City National Rochdale®

INVESTMENT MANAGEMENT

2017 Fixed Income Outlook

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INTRODUCTION

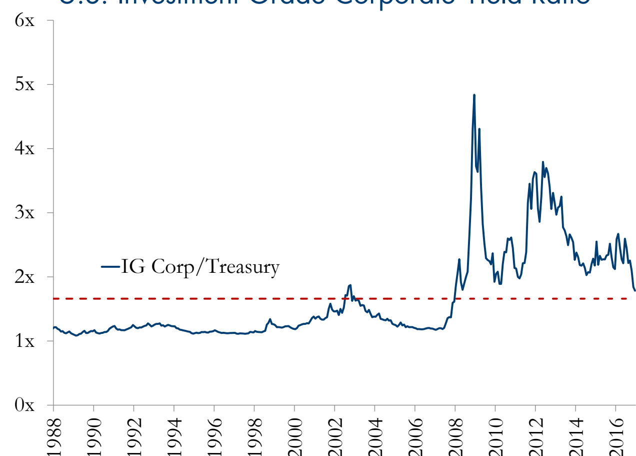
Turbulence in 2016 disrupted U.S. interest rates, but overall fixed income performance remained positive across credit sectors. Some of the dominant themes of last year continue to influence market behavior—notably politics and policy—but the uncertainty over the new U.S. administration is likely to be a central driver of sentiment in 2017. Current economic trends appear to be in an upward swing, which is supportive of higher rates, but a combination of technical factors and negative and weak global yields could keep the long end of the curve relatively contained. In our view, the 10-year U.S. Treasury yield will gradually move higher to within a range of 2.5% to 3%, and we expect the FOMC to implement two to three rate hikes by year-end. The normalization of rates could lead to a steeper yield curve if inflation expectations accelerate, but credit spreads may provide some cushion to temper the impact. In the year ahead, developments in the U.S. and abroad could change the orientation of the economy and financial markets. Conversely, we expect volatility to persist, which should create opportunities for investors. Fixed income returns are forecasted to be positive in the upcoming year, and we continue to believe that the asset class is an appropriate allocation to generate income and counter instability.

INVESTMENT GRADE TAXABLE

Investment Grade (IG) corporates were less affected by the post-election price free-fall experienced by other select sectors of the fixed income markets. Notwithstanding the correction in rates, corporates delivered a decent total return in 2016. The Bloomberg Barclays Intermediate U.S. Corporate Index, which is a proxy for our IG strategy focus, earned 4% last year, outperforming the comparable Treasury index with its 1% total return. As we begin the new year, we believe nominal rates are attractive, and corporates continue to offer a yield advantage over Treasuries. While valuations have narrowed from a year ago, current credit spreads are in line with multi-year averages and, we believe, have room to compress further. Also, expectations for lower net supply, due in part to a shallower pipeline of M&A activity and a busy maturity schedule, should further buoy prices. We would expect intermediate IG corporates to earn between 2% to 3% this year, outpacing Treasuries.

Our view on credit is optimistic, and we are overweight lower quality tiers. Improving economic fundamentals should accrue to corporate profitability as forecasts target 7% and 12% increases in sales and earnings this year. A consequence of low rates has been increased debt issuance, but we would expect the near-term benefit of earnings growth to temper weakening leverage trends observed in the space. In our view, special opportunities are developing within the energy, commodities, and financial sub-sectors. The recent stabilization in oil and iron ore prices, as well as curtailments to capital spending, should bode well for companies within these industries. A rise in interest rates will likely benefit financial services companies as this late-cycle industry tends to perform well during a tightening phase. Nevertheless, as we enter a period of uncertainty, which could drive rates higher if the new administration implements expansionary policies, we are positioning our portfolio duration short to neutral against the benchmark. In this environment, floating rate and structured products (such as various asset-backed securities) serve to buffer rising rates, and within this context, we will likely increase our exposure to contain interest rate sensitivity.

FIGURE 1
U.S. Investment Grade Corporate Yield Ratio



Source: Bloomberg Barclays, January 2017

HIGH YIELD TAXABLE

High Yield (HY) corporates outperformed other major fixed income asset classes by a wide margin last year. According to the Bloomberg Barclays family of indices, the U.S. Corporate HY Index returned an astounding 17.5%, besting all historical performance records except 2003 and 2009. The demand

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for HY corporates was led by several factors, including persistently low global yields, which is a byproduct of central bank easing policies. We would also be remiss not to mention that the valuations of HY corporates were much different at the beginning of 2016 than they are today—bond prices have risen to nearly par from 90 cents on the dollar, and yields (along with credit spreads) have declined approximately 2.75%. That said, current valuations suggest more limited room for spread tightening, but we believe HY corporates remain relatively attractive versus other asset classes, particularly in light of negative yields in other world economies. In our view, the economic landscape remains supportive, with commodity price-sensitive industries doing better, leading to broadly solid issuer credit fundamentals, including low rates of default experience. Our expectation for returns is favorable, with HY corporates and leveraged loans to earn 5% to 7% in 2017.

Our constructive tone heading into the new year is not without risk, however. The dollar, central bank actions, and foreign political elections could all impact the behavior of the HY markets. Stateside, inflationary measures, such as increased fiscal spending, could raise the level of interest rates. However, these risks would not likely cause near-term concerns over credit quality. To limit interest rate risk, we view bank loans as "defensive" investments with attractive income potential. Often, periods when the Federal Reserve is actively raising short-term interest rates result in increased flows into the U.S. at the expense of emerging market bonds. However, at this time, potential Fed activity is already priced into the markets. We expect the HY sector to be able to absorb volatility should it develop.

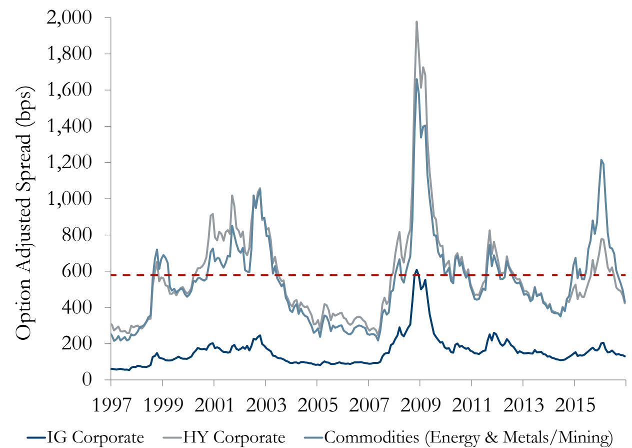
MUNICIPALS

Tax-exempt municipal bonds have seemingly hit the reset button in the wake of the presidential election. The implications of pro-growth policies coupled with an aggressive tax-reform agenda proposed by the Trump administration led to a repricing in rates. The technical tailwinds that benefited the asset class eventually reversed course, with both IG and HY municipal bonds delivering low returns for the year. The Bloomberg Barclays Inter-Short Index, which is a good proxy for our strategy focus for IG, was relatively flat at negative 0.15%, while the HY Index returned a modestly positive 2.99% in 2016. However, the silver lining is nominal, and relative yields reached thresholds that were attractive enough to lure traditional and non-traditional investors in the asset class. The municipal market has received technically driven price support heading into the new year, which is a seasonal interval where demand typically outstrips lower net supply. We expect intermediate and HY municipals to earn (nominally) 1% to 3% and 4% to 6%, respectively, in 2017.

The primary focus of the municipal bond market will be on the direction and timing of congressional policy. Perhaps the "topic du jour" in the new year is the impact of potential tax reform. We expect any reduction in top marginal tax rates to have a more limited impact on demand given the historically weak correlation, and we assign a low probability of an outright elimination of the municipal tax exemption. However, a watchful eye is needed because these dynamics could cause yields to respond to even the threat of such actions. Record supply in 2016 is likely to recede this year due to forecasted higher rates and lower refinancing activity, but a wildcard that could influence issuance is movement on any infrastructure spending initiative. While there is a lack of details on what an infrastructure financing program would look like under the new administration, early indications point to the use of private capital and tax credits or subsidies as possible funding sources. Accordingly, the pattern of municipal debt issuance could change, but it depends on the role of state and local governments within the overall framework.

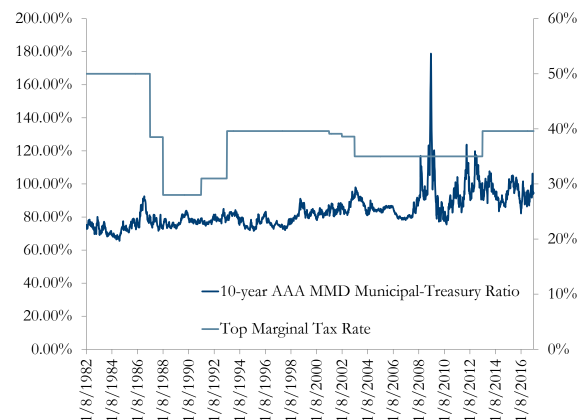
Deregulation and health care reform are expected to be a part of the narrative this year. The dismantling of the Affordable Care Act (ACA) or any of its major provisions would filter through the health care sector. Depending on the particular reform, state and potentially local governments could be affected. We continue to selectively reduce our health care exposure across our IG and HY mandates as a defensive maneuver to sector-specific concerns. However, municipal

FIGURE 2
U.S. High Yield Corporate Option Adjusted Spreads



Source: Bank of America Merrill Lynch Fixed Income Indices, January 2017

FIGURE 3
Relationship Between Top Marginal Tax Rates and 10-Year AAA MMD Municipal-Treasury Ratio



Source: MMD, Tax Policy Center, January 2017

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finances are currently stable for most issuers, and default rates remain low for IG and HY borrowers. A recent Moody's report noted that, other than Puerto Rico, no defaults were recorded in 2016 across their rated universe, which underscores the relative safety of the asset class. Moreover, the continued growth in the economy has positively impacted revenue collections, albeit unevenly. In our view, the slow and differentiated recovery is not a cause for alarm but bears monitoring. Heading into the new year, we are overweight single (A) credits in our IG portfolios, but gradually migrating to a higher (AA) quality bias. We have a preference toward revenue bonds versus GO bonds as pension-related difficulties have led to various levels of fiscal strain among some state and local governments. We expect rate volatility to be protracted and are currently positioning duration targets short to neutral against the benchmark for our IG portfolios. Our outlook on the broader municipal sector is positive, and performance could surprise to the upside.

KEY TAKEAWAYS

- Interest rates are forecast to increase gradually in 2017.
- Policy uncertainty is likely to drive volatility up, creating opportunities for fixed income investors.
- Tax reform is a key initiative we are monitoring closely within the municipal space.
- We are overweight credit sectors versus government securities.
- Portfolio duration is short to neutral against the benchmark.
- Fixed income returns are expected to be positive this year.
- Security selection and active management are even more important in the current environment.

Index Definitions

Bloomberg Barclays Intermediate U.S. Corporate Index: measures the performance of U.S. corporate bonds that have a maturity of greater than or equal to 1 year and less than 10 years. The Index is a component of the Barclays U.S. Corporate Index and includes investment grade, fixed-rate, taxable, USD-denominated debt with $250 million or more par outstanding, issued by U.S. and non-U.S. industrial, utility, and financial institutions.

Bloomberg Barclays Inter-Short Index: measures the performance of U.S. municipal bonds that have a maturity of greater than or equal to 1 year and less than 10 years, and that are rated investment grade (Baa3/BBB- or higher) by at least two of the following ratings agencies: Moody's, S&P, Fitch. If only two of the three agencies rate the security, the lower rating is used to determine index eligibility. If only one of the three agencies rates a security, the rating must be investment grade. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed-rate, have a dated-date after December 31, 1990, and must be at least one year from their maturity date. Remarketed issues, taxable municipal bonds, bonds with floating rates, and derivatives, are excluded from the benchmark.

Bloomberg Barclays U.S. Municipal High Yield Index: measures the non-investment grade and non-rated USD-denominated, fixed-rate, tax-exempt bond market within the 50 United States and four other qualifying regions (Washington DC, Puerto Rico, Guam, and the Virgin Islands). The Index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

Bloomberg Barclays U.S. Corporate High Yield Index: measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch, and S&P is Ba1/BB+/BB+ or below.

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

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