OCTOBER 2016

Quarterly Update

Economic and Investment Management Perspectives

THIS ISSUE

City National Rochdale®
INVESTMENT MANAGEMENT

From the Desk of

GARRETT D'ALESSANDRO, CFA, CAIA, AIF®

As part of City National Rochdale's asset allocation process, we develop various scenarios based on our expectations regarding corporate profits, interest rates, employment, consumer spending, the overall economic cycle, geopolitical developments, and other factors that can influence returns and risks for each asset class in which we invest. From these scenarios, we create our base case, which we usually assign a 65.0% to 75.0% probability, along with a more optimistic and a more pessimistic forecast. Our current base-case scenario (65.0% probability) for the next two to three quarters includes the following:

- U.S. GDP growing about 2.0% (annualized)
- Moderate job growth
- Reasonable growth in consumer spending (about 2.0%)
- Slow corporate profit growth (about 4.0%)
- Continued low interest rates (10-year Treasuries yielding 1.5% to 2.0%)
- No major geopolitical event that would create significant sustained retrenchment by business or consumers
- Lower than average returns for equities and bonds
- Continued sub-par growth in Europe, but no recession

Our more optimistic scenario (15.0% probability) calls for slightly better growth in GDP, jobs, and consumer spending. Our more pessimistic scenario (20.0% probability) envisions lower growth in these three areas.

Our current asset allocation in client portfolios is predicated on the base case. However, we remain flexible, ready to alter our equity and bond allocations as warranted. Here are some events that would lead us to modify our portfolio positioning:

- A meaningful increase in interest rates (above 2.25% on the 10-year Treasury) within the next two to three quarters
- The risk of a U.S. recession in 2017 exceeding 35.0% (our current forecast)
- A victory by Donald Trump becoming likely

The U.S. economy remains in an extended slow recovery. While time does not determine when a recovery ends, history shows that as economic expansions continue, there is an increased likelihood of unsustainable spending by consumers, and sometimes by businesses. This sows the seeds for the next downturn. Currently, there are no meaningful sectors relating to consumers or businesses that appear to have reached unsustainable levels.

As the final quarter of 2016 unfolds, we will be keeping a close eye on corporate profits, the Federal Reserve System, and especially the election. While we have confidence in our economic models and financial indicators, we also know that polling data is suspect – as the citizens of the United Kingdom learned earlier this year. Stay tuned.

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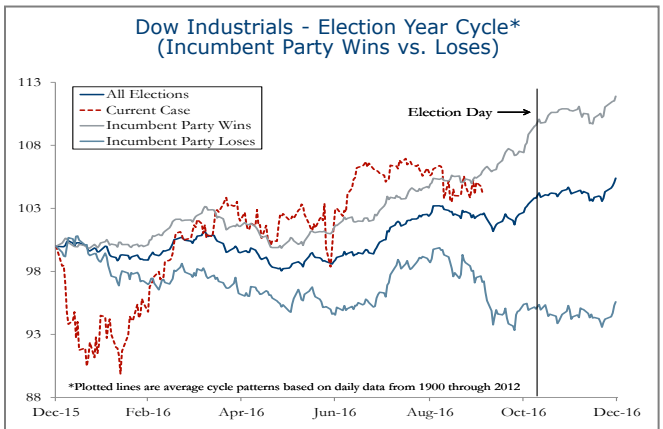
Elections Matter, but Earnings, Dividends, and Valuations Matter More

By Garrett D'Alessandro, CFA, CAIA, AIF®

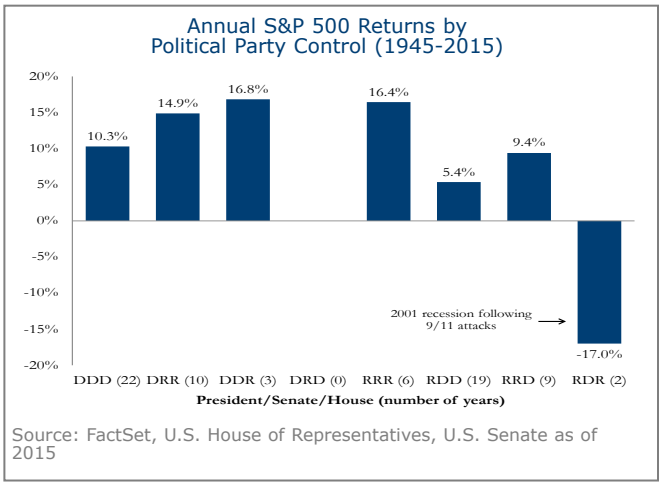
- **Economic growth depends on consumer and business confidence**
- **Polls currently point to a Clinton victory, which would avert the anticipated market uncertainty associated with a Trump win**
- **Equities are likely to outperform bonds in the year ahead, but both asset classes will be challenged to deliver average returns**

The presidential election is front and center for consumer and business decision-makers. **We take no view on either candidate and are basing our investment strategy on the collective intelligence we have from the financial markets, along with polls.** As of now, political polls and market sentiment both indicate a Clinton win. We remain cautious but willing to maintain our current equity exposure as long as these expectations hold. A change in those expectations could alter our allocations. City National Rochdale believes the U.S. economy is growing at a slow but steady rate, with corporate profits likely to rise about 4.0% next year while interest rates stay low enough through mid-2017 to benefit both consumers and businesses.

For patient, long-term investors, the most influential variables determining stock returns are the propensity for companies to naturally grow their earnings and dividends (if valuations are reasonable). While elections can cause volatility, successful investing requires staying focused on real economic and business activity. That said, this is an important election, so let us look at what history can tell us. Analyzing the Dow Jones Industrial Average, **equities generally have gained during presidential election years when the incumbent party won, but ended modestly lower when the challenger succeeded**. There are many possible political combinations for the White House, Senate, and House. However, equities tend to gain regardless of which party controls these institutions. In the year after a presidential election, history indicates that which incumbent party wins does matter. A Democratic victory is usually followed by positive but well-below-average returns, while a loss leads to a negative return for the market.



Source: Standard and Poor's Dow Jones Indices, Ned Davis Research as of 10/4/2016. All indices equal-weighted and geometric.



Source: FactSet, U.S. House of Representatives, U.S. Senate as of 2015

While incumbent victories historically have been better for bonds, **we believe the historically low current yields on government bonds and the actions of the Fed will have more influence on fixed income returns than the election results**.

In summary, **while we pay attention to elections, we believe that the economy, interest rates, corporate profits, and valuation levels matter far more**. Based on our outlook for these factors, our investment position remains moderately optimistic.

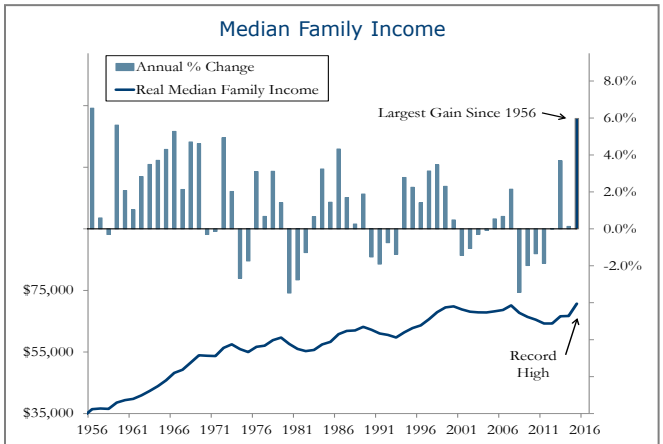
All returns cited are in USD. Index returns include the reinvestment of dividends.

Domestic Economic Strength Still Outweighing Challenges from Abroad

By Steven Denike

- **U.S. economy set for modest rebound after several disappointing quarters**
- **Domestic demand continues to drive growth**
- **Worst for industrial sector may be behind us**
- **Economy not showing signs of excesses that lead to recessions**

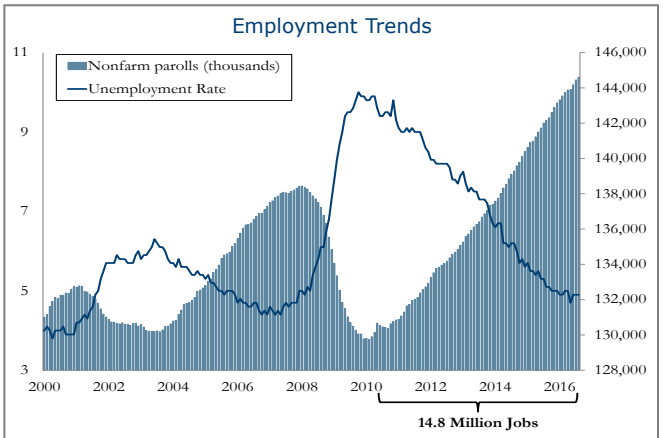
As another uneven year of growth draws to a close, a modest economic expansion remains the outlook in the United States. The reason behind our continued optimism is that the challenges facing the economy are largely coming from external rather than internal sources. Problems abroad have slowed U.S. exports and hurt commodity industries, leading to a modest decline in business investment. However, steady domestic demand (particularly in the consumer sector) has more than offset that drop.



Source: Federal Reserve Bank of St. Louis as of 12/31/2015

This **tug-of-war between domestic strength and global weakness is one reason overall U.S. growth has been slow.** After leading the economy out of recession, mining- and export-oriented manufacturing sectors have been hit hard by the double whammy of collapsing energy prices and a higher dollar. The good news is that **much of this painful adjustment is now behind us, which should pave the way for steadier growth in 2017.**

In terms of the **key variables that drive household confidence and spending (namely employment and income), the outlook is the brightest since the Great Recession**. Households have not only resumed spending at a decent clip, but they are doing so for the right reason: they are earning more. This differs from what happened a decade ago, when spending was fueled by debt accumulation. The latest Census Bureau figures show that real median family income rose 6.0% in 2015. That is the largest gain in almost 60 years, and it finally brings income above pre-recession levels.



Source: Federal Reserve Bank of St. Louis as of 8/1/2016

The **persistent improvement in the household sector is underscored by strength in the labor market**. Solid, steady job growth has been the one constant amid the ebbs and flows of the economy's expansion. More than 14 million workers have been added to American payrolls since the worst of the financial crisis, and the headline jobless rate is now effectively at a level the Fed considers full employment. Cyclical improvement in the labor market appears to be finally outweighing headwinds from retiring baby boomers, easily available disability benefits, and generous student aid.

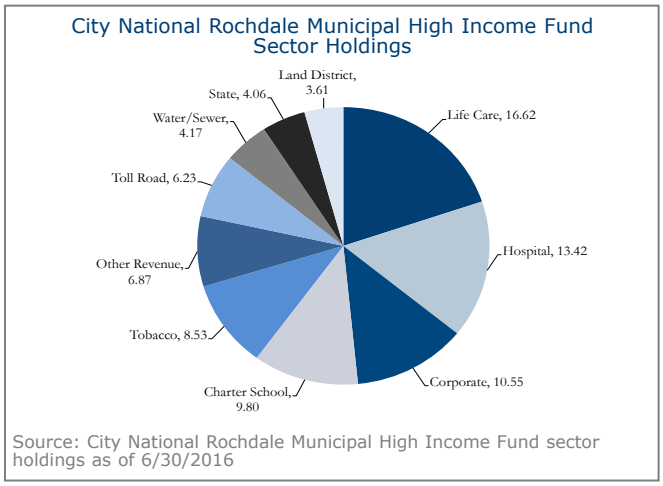
Putting all of this into perspective leaves us less pessimistic than many market commentators who worry that the current economic expansion (while admittedly long historically) is showing signs of petering out. No expansion lasts forever, and our sense is that we are now into the later stages of this one. But **while risks have edged up slightly over the past year, they remain modest by historical standards**. Indeed, although the U.S. expansion is aging, it appears to be aging well.

Selectivity Is Key in Strong High Yield Municipal Market

By William Black, CFA and Douglas Gibbs

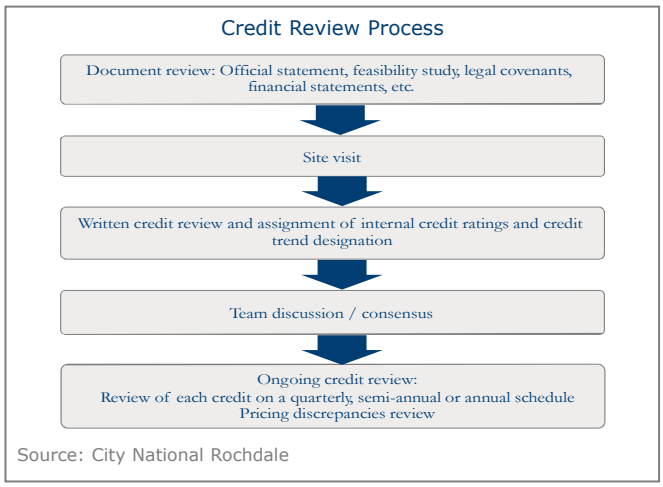
- **Continued demand for high yield municipal bonds**
- **High Yield Municipal team remains selective on credit exposure**
- **Puerto Rico defaults on general obligation bonds**

Demand for high yield municipal bonds remains strong, as evidenced by 49 weeks of consecutive inflows into high yield municipal bond funds as of September 28 (according to Lipper). Year-to-date inflows into high yield municipal bond funds have totaled $10.1 billion, with a four-week average of $179 million. **New issues in the high yield municipal market are well over-subscribed,** with demand typically six to eight times greater than the amount of bonds being offered. This allows underwriters to lower the yield and then selectively allocate bonds to buyers (typically high yield municipal bond funds). The new issue calendar remains robust through year-end.



Source: City National Rochdale Municipal High Income Fund sector holdings as of 6/30/2016

We remain highly selective in the bonds we are buying for the City National Rochdale Municipal High Income Fund. **Our team utilizes a bottom-up analytical approach that involves due diligence meetings with management of the borrower, site visits, surveillance of the competitive service area, and a credit committee approval process that involves the entire high yield municipal team.**



Source: City National Rochdale

The City National Rochdale Municipal High Income Fund holdings remain diverse, with the life care sector being the largest exposure, at 16.62%. The second largest exposure, at 13.42%, is the hospital sector. The new issue calendar for both of these sectors through the end of 2016 is robust. We anticipate that the Fund's charter school exposure, at 9.80%, will continue to decline, as we have been on the sidelines for most new issuance in this sector due to lack of yield for the inherent risk.

As anticipated, **Puerto Rico defaulted on its July 1 bond payment**. An oversight board appointed by the U.S. government will determine the best way to restructure Puerto Rico debt, as the commonwealth is not legally allowed to declare bankruptcy. Without the structure and orderliness of a bankruptcy court proceeding, this restructuring process will likely last for several years. **As of June 30, the Municipal High Income Fund did not have any exposure to Puerto Rico general obligation bonds**. The Fund does hold Puerto Rico water and sewer senior bonds backed by a pledged revenue stream. The senior water and sewer bonds made their July 1 bond payment in full. The other Puerto Rico holding is a securitized tobacco bond whose revenue stream cannot be intercepted by the commonwealth.

Investing involves risk including loss of principal. Bonds and bond funds are subject to interest rate risks and will decline in value as interest rates rise. Investing in securities that are not investment grade offers a higher yield but also carries a greater degree of risk of default or downgrade and are more volatile than investment grade securities, due to the speculative nature of their investments.

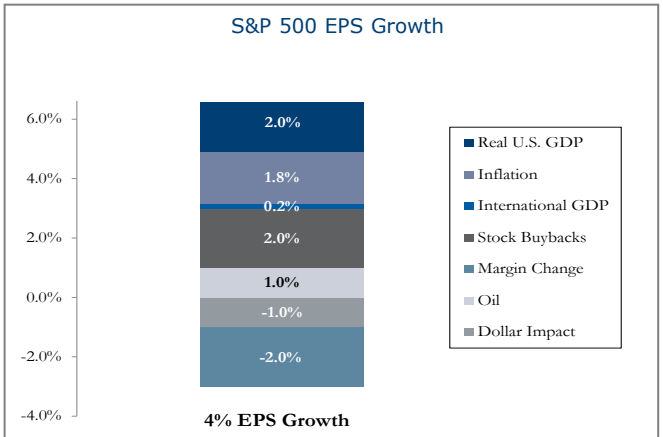
Choppy Seas Likely for Equities through Year-End

By Thomas Galvin

- **EPS season will be choppy, but should be fine**
- **Business and consumer confidence should improve after the election**
- **December rate decision by Fed remains a wild card**

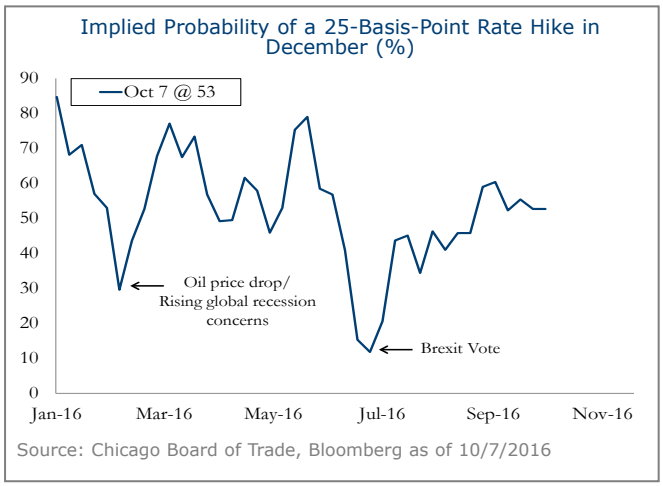
There are many significant crosscurrents at work that will influence the returns of U.S. equities through year-end. Foremost among these are corporate profits, the outcome of the U.S. elections, and prospects for a Fed rate hike. While we believe equity markets will be able to move forward in a positive manner during this time frame, investors should expect heightened volatility.

In the coming weeks, Corporate America will report third-quarter results that will provide insights into the level of revenue growth and profitability that companies achieved, as well as their outlook for the fourth quarter and beyond. There are numerous positives and negatives at work. On the plus side, estimates for growth were reduced as the quarter unfolded, so the bar for positive surprises is lower. Also, the dollar should be less of a headwind for results at multinational companies. On the negative side, uncertainty about the election seems to be dampening business confidence and appetites for capital spending and inventory accumulation, which will likely lead to shortfalls for some companies. Overall, we believe **earnings season should be fine and companies will likely remain cautiously optimistic about prospects through year-end**. This should set the stage for a continued modest increase in EPS growth into 2017.



Source: City National Rochdale estimates as of 10/2016

Uncertainty about the presidential and congressional elections has been high throughout the past few months. The probabilities of a victory by Hillary Clinton assigned by polling organizations such as fivethirtyeight.com have ranged from 50.0% to 86.0% since June. Despite a recent rise in this measure for the Democratic candidate, our view remains that Clinton will win but will not get a sweeping mandate and that Congress will be split. As a result, we believe no meaningful changes in fiscal policy are likely to occur next year to alter the current fundamental trajectory of the economy or corporate earnings. **Post-election, we believe political uncertainty will be removed and businesses and consumers will return to normal patterns for spending through year-end and heading into 2017.**



Source: Chicago Board of Trade, Bloomberg as of 10/7/2016

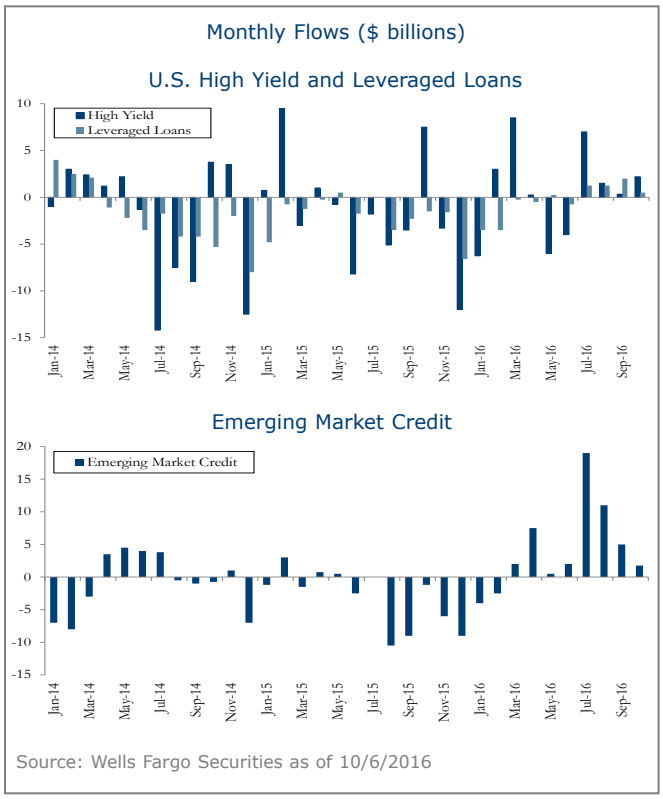
The final uncertainty relates to whether the Fed will raise interest rates at its December meeting. While a modest increase in the Fed Funds rate is our base-case scenario (and an improving set of economic signals post-election could increase the probabilities), **the Fed may be reluctant to raise rates as, in the short term, such an action would likely lead to heightened uncertainty about the direction of future hikes and put downward pressure on stocks. In the longer term, we believe investors should not fear a rate rise by the Fed, as it would signal confidence in the economy**.

Investors Resume Allocating to Higher-Yielding Assets

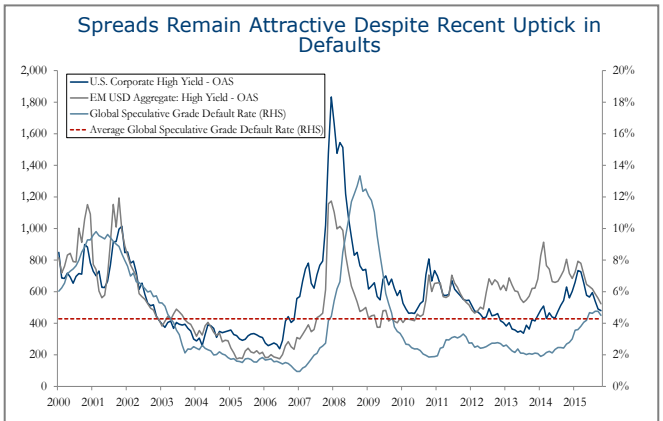
By William Miller, CFA and David Krouth, CFA

- **Third-quarter returns driven by price appreciation as global search for yield intensifies**
- **Default rates slightly exceed long-term average; commodity-centric sectors weakest**
- **Low level of global interest rates continues to support higher-yielding asset classes**

The global reach for yield intensified in the third quarter. The Bank of Japan continued its quantitative easing program, with the most recent iteration providing for outright yield caps of 0.0% on 10-year Japan Government Bonds; the Federal Reserve held interest rates steady while noting continued strength in the underlying U.S. economy; and European sovereign interest rates remain negative to nearly zero. **With the stabilization in commodity prices and the abundance of low global rates, investors have resumed allocating to higher-yielding assets, as shown in the flow of funds charts below.**



Source: Wells Fargo Securities as of 10/6/2016



Source: Moody's, Bloomberg Barclays U.S. High Yield and Emerging Markets Aggregate High Yield index data as of 9/30/2016

This inflow of assets has resulted in strong returns for opportunistic asset classes. However, the upcoming U.S. elections, December's Federal Open Market Committee meeting, and ongoing uncertainty around oil prices may induce material market volatility.

Although default rates are slightly ahead of the long-term average, we expect that accommodative credit market conditions will keep a lid on the level of defaults. Moody's expects the commodity-centric sectors to have the highest default rates in the coming year, with the metals/mining and oil/gas sectors predicted to peak at nearly 7.6% and 5.2%, respectively. Moody's also predicts that the aggregate default rate 12 months from now will be 3.3% (down from the August 2016 level of 4.8%). Therefore, **excluding the commodity-related sectors, default rates are expected to remain well below the long-term average, while the amount of risk compensation paid remains relatively elevated for both the U.S. high yield and emerging market high yield asset classes**.

Given the continued expectations of limited Federal Reserve tightening, the proliferation of negative global interest rates, and subdued corporate earnings growth, we believe high-income-generating assets remain very attractive.

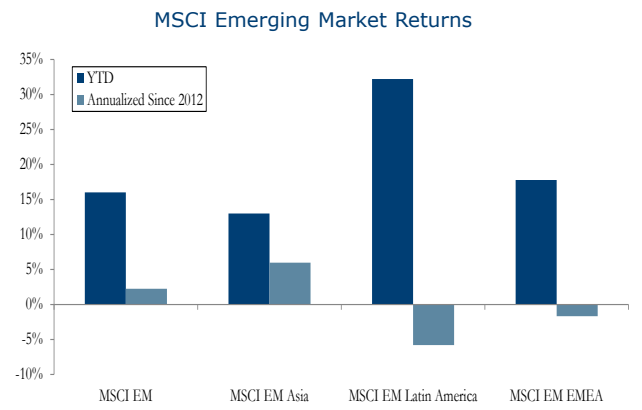
All returns cited are in USD. Index returns include the reinvestment of dividends.

Emerging Market Equities Experience Diverging Trends

By Anindya Chatterjee

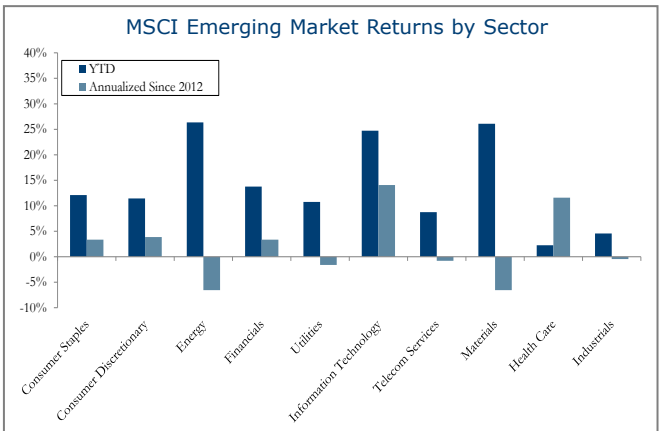
- **Emerging market equities performance kinder to commodity-producing/-exporting markets**
- **Domestic political risks have generally diminished**
- **Despite low funding costs, infrastructure spending remains disappointing**

Emerging market equities have had a good year so far despite a negative start to 2016 marked by concerns about China and the yuan. The MSCI Emerging Markets Index (MXEF) has returned 16.0% year-to-date. However, trends in EM equities have been divergent, with Latin America and EMEA (Europe, the Middle East, and Africa) issues sharply outperforming the rest of the EMs. While the **energy- and resource-heavy markets rallied, equity markets in the energy- and commodity-consuming EM economies remained laggards**.



Source: Morningstar as of 9/30/2016

We have seen encouraging signs of domestic political stability in EM markets. Ratification of a new constitution in Thailand (and a switch of the chief opposition party towards the present administration is reassuring) in terms of the continuity of the present regime. However, the recent death of King Bhumibol may have political repercussions, and we will continue to monitor the region closely. In the Philippines, the recently elected president (Rodrigo Duterte) has historically high approval ratings, his loose cannon status notwithstanding. We are encouraged by the Philippine government's economic agenda and plans for reform. There is



Source: Morningstar as of 9/30/2016

improved political and policy stability in China and India. **We believe the political stability in EM Asia keeps the policy environment conducive to continued economic reforms and growth.**

In a growth-challenged global environment of negative yields, passive flows have supported EMs so far, helping Asia outperform the other regions in the second half of 2016. **There is indeed some modest improvement in EM Asia's forward earnings estimates (about 4.5% from the end of last quarter according to MSCI), which somewhat justifies the improved equity market performance.** The continued tepid earnings growth effect is, in a way, dampened by a 13.0% decline in the largest constituent's (China's) forward earnings expectations.

We continue to believe that the region's consumption demand will remain resilient, and our focus remains on companies that can benefit. Asia Ex-Japan continues to grow stronger than the rest of the world (at about 5.0% to 6.0% in both 2016 and 2017), led by India, China, and the Philippines; the growth in our key markets remains enviable. Latin America is expected to see a decline of 1.3% in GDP for 2016 and an increase of 1.9% in 2017 (according to Bloomberg).

All returns cited are in USD. Index returns include the reinvestment of dividends.

Important Disclosures

The information presented does not involve the rendering of personalized investment, financial, legal, or tax advice. This presentation is not an offer to buy or sell, or a solicitation of any offer to buy or sell, any of the securities mentioned herein.

Certain statements contained herein may constitute projections, forecasts, and other forward-looking statements, which do not reflect actual results and are based primarily upon a hypothetical set of assumptions applied to certain historical financial information. Certain information has been provided by third-party sources and, although believed to be reliable, it has not been independently verified, and its accuracy or completeness cannot be guaranteed.

Any opinions, projections, forecasts, and forward-looking statements presented herein are valid as of the date of this document and are subject to change.

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.

Concentrating assets in the real estate sector or REITs may disproportionately subject a portfolio to the risks of that industry, including the loss of value because of adverse developments affecting the real estate industry and real property values. Investments in REITs may be subject to increased price volatility and liquidity risk; concentration risk is high.

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.* This risk is heightened with investments in longer duration fixed-income securities and during periods when prevailing interest rates are low or negative. 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 below-investment-grade debt securities which are usually called "high yield" or "junk bonds," are typically in weaker financial health and such securities can be harder to value and sell and their prices can be more volatile than more highly rated securities. While these securities generally have higher rates of interest, they also involve greater risk of default than do securitiesof a higher-quality rating.

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. Emerging markets bonds can have greater custodial and operational risks, and less developed legal and accounting systems than developed markets.

As with any investment strategy, there is no guarantee that investment objectives will be met, and investors may lose money. Returns include the reinvestment of interest and dividends. Investing involves risk, including the loss of principal. Diversification may not protect against market loss or risk. Past performance is no guarantee of future performance.

An investor should consider carefully the fund's investment objectives, risks, charges and expenses. The Fund's summary and full prospectus contains this and other important information about the investment company, and it may be obtained by calling 800-245-9888. Please read it carefully before investing.

City National Rochdale Funds are distributed by SEI Investments Distribution Co., which is not affiliated with City National Bank or any subsidiary or affiliate.

No investment strategy can guarantee a profit or protect against loss in periods of declining values. There is no guarantee that the Fund's income will be exempt from federal or state income taxes. Capital gains, if any, are subject to capital gains tax. Income from municipal bonds may be subject to the alternative minimum tax. Diversification does not protect against market loss.This material represents an assessment of the market environment at a specific point in time and is not intended to be a forecast of future events or a guarantee of future results.

Index Definitions

The Standard & Poor's (S&P) 500 Index represents 500 large U.S. companies. The comparative market index is not directly investable and is not adjusted to reflect expenses that the SEC requires to be reflected in the fund's performance.

The U.S. Treasury 10-year note is a debt obligation issued by the United States government that matures in 10 years. A 10-year Treasury note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

Dow Jones Industrial Average is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry.

The Barclays U.S. Corporate High-Yield Index covers the U.S.-dollar-denominated, non-investment-grade, fixed-rate, taxable corporate bond market and includes securities with ratings by Moody's, Fitch, and S&P of Ba1/BB+/BB+ or below.

The Barclays Emerging Markets USD Aggregate Bond Index is a flagship hard currency emerging markets debt benchmark that includes fixed- and floating-rate U.S. -dollar-denominated debt issued from sovereign, quasi-sovereign, and corporate EM issuers.

MSCI EM Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. Net total return indexes reinvest dividends after the deduction of withholding taxes, using (for international indexes) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties.

MSCI EM Asia Index is a free-float-adjusted market capitalization index that is designed to measure equity market performance in the Asian emerging markets. Net total return indexes reinvest dividends after the deduction of withholding taxes, using (for international indexes) a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties.

The MSCI EM EMEA (Europe, Middle East, and Africa) Index is a free-float adjusted market capitalization weighted index that is designed to measure the equity market performance of the emerging market countries of Europe, the Middle East, & Africa. The MSCI EM EMEA Index consists of the following 10 emerging market country indexes: Czech Republic, Greece, Hungary, Poland, Russia, Turkey, Egypt, South Africa, Qatar, and United Arab Emirates.

The MSCI Emerging Markets Latin America Index is a free-float adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets in Latin America. The MSCI EM Latin America Index consists of the following five emerging market country indexes: Brazil, Chile, Colombia, Mexico, and Peru.

Indices are unmanaged, and one cannot invest directly in an index. Index returns do not reflect a deduction for fees or expenses.