CITY NATIONAL ROCHDALE
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ON THE RADAR

FAQs on the Markets and Economy

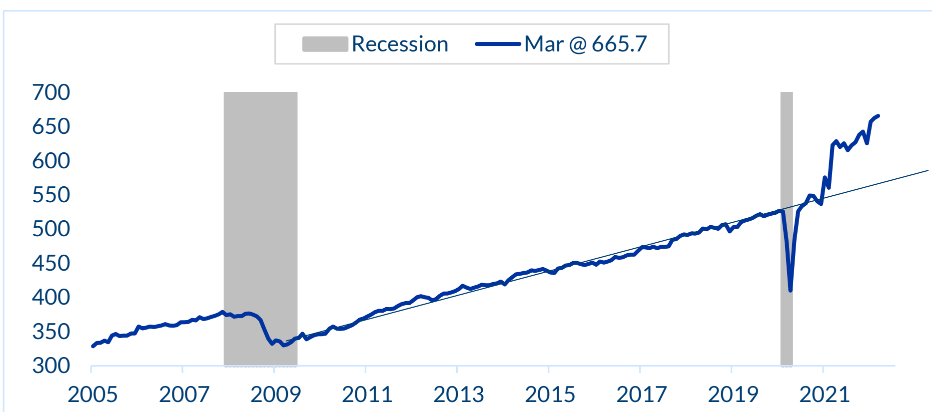
Has the increase in inflation slowed down consumer spending?

The recent retail sales report rose a healthy 0.5% month over month as spending showed minor damage from higher energy prices.

Of the 13 major categories in the report, gas stations had the most significant gain, up a whopping 8.9%, driven by the higher gasoline prices. It is important to note that gasoline prices rose 13.3% last month, according to the Consumer Price Index report. So the higher gasoline price has probably incentivized some people to drive less on the margin. Households are probably combining trips or taking advantage of work-from-home flexibility: This is a dramatic change from pre-pandemic life. Typically, gasoline demand is inelastic; people would buy about the same amount despite the higher prices. Potentially, that is changing due to the work-from-home flexibility. There will need to be more months of data to know for sure.

There appears to be an emerging change in consumer spending habits. They seem to be shifting back to the pre-pandemic style of shopping. Brick-and-mortar stores had a good month, with merchandise sales up 5.4% month over month and clothing up 2.6% month over month, while non-store sales (internet) fell 6.4% month over month. Also, services impacted by the pandemic have shown a nice bounce, with restaurant sales up 1.0%.

Retail Sales
monthly value, seasonally adjusted, $, billions



Source: U.S. Census Bureau

KEY QUESTIONS

What are we learning from Q1 earnings ?

Why is the market not showing signs of credit stress?

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Fixed income is off to one of its worst starts in more than 40 years, with index returns down across most maturity and sector groupings.

U.S. high-yield corporate bonds are no exception, having fallen almost -7% through the end of last week (April 22). Despite the increased risk typically associated with owning high-yield bonds credit stress has not been the primary driver of year-to-date performance.

In fact, credit strength across most of the fixed income universe is quite strong. Default rates remain near all-time lows, leverage has declined from pandemic highs, companies' earnings are recovering and most issuers have refinanced near-term bond maturities out five to 10 years and beyond. Geopolitical tensions have had little impact on high-yield returns either, with stress metrics falling below pre-invasion levels less than one month after the fact.

Instead, surging Treasury yields have been the main culprit for negative returns, which have more than doubled since December and account for more than 90% of the year-to-date decline. Rebounding economic growth, elevated inflation and increasingly restrictive monetary policy from the Federal Reserve have pushed yields to levels not seen since 2018, weighing heavily on bond valuations.

Looking forward, U.S. high-yield bonds should perform well, provided Treasury yields find their footing. In periods following a protracted drawdown in fixed income returns, bonds typically perform well over the subsequent 12 months. Should inflation fall more quickly than expected or economic growth cool, returns should be relatively neutral by year-end. In the meantime, higher yields are providing opportunities to put new money to work as well as reinvest proceeds from coupon payments and maturities in existing portfolios.

U.S. High-Yield Stress Level Gauge
20-Year History

Return Source	% Change
Return From Rates	-6.36%
Return From Credit Stress	-0.62%
Total Return	-6.98%

Source: Bloomberg

What are we learning from Q1 earnings ?

With nearly 20% of companies reporting, Q1 earnings season is off to a solid albeit choppy start.

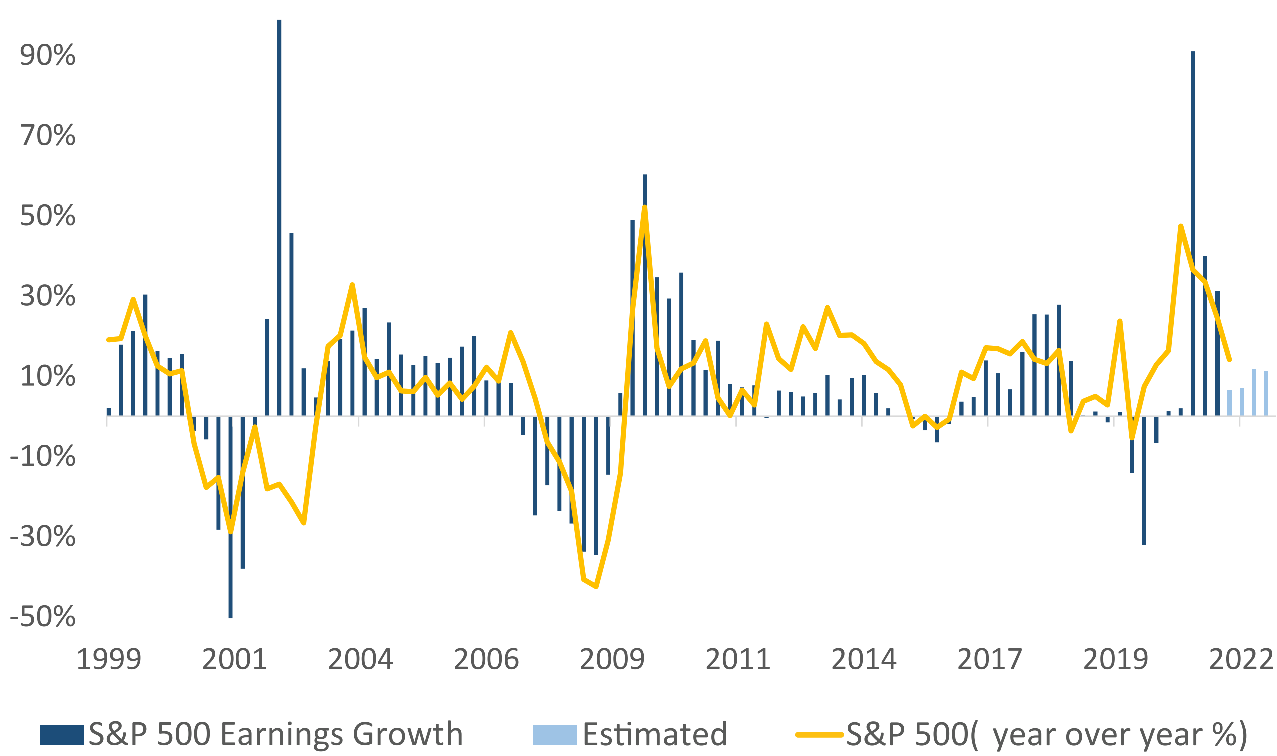
The percentage of companies beating earnings per share (EPS) estimates remains well above the five year average. However, the magnitude of those beats is now declining, with some notable companies either missed or guided down. For the first time since Q4 2020, earnings growth is expected to fall into the single digits.

The lower earnings growth rate relative to recent quarters can, in good part, be attributed to difficult comparison from a year ago when economic reopening drove unusually high earnings growth, but ongoing macroeconomic headwinds have also played a role. Higher costs on everything from labor to materials to transportation are putting pressure on profit margins. At the same time, companies are dealing with the spillover effects of the Ukraine war conflict and recurrent COVID-19 lockdowns in China.

Despite the increasingly challenging environment, forecasts for overall 2022 earnings growth have continued to move higher from expectations of 7.0% at the start of the year to 10.9% now. Although higher operating costs will translate into smaller corporate bottom lines, higher inflation also translates into more revenue, which can allow earnings to still grow at a solid pace even with some narrowing of margins.

As higher interest rates become a stronger headwind for valuations, we expect future stock prices to largely be determined by earnings results. After a year of stellar market returns and earnings growth, we think the backdrop for corporate profitability remains favorable, driven by further normalization of economic activity and solid private sector demand. However, with this cycle's earnings growth rate peak behind us, investors should also be prepared for more modest equity gains ahead.

S&P 500 Returns Historically Track Earnings Growth



Source: S&P 500

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INDEX DEFINITIONS

S&P 500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S. It is not an exact list of the top 500 U.S. companies by market cap because there are other criteria that the index includes.

Bloomberg Barclays U.S. Corporate High Yield Bond Index: measures the USD denominated, high-yield, fixed-rate corporate bond market.