City National Rochdale®
AN RBC/CITY NATIONAL COMPANY

# Quarterly Update

ECONOMIC & INVESTMENT MANAGEMENT PERSPECTIVES

January 2021

## IN THIS ISSUE

From the Desk of
Garrett R. D'Alessandro, CFA, CPWA®, CAIA, AIF®

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# Multiplication Through Addition – How the U.S. Treasury and Federal Bank Saved the Economy

The U.S. Federal Reserve and Treasury will have injected over $9 trillion in money or stimulus spending into the U.S. economy by the end of 2021. This quantum of money has never in modern history been pushed into any economy. The COVID-19 pandemic justifies this extreme monetary and fiscal thrust, but the consequences are difficult to fully comprehend. The near-term purpose and benefits are easier to measure; these actions saved the U.S. economy from depression.

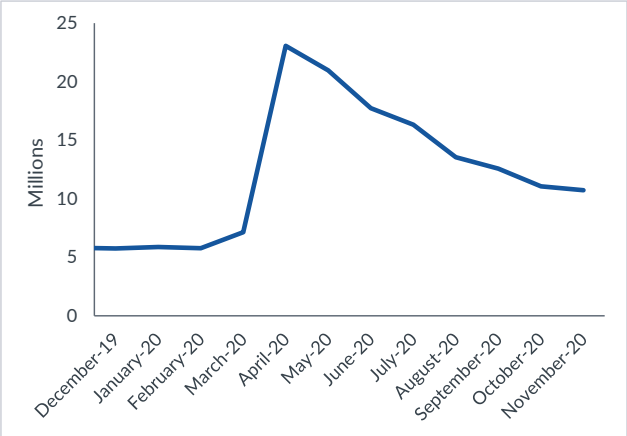
To put this into perspective, this is enough money to ostensibly buy the entire economies of the United Kingdom, France, Spain and Italy. Or, if we prefer U.S. history, this is about 1,000 times the amount of the Louisiana Purchase, arguably the best investment in U.S. history, which cost in today's dollars $342 million to France and about $8.5 billion to Native Americans, adding up to about $9 billion — compared with $9 trillion, not billion.

This $9 trillion benefitted the U.S. economy via workers and businesses.

Let's focus on individuals, whose consumption represents 69% of total GDP.

Presently, there are 10 million unemployed and another 4 million who have left the labor force for many reasons. While unemployment remains high, it is 9 million recovered jobs below the April peak of 23 million, mainly due to the stimulus provided.

**Unemployed**



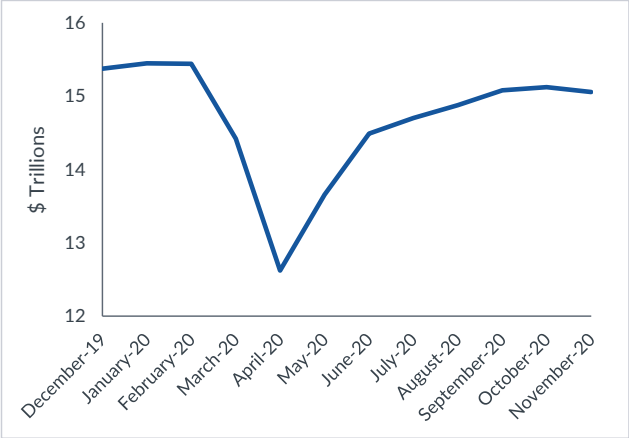

Source: Bloomberg as of November 30, 2020.

Had the U.S. Federal Reserve and Treasury not acted, 23 million unemployed individuals would otherwise lead to a deep recession.

Three charts tell us why we avoided a deep recession, perhaps unlike any in modern history. The cost of such a deep recession, it is argued, would be far in excess of the $9 trillion stimulus cost.

U.S. consumer spending, which is now within 97% of normal levels:

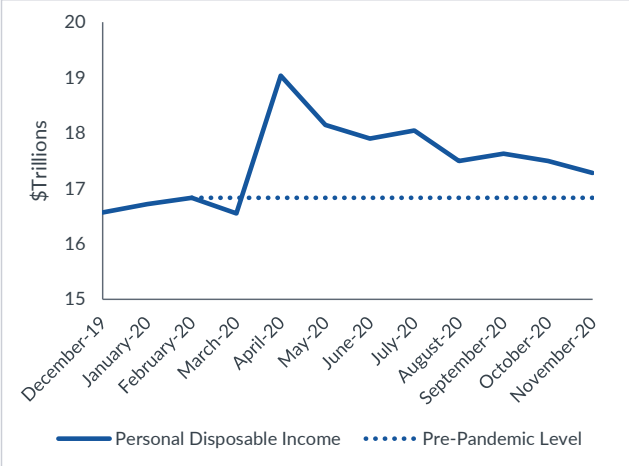
**Personal Spending**
*$ Trillions, SAAR*




Source: Bloomberg as of November 30, 2020.

U.S. personal disposable income, which is ahead of otherwise normal levels and which represents increasing potential future spending:

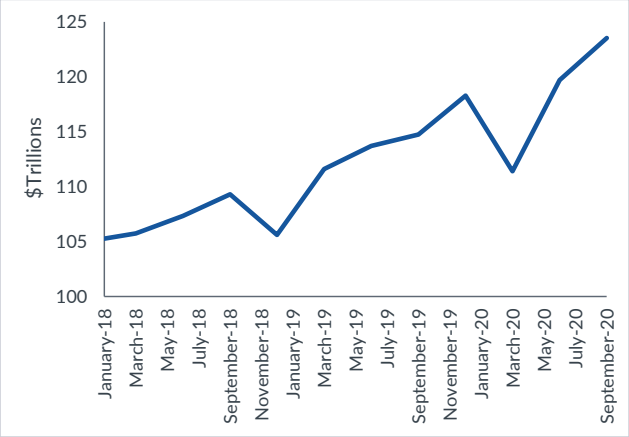
**Personal Disposable Income**
*$ Trillions, SAAR*




Source: Bloomberg as of November 30, 2020.

And record household net worth, which has increased significantly over pre-pandemic levels:

**Households and Nonprofit Net Worth**




Source: Bloomberg as of September 30, 2020.

These positive effects are well worth the cost, but there remain concerns as to how and when the millions of unemployed will return to work and how the stimulus will be paid for. These questions are to be answered over the long term. For now, the stimulus has created the foundation for a strong recovery from the pandemic-driven recession.

**Garrett R. D'Alessandro, CFA, CPWA®, CAIA, AIF®**
Chief Executive Officer

# Pivoting to a Post-pandemic Expansion

**Tom Galvin**
Chief Investment Officer

It is hard to recall another year in recent times that would even approach the incredible events of 2020. What started off as a novel virus, found in a far-off land, triggered unimaginable developments in every corner of the world, and did so in the blink of an eye.

Uncertainty surrounding the first global pandemic in 100 years and historical evidence that most vaccine development efforts fail or take years, combined with the unprecedented shutting down of national economies on a global scale, made the risk of severe and prolonged capital destruction very high. During these periods of high risk of capital destruction, City National Rochdale believes it is prudent to adopt a capital preservation strategy, which we did.

As the calendar turns to 2021, we know a lot more than we did in those frantic days when the financial markets seemed to be collapsing on themselves. We now know that policymakers will quickly step in to keep the nation's economic heart beating until this crisis passes, and on a scale never seen before. We know that safe and highly effective vaccines are on their way, with the promise of a return to more normal life as soon as this summer. And we know that in the meantime, American businesses will find innovative ways to adapt and weather the downturn.

**Post-pandemic economic expansion expected to last several years**

**Improved clarity provides increased confidence in economic outlook**

**Correction in risk assets overdue; believe it would be a buying opportunity**

With improved clarity has come improved confidence in the outlook, and our client portfolios are now positioned for a post-pandemic expansion we suspect will last for several years. Although the hardships brought about by the COVID-19 outbreak are very real and ongoing, it is encouraging so far to see how limited the signs of long-term economic damage have been, and we expect that this recovery will be faster and more durable as a result.

The great success story of this crisis has been the actions of government officials in backstopping markets and providing a fiscal lifeline to business and households with direct payments but also with loan forbearance and noneviction policies. Massive stimulus has not only helped avert the cascade of business failures that would normally accompany such a

2021 Forecasted Expected Returns (%)

| 2020 High Uncertainty | 2021 Improving Confidence |
|---|---|
| Will policymakers respond quicker and more powerfully than in the past? | Policy response has been massive, timely and well targeted |
| How soon can effective vaccines be developed and distributed? | Projecting ~2/3 of U.S. to be vaccinated by midyear, allowing for a return to more normal activity |
| How significant will COVID-19 economic restrictions be? | Repeated widespread lockdowns have been avoided |
| Which party will control Congress and the presidency? | Narrow Democrat congressional majorities mean significant policy shifts unlikely |

Source: City National Rochdale.

severe economic downturn but also allowed consumers to accumulate plenty of savings, leaving aggregate household balance sheets, believe it or not, in a stronger position than they were pre-pandemic. Together, all this should help propel future spending, investment and earnings growth once the economy begins to reopen.

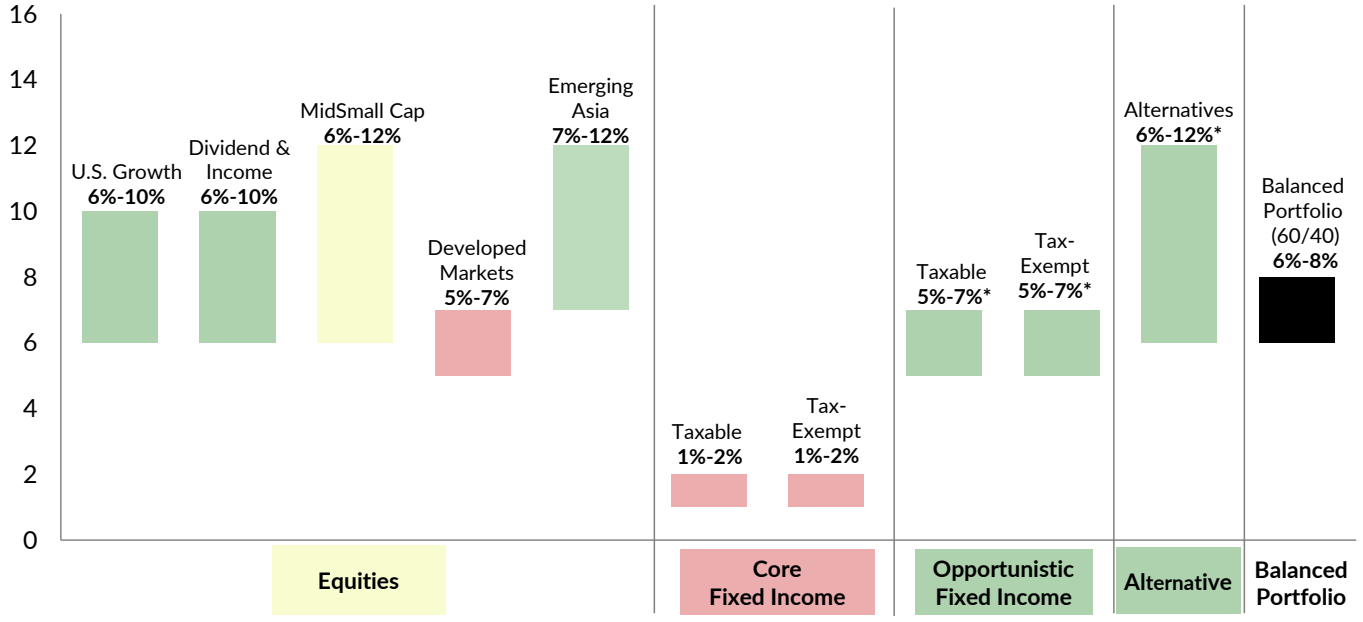
Investors certainly seem to be in tune with this view. Stock indices have, not unreasonably, continued to build on optimism of a vaccine-driven return to normalcy, with expectations for greater fiscal stimulus under a new, Democrat-controlled government. However, it is important to remember that we are not out of the woods just yet and that the next few months are likely to be challenging. The winter resurgence of the virus is still upon us, weighing down economic growth, and while the U.S. appears to now be moving past the peak post-holiday surge, if highly contagious variants of the virus begin hitting our shores, there is a chance things could take a turn for the worse before vaccine distribution becomes more widespread.

Of course, this doesn't mean stock gains have been exhausted. Indeed, an entrenched expansion should set the stage for an extended bull market, with the same forces that drove the post-Great Financial Crisis decade-long rally — positive growth, low inflation, negative real interest rates and supportive monetary policy — continuing to put upward pressure on equity prices in general.

Since the market lows, equity markets have been on an unprecedented run. Valuation is high on an absolute basis, and pockets of euphoria exist, especially in speculative emerging technology companies, IPOs and SPACs, with the growing influence of short-term traders also exerting powerful influences on stock prices. While difficult to time, we think a correction in risk assets is overdue, with unexpected developments in fiscal stimulus or virus-related items as potential triggers.

We would view such a correction as a buying opportunity given our increased confidence in the post-pandemic expansion. Finally, we are confident our pivot to the post-pandemic expansion, rebounds in our high dividend and opportunistic income strategies, differentiated asset allocation approach and regional equity allocation will add value to client returns in 2021 and beyond.

2021 Forecasted Expected Returns (%)




Source: City National Rochdale. As of January 2021. 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 43.4% tax rate.

# Economic Optimism Is Headwind for Rates, Tailwind for Credit Risk

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

Despite near-term challenges with higher COVID-19 virus rates and vaccine distribution, the generally optimistic outlook in response to vaccine progress supports our positive outlook for the U.S. economy. **This will likely pressure market rates and push inflation modestly higher but not enough to pull the Federal Reserve off the sidelines.** The adoption of "flexible average inflation targeting" by the Fed in 2020, along with continued low inflation, strongly suggests accommodative Fed policy will remain little changed in 2021. We also anticipate no change to the current $120 billion in bond purchases each month that will serve to expand the Fed's balance sheet and effectively inject additional liquidity into the U.S. economy. We expect the overnight Fed Funds rate to remain unchanged at 0.0%-0.25% and the 10-year U.S. Treasury yield to end the year in the range of 0.80%-1.3%.

Increasing inflation expectations will likely test our low-inflation thesis into the second quarter as both accommodative monetary and fiscal stimulus are met with improving sentiment. **Our forecast for low inflation remains grounded in the negative output gap (economy running below potential) and labor market gap (unemployment remaining above "full employment") that are likely to persist well into 2022, if not longer.**

Corporate leverage remains a concern, but investors should note that much of last year's heavy debt issuance was meant to create cash stockpiles to backstop uncertainty and is a credit positive for many issuers. Similarly, dire predictions for municipal budgets have proven too pessimistic, and while we expect additional credit downgrades, fears of defaults remain overblown. We favor lower tiers of the investment grade spectrum in 2021.

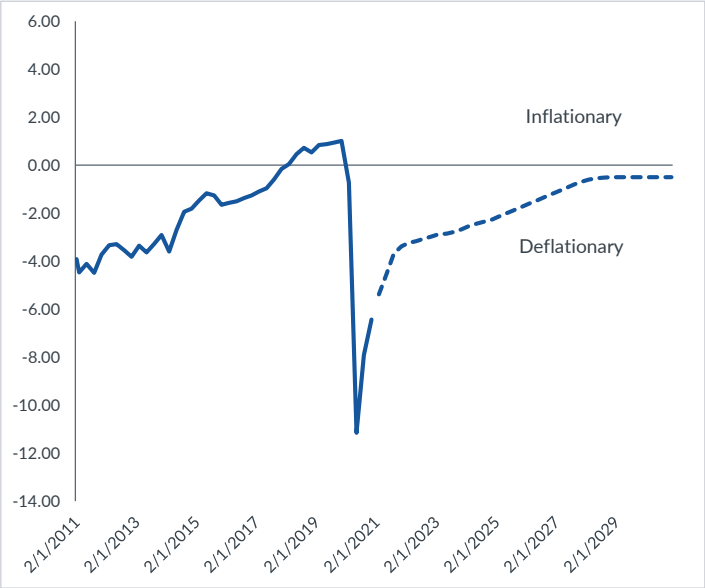
**Expect market interest rates and inflation to remain low but with upward bias**

**Inflation to firm, but remain contained; credit sectors likely to outperform**

**Expect low- to mid-single-digit returns for fixed income in 2021**

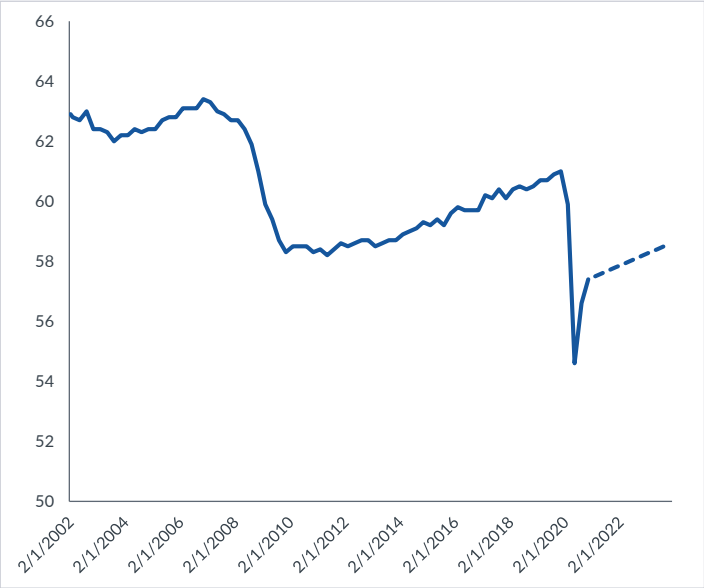
After a year that saw the Bloomberg Barclays U.S. Aggregate index return 7.5%, we anticipate 2021 to be more modest, with investment grade returns around 1-2% and high-yield returns in the 5-7% range. Any short-term spike in interest rates should be viewed as an opportunity to add exposure and/or extend duration, while market volatility will likely present opportunities to add credit risk. **We continue to favor opportunistic sectors over core fixed income for our client portfolios as appropriate.**

**U.S. Real Output Gap as a % of GDP**




Source: Bloomberg, Congressional Budget Office, CNR Research as of December 31, 2020.

**U.S. Employment to Population Ratio**




Source: Bloomberg, Bureau of Labor Statistics, CNR Research as of December 31, 2020.

# High Yield Municipal Bonds Turn the Page on 2020

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

High yield municipal (HYM) bonds recorded strong quarterly performance to close out an otherwise volatile year for the economy and financial markets. According to Bloomberg Barclays Indices, HYM bonds booked approximately 1.9% of return during December, versus a far weaker performance of 61 bps for the broader market. Outsized performance can be rationalized by tightening credit spreads, mounting cash availability driving investment needs and a willingness to take on selective credit risk. **We expect credit concerns to persist at least through the first quarter of 2021, yet, despite high caseloads, the public health policy environment should improve, while the prospects for additional fiscal relief support a more constructive economic outlook that bodes well for credit sentiment.** Against this backdrop, HYM bonds should reward investors with stable income and moderate tax-adjusted returns between 5%-7% in 2021.

A continuation of technical support for HYM bonds, such as light issuer supply and positive mutual fund flows, coupled with the relative value proposition versus other asset classes, should continue to benefit investors. **We expect HYM bonds to fare well against their investment grade counterpart at least over the near term as the spread differential between the two segments offers an opportunity for incremental performance, particularly given our estimates for economic growth in 2021.** While a large-scale credit incident, such as a default by a well-known issuer, or rising rates, could lead to a redemption cycle and weaker valuations, we view these events as potential opportunities to take advantage of credit and sector distinctions within the market.

**A recovering economy supports credit quality**

**Relative value opportunities persist**

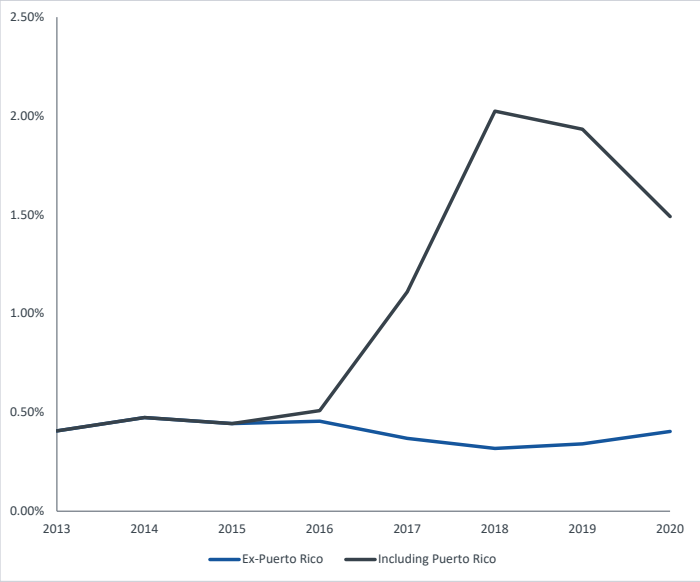
**Federal policy accretive to the market**

With a Democratic majority in Congress, the Biden administration's policy agenda will likely prioritize the need for further stimulus to counter the pandemic's implications. **A fair assessment that direct and indirect aid to municipal sectors is more likely under the new political regime bolsters issuers' fundamental credit quality.** Discussions to revisit the Tax Cuts and Jobs Act of 2017, such as rolling back the changes to individual and corporate tax rates, could elevate the desirability for tax efficiency, thus raising municipal bond demand. We also expect bipartisan efforts to enact an infrastructure investment program, positively impacting specific sectors within HYM bonds, such as public/private partnerships. Policy initiatives should provide a tailwind to credit and technical underpinnings in the market this year.

Bloomberg Barclays High Yield Municipal 2020 Total Return


Source: Bloomberg Barclays Indices as of December 31, 2020.

Municipal Default Rates




Source: Municipal Market Data.

# Opportunistic Credit Rally Likely to Continue

**Charles Luke, CFA**
Managing Director, Senior Portfolio Manager

The March 2020 market sell-off now seems distant and is squarely in the rear view mirror, erased by a relentless advance across credit markets. From the trough, U.S. High Yield[1] climbed 33.5% and was positive for 2020, rising 7.11% and eliminating the 20.78% virus-induced drawdown. It is natural to doubt this rally's sustainability, but the upward trajectory remains intact, especially in less travelled areas of the market. Nonetheless, **returns hinge on the battle to quell the virus and the fallout from tools utilized to stabilize the economy.**

This rally can continue, primarily based on the lack of yield available in high-grade bonds. Interest rates[2] across G7 countries average 22 bps, and global negative yielding debt[3] remains near its all-time high of $18 trillion. It makes sense to question the sanity of low yields and the obvious risk of a trend reversal in the 30-year bull market for rates. Yet "sanity" and "obvious" are not temporal measurements, and **rates are likely to remain low as global central banks double down on their commitment to market stability and low borrowing costs.** This creates a vacuum for compensation paid to high yield investors, and we believe the risk premium will continue to shrink, potentially falling below historical averages. We also expect increased flows into high yield asset classes due to low return assumptions for high-grade debt. This reflects a behavioral shift and a reluctant, but crucial, embrace of higher volatility within portfolios.

**Lower-rated debt and equity within structured credit represents the best reward potential in 2021.** Collateralized Loan Obligation (CLO) issuance is set to outpace 2020, with estimates as high as $120 billion[4]. The market is also likely to see additional cash flow as the pace of rating downgrades slows and the underlying loan market recovers to pre-pandemic levels. Yields remain above 7%[5] in BB-rated tranches, and equity returns could approach double-digits. Traditional U.S. High Yield is also likely to perform well, owing to Federal Reserve support and high liquidity within the asset class. **We expect opportunistic credit markets to provide returns between 4%-6%, on average.**

**Opportunistic credit can continue to climb, given the synthetic impact of central banks**

**Low interest rates are here to stay, creating a vacuum for risk compensation**

**Structured credit will perform well and is likely to lead opportunistic credit asset classes**

Footnotes:

[1]Bloomberg Barclays US High Yield, LF98TRUU
- Trough: From 3/23/20 – 12/31/20
- Drawdown: From 2/20/20 – 3/23/20

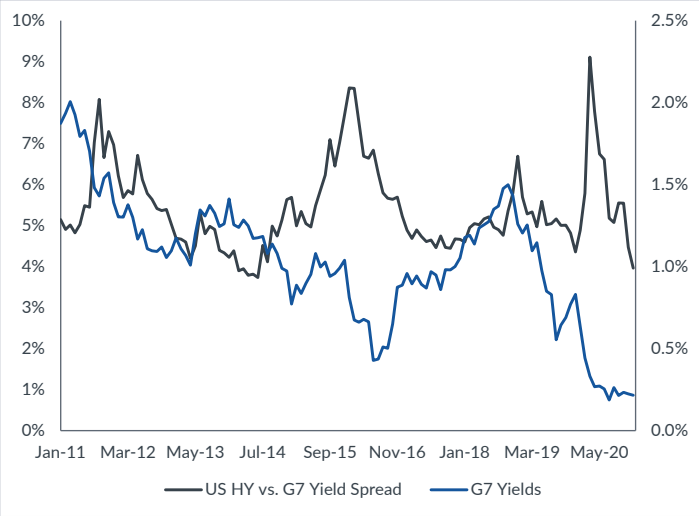
[2]Bloomberg Barclays Global G7 Yield-to-Worst, LGG7YW (as of 12/31/2020)

[3]Bloomberg Barclays Global Agg Neg Yielding Debt Market Value, BNYDMVU

[4]"CLO Credit Lines Surge as Market Readies for Record January" – Lisa Lee

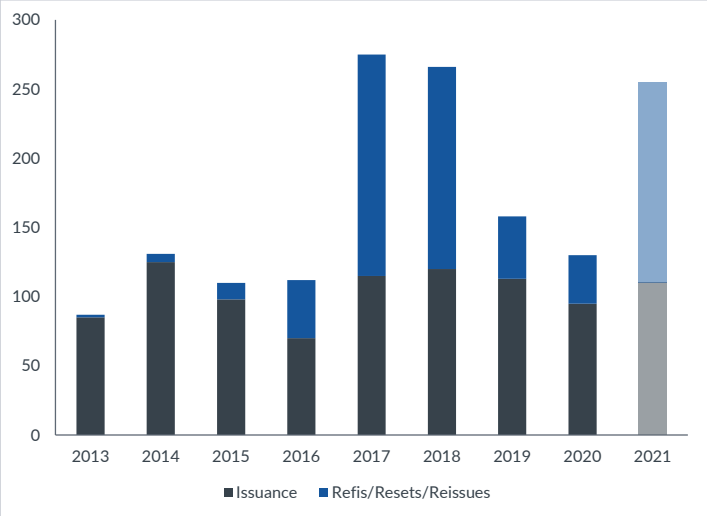
[5]Palmer Square BB CLO Index, PCLOBBYD

**US High Yield Spreads vs. G7 Government Bond Yields**
*US High Spreads Stable Advantage*




Source: Bloomberg Barclays Global G7 Yield-to-Worst.

**CLO Supply Forecast for 2021**
*$110B New Issue, $140B Refis/Resets*




Source: Bank of America/Merrill.

# Dividend Stocks: 2021 Looks to Be Much Brighter

**David J. Abella, CFA**
Managing Director, Senior Portfolio Manager

As we enter into the new year of 2021, we look to improved investment outcomes for our dividend stocks driven by several factors. First, given the success of new vaccines, there is a light at the end of the tunnel despite some wobbles with the rollout. This improvement and eventual move to normalcy should greatly help broader areas of the economy, including many areas in the dividend investment universe. Second is the prospect for increased government spending, which should help broaden the recovery and also benefit many companies in the dividend universe. Finally, there is an overall improvement in business and consumer sentiment.

Last year, our dividend research team focused on owning stocks that could maintain their dividends through the downturn, including those in "essential services" industries. In addition, strong balance sheets with reasonable payout levels were (and are) important. Given the factors above, **we have increased the forecast returns going forward to the 6-10% range (see chart) and with higher confidence.**

As the recovery builds throughout the year, we anticipate that dividend growth (the theme of our investing thesis pre-COVID) will again be paramount. We will be targeting companies with a dividend growth rate of 2-6% initially, with an expectation of 3.5% in aggregate. That would follow the 2% dividend growth realized for 2020. As momentum in the economy continues, we feel that this growth can hit 6% in 2022, which would be back in line with growth levels pre-COVID (ranging between 3% and 8%). Our expectations are for an upward growth in dividends coming off the 2020 plateau (see chart).

Focus on income from companies with opportunities for dividend growth

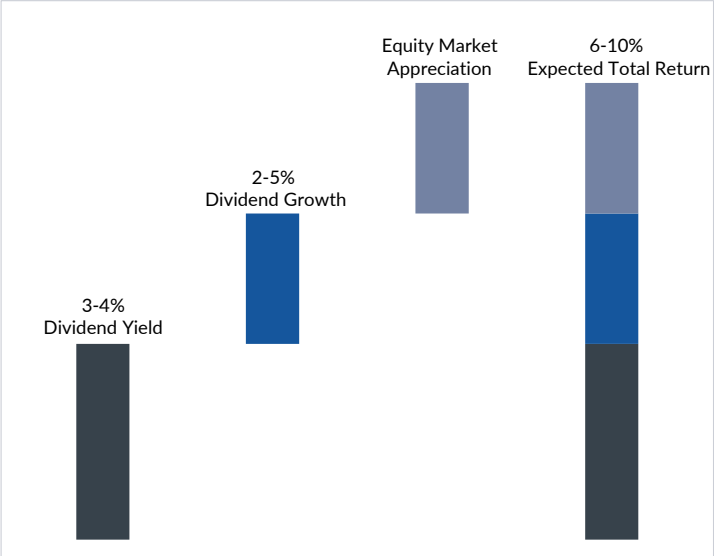
Continue to look for new opportunities as we move through this cycle

Let solid yields and compounded growth drive longer-run returns, with help from potential equity appreciation

**We believe that recovery in dividend stocks will be led with growth in yield as 2021 progresses, similar to years before the coronavirus pandemic.**

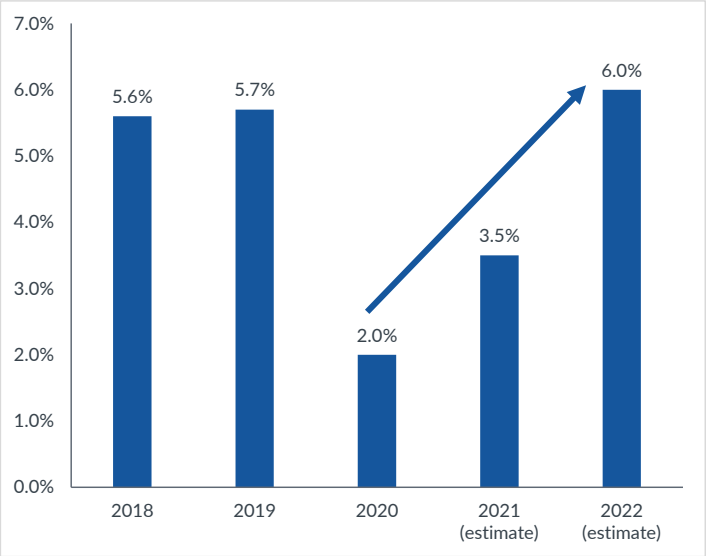
Our view is that **attractive yields of dividend stocks coupled with attractive valuations can also help drive solid returns over time, with a higher confidence in expected performance.**

**Breakdown of Total Return Components**




Source: City National Rochdale Research.

**Dividend Growth of the HDI stocks**
*(actual and CNR research estimates)*




Source: FactSet and City National Rochdale Research.

## Index Definitions

Bloomberg Barclays Municipal Bond Index is a market-value-weighted index for the long-term tax-exempt bond market. To be included in the index, bonds must have a minimum credit rating of Baa. They must have an outstanding par value of at least $7 million and be issued as part of a transaction of at least $75 million. The bonds must be fixed rate, have a dated-date after December 31, 1990, and must be at least 1 year from their maturity date.

The Bloomberg Barclays Global High Yield Index is a multi-currency flagship measure of the global high yield debt market.

Indices are unmanaged and one cannot invest directly in an index.

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Concentrating assets in a particular industry, sector of the economy, or markets may increase volatility because the investment will be more susceptible to the impact of market, economic, regulatory, and other factors affecting that industry or sector compared with a more broadly diversified asset allocation.

Private investments often engage in leveraging and other speculative investment practices that may increase the risk of investment loss, can be highly illiquid, are not required to provide periodic pricing or valuation information to investors, and may involve complex tax structures and delays in distributing important tax information.

Alternative investments are speculative, entail substantial risks, offer limited or no liquidity, and are not suitable for all investors. These investments have limited transparency to the funds' investments and may involve leverage which magnifies both losses and gains, including the risk of loss of the entire investment. Alternative investments have varying and lengthy lockup provisions. Please see the Offering Memorandum for more complete information regarding the Fund's investment objectives, risks, fees, and other expenses.

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.

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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.

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