City National Rochdale®
AN RBC/CITY NATIONAL COMPANY

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Dividend & Income Strategy

INTEREST RATES VS RETURNS

DIVIDEND STOCKS IN A RISING INTEREST ENVIRONMENT

As the City National Rochdale High Dividend Income strategy focuses on stocks with an attractive yield, the pressing question has been and continues to be: how can these stocks perform in a rising interest rate environment, especially after a difficult first quarter of 2018? Despite upward moves, interest rates, both short and long, are currently quite low by historical standards. The expectation for the year is that the Fed will increase the federal funds rate three more times (one has already happened) and that the ten-year Treasury rate is expected to move up as well (although not necessarily in-line with the move in the short-term rate).

PAST PERIOD EXPERIENCE

In past periods, we have experienced short-term volatility in our dividend stocks when the expectation of higher rates has been heightened. And now, in our view, much of the weakness in dividend stocks in the first quarter of 2018 was due to outsized expectations of higher rates. In looking at past periods, is there a pattern to how these stocks have traded and will this pattern continue in the next upward rate cycle? The answer is that there has not been a strong correlation between how these stocks trade longer-term and interest rates, as rates are just one of many stock-influencing factors. Other major factors include the growth rates of income and cash flows at the companies, expectations about the operational state of the underlying businesses, the conditions of the equity markets, and the strength and growth of the economy. For example, the fed funds rate went from 1.25% at the end of 2002 to a high of 5.25% at the end of 2006, the biggest upward sustained move since the 1980s. The ten-year Treasury rate went from 3.8% to 4.7% during this time.

KEY POINTS

Rates are not the main driver of performance for income stocks over the long-term if other factors are at play

Weak correlation between how dividend stocks trade longer-term and interest rates

We are continuing to add dividend growers

We do not believe we are entering a "doomsday" rate scenario, as our Asset Allocation Committee forecasts the ten-year treasury rate to be below 3.5% for this cycle

Given the current dividend yields, growth in yields, and attractive valuation we remain comfortable of our prospective one-year total return to be 6-8% rate scenario

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However, looking at returns of various income indexes we saw solid rates of total return in major income-related sectors, including REITs up 174% in this period, utilities up 117%, and the Dow Jones Select Dividend index up 91%. This was primarily because economic growth coming out of the recession of 2001-2002 was very strong, driving solid revenue and cash flow growth.

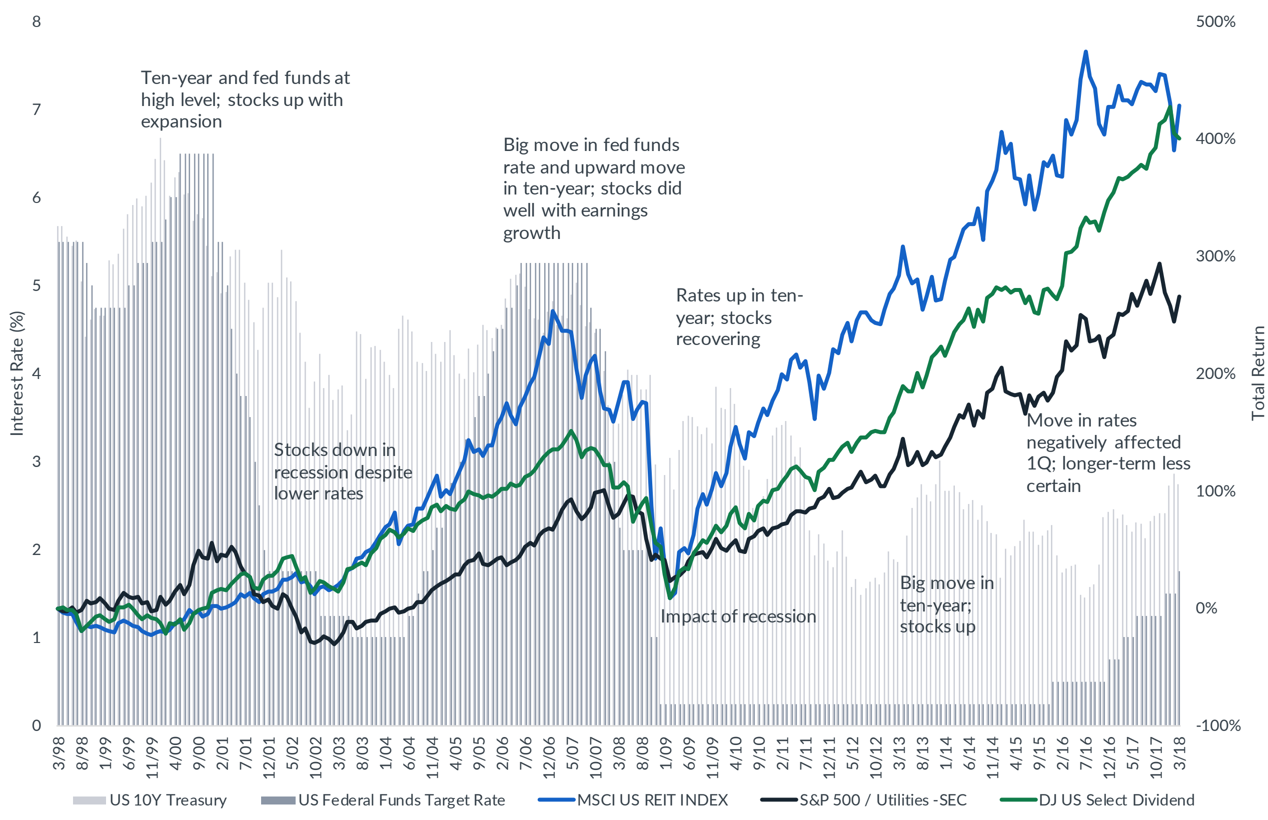
Another example was in the one-year period from July 2012, when the ten-year bottomed at 1.49%. Then looking out one year later the ten-year was 2.59%. At the end of that one-year period, REITs were up 7.8%, utilities were up 8.0%, and the Dow Jones Select Dividend index was up 22.5% (more in-line with the strong broader market). While it should be noted that utilities and REITs underperformed the Dow Jones Select index (which had more market-correlated names), the results were still positive and within our usual range of expected returns. Since that time ten-year rates have been in range (with a high of 3.01% in December of 2013 and a low of 1.46% in July of 2016).

We also examined rolling quarterly stock price performance vs. interest rates going back 20 years for REITs, Utilities, and the DVY Index. Our data showed no sustainable pattern or high correlation. In some cases higher rates did mean negative price performance and in other cases it was positive.

We conclude that rates are not the main driver of performance for income stocks over the long-term if other factors are at play, such as solid cash-flow growth. Note that our experiences in the short-term have felt the pain of either upward rate movement or expectations of upward movement, and our experience tells us continued caution is in order in the short run.

Finally we would like to point out a NAREIT study published on March 7, 2018 that looked at returns for REITs from 1992 to the end of 2017. This data looked at changes in the ten-year Treasury and the following four quarter returns. The conclusion showed that REITs had positive returns during periods of rising rate environments 87% of the time. In addition, REITs outperformed the S&P 500 53% of the time in periods of rising rates going back to 1992.

FIGURE 1
Interest Rates vs. Select Equity Income Total Returns



Source: Federal Reserve Bank as of 3/31/2018.

ACTION PLAN

While we are encouraged by past data that shows how dividend stocks can (and have) done well in upward rate environments, we acknowledge that the short-term trade is often negative. In addition, given how low rates have been coupled with the idea that an increase in rates may exceed market expectations (given potential for economic growth, inflation, and an increasing budget deficit), it is prudent in our view to continue to increase the weight of holdings toward higher growing dividend names. Simply put, interest rate sensitivity may be higher this time given the above-mentioned factors.

We started this process last year and increased it in the first quarter of 2018. Our goal is to continue the process, on an opportunistic basis, of adding dividend growers both this quarter and next.

Was the move in the first quarter of 2018 foreseeable? In our view, the downward market move was outsized given the actual move in rates. The ten-year went from 2.41% at the end of the year to 2.74% at the end of the first quarter.

While we expect further fed fund increases, which in turn will likely pressure the ten-year rate higher, we do not believe we are entering a "doomsday" rate scenario. Overall, we do believe dividend growers will allow us to seek higher total returns, but in our view the more rate-sensitive stocks "oversold" in the first quarter.

All told, our total return one year forward remains at 6-8%, driven by the current dividend and the growth in dividend, with more of the balance coming from the growth part and less from the yield part as we continue to transition the portfolio. Our Asset Allocation Committee currently forecast the ten-year Treasury rate to be in range that does not exceed 3.5%, which would be a manageable increase of the strategy longer-term.

Therefore, our focus will remain on identifying attractively valued, high-quality companies with solid prospects for dividend growth that can operate well under most conceivable economic environments.