ON THE RADAR

FAQs on the Markets and Economy

February 26, 2024

Will the Federal Reserve start easing monetary policy?

In a significant development, the Federal Open Market Committee (FOMC) decided to remove the bias to tighten policy, setting the path toward easing monetary policy. The Fed is not ready to declare victory over inflation; they still have a way to go. They gave no hint that an interest rate cut was impending.

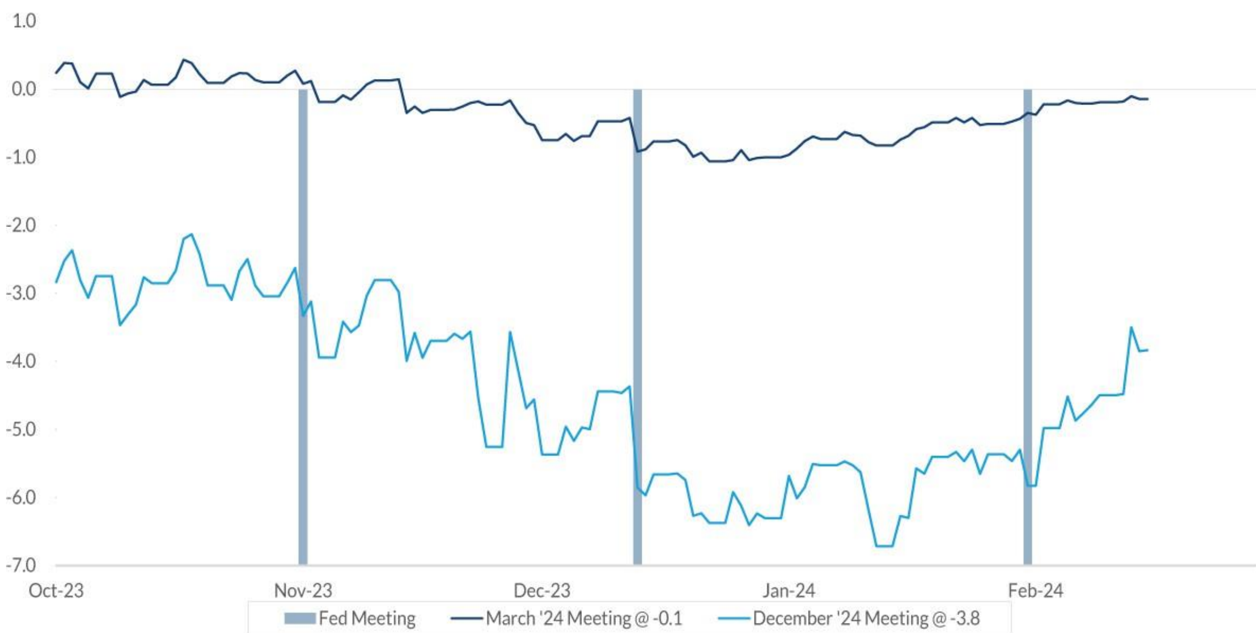
The Fed has been pushing back hard on the market's expectation of a rate cut as early as mid-March. In the Fed's view, it is premature to claim that the inflation problem has been solved. Although the headlines of the inflation reports are attractive, the Fed knows that much of the decline in inflation in the past year can be traced to components that are volatile: Those volatile prices can go up as easily as they can go down, and they are not under the Fed's control.

The market's view of the Fed cutting interest rates has been volatile this year. In January, The market was expecting almost seven cuts of 25 basis points, it has since retreated to about four. The Fed expects three.

There was no indication of a change in policy for the Fed's balance sheet to slow the pace of quantitative tightening. Over the past few weeks, several policymakers have talked about slowing the pace of the run-off. The Fed plans to take up the topic in March, and policy changes will occur over the course of the year. Since December, City National Rochdale's belief has been that the Fed will wait until summer before they start cutting interest rates, much later than market expectations.

Number of 25 bp Hikes (+) or cuts (-) at Upcoming FOMC Meetings

implied, based upon federal funds futures market from the present level of 5.375%, as of February 15, 2024



Source: Bloomberg WIRP page, as of February 15, 2024.

Information is subject to change and is not a guarantee of future results.

What has caused the pace of deflation to stall?

As the adage goes, "The last mile is the hardest." In the 12 months ending June 2023, the annual change in consumer price index (CPI) had declined 6.0 percentage points, from 9.1% to 3.1%. In the seven months since then, CPI is still at 3.1%. The Fed's goal is 2.0%.

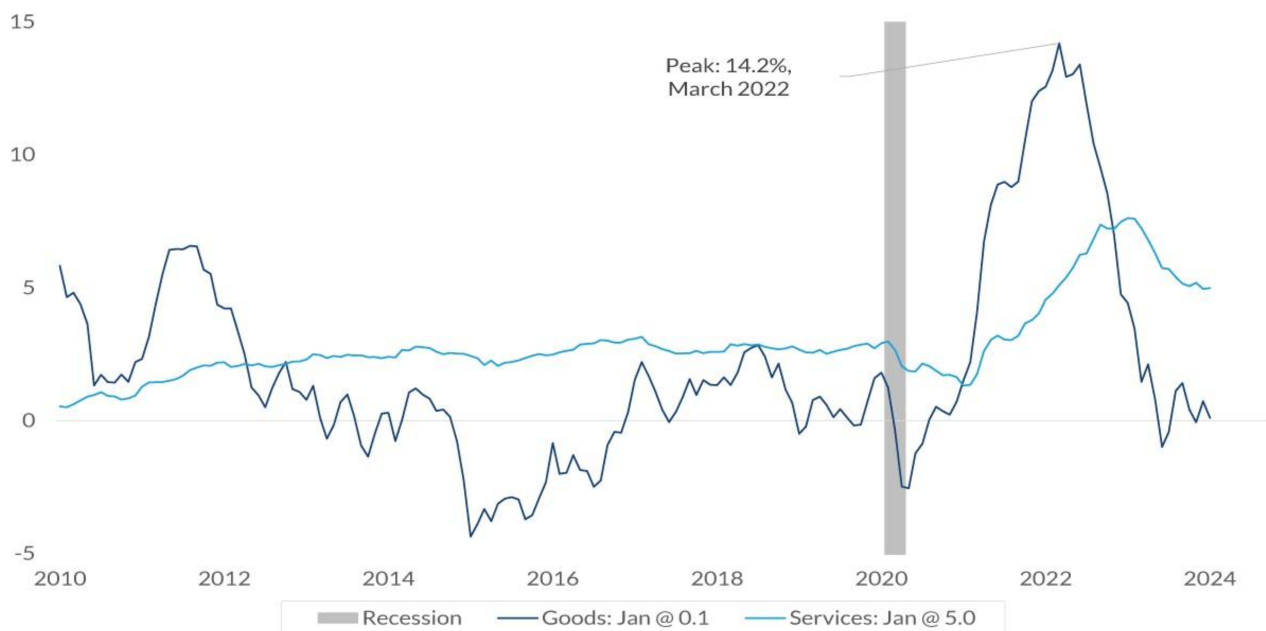
The primary force in the sweeping 6 percentage point drop was goods prices. Goods prices peaked at 14.1% year-over-year in March 2022, and they are now 0.1% (see chart). Back in 2022, prices were quickly impacted by the strong demand driven by the COVID-19 pandemic, extreme shortages and logistical snarls in transporting goods. Since then, the supply/demand relationship has neutralized, and transportation pressures are back to normal.

The high inflation issue surrounds service costs, mostly housing (CPI calls shelter) and other services that tend to be labor intensive, so wage costs significantly impact the price. Shelter costs are the largest component of CPI (36.2% weighting) and are up 6.1% year-over-year. The other part of services, what is called "super-core" (services without shelter), is also high, standing at 3.9% year-over-year and an annualized 4.3% for the past three months. Wages are still too high for the Fed's comfort. They are hovering around 4.0% to 5.0%, the Fed believes they need to return to their pre-pandemic range of 2.5% to 3.5% for inflation to move back to the 2.0% range.

The Fed is expected to keep interest rates higher for longer (maybe into the summer) as a way to help moderate the pace of spending and bring down the super-core inflation.

CPI: Goods and Services

% change, year-over-year, seasonally adjusted



Source: Bureau of Labor Statistics, as of January 2024.

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What does lower recession risk mean for the outlook on equities?

City National Rochdale's recession risk was recently lowered from 50% to 40%, due to resiliency of the U.S. consumer, continued disinflationary trends and expectations of two to three Fed rate cuts beginning sometime around midyear. To reflect this within the context of intelligently personalized portfolios, we continue to increase equity exposure and adjust the growth and income mix, especially for those clients seeking greater growth or capital appreciation.

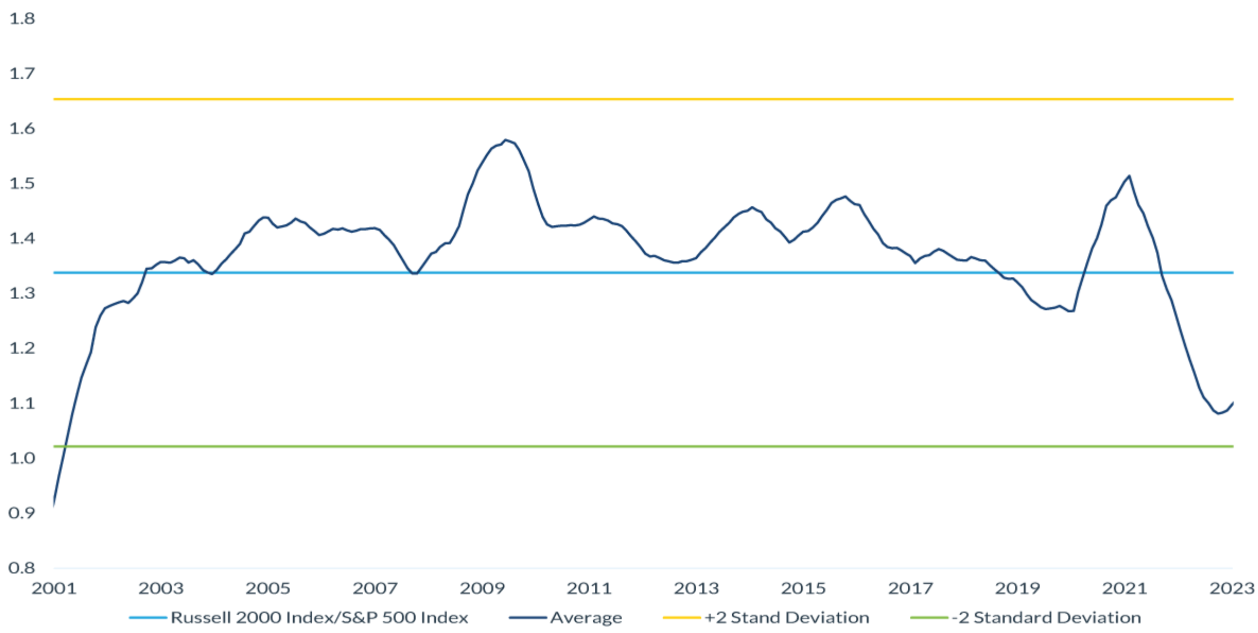
The case for mid-small cap stocks, in particular, is growing more compelling. From a valuation perspective, small and mid-cap equities are trading by some measures at a discount to their large cap peers not seen since the dot-com bubble of the early 2000s. A decade of MidSmall-cap leadership followed the last time relative valuations were at these levels.

From a profitability perspective, Russell 2000 Index constituents generate about 90% of their revenue domestically versus around 60%–65% from S&P 500 constituents. Given the expected relative resilience of U.S. growth compared to other international economies in 2024 and beyond, the greater domestic orientation of MidSmall-cap companies should be a more positive tailwind for profitability compared to Larger-cap companies.

Earnings revisions for mid and small cap equities have already begun to turn more positive and, historically, have recovered stronger than large cap after steep downcycles. A stabilizing interest rate environment ahead should also benefit smaller cap companies, as they often rely on borrowing to enhance profitability and fuel growth. We think that a greater rotation into more cyclical and economically sensitive investments is still in the cards as the year progresses, especially if the Fed cuts rates due to improvement in inflation rather than concerns about economic growth.

Relative Valuation: Small Caps / Large Caps

(Rolling 12M Fwd P/E)



Source: Factset, as of January 2024.

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Is the juice worth the squeeze?

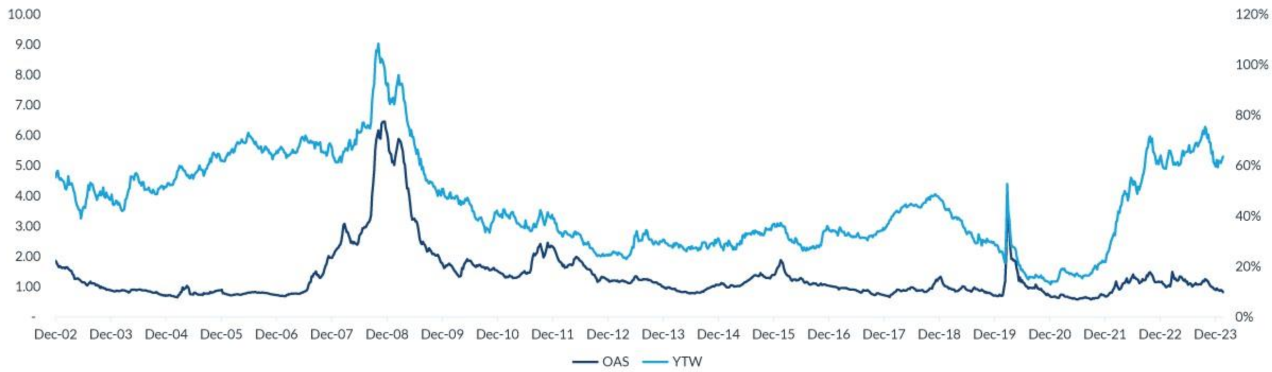
For several years the financial media and market participants have been hyperfocused on the Fed and the level of market yields. Somewhat lost in this story is a metric whose importance seems to vary from time to time. The option-adjusted spread (OAS) is a measure of risk premium over a risk-free rate (Treasurys) that compensates for credit risk and potential embedded options. The OAS for an index is often used to compare current credit conditions to other points in history in order to glean insights and note different drivers of valuations.

As shown in the chart below, the current level of yields was last experienced near the tail end of the Great Financial Crisis. However, the OAS in mid- to late 2009 was nearly 60% of the index yield (as shown in the bottom graph), whereas on Feb. 16, 2024, the OAS was just 16% of the index yield.

There is a strong argument that investors are not being adequately compensated to take on corporate credit risk at the moment. That said, OAS is not currently driving the bus. Investors are more motivated by the relatively higher nominal yields of corporates versus Treasurys. After all, yields of 5%+ for 5- to 10-year maturity A-rated corporate bonds are a welcome sight versus the near 1% yields for the similar bonds at the end of 2020.

In addition, low levels of OAS may persist. Credit fundamentals continue to look healthy while demand technicals look strong. New bond issuance has started the year well ahead of expectations, with 13% more corporate debt issued year to date compared to 2023. Despite the uptick in new debt issuance, OAS is expected to remain relatively range-bound as investors continue to prefer the relatively higher nominal yields of corporates and look to reinvest proceeds from higher coupon income up from $290 billion in 2023 to $360 billion in 2024.

Low Credit Risk Premium May Persit As Yields Remain Attractive



Sources: Bloomberg, Barclays, as of February 2024.

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***Graphs based on the option-adjusted spread (OAS) and yield to worst (YTW) of the Bloomberg Intermediate Corporate Total Return Index.**

IMPORTANT INFORMATION

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INDEX DEFINITIONS

S&P 500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market- capitaliza on-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 Investment Grade Municipal Index: Bloomberg Municipal Index The Bloomberg Municipal Index measures the performance of the Bloomberg U.S. Municipal bond market, which covers the USD- denominated Long-Term tax-exempt bond market with four main sectors: state and local general obliga on bonds, revenue bonds, insured bonds, and pre-refunded bonds.

High Yield Municipal:A high yield municipal bond index is a benchmark that measures the performance of non-investment grade and non-rated, tax-exempt bonds issued by U.S. states and local governments.

Yield to Worst (YTW): Yield to worst is a measure of the lowest possible yield that can be received on a bond that fully operates within the terms of its contract without defaul ng.

Tax-Equivalent Yield (TEY): The tax-equivalent yield is the return that a taxable bond needs to possess for its yield to equal the yield on a comparable tax-exempt municipal bond.

DEFINITIONS

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 me.

PCE: The PCE represents the prices of goods and services purchased by consumers in the U.S. Since inflation is a measure of the trend in rising prices, PPCE is an important metric in determining inflation.