CAPITAL GROUP™

FOR PROFESSIONAL / QUALIFIED INVESTORS ONLY
Marketing communication

Fixed Income Perspectives

Q1 2024

50 YEARS OF FIXED INCOME INVESTING

Quarterly macro and market insights

from Capital Group's fixed income team

PORTFOLIO STRATEGY INSIGHTS	Staying balanced as central bank policies shift
US INTEREST RATES	Positioning for a turn in the interest rate cycle
EUROPEAN INTEREST RATES	ECB could be more cautious than markets expect in cutting rates this year
JAPANESE INTEREST RATES	Labour shortages are driving up wages and inflation
GLOBAL RELATIVE VALUE	Compelling opportunity to add high-quality global rates exposure
GLOBAL CORPORATES	Focus on finding idiosyncratic opportunities at the company and sector level
US INVESTMENT-GRADE CORPORATES	Valuations don't leave much room for downside surprises
US HIGH-YIELD CORPORATES	Doubling down on credit selection amid tight valuations
EMERGING MARKETS DEBT	A dovish Fed could unlock opportunity, some caution warranted
MUNICIPAL BONDS	Seeking value in select parts of the muni curve
US AGENCY MORTGAGE-BACKED SECURITIES	Compelling relative value despite recent rally

The statements expressed represent perspectives from Capital Fixed Income Investors, as at 31 December 2023. The views of individual portfolio managers and analysts may differ. Data as at 31 December 2023, and attributed to Capital Group / Bloomberg Index Services Ltd, unless otherwise stated.

Staying balanced as central bank policies shift

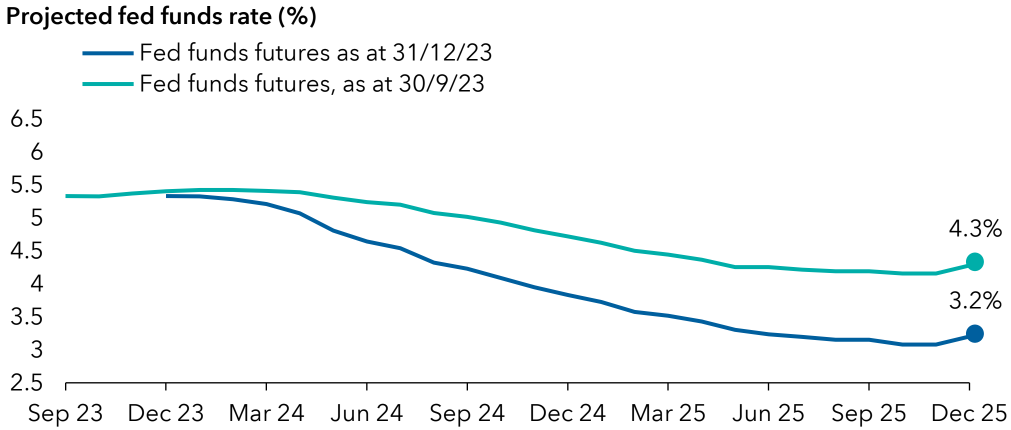
- A more dovish stance by the Federal Reserve (Fed) helped push US Treasury yields down from an annual high of 4.99% in mid-October to unchanged on the year at 3.88%.
- We expect US inflation to be within striking distance of the Fed's 2% target in the next six to 12 months. Inflation has been falling globally, but the path forward is less clear.
- US economic growth may persist, albeit at a slower pace, while prospects for economic growth around the world are mixed.
- We remain cautiously constructive on the US economic outlook and are looking to remain balanced in portfolios. Our highest conviction ideas call for a steepening of the yield curve and positions in agency mortgage-backed securities.

Softer economic data coupled with a large shift in Federal Reserve policy expectations helped push yields lower and risk assets higher to close out 2023. The year-end rally marked a swift turnaround from the beginning of the fourth quarter, when the "higher for longer" narrative drove 10-year US Treasury yields to a high of 4.99% in mid-October - levels not seen since before the Great Financial Crisis. As the quarter progressed and the US economy showed signs of moderating growth, investors placed a greater emphasis on potential Fed rate cuts in 2024. That led rates to rally and spreads to tighten. A more dovish stance by the Fed in December, including Chairman Powell's framing of current policy as "well into restrictive territory" and Fed projections showing three rate cuts in 2024, helped push bond yields lower. The rally reversed the move higher in yields, with the 10-year closing 2023 at 3.88%, unchanged from where it started the year.

We expect that slowing inflation should allow rates to move lower over the medium term. Inflation is trending downwards, with goods deflation and shelter disinflation momentum picking up. We believe headline and core inflation will be within striking distance of the Fed's 2% target in the next six to 12 months. This should support the Fed cutting rates, though volatility may persist in the near term given the extent of the recent rally in rates and the large gap between Fed projected rate cuts in 2024 and market expectations.

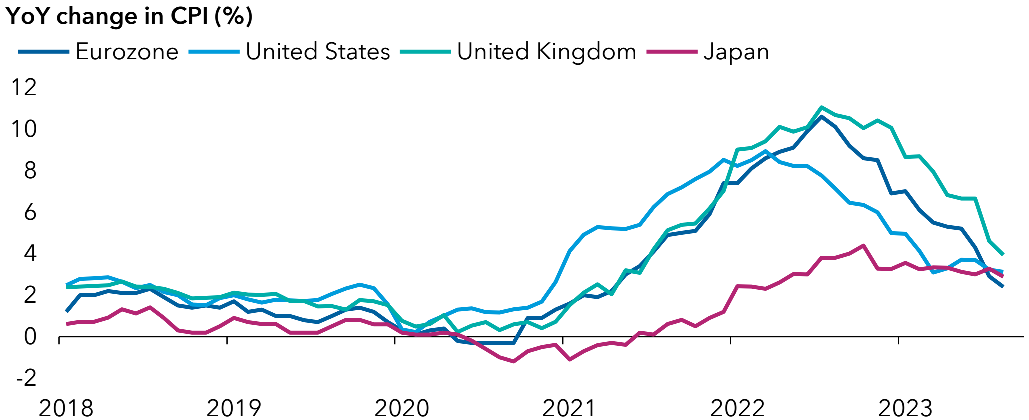
We believe US economic growth may persist at a slower pace, though recessionary risk should not be fully ruled out. Labour markets are softening yet remain robust overall, wage growth is solid, and home values are above

Market expectations for the fed funds rate have fallen



Figures shown reflect 30-day fed funds futures. Source: Bloomberg

Inflation is declining from peak levels across regions



Data as at 30 November 2023. YoY = year-over-year. CPI = Consumer Price Index. Sources: Capital Group, FactSet, Bureau of Labour Statistics, Eurostat, UK Office for National Statistics, Japanese Statistics Bureau & Statistics Centre, International Monetary Fund

Staying balanced as central bank policies shift

pre-pandemic levels. In addition, substantial federal deficits and spending, particularly on infrastructure projects, from previous stimulus packages, should continue to support economic growth. However, leading indicators are at levels consistent with past recessions and growth momentum is slowing. Economic weakness overseas may also be a headwind for US growth in the coming year.

The outlook for Europe and the UK is less clear. Inflation has trended lower but may prove more stubborn going forward. With low unemployment and wage growth that has remained reasonably robust in both the eurozone and the UK, the European Central Bank and Bank of England may look for clear evidence of loosening labour markets and labour cost disinflation before they consider cutting rates. A longer period of more restrictive monetary policies raises the risk for a potential recession. This risk may be further compounded by an increasingly difficult environment for trade and ongoing geopolitical tensions across the region that has weighed on industrial activity.

China's post-COVID recovery has ended, and we anticipate weaker growth than consensus going forward. Policy stimulus hasn't been adequate to meet growth expectations. Unless the government intervenes with additional stimulus, China's growth may remain low.

In Japan, inflationary pressures have risen after years of either low inflation or outright deflation. The Bank of Japan (BoJ) has been slow to tighten monetary policy but has relaxed its yield curve control policy. A combination of wage pressures and positive global growth may pressure the BoJ to tighten monetary policy more significantly.

As a result of this economic backdrop, we are looking to remain balanced in portfolios. A more benign outlook can support certain sectors, but valuations are not particularly compelling in many risk assets. Higher quality credit can remain well supported and we are emphasising security selection given the extent of dispersion between and within sectors. We see value in mortgages, as elevated interest rate volatility has contributed to attractive risk-reward opportunities. In addition, securitised credit continues to offer compelling yields for senior debt. Against these select credit and spread exposures, the yield curve remains compelling from a valuation perspective and for the positive expected value in various scenarios, especially if the Fed begins cutting rates.

The fixed income investment group's highest convictions

The yield curve steepener continues to be a preferred position, based on how several economic and rate scenarios could play out. An inverted yield curve is not a normal condition over extended periods, and given the length of the current inversion, we believe there is a greater chance of the curve dis-inverting. Historically, the yield curve has steepened shortly after the Fed has ended hikes.

Agency mortgage-backed securities (MBS) valuations remain attractive relative to other spread sectors, supported by both positive technical and fundamental factors. Seasonal supply factors look more favourable in the winter (when supply is typically lower), and the potential for a decrease in interest rate volatility should contribute to excess returns. In addition, demand factors appear better balanced given the attractive valuations in the sector.

Credit valuations are less compelling. Over the past several months, investment grade credit spreads have compressed substantially and moved from modestly attractive to modestly tight. While we are less constructive on the sector broadly, we do believe there are sectoral and geographic components of the asset class where compelling opportunities exist that will be highly dependent on credit selection. While corporate credit can still fare well in a benign growth environment, credit spreads likely have limited room to tighten and there appears to be asymmetrical risk toward spread widening.

These and other convictions were established during the Capital Group fixed income team's Portfolio Strategy Group (PSG) forum in late September 2023 and revised at a PSG meeting in early December 2023. The PSG analyses the global macro and bond market dynamics and considers how differing portfolio positions could produce varying investment outcomes amid possible economic scenarios. The outcome of the group's work provides a broad directional framework and guidance and is intended to be a package of positioning themes, rather than individual investment recommendations.

The information provided is not intended to be comprehensive or to provide advice. Past results are not a guarantee of future results.

Positioning for a turn in the interest rate cycle

The Federal Reserve's (Fed) dovish pivot drove a significant repricing of the interest rate market with over 150 basis points (bps) of cuts now expected in 2024, compared to the Fed's projected 75 bps reduction. Following a strong technical bid in the fourth quarter, the 10-year US Treasury yield closed 2023 exactly where it began the year, at 3.88%, while the curve steepened modestly with short-term yields falling more than long-term yields.

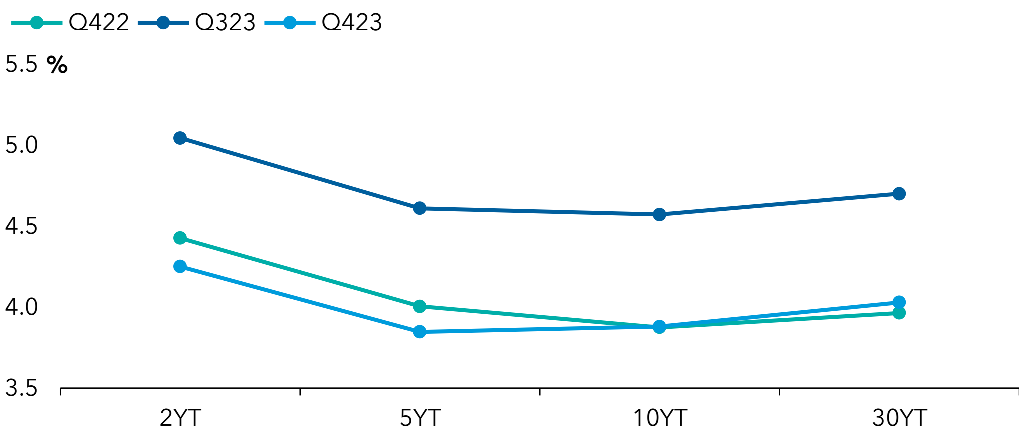
The outlook for economic and policy fundamentals, as well as valuations, favour positioning for a turn in the interest rate cycle. Positioning for a steeper yield curve is the US rates team's preferred structural position, while an overweight to duration has become less attractive following the recent rapid decline in yields.

While the Fed is likely to reduce its policy rate in 2024 in response to declining inflation, there is potential for more significant cuts should a recession occur. The team's expected value framework suggests the market's expectation for rate cuts in 2024 remains underpriced if a recession is the modal outcome. The Fed typically cuts 20–50% of the peak policy rate in soft landings and 75–100% of the peak policy rate in hard landings, implying that cuts of more than 150 bps from the current policy rate of 5.25–5.5% could occur in any magnitude of recession. Given the recent decline in yields, duration is a relatively less attractive expression to benefit from this scenario compared to positioning for a steeper yield curve.

Positioning for the yield curve to steepen remains a key structural position across portfolios, given that periods of extended yield curve inversion are rare. Going forward, the yield curve could steepen in a recession, as it generally steepens notably in a hard landing. Should growth remain resilient, the curve could also steepen in a different scenario where the Fed simply employs maintenance cuts and longer-term yields rise. Technical factors further support the potential for yield curve steepening as higher supply meets with lower demand from foreign investors and banks. This shift may require that households, which tend to demand a higher term premium to invest, fill the gap.

Although technical factors for Treasury Inflation Protected Securities (TIPS) are negative, near-term market-implied inflation is extremely benign, even compared to our expectations for continued deceleration in inflation. TIPS offer an attractively priced hedge which could help to buffer potential yield curve flattening should inflation reaccelerate.

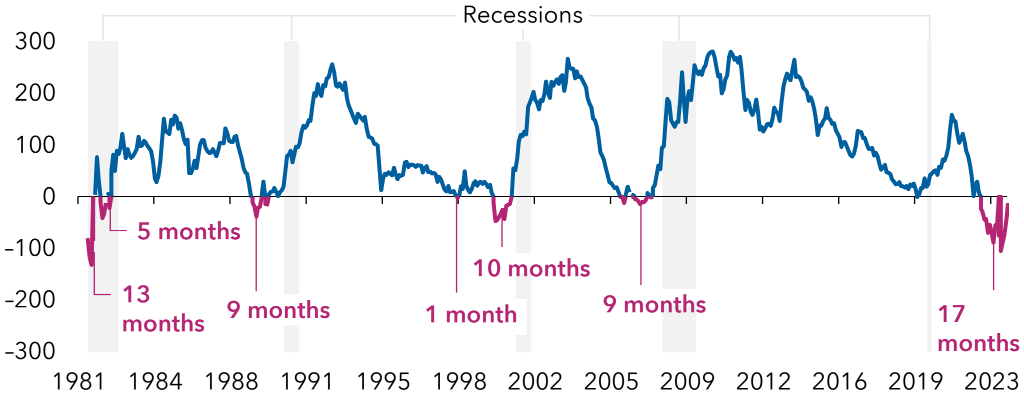
Treasury yields fell dramatically and reversed a year of increases



As at 31 December 2023. 2YT: 2-year Treasury. Source: Bloomberg

Yield curve inversions have been short-lived

Spread between 2-year and 10-year Treasury yields (bps)



As at 31 December 2023. Monthly figures represent the length of time that the yield curve was inverted. Sources: Bloomberg, Refinitiv Datastream

The information provided is not intended to be comprehensive or to provide advice. Past results are not a guarantee of future results.

ECB could be more cautious than markets expect in cutting rates this year

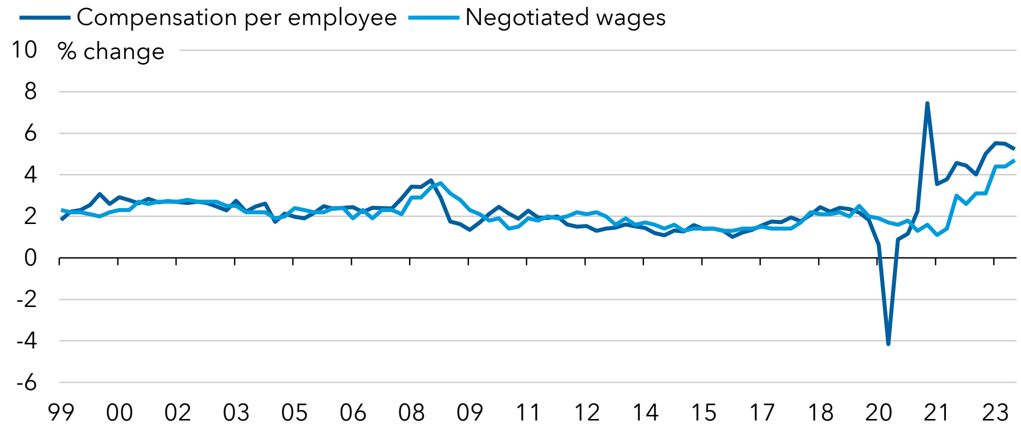
Core inflation in Europe eased significantly in December. While headline inflation rose to 2.9% from 2.4% in November, core inflation (excluding food and energy) fell to 3.4% from 3.6%. There was a distinct easing of core price increases in the final quarter of 2023, with the three-month annualised increase at just 1.4%, compared with 3.6% in the third quarter. Nevertheless, inflation might prove more persistent than expected given further potential supply-chain disruptions caused by the current tensions in the Red Sea and the associated increase in freight-shipping costs from Asia.

There are also concerns that wage costs will remain too high in 2024. Wage growth has picked up sharply over the past year, with workers anxious to recoup some of the loss in real income caused by high inflation. The upcoming wage round in the eurozone (notably in Germany) will be important in determining the extent of real-wage increases in 2024. Widespread labour shortages and intensifying industrial action suggest that employers might have to accept higher wage increases.

Markets may be premature in expecting the first cut in the European Central Bank's (ECB) policy rate in March. The ECB will likely want clearer evidence that wage growth is easing and companies are absorbing higher labour costs into their profit margins before it can ease policy. Isabel Schnabel, the influential German member of the ECB's executive board, gave an interview in December where she sounded more cautious about the prospects for monetary easing. Her more guarded comments recently suggest she is content that interest rates don't need to rise any further. While we think that the markets currently imply too many rate cuts and too soon, the fact that the ECB has finished with the hiking cycle is going to be a strong tailwind to rates over the medium term.

In portfolios, we favour Greece over Italy and are also underweight the front end of curves given current market expectations of rate cuts. The ECB has now set in place quantitative tightening and this should lead to higher term premiums. We remain underweight Italian government bonds as valuations have become less attractive. Italy remains the weakest link within eurozone sovereigns, with lack of commitment towards fiscal consolidation and potential headwinds as the service sector slows. On the other hand, we continue to see value in Greek government bonds. A constructive growth outlook, coupled with prudent fiscal policy and debt management, may result in a steady downward debt profile in coming years. Greece also regained its investment-grade credit rating which could cause further spread compression.

Wage growth remains elevated in Europe



Data as at 15 August 2023. Source: Eurostat, ECB

Yield differential between German Bund and Italian BTP

Data as at 29 December 2023. Source: Bloomberg

The information provided is not intended to be comprehensive or to provide advice.

Labour shortages are driving up wages and inflation

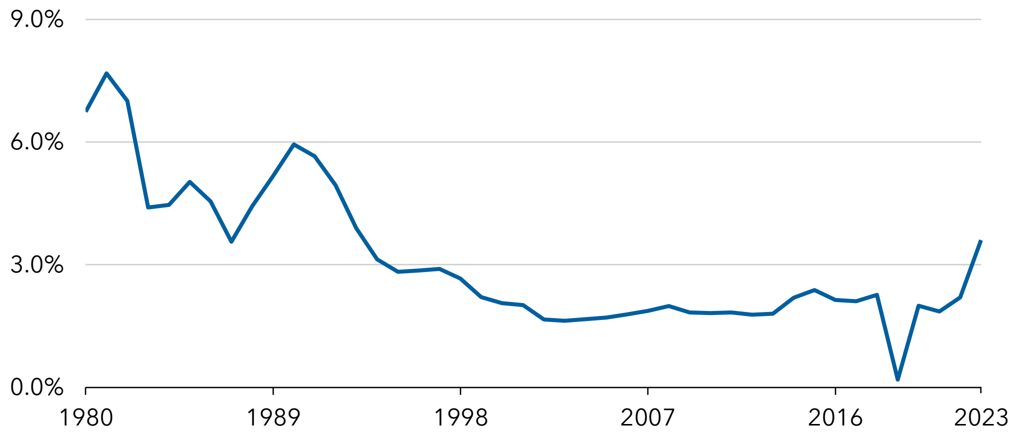
Japan's inflation remains well above its official target, raising hopes for the Bank of Japan's (BoJ) long-sought goal of achieving sustainable 2% inflation. The increase is largely due to the higher cost of imported goods, such as food and energy. However, this trend is expected to slow in the next six months as the Japanese yen stabilises and input costs moderate. Nevertheless, the gradual rise in wages, driven by labour shortages, is likely to push service prices higher. Nominal wage growth is accelerating in line with last April's annual wage agreement. The BoJ is also paying attention to the growth in 'recruitment wages' from online ads, which is rising even faster, partly due to a shortage of IT engineers. Minimum wage increases and additional regulations to limit overtime in transportation and logistics will likely continue to boost pay for more workers.

The Shunto wage negotiations will likely be the focus of attention in the first quarter. These annual wage negotiations between unions and employers are expected to confirm the trend that higher prices have led to higher wages. This means that companies will have to pay more to attract talent, especially younger workers who are increasingly less interested in lifetime employment at traditional companies or in government.

Achieving a sustainable inflation rate of 1-2% has meaningful implications for monetary policy going forward. The BoJ may be able to exit its negative interest rate policy by the first half of 2024 and additional rate hikes may be possible if inflation and the economic outlook remain positive. However, the BoJ will likely continue to carefully manage the market to avoid any unexpected volatility. Any modest changes to the BoJ's monetary policy are unlikely to have a significant impact on the Japanese yen. Although nominal Japanese interest rates may increase over time, if the real interest rate differential with the US remains unchanged it is unlikely that the US dollar-yen exchange rate will move significantly.

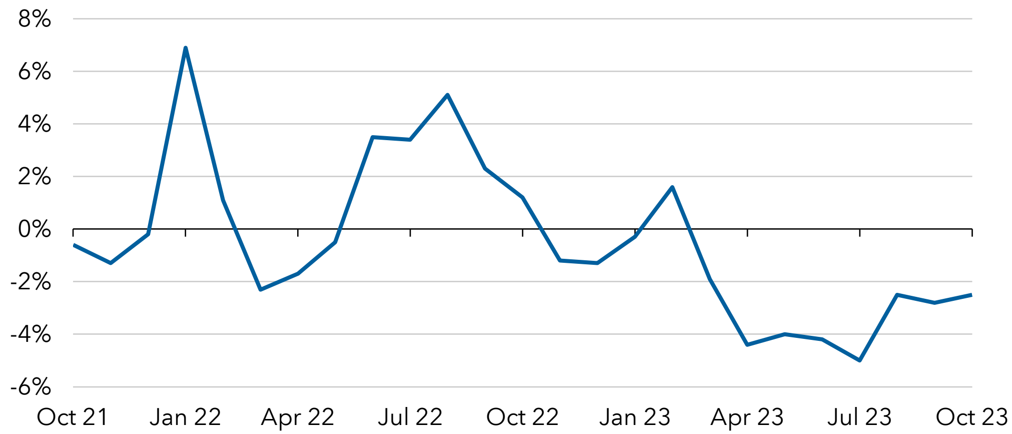
For inflation to be sustainable, real wages must turn positive. There are some concerns regarding this. Domestic demand could weaken before nominal wage growth improves. Nominal wage growth hasn't kept pace with inflation, so real wages have fallen and household consumption has weakened. For real wages to turn positive, inflation needs to slow as wage growth accelerates. This could happen sometime in the first half of 2024. Until then, however, households must be prepared to continue dipping into savings. Moreover, further weakness in China and/or a recession in the US could also disrupt the process.

2023 saw a significant jump in wages



Data as at 4 August 2023. Source: Ministry of Health, Labour and Welfare

Real spending has shrunk



Data as at October 2023. Source: Ministry of Internal Affairs and Communications

Compelling opportunity to add high-quality global rates exposure

Expectations of further interest rate rises in the US, eurozone and UK have been fully priced out on strengthening optimism that we have reached a cyclical peak in interest rates and that developed central banks will ease policy in 2024. Yields peaked in October 2023 on the 'higher for longer' narrative before moving sharply lower through the end of 2023 with a pivot towards earlier and faster rate cuts becoming embedded in futures pricing. The rally meant the Bloomberg Global Aggregate Treasuries Index returned 8.1%, marking its strongest quarter since 2010.

The consensus is now for a soft landing with continued disinflation while avoiding undue economic impact. Expectations for interest rate cuts in 2024 should be a tailwind for duration-related assets. The US Federal Reserve (Fed) and European Central Bank (ECB) are expected to begin easing rates in March/April, with the UK to follow in the second quarter. Markets have now priced in more than 100 basis points of rate cuts in each market during 2024.

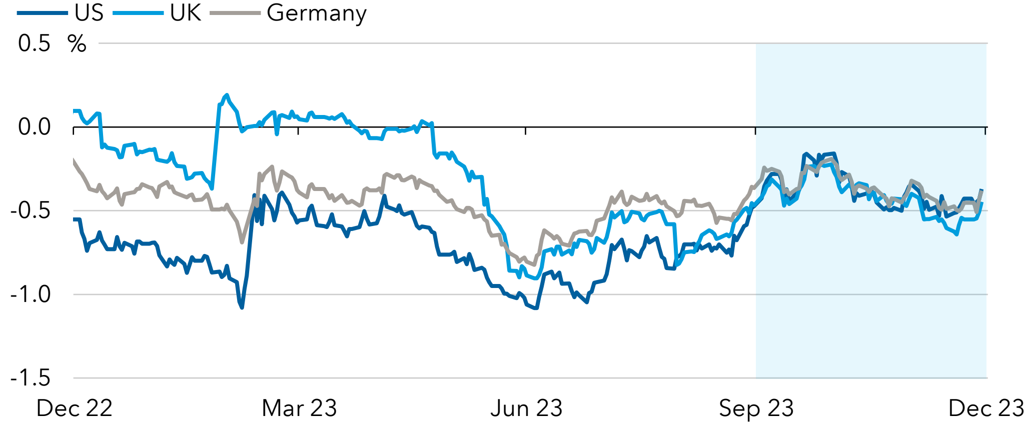
Our highest conviction is in US and UK rates exposure. The Fed has historically been the first mover across developed market central banks, whereas we think the ECB is likely to delay cuts until there are firmer signs of easing wage growth.

We see value in the UK relative to Europe given the UK's higher interest-rate sensitivity and its more attractive yields. Exposure to Japanese Government Bonds remains less appealing given the expected policy normalisation from the Bank of Japan.

We also favour curve steepener positions as a recession remains a possibility given the extent of interest rate increases and that we may yet see the full impact of those increases. Given the strength of consensus behind a soft-landing scenario and extent of cuts already priced by the market, our strategy is to combine modestly increased duration exposure with curve steepener positions. This positioning should help to mitigate against the risk of investing exclusively around the binary outcome of hard versus soft landing.

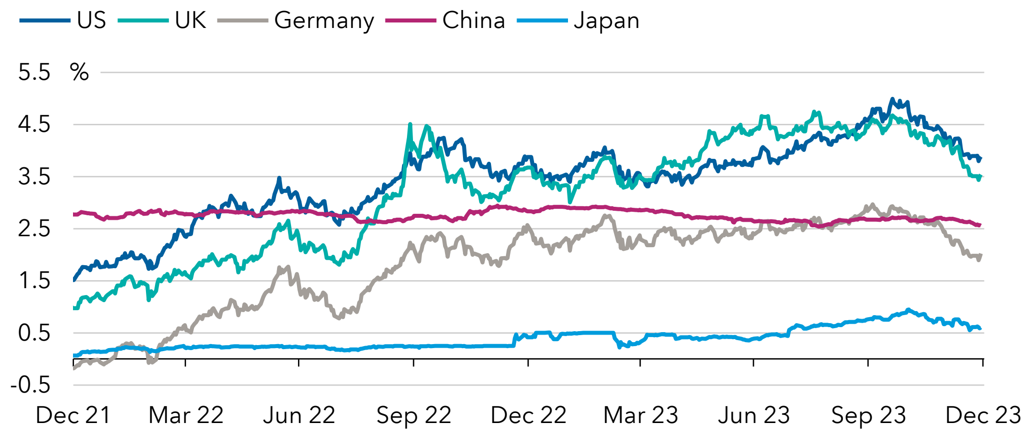
Our outlook for currencies is balanced. Lower US rates would reduce the real rate differential versus other currencies, however, this is offset by the downside risk of weaker global growth, which would support the US dollar. We do, however, see value in the Japanese yen given the Bank of Japan is expected to move away from its ultra-accommodative monetary policy stance in 2024.

Major curves remain inverted, offering opportunity for steepening positions to add value



Data as at 29 December 2023. Chart shows 2s10s curves for major markets. Source: Bloomberg

Yields are still high versus early 2023 levels despite the rally in Q4



Data as at 29 December 2023. Chart shows 10-year yields for major markets. Source: Bloomberg

Past results are not a guarantee of future results. The information provided is not intended to be comprehensive or to provide advice.

Focus on finding idiosyncratic opportunities at the company and sector level

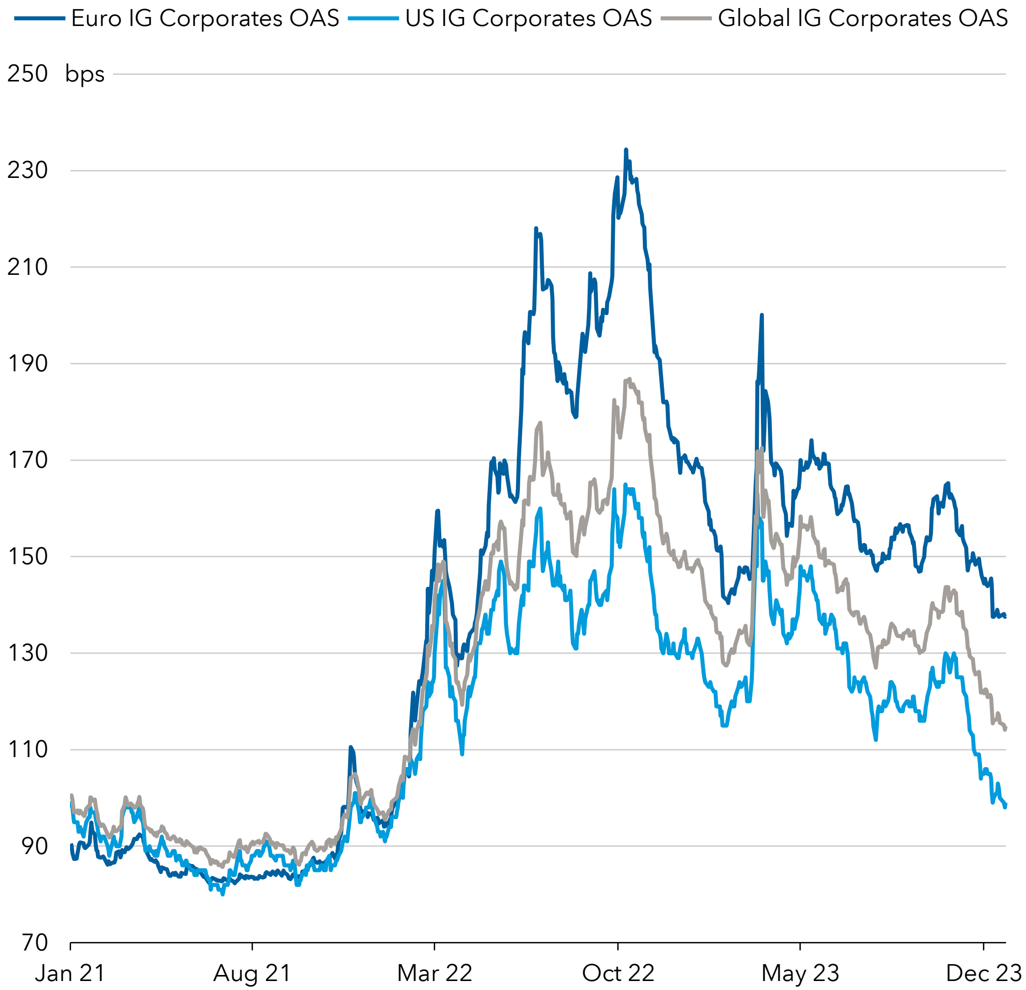
The global corporate bond market benefitted from a resurgence in investor sentiment in the final three months of 2023. Optimism about the prospects for policy rate cuts by central banks, together with expectations for a relatively resilient economic outlook, led to tighter credit spreads. Corporate issuers took the opportunity to issue a large volume of new bonds, which were taken up very well by the market overall. The global corporate bond index spread (Bloomberg Global Aggregate Corporate Index) ended the quarter at 115 basis points (bps), 20bps tighter versus end-September levels. However, the move was not in a straight line: October saw the spread rise as high as 144bps as the 'higher-for-longer' mantra took hold, before it tightened all the way down to 115bps.

US corporate bonds outpaced their European counterparts. US corporate bond spreads tightened by 22bps to finish the quarter at 99bps, whereas spreads on European corporate bonds tightened 16bps to finish the quarter at 138bps. These respective movements meant the spread between US and European corporates widened 7bps to 39bps. This is perhaps unsurprising given the euphoria around potential monetary policy easing in 2024 was focused on the US, with the US Federal Reserve (Fed) now forecasting three rate cuts in 2024, whereas the European Central Bank has pushed back against expectations for cuts.

The global economic, geopolitical and monetary policy outlook remains uncertain. The potential for recession and weakening corporate fundamentals are still present, despite the significant improvement in financial market conditions over recent months. At an index level, valuations are not compelling overall, as corporate credit spreads are slightly tight versus historical averages. However, there are pockets of opportunities, given wider spreads in European corporate bonds versus their US counterparts, and better valuations in bonds issued by financials companies than those in the industrials sector.

Investor demand for corporate bonds remains very solid and recent heavy issuance has been taken up well. The all-in-yield of global corporate bonds remains reasonably attractive, and the opportunity to secure today's yield levels may not be sustained for long given the potential for interest rate falls in 2024, as predicted by the market (and now the Fed). Given the uncertainties, we are not positioned for one particular macroeconomic outcome in global corporate bond portfolios – instead our focus is on finding idiosyncratic opportunities at the company and sector level, such as in banking, utilities and chemicals.

Corporate bond OAS



Data as at 29 December 2023. IG: investment grade, OAS: option adjusted spread. Indices: Bloomberg Euro Aggregate Corporate Index, Bloomberg US Corporate Investment Grade Index, Bloomberg Global Aggregate Corporate Index. Source: Bloomberg

Past results are not a guarantee of future results.

Valuations don't leave much room for downside surprises

Strong demand for investment grade credit in the fourth quarter pushed spreads tighter as US Treasury yields declined. Spreads for the Bloomberg Investment Grade Corporate Index fell 22 basis points (bps) to finish the year at 99 bps. That brought spread tightening for the year to 31 bps and marked an even stronger compression from a period of banking-related volatility in March that pushed spreads above 160 bps. The decline in Treasury yields and tighter spreads brought the yield down to 5.06% for the investment grade corporate index, nearly 100 bps lower for the quarter and 36 bps lower for the year. This helped drive the return of 8.50% for the quarter and 8.52% for the year.

The compression in yields and spreads reflects optimism for lower inflation and a constructive economic backdrop for corporations. Credit spreads are starting 2024 roughly 30 bps lower than both their long-term average and where they were one year ago. Recession concerns have been replaced by a higher level of confidence in a soft landing, where the Federal Reserve (Fed) hits the brakes on inflation without sending the economy into a downturn. Under this scenario, it is conceivable that spreads could continue to tighten as the year progresses, but valuations are already discounting a benign outcome for the economy.

The sector's credit fundamentals remain sound but are deteriorating at the margin. Revenue growth has slowed and interest costs are increasing on the back of higher interest rates. Investment grade issuance in 2024 is expected to be consistent with 2023 and easily absorbed by the market as investor appetite for investment grade debt should remain firm.

Corporate bond spreads have widened in the last three major rate-cutting cycles, but this time may be different. Spreads have historically widened several months after the Fed first begins cutting its policy rate. However, it's not clear that this cycle will follow a similar pattern. If the Fed engineers a soft landing and cuts rates as inflation returns to target, then corporate bond spreads could remain around current levels. In that case, returns should be driven more by yield changes in Treasury rates.

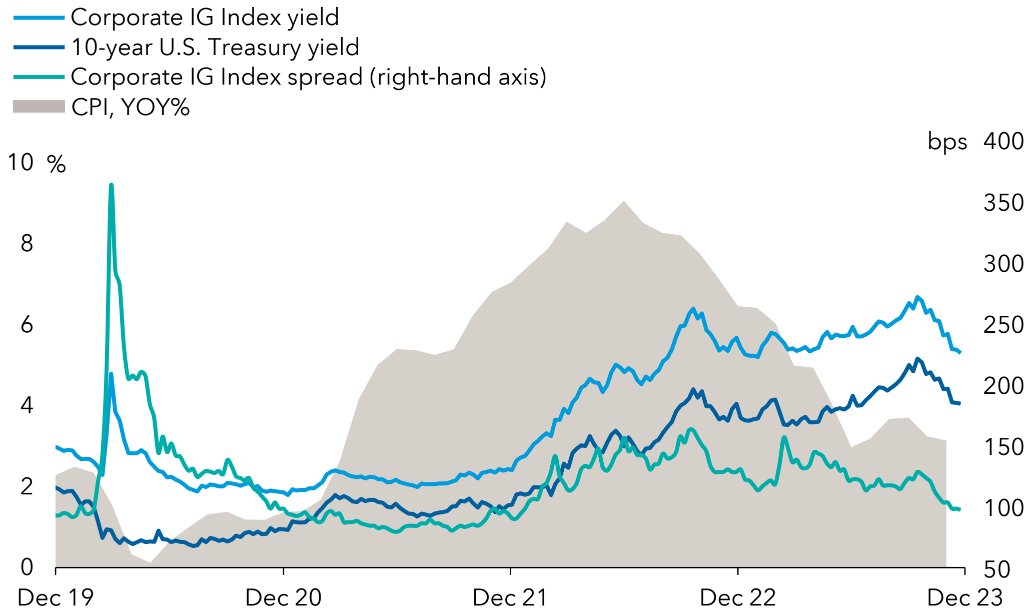
If the environment is less benign in the coming year, then any spread widening would likely be offset by lower Treasury rates. In an environment where growth disappoints and a recession does occur, this would likely drive Treasury rates lower, as the Fed moves to cut rates, while pushing spreads wider. Lower Treasury yields along with the sector's average seven-year duration should help to alleviate the negative return impact of wider spreads.

Bloomberg US Corporate Investment Grade Index

	Δ Q4	Δ 2023	As at 31 Dec 2023
Spreads	▼ 22 bps	▼ 31 bps	99 bps
Yields	▼ 98 bps	▼ 36 bps	5.06%
Returns	▲ 8.50%	▲ 8.52%	–

Data as at 31 December 2023. Figures reflect option-adjusted spreads and yield-to-worst. Source: Bloomberg

US IG spreads and yields reflect optimism for lower inflation



As of 31 December 2023. Corporate IG Index reflects the Bloomberg US Corporate Investment Grade Index. CPI reflects the Consumer Price Index. IG: investment grade. Source: Bloomberg

Past results are not a guarantee of future results.

Doubling down on credit selection amid tight valuations

The high-yield bond market's fourth quarter return was one of its strongest quarterly returns on record, excluding recession-linked recovery periods, due to a continuation of strong economic data, Fed rate-cut expectations and continued moderation of inflation. Longer duration, high-quality BB-rated bonds led the market, with B- and CCC-rated bonds not far behind.

Current valuations reflect an expectation of continued economic and earnings growth, and potential for monetary easing. This may create periods of spread volatility in the near term as the trajectory and timing of a deceleration of inflation, Fed cuts and/or overall economic conditions remain uncertain. That said, corporate leverage levels appear in check and mirror other periods of economic growth.

We expect new issuance to increase in 2024, albeit from very low levels over the past two years. With rates still elevated, though expected to decline as the year progresses, issuance is likely to be focused around the estimated US$150–US$200 billion in refinancing of 2024/2025 maturities. Still, refinancing needs remain generally low through 2026. Opportunistic issuance may remain limited since current rates exceed existing coupons.

Given these factors, 2024 appears to be a credit selector's environment.

The dispersion of potential earnings growth is wide and some sectors, like gaming/leisure, cruise lines and entertainment, may see significant year-over-year declines in earnings growth following significant gains in 2023. That said, a low growth economy is generally good for credit, but highly idiosyncratic with excess returns highly dependent upon issuer selection.

We continue to be defensively positioned, which includes a bias toward higher-quality lower-yielding bonds and higher-than-normal levels of cash in high-yield portfolios. We believe liquidity could be beneficial should volatility pick up and spreads widen in a risk-off environment and serve to add to risk when prudent. From a sector perspective, we remain underweight consumer cyclical and overweight the higher quality energy sector.

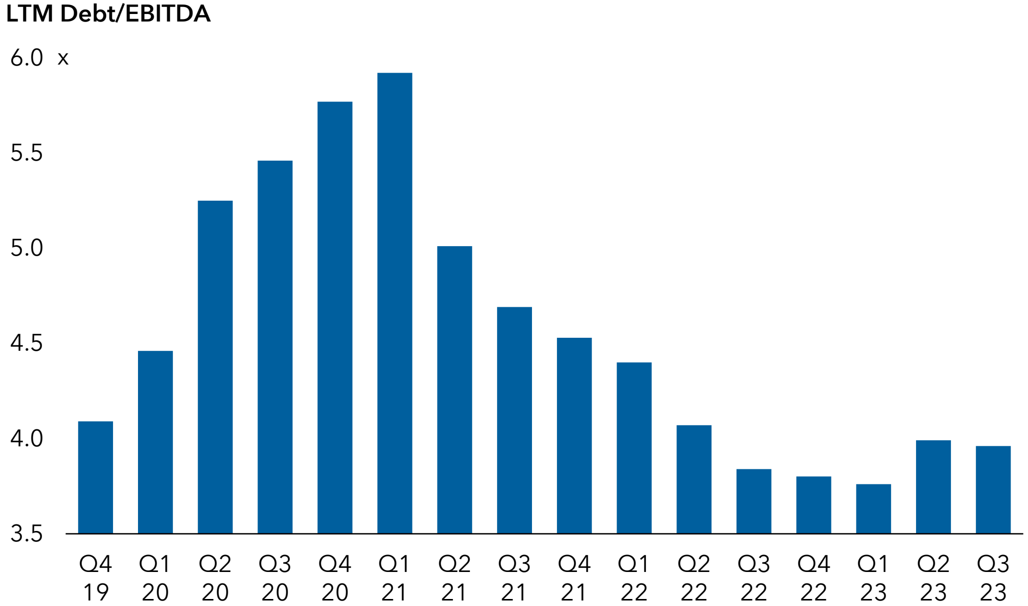
While valuations appear to be tight, high-yield fundamentals and balance sheets generally remain healthy. A fundamental backdrop of slow yet positive economic growth and technical backdrop of low non-refinancing issuance is supportive of the sector. While spreads may widen from current levels, the positive economic backdrop and potential Fed rate cuts could offset credit risk and provide attractive returns for high-yield investors.

Bloomberg US Corporate High Yield 2% Issuer Capped Index

	Δ Q4	Δ 2023	As at 31 Dec 2023
Spreads	▼ 73 bps	▼ 147 bps	323 bps
Yields	▼ 131 bps	▼ 138 bps	7.59%
Returns	▲ 7.15%	▲ 13.44%	–

Data as at 31 December 2023. Figures reflect option-adjusted spreads and yield-to-worst. Source: Bloomberg

US high-yield issuers maintain low leverage levels



As at 31 December 2023. LTM = last 12 months. EBITDA = earnings before interest, taxes, depreciation and amortisation. Source: JPMorgan, S&P Capital IQ

Past results are not a guarantee of future results.

A dovish Fed could unlock opportunity, some caution warranted

Emerging markets (EM) bonds notched significant gains during the fourth quarter, as the Federal Reserve (Fed) struck a more dovish tone on the back of softening economic data. Risk markets rallied on expectations that rate cuts could come earlier than expected in 2024. Both hard- and local-currency-denominated EM bonds benefitted broadly across regions and ratings cohorts from the shift in market sentiment.

Higher yielding hard currency issuers outpaced their investment-grade-rated counterparts during the period. African high-yield issuers posted some of the strongest gains, as investors favoured the added yield pick-up in these credits despite their elevated risk of default.

Across local-currency-denominated EM sovereign bonds, Latin American and European issuers drove overall results through a combination of price and currency appreciation. Rate differentials between a number of these issuers and US Treasuries remained attractive despite the recent pivot toward rate cuts by several Latin American and peripheral European central banks.

Looking ahead, the somewhat unexpected dovish shift from the Fed in late 2023 should provide a reasonably constructive backdrop for EM debt in 2024. A more accommodative Fed should allow many EM central banks to move monetary policy in a direction that better reflects their domestic outlooks. In most of the core EM economies, inflation is expected to decline throughout 2024, allowing policy rates to come down.

Falling EM interest rates should provide a duration tailwind for local currency debt holders. To that end, we favour owning local duration in countries where inflationary pressures continue to abate and monetary policies have become more accommodative. Many of these are in Latin America, including Brazil and Mexico, but we are also finding select opportunities across Asia and Africa. We remain more cautious in Central Europe where aggressive easing cycles appear to largely be priced into bonds.

Across EM hard currency debt issuers, the Fed's dovish tilt should reduce some of the external financing pressures on lower rated frontier economies. We continue to find value in a limited number of these bonds where high yields and reasonably wide spreads provide a cushion against likely volatility and high default risk.

We also find value in some EM corporate dollar issuers where fundamentals are generally good. The geographic representation and risk structure of EM corporates are quite different than sovereigns, and help provide an element of diversification.

Overall, the outlook for EM debt becomes more favourable if the Fed pursues earlier and more aggressive monetary easing than markets initially expected. That said, caution is warranted as EMs may still have to contend with weak global growth, ongoing geopolitical uncertainty and a busy global election year.

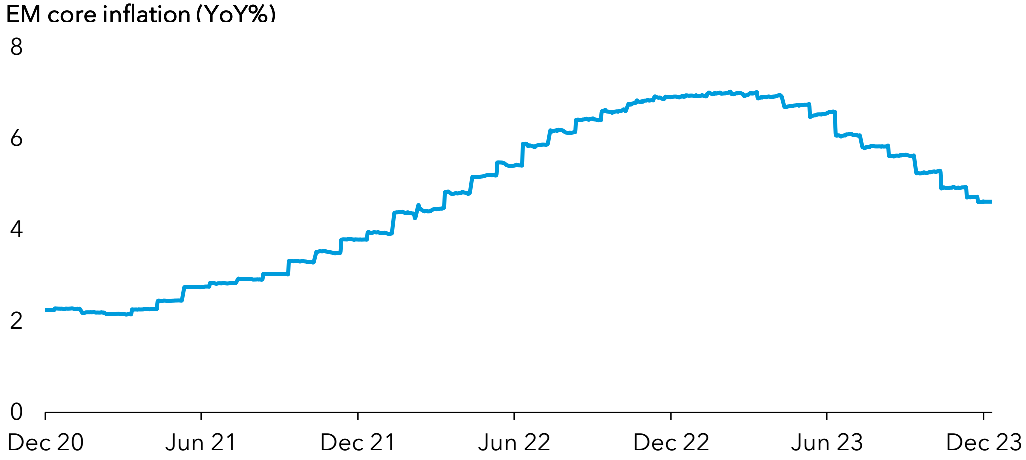
Notable emerging markets spreads, yields and currencies

	Δ Q4	Δ 2023	As at 31 Dec 2023
EM USD investment-grade index spreads[1]	▼ 12 bps	▼ 18 bps	116 bps
EM USD high yield index spreads[2]	▼ 88 bps	▼ 122 bps	701 bps
EM USD index returns[3]	▲ 9.16%	▲ 11.09%	–
EM local index yields[4]	▼ 57 bps	▼ 66 bps	6.19%
EM local index returns[5]	▲ 8.07%	▲ 12.70%	–
EMFX versus USD[6]	▲ 5.28%	▲ 8.44%	–

Data as at 31 December 2023. Sources: Bloomberg, JPMorgan.

1. Figures reflect spread to worst on the IG component of the JPMorgan Emerging Markets Bond Index (EMBI) Global Diversified index.
2. Figures reflect spread to worst on the HY component of the EMBI Global Diversified index.
3. Figures reflect the EMBI Global Diversified index.
4. Figures reflect yield to maturity on the JPMorgan Government Bond Index - Emerging Markets (GBI-EM) Global Diversified index.
5. Figures reflect the GBI-EM Global Diversified index.
6. EMFX reflects JPMorgan ELMI+ index returns in US dollars.

Inflation in most EMs may continue to decline in 2024



As at 31 December 2023. Index: JPMorgan GBI-EM Global Diversified index, excluding Argentina and Turkey. YoY: year-over-year. Source: JPMorgan

Past results are not a guarantee of future results.

Seeking value in select parts of the muni curve

Municipal bond market yields had a very strong rally in the fourth quarter alongside the Treasury market. The market reaction was driven by a view that the Federal Reserve (Fed) was done raising rates and prepping for a pivot toward rate cuts. Going forward, the demand for municipal bonds should remain strong as investors transition out of cash.

Rates declined as investors recalibrated their future interest rate expectations as the Fed turned dovish. Yields on 10-year AAA-rated municipals decreased 117 basis points (bps) during the quarter to reach 2.25%. The move in the Treasury market was not as significant as in the municipal market; the 10-year Treasury declined 69 bps during the quarter. The rapid decline in rates provided a significant tailwind for municipal returns, with the Bloomberg Municipal Bond Index posting a gain of 7.89% for the quarter while the Bloomberg High Yield Municipal Index rose 9.21%.

The municipal yield curve remains inverted. The curve did steepen, reversing some of the inversion, primarily due to the larger movement in the front end of the curve during the recent rally.

Three-month AAA-rated municipal rates decreased 147 bps, which was 30 bps more than the decline on similarly rated 10-year municipals. We continue to find the belly of the curve less attractive and find value in moving out the curve. The 10s to 30s slope of the curve is reasonably attractive.

Fundamentals for states and local governments remain solid with the continuation of a relatively strong employment and economic outlook. As state and local governments spend the last of their stimulus cash, credit selection may become increasingly important. Even though yields have rallied significantly, they still represent an attractive opportunity at current levels as the Fed is expected to start lowering rates in 2024.

The municipal single-family housing sector offers very compelling valuations. Municipal single-family housing bonds are mortgage-backed issues that are a AAA/AA-rated segment of the market and offer similar yields to much lower quality segments of the market. We are also finding attractive opportunities in the tax-allocation and tax-assessment segments of the market.

Bloomberg Municipal Bond Index

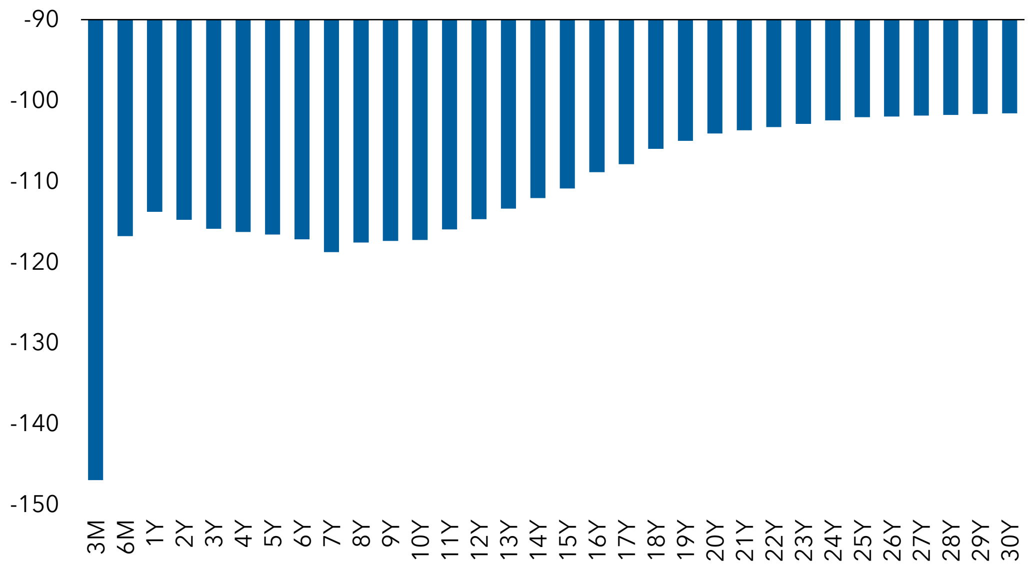
	Δ Q4	Δ 2023	As at 31 Dec 2023
Spreads[1]	▼ 7 bps	▼ 5 bps	97 bps
Yields	▼ 110 bps	▼ 33 bps	3.22%
Returns	▲ 7.89%	▲ 6.40%	–

Data as at 31 December 2023. Yields reflect yield-to-worst. Source: Bloomberg

1. Spreads reflect the difference in yield-to-worst between the Bloomberg Municipal Bond Index and the BVAL Municipal AAA (Callable) 10-year Yield Curve.

Short-term muni yields saw an outsized decline in the recent rally

Change in AAA-rated muni yields during Q423 (bps)



Data as at 31 December 2023. Figures reflect the change in yield from 30 September 2023 to 31 December 2023 for various tenors in the AAA-rated muni universe. Source: Bloomberg

Past results are not a guarantee of future results.
The information provided is not intended to be comprehensive or to provide advice.

Compelling relative value despite recent rally

Agency mortgage-backed securities (MBS) experienced one of its best quarters in at least a decade, from both a total and excess return perspective. Alongside a broad rally spurred in part by the Federal Reserve's dovish shift, spreads tightened meaningfully during the quarter to close a relatively volatile year. The tightening in spreads marked a sharp reversal from widening earlier in the year that peaked at the start of the quarter, when the market was driven by a "higher for longer" narrative on rates.

Valuations, particularly relative to other asset classes, remain attractive despite the recent tightening. Agency MBS as a sector significantly lagged sectors like investment grade corporate credit during 2023 and offers a compelling risk-to-reward tradeoff, particularly given a higher quality profile, little to no credit risk, and generally greater liquidity. The combination of high-quality assets with attractive excess return potential underpins the value proposition for agency MBS relative to other sectors.

The potential for volatility in interest rates to subside could improve valuations. The Fed sent one of its strongest signals in its December meeting that the current hiking cycle - one of the most aggressive in decades - is likely coming to an end. Slowing inflation could allow interest rates to fall over the medium term, which typically coincides with lower volatility. In the recent rally, implied volatility in interest rates has declined but remains historically elevated and has further room to fall.

Fundamentals remain healthy for agency MBS. The negative convexity, a typical characteristic of the asset class, is at relatively low levels. The recent decline in mortgage rates may lead to some increase in refinancing activity, but selection within the coupon stack could help blunt at least part of that impact. The extent of prepayment risk varies depending on the coupon stack, with higher coupons - which have been more resilient and offered compelling yield and income profiles - likely facing higher prepayment risk now. We are still finding attractive opportunities in the higher end of the coupon stack, but less than in the past six to 12 months.

Supply may be less of a tailwind, but valuations relative to other asset classes should bolster demand. MBS supply may increase as mortgage rates fall, though seasonal factors in the winter remain favourable. In addition, the potential for resiliency in a risk-off environment alongside a still robust income profile should draw investors facing tight valuations and higher credit risk in many other sectors.

Bloomberg US Mortgage Backed Securities Index

	Δ Q4	Δ 2023	As at 31 Dec 2023
Spreads	▼ 19 bps	▼ 4 bps	47 bps
Yields	▼ 89 bps	▼ 3 bps	4.68%
Returns	▲ 7.48%	▲ 5.05%	–

Data as at 31 December 2023. Figures reflect option-adjusted spreads and yield-to-worst. Source: Bloomberg

Interest rate volatility has declined but remains relatively elevated

As at 31 December 2023. 1yr10yr vol measures the implied volatility for interest rates based on the options market. Source: Bloomberg

Past results are not a guarantee of future results.

Important information

About Capital Group

Founded in 1931, managed fixed income assets since 1973

Privately held

Over US$2.5 trillion in assets under management*

* Assets under management as at 31 December 2023, and is preliminary. All values are in USD. Totals may not reconcile due to rounding.

Capital Group manages equity assets through three investment groups. These groups make investment and proxy voting decisions independently. Fixed income investment professionals provide fixed income research and investment management across the Capital organisation; however, for securities with equity characteristics, they act solely on behalf of one of the three equity investment groups.

The statements expressed herein are as of the date published, are subject to change at any time based on market or other conditions and are based on information from sources believed to be reliable. This publication is intended merely to highlight issues and is not intended to be comprehensive or to provide advice. Permission is given for personal use only. Any reproduction, modification, distribution, transmission or republication of the content, in part or in full, is prohibited. Certain market indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index.

Index definitions: The Bloomberg indexes are unmanaged, and results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or US federal income taxes.

Bloomberg Municipal Bond Index is a market value-weighted index designed to represent the long-term investment-grade tax-exempt bond market.

Bloomberg US Corporate High Yield Index covers the universe of fixed-rate, non-investment-grade debt.

Bloomberg US Mortgage Backed Securities Index is a market-value-weighted index that covers the mortgage-backed pass-through securities of Ginnie Mae (GNMA), Fannie Mae (FNMA), and Freddie Mac (FHLMC).

Bloomberg US Treasury Index is a market-value-weighted index including US Treasury securities with at least one year to final maturity.

Bloomberg High Yield Municipal Bond Index is a market-value-weighted index composed of municipal bonds rated below BBB/Baa.

Bloomberg US Corporate Index represents the universe of investment grade, publicly issued US corporate and specified foreign debentures and secured notes that meet the specified maturity, liquidity, and quality requirements.

J.P. Morgan Emerging Markets Bond Index (EMBI) Global Diversified and related country-specific indexes track total returns for US dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities: Brady bonds, loans, eurobonds.

J.P. Morgan Government Bond Index – Emerging Markets (GBI-EM) Global Diversified and related country-specific indexes cover the universe of regularly traded, liquid fixed-rate, domestic currency emerging market government bonds to which international investors can gain exposure.

Bloomberg® is a trademark of Bloomberg Finance L.P. (collectively with its affiliates, "Bloomberg"). Neither Bloomberg nor Bloomberg's licensors approves or endorses this material, guarantees the accuracy or completeness of any information herein and, to the maximum extent allowed by law, neither shall have any liability or responsibility for injury or damages arising in connection therewith.

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.