CITY NATIONAL ROCHDALE
AN RBC/CITY NATIONAL COMPANY

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ON THE RADAR

FAQs on the Markets and Economy

What does CNR make of the negative GDP report for Q1?

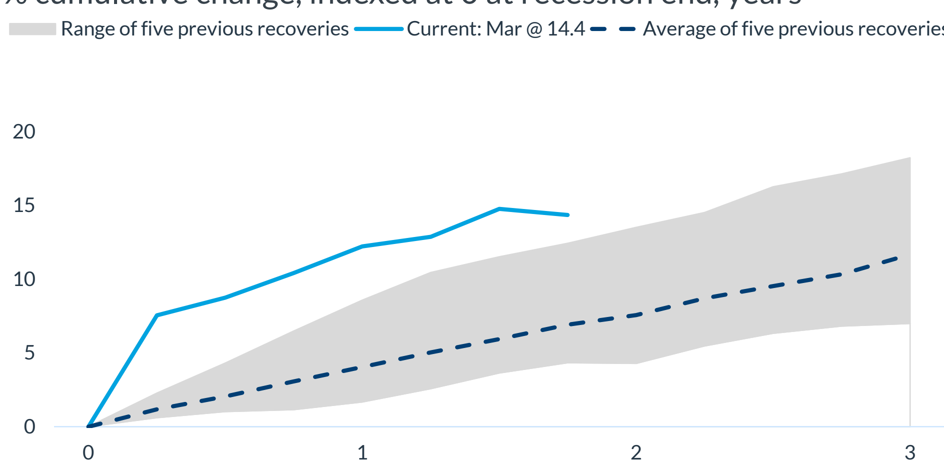
GDP took a surprising decline in Q1, falling 1.4%. It was brought down by the trade deficit widening and a slower pace of inventory growth. However, the pace of consumer spending remains strong, increasing 2.7% quarter over quarter.

Despite the decline in Q1 growth, this expansion continues on a steep upward trajectory, especially compared with past expansions (see chart). The GDP report does not alter our view of a multi-year recovery. First, let's put some context around this report. The unemployment rate is at 50-year lows with plenty of jobs available, wages are up, and household balance sheets are solid. When concerned about the risk of a recession, the first place to look is a sharp decline in domestic demand. We do not see that happening in the near term. What caused Q1 GDP to be negative was demand being too strong. The trade deficit resulted from demand outpacing domestic production, so imports had to be increased to meet that demand. Inventories had trouble recovering because demand is too strong. This is why the Fed has to raise interest rates along the entire curve to slow down the pace of demand. For some, the concern is that the Fed over-tightens and chokes off demand. But with the interest rate still hovering around the emergency level of near-zero percent, the Fed needs to have several hikes to bring the rate up to the neutral level, never mind a restrictive level. The risk of a recession is far out in the distance.

KEY QUESTIONS

- What did the Fed decide at their recent meeting?
- What's behind recent market volatility?
- What are the credit quality trends of U.S. States?

Gross Domestic Product
% cumulative change, indexed at 0 at recession end, years



Source: Bureau of Labor Statistics

What did the Fed decide at their recent meeting?

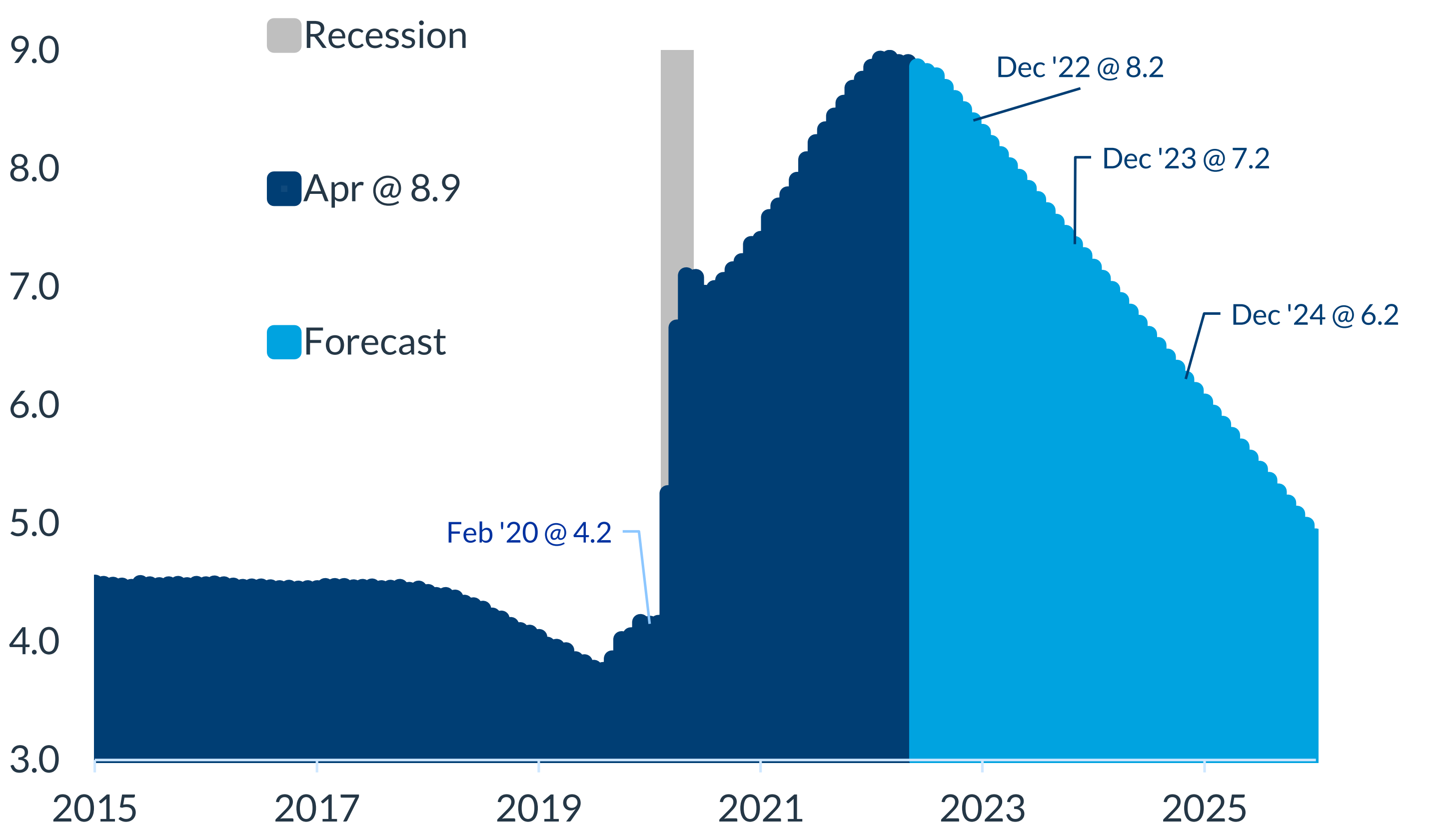
The Fed is taking a double-barreled approach to removing monetary stimulus. Regarding the federal funds rate, they just approved a rare 50 bp increase. That will put the median funds rate at 0.875%.

That increase was the largest jump in the funds rate since 2000. For the past 20 years or so, they had only raised rates in 25 bp increments.

In regards to the balance sheet, they plan to shrink their bond holding. They will taper into this strategy. Starting in June, they will allow bonds in their portfolio to mature without reinvesting the proceeds. For the first three months, they will allow $30 billion in Treasuries and $17.5 billion in mortgages to mature. After that, they will ramp it up to $60 billion in Treasuries and $35 billion in mortgages.

The Fed has a tough job ahead of them. They are attempting a soft landing of the economy. The slower pace of growth should help bring down the inflation rate toward its target of 2.0%

Fed Balance Sheet
$, trillions, not seasonally adjusted



Source: Federal Reserve

What's behind recent market volatility?

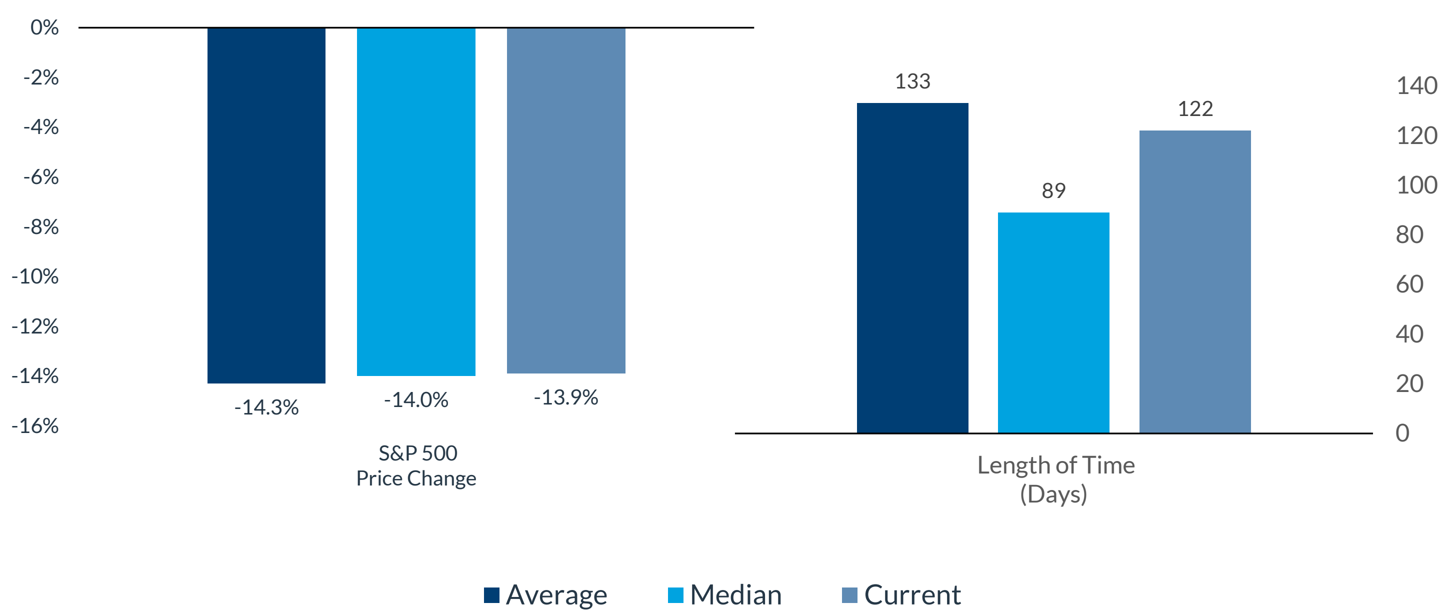
With 2022 shaping up to be one of the worst starts ever for the S&P 500, markets continue to grapple with the potential impacts of Fed tightening and higher inflation on the economy, corporate profits and stock valuations, in addition to heightened uncertainty around the global outlook.

While risk to the outlook has risen, and further downside is possible, some perspective is also in order. Even with sharply higher interest rates, US stock valuations remain attractive relative to bond valuations. Meanwhile, earnings in aggregate have been relatively strong, with approximately 80% of companies in the S%P 500 reporting better than expected results in Q1, and forward earnings estimates remain over the long-term average.

Although the volatility seen this year can be uncomfortable, we continue to think the strength of underlying US fundamental conditions should offer broader support to stock prices over time. Recession risk over the next 12 months remains fairly low and corrections tend not to become prolonged bear markets when the outlook for economic and corporate profit growth remains positive.

So far the current correction of 13.9% is not abnormal and matches closely in line with the historical postwar average of 14.3%. We are now likely headed toward later stages of this economic cycle, which is typically marked by more modest returns and higher volatility. Equity markets tend to hold up reasonably well during this period, but as the cycle advances, liquidity is withdrawn and growth slows, the investment backdrop becomes more challenging.

S&P 500 Corrections
(1946-2021)



Source: Federal Reserve

What are the credit quality trends of US States?

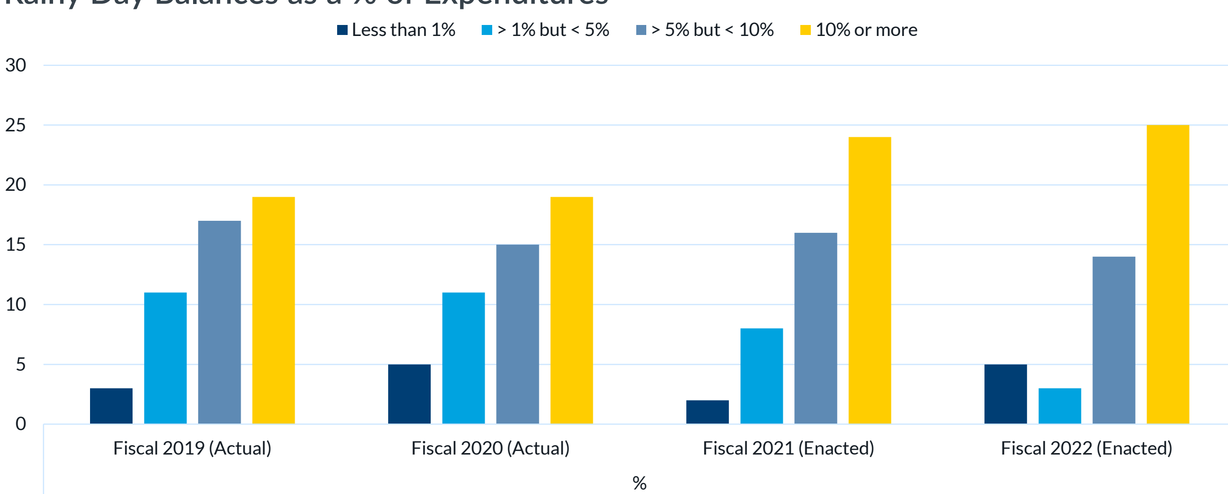
Despite the evolving macroeconomic and policy environment, US state quality benefits from positive credit and sector fundamentals that should persist over the near term, further bolstering fiscal positions ahead of the next budget cycle beginning July 1st (for 46 states).

Since the initial months of the pandemic, the rebound in most states' economies, particularly labor gains and consumer spending, is leading to solid tax collection performance and surplus revenue. According to the Urban Institute, FY 2021 total state revenues recovered nicely with a more than 17% increase year-over-year (YoY), while FY 2022 forecast revenue is in line for at least 4% YoY growth. State budget projections for FY 2023 show a slowdown in tax collections as the national economy moderates, exposing potential downside risks amid geopolitical events and U.S. monetary policy decisions. However, federal aid and reserve build-up should support a timely budget enactment process in the coming weeks.

Per a recent survey from the National Association of State Budget Officers (NASBO), projected rainy day balances for states will be stronger this budget cycle than pre-pandemic FY 2019, enhancing budget flexibility. Moreover, liquidity levels remain sound, an essential cash management tool typical of state governments that helps underpin the strong credit ratings of the sector (high-AA quality on average). We continue to monitor the increasing number of states either proposing or enacting tax reform, such as lowering personal income tax rates and property tax rebates to temporary suspensions of the gas tax, among other legislative actions. Prudent planning paired with the maintenance of sufficient reserves and other fiscal safeguards is necessary to achieve budget balance and mitigate potential pressure at both the state and lower levels of government, such as cities and counties.

Last year, the above-target financial market returns improved the funded status of many of the largest public pension plans of states. PEW data calculate FY 2021 pension funded ratios exceeded 80% for the first time since the financial crisis of 2008-2009. CalPERS earned above 21% in California, raising its funded ratio to 82%. Some states used excess returns to improve their plan assumptions, while others used budget surpluses to augment scheduled pension contributions. Current financial market volatility underscores the need to continue managing long-term liabilities effectively. Nevertheless, most states enter the upcoming FY in a reasonably good position to maintain budget stability.

Rainy Day Balances as a % of Expenditures



Source: NASBO Fiscal Survey of the States

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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 which 38% are school members, 31% public agency members, and 31% state members.