Capital Group

Answers to your 5 biggest interest rate and bond questions

IMPORTANT NOTICE

The following material is provided by a third-party strategist unaffiliated with AssetMark. The strategist is solely responsible for its content. Please read the risks and disclosures section for additional important information. AssetMark has not verified the accuracy of the information contained in this material.

For financial advisor use with advisory clients.

C20-15700 | 03/2020 | EXP 03/31/2021

Capital Group Disclosure:

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. Investors should carefully consider investment objectives, risks, charges and expenses. This and other important information is contained in the fund prospectuses and summary prospectuses, which can be obtained from a financial professional and should be read carefully before investing. Securities offered through American Funds Distributors, Inc. Statements attributed to an individual represent the opinions of that individual as of the date published and do not necessarily reflect the opinions of Capital Group or its affiliates. This information is intended to highlight issues and not to be comprehensive or to provide advice. Any reference to a company, product or service does not constitute endorsement or recommendation for purchase and should not be considered investment advice. American Funds are intended only for persons eligible to purchase U.S.-registered mutual funds.

Answers to your 5 biggest interest rate and bond questions

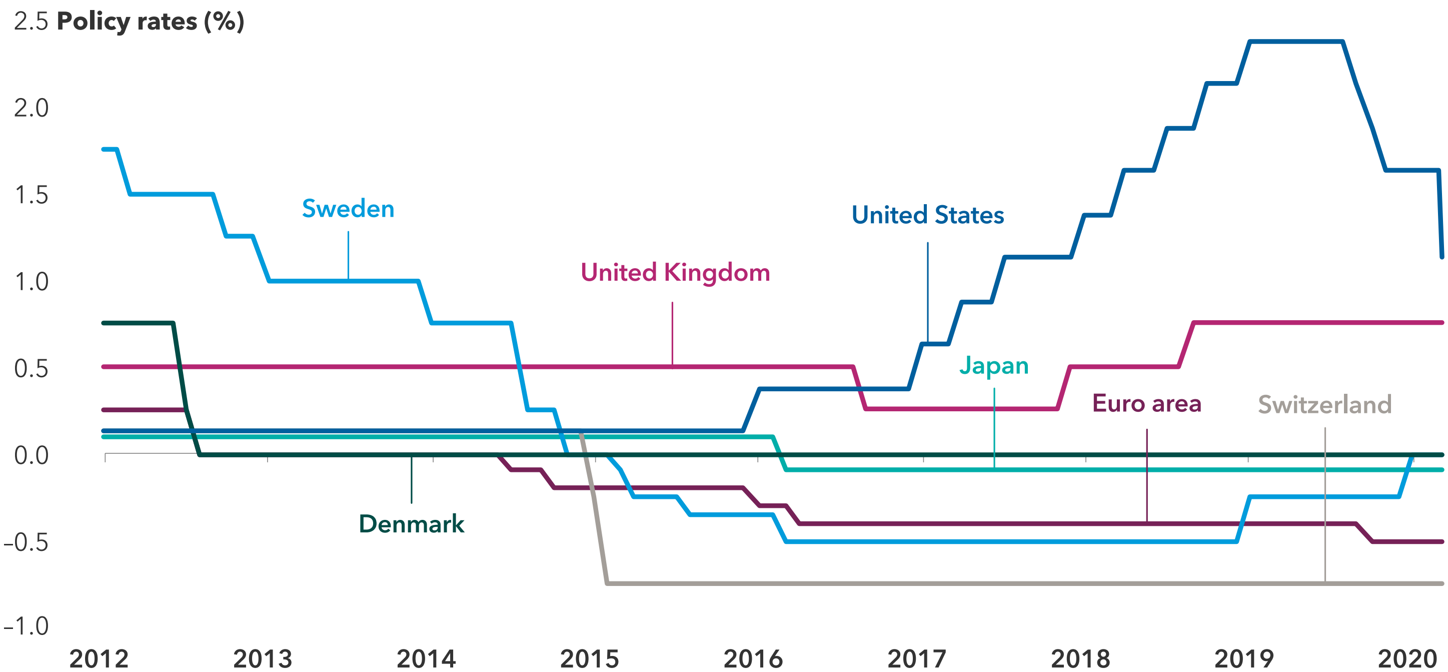
Interest rates have declined sharply over the past two weeks amid the economic uncertainty emanating from the spread of the COVID-19 virus and the stock market sell-off. The Federal Reserve moved quickly with a 50-basis-point cut and is likely to provide additional monetary stimulus using all the tools at its disposal. The bond market is in uncharted territory with 30-year U.S. Treasury yields touching below 1% and the 10-year yield dipping below 0.5% for the first time.

Against this backdrop, Mike Gitlin, head of fixed income, and Pramod Atluri, principal investment officer of The Bond Fund of America®, discuss fixed income markets and the outlook for interest rates.

1. What is your outlook for interest rates, and what are your expectations from the Federal Reserve?
We believe the Fed will continue to act to support financial markets and the real economy in the coming weeks and months. As 2020 began, the market expected a pretty uneventful year from the Fed. Economic growth looked to be improving as U.S./China trade tensions eased and employment growth remained healthy.

Then the outbreak of COVID-19 and the extraordinary efforts to contain it changed everything. As the virus spread and its deadly nature became more evident, this initial supply disruption morphed into a massive demand disruption as businesses and consumers began to self-quarantine, leading to reduced travel and consumption. This was then compounded by an oil price war

The Fed policy rate has fallen and may approach other policy rates later this year

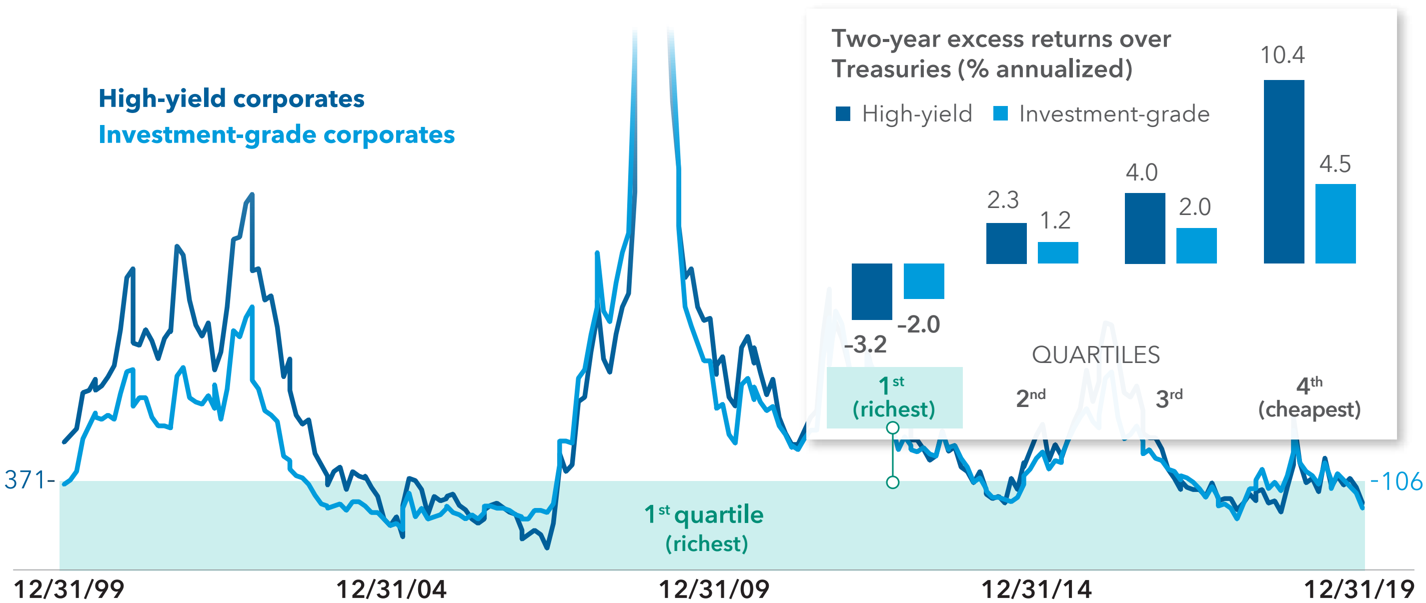


Source: Refinitiv Datastream. All data as of 3/6/2020.

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

When credit spreads are very tight, expect Treasuries to outperform

Range of credit spreads since 1999 divided into quartiles (bps)



Source: Bloomberg Index Services Ltd.: U.S. High Yield Corporates Index, U.S. Investment Grade Corporates Index and U.S. Treasury Index. Chart shows monthly spread data for high-yield and investment-grade credit from December 1999 through December 2019. 20-year monthly spread history (240 data points) is divided into quartiles, with divider points for each quartile represented by bars.

between Saudi Arabia and Russia that led oil prices to fall more than 25% in a day, causing yet another disruption to financial markets.

Interest rates have fallen and credit spreads have widened, leading to a tightening of financial conditions. If left unchecked, this would hurt both businesses and consumers, and ultimately worsen the economic outlook.

In response, the Fed made its emergency rate cut of 50 basis points on March 3, bringing the monetary policy rate down to 1.00%–1.25%. Despite the cut, financial conditions have further deteriorated as equity prices and credit spreads have continued to weaken. We believe the Fed will continue to act to support the economy using a variety of tools at their disposal, including additional rate cuts, a commitment to keeping rates low for the foreseeable future and potentially more large-scale asset purchases known as quantitative easing.

2. Do you think the Fed could eventually cut rates in the U.S. to zero? If it does, what other tools could it employ?

Given the rapidly worsening economic outlook, we believe the Fed will cut rates by 50–100 basis points in the coming months. With the federal funds rate currently in a range from 1.00% to 1.25%, this would put rates relatively close to zero, back to where it reduced rates in response to the 2008 financial crisis.

If the Fed cuts rates to the zero bound, it will likely lean on other tools before it considers joining other global central banks in adopting a negative interest rate policy. Those tools include:

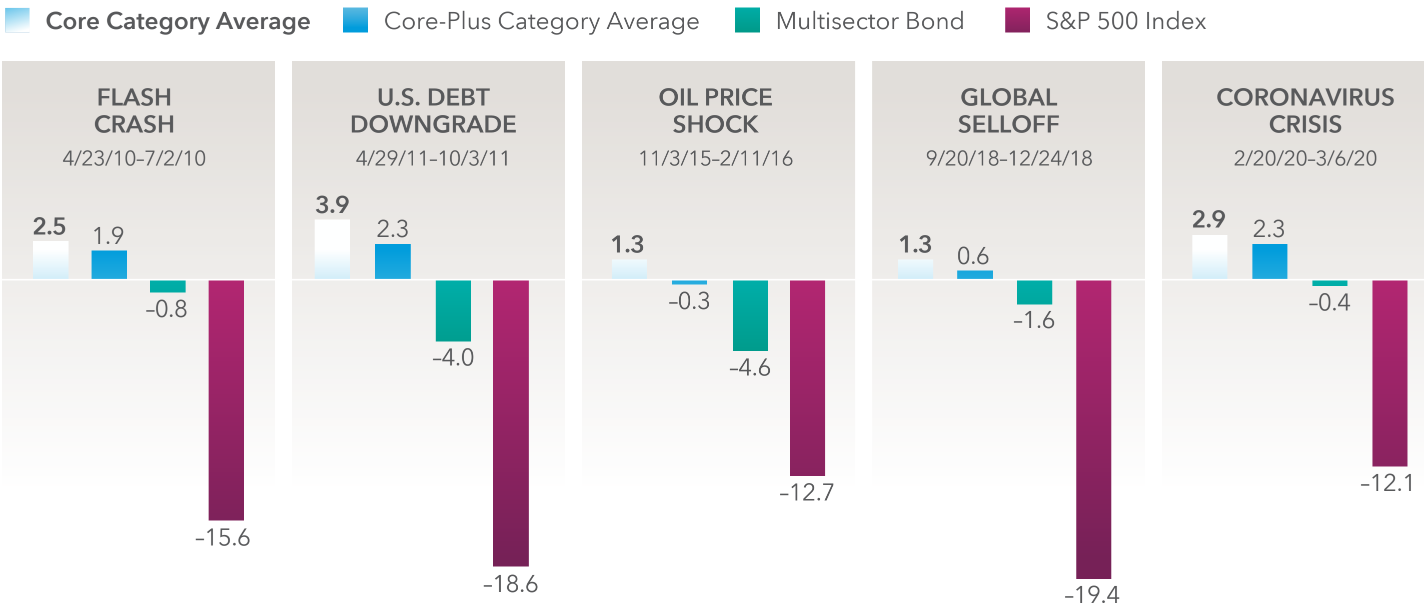
- Forward guidance: Telling the market to expect more stimulus in the future
- Average inflation targeting: An explicit willingness to let inflation rise above its 2% target for a period of time, since it may be below target during another period
- Quantitative easing: Expanding its balance sheet to buy assets

3. What is your outlook for credit? How do you distinguish between investment grade and high yield?

In times of enhanced uncertainty and volatility, the flight to quality is high and investors seek safety in U.S. Treasuries. If you look at credit markets, both high-yield and investment-grade bonds, the risk premium investors demand over Treasury yields can rise significantly. Corporate bonds tend to have a greater correlation to equities, so when equities decline in value, these bonds historically also decline, and high-yield bonds fall (credit spreads widen) typically much more than investment grade.

True core bond funds have provided strong diversification from equities in recent periods of volatility

Cumulative returns (%) during recent market corrections exceeding 12%



Source: Morningstar. Dates shown for market corrections are based on price declines of 10% or more (without dividends reinvested) in the unmanaged S&P 500 with at least 50% recovery persisting for more than one business day between declines for the earlier four periods shown. The most recent period is still in correction phase as of 3/6/20. The returns are based on total returns. There have been periods when the fund has lagged the index, such as in rising equity markets.

Given significant market volatility and the rapidly declining economic outlook, we are very cautious on the outlook for credit. We believe there are many scenarios where credit may continue to weaken before markets stabilize and prices improve. Over the past decade, corporations have tapped into the low interest rate environment and taken on a large amount of debt. Many companies are highly leveraged and will be vulnerable if credit spreads continue to widen. It is important to be very discriminating in the credit space, considering the increasing leverage we have seen over the past few years.

Overall, in our broad fixed income portfolios, we have generally had a long duration exposure, which translates into an exposure to interest rates, and a less-than-benchmark exposure to credit and mortgage-backed bonds. However, valuations are changing rapidly, and we are also likely to see a significant series of steps to help support markets and the economy from both central banks and fiscal authorities. Therefore, our analysts and portfolio managers look to take advantage of volatile markets to find investments in credits they like at more attractive valuations.

4. Given that we are in an environment facing constraints on both the supply side and the demand side of the economy, should investors brace for a recession in the U.S.?

Our economists believe that the U.S. has been in the late part of its economic cycle for some time. Before COVID-19 hit, investors anticipated modest growth might persist over the medium term. But the outbreak of COVID-19 and the Saudi/Russia oil shock are rapidly changing the economic outlook.

Suddenly, investors are faced with a grave new uncertainty that has caused significant disruptions. On the supply side, factories are experiencing stoppages and both supply chains and global trade have been disrupted. On the demand side, nervous consumers and businesses may not spend as much as they would in normal times. And given the oil price collapse, the market is bracing for another wave of defaults from related sectors. This could particularly affect energy sector issuers in the high-yield market, as many of those issuers are already starting with more stretched balance sheets.

The probability of a recession has increased dramatically from where it was just a few weeks ago. The U.S. is already in the late part of its economic cycle, so it's more susceptible to falling into a recession due to a painful external shock like the one we're seeing now. Investors should expect a period of heightened volatility. Knowing how much risk they are taking in their overall portfolio is essential, and they should consider upgrading their bond portfolios to hedge against the volatility of their equity portfolio.

5. How should investors position bond portfolios?

The recent drop in equities and rise in price of 10-year Treasuries is a timely reminder that high-quality bonds can help to stabilize investor portfolios against losses during volatile periods. In times of great uncertainty, investors should look to bond funds first and foremost as a way to diversify their portfolio and preserve capital. But not all bonds or bond funds are created equal. There are many broad bond funds which own significant amounts of lower quality bonds that may not provide the protection and stability investors need when risk assets decline.

We would encourage investors to do a health check and ensure the bonds in their core portfolios are high quality, like U.S. government bonds, AAA-rated mortgage bonds and investment-grade corporate credit. These bonds have historically been more resilient when shocks occur, helping to preserve investors' capital while also providing some income.

While it can be tempting to increase holdings of riskier bonds like high-yield corporate debt in a reach for yield as interest rates fall, it is important that investors know that high-yield bonds can be highly correlated to equities. When equity prices fall, so do many high-yield bonds, which means investors have not really reduced risk in their overall portfolio.

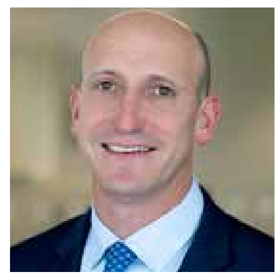
Consider the five deepest equity market corrections — those where the S&P 500 Index lost at least 12% — since the financial crisis ended. In each one, higher quality bond funds experienced solid absolute returns, on average. Importantly, during these stressed equity periods, higher quality funds as represented by the Morningstar U.S. Intermediate Core category experienced stronger returns than the Intermediate Core-Plus and Multisector Bond categories that tend to be much more exposed to the higher risk end of high-yield bonds.

This demonstrates how a strong core bond allocation can act as a ballast in an investor's overall portfolio. A fixed income allocation should zig when stocks zag to provide some shock absorption. Our core and core-plus bond funds, including The Bond Fund of America and American Funds Strategic Bond Fund,[SM] aim to do this through careful attention to risk and correlation to equities.

We would urge investors to focus on the important role of bonds in an overall portfolio. When the economic outlook becomes more uncertain, we believe investors should prioritize capital preservation and diversification from equities over adding a few more basis points of yield.

Since investors never know when volatility will hit or how bad it will get, maintaining a core bond fund allocation may be their best defense against the unknown. This present episode of market volatility is not unique. Long-term investors know that bouts of volatility are a constant in the market. Even if the current scare fades, another will eventually take its place — and a recession at some point is inevitable. For this reason, we encourage investors to take a long-term view when making investment decisions and to consider whether their fixed income funds are positioned to serve their important role in maintaining a well-balanced portfolio.

Pramod Atluri is a fixed income portfolio manager at Capital Group. He holds an MBA from Harvard and a bachelor's in biological chemistry from the University of Chicago. Pramod is also a CFA charterholder.



Mike Gitlin is head of fixed income at Capital Group. He has 25 years of investment experience. Before joining Capital in 2015, Mike was head of fixed income and global head of trading for T. Rowe Price. He holds a bachelor's from Colgate University.