City National Rochdale®
INVESTMENT MANAGEMENT

Quarterly Update

ECONOMIC AND INVESTMENT MANAGEMENT PERSPECTIVES

JANUARY 2018

THIS ISSUE

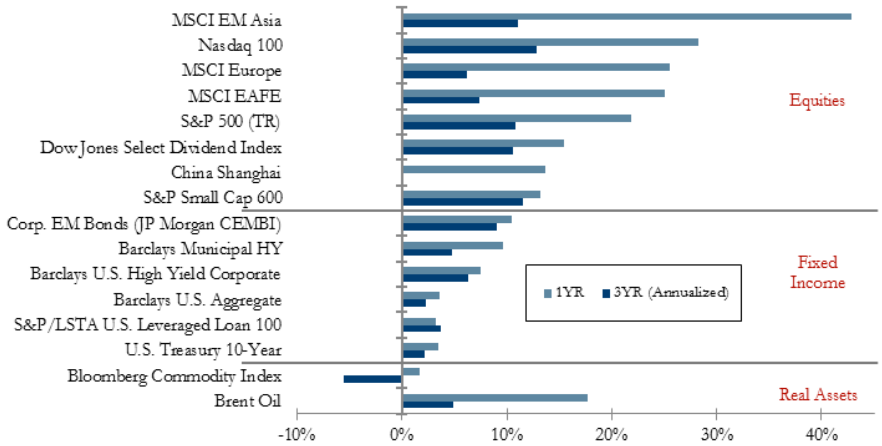
- Bull Market in U.S. Equities Likely to Continue
- U.S. Economy on a Roll, but There Are Caveats
- Positive Year Expected for Fixed Income Markets
- High Yield Municipal Bonds Moving the Needle

From the Desk of

Garrett D'Alessandro, CFA, CAIA, AIF®

Equities had an outstanding year in 2017. Returns were high across the U.S., Europe, and Asia (see chart), while volatility remained at record lows. Equities in particular registered some of the best performances in recent memory as the top 30 global stock markets all posted gains, most of them in double digits. Corporate and government bonds around the world enjoyed moderate returns, as did many commodities.

Asset Class Returns
(One-Year Trailing and Three-Year Annualized as of December 31, 2017)



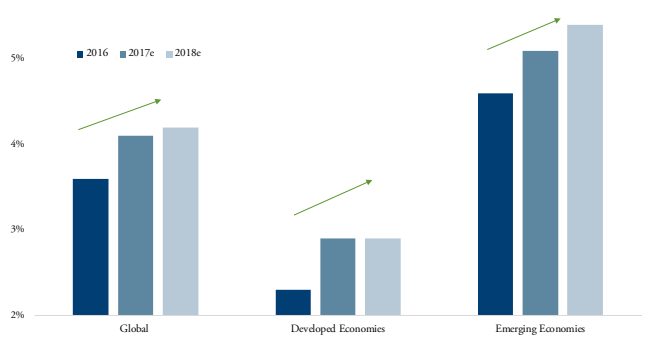
Sources: Bloomberg, FactSet as of 12/31/2017. Total returns include dividends reinvested.

As we go forward in 2018, most of the positive developments that drive financial markets remain in place, including improving global growth, benign inflation, low interest rates and strong corporate profits. While future stock returns will likely be moderate, there are worthwhile gains ahead in equity markets and select credit opportunities in fixed income. This year will likely have more volatility as well as more moderate returns. Given current valuations levels, if history is a reliable guide, equities are likely to generate lower overall annual returns during the next several years.

On the positive side, the world economy looks set for its best back-to-back years of growth in more than a decade, and there are few obvious clouds on the horizon (see chart). A rise in corporate profits has helped revive capital investment, while strong labor markets and relatively low inflation are fueling consumer spending. This has lifted confidence, creating a positive feedback loop where the pickup in global GDP and better financial conditions are further boosting spending and investment. Meanwhile, inflation shows some signs of moderate acceleration and, while central banks have thus far been patient as they seek to normalize monetary policy, the Federal Reserve has said it will raise interest rates 3-4 times in 2018.

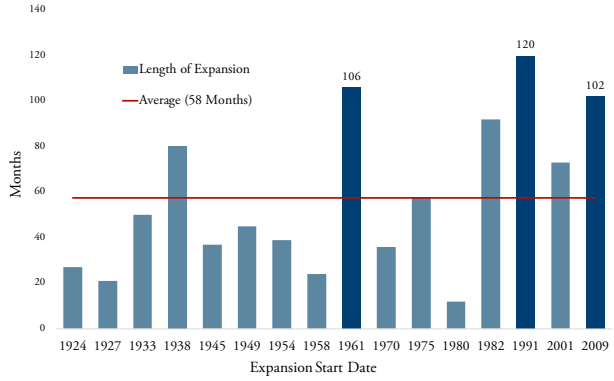
In the U.S., the expansion is on track to soon become the second-longest in post-war history and, despite its advanced age, fundamentals remain good (see chart). The unemployment rate has reached its lowest level in 17 years, confidence is high,

Broad-Based, Synchronized Global Growth Underway



Sources: International Monetary Fund as of 10/31/2017

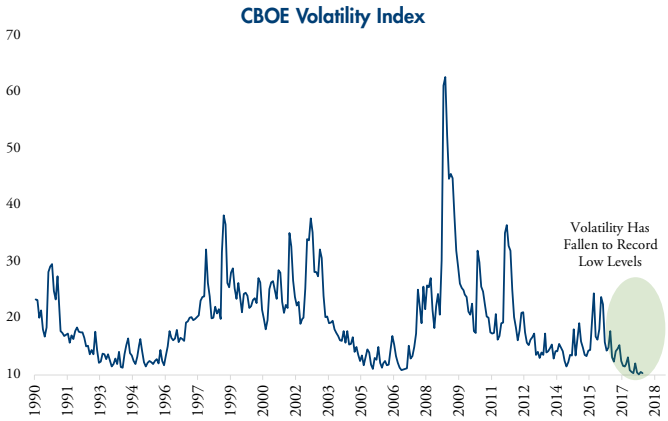
U.S. Expansion Set to Soon Be Second Longest in History



Sources: National Bureau of Economic Research as of 12/31/2017

and business surveys support continued economic expansion. We expect recently passed tax cuts to provide an additional modest boost to GDP growth over the next several quarters.

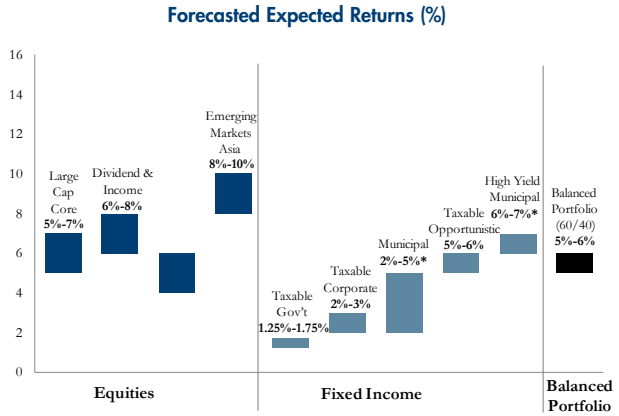
Investors – as they should be – are clearly focused on this positive outlook. After three years of modest growth, the upturn in the world economy has fueled an impressive recovery in corporate profits, which should help extend the long-run bull market for another year. What's been remarkable about the recent rally is how low volatility has been (see chart). While many investors expected more turbulence last year due to Washington politics, European elections, or conflict with North Korea, the market has largely shrugged off all negative news. Indeed, 2017 was the first calendar year without a single negative month in the history of the S&P 500. However, we expect more volatility ahead.



Sources: FactSet as of 12/31/2017

From the perspective of the past year, with broad global economic growth, solid corporate fundamentals and attractive financial conditions, these low levels of volatility appear justified. However, the expectations bar is now set quite high and growing market enthusiasm means that equities are fully valued. This suggests that future returns will be lower and also subjects investors to potential shocks and unexpected shifts in policy going forward. At 14 months and counting, we are in the longest period in S&P 500 history without a correction of 3% or more, but we do expect a correction in 2018.

Given all of this, our advice for investors is to stay invested while lowering expectations and preparing for choppier markets. Global economic growth will likely continue to lift earnings and power the bull market higher. However, we appear to be entering the later stages of the market cycle, and investors should remain disciplined. The final stages of a bull market can be rewarding, but last year's impressive gains are unlikely to be repeated, and investors should expect more moderate returns in 2018.



Source: City National Rochdale as of 1/24/2018. Forecasted expected returns represent City National Rochdale's opinion for these asset classes, are for illustrative purposes only, and do not represent client returns. The expected returns presented for these asset classes do not reflect any deductions for City National Rochdale fees or expenses. Actual client portfolio and investment returns will vary.
*Forecasted expected returns for HY Municipal and Municipal FI represent the taxable equivalent return at a 43.40% tax rate.

Our relationship with you is very important to us. If there is something you would like to discuss, please contact your advisor or portfolio manager. If I can be of assistance to you, please contact me directly at garrett.dalessandro@cnr.com.

Garrett R. D'Alessandro, CFA, CAIA, AIF®
Chief Executive Officer and Chief Investment Officer
City National Rochdale

OUR CONTRIBUTORS

Garrett D'Alessandro, CFA, CAIA, AIF®
Chief Executive Officer, Chief Investment Officer

Paul Single
Managing Director, Senior Portfolio Manager

Tom Galvin
Managing Director, Senior Portfolio Manager

Gregory S. Kaplan, CFA
Managing Director, Director of Fixed Income

David Krouth, CFA
Portfolio Manager

William D. Black, CFA
Managing Director, Senior Portfolio Manager

U.S. Economy on a Roll, but There Are Caveats

By Paul Single

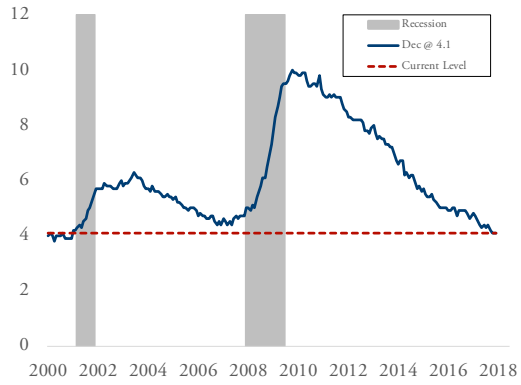
The economy finished 2017 in good shape, achieving a so-called "Goldilocks" performance of neither too hot nor too cold. Economic growth topped 3.0% in the middle two quarters and is also expected to be strong for the recently concluded quarter. The unemployment rate is at 4.1%, a 17-year low; inflation is stable and below the Fed's target rate of 2.0%, and consumer confidence is at its highest since the early 2000s. Meanwhile, **the global economy is on an upward swing, which is boosting our exports; and recent reductions in corporate taxes should help future growth.**

With all the good news, the big question for many investors is: "How long will this last?" Unemployment is expected to continue falling and should pierce the 4.0% level in the first half of 2018 (see chart). There has not been a "3" handle on the unemployment rate since 2000. Inflation has been a relatively low 1.5% (see chart) and is expected to move toward the Fed's target level of 2.0%, but not much above it. **Consumer confidence, which is closely linked to stock market performance, is expected to continue riding the upward trend in equities.**

We see two possible caveats to this optimistic outlook. First, **geopolitical risks are high.** The U.S. is at loggerheads with North Korea, and Saudi Arabia is going through a consolidation of power. Finally, there are concerns with Russia and the Baltic States, China and territorial disputes, and the United States with its protectionist trade views.

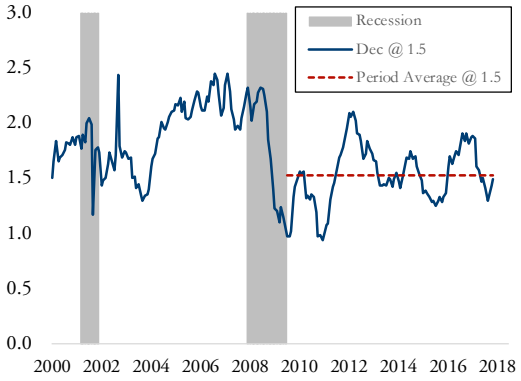
The other caveat surrounds new tax policy. It will provide an economic boost, but how much? We expect it to increase GDP in 2018 by 0.4% (in total). Half of that will come from the tax cuts and half will come from higher federal spending. Those who were strong supporters of the plan expect much more growth. We think growth will be moderately higher due to increased capital spending, which will drive economic growth to higher levels.

Unemployment Rate (%)



Source: Bureau of Labor Statistics as of 12/31/2017

Inflation: Core Personal Consumption Index (% change, y-o-y)



Source: Bureau of Economic Analysis as of 11/30/2017

- Economic indicators flashing green, geopolitics a concern
- Tax cuts a positive, but exact effects are still unknown
- Consumer confidence rising as stock market surges ahead

Bull Market in U.S. Equities Likely to Continue

By Tom Galvin

2017 was an exciting year for equity markets around the world. Investors looked past rising geopolitical tensions, governmental leadership changes and anticipated shifts in monetary policy, focusing instead on the strong fundamentals of improving economic activity and strengthening profit growth. **Helped by solid and accelerating global growth, corporate revenues grew nicely and margins were solid, generating EPS growth in the U.S. of approximately 10%.** Rising earnings were a strong influence in the 21.8% total return for the S&P 500. The balance came from a rising PE multiple, with returns also helped by lower-than-expected inflation and interest rates.

We remain bullish on stocks, and we expect positive returns in 2018. We believe the pace and direction for U.S. equities will be influenced by several key factors. The first is our expectation that economic activity on a global basis will be solid. **Tax cuts in the U.S., while likely to have a modestly positive impact on overall economic activity, will help corporate profit growth significantly in 2018** – we are looking for an increase of 10%-14% (see charts). Spending by consumers and corporations should increase modestly from 2017 levels. **Inflation, while likely to rise somewhat, should remain low in 2018.** This in turn should help keep interest rates low, a positive for multiples, which we believe will remain elevated. **Despite the positive earnings backdrop, volatility will likely be higher in 2018 from exceptionally low levels in 2017.** Potential risks are centered on rising geopolitical tensions, the ability of companies to deliver on heightened earnings expectations, potential mistakes in monetary policy, and actions by the Trump Administration that would hurt global trade.

After the dramatic surge in U.S. equity prices in 2017, we think investors should expect more modest returns in 2018, in the 5%-7% range, as valuations are high and a certain amount of the benefits of tax cuts has likely been discounted by the market. With the risk of recession low, and with a favorable backdrop for profit growth, **we believe the secular bull market will continue.**

- **2017 was an exciting year for returns in stocks**
- **Investors should expect positive but moderate returns in 2018**
- **We believe the secular bull market in stocks is intact**

Tax Cuts Could Provide Fuel for Higher Equity Prices

S&P 500 EPS		Fwd. P/E					
CNR Estimate	Y/Y Change	17.5	18	18.5	19	19.5	20
		Expected Total Return*					
$145	10.0%	-3%	0%	2%	5%	8%	11%
		2,541	2,614	2,686	2,759	2,831	2,904

S&P 500 EPS		Fwd. P/E					
CNR Estimate	Y/Y Change	17.5	18	18.5	19	19.5	20
		Expected Total Return*					
$148	12.0%	-1%	2%	4%	7%	10%	13%
		2,587	2,661	2,735	2,809	2,883	2,957

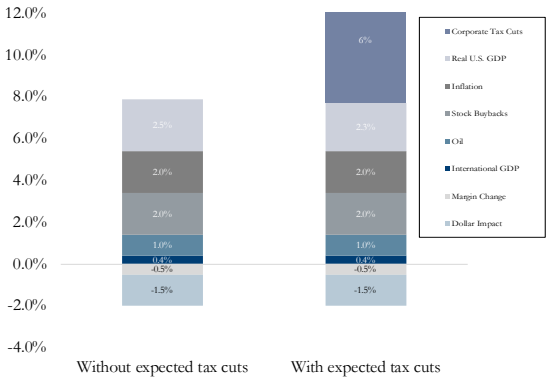
S&P 500 EPS		Fwd. P/E					
CNR Estimate	Y/Y Change	17.5	18	18.5	19	19.5	20
		Expected Total Return*					
$150	14.0%	0%	3%	6%	9%	12%	15%
		2,633	2,709	2,784	2,859	2,934	3,010

25%	Downside Risk
50%	Base Case
25%	Upside Potential

Source: City National Rochdale as of 12/31/2017

Assumes reduction in the statutory corporate tax rate to 21%. Based on S&P 500 Index value.

Tax Cuts Bolster the EPS Outlook



Source: City National Rochdale as of 12/31/2017

Positive Year Expected for Fixed Income Markets

By Gregory S. Kaplan, CFA and David Krouth, CFA

Interest rate volatility remains near all-time lows as improving GDP growth, subdued inflation expectations and three rate hikes by the Federal Reserve in 2017 generated little change in longer-term interest rates, but did produce a significant uptick in shorter term rates. These trends resulted in a material flattening of the yield curve, with the differential between two-year and 10-year Treasury yields finishing 2017 at just 51 basis points, down from 125 basis points at the start of the year (see chart).

Recessions have historically been preceded by a flattening and eventual inversion of the yield curve, where longer-term rates yield less than shorter-term rates. With the current economic expansion getting long in the tooth, some market participants are worrying about this growth ending. **Although an inverted yield curve is a leading indicator of a coming recession, it does not cause a recession and is not great at timing a downturn.** As shown in the chart, the yield curve inverted 1.5 years prior to the 1990 recession, one year before the 2001 recession and nearly two years prior to the 2007 recession.

For 2018, City National Rochdale expects an additional two to three rate hikes and a yield curve that will flatten, but not invert.

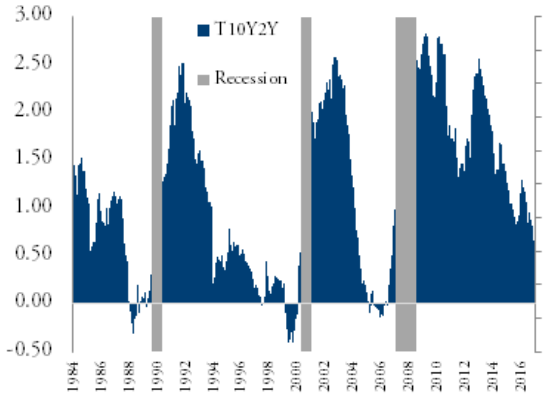
Investment Grade Taxable and Municipal bonds should benefit from strong inflows, open capital markets, and credit spreads near 10-year lows. **Corporate tax cuts, synchronized global GDP growth and strong corporate fundamentals will also help the taxable market.** The flat yield curve, tighter monetary policy and a potential uptick in M&A may serve as headwinds. Municipals should benefit from a reduction in supply.

We expect credit spreads to remain somewhat range-bound and Investment Grade Taxables and Municipals to provide modest single-digit total returns. 2018 looks to be a year where security selection, tactical yield curve positioning and the ability to tap into unique opportunities will provide superior returns relative to passive allocations.

Flattening Yield Curve

Source: St. Louis Federal Reserve (FRED) as of 12/31/2017

An Inverted Yield Curve Precedes Recessions



Source: St. Louis Federal Reserve (FRED) as of 12/31/2017

- **A flat, but not inverted, yield curve is likely to persist this year**
- **A near-term recession is unlikely**
- **Actively managed strategies should outperform passive/indexed products**

High Yield Municipal Bonds Moving the Needle

By William D. Black, CFA

A post-election high yield municipal bond market was poised to enter 2017 with a constructive backdrop of attractive prices and stabilizing technicals. Throughout most of the year, strong demand for tax-efficient income outpaced the available supply of bonds, thus catalyzing the "search for yield." As a result, **high yield municipal investors were rewarded with stellar outperformance, as reflected by the Bloomberg Barclays Municipal High Yield Index, which returned 9.69% in 2017.**

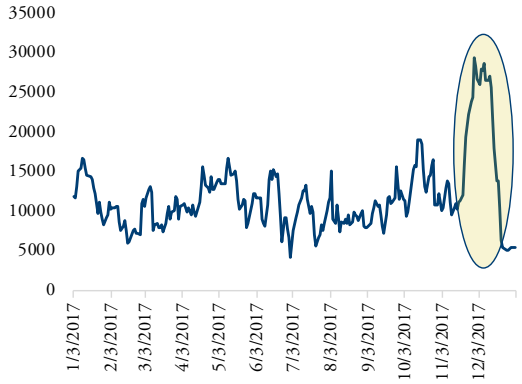
Another contributor to last year's gains was the broad U.S. economic expansion, which generated stronger credit quality across the municipal space for many issuers. Defaults remained low (ex-Puerto Rico), and an appetite for high yield led investors to purchase bonds of lower qualities and characteristics. Consequently, **diligent credit analysis and sector selection were key contributors to a successful investment strategy.** For example, our bias toward better-performing, asset-backed and revenue-secured bonds provides repayment advantages over a typical government obligation that may be exposed to elevated political risk or pension stress.

The most discussed topic within the municipal asset class has been the impact of tax reform on market demand and pricing. **Policy uncertainty created periodic volatility, but an overwhelming need for tax-exempt bonds marginalized any market disruption.** The municipal market experienced a record supply of approximately $60 billion in long-term debt in December, with issuers pulling forward bond deals to avoid the potential constraints of tax reform. In particular, the inability to advance refund older, higher-interest cost debt, will likely diminish the future supply of bonds.

In 2018, we expect high yield municipal bond supply to be very limited, underscoring our view that an atypically light first quarter should provide price support. Demand should remain healthy for high yield municipal bonds, and we expect tax optimization efforts by high-net-worth investors to favor the asset class. Although policy tightening measures such as Fed rate hikes and the unwinding of its balance sheet could influence rate trajectory, the economic tailwinds should have a positive impact on the high yield municipal bond market. We remain focused on well-structured bonds with compelling credit fundamentals.

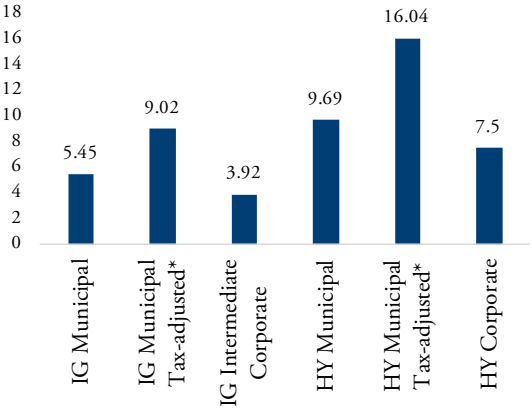
- Tax reform to limit issuance trends in 2018
- Demand should support prices for high yield municipals
- Careful security selection will be critical in year ahead

Muni Issuance Sets Monthly Record in December Ahead of Tax Reform



Source: Bloomberg as of 1/2/2018

2017 Annual Returns



Source: Bloomberg Barclays as of 12/31/2017
*Tax-adjusted by 39.6% federal rate

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 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 in 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.

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 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.

MSCI Emerging Markets Asia Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the Asian emerging markets.

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. & Canada. As of June 2007, the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

The MSCI Europe Index is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Europe. As of September 2002, the MSCI Europe Index consisted of the following 16 developed market country indices: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, and the United Kingdom.

The Barclays Aggregate Bond Index is comprised of U.S. government, mortgage-backed, asset-backed, and corporate fixed income securities with maturities of one year or more.

The Barclays High Yield Municipal Index covers the high yield portion of the U.S.-dollar-denominated long-term tax-exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds, and pre-refunded bonds.

The Bloomberg Barclays U.S. Corporate High Yield Index is an unmanaged, U.S.-dollar-denominated, nonconvertible, non-investment-grade debt index. The index consists of domestic and corporate bonds rated Ba and below with a minimum outstanding amount of $150 million.

S&P Leveraged Loan Indexes (S&P LL indexes) are capitalization-weighted syndicated loan indexes based upon market weightings, spreads, and interest payments. The S&P/LSTA Leveraged Loan 100 Index (LL100) dates back to 2002 and is a daily tradable index for the U.S. market that seeks to mirror the market-weighted performance of the largest institutional leveraged loans, as determined by criteria. Its ticker on Bloomberg is SPBDLLB.

The Dow Jones Select Dividend Index seeks to represent the top 100 U.S. stocks by dividend yield. The index is derived from the Dow Jones U.S. Index and generally consists of 100 dividend paying stocks that have five-year non-negative Dividend Growth, 5-year Dividend Payout Ratio of 60% or less, and three-month average daily trading volume of at least 200,000 shares.

The Bloomberg Commodity Total Return Index, formerly known as Dow Jones-UBS Commodity Index Total Return (DJUBSTR), is composed of futures contracts and reflects the returns on a fully collateralized investment in the BCOM. This combines the returns of the BCOM with the returns on cash collateral invested in 13-week (three-month) U.S. Treasury Bills.

The Corporate Emerging Market Bond Index (CEMBI) is JP Morgan's index of U.S.-dollar-denominated debt issued by emerging market corporations.

The Standard & Poor's Small Cap 600 Index (S&P 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.

Nasdaq 100 Index is an index composed of the 100 largest, most actively traded U.S. companies listed on the Nasdaq stock exchange.

The U.S. Treasury 10-year Note is a debt obligation issued by the United States government that matures in 10 years. A 10-year Treasury Note pays interest at a fixed rate once every six months and pays the face value to the holder at maturity.

The Shanghai Stock Exchange (SSE) composite is a market composite made up of all the A shares and B shares that trade on the Shanghai Stock Exchange.

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