SPRING 2018

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Quarterly • Insights

A welcoming economy is boosting occupancy for the hotel industry.

ANALYST PERSPECTIVES
China's consumer culture is lifting the fortunes of a variety of industries

CRYPTO CRAZE
Making sense of bitcoin and the blockchain technology behind it

NOW HEAR THIS
Tips for having meaningful and productive conversations

AUTHOR INTERVIEW
Decluttering your life starts with the right frame of mind

IT'S IMPORTANT TO ALWAYS BE WATCHFUL AND AWARE THAT MARKET CORRECTIONS CAN COME AT ANY TIME, AND OFTEN FOR UNEXPECTED REASONS.

A Return to Volatility

I just got back from a trip to Chicago, where we celebrated the opening of our new office in the Windy City. We've had a presence there for more than two decades, but we just moved to a beautiful location on the riverfront. If you live in that area or plan to be there soon, I encourage you to stop by and say hi to our growing team in the Midwest.

Given the stormy conditions that persisted all the way back to Los Angeles, my flight home was one of the bumpiest in recent memory. And while I'm usually not an anxious flyer, it made me a little more angst-ridden than normal.

In many ways, the flight resembled current stock market conditions: more turbulent than we've seen in the recent past, but not unexpected given the huge run-up since 2009 and where we are in the economic cycle.

As we discuss in the investment commentary that starts on page 2, following a tranquil start to the year, volatility began to spike in February as investors became hyperfocused on ever-changing and often-conflicting news reports. In this issue, we take a closer look at what's been driving this turbulence, including concerns about looming inflation and the impact it may have on stocks. As you'll see in the article by Capital Group economist Darrell Spence on page 6, moderate inflation historically has been an overall positive for stocks, and our team remains constructive on the outlook for equities.

That said, risks do persist, including the trend of rising rates, which has started to rattle the bond market. But as Capital Group's head of fixed income, Mike Gitlin, explains on page 8, we'll likely stay in a period of low interest rates for some time, and bonds remain the best insurance to help offset equity volatility in a diversified portfolio.

Though we certainly don't consider bitcoin and blockchain to be asset classes per se, we've received many client questions about them. As a result, we are providing a primer from members of our emerging-technology group on page 14. We also delve into two compelling investment themes: strong consumer spending growth in China and the attractiveness of large hotel chains.

Additionally, on page 16 we share advice from a leading expert on how to have more-rewarding conversations with your spouse, family members, friends and colleagues. And if you've been gearing up for spring cleaning, our featured author has advice on how to declutter your home – and the benefits that brings.

In closing, I want to say how great it was to meet so many of you at our recent client luncheon series on artificial intelligence. Even if you didn't attend, you may have received a synopsis via email, along with a link to two of the videos we showed. If not, just contact your Investment Counselor, who will be happy to send it to you.

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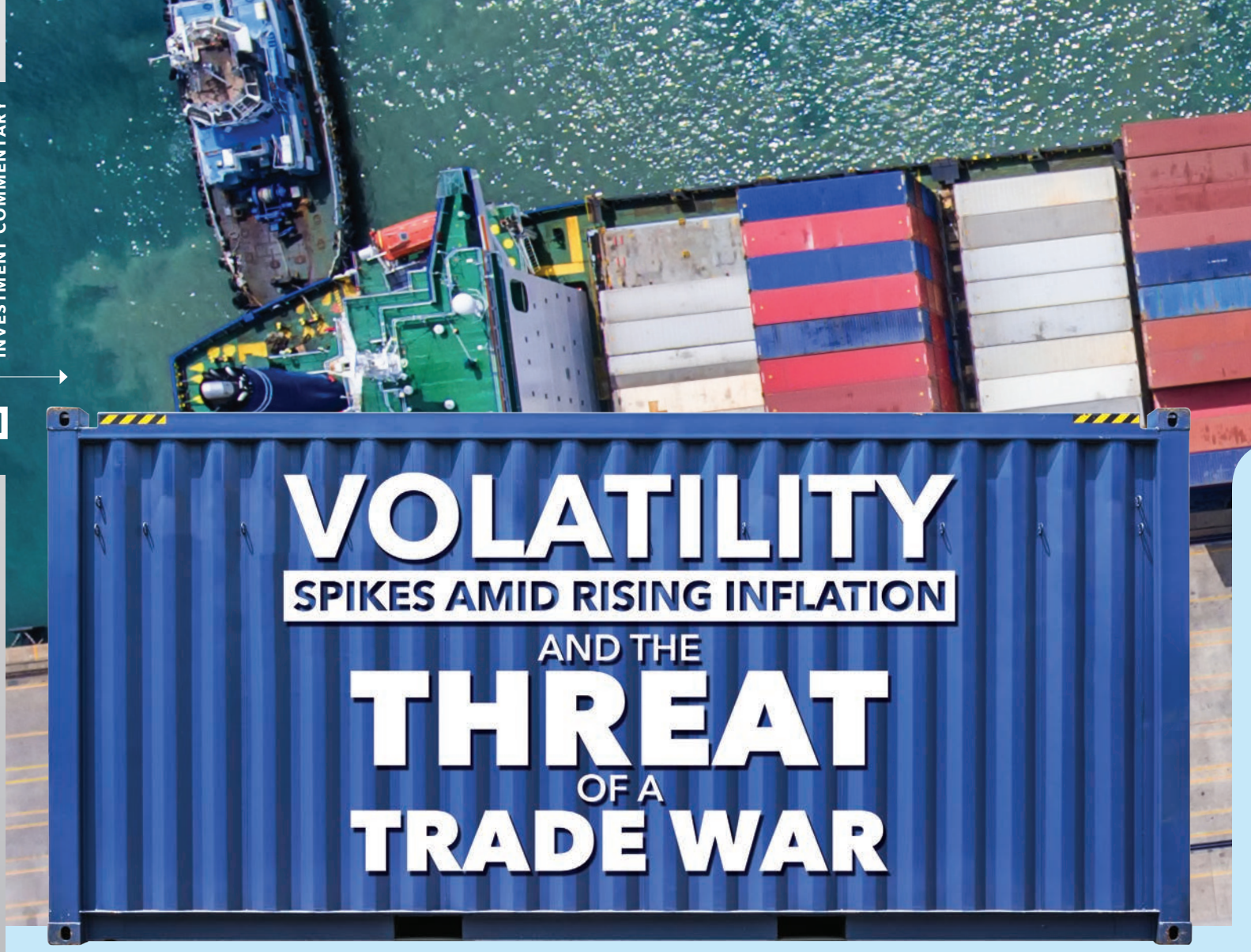


VOLATILITY SPIKES AMID RISING INFLATION AND THE THREAT OF A TRADE WAR

The low volatility that's been a trademark element of the stock market in recent years was always a bit of a double-edged sword. Though it was a symbol of economic optimism, it carried the risk of investors being caught off-guard when turbulence returned to historical norms. That scenario has played out twice in the early stages of this year, with stocks gored first by concerns about inflation and later by the specter of a trade war. Economic reality is far more promising, as the global expansion remains on track. Still, the undulations in stock prices highlight the risks facing the market in the 10th year of a bull run.

Inflation worries spiked after a government report showed wages jumping as employers scrambled for workers. The news shouldn't have been surprising given the ongoing drop in unemployment. But it startled investors nonetheless, and the S&P 500 tumbled 10%, the traditional definition of a correction. Subsequent data indicated that inflation remains under control and that investors' initial agitation was overblown. Consumer prices are likely to rise this year, but at a restrained pace that is not expected to undermine the equity market. Capital Group economist Darrell Spence addresses this in greater detail on page 6.

The prospect of higher inflation rattled the bond market, with the 10-year Treasury yield briefly threatening to exceed 3%. Though that would still be low by historical standards, it stirred debate about whether the era of low interest rates was drawing to a close. The Federal Reserve has raised rates six times since late 2015, and two additional hikes are expected this year. Investors are on the lookout for any signs of an overheating economy that could prompt the central bank to tighten more vigorously. The immediate pressure on bonds eased as anxiety about inflation receded, and the 10-year Treasury finished the quarter at 2.74%. Mike Gitlin, Capital Group's head of fixed income, offers a detailed outlook for bonds on page 8.

Given that rising rates often precede recessions, the Fed moves have raised questions about whether an economic downturn may be in the offing. Capital Group research

suggests otherwise. An analysis of past rate hikes shows that the speed with which the Fed acts can play a role in the timing of contractions. In general, recessions take far longer to develop when the central bank moves gradually, as it is today. As a result, a recession is very unlikely before late 2019 or early 2020 at the soonest, according to our analysis. Our research also found that the stock market peaks an average of nine months before the start of an economic contraction, suggesting that a bear market is unlikely for at least an additional 12 months.

The specter of a trade war has unnerved investors.

Of course, other forces can chill the market, including the outbreak of a pernicious trade war between the U.S. and China. President Trump's threat to slap $60 billion in tariffs on Chinese-made goods – which came barely a week after the announcement of tariffs on foreign-made of steel and aluminum – raised the prospect that the U.S. would retreat from its once-inviolable commitment to unfettered trade.

The immediate impact of escalating trade friction is likely to be limited, according to one estimate. The announced tariffs could shave an estimated $82 billion from U.S. growth this year, which is minor compared with the $800 billion in stimulus money funneling into the economy from tax cuts and other fiscal measures. (See the chart on page 4.)

However, the long-run fallout is unclear, as deeper tensions have percolated for some time. The antagonism stems from many factors, including the impact of Chinese exports on U.S. manufacturing jobs and long-standing complaints that China is expropriating American technology through lopsided trade deals. The Asian giant's abolition of term limits, which effectively installed President Xi Jinping in power indefinitely, has aggravated the situation given his determination to make China a dominant force in areas such as advanced semiconductors, robotics and artificial intelligence. That has fanned worries that China is less likely than ever to move toward a market-based economy, as the U.S. has long sought.

THE TRADE CLASH HAS OVERSHADOWED THE ROBUST ECONOMIC PICTURE AROUND THE WORLD.

An all-out trade war is doubtful because of the economic dangers it would pose to both countries, according to an internal analysis. But smaller skirmishes and tit-for-tat retaliatory measures are possible as the U.S. and China recalibrate their relationship amid a broader debate about global integration and the decades-long dismantling of trade barriers.

The trade clash has overshadowed the robust economic picture around the world. Global growth is projected to edge up this year, thanks partly to continued improvement in emerging economies. Corporate earnings are likely to ease back from their feverish pace of 2017, but U.S. and foreign companies are still expected to achieve double-digit profit growth this year. With the U.S. in the late stage of the economic cycle, indicators such as increased merger activity and a rise in inflation-adjusted interest rates have begun to flash cautionary signs. However, other signals that typically foreshadow market breaks are not present, including a weakening of earnings upgrades and a shift to defensively oriented stocks.

Our portfolio managers have selectively deployed capital into sectors with promising long-term outlooks while seeking to minimize downside volatility in industries with high valuations. For example, some added to exposure in the energy sector through positions in oilfield services and drilling companies. Demand for oil is strong amid the global economic upswing, and exploration projects are slowly ticking up after a lengthy hibernation. The increasing number of rigs in operation bodes favorably for companies offering oilfield services.

Opportunities are also being created by artificial intelligence. The technology industry is working furiously to develop AI in the belief that it will have applicability across many industries in coming years. In what amounts to an arms race for talent, leading companies have rushed to scoop up engineers and programmers.

Our managers also have been drawn to select health care businesses. The combination of faster regulatory approvals and more-efficient research is helping to lower the cost and speed the development of new medicines. That's increased the willingness of companies to devote research to so-called orphan

diseases, which afflict a relatively small number of patients compared with more-common ailments. The limited potential audience for orphan drugs has made it financially infeasible for drug companies to pursue remedies. But the streamlined research process has altered that calculus, as quicker and cheaper clinical development opens new markets for companies while providing a source of potential cures for patients.

The rise in interest rates took a toll on bonds.

Increasing yields weighed on fixed-income returns around the world, with bonds suffering a down quarter. The movement in rates has caused a flattening of the yield curve in the U.S., which measures the relationship between short and long rates. That has increased the risk of a so-called inversion, in which short rates exceed long rates. (By virtue of the greater risk inherent in holding bonds over extended periods, long bonds typically carry higher rates.)

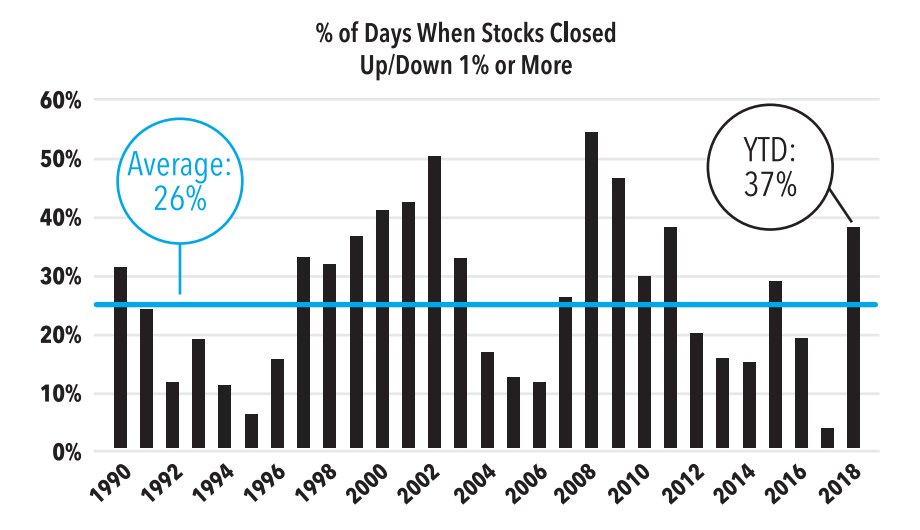
Historically, inversions have preceded market downturns by an average of nine months. However, an inversion is likely to be a less reliable indicator in the current market cycle because a number of factors are artificially depressing bond yields. These include the Fed's unwinding of its balance sheet, ongoing quantitative easing programs outside the U.S. and the savings glut in Asia.

After a years-long rally in the bond market, credit spreads have tightened as investors have stretched for yield in a low-rate environment. Our managers have been careful not to take such undue risk. As a result, our exposure to investment-grade corporate bonds is below the benchmark, providing a potential cushion if spreads on these securities tighten further. Meanwhile, the possibility that inflation could exceed current market estimates has caused our fixed-income team to favor Treasury Inflation-Protected Securities, or TIPS, which could benefit in such a scenario.

Though rising rates can be unsettling to investors, the additional income generated by higher-yielding securities can more than offset short-term capital losses.

Regardless of short-term gyrations, bonds remain an essential component of broadly diversified portfolios. Aside from their income generation, bonds provide diversification from equities, and can be a safe haven during bouts of turbulence in the stock market. That's particularly important now, given the heighted volatility in stocks after the lengthy advance of recent years.

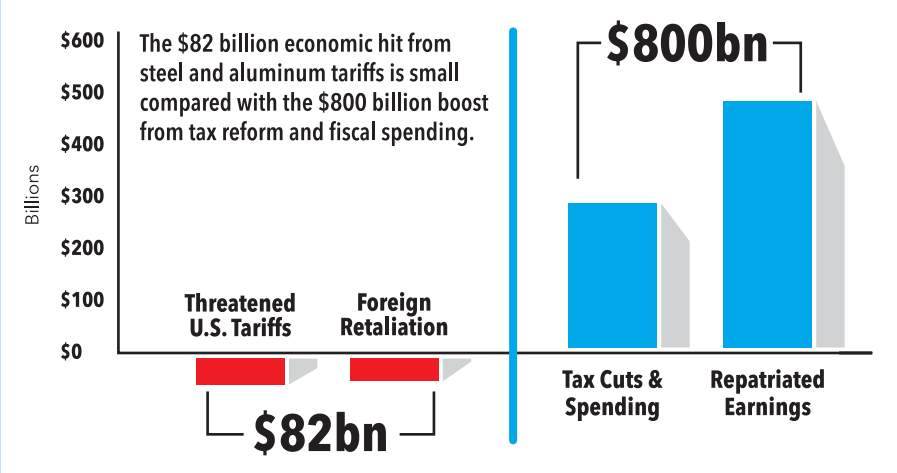
VOLATILITY IS BACK



Source: Morningstar Direct. Calculated by Capital Group, based on the S&P 500. As of March 31, 2018.

REGARDLESS OF SHORT-TERM GYRATIONS, BONDS ARE AN ESSENTIAL PART OF DIVERSIFIED PORTFOLIOS.

TAX CUTS OUTWEIGH TARIFFS



Source: Strategas Research Partners.

Q&A

EQUITY PORTFOLIO MANAGER

ALAN WILSON

33 YEARS IN PROFESSION

27 YEARS WITH CAPITAL GROUP

Alan Wilson is a Capital Group equity portfolio manager in the Capital World Investors division, based in our Los Angeles office. In this interview, he assesses the U.S. economy and stock market following the recent pickup in volatility. He also outlines some of the sectors where he is finding opportunities.

What is the outlook for the economy?

A lot is going right. Earnings are likely to rise nearly 20% this year thanks to the combination of organic growth and tax cuts. Exports are strong. Growth is synchronized around the globe. All of these positives are showing up in the companies we visit. For example, I was in Pittsburgh and Cleveland recently meeting with industrial coatings companies. These businesses sell to manufacturers in a wide range of industries, so they are good barometers of the economy, and they are very optimistic.

Are you worried about the threat of inflation as wages tick up?

One of the signs of a vibrant economy is that businesses are forced to compete for scarce resources. In this case, the resource is labor and companies are starting to raise wages to attract and retain good employees. Analysts are hearing positive comments from executives across most industries. They're saying their sales are strong and they're comfortable sharing some of that with their employees. So even though wages are going up, CEOs are confident that they can pass some of their added costs on to customers. Like most things in life, everything's good in moderation. Right now we are seeing the upside of growth, with no signs of excess. I believe companies can increase productivity to avoid damaging their earnings or rolling out huge price increases for end customers. But this is something I'm watching closely.

What might all of this mean for the stock market?

The investment outlook is a bit more uncertain. Let me illustrate it this way. I do a lot of traveling for my job. I was once on a flight and, even though it was a beautiful sunny day, it went through very bad turbulence. I found out later that this is known as clear-air turbulence. It's bumpiness that occurs in a pristine sky with little warning.

That's the way the market feels right now. Despite all that's going right in the economy, hiccups happen, and I worry that market participants aren't prepared for anything but clear skies. If there is unexpected bad news, they could overreact and push markets to extreme positions. Investors are a bit less complacent than they were before the recent volatility. But I worry that there's still an unsettlingly high degree of calm.

Given your assessment of the market, how have you positioned the portfolios you manage?

I'm typically fully invested and do not hold a lot of cash. But I have a high-single-digit cash position at the moment and hold fewer stocks than I normally do. Basically, I'm seeking to mitigate the impact of clear-air turbulence, if it occurs.

That said, there are certain areas of the market that I believe are attractive. One example is regional banks. Many areas of the country are experiencing strong growth, which is translating into increased loan demand. Combined with slowly rising interest rates, that's favorable for some regional banks. Along that same line, there are some opportunities in the consumer discretionary sector. The robust job market is boosting disposable income, meaning these businesses should benefit from increased consumer spending. This won't be the case for every company, and selectivity is critical. But the analysts have done a great job of identifying well-run franchises with good prospects.

What are your thoughts on technology stocks, especially as valuations have risen during the sector's lengthy rally?

It's important to consider valuations,but you have to assess the full picture. You can't just look at the valuation of the overall market, or of a specific sector, because there is a lot of variation among companies. This may seem counterintuitive, but some high-multiple companies are really attractive because their growth, and the projected duration of that growth, are very strong. Conversely, some companies with very low multiples are not good investments because the outlook for them is not particularly encouraging.

Think of it this way: It's usually not a surprise when a well-thought-of stock turns out to be great; what is surprising, however, is when a stock turns out to be even greater than expected. The magnitude of the greatness is a surprise, with gains that can last over a long period. Of course, this usually isn't the case. That's because even very successful companies dominate only a single industry or line of business. They can't expand beyond their niche. They're one-trick ponies. By contrast, a handful of today's technology companies are successfully innovating across multiple areas, from cloud computing to self-driving cars. It's critical to be extremely selective, but it's important to identify when a company has significant potential in multiple large markets.

A MODERATE RISE IN INFLATION ALONE IS UNLIKELY TO DERAIL THE STOCK MARKET

DARRELL SPENCE

Darrell is a Capital Group economist who covers the U.S. and global economies. Based in Los Angeles, he has 25 years of investment industry experience, all with Capital Group.

Ever since inflation catapulted into the national psyche in the 1970s, even the slightest uptick in consumer prices has tended to stoke investor angst. Unchecked inflation, after all, grinds away at Americans' purchasing power, drives up interest rates and eventually takes the wind out of the economy. After several years of relative dormancy, inflationary pressures have edged up recently, igniting fear of a larger outbreak that could ultimately short-circuit the equity market. The jitters are understandable given the potential downside, but I believe the likelier path for the economy and financial markets is more encouraging.

It's not surprising that inflationary concerns have ramped up amid the vitality in the U.S. economy. Falling unemployment, vigorous consumer spending and the stimulative effect of tax cuts have pushed up growth expectations. Given that backdrop, it's doubtful that consumer prices will remain as muted as they have been in the past few years. The likelier scenario is that inflation and interest rates will both drift higher in 2018.

However, any upswings are likely to be moderate and gradual, with inflation and rates remaining low by historical standards. There are several reasons for this. The underlying forces that have helped to muzzle inflation – including globalization and the aging of the U.S. workforce – remain in place. Also, some of the factors that contributed to the recent inflationary readings are likely temporary and thus should recede.

Overall, we are returning to a more-normalized environment in which inflation is an expected by-product of economic vigor. The 2008 financial crisis, and the subsequent years-long mopping up by the Federal Reserve and other central banks, led to a number of economic and policy anomalies, including extraordinarily accommodative monetary policies. That period is coming to a close, and we are once again in a world in which inflation is likely to become more of a factor as economic growth continues.

Periods of moderate inflation have been positive for the stock market.

These conditions should provide a solid underpinning for stocks this year. The synchronized global expansion is driving up corporate profits, which I believe may climb a cumulative 25% over the next two years. Furthermore, stocks historically have registered solid gains when consumer prices have risen at a measured pace. An economy that's neither too hot nor too cold – in other words, with sufficient energy to drive earnings but not so much as to unsettle the Fed – has been favorable for the equity market over time.

The accompanying chart illustrates this trend. Dating back to 1820, the S&P 500 index has notched a 9.6% average annual return when inflation ranged between 0.1% and 2.5%. It gained an average of 5.9% a year when inflation ran between 2.5% and 5%, and 4.1% when consumer price jumps were 5% to 10%.

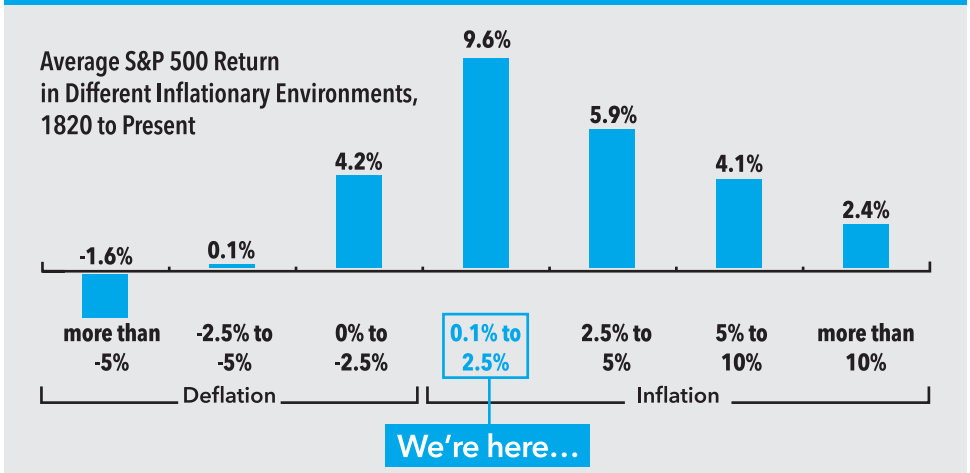
Compensation costs are picking up as unemployment falls.

The inflation scare stemmed partly from signs of rising employee compensation. Wage growth in the current upturn has been slower than in past expansions. But with unemployment at a 17-year low and potentially descending even further, a tighter labor market is forcing businesses to boost compensation to lure and hang on to employees. The brief but sharp equity market correction this past quarter was triggered by a government report showing a 2.9% year-over-year pickup in compensation costs.

The rising tab for labor won't all be passed through to consumers. Given their strong profits, companies have some leeway to absorb the higher costs without raising prices. Thus, after several years in which inflation fell shy of the Federal Reserve's 2% annual target, I expect consumer prices to rise about 2.25% in 2018. Barring something unforeseen, a more abrupt jump appears unlikely. Not surprisingly, the economic vigor has had an effect on interest rates, which began climbing at the start of the year as the market began to acknowledge the strength of the global economy. The yield on the 10-year Treasury note, which began 2018 at 2.41%, ended the first quarter at 2.74%.

Certainly, there are risks on both the upside and the downside. An exogenous shock or geopolitical event could throw the economy off course. Conversely, a steadily rising economic trajectory could nudge up long-term interest rates and pressure the Fed to swing into action. After lifting short-term interest rates six times since late 2015, the central bank has indicated that it will hike an additional two times this year. I believe that's the likeliest scenario. The outlook for 2019 is less clear, as ongoing growth could intensify pressure on the Fed. Still, the near-term outlook appears favorable. A recession seems unlikely anytime in the immediate future, and ongoing earnings growth should continue to support stock prices.

EQUITIES HAVE FARED WELL WITH MODEST INFLATION



Source: Global Financial Data, Standard & Poor's, Bureau of Labor Statistics. Calculated by Capital Group. U.S. equities represented by the S&P 500 index. Average annual returns from 1820 to 2017.

AS VOLATILITY RETURNS, BONDS PLAY A PROTECTIVE ROLE IN CLIENT PORTFOLIOS

Of the many factors that have propelled the fixed-income market, none has been more important than low interest rates. For much of the past decade, global central banks kept a lid on rates in hopes of jump-starting their countries' economies. Those efforts had an impact, with growth picking up first in the U.S. and more recently in Europe and Japan. Bond investors, of course, welcomed declining rates because they boosted returns and provided a general sense of comfort to the market.

The backdrop has gotten a bit cloudier lately. Improvement in the global economy has prompted central banks to throttle back on easy-money policies, while accelerating wages have stoked concerns about inflation. The resulting rise in yields has jostled the market and sparked fear that bond returns could be pinched.

MIKE GITLIN

Mike oversees Capital Group's fixed-income team and is a member of the firm's management committee. Based in Los Angeles, he has 24 years of investment industry experience and has been with Capital Group since 2015.

Though volatility is always unsettling, I believe the consternation is overblown. Investors have focused on the directional change in rates from their extraordinary lows while overlooking the actual size of those moves, which have been quite moderate. Most notable, the 10-year Treasury yield ended the first quarter at 2.74%, less than half a percentage point higher than it was at this time last year.

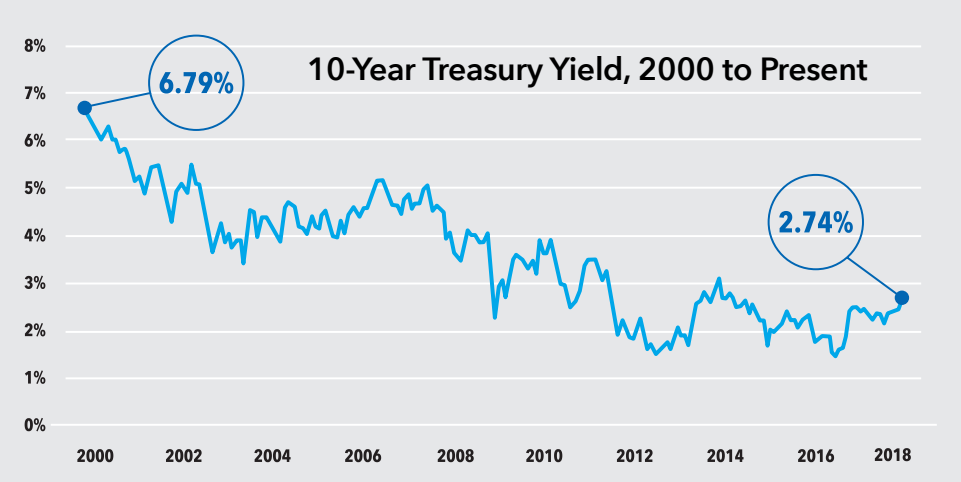
Certainly, rates may rise further if the global economy continues to gather momentum. As Capital Group economist Darrell Spence notes in the previous article, inflation is expected to edge up, but at a gradual pace from the uncharacteristically low levels of recent years. Barring something unforeseen, I believe that any rise in bond yields will also be slow and orderly; the forces that would have to come together to push rates up dramatically are not present at the moment. Overall, I expect the "lower for longer" dynamic that has held sway in the fixed-income world for much of the past decade to remain in place. The markets are also factoring in this potential, with forward pricing for the 10-year U.S. Treasury only showing a 20 basis point increase in yields two years from now.

Beyond all of this, the spotlight on yields threatens to obscure the central role that fixed income plays in a balanced portfolio. Bonds serve four essential functions: diversification from equities, income generation, inflation protection and capital preservation. These are always important, but especially so given the uncertainty in all financial markets following years-long rallies. With greater volatility and uncertainty about the change in direction of developed market central banks, one needs to remain balanced and remember the benefits of holding bonds in a diversified portfolio.

Central banks are less accommodative.

This isn't to say that the bond market doesn't face headwinds, starting with shifting monetary policies. Central banks in developed markets are beginning to tighten after years of being enormously accommodative. The Federal Reserve has hiked six times since late 2015. It is expected to do so two more times this year and perhaps twice in 2019. The Fed is also reducing the size of its balance sheet as it unwinds the quantitative easing program it undertook in response to the 2008 financial crisis. Meanwhile, the Bank of England raised rates in November for the first time in nearly a decade, the Bank of Canada has moved three times since last July, and the European Central Bank has committed to reducing asset purchases.

THOUGH YIELDS HAVE TICKED UP, THEY ARE STILL LOW



Source: Thomson Reuters. As of March 31, 2018.

This comes at a moment when valuations in the credit market have risen. The stretch for yield by some investors has caused credit spreads to tighten significantly. As a result, credit is priced somewhere between fair value and full value. And although investment-grade spreads could tighten a bit further, we believe there is a greater likelihood of spread widening. Even if that occurs, however, I don't expect anything resembling the dramatic widening that occurred in 2008.

Lately, discussion has centered on the possibility that the 10-year Treasury yield could top 3%. Other than briefly scratching 3% in late 2013, the 10-year hasn't exceeded that level since 2011. But while this topic has generated a lot of hand-wringing, it's important to point out that 3% is still extremely low by historical standards.

Beware of the danger of credit risk.

The fixation on interest rate risk has overshadowed the threat of credit risk. The low-rate environment prompted managers at some firms to goose returns by plowing into bonds with greater yields but notably higher risks. Those securities could be adversely affected in a market downturn, subjecting investors to outsize losses. Capital Group's fixed-income team has been mindful not to stretch for yield, as we stick to our knitting of trying to generate predictable and appropriate risk-adjusted returns for our clients.

Given the possibility of higher inflation, our fixed-income team favors Treasury Inflation-Protected Securities, or TIPS, which we believe could benefit if consumer prices rise slightly more than the market expects. Conversely, our exposure to investment-grade corporate bonds is below benchmark given that spreads on these securities have become tight.

The uncertainty that has cropped up in all financial markets this year underscores the importance of holding bonds as a fundamental component of a broad investment portfolio. Fixed income provides a protective counterweight to stocks and other risky assets. And despite temporary bouts of volatility, bonds have historically generated positive returns through full economic cycles. With stretched valuations, tighter monetary policy and the likelihood of increased volatility, we believe in staying balanced and allowing bonds to do their job in a diversified portfolio.

APPEALING BUSINESS MODELS HELP HOTELS BOOK STRONG PROFITS

The first priority when scheduling any vacation or business trip is to avoid unpleasant surprises – no scheduling conflicts, jumbled reservations or misplaced passports. This maxim is especially true when it comes to lodging. Being stranded in a hotel that looks appealing online but is a letdown in reality is the travel equivalent of a bad blind date. That's a big reason many travelers choose to stay at leading hotel chains rather than smaller independents. Even if the brand name carries a slightly higher price, the dependability and peace of mind are worth it.

Such customer allegiance is one of many features that make hotels alluring from an investment standpoint. Among other advantages, leading chains tend to boast high profit margins, modest capital needs and ample room for expansion, both within the U.S. and overseas. A hallmark of the hotel business is that growth tends to feed more growth: The greater number of locations a chain offers – from mid-priced business hotels to luxe destinations with spas and golf courses – the likelier travelers are to stay there. That's particularly true if customers can accumulate or cash in points in popular loyalty programs.

Certainly, the lodging industry faces some headwinds. Its fortunes are somewhat tied to the economy, which is providing a lift at the moment but could pose a challenge

MATT WILSON

Matt is an equity analyst who covers the lodging industry. Based in Los Angeles, he has 10 years of investment industry experience and has been with Capital Group since 2013.

if the cycle turns. Also, apartment-rental websites such as Airbnb are sapping some demand that would otherwise flow to traditional hotels. Nevertheless, I believe the overall outlook is extremely bright. Leading chains have impressive name recognition and enviable business models that position them well for the future.

Hotels are consumer franchises in disguise.

At first glance, hotels might seem to be real estate enterprises. In reality, however, leading chains don't acquire real estate or construct buildings. Often, in fact, they don't even manage the properties bearing their names. Instead, these chains are consumer brands with franchise-oriented business models.

Here's how it works: Other entities – typically, mom-and-pop owners, investment groups or specialized real estate funds – control the land and buildings. These property owners pay a franchise fee to affiliate with a hotel chain, usually about 5% of annual revenue. As in other industries, property owners expect the imprimatur of the brand name to lure customers more successfully than they could on their own.

This structure benefits big hotel chains in several ways. It frees them of the risks and costs of property acquisition and development, while minimizing the need for capital. The chains pass along most operating expenses to the property owners, including those for marketing, website maintenance and reservation systems. In another quirk of the industry, big chains manage fewer than half of the hotels in their networks because it's often cheaper to outsource daily operations to third parties, especially for smaller locations. For the portion of hotels that the chains do manage – generally, flagship venues in choice cities – they earn additional fees.

Reward programs are a staple of the business.

Hotels benefit significantly from loyalty programs, which dole out room upgrades and other perks to repeat customers. Much like airline frequent flyer miles, the lure of reward points provides a strong incentive for travelers to stick with specific chains. Many people diligently accumulate points at midpriced hotels on business trips in order to redeem them at higher-end venues on vacation. Customer allegiance is critical to hotel chains, as loyalty programs fill more than half of all rooms on a given night.

Reward programs pay off in another way: by coaxing mom-and-pops, which make up the vast majority of U.S. hotels, to give up their independence and join the leading chains. That allows them to offer reward points while benefiting from the lower commissions that big chains negotiate with online travel services.

In some cases, iconic or trendy hotels opt to be part of so-called soft or collection brands. In these arrangements, they loosely align themselves with a chain but keep their names and wield greater operating freedom in exchange for higher franchise fees.

Within the U.S., much of the growth today is coming from the construction of "select-service" offerings, which provide basic accommodations with no restaurants, spas, convention space or high-end amenities. Select service is popular among business travelers who prize consistency, modern technology and moderate prices. Franchisees like select-service hotels because they're relatively easy to finance, build and operate, and tend to generate high profits.

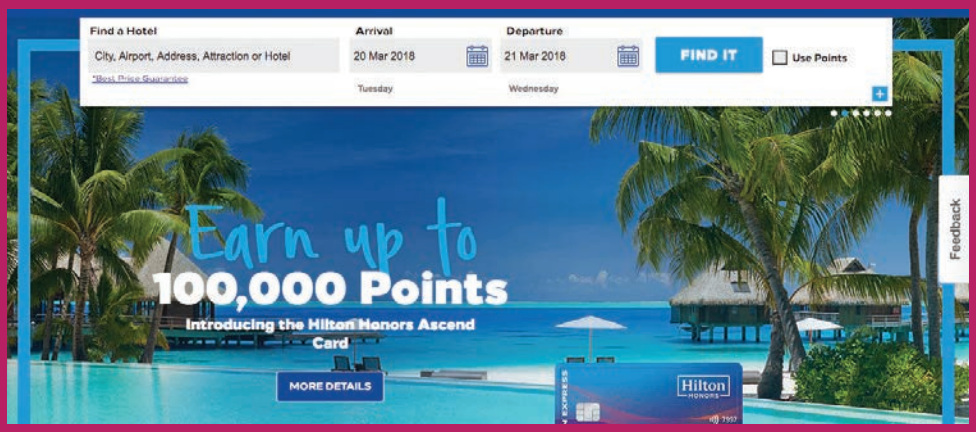
U.S. hotel brands also have favorable prospects in underpenetrated international markets. Leading chains have only 5% market share outside the U.S. but plan significant expansion in coming years. In fact, big chains are responsible for half of the rooms that are expected to come online in the next few years.

AIRBNB REPRESENTS AN IMPORTANT ITERATION, BUT IT PROJECTS LESS OF A SHADOW THAN IT MIGHT SEEM.

Airbnb isn't a significant threat to hotels.

Without question, one of the biggest trends in lodging has been the emergence of apartment-rental sites that match travelers seeking cozy rooms and cheap deals with homeowners eager for extra cash. But while Airbnb represents an important iteration, it projects less of a shadow than it might seem. These sites are primarily geared toward vacationers who book relatively long stays compared with the in-and-out dashes of peripatetic business travelers. And though Airbnb is siphoning off some hotel business, it's running up against its own challenges, especially tighter regulatory limits as major cities worry that an onslaught of vacation rentals is crowding out residents.

Overall, the outlook appears to be favorable for leading hotel chains, which should continue to benefit from compelling business models, strong growth prospects and impressive brand recognition.



Pictured above: easy online booking and robust reward programs benefit major hotel chains.

Growth in China's Consumer Class Benefits Many Industries

STEPHEN GREEN

Stephen is an economist covering China. Based in Hong Kong, he has 13 years of investment industry experience and has been with Capital Group since 2014.

Chinese consumers have become an especially potent force in the global economy over the past two decades. The country's rapid economic growth, combined with a steady rise in worker salaries, has fueled an ongoing expansion of China's middle and upper classes. Not surprisingly, greater levels of disposable income have translated into heightened spending on everything from the routine items of daily life to the affordable luxuries that are common throughout the developed world.

The effects of China's burgeoning consumer culture are evident across a variety of industries. Wealthier households, for example, have an affinity for luxury goods, overseas travel and, of course, housing. New entrants to the middle class, meanwhile, are shelling out for soft drinks, smartphones and premium baby formula. Across all income levels, there's an appreciation for quality-of-life services such as medical care, life insurance and wealth management.

I believe the purchasing power of Chinese consumers will be a vibrant source of demand for both domestic and foreign companies in coming years. The growth rate in the number of consumer households will edge back from its torrid

pace of the recent past, but there is already an enormous consumer base that will expand for years to come.

Recently, the issue of global trade has generated attention – particularly the flare-up of tensions between China and the U.S. Despite the aggressive tone of the rhetoric, I believe the economic impact at this point is likely to be modest. Though the outlook could change if frictions worsen, the underlying consumer appetite in China is unlikely to reverse course, and this trend should bode well for companies over the long term.

There has been a remarkable surge in the number of Chinese consumers.

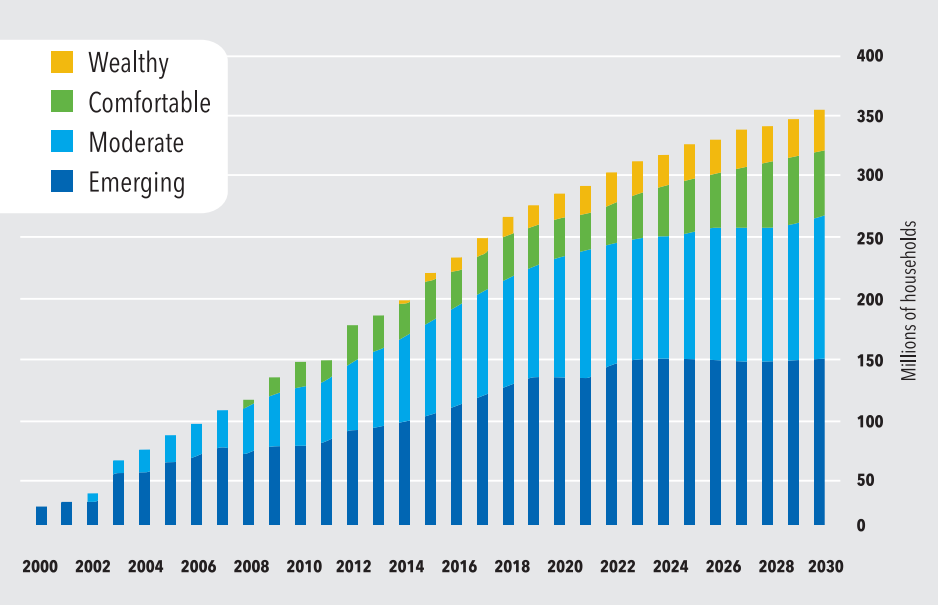
I have studied the size and spending patterns of what I refer to as consumer households. These are families earning enough money to earmark some of it for traditional consumer goods, ranging from higher-quality foreign products to the small indulgences that signify entry to the middle class. Of China's nearly 500 million households, roughly 260 million fall into the consumer category, with an additional 100 million or so likely to be added by 2030.

The growth of China's consumer class is depicted in the chart below, which shows there were fewer than 17 million such households in 2000. The chart partitions the group into four segments, ranging from those just breaking into the middle class to those at the upper end of the income scale. Some of the most notable growth has come in the "emerging" and "moderate" categories, with annual household income equivalent to a range of $8,000 to $45,000 in the U.S. That might not sound like much, but the cost of living is significantly lower in China.

In recent years, there's been steady growth in the "comfortable" segment and the emergence of a "wealthy" cohort. There are roughly 14 million wealthy families today – a portion of them extremely affluent. Though small in total size, the number of these higher-income households has nearly tripled in the past two years and is expected to expand by a further 10 million within the next five years.

Beyond the 260 million consumer households described above, there are 217 million nonconsumer households: lower-income families that sometimes struggle to cover the bare necessities. In a measure of China's economic progress, there were 386 million low-income households in 1995, and the number should decline further in coming years.

THE GROWING WEALTH OF CHINA'S MIDDLE AND UPPER CLASSES



Source: Capital Group research and estimates.

Incomes are growing 4% to 5% annually across the country and at an even quicker pace for many low-income workers.

The growth of the middle class is fueling spending on a range of products.

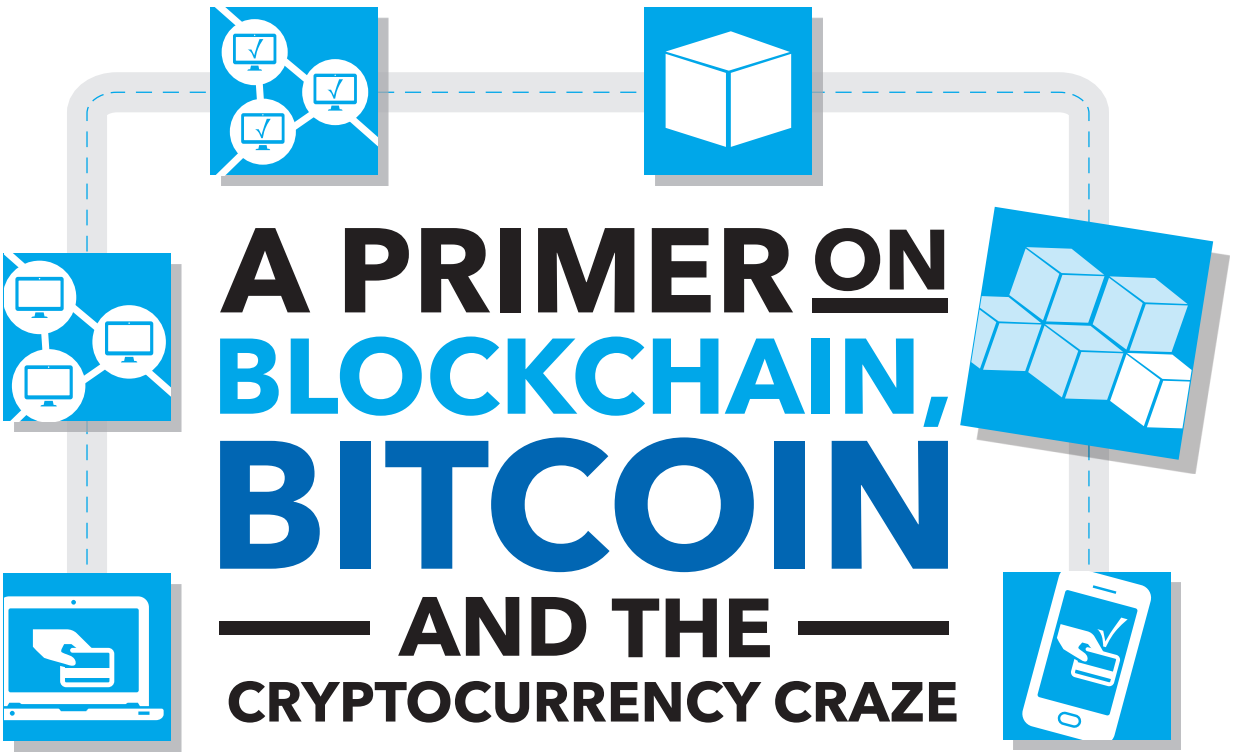
The spending power of Chinese consumers is visibly on display in the skincare and cosmetics industry. Asian beauty products constitute a $60 billion market, and 80% of its growth in the next five years is expected to come from China. That's due partly to the fact that Chinese consumers spend far less on these items than their counterparts in Japan and South Korea, which have similar beauty ideals and routines.

Skin care and cosmetics is an attractive business with strong growth potential, enviable customer loyalty and good cash flow. As their discretionary incomes rise, Chinese consumers tend to move up to premium products with brand names and stronger profit margins.

Similar dynamics are taking place in other industries, including alcoholic beverages and premium foods. Demand for high-quality baby formula, for example, has risen as parents focus more attention on infant nutrition. High-end chocolates have also gained traction in China, with some newlyweds handing them out as gifts to wedding guests.

The transformation of China's consumer class is also benefiting luxury goods makers as demand climbs for expensive jewelry, watches and handbags. The country's growing wealth is evident in increasing air travel and foreign tourism. Outbound tourism has surged in recent years, creating more business for luggage manufacturers and online travel companies, not to mention aircraft makers and companies that sell related components.

These trends are driven partly by shifts in savings habits and borrowing patterns. The willingness of consumers to take on debt has risen notably, while personal savings rates have declined, especially among people in their 20s. Overall, the consumer mentality that has become more prevalent in China over the past two decades appears to be firmly rooted.



A PRIMER ON BLOCKCHAIN, BITCOIN AND THE CRYPTOCURRENCY CRAZE

From bitcoin to ethereum, ripple and dash, so-called cryptocurrencies have transfixed speculative investors around the world in recent months. Aside from their drastic contortions in price, these highly volatile instruments have also trained a spotlight on the blockchain technology underpinning them. But what exactly are cryptocurrencies, how does blockchain actually work, and why have they stirred such a frenzy?

Part of the answer lies in the fledgling currencies themselves and the possibility of an alternative to the centuries-old global payment system. The rest of the answer comes from the enthusiasm for blockchain, which may have far-reaching applications regardless of the fate of digital money.

Essentially, blockchain is a digital recordkeeping system intended to speed up transactions, lower costs and improve security. It's designed to facilitate peer-to-peer transactions, thus eliminating the need for intermediaries such as banks or credit-card processors.

Dispensing with middlemen could bolster efficiency and slash layers of costs for industries ranging from finance to medicine. On a broader societal level, blockchain could streamline everyday activities. Imagine, for example, ordering a ride share on a smartphone without going through an Uber-like service. Instead, drivers and passengers would communicate directly, and the entire transaction would take place via a blockchain.

Of course, blockchain development has a long way to go, and many questions must be resolved for a mainstream rollout to be possible. Capital Group's emerging-technology team is studying these technologies extensively to assess their long-range prospects.

"We're just starting to imagine what we can do with this technology," says Rohan Hall, a Capital Group emerging-technology researcher. "We're still in version 1.0. We won't see meaningful adoption for at least several years."

Bitcoin sparked the cryptocurrency mania.

Depending on one's point of view, cryptocurrencies are either a quixotic investment fad or a genuine advance. The digital fervor began with the launch of bitcoin in the aftermath of the 2008 financial crisis. Bitcoin was designed to allow fast, cheap and anonymous transactions outside the purview of banks and governments. Created by a cryptography expert, or group of experts, toiling under a pseudonym, bitcoin caught on among enthusiasts enticed by the idea of a decentralized currency impervious to banking crises and free of government interference.

Each "coin" is created through an elaborate "mining" process in which highly torqued computers race to solve complex mathematical equations, with the winner granted a small number of coins. These computers, known as nodes, essentially oversee the system, processing and cross-checking every transaction. Bitcoin holders keep their coins in digital wallets that are accessible through passwords known as private keys. If a private key is lost or stolen, access to the wallet is gone forever. (The bitcoins still exist, but it's as though they're locked in a safe that can't be cracked.) Holders also have public keys that are akin to account numbers.

Among the many question marks surrounding bitcoin is whether it's used much as a currency. A growing number of stores and restaurants accept it, and securities exchanges have introduced bitcoin-related futures contracts. But mainstream acceptance has been slow.

Worries about fraud, for example, have prompted Google and Facebook to ban cryptocurrency ads. At least for the moment, bitcoin may be functioning more as a vehicle for financial speculation than as a practical transaction mechanism.

Such uncertainty has caused fitful price swings. Bitcoin has attracted interest from prominent corners of the financial world, but it also faces daunting regulatory and logistical obstacles, and is tarred by a lingering image as the payment of choice among drug dealers and online renegades. After zooming from roughly $1,000 in early 2017 to nearly $20,000 toward year-end, a brutish sell-off pushed it below $7,000. It trades around $9,000 today.

Bitcoin is popular now, but blockchain may turn out to be the real breakthrough.

At their core, financial transactions are simply entries in a ledger. Financial institutions typically maintain these ledgers themselves – recording, for example, a debit in the account of an apartment dweller writing a rent check and a credit in the account of the landlord cashing it. Blockchain, by contrast, consists of public ledgers maintained by a network of computers, known as nodes. Nodes process "blocks" of transactions, with each block mathematically affixed to the group preceding it, thus forming a chain. An account holder's public key is visible to the nodes, but both the private key unlocking a wallet and the user's identity are not.

Members of Capital Group's emerging-technology team studying blockchain (from left to right): Rohan Hall, Basit Sheikh and Ninou Sarwono

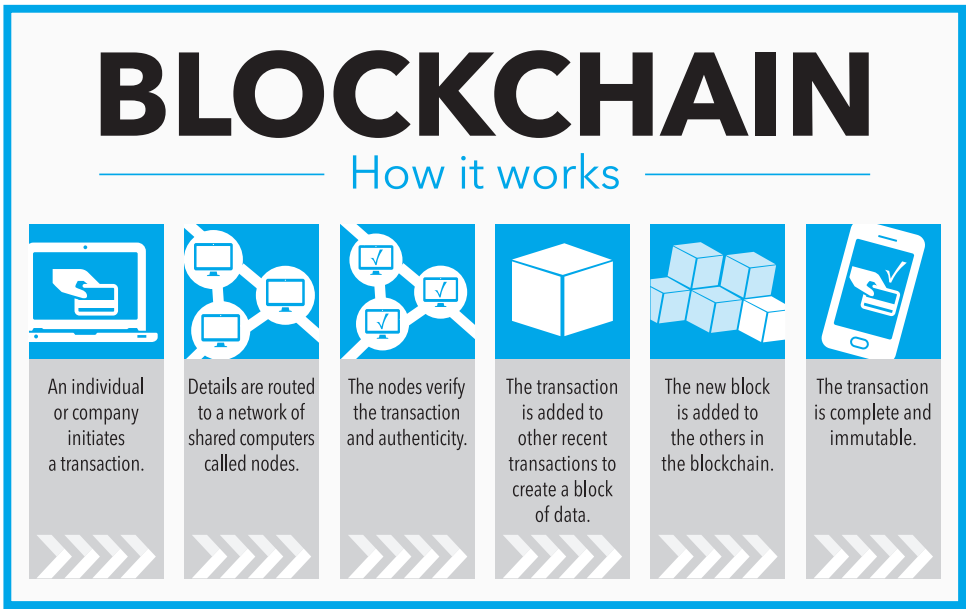
Blockchain could prove to be more electronically secure than the banks and retailers keeping customers' financial data. In-house ledgers require hackers to breach only one entry point to gain illicit access. If a hacker were to infiltrate one node of a blockchain, however, an attempt to pilfer funds would be rejected because the transaction would conflict with the history recorded on other nodes.

"It's a very different model from what exists today," says Ninou Sarwono, a Capital Group emerging-technology lead.

Eventually, other types of data could be stored on blockchains. Personal health records could be accessed quickly if someone fell ill on vacation. Property sales could be faster and less cumbersome if files were readily available. Ditto for voter registration, census data and intellectual property records. One day, each step in a process could be memorialized and verified on blockchains. To ensure that a restaurant's seafood is truly organic, for example, a blockchain could track a fish from the moment it's caught to its arrival on your plate.

Though these uses are unlikely in the near future, they are well within the realm of possibility.

"Blockchain is a very large boulder that's moving slowly, and its impact will be gradual," says Basit Sheikh, vice president of Capital Group's emerging-technology group. "But when it comes, it'll be massive and long-lasting, which is why we're keeping such a close eye on it."



A Few Simple STEPS Can Lead to More-Rewarding Conversations

Everyone has endured bad conversations – the ones with awkward pauses, poor communication or the failure to make a personal connection. Though such problems are most pronounced when meeting new people, they can be surprisingly common among friends, co-workers and even family members. In fact, having rewarding conversations – in which you not only convey your thoughts and feelings but listen to other people and absorb theirs – can be challenging.

There are several reasons for this, including the intrusion of technology in daily life and the hardening of political discourse in society. But many of the problems stem from the fact that most of us don't think we need to improve our interpersonal skills. Studies show that people rate their communication abilities as better than they really are and tend to blame others for conversational potholes.

"Having conversations and listening are not things we were born knowing how to do," says Celeste Headlee, author of *We Need to Talk: How to Have Conversations That Matter*.

Fortunately, a handful of strategies can bring about more-meaningful and rewarding interactions, Headlee says. Below, she outlines some of her recommended techniques.

Put away your smartphone, don't multitask and really listen.

A fundamental component of any conversation is the willingness to actually have one. Cell phones are often

deployed to sidestep interactions rather than enhance communication. It's common to fiddle with devices while waiting in checkout lines, sitting in cabs or standing in elevators (even for a split second). By doing so, we forgo chance encounters and deprive ourselves of the personal interactions that human beings need. The solution isn't to ditch our smartphones, Headlee says, but to avoid the knee-jerk temptation to summon them from our pockets at every free moment.

REMEMBER THAT THE GOAL OF A CONVERSATION IS TO SHARE THOUGHTS, FEELINGS AND EXPERIENCES.

In the same vein, don't multitask. The human brain can't focus on two things simultaneously. Try as you might, it's impossible to read email and talk to someone at the same time. Devote your full attention to conversations, and be present in the moment. That involves listening. Really listening.

Most of us are conditioned to speak, not just to verbalize our thoughts but to burnish our egos, Headlee believes. Have you ever missed what someone said because you were trying to hatch a witty response to demonstrate your smarts? Listening requires an open mind, she argues, and a recognition that the goal of a conversation isn't to win; it's to exchange thoughts, feelings and experiences. Enter every dialogue assuming that you might learn something. This is especially necessary in today's politically splintered world where like-minded people tend to cluster into groups, with limited exposure to countervailing views, Headlee says.

"The fact that we're not listening to people who disagree with us means we're not hearing anything but that which we agree with," Headlee observes. "That is a very dangerous thing."

Break with conventional wisdom, and vary your conversational techniques.

There is no shortage of generic advice that purports to improve communication. These age-old pointers include exhortations to maintain eye contact, nod your head to demonstrate involvement or rehearse topics ahead of time to fall back on if the dialogue falters. In reality, Headlee shares, these measures are ineffective and can even come across as disingenuous. After all, there's no need to feign interest if you're actually paying attention to what someone is saying.

Of course, everyone has endured strained conversations with strangers. Headlee suggests breaking through the initial discomfort by using open-ended queries to draw out the other person. Ask broad questions using words such as "who," "what," "why," "when" or "how." They can elicit substantive responses that lead to engaging interactions. Follow up with equally broad responses – "What was that like?" or "How did that feel?" – that require detailed answers rather than a conversation-smothering "yes" or "no."

Take a different tack when a close friend or family member discloses a sensitive issue, such as the death of a loved one or a personal setback. The natural urge is to offer details about our own experiences, thinking we're showing empathy by relating our recovery from a job loss or broken romance. But emotional reactions vary from one person to the next, and people often need us to listen rather than tilt the discussion toward ourselves, Headlee explains.

A few other suggestions: Don't repeat yourself when striving to make a point. Reiterating the same thing with slightly altered phrasing is not only condescending but will cause others to tune you out. Brevity is usually the best course. People want to connect through shared experiences, not an avalanche of facts. If you don't know something, acknowledge that. Admitting you're not an expert on a topic builds trust and credibility.

Through it all, remember to take a deep breath and listen. And don't worry that your voice won't be heard, Headlee advises.

"You're going to talk and you'll probably talk plenty," she says. "We're aiming for a balance."

NOW HEAR THIS: TIPS FOR BETTER COMMUNICATION

Keep a few basic rules in mind to cultivate productive and engaging conversations.

Be curious. Everyone has an interesting story to tell if you show them you want to hear it.

Check your bias. Keep an open mind and suppress preconceived notions about people or their viewpoints.

Show respect. The fastest way to poison an interaction is with disrespect, even if it's transmitted through body language or demeanor.

Stick it out. No matter how bored or frustrated you may become, don't end a conversation abruptly. Keeping quiet is preferable to walking away.

End well. Lay the foundation for future exchanges by finishing on friendly terms. Express gratitude and avoid the inclination to get the last word.

Source: *We Need to Talk: How to Have Conversations That Matter*

THE JOYS OF DECLUTTERING

Regardless of how big or small your home may be, it's easy to wind up with more "stuff" than you really need. But how much is too much, and where should you begin the sometimes-emotional process of letting go of what you don't have a use for? (After all, it sometimes means giving away those family heirlooms you always thought you'd need but have never once touched.)

Organizational expert Dana White is here to help. Her new book, *Decluttering at the Speed of Life*, offers strategies for tackling head-on the project of getting more organized. Below she shares some of her top ideas for leading a less cluttered life.

How do you define clutter?

In essence, it's anything that consistently gets out of control in your home. In that sense, it's different for everyone. By the way, it's natural to collect clutter, especially if you have a growing family. Stuff comes in at every stage of life, and we struggle to let go. A lot of clutter is aspirational, which means it sounds good at the time we first bring it in, but then realize we don't really need it after all.

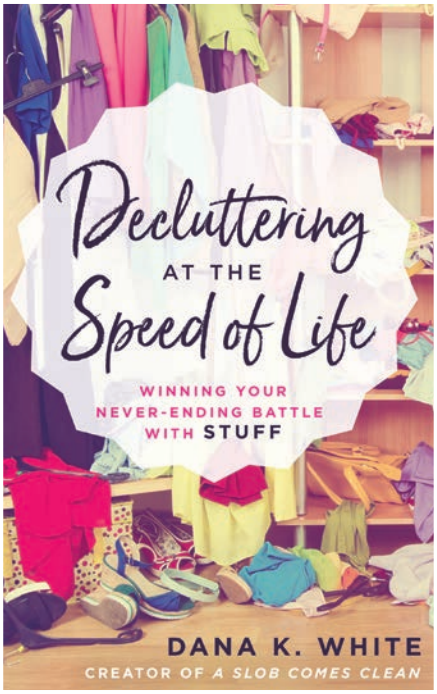
Some people reading this may say, "My house is big enough to hold everything I own, so I don't really have any clutter." Would it still be beneficial for them to follow your advice?

If you have the space for it and you're pleased with how your home is functioning overall, you're probably okay. But if you're

frustrated by having some out-of-control areas or rooms, you probably have too much stuff. Interestingly, I get lots of email from people with huge homes who still find things are out of control. In the book, I write about what I call the container concept. This is really a game changer for deciding whether you have a problem. The notion is that space should be the natural limiter for how much a room or area can hold. Once you exceed that limit, it's time to declutter. So if you have a bookshelf, for instance, once it is full of books, don't add any more until you start to get rid of some titles to make additional space. Or if your closet can't hold any more clothes, it's too crowded.

What's the best way to start the decluttering process?

First, don't think of it as one big project. You've got to break it down into steps to avoid what I call decluttering paralysis. Get started by looking around for anything that's truly trash and needs to be thrown away. You'll be surprised by how much that alone can help. Then move on to the easy stuff, which is anything lying around that shouldn't be there. Maybe it's clothes that need to be put away, or it might be something you really don't need and just want to get rid of.



How about items – say, from childhood – that you don't really need but have a sentimental value?

It comes down again to the container concept. Keep anything you want as long as you have the space for it. I'm a sentimental person myself, but my decluttering strategies take out the emotion when making decisions. No matter how much I love something, if there's no space for it, it goes.

Once someone has made a decision to declutter, what's the best way to get rid of items that still have value?

I have come to the point where I almost exclusively donate everything. I don't give it away to friends or find other outlets because that takes a lot of time and coordination. Instead, I look for an organization that will take everything, from clothes and kitchen items to furniture. I just make one call, and they pick everything up.

Lately, there's been an increasing trend toward minimalism – the notion of removing everything from your life other than what you value most. Is that similar to what you espouse?

Not really. For me, it's more about the realization that I function better with less stuff. I look at minimalism as getting rid of anything you absolutely don't need versus accepting the limits of your space and decluttering to the point where everything is comfortable and easily under control. The two have a similar goal, but I'm less about sacrificing and more about making sure you need everything you have – and that it all fits properly in your house.

FIVE STEPS TO DECLUTTERING YOUR HOME

Dana White recommends following this process to start tidying up each room in your house:

1 Get Rid of Trash

Start with the most visible mess that can easily be thrown away. Examples include brochures, broken items and actual trash that should be in the garbage to begin with.

2 Do the Easy Stuff

These are items that have a place in your home but are somewhere else for whatever reason – for instance, a book lying on the kitchen table that should be on the shelf instead.

3 Remove Duh Clutter

Simply put, this is clutter that makes you say, "Duh. Why do I have this?" These are items you know you should have got rid of ages ago and maybe never even liked in the first place.

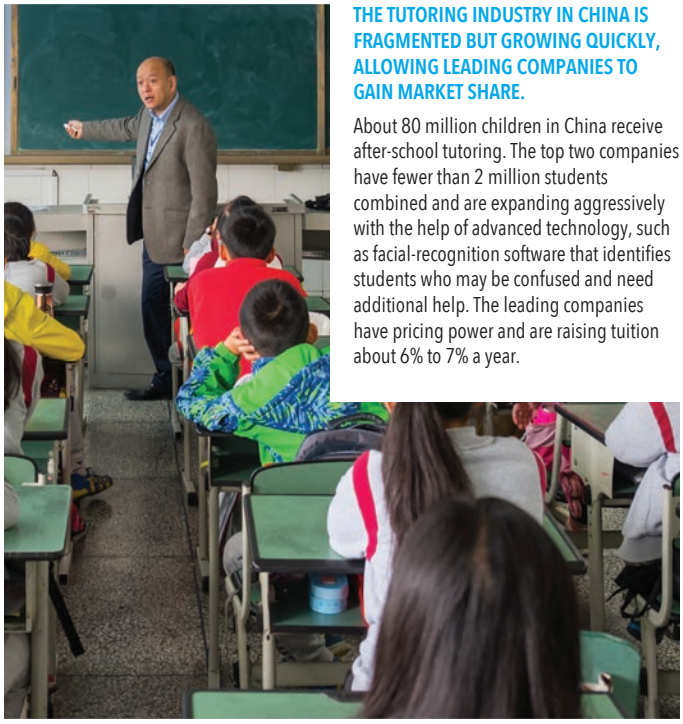
4 Ask These Two Decluttering Questions

Question 1: If I needed this item, where would I look for it first? (Then take it there.) Question 2: If I needed this item, would it ever occur to me that I already had it?

5 Make It Fit

This is where you apply the container concept of making sure everything fits in the space you have. If you haven't done so already, start the purging process with steps 1-4.

OBSERVATIONS FROM CAPITAL GROUP ANALYSTS AROUND THE WORLD



THE TUTORING INDUSTRY IN CHINA IS FRAGMENTED BUT GROWING QUICKLY, ALLOWING LEADING COMPANIES TO GAIN MARKET SHARE.

About 80 million children in China receive after-school tutoring. The top two companies have fewer than 2 million students combined and are expanding aggressively with the help of advanced technology, such as facial-recognition software that identifies students who may be confused and need additional help. The leading companies have pricing power and are raising tuition about 6% to 7% a year.

WAGE GROWTH IS ACCELERATING AS THE U.S. ECONOMY ADDS JOBS, BUT RISING PAY IS UNLIKELY TO SQUEEZE CORPORATE PROFITS.

Though wage gains have been modest compared with previous economic expansions, pay is climbing as the employment picture brightens. Even so, wage hikes are unlikely to dent profit margins, as compensation costs are quite low as a share of revenue.

GROWING DEMAND FOR ELECTRIC VEHICLES COULD BENEFIT COMPONENTS MANUFACTURERS SPECIALIZING IN AUTOMOTIVE TECHNOLOGY.

Thanks partly to technological progress, electric vehicles are expected to become price competitive with traditional internal combustion engines in the next five to eight years. As automakers increasingly focus on this market, there is likely to be heavy demand for suppliers of EV technology.

EUROPE'S ECONOMIC RESURGENCE IS PARTICULARLY NOTABLE IN PORTUGAL, WHICH HAS REDUCED ITS BUDGET DEFICIT, SHORED UP ITS BANKING SYSTEM AND BOOSTED EXPORTS.

The economy is also benefiting from a higher-quality workforce after years-long upgrade of its education system. And compared with the stresses afflicting some of its European neighbors, Portugal has a relative absence of immigration pressures.

COMPETITIVE VIDEO GAMING IS SURGING IN POPULARITY AND MAY ONE DAY TOP U.S. PROFESSIONAL FOOTBALL IN REVENUE AND PROFITABILITY.

So-called eSports are multiperson video games that are often played by professionals in front of live or online audiences. Although eSports make up a small segment of the gaming business, there is enormous potential for advertising, ticket sales and broadcasting rights. International growth prospects are particularly strong.

CHINA'S EFFORT TO IMPROVE HEALTH CARE IS SPURRING A RAPID EXPANSION OF THE COUNTRY'S PHARMACEUTICAL MARKET.

Chinese health care spending is rising as much as 15% a year, with medical outlays expected to hit 7% of GDP by 2020. The government hopes to spur medical innovation by speeding up drug approvals and extending patent protections.

◀ An interior view of the Burj Al Arab Hotel, in Dubai, which has been described as the world's only seven-star hotel. See our article on the burgeoning hotel industry on page 10.

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