



# On the Radar

FAQs ON THE MARKETS AND ECONOMY

MAY 23, 2017

## 1. What are City National Rochdale's expectations for economic and investment outcomes in 2017?

We continue to overweight U.S. growth and dividend equities and to underweight investment-grade bonds.

With the potential pro-growth policies forthcoming in 2018, including tax cuts and stimulus spending, we project corporate profit growth improving over the next two years at about 5% per year, supported by a globally synchronized economic expansion.

We expect moderate inflation from wage increases and stimulus spending, which should cause interest rates to rise moderately over the next 18 months. We do not expect a recession now through the middle of 2018 at the earliest.

Surveys show consumer and business optimism has reached multiyear-high levels while real economic growth in the U.S. and globally validates these surveys.

Equity investors should benefit, while fixed income investors could experience modest downward bond value pressure as interest rates rise.

With an uncertain legislative process and delayed fiscal stimulus, investors should expect bouts of downward equity price volatility until we know the outcome for tax changes, healthcare rules, and regulatory changes.

## 2. With weak Q1 GDP growth and the recent moderation in inflation, will the Fed still raise rates several times over the next 18 months?

Although GDP growth was 0.7% in Q1 and CPI unchanged for the past three months, we fully expect the Fed to raise the federal funds rate at its June 14 meeting and a few times further over the next 18 months.

The Fed has been clear about its view that the beginning of the year slowdown was transitory.

Offsetting the recent drop in inflation has been consistent strength in the labor market, with the unemployment rate falling to just 4.4% and headed lower. This will likely lead to a moderate increase in wages. In addition to that, the underemployment rate (U-6 report) is now at a cycle low of 8.6%, nearing the low of 7.9% of the previous expansion.

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### 3. What are the reasons behind City National Rochdale's equity underweight to Europe?

Despite the recent rally, European equities have lagged U.S. equity returns significantly over the past three years and City National Rochdale investors have benefited from our underweight position.

European equity outperformance this year has been driven by improving economic and earnings data, as well as lessened political risk.

However, the current market trend is principally from a tactical perspective, and the Euro Area economic surprise indicator seems to have now topped, possibly signaling a slowdown in the near future. Competitiveness factors across the EU, including ongoing Brexit negotiations, have also not gone away.

Longer-term growth prospects compared to the U.S. remain less attractive due to unresolved structural issues (i.e. low productivity growth, unfavorable demographic trends, onerous regulatory environment, and high debt levels) and a continued emphasis on austerity.

As a result, earnings have been, and may stay, in a slow growth trend. Valuations are not meaningfully attractive on a relative or historical basis (see chart).

While Europe has benefited near-term from the synchronized upturn in global growth, we believe there are better ways to access this strengthening demand, such as U.S. multinational companies and emerging markets. However, we are considering finding attractive opportunities within specific regions in Europe.

### 4. What is happening with oil prices?

Oil prices have rallied \$5.20 from a recent low of \$45.13 on May 3<sup>rd</sup>. Prices have been pushed up on news of Saudi Arabia and Russia's planned extension of production cuts.

Late last year, OPEC and some other producers (like Russia) agreed to reduce production for six months. Now, they plan to extend those production cuts for nine months after the six-month plan expires, which will likely keep production down until March 2018.

Saudi Arabia and Russia are the largest of the 24 producers that agreed to reduce supply for six months. By reaffirming this deal, they hope to bring global inventories back to their five-year average.

Industrialized nations have over 3 billion barrels in inventory, which is almost 10% above their 5-year average. We expect oil prices to remain in the \$50-\$60 range within our 18-month forecast period.

## 5. Is the U.S. economy bouncing back after the first quarter slowdown?

After the slow start to the year, there is growing evidence that the U.S. economy is regaining momentum this spring.

Fed GDP trackers and consensus forecasts are currently estimating real GDP to rise 3% over the second quarter from just 0.7% in the first. This is not surprising, given that much of the weakness in the first quarter was due to transitory factors that affected consumer spending rather than any problem with the underlying fundamentals of the consumer or businesses.

The unemployment rate now sits at a 10-year low, manufacturing output is at a 2-year high, business investment just recorded its strongest gain since 2012, and housing sales have risen to the fastest pace in a decade.

Most importantly, households continue to enjoy a number of tailwinds that should support better spending in the quarters ahead, including a tightening labor market with rising income growth, high confidence, and a significant boost to wealth from increases in home and stock prices.

## 6. The state of Connecticut was recently downgraded. What were the factors that contributed to its lower ratings, and how has the market digested this news?

Prolonged economic weakness in the state has led to deterioration in Connecticut's financial position.

The state recently revised its current year budget to account for a steep decline in revenue collections, in particular personal income taxes. The sizeable shortfall will likely necessitate draws on its reserve fund, rendering it depleted. Moreover, the upcoming biennial (2-year) budget forecast now projects a multibillion-dollar cumulative deficit.

Constraining Connecticut's flexibility is its very high levels of debt and long-term retirement obligations, which results in elevated fixed costs relative to discretionary resources. Despite strong fiscal decision capabilities, such as broad authority over cash management, revenue-raising, and expenditure containment, the weakened budget condition makes closing the deficit quite difficult.

The credit downgrades (to the A quality tier) by all three major rating agencies was not wholly unexpected. The value of Connecticut bonds has weakened, as evidenced by the higher yield required by investors versus peers in the sector. The City National Rochdale fixed income team continues to limit its exposure to the state and its local governments.

## 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.

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There are inherent risks with equity investing. These include, but are not limited to, stock market, manager, or investment style risks. 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 may include, but are not limited to, interest rate, call, credit, market, inflation, government policy, liquidity, or junk bond risks. 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.

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.

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.

Floating rate loan securities generally trade in the secondary market and may have irregular trading activity, wide bid/ask spreads, and extended trade settlement periods. The value of collateral, if any, securing a floating rate loan can decline, may be insufficient to meet the issuer’s obligations in the event of nonpayment of scheduled interest or principal, or may be difficult to readily liquidate.

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 Standard and Poor’s 500 Index (S&P 500) is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

The Citigroup Economic Surprise Indices are objective and quantitative measures of economic news. They are defined as weighted historical standard deviations of data surprises (actual releases vs. Bloomberg survey median).