City National Rochdale®
INVESTMENT MANAGEMENT

On the Radar

FAQs ON THE MARKETS AND ECONOMY

SEPTEMBER 27, 2017

1. What are City National Rochdale's expectations for economic and investment outcomes over the next 12 months?

The U.S., Europe, and emerging market nations are experiencing a coordinated period of expanding economies, rising corporate profits, rising incomes, moderate inflation, and low interest rates.

Though we see some indications the U.S. economy is entering the later stages of the business cycle, the domestic expansion is expected to continue at a modest pace over the next several quarters, and likely longer, provided there are no policy mistakes by the Fed (which is proceeding cautiously) or major disruptions on the geopolitical front.

We see continued growth for U.S. and global economies ahead; however, investors have fully priced in this positive outlook, and currently we see few compellingly attractive asset classes, whether we look at equities or fixed income. Of course, our economic and financial market outlook can be materially and adversely impacted by political events, which are not predictive.

Consequently, we have trimmed our expected returns for growth equites over the next 12 months. On the fixed income side, given our forecast of moderately rising rates ahead, we are also trimming our projected returns for high yield fixed income asset classes.

Overall, we believe economic conditions, relative valuations, and earnings growth expectations continue to support our overweight to U.S. equities and opportunistic credit, as well as our underweight to investment-grade bonds. However, given the recent appreciation in financial markets, investors should lower expectations for portfolio returns over the next one to three years. Moreover, patience is warranted for new cash investment.

2. After this year's rally, are EM Asia equity markets still attractive?

Even after this year's +30% rally, we believe EM Asia equity valuations do not appear overvalued and continue to look attractive for investors with a long-term horizon. Improving corporate profits have helped drive the recovery in EM Asia equity prices recently and the region's growth outlook remains positive.

We expect China's economy will grow at a moderate rate over the next year, and do not see a "hard landing." At the same time, we are also anticipating a cyclical pick-up in growth in other key emerging Asian economies, including India, Indonesia, and Thailand.

Longer term, the outlook is supported by positive fundamentals, including demography, income growth, urbanization trends, and favorable saving/investment dynamics. Our focus continues to be on sectors and companies in emerging Asian economies that should benefit from these structural tailwinds.

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3. How will Hurricanes Harvey and Irma impact the economy?

Beyond the heartbreaking human tragedies we have witnessed thus far, the impact of Hurricanes Harvey, Irma, and now Maria, will ripple through the economic data in the coming months.

Early estimates suggest Q3 GDP growth may be reduced by 0.5 - 1.0 percentage points, due to lost sales, employment, and production, along with a sharp price shock from the spike in gas prices. Still, we do not believe the impact from the storms will change the overall trajectory of the U.S. economy, which remains on a modest path of growth.

Although disruption caused by natural disasters is negative for the economy in the short term, the rebuilding period that follows will be positive.

Looking at the legacies of Sandy and Katrina, immediate negative impacts soon gave way to a rebound in retail sales, consumer spending, and construction once stores opened back up and rebuilding began.

We believe the hurricanes' gasoline-driven inflation impact will be felt nationwide and temporarily restrain consumer spending, but using Katrina as a guide, gas prices should pull back after an initial spike and also help support 4Q growth.

4. Why have municipal high yield bonds done so well this year?

The tax-exempt municipal high yield bond sector has performed well year-to-date due to less supply, stable credit quality, and steady demand for higher-yielding tax-exempt investments.

Through the first two-thirds of the year, issuance of municipal bonds has been 14% lower than last year, and we anticipate this trend to continue.

Despite uncertainty surrounding health care and tax reform out of Washington, and credit troubles in Puerto Rico, the overall credit quality across the high-yield sector is relatively stable. The number of bond issues entering default is lower again this year compared to 2016.

The search for yield combined with their tax exemption has resulted in consistent demand for high-yield bonds as evidenced by positive fund flows throughout the year.

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5. What's behind City National Rochdale's overweight to large-cap companies and underweight to mid- and small-cap companies?

After eight years of economic growth, our forward-looking measures tell us that we are now in the later stages of this expansion. During such periods, larger companies have better operating capabilities and earning quality, which leads to better stock performance.

Later in the business cycle, profits come under pressure from rising labor costs. Smaller companies have less pricing power and fewer operating efficiencies versus larger companies that are able to more effectively spread higher costs without hurting their bottom lines.

Smaller companies, with less international exposure, are also seeing fewer benefits in terms of sales growth from the upswing underway in global demand.

As a result, as the chart shows, net profit margins for mid- and small-cap companies have experienced greater downward revisions. Valuations, meanwhile, are not attractive relative to large-cap stocks.

Finally, expectations have been scaled back for policy changes that would have benefited smaller companies most, including significant corporate tax cuts, health care reform, and infrastructure spending. If significant beneficial policy changes were to occur, we would expect mid- to small-size companies to outperform.

6. What was decided at the recent FOMC meeting?

As widely expected, the Fed left rates unchanged and announced the beginning of balance sheet normalization.

Officials continue to expect one more rate hike this year, probably in December. This will bring the count to three rate hikes this year, just as they projected at the beginning of the year. However, the Fed's long-term expectation of the federal funds rate fell again and now is projected at 2.75%. Since 2012, when officials initially began projecting the target rate would eventually rise to 4.25%, the estimate has steadily fallen 150 bps.

This will likely have important benefits for the sustainability of the current economic expansion and is consistent with officials extending outward to 2020 the timeline for inflation to hit their target level of 2.0%.

With a lower expected end-rate for this tightening cycle, the Fed is acknowledging that the benign inflationary pressures will not require a significant rate increases.

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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.

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 S&P MidCap 400® provides investors with a benchmark for mid-sized companies. The index, which is distinct from the large-cap S&P 500®, measures the performance of mid-sized companies, reflecting the distinctive risk and return characteristics of this market segment.

The S&P SmallCap 600® measures the small-cap segment of the U.S. equity market. The index is designed to track companies that meet specific inclusion criteria to ensure that they are liquid and financially viable.

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