AMERICAN FUNDS®

From Capital Group

Market Update

September 2015

Interest Rates

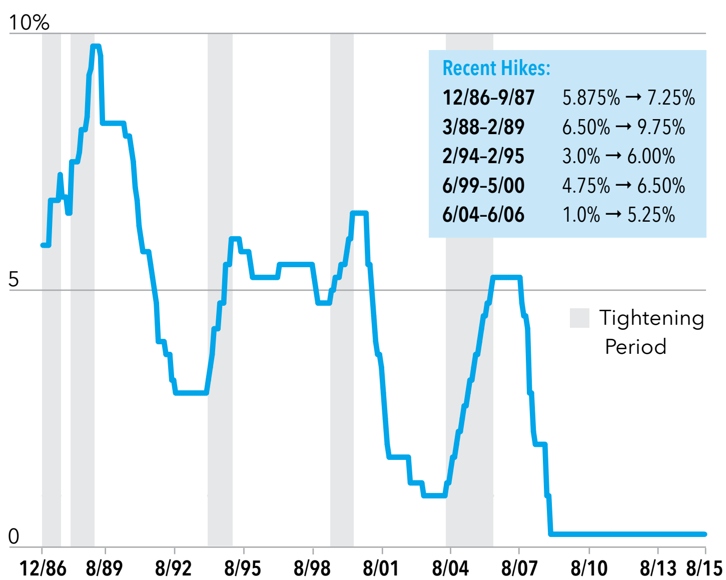
Fed Rate Decision: Near-Zero For Now, But Higher Soon?

Summary

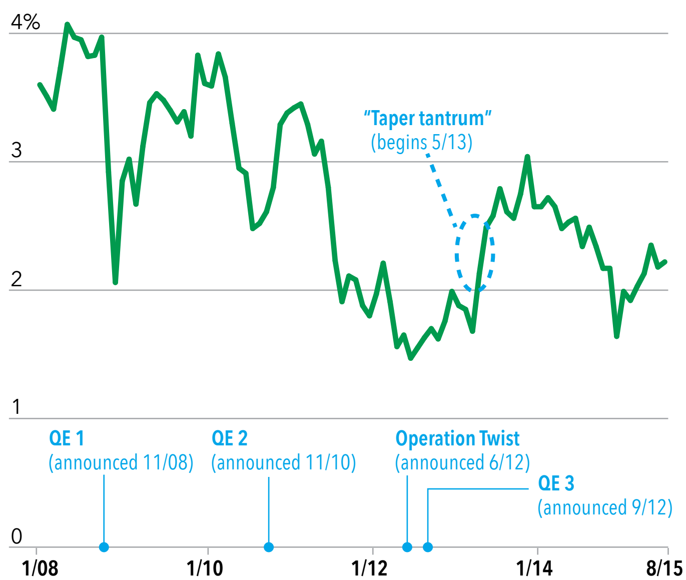
- The Federal Reserve has decided to keep interest rates close to zero, as concern about global economic conditions casts a shadow over an otherwise fairly positive outlook for the U.S. economy.
- Looking forward, the Fed is expected to raise rates gradually, and an increase of 0.25%, for example, would be unlikely to have a significant impact on the economy.
- Over time, higher interest rates can be beneficial for active bond investors, enabling reinvestment in issues offering higher yields and, therefore, possibly greater potential returns.
- Rising rates have a varied impact on stocks. Selective investors who emphasize company-specific research should continue to find attractive longer term income and return opportunities.

The Fed Last Hiked Rates in 2006, and Has Deployed Unconventional Monetary Policy Since 2008.

Fed Funds Rate



10-Year U.S. Treasury Yields



All data through August 31, 2015. Recent hikes shown exclude single rate hike in March 1997.

Sources: Capital Group, FactSet.

Multiple Perspectives. One Approach.®

How Did We Get Here?

The last U.S. interest rate hike was in June 2006 – the culmination of a two-year period during which the federal funds target rate was raised from 1% to 5.25%. Then, in September 2007 – amid rising market volatility and a housing market correction – central bank policy began to head in the opposite direction.

Over the next 15 months, the Fed progressively lowered rates in a bid to counter the sharp deterioration in economic and market conditions prompted by the global financial crisis. In November 2008, the Fed announced its first quantitative easing bond-buying program (QE1), and a month later it lowered interest the benchmark interest rate to virtually zero. Further bond-buying programs were unveiled over the next five years, the third of which (QE3) ended in October 2014.

With the world watching closely, the U.S. Federal Reserve on Thursday decided to leave short-term interest rates unchanged, allaying fears that a rate hike now could threaten the U.S. economic recovery and add to already high levels of market volatility seen over the past two months.

U.S. government bonds rallied as Fed officials made it clear that the seven-year experiment with zero-bound interest rates would not end in September. The federal funds rate has remained near zero since December 2008 amid the global financial crisis. Moreover, the Fed has not increased rates in nearly a decade. Speculation around the timing of the first hike has been rampant for months; however, the significance of that milestone remains up for debate.

"The first move, in my view, is not nearly as important as the slope of subsequent rate increases," said David Hoag, a portfolio manager with The Bond Fund of America®. "I expect that slope to be shallow, with very slow, measured movements. The message we just heard from the Fed confirms that view for me. The 'lower for longer' interest-rate scenario is still very much intact."

"I am less concerned about the first rate hike and more focused on the second, third and fourth," Hoag explained. "I think those have been pushed a bit farther out now."

In addition to standing pat on rates, the Fed slightly downgraded its outlook for U.S. economic growth in 2016, acknowledging that a strong dollar and turmoil in international markets, particularly China, were taking a toll. Both events have effectively tightened financial conditions without a rate increase. Fed officials also noted that inflation remains well below their 2% target, and they expect it may take longer to reach that goal, largely due to falling energy prices.

"There are still a lot of questions in my mind about the health of the U.S. economy," said Ritchie Tuazon, a portfolio manager with American Funds Inflation Linked Bond Fund ®. "Thursday's meeting confirms that Fed officials also believe there are questions and, therefore, it is sensible to wait a little longer before raising short-term rates."

Although the Fed can hike rates at any time, the next official meetings of the Federal Open Market Committee are scheduled for October 27-28 and December 15-16. A majority of FOMC members expect to raise rates before the end of the year, according to Thursday's Fed announcement.

The Fed's Difficult Balancing Act

In the weeks leading up to the Fed's September meeting, prices in financial markets suggested that a rate hike would almost certainly happen at some time in 2015, with a first move toward year-end more likely. The decision was, therefore, not a surprise. That said, even within the Fed, the question of when rates should be raised has sparked much debate. Reflecting the dilemma that the central bank is confronting, policymakers have expressed a range of views over the past year or so.

On one side of the debate, a largely rosy domestic picture bolsters the case for higher interest rates. Though inflation remains below the Fed's 2% official target, the economy is growing steadily and the labor market is in good shape. According to the Fed, the U.S. now has "full employment," with an unemployment rate of 5.1% in August (the lowest level since April 2008).

On the flip side, there's concern that the domestic economy may lack resilience – especially if the global backdrop deteriorates further. In recent weeks, financial market volatility emanating from China has added another wrinkle – helping prompt a selloff in U.S. stocks, rising corporate borrowing costs and further strengthening of the dollar that may hurt U.S. exports. Given these developments, it could be argued that to do anything other than maintain zero interest rates may risk derailing growth.

This kind of thinking has been evident in recent cautionary statements from both the International Monetary Fund and the World Bank. Both institutions have argued that, given the global repercussions of slowing growth in China, low U.S. inflation may persist – and that to raise rates could further destabilize emerging markets, which would likely have knock-on effects for many developed economies.

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– **David Hoag,** Portfolio Manager

Gradual Rate Hikes Still the Likely Scenario.

The Fed is still widely expected to increase interest rates gradually over the next year or so. We are, however, mindful that monetary policy may follow a different path if Fed leaders become concerned by the domestic outlook for growth, employment or inflation.

For example, Fed Vice Chair Stanley Fischer recently noted that there was good reason to believe that inflation would move higher. And yet, this view contrasts with the market's view: bond pricing suggests that inflation could remain stubbornly below the Fed's 2% target for years. Should inflation or other key economic data not evolve as currently anticipated, it may give the central bank pause.

Globally, monetary policy is overwhelmingly easy with many central banks lowering interest rates or on hold, having previously lowered. Consequently, relatively low interest rates prevail – notably augmented by official bond-buying programs in the euro zone and Japan. Just a handful of central banks in developed and developing nations have raised rates in the past few months, mostly to counter currency depreciation, inflation or capital flight.

Bond Investors Shouldn't Fear the Fed.

Actual and anticipated changes in Fed policy are often accompanied by bursts of volatility, though markets tend to settle down after a period of initial reaction. For bond investors, it's important to remember that, although rising interest rates hurt bond prices in the near term, that's far from the whole story. Over time, higher rates are beneficial for fixed-income investors because they allow reinvestment to occur at higher yields – ultimately producing better total-return opportunities down the road.

And even in periods when bond yields trend higher, active managers have the scope to confront this challenge. For example, depending on their investment guidelines, active bond investors can increase exposure to shorter maturity bonds, inflation-linked bonds and other types of issues whose values tend to be more resilient amid rising interest rates.

However the Fed Proceeds, it's an Easy World.
A Selection of Developed-Country Central Bank Interest Rates

	Key Interest Rate	**Most Recent Move**
Canada	0.50%	–0.25% (7/15/15)
Euro Zone	0.05%	–0.10% (9/4/14)
Japan	0%–0.10%	–0.10% (10/5/10)
United Kingdom	0.50%	–0.50% (3/5/09)
United States	0%–0.25%	–0.75% (12/16/08)

As of August 31, 2015.
Sources: Capital Group, central banks.

Investors Should Continue to Find Opportunity in U.S. Stocks.

For stocks, the potential impact of higher interest rates varies across sectors and from company to company. The financial industry has often (but not always) benefited from higher rates which can make lending potentially more profitable. Conversely, higher financing costs can pressure profit margins in some industries; airlines, for instance, may find it more costly to finance aircraft leases and purchases.

Meanwhile, income-oriented investors who have favored the highest yielding, more rate-sensitive sectors such as utilities and telecommunications may encounter a more challenging investment environment. That said, not all areas of the equity-income market are similarly susceptible to rising rates.

Arguably, higher yielding companies in economically cyclical industries, such as those in the consumer discretionary sector, may continue to look relatively favorable. Because they have the potential to benefit from growth, such stocks may be less impacted by rate increases tied to an improving economy. So, in a rising-rate environment, a focus on lower yielding companies with the potential to grow their dividends over time could prove beneficial.

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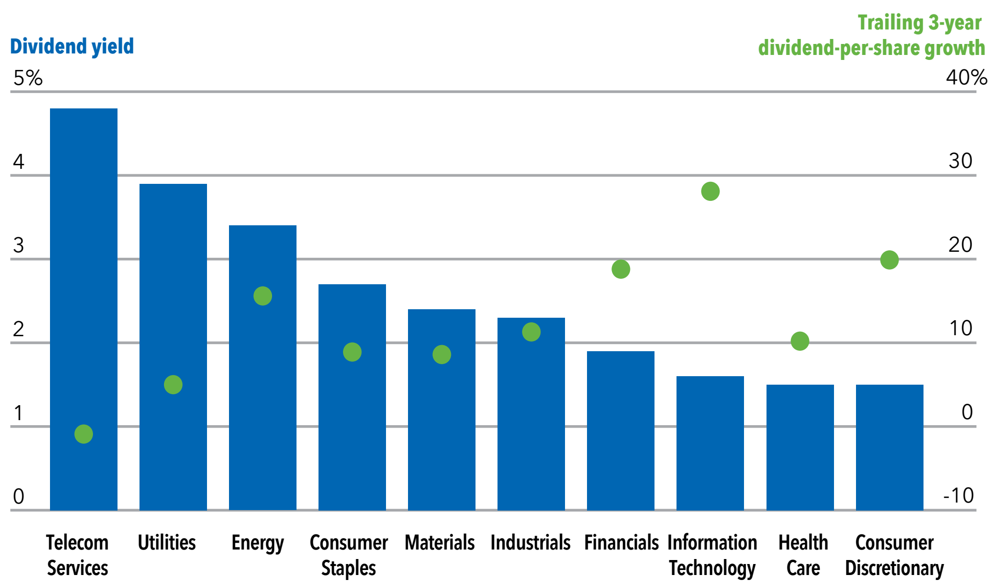
In a Scenario of Rising Rates and an Improving Economy, Firms in Cyclical Industries Could Still Grow Dividends.



As of August 31, 2015.
Source: FactSet.

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