City National Rochdale | April 10, 2023

March 2023 Market Update: A Deep Dive into CNR's Economic and Investment Outlook

Summary of March 29 Market Update Webinar

Evaluating Interest Rates & Banking Worries

The probability of a recession occurring in the second half of 2023 has risen from 70% to 75%, according to the March 2023 market update presented by the leadership team of City National Rochdale.

However, the most likely scenario is for a mild recession, according to Garrett D'Alessandro, City National Rochdale CEO.

Inflation is expected to moderate over the year, but it will be bumpier than anticipated earlier. Generally, equities are not particularly attractive at the moment because the market isn't discounting enough for continued inflation, higher for longer interest rates and the mild recession, D'Alessandro said.

CNR Speedometers®, which are forward-looking indicators for the next six to nine months, are all yellow or red this month.

The credit speedometer turned red this month, which is particularly notable because of America's reliance on credit. Tightening credit conditions are the biggest fallout from the recent banking industry turbulence, with further tightening anticipated.

Consumer resilience, which has remained strong so far, is likely to be tested in the months ahead by the lagging impact of higher interest rates, the weight of inflation and tighter credit.

Is the Banking Sector at Risk?

While anxiety around the banking system may persist, our view is that the industry is generally on solid footing, especially when compared to the situation during the Great Recession of 2007-2008.

In comparison to that era, capital and liquidity ratios are significantly higher today than they were. Additionally, authorities have acted very swiftly to manage the current crisis compared to what they did during the Great Recession.

"Overall and in total, banks have more than sufficient capital to meet demands or stress, but we're not saying that every single bank out of the thousands of banks that exist is perfect," D'Alessandro said. "We're saying that the system overall is not likely to see anything like what happened in 2008."

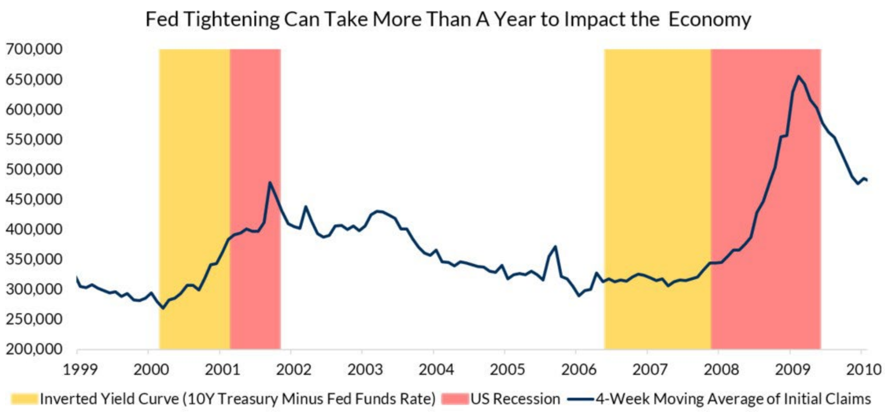
Regulations are in place to maintain the flow of credit and there are a plethora of tools available to officials to manage bank stress.

A look at credit default swaps, and measures of bondholder nervousness, indicates that the markets are not seeing significant concerns about the banking system at the moment either.

However, CNR is keenly aware that restrictive policy tends to uncover vulnerabilities lurking in the financial system and that concentrated pressures on weak links in the banking sector can spill out in unexpected ways.

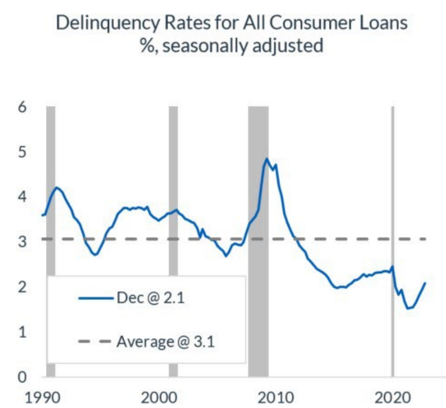
What Will the Fed Do Next?

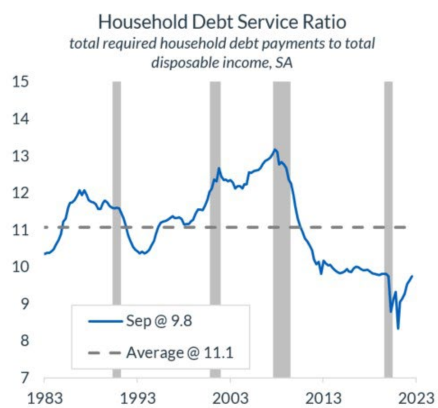
Current economic strength, including consumer spending and employment activity, along with the stickiness of underlying inflation pressures, is creating a dilemma for the Fed. The Fed needs to balance the competing goals of achieving price stability (controlling inflation) and maintaining financial stability (preserving access to credit and confidence in the financial system). For now, the Fed is prioritizing controlling inflation.



Source: St. Louis Fed, as of March 2023.

Reactions to changes in monetary policy often have a long lag time, so the full effect of Fed tightening has yet to be felt. Further tightening after recent events will likely negatively impact economic growth.



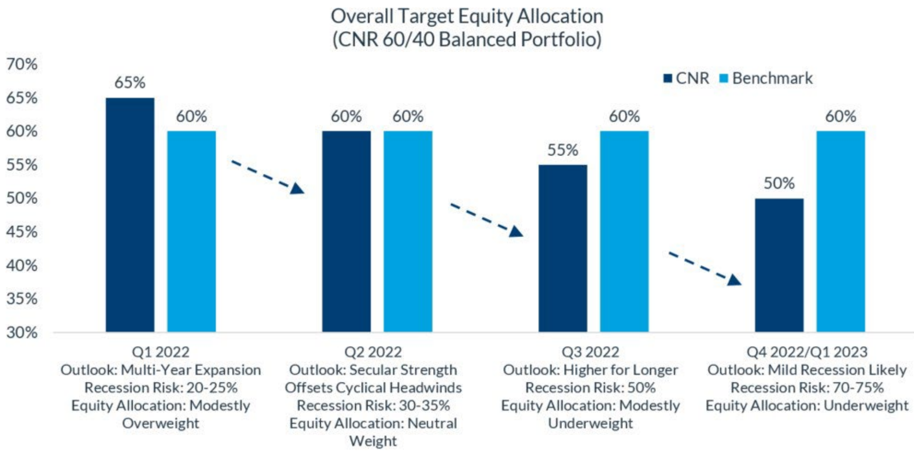


Source: Federal Reserve, Bureau of Economic Research.
Information is subject to change and is not a guarantee of future results.

However, CNR continues to believe that the strength of consumer balance sheets and the job market will continue to mitigate the severity of any economic downturn.

CNR continues to review its equity and fixed-income investment strategies and is comfortable with its current exposures. Portfolios are constructed to be well diversified across sectors and industries.

Bank exposure is modest, and holdings have strong fundamentals with well-balanced sources of deposits and lending books.



Source: CNR Research. Benchmark is S&P 500.

Overall, CNR's portfolios have been appropriately positioned for the elevated risk of recession. CNR is maintaining its defensive positioning with a focus on holding high quality U.S. stocks and bonds. CNR remains underweight on Europe, a position that has been validated by recent developments there.

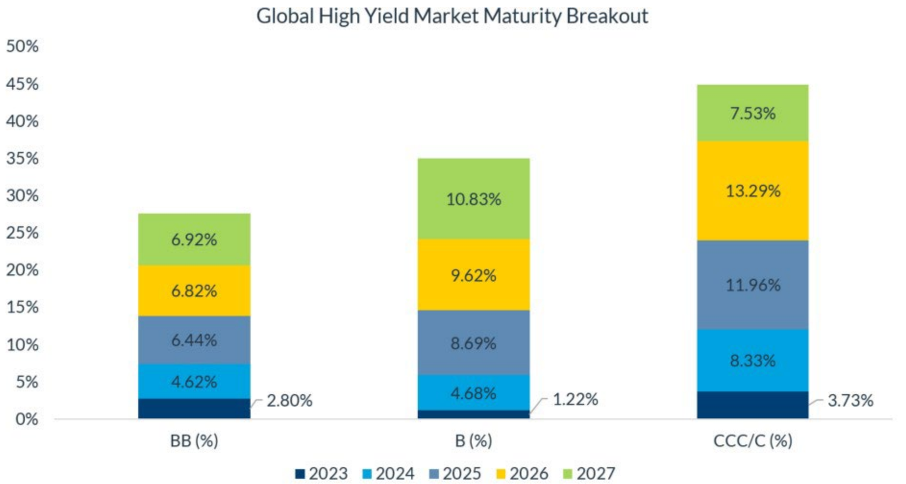
CNR anticipates that the Fed will raise the federal funds rate once more in May by 25 basis points and then pause, keeping rates at 5% to 5.25%.

While the market expects the Fed to cut rates in the coming year, CNR disagrees and expects them to hold rates higher for longer, said Charles Luke, managing director and co-director for fixed income for City National Rochdale.

Instead of cutting rates, City National Rochdale expects the Fed to turn to the other tool at its disposal, its balance sheet. Reducing that balance sheet will lower liquidity in the economy.

City National Rochdale anticipates that as a result of Fed moves, there is a high probability that the recent rally in yields will reverse itself. However, if economic data remains strong and inflation remains high, long-term rates may rise.

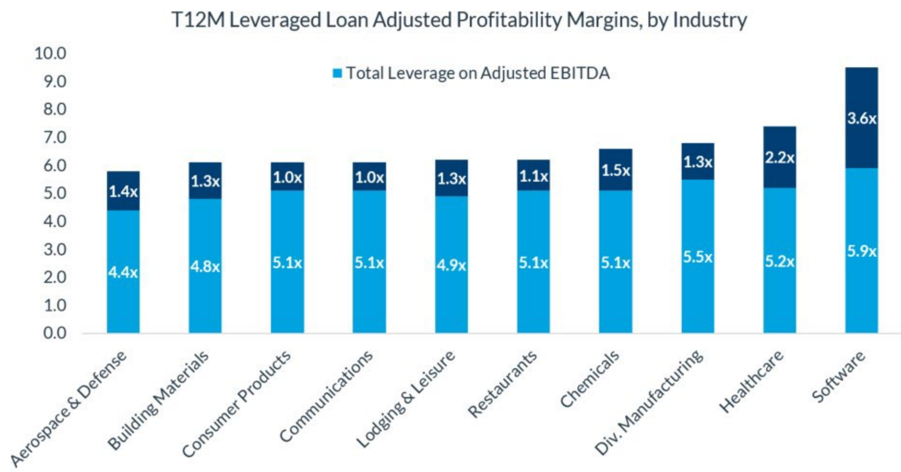
How Are Interest Rates Affecting Credit?



Sources: S&P Global Ratings Research, CNR Research, as of January 1, 2023. Information is subject to change and is not a guarantee of future results.

Higher interest rates will begin to erode credit quality, which will be more acute for private lending. City National Rochdale anticipates that defaults will rise, with leveraged loans likely to face higher defaults than corporate bonds, a reverse of the historical track record.

However, the rise in defaults will be slow since maturities are pushed out beyond 2023.



Source: Bloomberg, CNR Research, as of March 2023.

Global merger and acquisition volume has slowed to a standstill, with no deals getting done, Luke said.

City National Rochdale believes leverage may be higher than reported when profitability adjustments are reversed.

The growth in private equity and leveraged lending has changed the composition of the sector and credit quality is weaker, especially at higher interest rates.

City National Rochdale is reviewing its exposure and is likely to make reductions going forward. Investors may want to review their positions, Luke said.

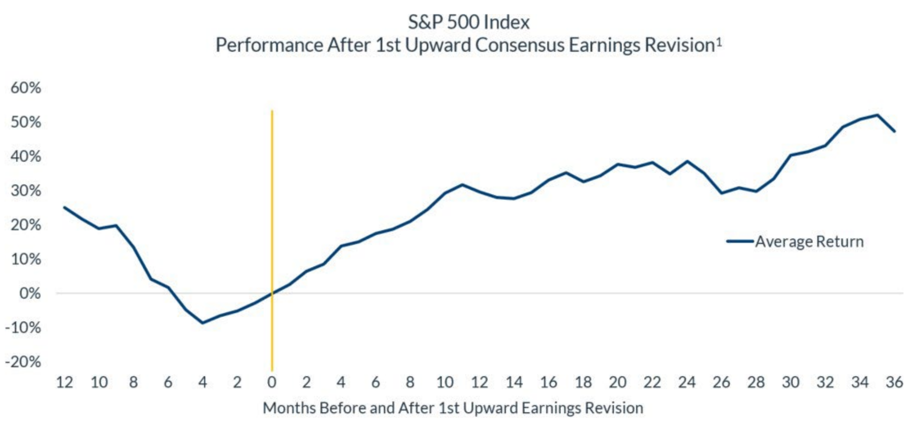
Three Important Economic Trends to Watch

Indicator	Apr.	May	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.
Economic Activity Bottoming									
Upward Earnings Revisions Begin									
High Yield Spreads Peak									

Source: CNR Research, March 2023. Information is subject to change and is not a guarantee of future results.

CNR is watching three important trends prior to increasing equity exposure in its portfolios. The investment team is waiting to see economic activity bottoming, a start to upward earnings revisions and a peak in high-yield spreads.

“Just one event of the three isn't enough," Luke said. “Our confidence will grow when these trends happen in tandem. We still think a defensive position is best for now."



Sources: Bloomberg, CNR Research, as of February, 2023. Information is subject to change and is not a guarantee of future results.
[1] Covers performance periods with GDP troughs in 1990, 2001 and 2008

Given the potential cuts in earnings estimates, CNR believes that equity markets are overvalued. We remain underweight on equities and overweight on investment-grade fixed income.

Asset Allocation Positioning	Stocks	Bonds
Current	Modest Underweight	Modest Overweight
Base Case	Neutral Weight	Neutral Weight
Best Case	Modest to Strong Overweight	Modest to Strong Underweight
Worst Case	Strong Underweight	Strong Overweight

Asset Allocation Positioning
Base Case
• Signs of in bottoming economic activity/beginning of new growth cycle • Add cyclical US equity exposure • Reduce investment grade (IG) fixed income allocations
Best Case
• Higher confidence of multi-year expansion/geopolitical risk easing • Overweight US equity exposure, underweight IG fixed income allocations • International equity contingent on geopolitical considerations
Worst Case
• High risk of structural bear market/deeper recession, exogenous shock • Meaningfully lower overall equity exposure • Meaningfully increase allocations to IG fixed income

Source: CNR Research, March 2023. Information is subject to change and is not a guarantee of future results.

CNR stands ready to reposition asset allocations as economic conditions change. Our investment strategy is in place for several scenarios, including the likelihood of a mild recession in the second half of 2023.

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Gross Domestic Product (GDP) is the total monetary or market value of all the finished goods and services produced within a country’s borders in a specific time period.

The Consumer Price Index (CPI) measures the monthly change in prices paid by US consumers.

Yield to Worst (YTW) is the lower of the yield to maturity or the yield to call. It is essentially the lowest potential rate of return for a bond, excluding delinquency or default.

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