City National Rochdale®
AN RBC/CITY NATIONAL COMPANY

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# On the Radar

FAQS ON THE MARKETS AND ECONOMY

## What does impeachment mean for the market?

U.S. constitutional clashes like impeachment are rare events, with market outcomes too context-specific to draw definitive conclusions regarding current developments. However, going by the limited history we have, market reaction over the long term seems more linked to economic fundamentals.

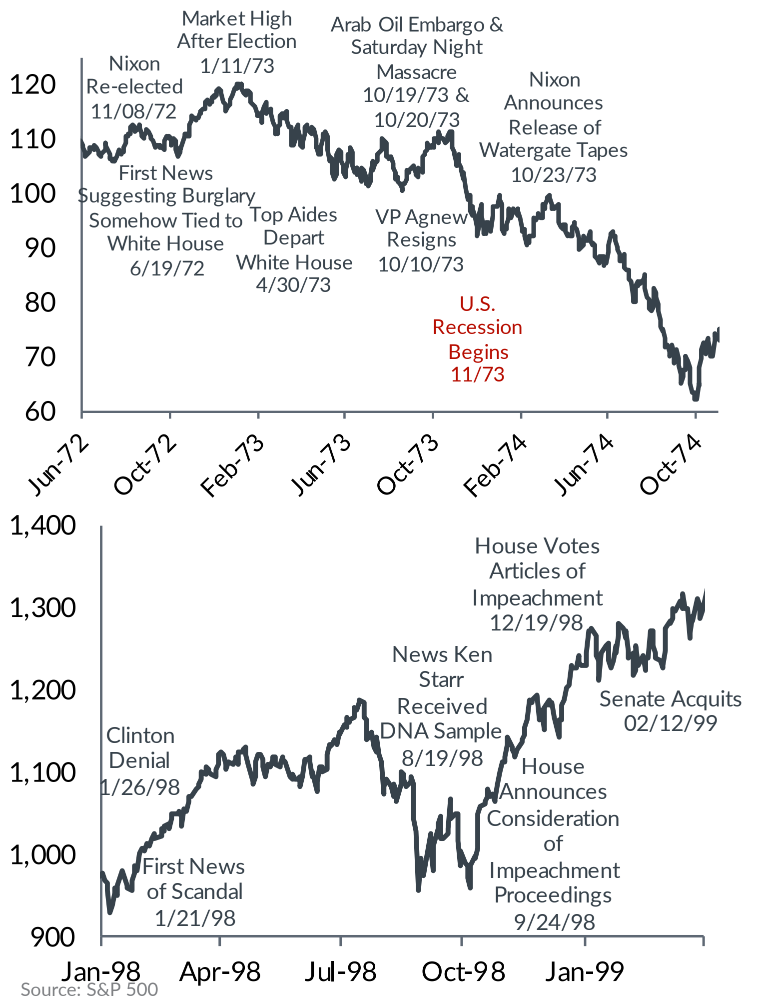
Although the S&P 500 fell almost 50% through the Watergate affair and its aftermath, this decline reflected much more than concerns surrounding the fate of the Nixon administration. The country was slipping into recession, hit by an oil embargo and spiking inflation. In contrast, with the U.S. economy growing well over 4%, earnings strong and moderate inflation, President Clinton's troubles did little to blunt the bull market of the 1990s.

We think the same is true today. Rather than political turmoil in Washington, recent market movements appear driven by developments in trade negotiations, as well as incoming data on the economy and corporate profits.

Nevertheless, it would be complacent to think that potential impact from impeachment will be limited. At a minimum, it adds another layer of uncertainty to the economic backdrop and should contribute to further market volatility ahead.

Our late cycle playbook has positioned us well for an environment of heightened policy and political uncertainty, and we will be closely monitoring developments for signs that this uncertainty is bleeding into the broad economy and affecting consumer confidence. If so, we will act to further de-risk our portfolios as conditions warrant.

**Stocks and Presidential Scandals**
*S&P 500*



Source: S&P 500

**KEY QUESTIONS**

With three cuts under its belt, what is the Fed thinking?

What is the change in the term premium telling us?

What does the recent decline in productivity tell us?

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# With three cuts under its belt, what is the Fed thinking?

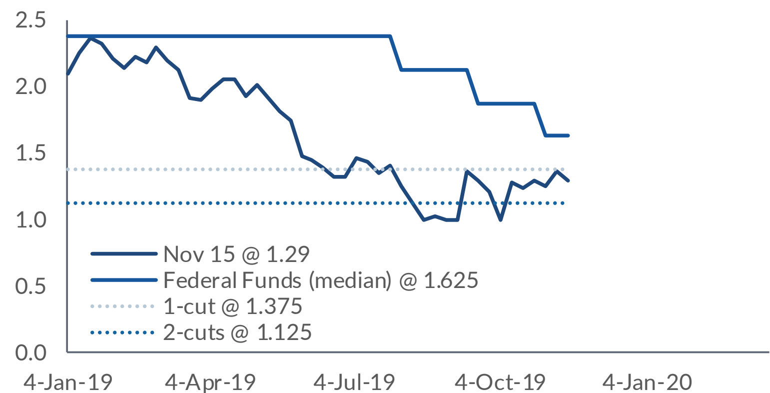
Fed chair Jay Powell recently told Congress that monetary policy is on hold in the near term, but the Fed could resume its easing of monetary policy if the economic outlook falters.

Knowing that it takes 9-18 months for moves in monetary policy to work their way through the system, the Fed would like to see the impact of the summer interest rate cuts before it makes further adjustments, all else being equal.

The Fed continues to have the primary concerns with slowing global growth and trade developments. Another concern, inflation and inflationary expectation, continues to run slightly below its target.

The Fed learned a lesson from last year when it was raising short-term interest rates. At the time, it was somewhat fearful that the low unemployment rate would bring on higher inflation. Since then, the market has experienced even lower unemployment, and inflationary pressures are remaining subdued. This is being interpreted as a dovish view; the Fed will tolerate even lower unemployment, if it happens, without raising interest rates. As it stands now, the federal funds futures market expects just one more reduction next year.

**Yield of the December Federal Funds Contract (%)**




Source: Chicago Board of Trade as of November 15, 2019.

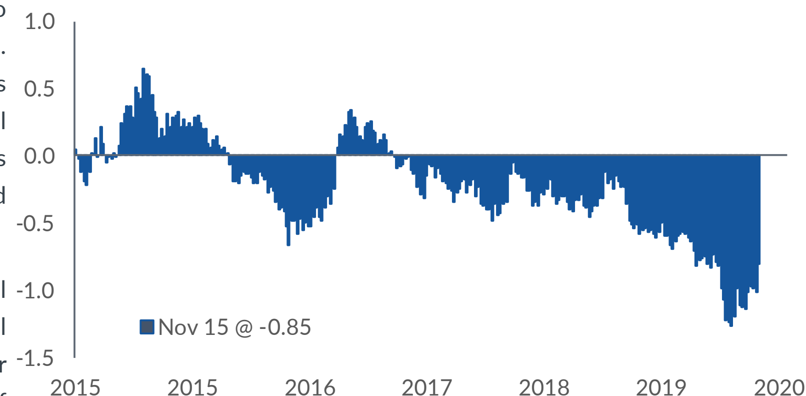
# What is the change in the term premium telling us?

The term premium has snapped back 44 bps from the August low of -1.29% to stand at -0.85%. This happened at a time the U.S. 10-year treasury has increased about 37 bps to the yield of 1.83%.

The term premium is the extra yield required by bond investors to hold a long-term bond instead of rolling a series of short-term bonds. Unlike yields, the term premium is not visible directly. Researchers at the Federal Reserve Bank of New York have developed a model to estimate term premium (chart). It is one of three components that make up the yield on a bond, the other two being inflation and monetary policy expectations.

Up until August, there had been the flight to quality where global investors flocked to high-quality, longer-term sovereign debt, fearful of the economic uncertainties of the to trade war, Brexit and other concerns, thus pushing down longer-term yields. But easing of economic anxiety over the past few months has reduced the need for those assets, and investors have returned to riskier investments, thus yields on those securities and the term premium have moved up, and riskier assets, like equities, have rallied.

**Term Premium**
*Adrian Crump & Moench 10-year Treasury*




Source: Federal Reserve Bank of New York as of November 15, 2019.

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# What does the recent decline in productivity tell us?

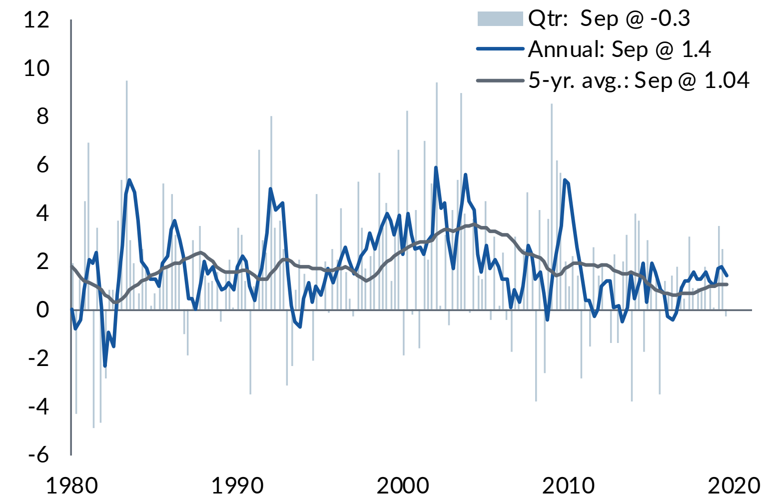
Productivity in Q3 was significantly weaker than expected, slipping 0.3%, following a surge in the previous two quarters. Hours worked increased 2.4%, which more than offset a 2.1% gain in business output. The yearly change stands at 1.4%, slightly above the 5-year average of 1.0%.

Productivity that accelerated last year has begun to fade. The forces behind the decline in productivity rest on the shoulders of the sharp decline in business investment (Q3 at -3.0%, Q2 at -1.0% and y-o-y stands at 1.3%, well below the expansion average of 4.2% ), which is due to trade uncertainty.

Productivity is a volatile report, and economists tend to look at 5-year (yes, you read that right — changes in directions are often compared to turning an oil tanker...) moving averages (see chart). Throughout this expansion, it has been erratic and sluggish, averaging just 1.2%, well below the 2.9% average of the 10 years prior to the financial crisis.

Some economists question the accuracy of this report; it was developed shortly after WWII when the economy was far more focused on manufacturing. It is hard to determine the accuracy of productivity of a service based economy because it is hard to define "output."

**Productivity (%)**




Source: Bureau of Labor Statistics as of September 2019.

# What is City National Rochdale's investment outlook?

Given our continued positive assessment of the fundamental backdrop, we remain positive on U.S. equities in general and continue to see attractive prospects in the opportunistic fixed income class.

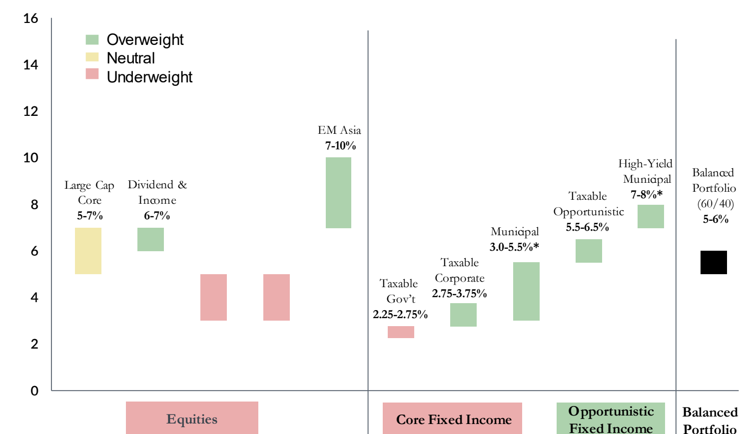
Still, downside risks have increased somewhat, and the investment landscape is growing more challenging.

Late-cycle conditions of slowing growth and greater vulnerability to policy missteps will require investors to change their approach and be more selective in their portfolios.

None of this means there are not more opportunities ahead for investors, but gains are likely to be more muted. At the same time, concerns over global growth, trade tensions and the path of interest rates mean markets will likely continue to be subject to periodic swings in sentiment and potential pullbacks.

Our equity and fixed income research teams have made deliberate risk-mitigating changes to help fortify client portfolios against the type of market turbulence we have recently experienced, while leaving them well-positioned to take advantage of opportunities that present themselves.

**One-Year Forecasted Returns (%)**




Source: City National Rochdale as of September 2019. Forecast 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.

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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 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.

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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 & 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.

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