World Markets Review — Third Quarter 2016

Stocks rebounded amid signs of stabilization in the global economy, strong earnings at bellwether companies and ongoing central bank stimulus measures. A “risk on” rally characterized the July-to-September period, following a highly volatile second quarter. Technology and materials stocks led markets higher, while the utilities and telecommunication services sectors declined. High-grade bonds advanced and the U.S. dollar fell against the euro and the yen.

Index Returns

<table>
<thead>
<tr>
<th>Index</th>
<th>September 2016</th>
<th>Q3 2016</th>
<th>YTD 2016</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>U.S. dollar %</td>
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<tr>
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<td>MSCI Pacific ex Japan</td>
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<td>S&amp;P 500</td>
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<tr>
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<td>J.P. Morgan GBI–EM Global Diversified</td>
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MSCI index returns reflect net dividends. Source: RIMES

North America

U.S. stocks advanced, buoyed by the Federal Reserve’s decision to stand pat on interest rates, positive economic news and strong quarterly earnings reports from several companies. The Standard & Poor’s 500 Composite Index gained 4%, posting strong results in July and moderating in August and September. The Dow Jones Industrial Average rose 3% and the Nasdaq composite index soared 10%.

Information technology stocks lifted the S&P index, surging 13%. Apple shares gained 19%. While its fiscal third-quarter earnings and revenues declined from a year previous, they were better than analyst estimates. The release of the iPhone7 in mid-September also supported gains. Bellwethers Microsoft and Alphabet, social media platform Facebook and graphics chipmaker Nvidia also advanced after easily beating analyst forecasts.

Dividend-oriented sectors lagged during the quarter, giving back some gains from the first half. Telecommunication services and utilities declined 6%, while the real estate sector, which launched on September 19, lost 1%. The new S&P category comprises 28 real estate investment trusts (REITs) and other related firms that were previously included among financials.

The financials sector rose 5% despite a high-profile scandal in the banking industry. Wells Fargo shares dropped 6% after the bank paid $185 million to settle charges that thousands of branch employees had opened

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Unauthorized accounts to meet sales quotas. While relatively small, the fine shook confidence and led to congressional hearings and the clawback of unvested stock awards from CEO John Stumpf. The bank also was banned from underwriting bonds in California and other states, and paid a separate fine for illegally repossessing service members’ cars. Elsewhere, the energy sector gained 2% as the Organisation of Petroleum Exporting Countries announced production curbs.

Despite stock gains in the quarter, S&P 500 earnings were forecast to decline 2%. It would be the sixth consecutive quarter of year-over-year earnings declines, the longest such streak since such data began being tracked in 2008 by market data provider FactSet. The energy sector led downward revisions.

The Federal Reserve let the federal funds target rate range stand at a range of 0.25% to 0.50% during its July and September meetings, but gave a generally upbeat outlook for the economy in both announcements. Three members dissented from the September decision, tipping a hike before year-end. The unemployment rate remained at 4.9%. The final estimate of second-quarter gross domestic product was revised upward to 1.4% from 1.1%. But inflation remained below the Fed’s 2% target and some measures of manufacturing activity slowed.

In bond markets, the Bloomberg Barclays U.S. Aggregate Index gained 0.5%. The yield on the benchmark 10-year Treasury note rose 11 basis points to 1.60%. Investment-grade corporate spreads to Treasuries ended 18 basis points tighter at 138 basis points. Although strong demand drove corporate spreads to the lowest levels in more than a year earlier in the quarter, they have widened slightly from that point. Investment-grade corporates gained 1.4%, while high-yield corporates rose 5.6%. Treasury Inflation-Protected Securities notched a 1.0% return. Municipal bonds lost 0.3%.

Companies continued to issue debt at relatively strong levels. One of the quarter’s most notable deals was Microsoft’s $19.75 billion bond offering in August, the year’s third largest, with proceeds being used to fund the software company’s acquisition of LinkedIn.

Europe

European stocks rebounded from steep losses experienced in the second quarter after U.K. voters shocked markets by opting to leave the European Union. Within three weeks of the June 23 Brexit vote, investor sentiment reversed course as it became evident that the European and U.K. economies would not suffer immediate consequences from the departure of a key EU nation. Indeed, U.K. stocks gained 7% during the third quarter. Overall, the MSCI Europe Index advanced 6% and the euro rose modestly against the U.S. dollar.

British Prime Minister David Cameron resigned and was replaced by Theresa May, the first woman to hold the office since Margaret Thatcher. Dismissing talk of a revote, May vowed that the U.K. will march on to the EU withdrawal process. The official departure negotiations, however, are expected to take two years. Meanwhile, the Bank of England reduced its benchmark interest rate from 0.5% to 0.25% and announced it would start buying bonds in a bid to stimulate lending activity and boost the economy.

Economically sensitive stocks led the rally, highlighted by a 16% gain in the information technology sector. Shares of SAP advanced after the German software giant reported better-than-expected earnings, driven by growth in sales of traditional software licenses as well as subscription-based cloud computing products. NXP Semiconductors shares also moved sharply higher amid widespread reports that Qualcomm was preparing an acquisition offer for the Dutch company.

Stocks in the materials sector gained 15%, supported by improving prices for some commodities and signs of stabilization in China’s economy. Glencore shares climbed nearly 40% amid rising iron ore prices. BASF shares also rose substantially despite a disappointing earnings report as the German company was hurt by softening
demand for agricultural chemicals. M&A activity in the sector also helped to support share prices. In the largest deal of the year so far, Bayer launched a $66 billion bid to acquire agricultural seeds giant Monsanto.

Financial stocks rebounded strongly from a difficult second quarter, rising 11% in aggregate. Shares of HSBC, Europe’s largest bank, rallied on the announcement of a $2.5 billion share buyback program. HSBC shares rose 26% despite a sharp drop in second-quarter profitability. On the other hand, shares of Deutsche Bank came under pressure after U.S. authorities demanded that the German bank pay a multibillion-dollar fine related to the sale of mortgage-backed securities leading up to the 2008–09 financial crisis.

Health care stocks experienced the biggest losses, falling 3% as drug pricing practices came under renewed criticism during the U.S. presidential election campaign. Shares of Novo Nordisk, the world’s largest provider of insulin, declined sharply after the company lowered its profit and revenue expectations for the year due to fierce competition in key markets. Additionally, Novo announced that longtime CEO Lars Rebien Sørensen would retire. He will be succeeded in January by Lars Fruergaard Jorgensen, the company’s head of corporate development.

In fixed income markets, European government bond prices rose amid market expectations for additional central bank stimulus measures. The yield on the U.K.’s benchmark 10-year note declined by 12 basis points to 0.75%. Similar maturities in Italy fell by 7 basis points to 1.19%. German yields were essentially flat. In one of the more interesting bond deals this year, Russia’s government sold $1.25 billion of 10-year euro-denominated debt at a yield of 3.99%. It was the first successful global debt issuance for Russia since the country was hit with international sanctions following its 2014 military intervention in Ukraine.

Asia-Pacific
Japanese equities rebounded in the third quarter amid fresh stimulus measures after lagging most developed markets in the first half. Following years of large-scale quantitative easing, the Bank of Japan introduced a long-term interest rate target and the government announced a fiscal stimulus package. The MSCI Japan and MSCI Pacific indexes both rose 7%. The yen gained 1% against the U.S. dollar, and has appreciated 19% year to date.

The Bank of Japan introduced an interest rate target for 10-year government bonds in an effort to steepen the yield curve. The central bank said it would aim to keep the rate “more or less at the current level,” which is roughly 0%. Under the new policy, the BOJ will maintain its ¥80 trillion a year asset purchase program but has removed the average maturity target of government bond holdings. The bank opted not to reduce its short-term target rate further into negative territory, but kept the option open for future meetings.

Prime Minister Shinzō Abe announced plans for a ¥28 trillion fiscal stimulus package in July, shortly after his ruling coalition won a majority of seats in Japan’s upper house. The program includes spending on infrastructure projects, the reconstruction of disaster zones, and subsidies for child and elder care workers. The stimulus measures were seen as a way to combat sluggish economic growth and stubbornly low inflation. In the second quarter, Japan’s economy grew at an annualized 0.7% rate. Consumer prices declined 0.5% in August, while prices excluding food and energy rose 0.2%. The unemployment rate ticked up to 3.1%, but remains a bright spot since reaching a 21-year low in July.

Financial stocks rallied following the Bank of Japan meeting as investors continue to shift to more cyclical sectors. Shares of the three largest megabanks, which has been hurt by perpetually low interest rates, each rose sharply. The consumer discretionary sector gained 11%. Nintendo shares surged 83% following the release of “Pokémon GO,” which became the fastest selling mobile game in history. The company’s announcement that it was releasing the first “Super Mario” game for mobile devices also contributed to the stock’s rise.
manufacturers Toyota and Honda each had double-digit gains. Ono Pharmaceutical shares had the largest decline in the index, falling after a key drug failed a late-stage trial.

**Australian equities rose 5%, led by materials companies.** Shares of miners Fortescue Metals and South 32 both surged by at least 45% as commodities rallied. Shares of Australian megabanks also gained. Telecommunication companies Vocus Communications and TPG Telecom had the lowest returns in the index; poor financial results and low subscriber growth across the industry weighed on share prices of both companies. In August, the Reserve Bank of Australia cut its official cash rate by 25 basis points to 1.5%, a record low. The MSCI Hong Kong Index gained 12%. All Macau-based casino operators rose by at least 15% amid signs the region’s gaming revenues were stabilizing after a long decline.

**Emerging Markets**

Emerging markets notched their strongest quarterly gain since early 2012 as U.S. interest rates remained unchanged and central banks globally provided further stimulus. Fiscal stimulus in China and attractive valuations in the developing world also helped boost sentiment. The MSCI Emerging Markets IMI climbed 9%, elevating its year-to-date return to 15% — the best among major global equity indices. In the third quarter, technology stocks posted the strongest returns to lead all sectors. U.S. dollar–denominated bonds, as measured by the J.P. Morgan EMBI Global index, rose 4% as investors searched for higher yields in a low-rate environment. Local currency debt, as measured by the J.P. Morgan GBI-EM Global Diversified index, gained 3% in dollar terms.

**Chinese stocks led returns for major developing countries,** bolstered by strong gains for technology and financials companies. The MSCI China IMI surged 13%, its best three-month gain since the third quarter of 2013. Shares of e-commerce giant Alibaba soared 33% on stronger-than-forecast results for its most recent quarter. Tencent shares leaped 21% after the social media and online gaming firm beat second-quarter estimates for sales and profit. Shares of Baidu, China’s largest internet search provider, increased 10%. Several large Chinese banks posted double-digit returns, including China Construction Bank and Bank of China, as midyear earnings reports suggested loan defaults may be leveling off. After steep declines earlier this year, Chinese stocks regained their footing, moving into positive territory in August. For the year to date through September 30, the MSCI China IMI rose 7%.

**Gains in the technology sector helped lift major Asian markets.** Taiwanese stocks soared 12%. The country’s technology component suppliers rose, boosted by the release of Apple’s iPhone 7. Shares of index heavyweight Taiwan Semiconductor, a chip contract manufacturer for Apple, shot up 16%, while Hon Hai Precision, Apple’s largest assembler of iPhones, surged 14%. South Korean stocks gained 9%, led by Samsung Electronics, memory chipmaker SK Hynix and internet portal operator Naver. Samsung shares advanced despite a massive recall of its Galaxy Note 7 smartphone. The world’s largest smartphone maker also sold its stakes in four technology companies to raise cash. Indonesian equities climbed 9%, extending impressive year-to-date gains fueled by interest rate cuts and government measures to promote economic growth. The MSCI India IMI rose 7%. In a key legislative victory for Prime Minister Narendra Modi, India’s parliament approved a goods and services tax designed to make it easier to conduct business throughout the country.

**Brazilian stocks marched higher on hopes of economic change under new political leadership.** Michel Temer succeeded Dilma Rousseff as president after Rousseff was ousted from office in a long-awaited impeachment trial. The MSCI Brazil IMI increased 11%, elevating its year-to-date gain to 63%. During the quarter, banking giants Itaú Unibanco and Banco Bradesco rose 17% and 16%, respectively. Shares of Petrobras soared 42% as the state-run oil giant made progress on reducing its heavy debt load. Elsewhere in Latin America, Mexican stocks slid 2% as the peso fell 5% against the U.S. dollar.

**In Russia, equities climbed to their highest level in a year** amid increased confidence Russia’s economy will start to grow again. The MSCI Russia IMI gained 9%. Shares of Lukoil soared 20% as quarterly profit at the country’s second-largest oil producer topped the consensus forecast. Other top gainers included Sberbank,
whose shares rose 11% after the banking giant reported its second-quarter profit almost tripled, and Magnit, the country’s largest grocery chain.

**Stocks in South Africa overcame ongoing political turmoil**, helped by encouraging economic data. The country’s economy grew 3.3% on an annualized basis during the April-to-June period, reversing a contraction in the previous three months. The MSCI South Africa IMI rose 7%. Shares of media conglomerate Naspers, which owns stakes in Tencent and other internet firms in emerging countries, increased 13%.

**In debt markets**, Latin American countries and companies were active. Mexico sold $2.7 billion of U.S. dollar–denominated bonds in two tranches, a 10-year bond yielding 3% and a 30-year bond yielding 4.3%. Argentina sold $2.7 billion of U.S. dollar–denominated bonds in two tranches, a 12-year bond yielding 6.6% and a 20-year bond yielding 7.1%. In terms of corporate issues, Mexican state-owned oil company Pemex issued $4 billion of dollar bonds. Brazilian mining giant Vale placed a $1 billion dollar bond offering.

Developed market returns are in local currency and include net dividends. Emerging markets returns are in U.S. dollars.

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Bloomberg Barclays Global Aggregate Index represents the global investment-grade fixed income markets. This index is unmanaged, and its results include reinvested distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or U.S. federal income taxes. This index was not in existence as of the date Class A shares became available; therefore, lifetime results are not shown.

Bloomberg Barclays U.S. Aggregate Index represents the U.S. investment-grade fixed-rate bond market. This index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or U.S. federal income taxes.

Dow Jones Industrial Average is a price-weighted index of 30 component common stocks, the components of which are determined by the Averages Committee, which is composed of the managing editor of The Wall Street Journal, the head of Dow Jones Indexes research and the head of CME Group research.

J.P. Morgan Emerging Markets Bond Index Global measures total returns for foreign-currency-denominated emerging markets bonds.

J.P. Morgan Emerging Markets Bond Index Global Diversified measures total returns for foreign-currency-denominated emerging markets bonds, employing limits on the weight of countries with large debt stocks.

MSCI EAFE® (Europe, Australasia, Far East) Index is a free float-adjusted market capitalization weighted index that is designed to measure developed equity market results, excluding the United States and Canada. Results reflect dividends net of withholding taxes. This index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or U.S. federal income taxes.

MSCI Emerging Markets Investable Markets Index includes large, mid-cap and small-cap segments, targeting a coverage range of close to 99% of the free-float-adjusted market capitalization of more than 20 emerging equity markets. Results reflect dividends gross of withholding taxes through December 31, 2000, and dividends net of withholding taxes thereafter.

MSCI Europe Index is a free float-adjusted market capitalization weighted index that is designed to measure developed equity market results across 15 developed markets countries in Europe. Results reflect dividends net of withholding taxes. This index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or U.S. federal income taxes.

MSCI Japan Index is a free-float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of Japan. Results reflect dividends net of withholding taxes. This index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or U.S. federal income taxes.

MSCI Pacific ex Japan is a free-float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of the developed markets in the Pacific region, excluding Japan. It consists of Australia, Hong Kong, New Zealand and Singapore. Results reflect dividends net of withholding taxes. This index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or U.S. federal income taxes.

MSCI United Kingdom Index is a free float-adjusted market capitalization weighted index that is designed to measure the results of the U.K. market. Results reflect dividends net of withholding taxes. This index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or U.S. federal income taxes.
MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure equity market results of developed markets. The index consists of more than 20 developed market country indexes, including the United States. Results reflect dividends net of withholding taxes. This index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or U.S. federal income taxes.

Nasdaq Composite is an unmanaged index representing the companies traded on the Nasdaq stock market and the National Market System.

S&P/TSX Composite Index is an unmanaged market capitalization weighted index of stocks traded in the Canadian markets.

S&P 500 Index is a market capitalization-weighted index based on the results of 500 widely held common stocks. This index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or U.S. federal income taxes.

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