CITY NATIONAL ROCHDALE
AN RBC/CITY NATIONAL COMPANY

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ON THE RADAR

FAQs on the Markets and Economy

With the strong data at the beginning of the year, what do you think the Fed will do at its upcoming meeting?

Economic reports from the past few weeks have added to earlier data confirming January had a stunning economic turnaround.

It has caused a sharp reassessment of what the market thinks the Fed needs to do to slow the pace of economic growth and bring down inflation. This year's peak rate in the federal funds' futures had jumped almost 50 basis points (bps) since before the economic reports were released (see chart). The earlier belief that the Fed will need to cut interest rates later this year is no longer the general assumption. Higher for longer continues to be the Fed's mantra.

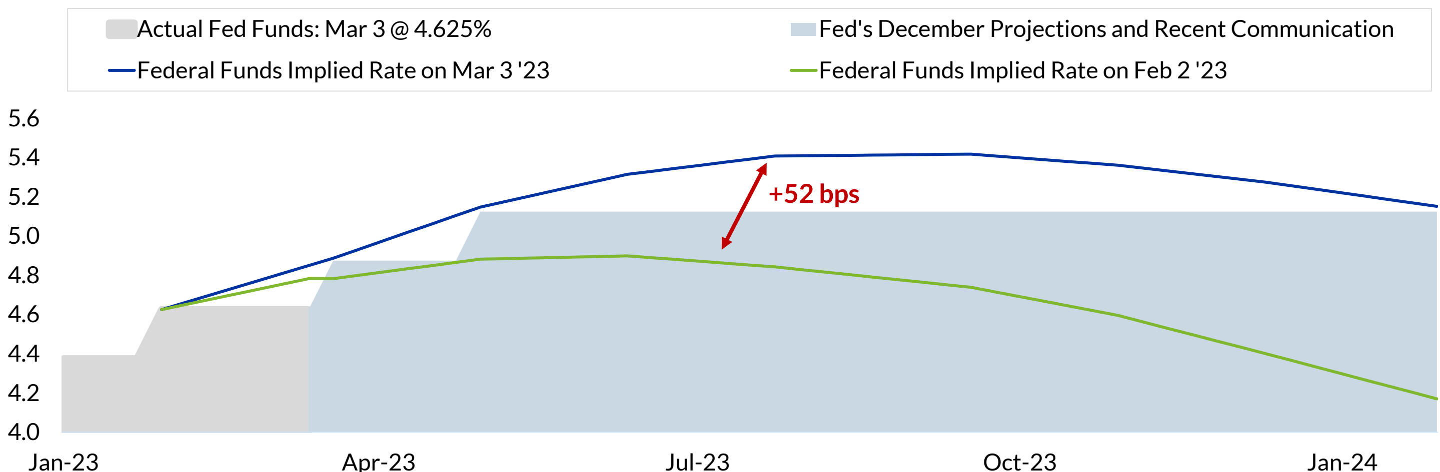
The question is, will this hot pace continue or not? How much of January's strength can be attributed to seasonal adjustments or the switch from brutal weather in December to warm January weather? Fortunately, much of the important economic data (labor, ISM, CPI & retail sales) for February will be released over the next few weeks and before the next FOMC meeting on March 22.

We believe that the Fed will raise the federal funds rate by 25 bps to the median level of 4.875% at its March 22 meeting.

KEY QUESTIONS

- **At what point will the higher level of interest rates start to slow down consumption?**
- **Is recent international equity outperformance sustainable?**
- **Certificate of deposit rates are finally attractive, or are they?**

Fed Funds: The Fed vs. Market Expectations (%)



Sources: Bloomberg, Federal Reserve; February, 2023

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

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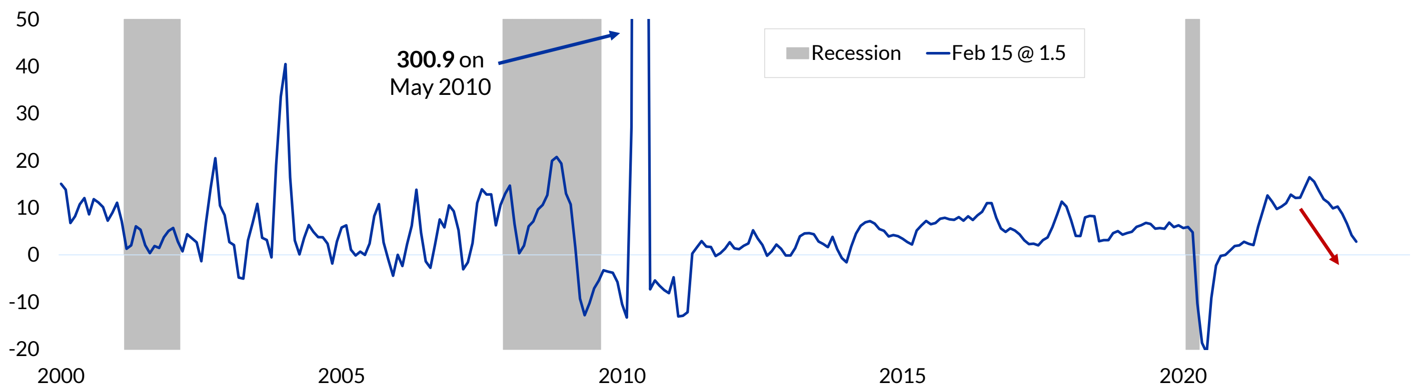
At what point will the higher level of interest rates start to slow down consumption?

Although the strong labor report, robust spending, and waning disinflationary pressures are capturing the headlines and keeping the outlook of a robust economy alive, there has been some important information from banks.

There has been a marked shift in loan demand. It may be because interest rates are now well into the restrictive territory, or because banks are becoming more stringent in lending due to growing fears of a recession and the quality of their loan portfolios (especially commercial real estate). In the past few quarters, almost half the banks have tightened their lending standards to the level only seen in past recessions. This includes widening the spread over the cost of funds, tighter loan covenants and collateralization requirements, shorter maximum maturities, and a reduction in the sizes of credit lines. The numbers of consumers and businesses wanting loans are fading. More importantly, the growth rates in the numbers of consumer and business loans is falling (see chart). This economy runs on credit, but without that credit expanding, economic growth will slow over the next few quarters.

Consumer Loans
%, 3-month change annualized



Source: Federal Reserve, February 15, 2023

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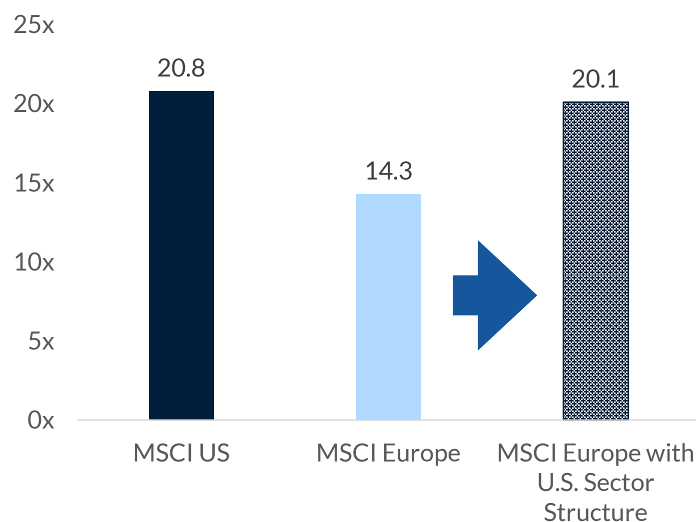
Is recent international equity outperformance sustainable?

After meaningfully lagging over the past several years, international stocks have outperformed U.S. equities since last November.

Among the reasons for this recent outperformance are the perception that European valuations were cheap, and that Europe's economy was not in as bad a shape as feared, as well as optimism around China's reopening. While it is not surprising for international equities to have periods of outperformance, we do not think such outperformance is sustainable over the longer term. Indeed, with the current rally in particular, markets seem to have priced in all the positives and none of the negatives surrounding the outlook ahead.

Trailing P/E Ratios in Europe and in the U.S. (Raw Data and Sector-Adjusted)



Sources: FactSet, Ned Davis Research, as of February 2023
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In Europe, economic data has been surprisingly resilient as consumers benefited from a milder-than-expected winter and declining energy prices, but growth expectations remain subdued. The economy still faces strong headwinds from high inflation, and with European Central Bank (ECB) policymakers behind the curve, the drag from rising interest rates looks set to intensify in coming quarters. Meanwhile, with no end in sight, the Ukraine War continues to weigh on consumer and business sentiment.

For investors, European corporate earnings also continue to significantly lag behind their U.S. counterparts and longer-term expectations remain lower. Relatedly, much of the difference in valuations between the U.S. and Europe can be explained by different sector structures of the equity markets. Euro equities are as expensive as U.S. equities when viewed on a sector-adjusted basis.

In China, near-term consumption is expected to get a significant boost from the lifting of virus restrictions, but reopening effects will likely be smaller and shorter-lived than seen in other advanced economies, due to relatively less accumulated savings and destruction of net wealth. Chinese policy uncertainty also remains significantly elevated based on rising tensions with the U.S. and West, continuing support for Russia, and a radical shift in the country's economic model from one prioritizing economic growth to one that emphasizes common prosperity and national security over profitability and shareholder rights.

Given all this, we continue to believe the U.S. equity market outlook remains the most resilient for investors. As reflected in our 4Ps framework, the U.S. economy holds a significant advantage across several policies, demographics, potential for innovation, and profitability criteria that drive long-term growth. For CNR to become more constructive on the outlook for international equities, we would likely need to see several important changes, including an end to the war in Ukraine and a reversal of authoritarian trends in China, among other developments.

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Certificate of deposit rates are finally attractive; or are they?

It's no secret that short-term interest rates have skyrocketed, moving from 0.04% to 4.81% in fewer than 14 months.[1]

Cash pays well for the first time in more than 15 years,[2] but now that cash investments are attractive, where should you invest? This is often a confusing decision, given options from Certificates of Deposit (CDs), Commercial Paper (CP), Money Market Funds, and Repurchase Agreements to Treasury Bills (T-Bill), Short-Term Corporate Debt, and plain-vanilla Deposit Accounts.

We've found that investors feel two times worse about losing money than they feel good about making money,[3] so decisions are often led by what is perceived as the safest option. As a result, investors discard investments not backed by the FDIC, and with many online banks, such as Capital One, Synchrony and Goldman Sachs' Marcus offering rates above 4% for one-year CDs, why do anything else[4]?

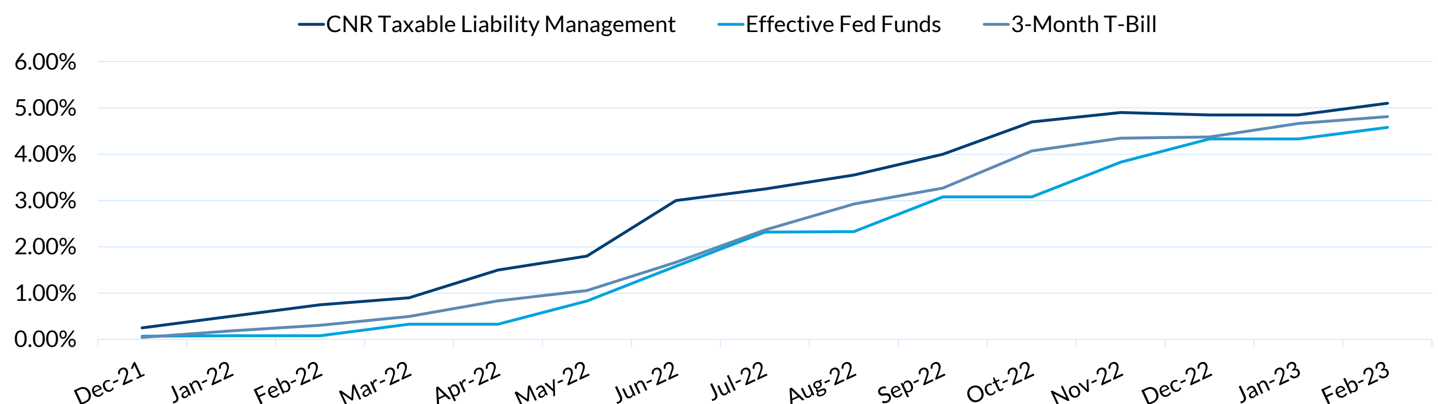
For starters, a six-month T-bill pays 5.08%[5] and, if you check your bank's rates, they are likely closer to the national average for a one-year CD of 1.44%[6]. FDIC insurance is nice, but not foolproof, and it only protects investors up to a limit of $250,000. Historically, the FDIC has failed to support investors impacted by fraud. T-bills are backed by the U.S. Government and can be purchased in unlimited amounts through an investment account. While concerns about the debt ceiling are valid, history shows that the Treasury would be forced to prioritize T-bill payments and keep paying debts. From a tax perspective, CDs are subject to state, local and federal tax while T-bills are only subject to federal taxes, saving investors in high-tax states a significant amount of money.

The investment decision becomes even clearer when comparing an investment account to bank solutions, even assuming investors could access Fed rates over the past 14 months that have been far higher than any comparable bank product. Assuming a $10 million balance, the investment account resulted in an $82,000 income advantage.[7]

Components of a managed account include overnight repurchase agreements, which are backed by treasury collateral and move in lockstep with Fed rates and short-term corporate debt through bonds and commercial paper. These investments are often the underlying positions in Prime Money Market funds and can yield well over 5%.[8] Your cash in a bank savings account may be sitting in these asset classes already and at eye-popping fees when an investment account is available at much lower expenses.

So, the next time you are tempted to spring for that CD, consider the whole spectrum of offerings and remember that working with an investment manager can result in substantial outperformance.

Active Management Relative To Short-Term Fed Rates



Source: Bloomberg, *REFER TO COMPLETE ARTICLE REFERENCES ON PAGE 6*

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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: The Consumer Price Index (CPI) measures the monthly change in prices paid by U.S. consumers. Changes in measured CPI track changes in prices over time.

4P: The 4P analysis is a proprietary framework for global equity allocation. Country rankings are derived from a subjective metrics system that combines the economic data for such countries with other factors, including fiscal policies, demographics, innovative growth and corporate growth. These rankings are subjective and may be derived from data that contain inherent limitations.

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ARTICLE REFERENCES

[1] U.S. 3-Month T-bill Yields as of 12/31/2021 and 2/28/2023, Bloomberg

[2] 8/6/2007 was the last time 3M T-bill rates were this high, Bloomberg

[3] Richard Thaler, “Misbehaving”

[4] Can be found on their respective websites

[5] U.S. 6-Month T-bills (8/31/23 bill) as of 3/1/2023, Bloomberg

[6] Bankrate 1-Year CD National Average, Bloomberg

[7] CNR Taxable LM yield sourced from the internally distributed Liquidity Dashboard. Effective Fed Funds data sourced via Bloomberg. Bank Deposit Index and the National Rate Cap sourced from the Federal Reserve (FRED).

[8] 90-Day Commercial Paper yields 4.83%, Fed Repo (SOFR) yields 4.52%, 1-Year Corporate Debt yields 5.55%, Bloomberg

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