City National Rochdale®
INVESTMENT MANAGEMENT

On the Radar

FAQs ON THE MARKETS AND ECONOMY SEPTEMBER 26, 2016

1. What expectations should investors have for portfolio returns?

Over the next year, we anticipate equity and fixed income returns to be below historical averages, tempered by the effects of global monetary policy and the influence of global economic growth.

U.S. equities remain near record highs, supported by a modest but improving corporate profit outlook. However, valuations – though not excessive – do appear "full & fair." This will likely limit upside potential in stocks to below historical average while volatility levels are expected to be at least normal, if not higher.

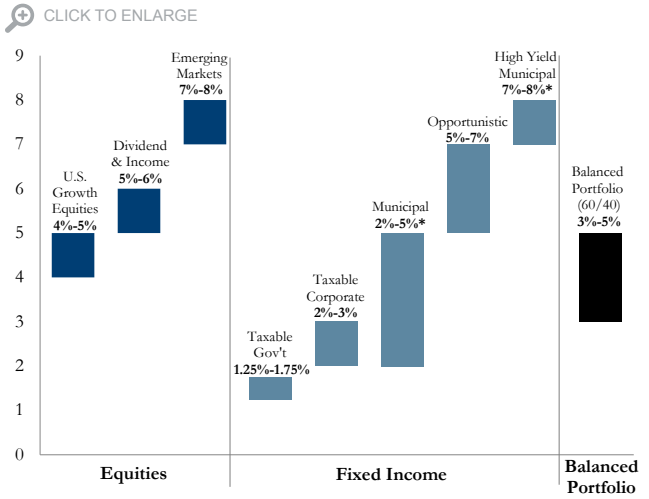
While our current overweight for growth and dividend equities has been rewarding for all clients, from a risk/return perspective we are carefully considering whether a reduction in our equity exposure going forward is warranted.

Nearly two years ago, we reduced European equity exposure in client portfolios to just 5%, which is significantly lower than the typical allocation of 10%-20% in a normal global asset allocation, thereby limiting clients' exposure to challenges now confronting Europe.

We continue to maintain our exposure in EM Asia, which is focused on healthy growing domestic consumption and new-economy businesses in the region.

In fixed income, we are maintaining our current positioning across government, IG, and HY bonds. While IG bonds appear fully valued and yields are historically low, potential uncertainty ahead reinforces core fixed income's role as a stabilizer in volatile markets.

Forecasted Expected Returns (%) 12-month Horizon



Source: City National Rochdale, August 2016
Forecasted expected returns represent City National Rochdale's opinion for these asset classes, are for illustrative purposes only, and do not represent client returns. The expected returns presented for these asset classes do not reflect any deductions for City National Rochdale fees or expenses. Actual client portfolio and investment returns will vary.

***Forecasted expected returns for HY Municipal and Municipal FI represents the taxable equivalent return at a 43.40% tax rate.**

2. What did the Fed decide at the recent FOMC meeting?

The Fed voted to keep the federal funds rate unchanged, as Chairwoman Yellen stated that the case for a future rate hike has "strengthened." Officials reiterated that any decision to raise interest rates will remain dependent on incoming economic data.

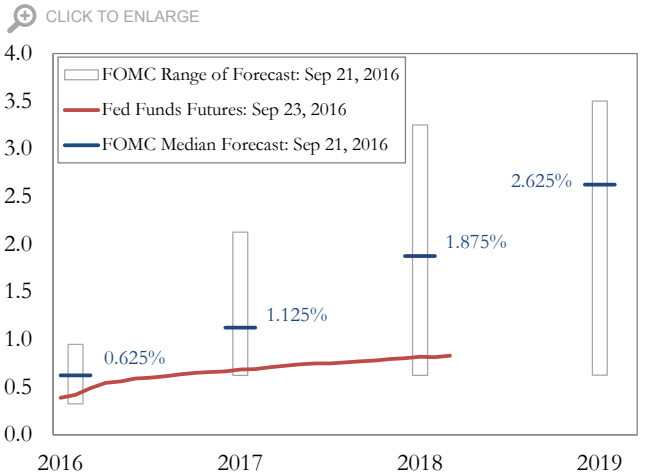
Interestingly, there was some discord at the meeting; three members cast dissenting votes to increase interest rates.

The next FOMC meeting is six days before the presidential election, and we do not expect to see any action on interest rates at that time. The following meeting will be in mid-December. We expect a rate hike then, assuming economic data remains strong.

The Fed continued to trim its projections for future interest rate hikes in 2017 and 2018.

The federal funds futures market has a much lower expectation of rate hikes compared to the FOMC projections *(see chart)*.

FOMC Federal Funds Projections & Federal Funds Futures Rate (%)



Source: Federal Reserve Bank, Chicago Board of Trade

3. Is recent weakness in U.S. economic data a concern?

Despite a number of recent disappointing data releases (including ISM business surveys, industrial production, and retail sales), U.S. third quarter GDP is still expected to rebound at a solid rate of around 2.5%.

This would be sharply above the roughly 1% gains that have prevailed in each of the previous three quarters.

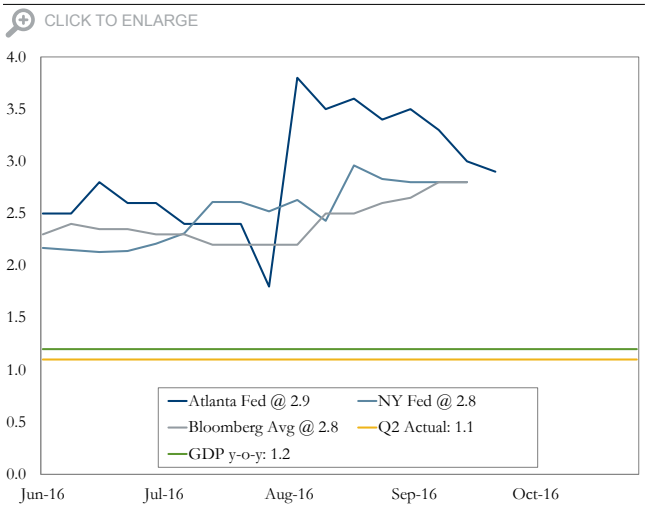
Monthly economic data is volatile, and some pullback could be expected after several months of better-than-expected data releases.

Soft spots in the economy remain, such as manufacturing, but are not enough to offset the positive fundamentals in place.

We believe that consumers in particular remain the stalwart of the expansion, supported by steady job growth, increasing income gains, and low inflation, to name a few.

As long as consumer fundamentals remain healthy, we believe the expansion should remain on a stable footing.

GDP Forecasts: Q3 (%)



Source: Bloomberg, BEA, Atlanta Fed, New York Fed

4. Is a recovery in U.S. corporate profit growth at hand?

After six consecutive quarterly declines, U.S. corporate earnings appear set to resume growth at a low- to mid-single digit rate through 2017.

While overall EPS estimates for the current quarter have declined very modestly, profit growth outside the energy sector is now expected to be positive.

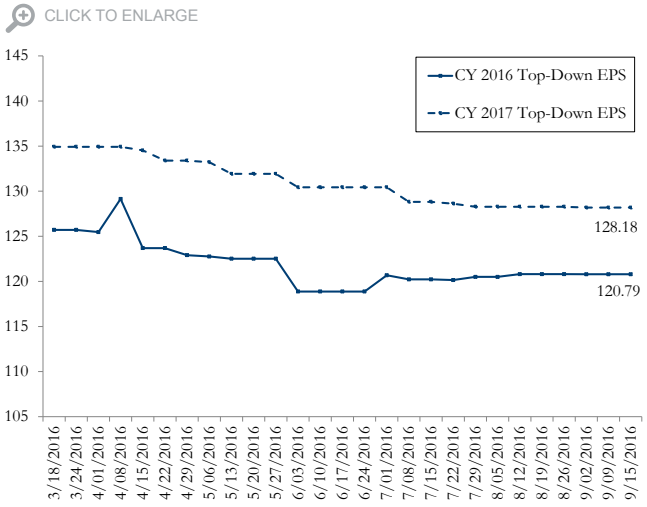
This reinforces our view that a trough in EPS growth is occurring. This is supported by a slowdown in the U.S. dollar's rise, stabilizing energy prices, and solid consumption growth driven by rising wages.

The recovery in earnings serves as the underpinning for our expectations of 4-5% total return for the S&P 500 over the next year.

While modest from a historical perspective, this rate of return still looks relatively attractive in the current low inflation and low yield environment.

However, because volatility is likely to remain at least at normal levels, if not higher, and valuation levels are near the upper end of the fair value range, we remain on "reduction watch."

S&P 500 Calendar-Year Top-Down EPS Estimates



Source: FactSet, as of September 15, 2016

5. What has driven the move up in very short-term municipal yields?

In addition to last December's Fed rate hike, money market reform has caused a dislocation in the marketplace.

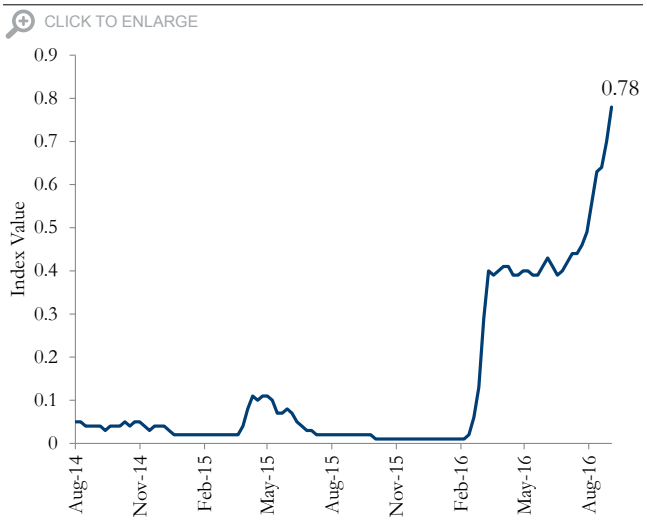
The upcoming October reform deadline will subject retail municipal money market funds to potential redemption restrictions. Several municipal money market funds have decided to close, and assets are flowing into Government money market funds. Consequently, tax-exempt money funds have lost $117 billion in assets year to date.

The money fund redemptions have caused increased supply and a steep decline in demand for Variable Rate Demand Notes (VRDNs), which are high-quality assets that trade at par and offer daily or weekly liquidity.

As inventories of these assets have built up, dealers have increased yields to make them more attractive to buyers. Rates, as measured by the 7-day SIFMA index, had lingered at low single digits for the last few years, but have now reset to 78bps and are expected to edge higher.

The recent increase in short term yields has made tax-exempt liquidity management an attractive solution for clients with large liquidity events, pending liabilities or other short term needs.

SIFMA Municipal Swap Index



Source: SIFMA, as of September 21, 2016
SIFMA: Securities Industry and Financial Markets Association

6. Will the Bank of Japan's recent move help their economy?

It is far too early to tell, but the history is not very good. The BOJ has conspicuously failed to meet past goals.

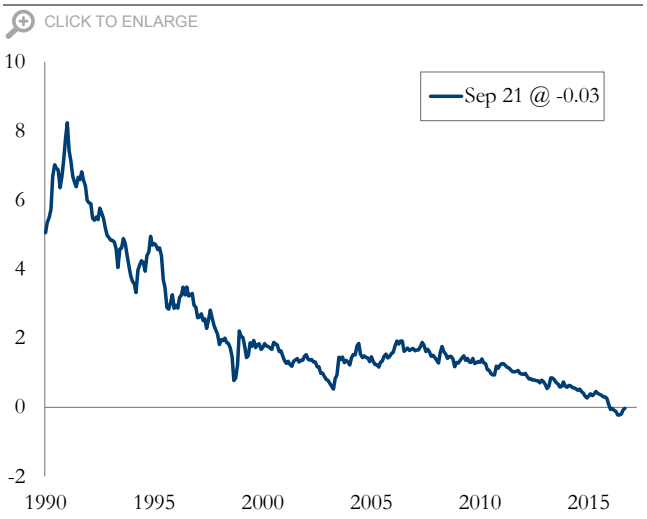
The BOJ will likely maintain short-term interest rates at -0.1%.

They will likely continue their asset purchases (80 trillion yen per year).

Now, they can be expected to engage in "yield curve control," which is intended to keep 10-year government bond yields near zero.

This move should help the profitability of many financial institutions (banks, insurance companies) that had been hurt by negative interest rates.

Japan: 10-yr Government Yield (%)



Source: Bank of Japan, Bloomberg

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There are inherent risks with equity investing. These risks include, but are not limited to, stock market, manager, or investment style. Stock markets tend to move in cycles, with periods of rising prices and periods of falling prices.

Investing in international markets carries risks such as currency fluctuation, regulatory risks, and economic and political instability. Emerging markets involve heightened risks related to the same factors as well as increased volatility, lower trading volume, and less liquidity. Emerging markets can have greater custodial and operational risks, and less developed legal and accounting systems, than developed markets.

There are inherent risks with fixed income investing. These risks may include interest rate, call, credit, market, inflation, government policy, liquidity, or junk bond. When interest rates rise, bond prices fall.

An investment in money market funds is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although money market funds seek to preserve the value of your investment at $1.00 per share, it is possible to lose money by investing in money market funds.

High yield bonds offer a higher yield and carry a greater risk of loss of principal and interest and an increased risk of default or downgrade than investment grade securities.

The yields and market values of municipal securities may be more affected by changes in tax rates and policies than similar income-bearing taxable securities. Certain investors' incomes may be subject to the Federal Alternative Minimum Tax (AMT), and taxable gains are also possible.

Investments in the municipal securities of a particular state or territory may be subject to the risk that changes in the economic conditions of that state or territory will negatively impact performance. These events may include severe financial difficulties and continued budget deficits, economic or political policy changes, tax base erosion, state constitutional limits on tax increases, and changes in the credit ratings.

Investments in emerging markets bonds may be substantially more volatile, and substantially less liquid, than the bonds of governments, government agencies, and government-owned corporations located in more developed foreign markets.

Returns include the reinvestment of interest and dividends.

Investing involves risk, including the loss of principal.

As with any investment strategy, there is no guarantee that investment objectives will be met and investors may lose money.

Past performance is no guarantee of future performance.

Index Definitions

The Securities Industry and Financial Markets Association Municipal Swap Index is a 7-day high-grade market index comprised of tax-exempt Variable Rate Demand Obligations (VRDOs) with certain characteristics. The Index is calculated and published by Bloomberg. The Index is overseen by SIFMA's Municipal Swap Index Committee.