FAQs on the Markets and Economy

December 7, 2023

Is the Fed getting the economic response it needs from the 525 bps increase in the federal funds rate it engineered?

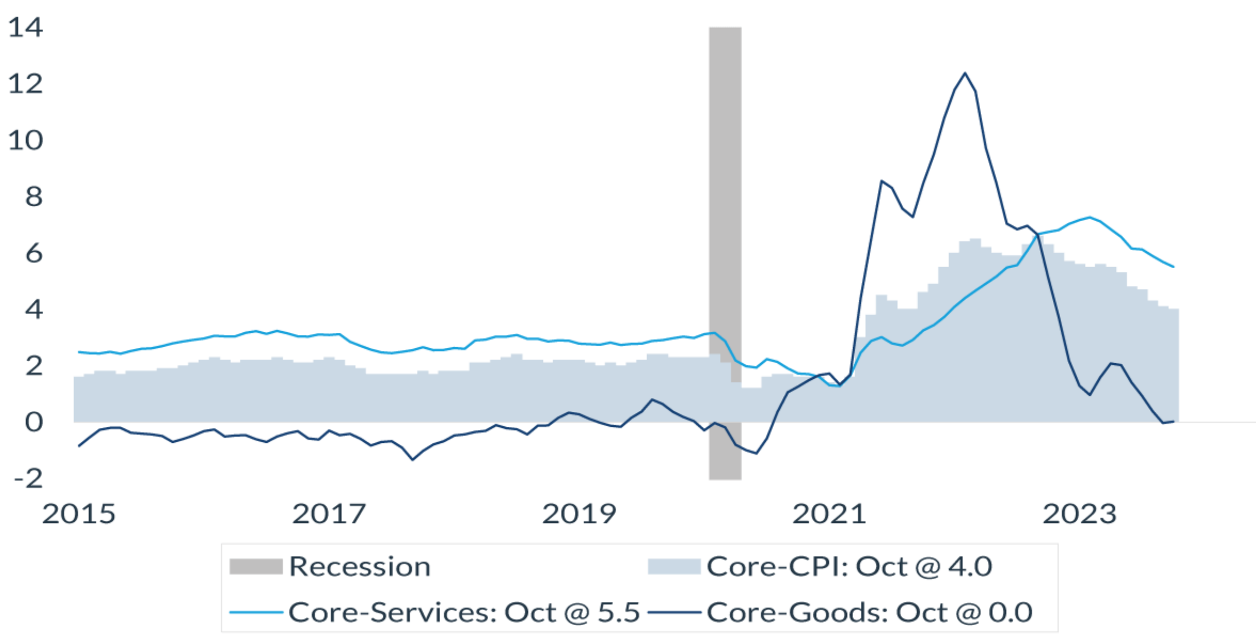
Since the Fed began raising the overnight rate in March of 2022, its goal has been to reduce inflation by bringing about a gentle slowing of the economy, thereby ensuring a soft landing instead of a harsh recession. So far, it seems to be working. The pace of workers getting jobs in the past three months has averaged just 204,000, about half the level of the 2022 average of 399,000. As for inflation, CPI stands at 3.2% y-o-y, getting close to the Fed's target rate of 2.0%, down from the 8.5% it was when the Fed started raising interest rates and the peak of 9.1% in June of 2022.

Market participants believe the Fed will need to cut the federal funds rate in early 2024, maybe as early as March. City National Rochdale (CNR) is not in that camp. We believe the Fed will not cut the federal funds rate until the latter part of the second half of 2024, at the earliest. Although overall inflation has declined, it has been brought down mostly by goods prices (the fixing of supply chain problems and demand for goods has fallen due to greater consumer interest in experiences like travel, entertainment, ball games, etc.). The other issue about goods prices is that they can move up as quickly as they move down (like oil prices).

But service prices remain elevated (see chart), and they consist of housing costs and other services where labor is a big part of the cost (restaurant, auto care, travel, etc.). Also, they are sticky, meaning they are very slow to move in any direction. We think the Fed will need to keep the funds rate high until service prices drop enough so they will be comfortable that the overall inflation rate will be on a path for a sustainable 2.0%. That will take at least six to nine months.

Core CPI: Goods and Services

% change, year-over-year, seasonally adjusted



Source: Bureau of Labor Statistics, as of October 2023.

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

Why have oil prices been falling?

Oil prices are around $75 per barrel, down from $94 in late September and $128 at its height early in the Ukraine war. This has pushed the average national gasoline to $3.24 per gallon, 33 cents lower than the day before Russia invaded Ukraine.

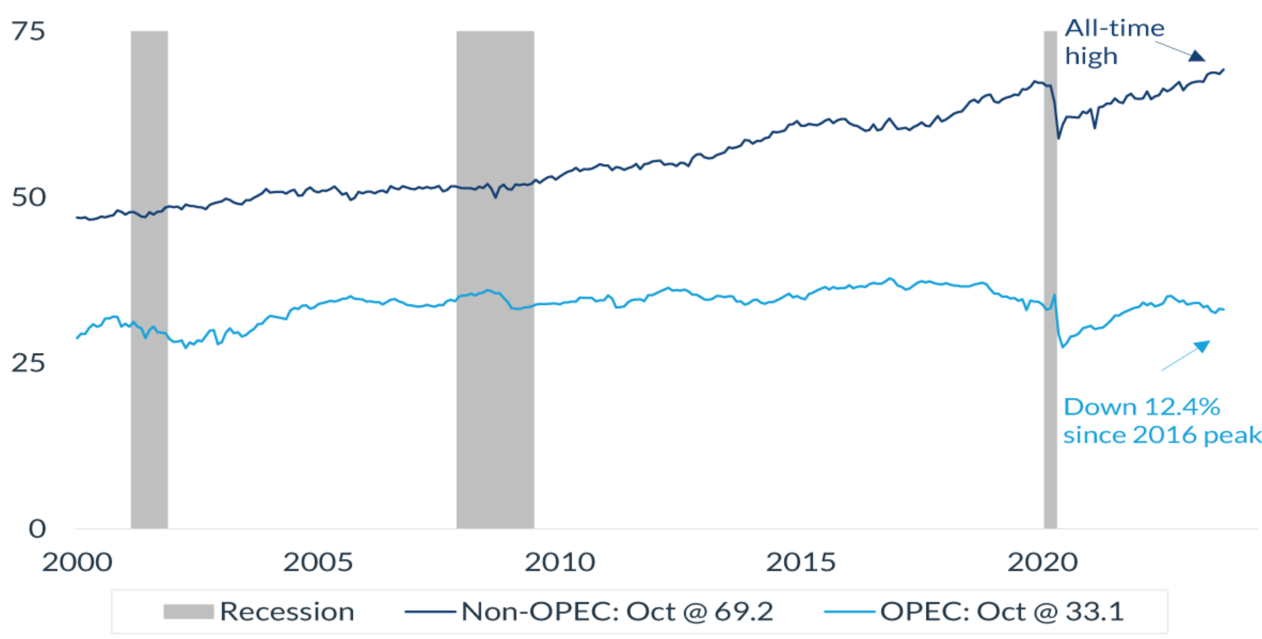
The prices have fallen due to declining demand, most notably from China, which is facing a slower pace of economic growth. China is the world's largest importer of oil.

At the same time, oil production has not fallen as much as Saudi Arabia, which plays the leading role in OPEC, would like. OPEC+ (OPEC with Russia and a few of its allies) have cut production this year. Saudi Arabia, the main force behind reducing supply, is producing 9 million barrels per day, down 2 million from a year ago.

But non-OPEC members have been increasing their production, most notably from the United States and Brazil. These countries are producing near-record levels of oil. Unlike OPEC, these countries have capitalistic economies and are trying to recoup their investment as soon as possible. So, they have been extracting oil as fast as possible, adding to the supply.

World Crude Oil and Liquid Fuel Production

millions of barrels per day



Sources: U.S. Department of Energy, as of October 2023.

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Is the current equity rally sustainable?

November was a banner month for stock investors. The S&P 500 gained 9%, the best return in nearly a year and a half, and the seventh-best monthly return in the last 30 years. Even more encouraging, the rally has become increasingly broad-based beyond the “Magnificent Seven” megacap tech stocks that have dominated headlines and investor returns this year.

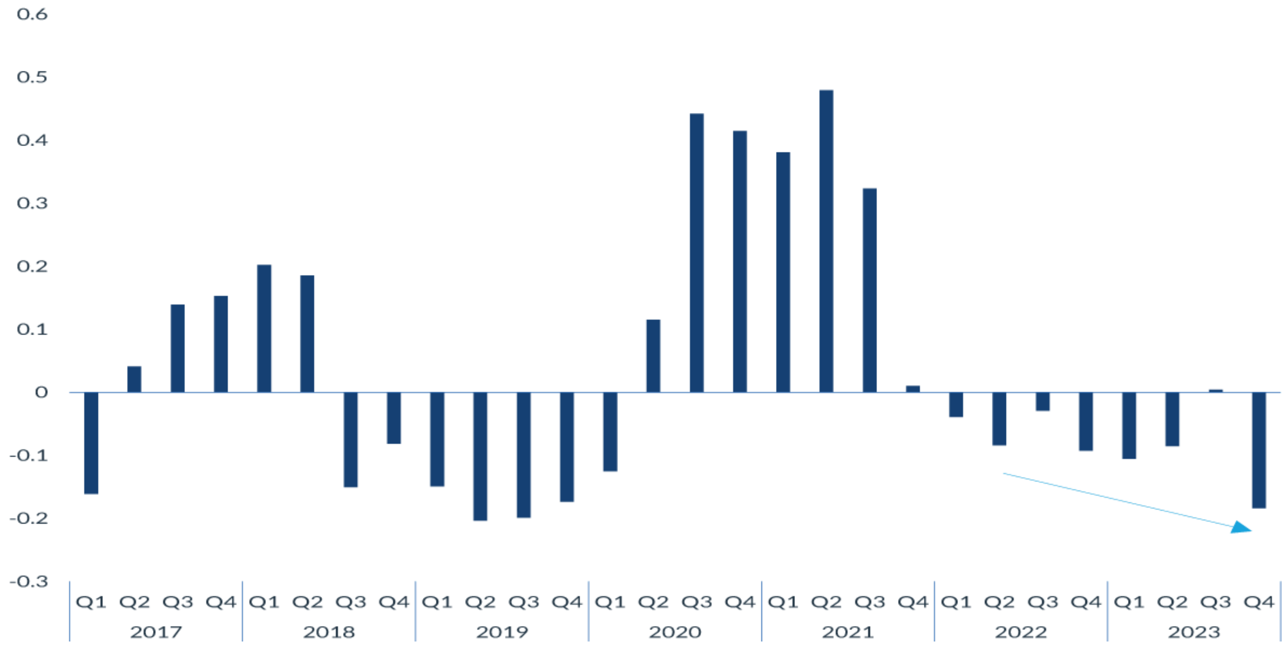
Fueling this broad market rally has been a steep drop in bond yields with investors anticipating Fed interest rate cuts in 2024 in response to cooling inflation. While the reaction in markets to recent positive developments, particularly on the inflation front, is understandable, we still advise caution in the near term.

Although the Fed has likely finished its rate hiking cycle, we think officials will be in no rush to cut rates as inflation remains above target. As market expectations are eventually forced

to adjust in the direction of our forecasts, the recent pace of improvement in interest rates will be difficult to sustain and yields could again come under pressure.

There are also rising concerns about Corporate America's profit outlook. Despite a stronger-than-expected result for the third quarter, earnings guidance momentum is hovering at the lowest level since 2019. Q4 EPS growth estimates have already been downgraded from 8% to 2.9% over the past two months, amid noticeably increased concerns about consumers, while companies maintain caution regarding the high cost of capital.

Looking forward, we continue to believe the path of earnings season will be critical to the market's direction for the rest of the year and early 2024. With economic growth set to slow markedly in coming quarters, we suspect negative earnings revisions ahead could be a renewed source of pressure on stock prices before a more durable rally takes hold.



Source: Bloomberg, as of December 2023.

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Do municipal bonds provide long-term value for investors?

In a sharp reversal of fortune for municipal bonds, November is shaping up to deliver exceptional performance for investment grade (IG) and high yield municipal (HYM) investors. According to Bloomberg municipal indices, IG and HYM bonds rewarded their

investors with 6.35% and 7.75% monthly returns, respectively. During 3Q2023, when absolute yields increased across the municipal curve to their highest levels in at least fifteen years, the recent rally has not diminished the attractive buying opportunities available for long-term investors. Price fluctuations and market volatility tend to anchor investors to a short-term view, especially when municipal technical indicators, such as bond fund outflows, temper demand or performance prints disappoint, which may shift asset allocation decisions. However, municipal bonds provide essential diversification benefits (low correlation to other asset classes) and tax-efficient income. Municipal forward-looking return potential may improve when absolute yields rise above their historical averages while generating a stable source of cash flow.

Turning the "muni yield curve clock" back to October month-end, index yield-to-worst (YTW) for IG bonds, per Bloomberg municipal indices, reached approximately 4.5%, while HYM index YTW touched about 6.5%. While current absolute yields are off recent highs, given the rise in bond prices across fixed income since the beginning of November, taxable equivalent yields (TEY at 37% federal tax rate) of about 6% and 9.5% for IG and HYM bonds*, respectively, still stands for a compelling opportunity to lock in a higher-quality portfolio of municipal bonds. As yields rise, it is important to note the value of each incremental basis point earned on a tax-equivalent basis increases. Given this relationship and current yields in the municipal bond market, staying engaged should compensate long-term investors on a relative and risk-adjusted basis. Over the near term, seasonal factors, like constrained supply, could further extend positive performance. December has delivered positive total returns since 2014. We continue to see continued entry points for income-oriented investors.

Municipal Yields Remain Attractive on an Absolute and Tax-Adjusted Basis

Sources: Bloomberg, as of November 2023.

*The Bloomberg Municipal Bond Index is used for Investment Grade Bonds, while the Municipal High Yield Index is used for High Yield Municipal.

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-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 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 obligation 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 defaulting.

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 infla on is a measure of the trend in rising prices, PCE is an important metric in determining infla on.

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