CITY NATIONAL ROCHDALE
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ON THE RADAR

FAQs on the Markets and Economy

The yearly change in CPI has been falling for two months, so what happened to the enthusiasm?

There has been a change in optimism on the inflation front.

Last month, the release of the July Consumer Price Index (CPI) report showed that the yearly change in CPI fell from the June peak of 9.1% y-o-y to 8.5%. There was hope that the economy was entering a period of sustained disinflation. That implied the Fed would not have to be aggressive in its interest rate hikes.

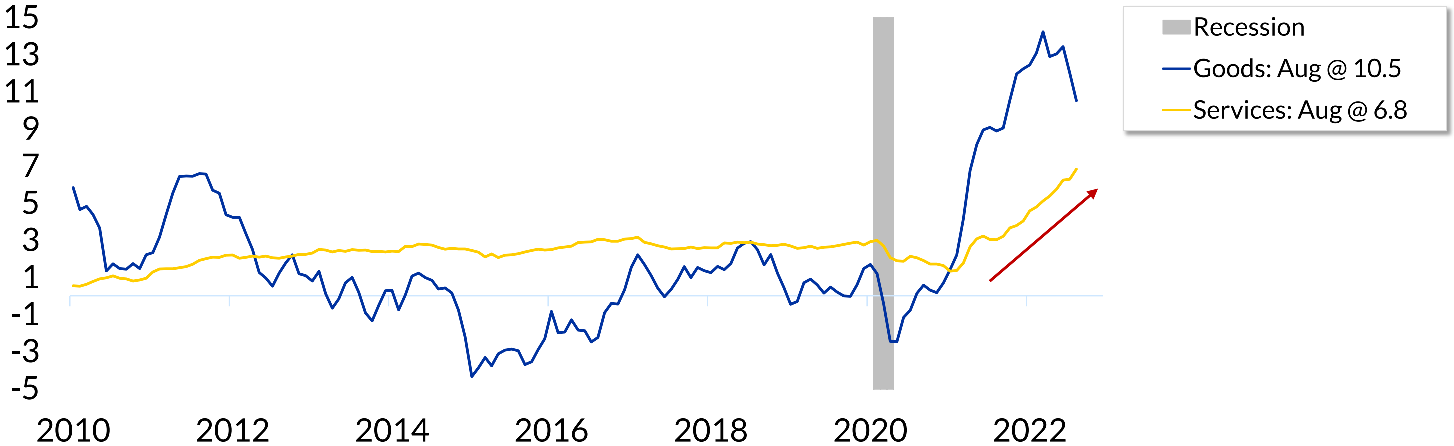
But the recently released August CPI report threw some cold water on that view. Although goods inflation is falling due to reduced demand for many of the goods purchased during the pandemic and improved supply chain conditions, service inflation continues to move upward *(see chart)*. Service inflation is stickier than goods inflation.

The service sector is heavily influenced by two sectors: housing costs (yes, housing is considered a service) and essential services (like eating at a restaurant or going to the dry cleaners, etc.), where labor costs are a critical component. The Fed has already helped orchestrate higher mortgage rates, helping to lower housing costs. The Fed's goal now is to get rid of the imbalance in the labor market that is causing wages to move up. That means raising interest rates higher for longer to slow down demand.

KEY QUESTIONS

- **What's behind recent equity market volatility?**
- **With lower gasoline prices, are consumers increasing their spending elsewhere?**
- **What is the near-term outlook for high-yield municipal bonds?**

CPI: Goods and Services
% change, year-over-year, seasonally adjusted



Source: Bureau of Labor Statistics

What's behind recent equity market volatility?

A hotter-than-expected consumer price index (CPI) report and negative-leaning Q3 corporate announcements last week triggered the biggest daily decline in the S&P 500 in over two years and drove interest-rate expectations higher.

Since its recent high reached in early August, the index has pulled back 10% and is now only 5.5% above June's low.

The continuing reversal of this summer's rally over the past month and a half is not very surprising. Bear market rallies are common and major bottoms tend to see a retest of previous lows. Investors continue to have a long list of uncertainties to ponder, including slowing US growth and overly optimistic earnings estimates, still-elevated supply chain challenges, China's economic concerns, Europe's increasing energy crisis and the ongoing Russia-Ukraine war.

Most importantly, with the Fed committed to reining in price pressures, the persistence and breadth of inflation have provided an unwelcome reminder to markets that rates may stay higher for longer than anticipated. For some time now, we have maintained our above consensus views on recession probability, the upward path of Fed Funds, and geopolitical risks. Indeed, the phrase "higher for longer" has increasingly been used by Fed officials and market pundits, supporting our strategic thinking.

Given this, we continue to recommend caution over the near term. Bottoming will be a process that could take some time to play out, and further swings in sentiment are likely as investors gain greater clarity on the outlook, particularly with rate hikes and inflation, and weigh their implications for the economy and corporate profits. We suspect downward earnings revisions in particular could be a catalyst for additional market declines ahead before a sustainable recovery in equity prices can begin.

S&P 500 YTD

Source: FactSet

With lower gasoline prices, are consumers increasing their spending elsewhere?

Yes, consumer spending appears to be rebounding in the third quarter.

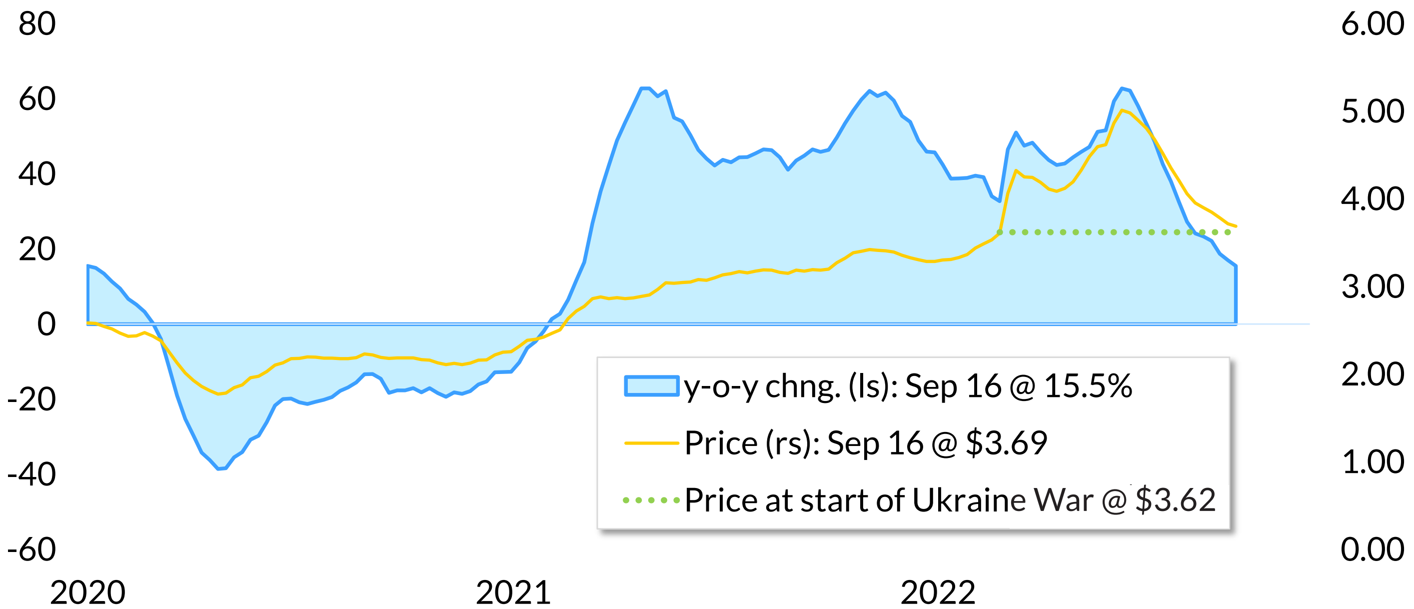
Gasoline prices peaked in mid-June at $5.02/gallon. Since then, they have fallen $1.33 to $3.69/gallon. They are now nearing the price they were at when the war in Ukraine started, $3.62 *(see chart)*.

Lower gasoline prices have provided households with more disposable income. This, combined with improved consumer confidence, has been the catalyst for increased consumer spending.

Retail sales in August increased by 0.3% m-o-m, boosted by more robust auto sales, home building supplies and restaurant sales. As a result, consumption for the third quarter is expected to grow stronger than the growth rate of the first two quarters of this year.

Gasoline

$ per gallon, % change y-o-y



Source: Automobile Association of America

What is the near-term outlook for high-yield municipal bonds?

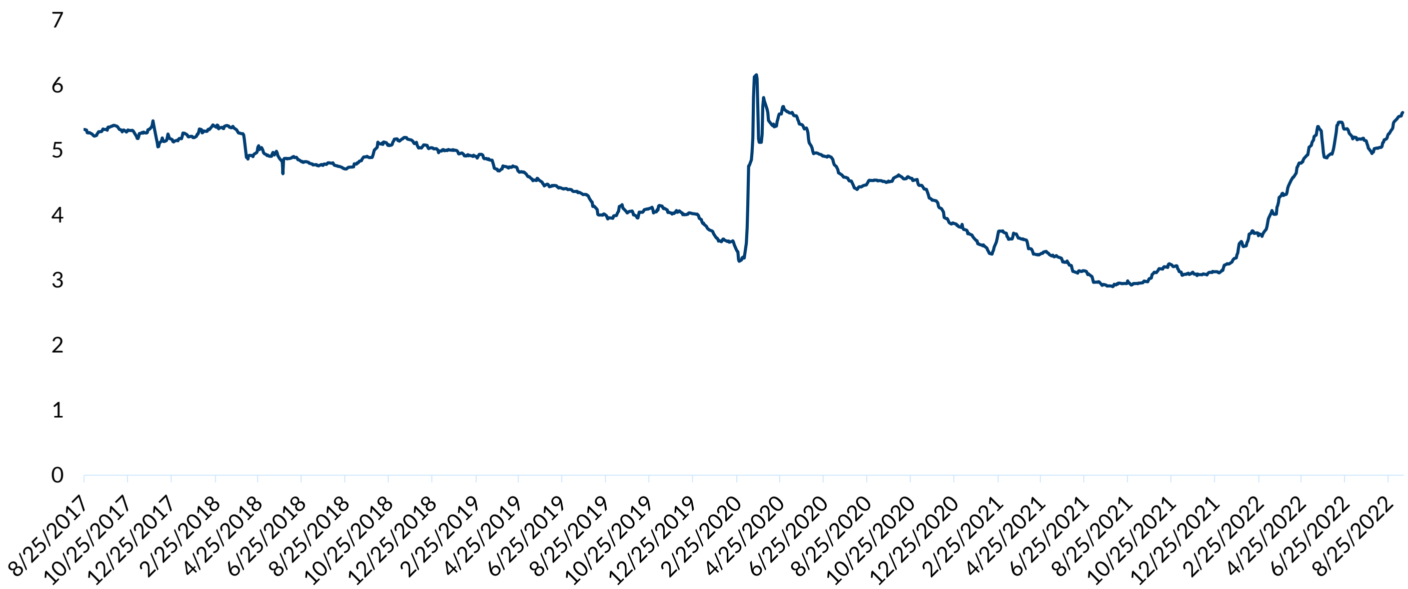
We would be remiss not to acknowledge the challenging year in the broad financial markets.

A Fed tightening cycle and rising rates have taken center stage as investors weigh the economy's trajectory against the potential for further volatility. While returns are negative in fixed income so far this year, the decline in prices and other market forces have resulted in yields much higher today than in recent memory. For example, the Bloomberg Municipal High Yield Index yield-to-worst increased nearly 250 basis points (bps) since the beginning of the year to approximately 5.6% (or a federal tax-adjusted yield of almost 9%). For long-term investors that seek competitive streams of tax-exempt income, staying engaged and not overlooking relative value opportunities can lead to attractive forward-looking returns.

A significant contributor to high-yield municipal (HYM) bond performance is the demand for bonds, as evidenced by the flow of money into and from bond mutual funds. According to Lipper, the municipal market has experienced approximately $85 billion in fund outflows year-to-date, with HYM bond funds accounting for more than $13 billion. The HYM market also drives the demand for bond supply, with YTD HYM issuance running at about 50% of last year's HYM supply, according to data from MMA. As we enter the year's final quarter, volatility is likely to persist, perhaps affected by seasonal technical factors. Still, clarity surrounding monetary policy, which should support a more settled trading range for Treasuries, has the potential to firm up the HYM market. With HYM bond valuations attractive in long maturities, absolute yields present a good entry point to lock in cash flows and raise portfolio book yields.

The credit quality trends of HYM bonds are currently stable for many sectors, but careful security selection is critical in a late-cycle stage. According to MMA, defaults in the HYM market remain reasonably low. However, lingering pandemic-related implications and expectations for economic moderation might weigh on some of the riskiest borrowers. A prudent research process that enhances portfolio allocation and decision-making can benefit patient investors in the current environment.

Bloomberg Municipal High Yield Bond Index Yield to Worst



Source: Bloomberg

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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.

CalPERS: The California Public Employees' Retirement System, also known as CalPERS, is an organization that provides numerous benefits to its 2 million members, of whom 38% are school members, 31% are public agency members and 31% are state members.

CPI: A consumer price index (CPI) is a price index, i.e., the price of a weighted average market basket of consumer goods and services purchased by households. Changes in measured CPI track changes in prices over time.

MOVE Index: Bloomberg Ticker "MOVE" — statistic is computed by ICE BofA.