City National Rochdale®
INVESTMENT MANAGEMENT

2018 Fixed Income Outlook

A SHIFTING LANDSCAPE FEBRUARY 16, 2017

Greg Kaplan, CFA
Director of Fixed Income

Michael K. Korzenko, CFA
Senior Fixed Income Analyst

David Krouth, CFA
Portfolio Manager

Alexander Nelson, CFA
Senior Fixed Income Analyst

KEY TAKEAWAYS

- Inflation expectations and global monetary policy will likely be the key drivers for rates this year
- We expect three more Fed rate hikes this year, with the risk of a fourth
- Overweight to opportunistic asset classes are supported by attractively priced credit risk
- Tax reform implications will have disparate impacts on parts of the fixed income markets
- Increased volatility should create opportunities for active managers to add value
- Returns are expected to be positive, albeit more muted, in 2018

INTRODUCTION

Fixed income returns exceeded many analysts' expectations last year. Attractive credit valuations, coupled with a strengthening economic landscape and robust demand for yield, led U.S. Treasuries to underperform the broader asset class. Throughout the past year, the shape of the Treasury yield curve flattened considerably, attributable to the Fed raising its policy rate three times, or 75 bps, and the lack of inflation pressure

Consequently, longer-duration and credit drove above-average returns. In particular, tax-adjusted returns of investment grade (IG) and high yield (HY) municipal bonds were stellar in comparison to their taxable counterparts, reflective of investor demand, supply constraints, and comparable yield advantage. The absence of rate volatility also added to a steady environment; however, in the new year we expect the narrative to shift toward a market informed by global policy decisions and U.S. tax reform implications. The emergence of volatility is likely to become more frequent and should present potential opportunities for active managers to add value to client portfolios.

Nevertheless, a repeat of last year's fixed income performance is unlikely in 2018, but we believe municipal and corporate bonds will outperform Treasuries with modestly positive returns reinforced by credit selection and duration management. Opportunistic asset classes will likely perform well, reflecting stable to improving credit trends globally. Senior secured bank loans and CLOs, in particular, will probably benefit as global central banks remove accommodation and the upward adjustment of the reference coupon.

STRENGTHENING U.S. ECONOMY WILL LEAD THE FED TO REDUCE STIMULUS FURTHER

Reinforcing our view that the Fed will continue to normalize its policy stance gradually is the moderate growth of the U.S. economy, which has gained momentum. Amid a synchronized global expansion, the U.S. economy has experienced a resurgence in consumer spending, bolstered by flourishing confidence from both households and businesses and strong corporate profitability. The recent implementation of the U.S. Tax Cuts and Jobs Act is expected to provide a near-term jolt to output, which could lift real GDP by up to 0.5% as lower tax rates and deficit spending filter through the economy. Consequently, the Fed recently increased its economic growth projections to 2.5% for 2018.

As the U.S. economic expansion gains altitude, we believe the Fed will raise the policy rate three times in 2018, or 75 bps, to a new range of 2% to 2.25%. The pace and magnitude of rate hikes will likely have a more substantial influence on the shape of the Treasury yield curve (more than the absolute level of rates). The spread between 2-year and 10-year Treasury yields narrowed considerably in 2017, and although we expect monetary policy will cause shorter-term rates to rise more quickly than longer-term rates, the risk of curve inversion is remote this year. Historically, yield curve inversion has preceded a recession, but economic indicators closely monitored by City National Rochdale support the case for the current U.S. expansion to persist into at least next year. Nevertheless, we view yield curve inversion as an increased risk for 2019.

The recent market turbulence in the U.S. and abroad demonstrates the sensitivity to renewed expectations of firmer inflation and quicker policy actions by central banks. While the degree of the rise in Treasury yields year-to-date (YTD) was sooner than anticipated by many market participants, in our view, the recent volatility is not out of character for a market returning to normal. Despite the risk of intermittent rate overshoots, we continue to believe the 10-year Treasury yield is likely to trade within a higher range, but likely to end the year below 3%.

MUNICIPALS

The new year brought a sea change for municipal bonds, with the Tax Cuts and Jobs Act introducing a range of considerations that have the potential to affect the structure and buyer composition of the asset class. However, we continue to view municipal bonds as an essential part of a fixed income allocation that rewards its investors with attractive after-tax relative yield opportunities and enjoys fundamental characteristics that underscore the safety and resiliency of the sector. The demand for municipal bonds remains healthy, despite recent Treasury rate moves, and we believe 2018 performance will benefit from a combination of lower supply and appetite for tax-efficient income. City National Rochdale maintains a bias toward HY municipal bonds versus IG with a short-to-neutral duration target. We forecast IG municipal bonds to deliver low single-digit tax-adjusted returns of 2%-5%, while HY municipal bonds should earn investors a tax-adjusted 6%-7% return this year.

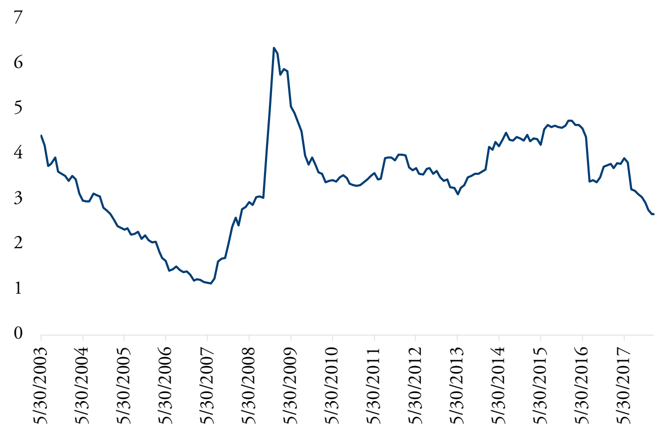
The most widely discussed topic in the municipal market has been the implications of tax reform. Provisions in the new tax law could affect the market over the near to longer term. While the law preserved the tax exemption and private activity bonds (PABs), municipalities lost the ability to advance refund (a debt refinancing) their obligations. Over the past ten years, advance refunding bonds amounted to about 15%-20% of total market issuance on average. Absent legislation that would reinstitute advance refunding capability, the lower supply trend could persist for years. We expect an atypically light calendar at least through the first half of 2018 (due to pulling forward of supply in December 2017) to create a tailwind for performance, all else equal.

Lower tax rates on individuals and corporations could alter the demand for municipal bonds over time. The modest reductions in individual rates, albeit temporary under the current tax law, will not likely impact retail demand for the asset class materially. In our view, the significant cut to the corporate tax rate to 21% from 35% could have a more substantial influence on the buying behavior of banks and property and casualty (P&C) insurers, which have historically been active buyers of medium- to longer-term municipal bonds. The investment decisions of these institutions will be more sensitive to the relative value of municipal bonds in comparison to other asset classes. Nevertheless, we expect banks and P&C insurers to remain active participants, given the diversification and quality benefits of municipal bonds as well as the lower correlation of the asset class to other segments of the financial markets.

The municipal credit cycle will likely receive support from broad U.S. economic growth this year, which should favor credit spread performance and result in mostly stable fiscal conditions for IG and HY issuers (see figure 1). We continue to monitor credit pricing within the market given the limited reward available for incremental risk. Sector pressure points that have surfaced are likely to create a widening gap among issuer credit quality this year and beyond (i.e., public pensions; revenue underperformance; and the effects of federal fiscal policy, such as the limitation to SALT deductions). Maintaining a rigorous security selection process will be a critical tool in navigating an evolving credit environment. We are more cautious on some sectors of the market where valuations are more expensive and potentially mask underlying issuer credit weaknesses. For example, heightened political uncertainty and rising fixed cost burdens have weighed on general government credit while the not-for-profit hospital sector confronts pressure from constrained reimbursement growth and the impact from the repeal of the individual insurance mandate. City National Rochdale is opportunistically upgrading the quality of its portfolios to be well-positioned for credit volatility should it develop.

FIGURE 1

YTW Spread Between HY and IG Municipal Bonds Above Historic Lows



Source: Bloomberg. As of 2/14/2018.

TAXABLE BONDS

The factors that contributed to strong municipal bond returns last year are similar to those that drove the risk premiums for corporate bonds to cyclical lows – 93 bps and 343 bps for IG and HY at the end of 2017 – a level last seen in 2014. The more significant spread compression within lower quality tiers has reduced the spread difference between IG and HY corporate bonds, which is currently near historically tight levels. Accordingly, the potential for spreads to narrow further appears more limited, but credit still provides attractive relative return opportunities. In our view, sector positioning has become increasingly important in a more fully valued market. For example, Energy and Materials leverage has declined amid a global economic expansion and recovery in commodities, while Consumer Discretionary and Technology leverage has increased due to share repurchases, M&A activity, and structural headwinds. The Financials sector could outperform in the coming quarters as it benefits from a relaxed regulatory regime in the White House and higher rates, but security selection within that space will still be the primary determinant of total returns, in our opinion.

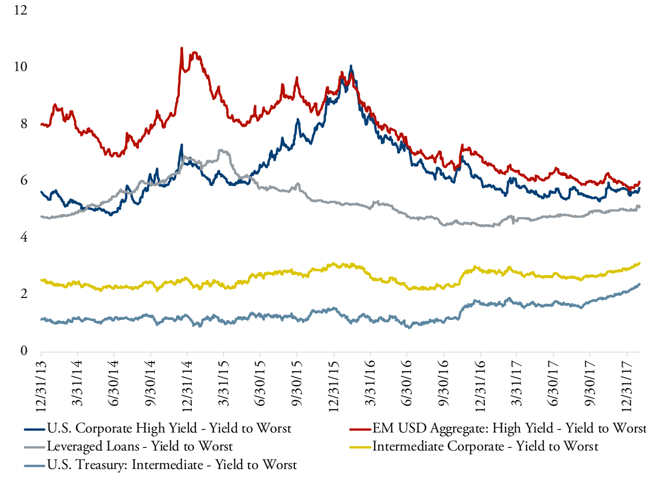
U.S. tax legislation is expected to provide a near-term boost to cash flow and credit metrics, as a materially lower corporate tax rate and the potential for repatriation and/or credit-friendly uses of said cash could improve both corporate balance sheets and profitability. That said, the implications for tax reform will be felt most in the HY corporate segment, where the inability to fully deduct interest expense will hurt select issuers at the lower end of the space. The impact will be phased in, however, with the early years of deductible interest expense capped at 30% of EBITDA, transitioning to a similar percentage of EBIT after that. These limitations will likely make debt issuance less attractive to the most speculative borrowers within the B and CCC credit tiers. The lower corporate tax rates will likely increase the cost of debt under their weighted average cost of capital; this could have the effect of reducing net supply and result in near-term maturities not being refinanced, but allowing them to mature as scheduled. The ability to deduct capital expenditures could mute the impact of the reduction of interest expense deductions somewhat, though the limited benefit is an annual charge and does not drive any durable savings.

Against a backdrop of renewed volatility in the financial markets, the downside risks to the taxable bond asset class have increased. While the fundamentals support our view that corporate bond spreads will likely remain range-bound, we would be remiss not to consider the potential for market technicals to push valuations wider, particularly for HY, where correlations with equity performance are much higher. Nevertheless, the IG and HY corporate bond relative performance YTD have been resilient to the aggressive moves in equity markets and Treasury yields.

Capital flows into the market have been healthy, and higher nominal yields now available to investors are more attractive than they have been in over a year for HY corporate bonds and since April 2011 for IG corporate bonds. We continue to forecast IG corporate bonds will deliver a positive performance, and we maintain a duration neutral position, which has historically led to excess returns during a tightening cycle. With opportunistic asset classes currently yielding 5%-7%, City National Rochdale forecasts a diversified portfolio within the space to generate returns of 5%-6% this year. High yield investments traditionally respond favorably to broad economic growth metrics. Despite the likelihood of periodic volatility, which would affect HY spreads, the gradual reduction of stimulus by global central banks should benefit leveraged loans (both U.S. and European) and collateralized loan obligations (CLOs), as these types of investment vehicles react favorably to higher rates. An extended period

FIGURE 2

Asset Class Yields



Source: Bloomberg. As of 2/14/2018.

of economic growth has led to domestic HY asset valuations appearing expensive relative to a global opportunity set. As such, select European assets are attractive given the lag of its credit and business cycle versus the U.S. With yields and economic growth rates in emerging markets higher than in the U.S., we find more compelling valuations and opportunities away from domestic markets.

CONCLUSION

In conclusion, we expect global monetary policy and firming inflation expectations to be the key drivers for rates and thus fixed income returns this year. Credit is expected to remain mostly stable, and we continue to favor opportunistic asset classes. Municipals remain attractive for high-tax-bracket investors, while domestic corporate bonds, on balance, will benefit from recent tax legislation. With well-broadcast Fed hikes priced into the market, we expect positive returns this year across fixed income asset classes but increased volatility likely to provide opportunities for active managers to add value.

Index Definitions

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.

The Bloomberg Barclays Municipal Bond Index is considered representative of the broad market for investment grade, tax-exempt bonds with a maturity of at least one year.

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.

The Bloomberg Barclays Emerging Markets Hard Currency Aggregate Index is a flagship hard currency Emerging Markets debt benchmark that includes USD-denominated debt from sovereign, quasi-sovereign, and corporate EM issuers.

The S&P/LSTA U.S. Leveraged Loan 100 Index is designed to reflect the performance of the largest facilities in the leveraged loan market.

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.

The Bloomberg Barclays US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint, but are part of a separate Short Treasury Index.

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

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.

Certain statements contained herein may constitute projections, forecasts, and other forward-looking statements, which do not reflect actual results and are based primarily upon a hypothetical set of assumptions applied to certain historical financial information. Certain information has been provided by third-party sources and, although believed to be reliable, it has not been independently verified, and its accuracy or completeness cannot be guaranteed.

Any opinions, projections, forecasts, and forward-looking statements presented herein are valid as of the date of this document and are subject to change.

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.

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.

All investing is subject to risk, including the possible loss of the money you invest.

As with any investment strategy, there is no guarantee that investment objectives will be met, and investors may lose money.

Diversification does not ensure a profit or protect against a loss in a declining market.

Past performance is no guarantee of future performance.

Investment management services provided by City National Bank through its wholly owned subsidiary City National Rochdale, LLC, a registered investment advisor.