020. GDP figures for 2020 and 2021 are projections.

Low rates, high markets: Central banks continue to support asset prices

The Fed cut rates in record time in 2020



Markets responded with the fastest recovery in history



As the coronavirus raced across the globe, the U.S. stock market took a wild ride of its own, plummeting more than 33%, recovering to its previous high in record time and reaching new heights in September. Since then, with the economy still digging out of recession, markets have remained elevated, if volatile.

Swift, aggressive action by the U.S. Federal Reserve and other central banks to cut rates and establish lending programs played a key role in the turnaround.

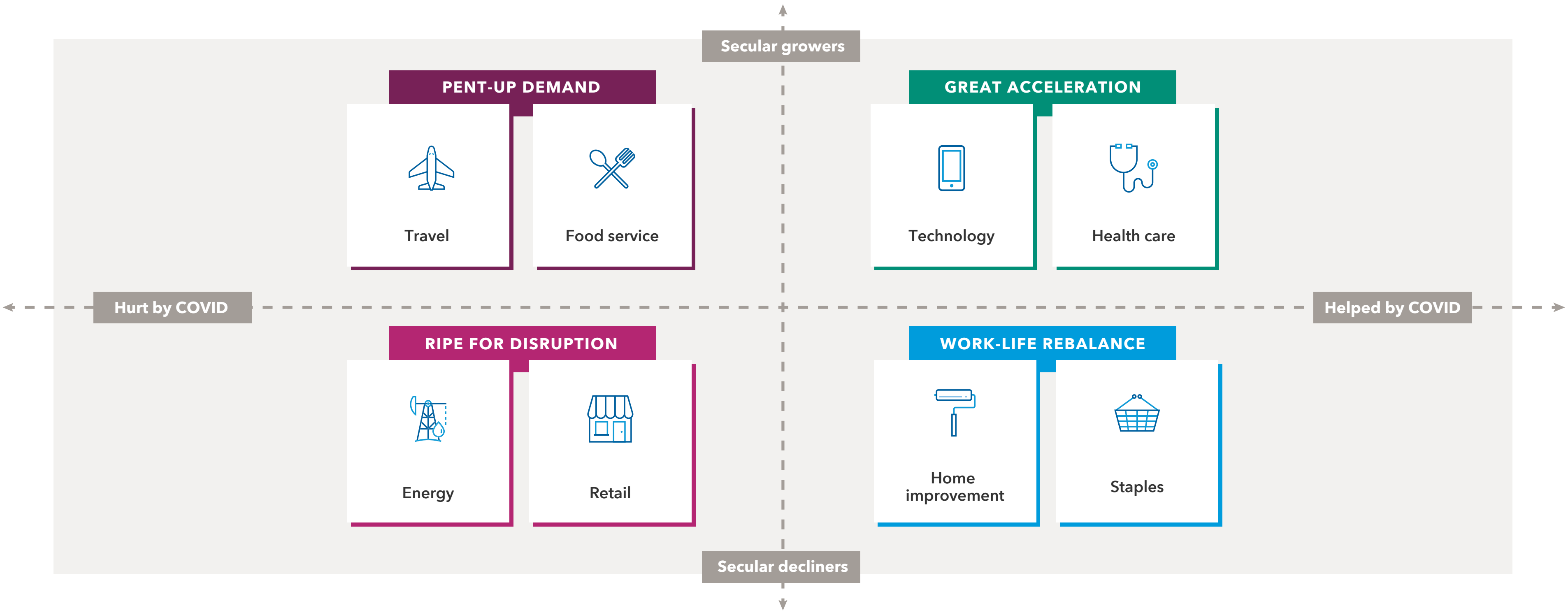
An ultralow interest rate environment encourages investors to move into riskier assets, stocks in particular. "High-valuation growth stocks were market leaders both on the way down and on the way up – a historically unusual pattern," says Capital Group portfolio manager Chris Buchbinder. "Looking further out, I expect a broader recovery across more sectors."

How long will rates remain near zero? Fixed income portfolio manager Pramod Atluri says, "The Fed has committed to maintaining near zero interest rates well into the recovery. I do not expect any rate hikes for the next two to three years."

What's more, with the 2020 U.S. election now in the rearview mirror, markets could get a further boost from government stimulus.

SOURCES: (Left chart) Federal Reserve. As of 11/30/20. In periods when the Federal Reserve had a target range, the lower bound has been used. (Right chart) RIMES, Standard & Poor's. As of 11/30/20. Returns are in USD.

A framework for evaluating COVID winners and losers



With all the talk about V-shaped, U-shaped and W-shaped economic recoveries, K-shaped may be the more appropriate alphabetical symbol. Major sectors of the economy have moved in sharply different directions, reflecting the disparity between companies that have benefited from the COVID-19 pandemic and those that have been crushed by it.

For some areas of the economy – restaurants, hotels, retailers, airlines and small businesses – it has literally been the worst of times. On the other end of the spectrum, the stay-at-home era has been a boon for e-commerce, cloud computing, video streaming, digital payment processors and home improvement stores.

As the recovery grinds along, separating the long-term winners from the losers will be the No. 1 job for investors who value fundamental, bottom-up research and highly selective investing.

"The post-pandemic economy is going to look very different than the one we had in February 2020," says Capital Group economist Jared Franz. "It's going to be more efficient and more dynamic, but there will be winners and losers. Our job is to identify them – finding the growing companies that have not only benefited from the pandemic but also have the potential to continue generating solid growth in a post-pandemic world."

SOURCE: Capital Group.

Digital leaders across industries are leaping ahead of the competition

The digital gap that existed long before the coronavirus outbreak has suddenly become a digital Grand Canyon.

Companies with fast and efficient online business models are soaring above the terrestrial competition, disrupting the status quo and displacing old-economy stalwarts. This broad-based investment theme crosses many key sectors of the economy – from retailing and entertainment to advertising and payment processing. Even the fitness industry is getting a vigorous digital workout.

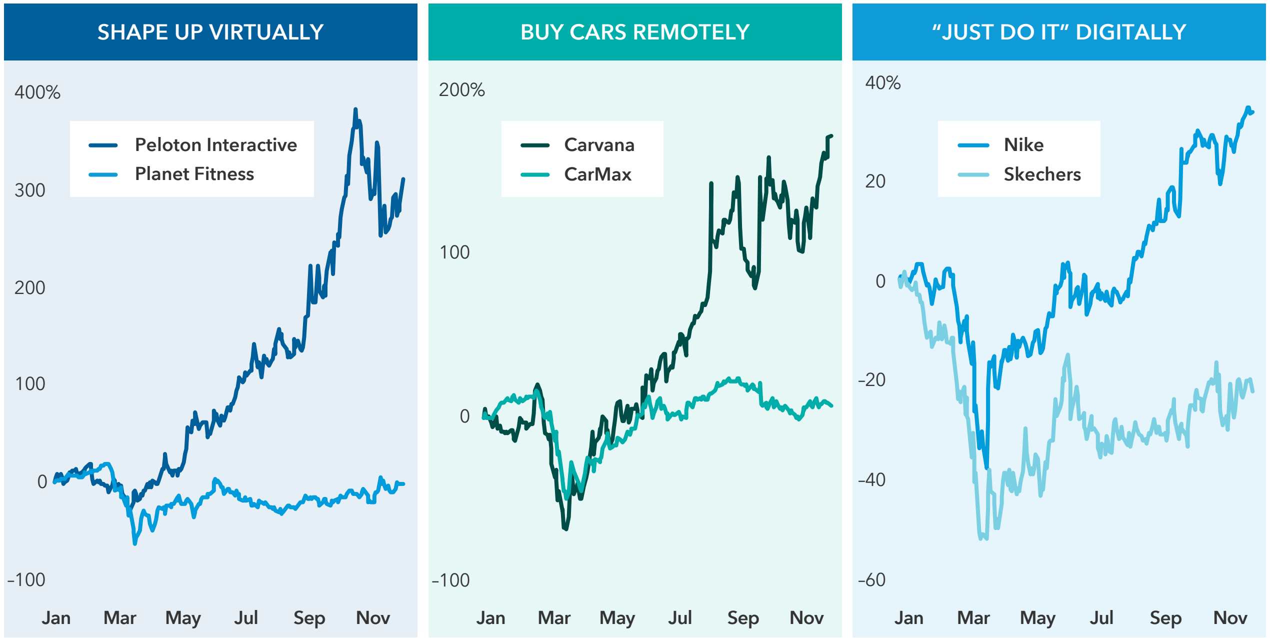
"We were already headed in this direction when COVID came along and gave it a huge shove forward," says portfolio manager Chris Buchbinder. "The growth rates at companies with a digital advantage have been phenomenal during the downturn and, in my view, we're not going back. When the pandemic is over, we may see slower growth rates, but I don't think a lot of people will be canceling their Netflix subscriptions or returning their Peloton bikes."

Investors should keep in mind, however, that the digital advantage only goes so far. While it is a powerful force in many industries, there are some places where it takes a back seat to good old-fashioned manufacturing muscle.

As Buchbinder says: "There are no digital aircraft engines."

Companies with strong online business models have an advantage

Cumulative returns year-to-date



SOURCE: Refinitiv Datastream. As of 11/30/20. Returns are total returns in USD.

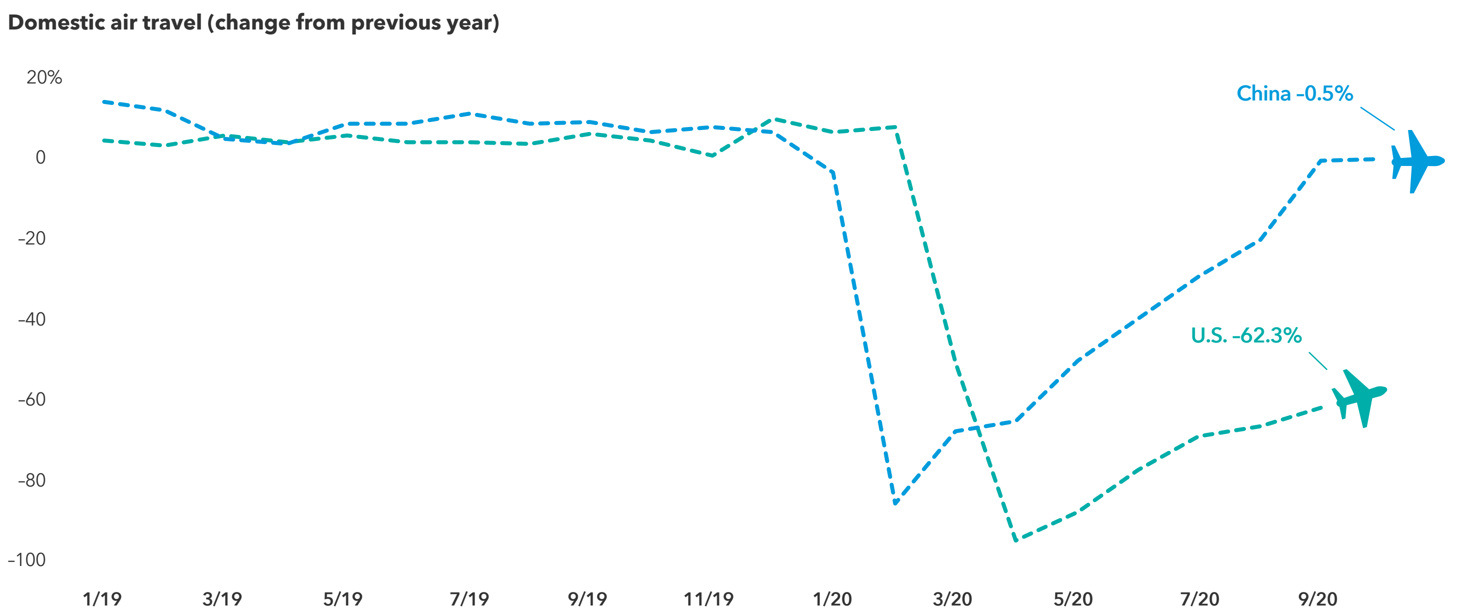
Pent-up demand: Some experiences can't be digitized

Have you heard of the flight to nowhere? On October 10, 2020, after months at home, 150 restless passengers boarded Qantas flight QF787 for a seven-hour flight from Sydney, Australia to … Sydney, Australia – just for the sake of traveling. The flight sold out in 10 minutes.

Few experiences animate the human spirit like the desire to travel, which gives equity investment analyst Todd Saligman confidence that demand for airlines and even cruises will bounce back. "The question is how quickly," says Saligman, who covers U.S. and European airlines and U.S. cruise lines. "I believe it will happen quickly once we get a vaccine. We also saw this after the September 11 attacks. A lot of people thought consumers would never fly again, and traffic recovered relatively quickly." Indeed, in China, where the virus is largely under control and the economy has rebounded, domestic air travel has nearly returned to pre-COVID levels.

Cruising has resumed in Europe, and the U.S. has lifted its "no sail" order provided ships meet strict health and cleanliness standards. "This industry has gotten so much negative media, yet people are still booking cruises for next year at prices higher than they were in 2019," adds Saligman. "That's pretty indicative of the pent-up demand for leisure travel."

Domestic air travel in China is soaring back. Will the U.S. follow?

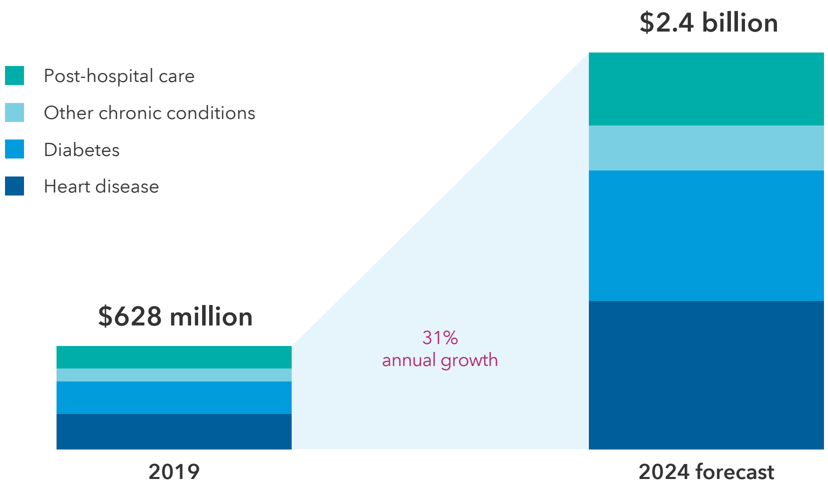


SOURCES: Capital Group, Bloomberg, Bureau of Transportation Statistics. China data is the change in combined revenue passenger kilometers of the three largest Chinese airlines and is through 10/31/20. U.S. data is the change in U.S. airline passengers and is through 9/30/20.

House calls are coming to health care

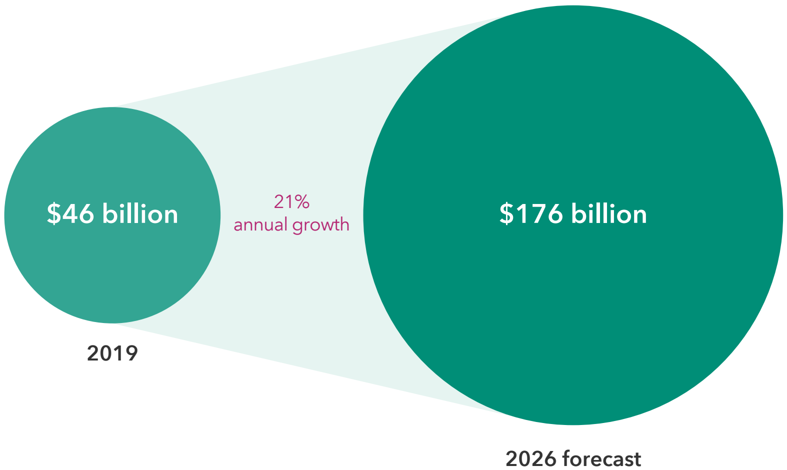
Home monitoring devices are gaining traction

Revenue of internet-connected home monitoring devices



Telemedicine growth expectations have accelerated

Global telemedicine market size



The future of health care is here, and it's coming to your house.

While the world's attention has been focused on the need for a COVID vaccine, stunning advances in medical technology, combined with shifts in consumer behavior, are converging to improve outcomes for patients, drive down medical costs and generate opportunity for companies. "There's never been a more exciting time in health care," says equity portfolio manager Rich Wolf.

Consider the recent spike in demand for online doctor visits. The service has been available for a few years, but its use was sparse until the pandemic struck. "Telemedicine was already a wave, but COVID and relaxed rules by regulators turned it into a tsunami," Wolf adds.

What's more, advances in home diagnostics – including continuous glucose monitors and insulin pumps for diabetes, as well as wearable monitors that track irregular heartbeats and other signs of heart disease – are allowing doctors to monitor patients remotely.

"We're still in the early stages of cost-efficient devices that can send a variety of health-related metrics to physicians or assist the patient in managing their own care," notes Wolf. "And there's a big opportunity for companies to fill this need ranging from connectivity to data management."

A range of companies could address the rising demand for remote monitoring, including DexCom, ResMed, Insulet, Tandem, iRhythm and Abbott Laboratories. It also includes telemedicine services like those offered by Teladoc and UnitedHealth.

SOURCES: (Left chart) Industry & government data, Kagan estimates, Standard & Poor's. Data compiled June 2020. (Right chart) Capital Group, Statista. As of 4/30/20. Forecast includes impact of COVID-19. Values in USD.

Renewable energy is lighting up the globe

Renewable energy is not just a bunch of hot air. The global shift to green energy sources is gaining steam as traditional utilities are relying less on carbon-based energy and increasingly on wind and solar.

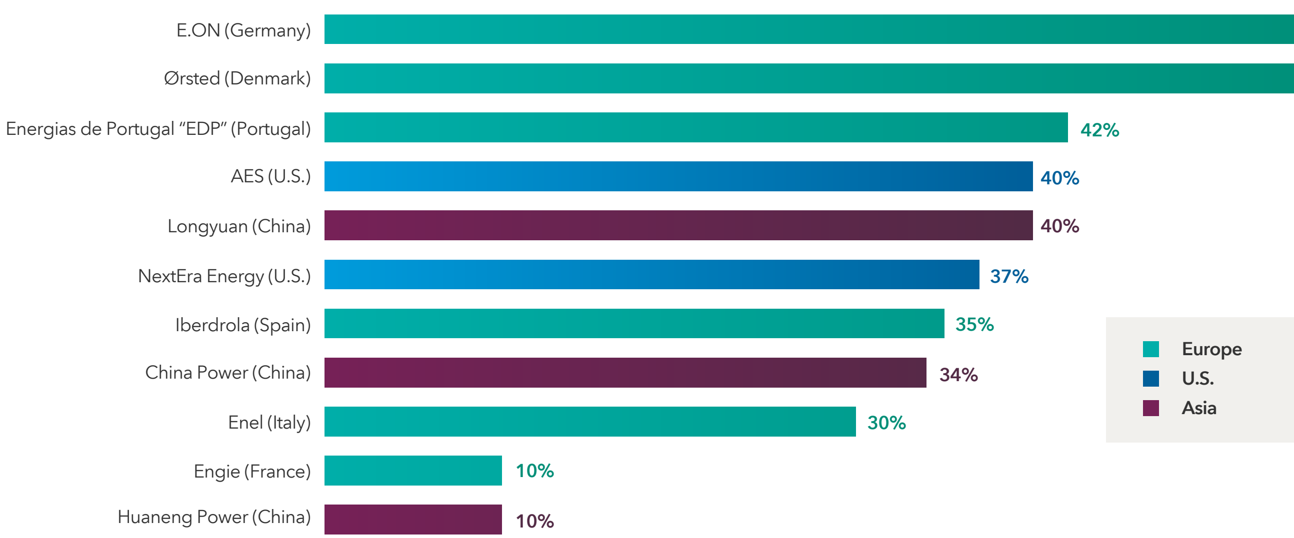
"We are in the early stages of the transition to an electrification of the grid and green energy, and there are strong tailwinds that could drive growth for years," says equity portfolio manager Noriko Chen. "Some traditional utilities are reaching an inflection point where they are starting to be recognized more as growth companies rather than just staid, old-economy power generators and grid operators." China has also recently announced it aims to cut its net carbon dioxide emissions to zero by 2060.

A number of factors are setting the stage for a golden age in renewables. Among these are declining costs, thanks to advances in automation, AI driving productivity and efficiency, lower energy costs and more effective storage. The move toward renewables is most pronounced in European utilities, including Enel in Italy, E.ON in Germany and Denmark's Ørsted. Their governments have set high decarbonization targets and created incentives for further investment – not only in electricity grids and infrastructure, but also in battery storage and other technologies that could accelerate demand.

"As we have seen with solar and wind energy, as you get closer to economic breakevens you see more investment going into the sector," notes Chen. "We are carefully watching for turning points for other renewables, like green hydrogen."

European utilities are among the leaders in renewable energy capacity

Renewables as a % of total energy capacity



SOURCE: Capital Group. Estimates are for fiscal year 2020 as of 11/18/20.

Think all innovation is in the U.S.? Think again

Cash is no longer king, especially outside the U.S.

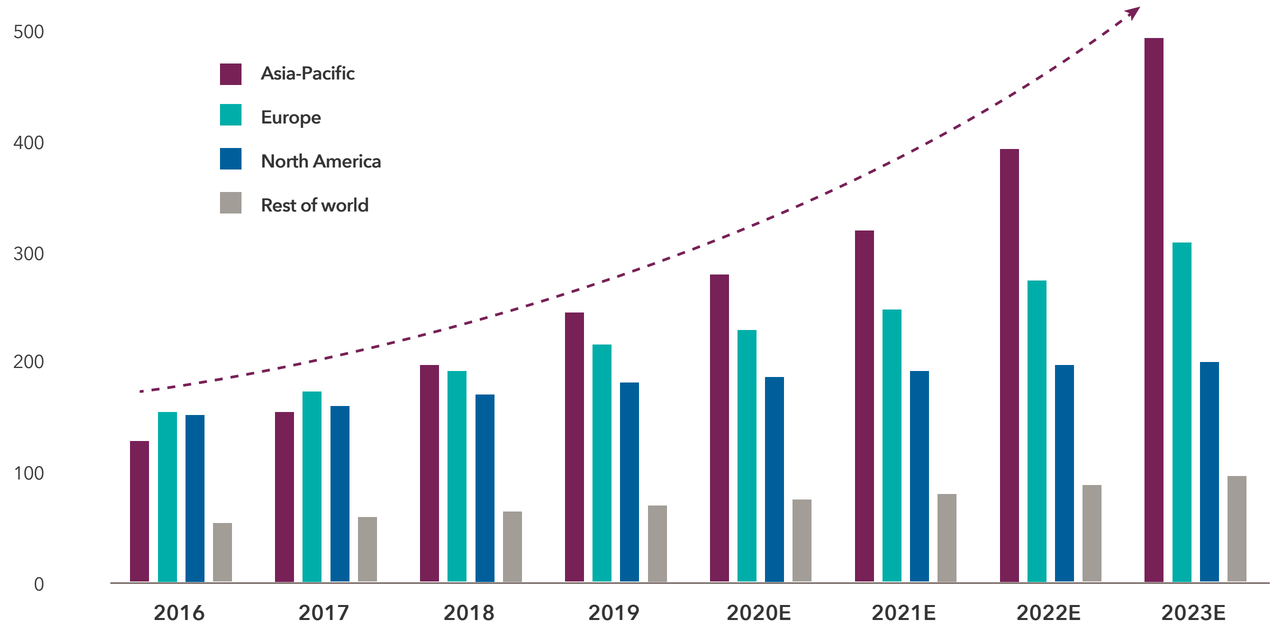
That's because innovation in digital payments has gained more traction abroad. For example, in emerging markets – where several years ago many consumers had no bank accounts but *did* have mobile phones – mobile payment technology has quickly been adopted. Yeahka in China and PagSeguro and StoneCo in Brazil, which offer mobile payment platforms for merchants, have seen strong growth for their services.

The global health crisis has accelerated use of mobile payments not only in emerging markets but around the world. In the U.S., companies like Mastercard and PayPal are poised to benefit as consumers become increasingly comfortable with the technology. "A decade from now, I think digital payments will be the norm and people will give you odd looks if you try to pay with cash," says equity portfolio manager Jody Jonsson.

America is likely to remain a primary engine for innovation, but it would be shortsighted to think of the U.S. as the sole province of inventive companies. What's most important for investors is to seek out the world's most innovative companies in growing industries wherever they are located.

Asia has quickly become the world leader in digital payments

Global digital payments revenue (billions USD)



SOURCE: World Payments Report 2020 from Capgemini. 2020–2023 are estimates. Figures reflect all non-cash payments. No third party whose information is referenced in this report under credit to it, assumes any liability towards the user with respect to its information.

Can a weaker dollar spell relief for global portfolios?

After a decade of strength, the U.S. dollar may be at a turning point. Rock-bottom interest rates, ballooning government debt and a muddled economic picture sent the greenback to multiyear lows in 2020. Timing the exact start of a currency cycle may be difficult, but if this trend continues it could be the catalyst that investors in global portfolios have been waiting for.

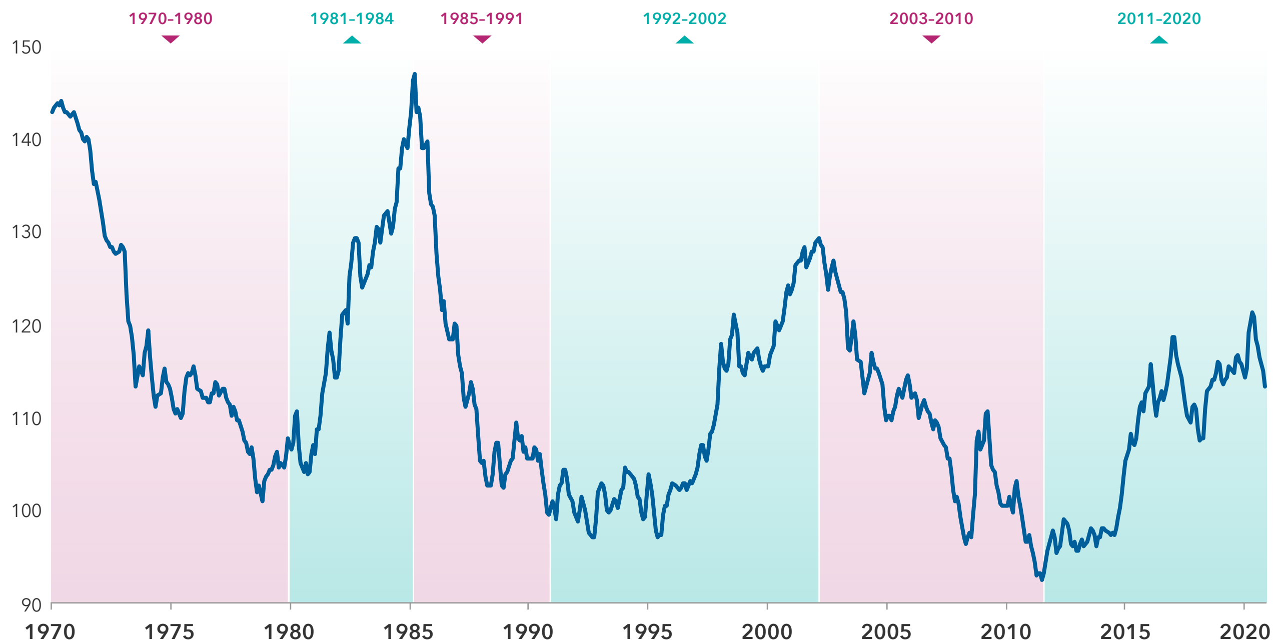
It's no secret that many investors are frustrated with their international equity holdings, which often lagged the U.S. in recent years. The strong dollar helped power this trend, and its reversal would likely boost foreign stocks and U.S. companies with global businesses. Likewise, global bond sectors such as emerging markets debt could become more attractive.

But Capital Group currency analyst Jens Søndergaard cautions that the shift could still take time. "I believe that the dollar is overvalued, but to get a proper dollar bear market, we need evidence that growth outside the U.S. is firming up."

In the near term that will largely depend on the trajectory of the virus, and how quickly a vaccine is approved and administered throughout the world. "Once global growth does take off, and we have a proper recovery from the pandemic, I think in all likelihood we will see the dollar weaken further," Søndergaard adds.

U.S. dollar bull and bear cycles since 1970

U.S. Dollar Real Effective Exchange Rate Index



SOURCES: Bloomberg, J.P. Morgan. As of 11/30/20. Bull and bear cycles are for illustrative purposes only. Data represents the U.S. Dollar Real Effective Exchange Rate Index, which measures the inflation-adjusted relative value of the U.S. dollar against a broad basket of foreign currencies. This report, and any product, index or fund referred to herein, is not sponsored, endorsed or promoted in any way by J.P. Morgan or any of its affiliates who provide no warranties whatsoever, express or implied, and shall have no liability to any prospective investor, in connection with this report. J.P. Morgan disclaimer: https://www.jpmm.com/research/disclosures.

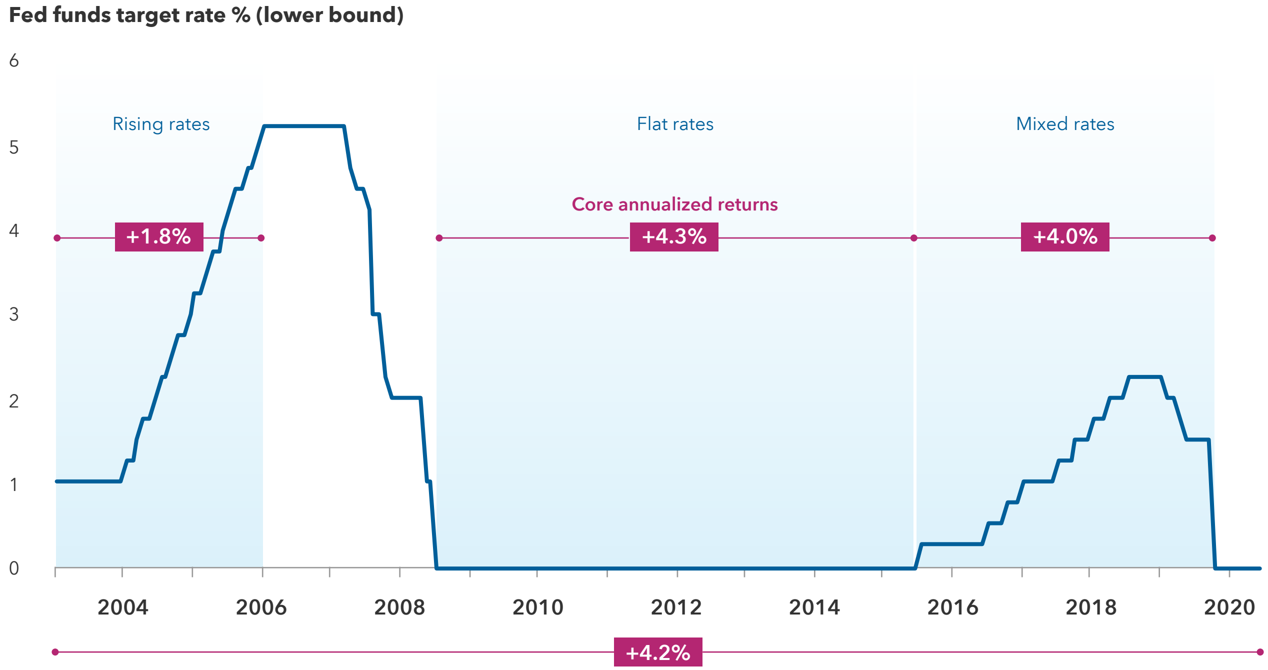
Whether rates are up, down or flat, core bonds have delivered

High-quality core bond funds helped stanch losses in balanced portfolios during 2020's equity bear market. Amid that sharp volatility, these bonds did exactly what they were meant to do: preserve capital and diversify equities.

But now that markets have calmed, you may think the need for strong core bonds is over. It isn't. "No matter the environment, a high-quality core bond fund is critical to act as ballast and fortify your portfolio for whatever the future holds," says Mike Gitlin, head of fixed income at Capital Group. "While total returns may be more modest in the coming years, the need for diversification, capital preservation, income and inflation protection in a balanced portfolio hasn't lessened."

Just look back at the diverse history of interest rates since 2003. When the Federal Reserve hiked more than 4 percentage points back then, the core benchmark Bloomberg Barclays U.S. Aggregate Index still saw an annualized positive return of 1.8% over the period. When rates sat at their zero bound during most of the recovery following the financial crisis, core bonds gained an annualized average of 4.3%. A mix of hiking and modest cuts more recently saw a similar return. In all these rate climates, core bonds held up.

Core benchmark annualized returns in varied rate environments

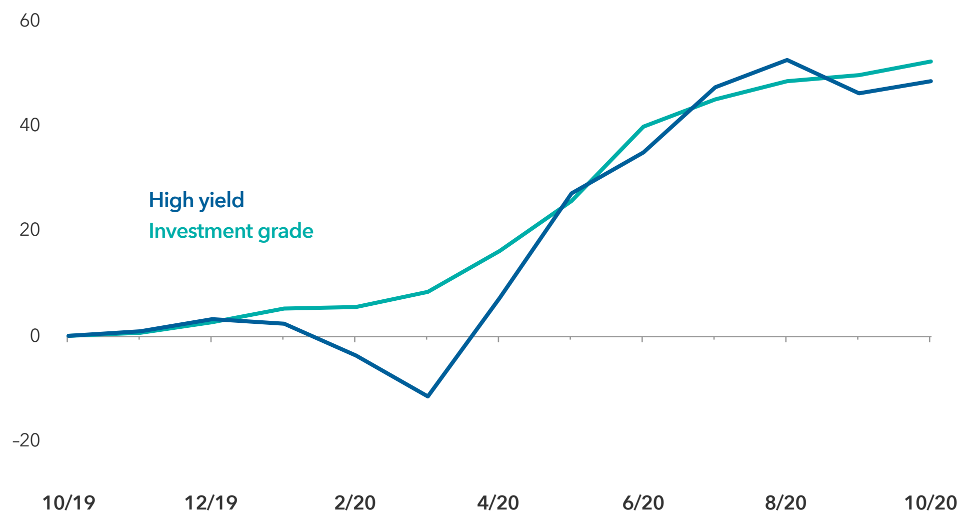


SOURCES: Bloomberg Index Services Ltd., Federal Reserve. As of 11/30/20. Year marks shown for June of each year. Core benchmark shown is the Bloomberg Barclays U.S. Aggregate Index. Periods shown span from 6/26/2003 to 6/29/2006, 12/17/2008 to 12/15/2015, 12/16/2015 to 3/15/2020 and 6/26/2003 to 11/30/20. Returns are in USD.

After big inflows into corporate bonds, it's time to be selective

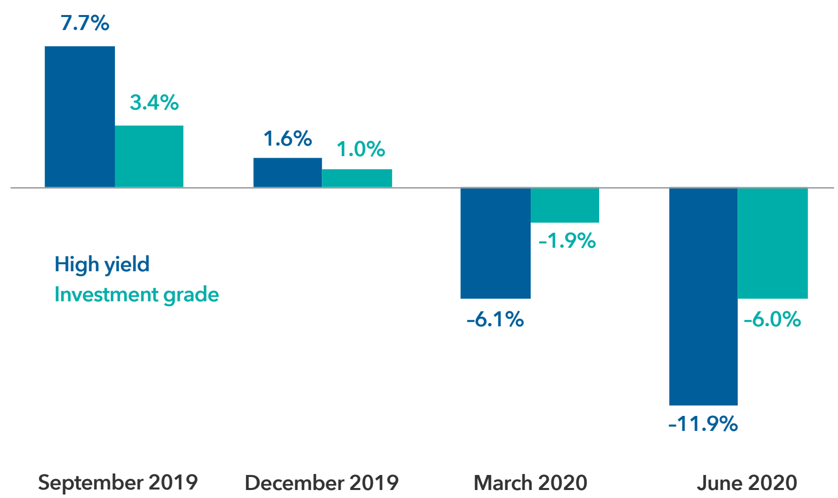
Investors flocked to corporate bonds in search of yield ...

Cumulative fund flows (billions USD)



... even as company earnings were declining

Year-over-year earnings growth



Corporate bonds have seen tremendous demand in recent years, driven by both low interest rates and a strong U.S. economy. The 2020 recession seemed to change all that – until the Federal Reserve stepped in and picked up the slack. As pandemic fears waned, investors returned. Late in the year, rising prices led corporate bonds to look only modestly less expensive than they did prior to the recession.

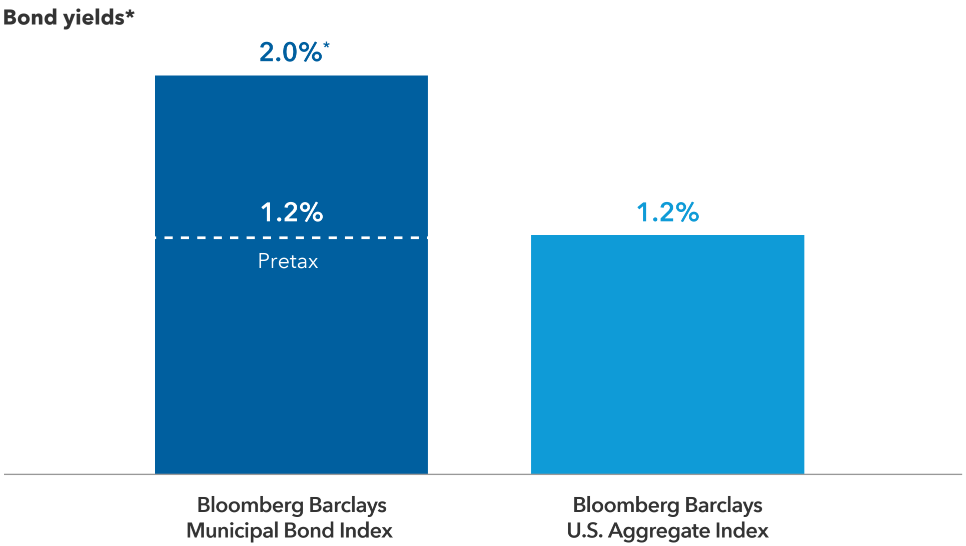
Yet the environment has gotten more challenging for companies, and earnings growth has plummeted broadly. Not all issuers and sectors will fare the same going forward. Some issuers can weather the storm, while others may get caught in the wave of downgrades that began in 2020.

"Credit sectors still offer value, but selectivity is crucial," says fixed income portfolio manager Damien McCann. "Buying corporate bonds indiscriminately could provide a portfolio with some winners, but also some losers. Using research to understand issuers and how their debt is likely to fare can help reveal which bonds are more likely to provide value and avoid downgrades."

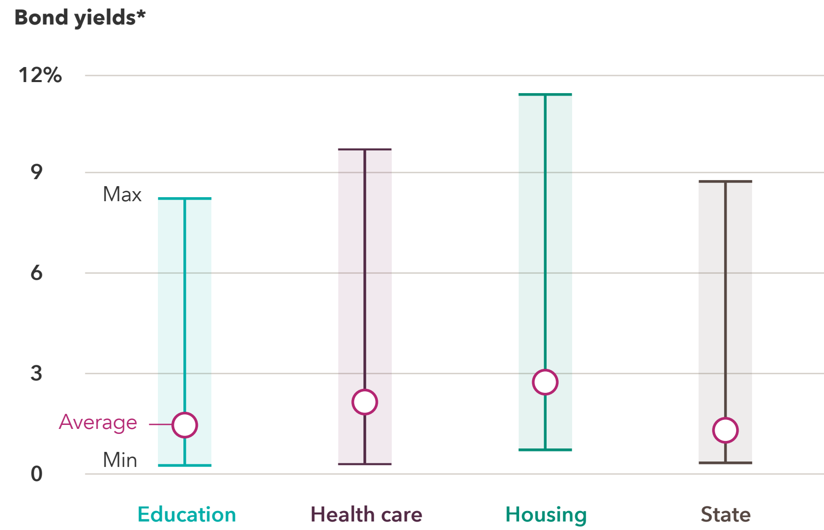
SOURCES: (Left chart) Morningstar. Flow data as of 10/31/20, based on Morningstar categories. (Right chart) Morgan Stanley. Earnings data from Morgan Stanley includes Q2 2020 filings (latest available) and represents EBITDA (earnings before interest, taxes, depreciation and amortization).

Municipal bonds continue to look attractive for tax-advantaged income

Tax-equivalent municipal yields exceed those of taxables



Income potential varies widely among sectors



Is the muni meltdown of March 2020 truly in the rearview mirror or a sign of things to come? So far, the market appears to have moved on, with volatility retreating from record highs and investor money pouring back in.

Take a closer look, however, and a more mixed picture becomes apparent. The pandemic has left state and local governments with major budget gaps as a result of lost tax revenue.

Other sectors have also been hit hard: think empty seats on public transportation and vacant dorm rooms.

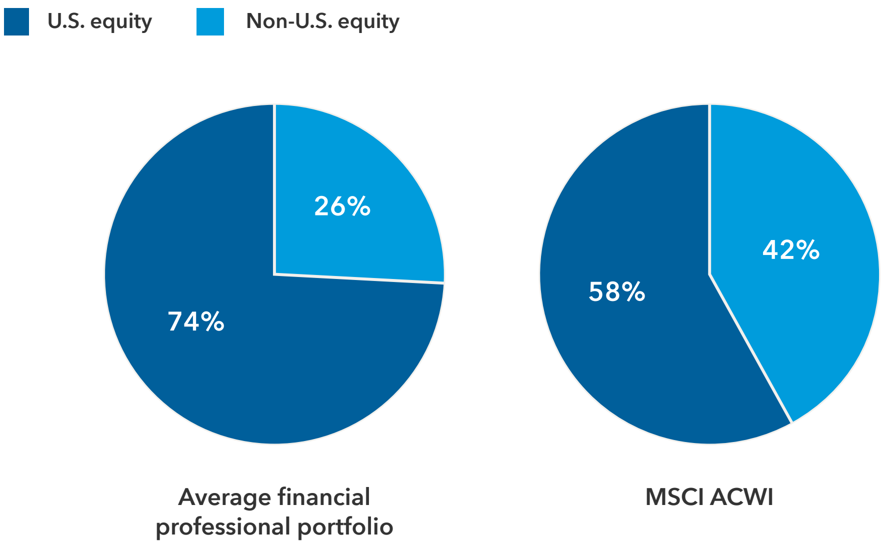
This challenging outlook does, however, have a silver lining in today's low-rate world: improved income potential and tax benefits. "Markets could remain choppy through 2021 as the economic downturn continues to reverberate and revenues fall short," says Capital Group fixed income portfolio manager, Karl Zeile. "Returns among municipals will, I believe, vary more widely. It's just the kind of environment where active managers like us can really prove our mettle."

There are even pockets of value in some of the hard hit sectors, such as education and health care. Higher yields offered by certain bonds appear to compensate investors for the risks entailed – especially if you factor in the possibility that plans around further federal support for states and munis firm up sooner rather than later.

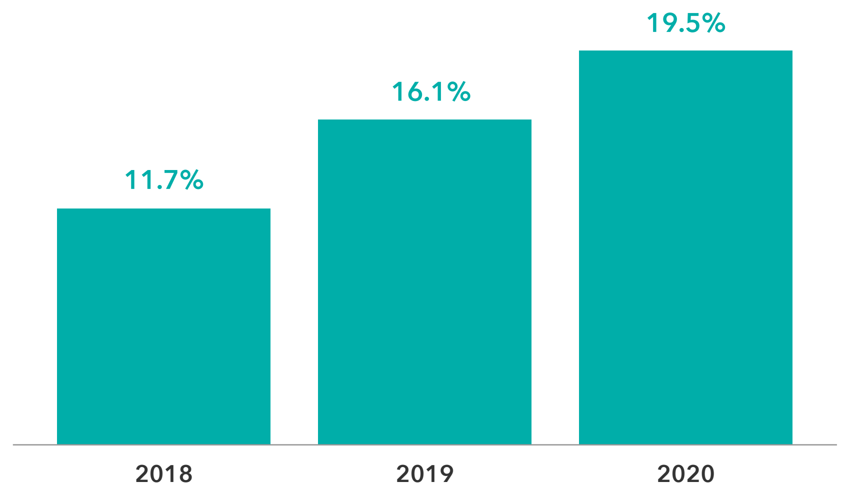
SOURCES: Capital Group, Bloomberg Index Services Ltd. All data as of 11/30/20. Chart on the right depicts tax-equivalent yields of select sectors within the Bloomberg Barclays Municipal Bond Index.
*Taxable-equivalent rate assumptions are based on a federal marginal tax rate of 37%, the top 2020 rate. In addition, we have applied the 3.8% Medicare tax. For in-state investors, tax-equivalent yields could be even higher than shown due to additional exemption from state income taxes. For example, top tax rates are 8.82% and 13.30% in New York and California, respectively.

Your portfolio may be overweight in U.S. equities and riskier bonds

Geographic weights in portfolios vs. markets



Average allocation to riskier bond categories



The start of a new year can be the perfect time to re-evaluate your portfolio, especially after a year like 2020 when it may have shifted unexpectedly. Capital Group's Portfolio and Analytics team analyzed more than 4,000 advisor portfolios last year and uncovered two key trends that can help refine your approach in 2021.

International travel may be limited in 2021, but international investing shouldn't be. Yet our research found that the average advisor portfolio had almost three times as much domestic equity as international. Even as non-U.S. equities have broadly lagged the Standard & Poor's 500 Composite Index's recent returns, most top stocks during that period came from outside the U.S. To achieve more geographic diversification, you may want to consider funds with flexible mandates that allow their managers to choose from the best companies, no matter where they are located.

Another noteworthy trend has been the shift toward riskier bond categories – a move that left many investors ill-prepared for 2020's volatility. This "hunt for yield" proved detrimental as riskier bonds lagged higher quality bond investments during the year. With market uncertainty likely to continue in 2021, it's not too late for investors to ensure that most of their fixed income portfolio is allocated to core bonds that can hold up when stocks go down.

SOURCES: (Left chart) Capital Group, Morningstar, MSCI, RIMES. As of 9/30/20. (Right chart) Capital Group, Morningstar. As of 6/30/20. Includes all allocation to spread categories, which include any fixed income category that maintains additional yield greater than a U.S. Treasury of comparable maturity.

2021 Outlook: Turning points on the road to recovery

Themes	U.S. equity	Global/International equity	Taxable fixed income	Tax-exempt fixed income
	The future is here, and it's digital.	If you think all innovation is in the U.S., think again.	Core bond strength matters when life is uncertain.	Municipal bonds continue to offer compelling values.
Investment implications	Rapidly changing consumer behavior will drive opportunity for digital leaders across industries. But not all experiences can be digitized. Pent-up demand is poised to drive opportunity in travel and other hard hit sectors.	European and Asian companies are among the leaders in some key innovations, such as renewable energy and digital payments. It's about companies, not countries.	Although rates will likely remain at ultralow levels, high-quality core bonds remain a crucial buffer against volatility. For investors seeking income, consider research-driven bond funds to uncover key opportunities among corporates.	After-tax income potential for munis exceeds what's typical among taxables. Budget gaps and revenue shortfalls will vary across issuers, creating pockets of value.

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