On the Radar

FAQs ON THE MARKETS AND ECONOMY NOVEMBER 7, 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 the U.S. economy is likely entering the last stage of the current business cycle, the domestic expansion is expected to continue at a modest pace over the next year, provided the Fed proceeds cautiously and no major disruptions arise on the geopolitical front.

While we expect continued growth for U.S. and global economies in 2018, investors appear to have fully priced in this positive outlook, and at the moment we see few compellingly attractive asset classes, whether we look at equities or fixed income.

Consequently, we have trimmed our expected returns for growth equities over the next few years. For investment grade and high yield fixed income investors, we have also trimmed projected returns given our expectations for moderately rising rates (see chart).

Overall, we believe economic conditions, relative valuations, and earnings growth forecasts continue to support our overweight to U.S. equities and opportunistic fixed income, as well as our underweight to investment-grade bonds.

However, given the recent appreciation in financial markets, investors should lower expectations for overall portfolio returns over the next one to two years. Moreover, patience is warranted for investing new cash.

2. With Jerome "Jay" Powell as the new chairman of the Fed, what is expected for the outlook?

Existing interest rate and balance sheet monetary policy are not expected to change significantly under Powell's leadership.

As a result, we believe policymakers will stay on track with their plans to raise the federal funds rate one more time this year and probably three times next year (see chart), as well as continue the process of slowly reducing the Fed's balance sheet.

However, as a member of the Fed's board of governors, Powell has not consistently voted on all of the central bank's monetary or regulatory policy votes over the past five years.

For example, he is an advocate of loosening some of the more stringent regulatory rules adopted by the Fed and other government agencies that were put in place as a consequence of the global financial crisis.

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3. Will weak U.S. state tax collection trends persist?

U.S. state tax collections from all major sources—personal, sales, and corporate—have experienced subpar performance over the last several quarters. According to the U.S. Census Bureau, inflation-adjusted tax data for Q2 2017 shows total collections increased just 0.2% year over year (four-quarter moving average), compared to the previous three quarters of negative growth (see chart).

Aggregate data disguise the uneven economic recovery and collections by U.S. states. Employment, wage growth, and consumption expenditure activity have been more favorable for some states than others that continue to experience pressures whether it be due to a stagnant tax base, recovering from depressed energy prices, or in other cases the effects of state legislative policy.

For those states that levy personal income taxes, this source of revenue has become more volatile during the current expansion. Financial market performance, coupled with federal tax reform uncertainty and changes in the behavior of taxpayers has contributed to collection surprises—in particular, estimated and final payments for April (Q2) tax filings.

The robust performance of financial markets YTD holds potential for tax collections over the next several quarters, but the pattern is more difficult to interpret and may cause budgeting stress for some governments.

Overall, moderate U.S. economic growth should accrue to benefit state tax revenues, and we expect collection growth rates to generally improve in 2018.

4. What did we learn from the recent release of third-quarter GDP?

We learned that even the disruption to business activity caused by two devastating hurricanes wasn't enough to hold back a resurgent domestic economy.

GDP grew at a brisk 3.0%, marking the first time growth topped 3.0% for two consecutive quarters since mid-2014.

Encouragingly, the composition to growth was solid (see chart). Compared to the second quarter, the investment component of GDP was stronger due to higher levels of inventories, probably in anticipation of stronger consumer spending in the future. Also, net trade was better as the pickup underway in global demand continues to boost export growth.

Consumption was not quite as strong as the previous quarter, partially as a result of the hurricanes disrupting normal purchasing patterns. However, household spending is expected to get a big boost in the fourth quarter due to replacement of many items lost in the storms.

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5. Is the recovery in corporate profit growth still on track?

Q3 S&P 500 earnings are on track to grow a solid 4.7%. This would represent the fifth consecutive quarter that U.S. corporations have posted positive earnings growth, after enduring four successive quarterly declines.

While that's also the lowest result since Q3 2016 (+2.8%), overall EPS is being significantly weighed down by the insurance industry, which has suffered due to catastrophic losses caused by recent hurricanes and the Mexico City earthquake.

If the insurance industry results are excluded, the S&P 500 EPS growth rate would jump to a much stronger 7.4% (see chart).

Overall, EPS growth is being driven by the continued synchronized upturn in global demand, as well as solid domestic economic fundamentals.

Assuming tax cuts are implemented, U.S. corporate earnings appear poised to increase another 6 to 8% over the next year, which should support moderately higher equity prices.

6. Is the Eurozone about to experience a sustainable period of growth?

It appears so. Third-quarter GDP growth came in at 2.5%, the fastest yearly change since Q1 2011, and the 17th consecutive quarter of positive GDP growth.

While details of aggregate Eurozone GDP have yet to be released, individual countries are showing broad-based strength, particularly in terms of consumption, business fixed investment, and public sector expenditures.

The unemployment rate at 8.9% continues to fall, down from 9.6% at the beginning of the year and a peak of 12.1% in 2013 (see chart).

But inflation, like in the United States, remains subdued. At 1.4%, Eurozone Consumer Price Index (CPI) remains well below the European Central Bank's (ECB's) target level of around 2.0%.

This is part of the reason why the ECB has extended its asset purchase program (Q.E.) through September 2018, or beyond, if necessary. That said, its view of the economy is strong enough to taper its purchases from 60 billion euro to 30 billion euro per month.

Improvements in Europe's growth prospects are part of broader, synchronized upturn in overall global demand.

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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 Eurozone Consumer Price Index (CPI) is a measure that examines the weighted average of prices of a basket of consumer goods and services, such as transportation, food, and medical care. It is calculated by taking price changes for each item in the predetermined basket of goods and averaging them.

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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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.

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