CITY NATIONAL ROCHDALE
AN RBC/CITY NATIONAL COMPANY

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ON THE RADAR

FAQs on the Markets and Economy

As we are starting a new year, what is the Federal Reserve thinking?

The most important message from the mid-December Federal Open Market Committee (FOMC) meeting was the Fed reaffirming its resolve to tame inflation by bringing it back to its target rate of 2.0%.

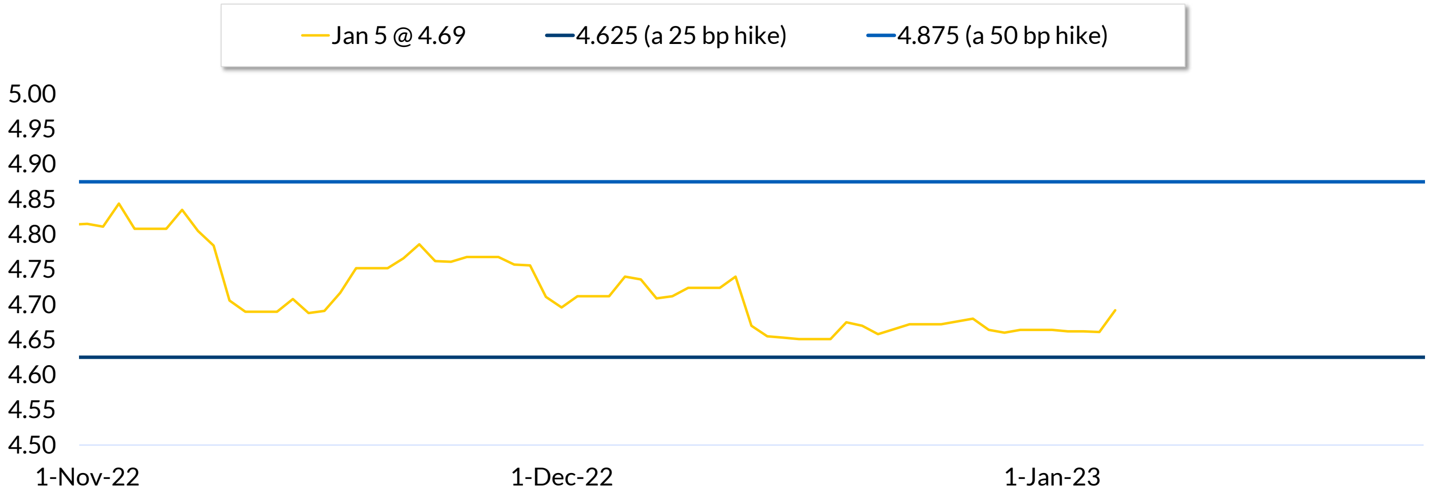
In addition, it also warned the markets not to expect a pivot to lower rates in 2023, which many Wall Street firms are expecting.

At the same time, the Fed will slow the pace of its interest rate increases. At the December meeting, it raised the federal funds rate by 50 basis points, a slight decrease from the record four hikes of 75 basis points from its previous meetings. The outlook for the next FOMC meeting on Feb. 1 is for a 25 basis point (bp) hike (see chart). This is where the Fed is concerned. It does not want the markets to misinterpret the slower rate increases with the belief that the Fed will soon be cutting interest rates. Although inflation has turned a corner, it is still a long way from getting near the target rate, so the Fed believes it needs to stay on course with interest rates being higher for longer.

KEY QUESTIONS

- **What is the outlook for labor in 2023?**
- **What is the investment outlook in 2023?**
- **The Fed and reinvestment risk. Is it time to extend the duration?**

Federal Funds Futures — Feb. 2022 Contract
%, implied rate



Source: Bloomberg, Jan. 5, 2023
Please note: Information is subject to change and is not a guarantee of future results.

What is the outlook for labor in 2023?

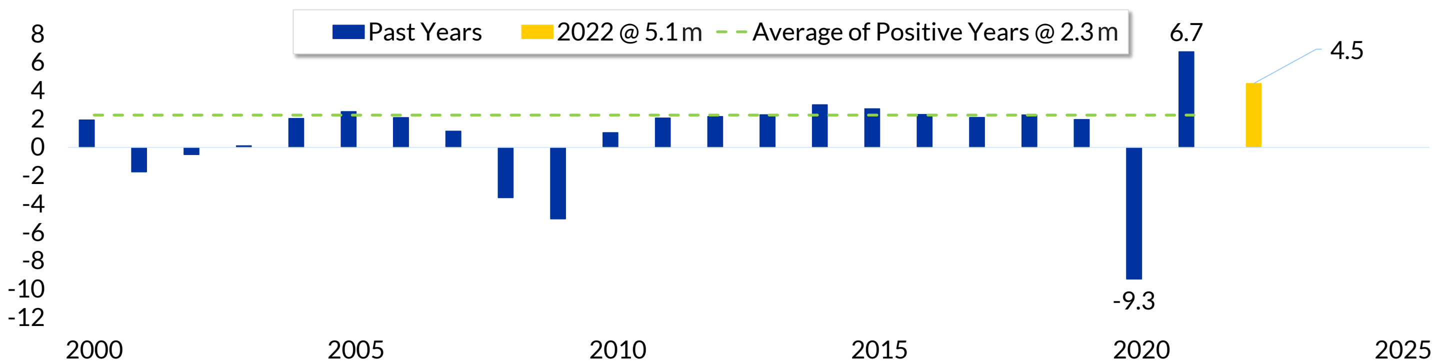
Understanding that 2022 was a red-hot year for the labor market is essential.

There were 4.5 million workers hired, which is about twice as strong as a good year (see chart). There are currently 153.5 million workers, 1.0 million more than the peak before the recession. In addition, hiring managers have 10.5 million job openings, which is about twice as many as the long-term average (5.1 million).

The outlook for 2023 is not as robust. With the Fed aggressively raising interest rates and the pace of the domestic economy slowing, and many parts of the global economy headed into a recession, job hiring is sure to slow down. There have been headlines of layoffs in some parts of the economy (technology, entertainment and real estate). Most sectors were over-hired during the solid economic rebound following the pandemic. The broader economy has not seen many layoffs.

The big question for the labor market is, "How severe will the recession be?" The answer will determine how most other businesses respond to changes in their labor force. If there is a mild recession, expected by economic surveys, there may not be a significant change in employment. Businesses may hold onto their workers during the mild slowdown for fear that if they lay off workers, it might be too difficult to hire back qualified workers. On the other hand, if the recession is more severe than expected, layoffs in the broader economy are expected to rise.

Nonfarm Payrolls — Yearly Change
millions, seasonally adjusted



Source: Bureau of Labor Statistics, December 2022

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

What is the investment outlook in 2023?

After the worst year for financial markets in decades, we see reason for optimism in 2023.

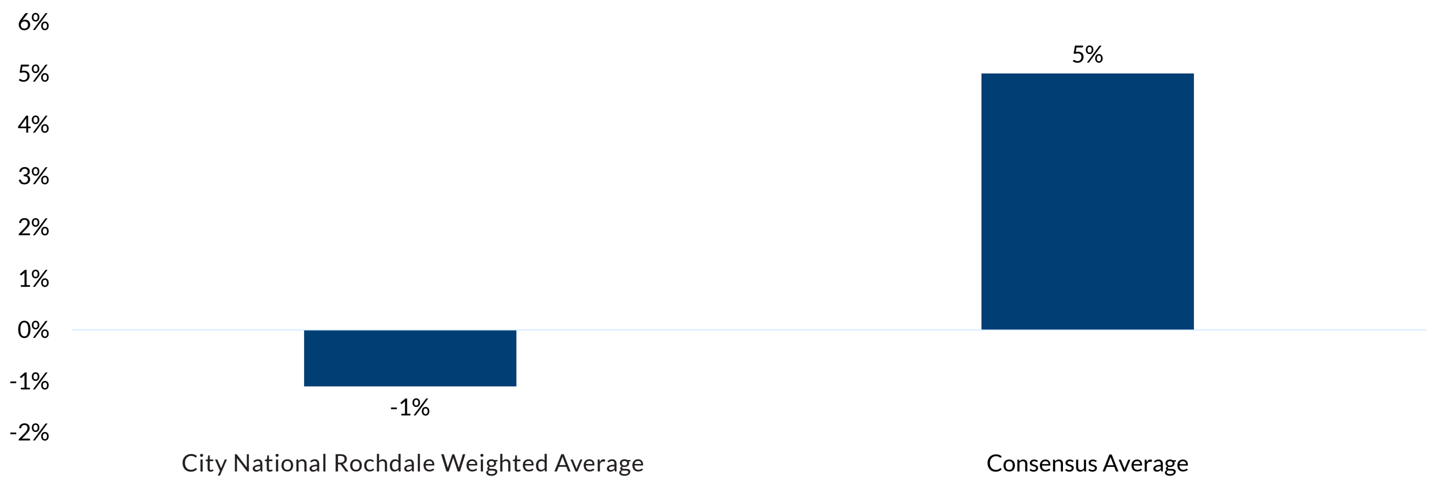
However, investors will likely need to first show a bit more patience. A recession in the first half remains our most likely economic probability, and we continue to recommend caution in the near term, with earnings expectations the biggest downside risk for equity markets.

The good news is that the argument for a relatively short and shallow recession remains strong. Despite the headwinds of higher interest rates, household balance sheets remain healthy, labor demand continues to be resilient and banks are well-capitalized. All of these factors should help mitigate against the risks of any downturn in economic activity turning into a deeper recession and a more serious structural bear market developing.

Still, even in a scenario where the economy enters a mild recession, we would expect earnings growth to contract, at least modestly. For some time, we have argued that earnings estimates will likely have to be lowered to reflect the challenging macroeconomic backdrop ahead and rising recession risk. Although consensus expectations for 2023 have declined over the past couple of months, they remain at a healthy 5%, suggesting further downward revisions are likely before a sustainable recovery in equity prices begins.

Market bottoming will be a process that could take more time to play out, and more volatility is likely until investors gain greater clarity on the path for rate hikes and inflation, and weigh their implications for the economy and corporate profits. In the meantime, we remain happy with the de-risking steps we've made over the past year, including our overall modest underweight to equities with a focus on quality and income U.S. stocks, and our increased allocation to investment-grade taxable and municipal bonds that now offer some of the highest yields and relative value in 15 years.

2023 S&P 500 Earnings Growth Estimates



Source: FactSet

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

The Fed and reinvestment risk. Is it time to extend the duration?

Since March of 2022, the Fed has aggressively increased its target interest rate in an attempt to curb the worst inflation seen since the 1970s.

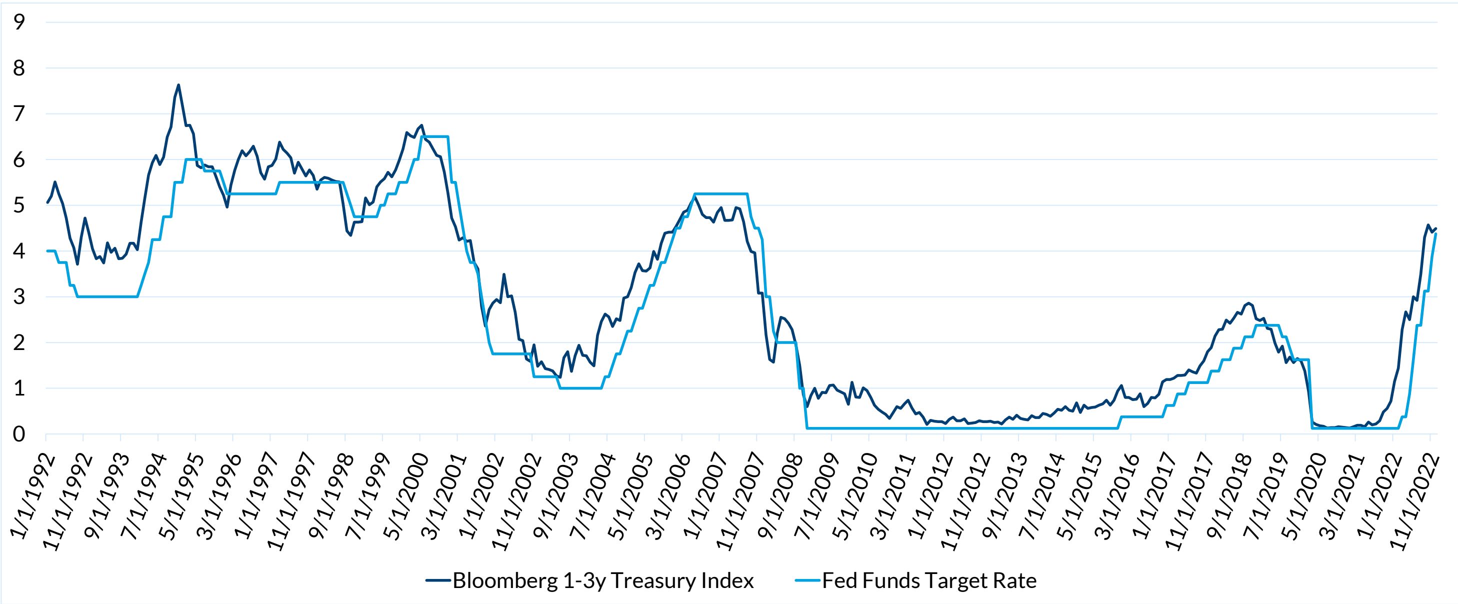
That key figure has risen from a modest 0.25% to more than 4.5% today and is expected to reach 5% before the cycle is through — a boon for short-term investors.

Indeed, after years of near-zero certificate of deposit (CD), bank sweep and government bond yields, investors can earn a healthier return on their cash. As a result, demand for Treasury Bills, floating-rate and ultra-short bonds, and bond funds has spiked, with some retail funds doubling their assets over the past 12 months.

As the Fed gradually reins in inflation and potentially pushes the economy into recession, short-term rates will eventually fall. City National Rochdale® sees a ~60% probability of a mild recession in 2023, as well as an end to the Fed hiking cycle, which should encourage investors hiding out on the short end of the yield curve to consider re-adding duration to their portfolios.

Treasury Bills and floating-rate notes provide increased income during hiking cycles, but reinvestment risk looms large as those rates peak and begin to fall. The chart below illustrates not only how closely short-term government yields follow the Fed's rate decisions, but how short-lived those "peak" rates can be. As a result, an investor rolling short Treasurys could see interest income halved in only a few short months.

Federal Reserve Target Rate vs. US Treasury Yields



Source: Bloomberg, Dec. 31, 2022

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

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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 U.S. Dollar-denominated, high-yield, fixed-rate corporate bond market.

Moody's Investors Service, often referred to as Moody's, is the bond credit rating business of Moody's Corporation, representing the company's traditional line of business and its historical name. Moody's Investors Service provides international financial research on bonds issued by commercial and government entities.

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 time.