City National Rochdale®
INVESTMENT MANAGEMENT

Quarterly Update

ECONOMIC AND INVESTMENT MANAGEMENT PERSPECTIVES

APRIL 2017

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From the Desk of

Garrett D'Alessandro, CFA, CAIA, AIF®

We expect U.S. economic growth of 2.0%-2.5% and corporate profit increases of 4.0%-6.0% for 2017. Consumers, businesses, and the government are all contributing. We are in a globally synchronized expansion with Europe and Asia. We believe the U.S. economy will grow without any beneficial action from Washington. However, if we get positive developments regarding lower taxes, less regulation, and increased infrastructure spending, our projections for 2018 growth and the length of the expansion would rise.

Achieving tax reform will be challenging. We believe the best approach is lowering taxes by instituting changes that over the long term will improve U.S. productivity and benefit the middle class, while also maintaining fiscal responsibility. Satisfying the varying needs of different constituent groups will require bipartisan thinking, attention to detail, and cooperation. Let us hope Congress does better on this than they did on health care.

The focus of our equity and fixed income strategies are the direction of corporate profits, interest rates, and the economy. Political circumstances, while relevant, can distract attention from what matters to investors. As long as our expectations for earnings in 2017 and 2018 remain positive, we will remain overweight in domestic growth and dividend equities. We project total 2017 returns for large blue chip companies in the range of 6.0%-8.0% and 5.0%-7.0% for high dividend equities. If earnings appear likely to falter, we will make the appropriate adjustments. With moderate economic growth ahead, we expect gradually increasing interest rates throughout 2017, which will slightly diminish bond returns.

At current levels, the market appears to be calibrating to the overall situation just about right. While political rhetoric is likely to be loud and ominous at times, investors should remain focused on the outlook for economic growth, corporate earnings, and interest rates. At present, these factors are positive, so we are staying with our current strategic asset allocation equity overweight, which positions clients to benefit from profit growth.

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How Should the U.S. Handle Global Trade?

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

It is time to take a closer look at the political rhetoric about U.S. trade deficits with China and Mexico, as well as accompanying assertions that global trade has caused substantial losses of American jobs.

Numerous studies show that **global trade has produced significant benefits for millions of workers, both here and abroad**. Although certain U.S. trade agreements need revising, protectionist measures ultimately will likely increase the costs of goods and services for American consumers, while also resulting in lower global growth, less global job creation, slower increases in living standards in emerging markets, and lower productivity in developed countries.

While it grabs the most attention, **increased global trade is not the primary cause of the decline in American manufacturing jobs**. Instead, it is new technologies – automation and increases in factor productivity – that studies show account for approximately 65% of our lost manufacturing jobs.

It is true that the effects of global trade have been poorly managed by both the U.S. government and U.S. businesses, with the resulting adverse consequences landing disproportionately on manufacturing workers. Also, gains from global trade have not been distributed equally, spurring social unrest linked to rising income inequality between the middle class and the wealthy. However, promising workers a future that somehow re-creates the past is misleading.

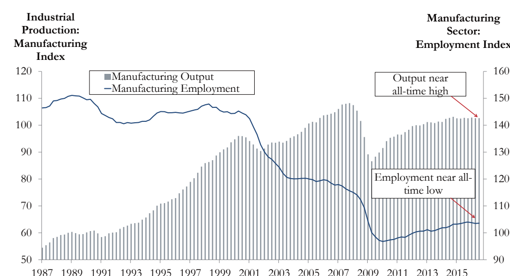
If protectionism is not the answer, how should the U.S. handle global trade? We believe **the key is to create a stronger U.S. economy that can succeed in today's globally competitive world**. Some specific recommendations include:

- Enhancing our system of education to create a more adaptive, flexible workforce that can capitalize on the benefits of technological change to compete better within global trade
- Driving higher productivity and higher quality in U.S. goods and services at lower costs, which will create more sustainable jobs domestically
- Managing trade agreements wisely to achieve the desired outcomes, so there are appropriate solutions for workers who may be adversely affected

In short, **we need to embrace global trade**. When innovation, education, and flexibility are enforced across the U.S. workforce, our productivity and competitive advantage will rise, enabling U.S. workers and the U.S. economy to succeed in the years ahead.

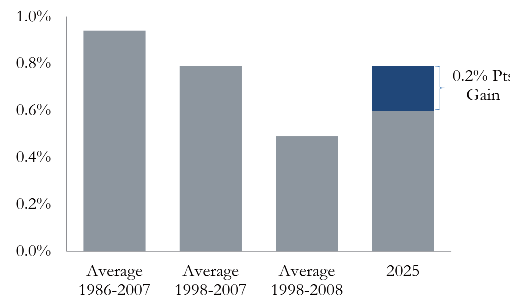
- **Political rhetoric distorts the realities of today's global economy**
- **Better education and innovation, not protectionism, are the answer**
- **Intelligently constructed trade agreements will help U.S. workers**

Manufacturing More With Less



Source: Federal Reserve Bank of St. Louis as of 12/31/2016

OECD Annual Productivity Growth



Note: Scenario in which world and OECD trade intensity (exports plus imports as a share of GDP at market exchange rates) increases by 1.3 percentage points per annum (the average over 1986-2007) from 2017 onward.

Source: Haugh et al. (2016), "Cardiac Arrest or Dizzy Spell: Why Is World Trade So Weak and What Can Policy Do About It?"; OECD Economic Policy Papers, No. 18; and OECD calculations as of 12/31/2016.

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Strong Fundamentals in Place for Faster Growth

By Paul Single

Economic growth in the first quarter was relatively slow, with GDP expected to advance just 1.0%, well below the 2.1% annual rate averaged since the conclusion of the recession. Interestingly, in each full calendar year since the recession ended, first-quarter growth has averaged 1.0%.

Although some believe this streak of weak first-quarter growth was caused by bad weather, economists generally believe it is due to faulty seasonal adjustments in the data. The important point is that, **in every year, economic growth has bounced back in the second and third quarters**.

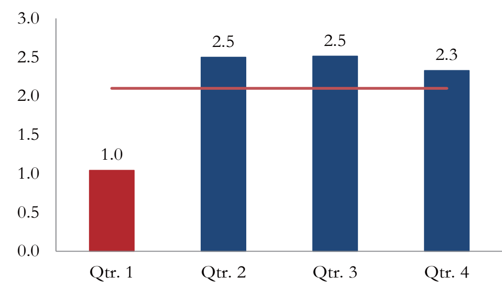
It looks like the rebound will happen again this year and may do so in spades. First off, **the underlying fundamentals of the economy are strong, with robust job growth. Secondly, consumer and business sentiment has moved upward to expansion highs**. Sentiment is a leading indicator, but, because reality does not always cooperate, sentiment is considered "soft data." The economic expansion needs improvement in "hard data" such as higher wages, greater manufacturing output, or a jump in consumption.

The economy also needs what the great British economist John Maynard Keynes called "Animal Spirits" – the collective confidence and optimism of consumers, investors, and businesspeople that the future will be much better. Some observers believe individual and corporate tax cuts would unleash "Animal Spirits." Others believe the economy will simply continue to grind ahead.

Moderate growth is expected to be sustainable for some time due to the strength of household balance sheets after years of massive deleveraging. The ratio of debt to disposable income is back at levels not seen since the early 2000s, giving households the ability to increase consumption (70% of GDP) and boost growth.

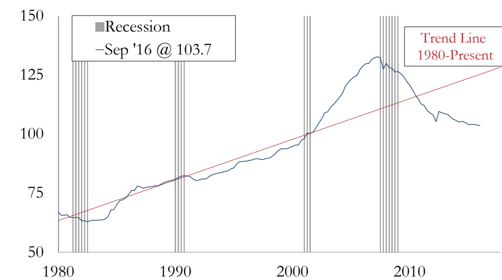
- **Consumers are in the best financial shape in decades**
- **Keynes' "Animal Spirits" need to be released**
- **Better growth appears to be sustainable**

GDP Average Quarterly Change (2010-2016)



Source: Bureau of Economic Analysis as of 12/31/2016

Ratio of Household Debt to Disposable Income



Source: Federal Reserve Bank, Bureau of Economic Analysis, as of 9/30/2016

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

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High Income Is Key to Withstanding Market Volatility

By Brian Winters and David Krouth, CFA

Fundamentals in the municipal high yield market improved in the first quarter. With the exception of Puerto Rico and the Virgin Islands, the credit environment was stable to better across the tax-exempt market. **Financial reporting from issuers shows positive trends in ratios and margins**, while default rates, both technical and actual, remain below historical trends.

New municipal bond issuance declined considerably from last year and was much lower than longer-term averages, which supported prices. Also helping was reduced market anxiety over the prospects of sudden and drastic changes in healthcare laws, tax reform, and the inflationary prospects of large deficit spending on infrastructure.

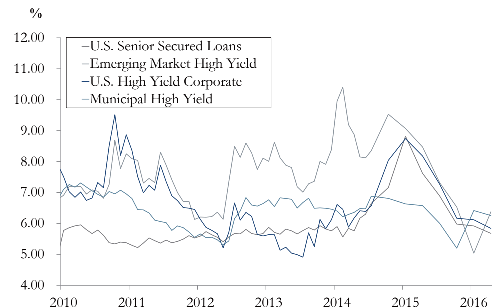
Continued improvements in the economy, solid credit profiles, and lower primary issuance have resulted in spread tightening and good performance in the municipal high yield market. Also assisting performance is the return to positive municipal high yield fund flows, which highlights the important role fund flows have generally.

While yields on high yield municipals have declined somewhat from their highs of last November, in our opinion they remain attractive. We believe emerging market high yield corporates and U.S. leveraged loans continue to be favored asset classes. Their yields are similar to those of U.S. high yield corporates while also benefiting from better overall credit quality and lighter overall market positioning.

Active management in credit selection and sector diversification remain the keys to managing risks and generating strong returns in the high yield municipal and taxable markets. For example, when yields and credit spreads on U.S. high yield corporates declined to a two-year low during the first quarter, nimble managers were able to swap in similar yielding leveraged loans and reap the benefits of the floating rate loan structure while also lowering credit risk.

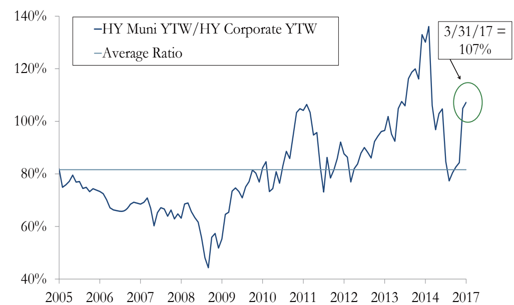
- **Positive technical factors produce tighter spreads**
- **Stable credit profiles, lower defaults aided performance**
- **Credit selectivity, sector diversification are keys to performance**

Asset Class Yields



Source: Bloomberg as of 3/31/2017

High Yield Municpal/High Yield Corporate Yield Ratio



Source: Bloomberg as of 3/31/2017

Dividend and Income-Oriented Equities Still Attractive

By David Abella, CFA

After solid performance last year, can dividend stocks continue to deliver solid income and overall results in 2017? The question is timely and relevant. With one interest rate hike already enacted by the Federal Reserve and two more possible this year, **many investors are wondering about the potential effects of rising interest rates on income-oriented equities**.

Despite concerns in some quarters about valuations, we remain optimistic about select companies and are continuing to maintain our overweight to dividend and income-oriented equities. **We are invested in companies we feel can continue their solid operating results under various scenarios**, potentially benefiting from tax reform but also retaining defensive characteristics in the event that tax reform stalls or is watered down.

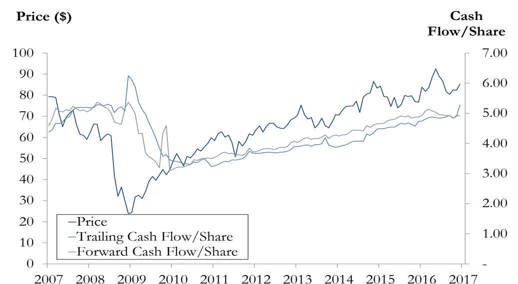
We have found that companies that can grow earnings and dividends have performed well over longer periods of time. Notice in the first graph how the price performance of Real Estate Investment Trusts (REITs) tracks closely with the upward movement in their cash flow growth, both actual and forecast. **As part of our equity analysis work, we seek to invest in REITs that can grow their earnings consistently**. We apply this growth discipline to other sectors as well.

We have solid confidence in our 3.0%-8.0% target growth in dividends, which have averaged 5.1% over the past two years (as shown in the second graph). We believe this kind of growth can help counter the fear of rising interest rates and the general concern over a higher rate environment.

Going forward, we feel that modest return expectations in the 5.0%-7.0% range, driven by yields and projected growth in yields, are realistic.

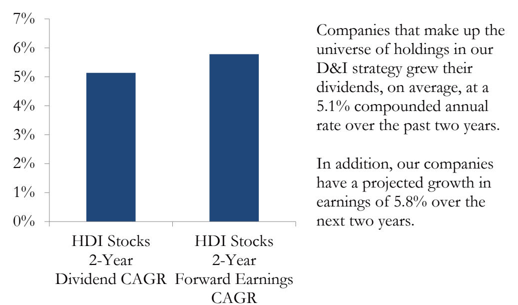
- **Operating earnings are driving dividends toward our growth target**
- **Ongoing economic expansion is supporting business fundamentals**
- **Select companies can deliver growth even with rising rates**

Vanguard REIT ETF
(Tracking MSCI U.S. REIT Index)



Source: FactSet as of 2/28/2017

Focus on Dividend and Earnings Growth*



Source: FactSet (based on published analyst estimates), based on City National Rochdale HDI strategy universe of stocks as of 2/28/2017

*The projected growth rate in earnings is the aggregate average of all of the published sellside anaylsts, as reported through FactSet.

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

Emerging Markets off to Strong Start in 2017

By Anindya Chatterjee

We see brighter prospects ahead for Emerging Market equities despite widespread uncertainties in overseas markets with respect to U.S. policies on bilateral trade, immigration, and taxes.

The sharp selloff in EM assets that followed the U.S. elections gave way to a strong first quarter rally that saw EM indices, particularly EM Asian equities, significantly outpace the S&P 500. For example, while U.S. equities advanced 6.1% in the first quarter of 2017, Taiwan posted gains of 11.8%; Singapore, 13.5%; and South Korea, 16.9%. China and Mexico, supposedly headed for trouble with Trump, had gains of 12.9% and 16.0%, respectively (*returns reflect MSCI indices in U.S. dollars*).

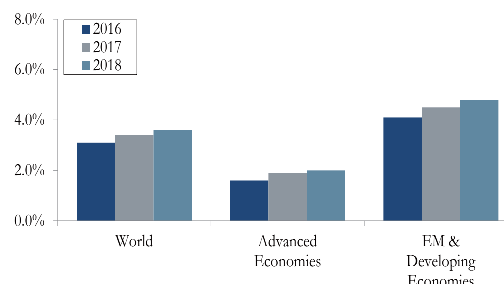
We attribute this strength in EM markets to rising confidence in the overall EM growth outlook and strong earnings momentum. For example, the International Monetary Fund raised its EM growth outlook in January from 4.5% in 2017 to 4.8% by 2018, forecasting stable growth in China and growth acceleration in India and Southeast Asia.

Investor sentiment toward EMs is also benefiting from targeted fiscal stimulus by China, with China's state-owned enterprises investing in and building railway projects in Malaysia, Indonesia, and the Philippines. EM economies, which are net oil importers, are also getting a boost from lower energy costs, with higher than expected U.S stockpiles keeping a lid on crude oil prices. Also, on a technical basis, the general underperformance of EM equities versus U.S. equities over the past few years has enhanced the possibility of mean-reversion trades that particularly favor EM Asian equities.

Many investors believe that protectionist moves such as America's abandonment of the Trans-Pacific Partnership (TPP) may hurt the U.S. more than its Asian counterparts, because **China and other Asia-Pacific Rim countries now have the opportunity to pursue aggressive trade and economic cooperation** through the Regional Comprehensive Economic Partnership (RCEP) agreement. The RCEP is a proposed multilateral free trade agreement between China and 15 other Asian nations.

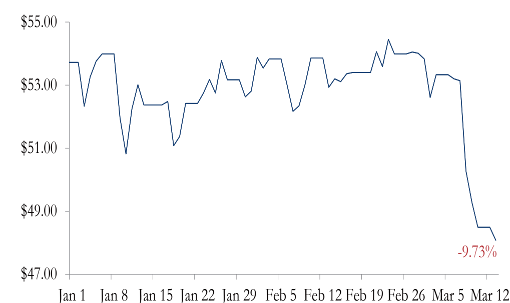
- **Many EM indices outperform U.S. equities**
- **Earnings momentum positive for EM Asia stocks**
- **Oil prices, technical factors favor EM markets**

Overview of World Economic Outlook Projections



Source: International Monetary Fund, "World Economic Outlook Update: A Shifting Global Economic Landscape" as of 12/31/2017

2017 Crude Oil Performance
(Jan 1, 2017-Mar 13, 2017)



Source: Bloomberg as of 3/13/2017

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

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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.

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.

Investments in Master Limited Partnerships (MLP) are susceptible to concentration risk, illiquidity, exposure to potential volatility, tax reporting complexity, fiscal policy and market risk. Investors of MLPs are subject to increased tax reporting requirements. MLP investors typically receive a complicated schedule K-1 form rather than Form 1099. MLPs may not be appropriate investments for tax-advantaged accounts because of potential negative tax consequences (Unrelated Business Income Tax).

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 securities of a higher-quality rating.

Investments in emerging market 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 market bonds can have greater custodial and operational risks, and less developed legal and accounting systems than developed markets.

Yield to Worst is the lower of the yield to maturity or the yield to call. It is essentially the lowest potential rate of return for a bond, excluding delinquency or default.

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.

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 Industrial Production Index (IPI) is an economic indicator that is released monthly by the Federal Reserve Board. The indicator measures the amount of output from the manufacturing, mining, electric, and gas industries.

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 U.S. REIT Index is a free float-adjusted market capitalization that is comprised of equity REITs. The index is based on MSCI USA Investable Market Index (IMI) its parent index which captures large, mid and small caps securities.

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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