



Benefit From Pessimism in International Markets.

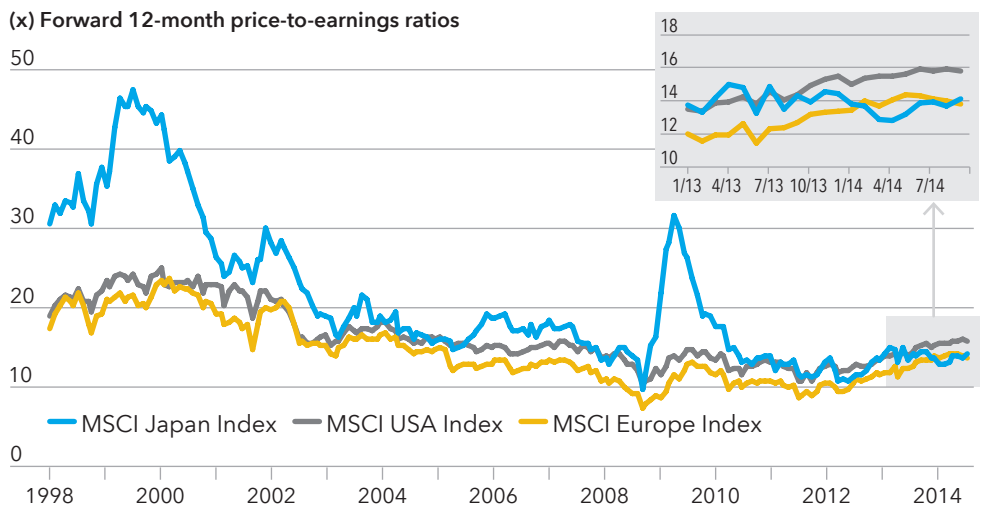
Investors Should Look Beyond the U.S. for Long-Term Growth Opportunities

Many of our equity portfolio managers are finding good value in European and Japanese businesses despite expectations of prolonged economic weakness in these areas of the world. In their view, markets are placing too much emphasis on economic conditions and are anticipating events – such as another recession in Europe – that seem unlikely. In addition to valuations that are far less challenging than in the U.S., managers see ample reasons why investors should be looking beyond the U.S. to find opportunities for solid long-term growth, including:

- **Accommodative monetary policies** being pursued by the European Central Bank and the Bank of Japan.
- **Currency weakness in both Europe and Japan** that should further boost earnings for exporters.
- **Falling prices for commodities**, which could benefit businesses by dramatically reducing their input costs.
- **Attractive dividend yields** on many stocks allow investors to get paid while they wait for economies to turn and earnings to ramp up.

Valuations on Japanese and European Businesses Are Compelling

At the start of 2014, investors were optimistic about equity markets in Europe and Japan. But a slow-moving ECB, geopolitical events and a consumption tax hike in Japan renewed worries about prolonged economic weakness. European stocks are now trading at a discount to U.S. shares, while Japanese stocks have recently traded cheaper than both European and U.S. stocks.



Source: Datastream. As of September 30, 2014.

Multiple Perspectives. One Approach.®

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

The Recovery That Wasn't

As we approach the close of the year, some investors may be questioning how long Europe's and Japan's weakness will persist – and more importantly whether it still makes sense to allocate funds to these markets given the economic outlook. Expectations for global gross domestic product (GDP) growth in 2014 and 2015, which were already low, were revised down further by the International Monetary Fund in October. In the view of many of our portfolio managers, there is the potential for attractive returns in Japanese and European equities, and market uncertainty is providing opportunities to pursue long-term growth at increasingly appealing entry points.

The U.K. and Some Periphery Economies Are Recovering

On the whole, Europe remains challenged, but managers see several factors that should provide support for European economies and markets. Among them is the ECB's continued commitment to doing "whatever it takes" to kick-start growth in the euro zone, including indications that a Fed-style quantitative easing program may be in the works. Measures by the ECB to ease credit conditions and encourage bank lending could also help brighten the outlook for economic growth.

"European economies are far more dependent on bank lending than the U.S.," observes portfolio manager Mark Denning. "Typically when you have programs to encourage lending, the money trickles into the economy quite quickly. In 2015, I would expect to see Europe's economies pick up as a result of the ECB's efforts to increase lending."

Adds portfolio manager Mark Brett: "Everybody thinks it's all about the Fed, but it's not. It's also about central banks in Europe, Japan and China. They are going in the opposite direction of the Fed and that's not likely to change anytime soon."

Some managers also point to a recovery in the United Kingdom and gradual healing in Europe's peripheral nations as signs that

things may not be nearly as bad as markets are pricing in. Spain has been surprising on the upside, with its labor market healing quite rapidly and domestic demand bouncing back. Even Germany, which saw a decline in manufacturing activity in August, continues to have a strong labor market, which is supporting household consumption and driving robust automobile and retail sales.

Japan Shows Signs of Promise

In Japan, the overall economy remains weak, but there are many reforms underway – both at the government and the corporate level – that, along with announcements by the Bank of Japan of unprecedented levels of quantitative easing, should help to support growth.

One potential catalyst is the Japanese government's ongoing efforts to encourage pension funds to buy more Japanese equities. Japanese businesses' new focus on enhancing shareholder value is another notable change. Historically, Japanese businesses have had some of the lowest returns on equity, and even on that front, they are slowly but surely improving.

A tangible sign of efforts toward better governance has been the establishment of the JPX-Nikkei 400, an index comprising companies that meet certain targets for returns, financial strength and other shareholder-friendly measures. The new index has the backing of Japan's \$1.1 trillion Government Pension Investment Fund and other large asset managers, and exchange-traded funds (ETFs) tracking it will be purchased as part of the expansion of the Bank of Japan's quantitative easing program. Now, a race of sorts has begun among Japanese corporations to be included in the index.

"We've tried to be very selective in Japan and find managements who have more shareholder-oriented points of view," says portfolio manager Jody Jonsson. "There are many businesses with high costs and low margins that are very cheap. Where managements are committed to cost-cutting and improving those margins, those are very interesting situations."

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– Mark Denning
Portfolio Manager

Also adding to the case for Japanese equities is extremely low market expectations. "The Japanese market recently traded at a lower valuation than the U.S. and European markets for the first time ever," observes portfolio manager Lisa Thompson. "But dividend yields there are comparable, bond yields are at the lower end, and the government is serious about trying to generate inflation. This could lead to a big improvement in stock returns."

Investing in Equities, Not Economies

Europe and Japan are both well integrated into the global economy. Companies in both regions are largely export-oriented, so their fortunes are tied as much to the U.S. and China as they are to their domestic markets. For instance, European companies on the whole earn more than half of their revenues from outside the region, as well as a good chunk of their profits.

Export-oriented businesses stand to benefit from the currency declines that usually accompany an easing of monetary policy. A weak currency makes businesses more competitive from a pricing perspective

and boosts the value of the revenue these companies generate overseas, increasing the chances for earnings surprises.

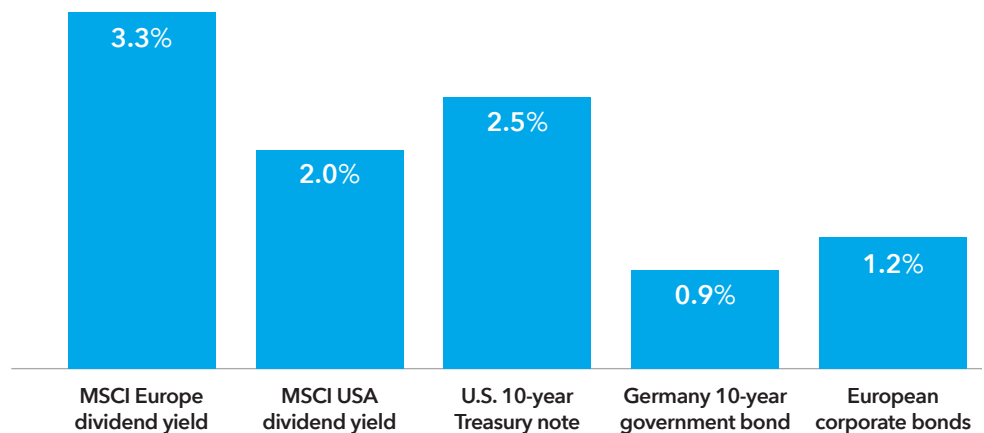
"If the ECB remains accommodative while the Fed tightens monetary policy, I would expect the euro to continue to weaken versus the dollar," says portfolio manager Eric Stern. "So I'm thinking about companies that benefit from a change in that relationship, such as large European industrial companies and auto makers."

Declining energy prices could also provide a tailwind by dramatically reducing input costs. While falling prices may hurt the profits of energy producers and services companies, other firms will benefit – including chemical companies, manufacturers, construction-related businesses and airlines, which count fuel as one of their major operating costs.

Finally, in Europe, where dividend yields average north of 3% compared with 2.0% in the U.S., investors can get paid to wait for an economic recovery to materialize and company earnings to improve.

In Europe, Investors Can Get Paid to Wait for an Economic Recovery

Dividend yields for companies in the MSCI Europe Index are attractive relative to equity yields in the U.S. and considerably higher than German government and European corporate bonds. Historically, dividends have provided a significant component of total return in Europe; with muted economic growth expected, dividends are likely to make up an even greater portion of total return going forward.



Source: RIMES. As of September 30, 2014.

Opportunities and Risks of a Weaker Euro and Yen

Opportunities

- Exporters: A weak currency makes exporters more competitive in overseas markets and increases the value of their revenue generated abroad.
- U.S. consumers: A weak euro and yen mean a stronger U.S. dollar, which increases the purchasing power of the U.S. consumer and benefits exporters in Japan and Europe.
- Domestic retailers: While a depreciating currency hurts domestic consumers, higher prices for imported U.S. goods may cause households to switch to domestic brands.

Risks

- Investors: Dollar strength could diminish unhedged total returns.
- European and Japanese consumers: A weak currency causes imported goods from the U.S. to be more expensive for European and Japanese consumers.
- Firms importing raw materials: A weaker euro and yen make commodities priced in U.S. dollars more expensive in euro and yen terms. Lately this hasn't been an issue given that a wide range of commodities, including crude oil, have slumped more than currencies.

Opportunities for Long-Term Investors

At the end of the day, long-term investing is all about discounting the future. Today, managers believe that some areas of the market are pricing in an overly pessimistic scenario. Consumer discretionary companies in Europe have lagged broader markets in 2014, especially those with significant exposure to China and other emerging markets. Fears of a slowdown in emerging markets demand are overdone, say some managers, who see flagging consumption as a cyclical rather than a structural phenomenon. "I continue to like the luxury segment in retail and especially in the auto sector," explains portfolio manager Michael Cohen. "We have not yet hit the sweet spot of where luxury peaks based on per capita GDP. I maintain there's still more to come in terms of Chinese consumption of luxury goods, and I view it as a long-term trend that will last at least another 10 years."

Make no mistake, enthusiasm for European and Japanese equities does not necessarily suggest that managers see no risks on the horizon, but rather that valuations are not fully reflecting the solid long-term fundamentals of many high-quality global businesses.

"This is the time that Capital's deep knowledge on companies and relationships with managements can make a real difference in capitalizing on short-term mispricing of stocks due to fear," observes portfolio manager Winnie Kwan. "During this period of volatility, I am looking to buy stocks of companies with strong business models that have sold down with the broader markets and currency weakness."

Key Takeaways

- A weak economy does not necessarily mean weak companies. Many European and Japanese companies have strong long-term fundamentals, and their businesses are tied as much to the U.S. and China as they are to their domestic markets.
- Accommodative monetary policies, positive corporate reforms and attractive dividend yields are among the biggest reasons to be enthusiastic about investing in businesses abroad.
- Buying opportunities exist for discerning investors.

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