City National Rochdale
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Economic & Market Perspectives

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WHIPLASH! HERE WE GO AGAIN

Matthew Peron, *Chief Investment Officer*
Paul Single, *Managing Director, Senior Portfolio Manager*
Steven Denike, *Portfolio Strategy Analyst*

Since 2017, increasing concerns over trade and interest rates have taken turns bearing the weight of the market's attention. The result has been much more frequent and sizable pullbacks. Each time, though, the road back for investors has eventually led to new peaks in stock prices. We believe that the market will grow slowly with earnings; however, the journey ahead will likely continue to be rocky, as we are now late in the cycle.

KEY POINTS

U.S. economic expansion is slowing and aging, but fundamentals remain healthy.

Rising trade tensions are a concern, but impact for now should be manageable.

Fed tightening cycle appears over, with policymakers now ready to act should risk to the expansion rise.

Expect more moderate equity price returns ahead and higher volatility.

Underneath recent seesawing headlines on trade and interest rates has been a steady slowdown in economic momentum. Global cyclical data has been disappointing for well over a year, and while the U.S. economy maintains a growth advantage, it too has seen a steady decline in domestic demand since the second quarter of last year (see Figure 1).

None of this on its own is enough to set off alarm bells. We expected the U.S. economy to slowly succumb to the gravitational pull toward potential growth as the impact from the fiscal stimulus fades. But of course, these issues are partly intertwined. Lagged effects from last year's Fed tightening campaign and uncertainty around the Trump administration's trade policy has helped to offset some of the economic boosting effects from tax cuts.

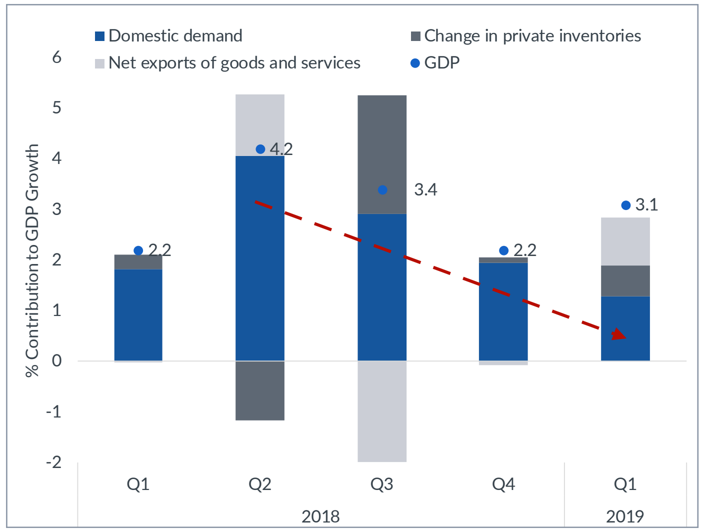
A prolonged business cycle like the one we are currently experiencing can properly be understood as being composed of a series of mini cycles, or alternating periods of accelerating and decelerating growth. Over the long term, economic growth may be tightly related to labor force and productivity gains, but shorter-term outcomes can be dominated by shifts in policy and their effects on psychology, or what economists have described as "animal spirits."

We've had three such growth cycles thus far in what is soon to be the longest expansion in history (see Figure 2). The question is, where do we go from here? Economic growth is slowing, but fundamentals remain reasonably healthy. Moreover, we still see few signs of overheating in sectors of the economy that have heralded some recessions in the past or the credit excesses that have preceded others. In theory, as long as imbalances don't accumulate, the economy should keep growing.

But the expansion is aging and becoming increasingly vulnerable to missteps in policy areas, such as trade and interest rates (see Figure 3). Many of the early-cycle growth impulses are behind us, and ballooning

FIGURE 1

U.S. Domestic Demand Slowing as Stimulus Boost Fades

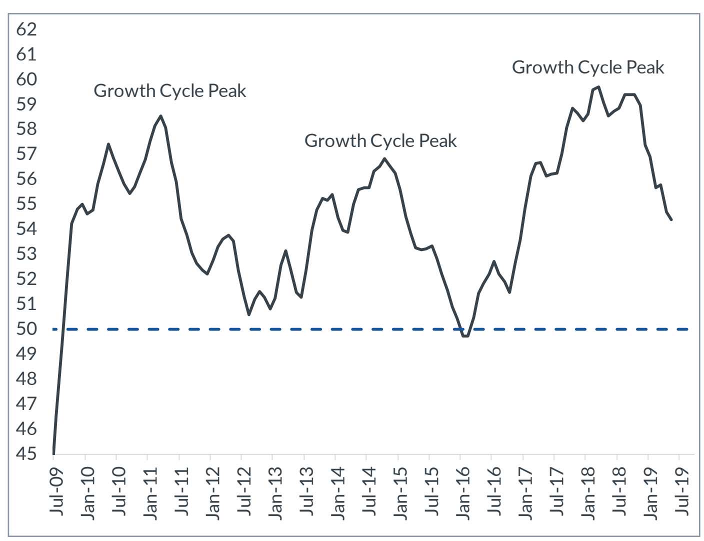


Source: Bureau of Economic Analysis as of 5/2019.

> ❝ A prolonged business cycle like the one we are currently experiencing can properly be understood as being composed of a series of mini cycles.

FIGURE 2

Expansion Has Consisted of a Series of Smaller Growth Cycles
ISM Composite (3-month moving average)



Source: ISM as of 6/2019.

federal deficit levels mean politicians going forward will be hard pressed to deliver the scale and scope of recent fiscal measures to boost growth should conditions deteriorate more than expected.

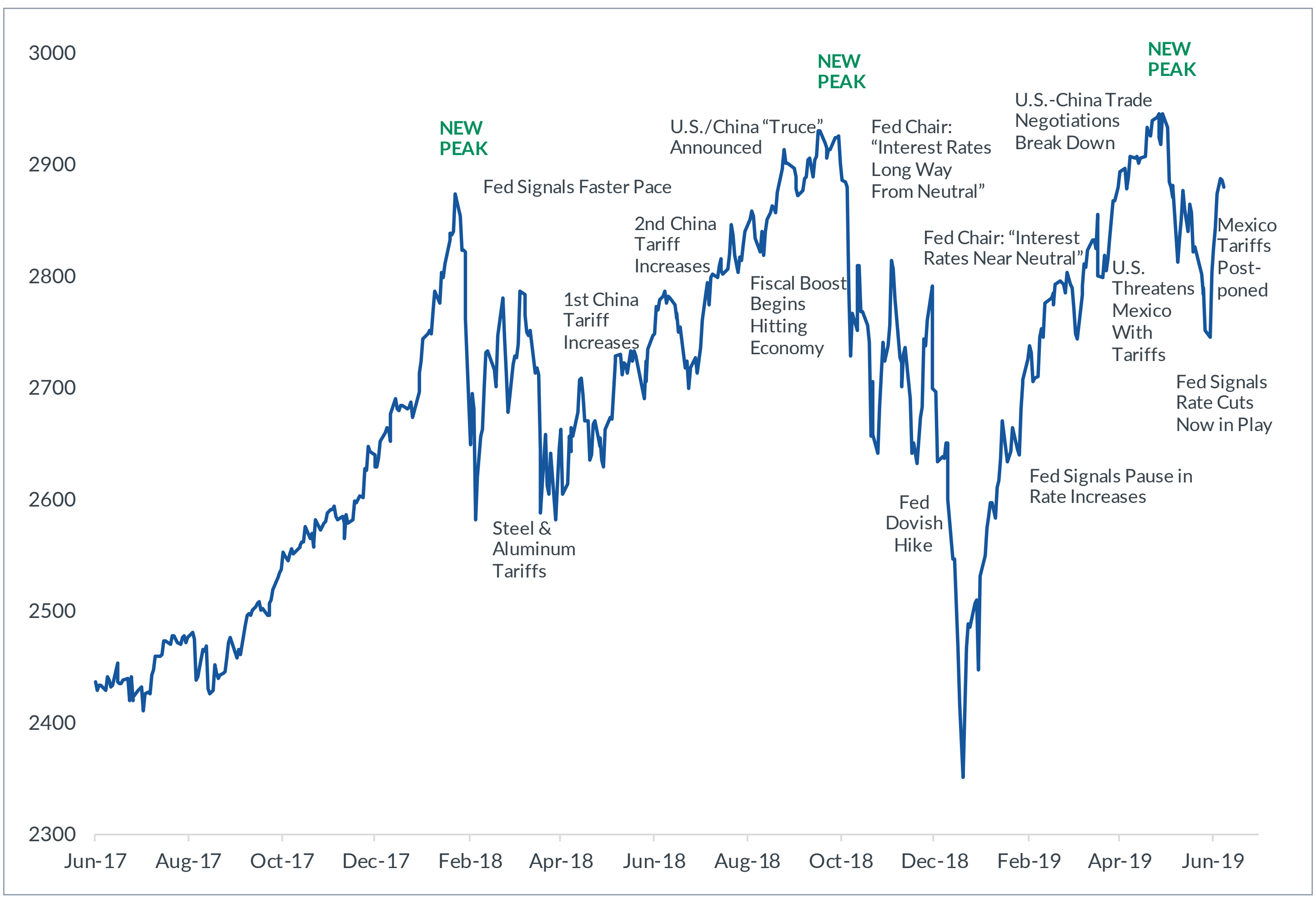
At the moment, the U.S. economy remains strong enough to withstand some trade-related headwinds. Trade with China accounts for only 1% of U.S. GDP, and we estimate the impact from current and potential tariffs will shave only about 0.35% off U.S. growth. However, the administration's threats to broaden its disputes with Mexico and other trade partners on key sectors like autos has grown more troubling. If the president were to follow through on all his threatened tariffs, it would act like a massive tax increase on American households and businesses, straining confidence and markets and perhaps ultimately short-circuiting the expansion itself.

We continue to believe that at least some superficial deals on trade will ultimately be struck, and worst-case scenarios will be avoided. Trade tensions have been running for over a year now, and uncertainty surrounding the issue has begun to weigh on overall global economic activity and corporate profits. Without such agreements, the greater potential harm will be to consumer/business confidence, which will impact decisions on spending, investment and hiring.

Fed officials are mindful of this burgeoning risk and have opened the door to one or more rate cuts this year. Though the sky-is-falling mentality captured by the recent rapid decline of U.S. and global interest rates seems overdone, officials appear ready to act in order to prevent the expansion from ending prematurely. A flexible Fed is a good thing. Low interest rates and accommodative policies have been a key source of support for rising

FIGURE 3

S&P 500



Source: FactSet as of 6/12/2019.

stock prices and may help to extend this long-running bull market.

For now, this has been enough to calm markets. In the meanwhile, May's selling pressure has helped relieve overly optimistic investor sentiment conditions that accompanied the late-April market highs. Recent corporate EPS results have also been better than feared, especially for companies with less overseas exposure, and we continue to see sufficient scope for earnings growth in the coming quarters to push stocks higher by year-end. However, with the market still up 16% YTD, returns from here are likely to be more muted and harder fought. As trade developments and incoming data shapes the Fed's expectations, policy uncertainty will likely continue be a central market driver ahead.

Complacency is the enemy of investors. For most of the past decade, asset prices have risen with limited interruption. But the investment environment has shifted, and the era of easy money is over. Late-cycle conditions of slowing growth, higher volatility and greater vulnerability to policy missteps require investors to change their approaches and be more selective in their portfolios.

In equity, we continue to carefully and methodically lower our risk exposure. Our focus is on higher-quality domestic companies, and we have reduced exposure to the cyclical and export-oriented sectors most affected by trade and global headwinds. We also like dividend-paying companies, which provide income and can help bolster returns in times of market stress. In fixed income, we still like credit as a way to earn a nice yield above treasuries, but we are careful to avoid overheated sectors.

More changes are likely to come as we respond to the maturing nature of the cycle. Investors can be forgiven if it seems they are ending each trading day with a sore neck and a headache. We wish we could say we expect the road will be smoother from here. But there are gains ahead to be made. A maturing cycle brings its own challenges, but also opportunities for investors who can proactively respond to shifting investment environments.

THE FED

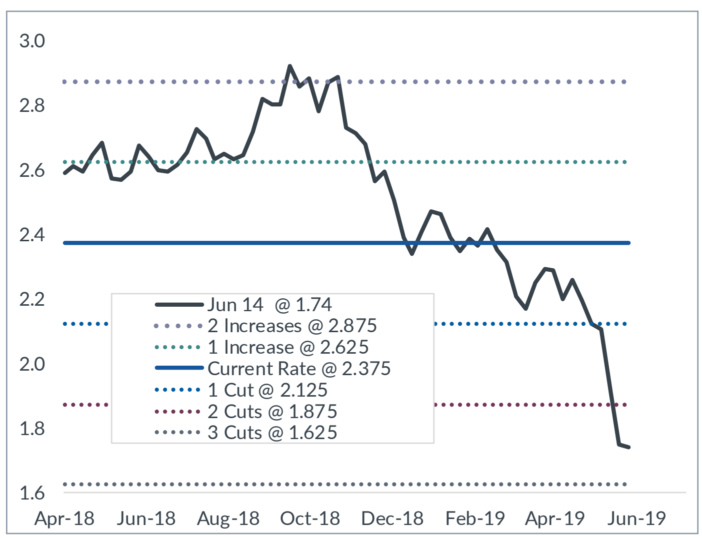
The Fed appears to be setting the stage for a possible easing of monetary policy sometime this year. Although the domestic economy still looks pretty decent (low unemployment, low inflation), there is growing pessimism about future economic growth brought on by the escalation of trade problems and the slowing global economy.

> “Many market forecasters and market participants are calling for an ‘insurance cut.’

Many market forecasters and market participants are calling for an “insurance cut” that will allow the Fed to lower rates to prevent the possibility of deterioration in the economy (see Figure 4). This will mirror what happened in the 1990s, when the Greenspan-led Fed lowered the federal funds rate to help extend the duration of that expansion. That expansion is on record as the longest-lasting one in U.S. history, at 120 months. This expansion is currently in its 120th month and come July will be the longest on record.

FIGURE 4

Federal Funds Futures Market Pricing in a Cut This Year
Yield of December 2019 Federal Funds Contract (%)



Source: Bloomberg as of 6/14/2019.

LABOR

The unemployment rate fell to 3.6%, depicting a robust pace of hiring and a shrinking labor pool. It has been at 4.0% or lower for the past 14 months and now stands at the lowest level since 1969. Gains in payroll continued to improve, with an increase of 263,000 in April. So far this year, this has been a volatile number, with gains ranging from a low of 56,000 (February) to a high of 312,000 (January). The wide range has been attributed to the polar vortex and poor seasonal adjustments.

Despite this range, the monthly average stands at 203,000, which is just above the 199,000 average of the past three calendar years. The streak of job creation stands at 103 months, marking the longest streak of job creation in modern times. Since the worst of the recession, there have been 21.4 million jobs created (see Figure 5), far outpacing the 8.2 million jobs that were lost as a result of the recession. Average hourly earnings, which were slow to improve in this expansion, have picked up in the past year as it has gotten more difficult to find skilled employees; the rate now stands at 3.2% year-over-year. This pushes off fears of an economic slowdown, something that plagued the market just a few months ago.

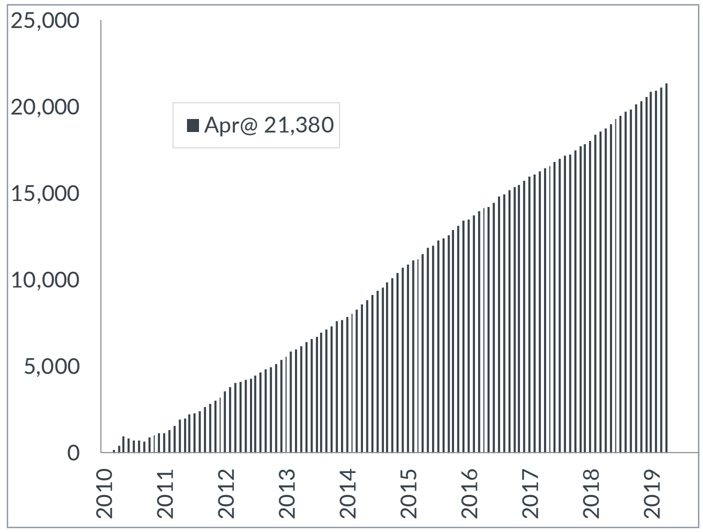
INFLATION

Strong price pressures continue to elude the Fed. The year-over-year change in inflation registers at just 1.6%, well below the target level of 2.0%. The three-month annualized rate of change is just 1.3% (see Figure 6). Fed Chair Powell blames the recent downturn on transient factors. We have seen that in some sectors, like the large inventory of new unsold cars keeping used car prices low. The Fed is not the only central bank with this problem; inflationary pressures around the world are consistently below central banks' target levels.

With the tariffs already imposed and additional ones threatened, we will be seeing higher prices on many products. How this feeds into higher inflation will be based on how much of the price increase can be passed

FIGURE 5

Nonfarm Payrolls
Change From Cycle Low of February 2010 ('000s)

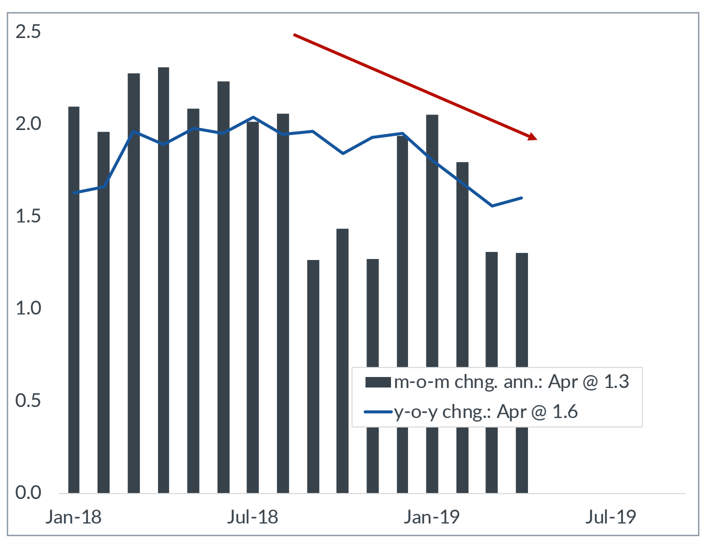


Source: Bureau of Labor Statistics as of 4/2019.

> Since the worst of the recession, there have been 21.4 million jobs created.

FIGURE 6

Inflationary Pressures Are Declining
Core-Personal Consumption Expenditures Price Deflator



Source: Bureau of Economic Analysis as of 4/2019.

onto consumers and how long the tariff lasts. Estimates for the tariff-induced change in inflation range from 0.1% to 0.6%. The higher level of inflation caused by the tariffs will not tempt the Fed to make any changes in monetary policy. It knows this is just a one-time event. The higher prices will weaken real consumer spending, and the Fed will be watching that and any adjustments in consumer sentiment from the higher prices, since that may alter the level of spending.

CONSUMER SENTIMENT

Against the backdrop of growing trade tensions and a global economy that has been slowing, domestic consumer sentiment has been on an upward trajectory since hitting a two-year low at the beginning of the year. The University of Michigan Consumer Confidence Index jumped more than 5 points, surpassing the previous cycle high by more than 1 point. It hit a 15-year high, which happens to be the record high of the data series that dates back to the late 1970s (see Figure 7). It is quite a surprise to see such high levels in an expansion that is in its 10th year since most respondents to the survey are aware that economic growth does not continue indefinitely and start to taper off their expectations. With a red-hot labor market, stable inflation keeping the Fed on the sidelines and the stock market near record highs, it is understandable consumers are very optimistic about the future. In one of the sub-comments of the report, only 36% of the respondents foresaw a downturn in the next five years, a 15-year low.

This report bodes well for a possible rebound in consumption this quarter. This is important since consumption makes up about two-thirds of GDP, and it grew at a paltry 1.2% in Q1. That is well below the year-over-year rate of 2.7% and expansion average of 2.4%. The reason for the slower consumption was attributed to a drop in sentiment, which was due heavily to the stock market swoon, the federal government shutdown and the polar vortex. In the past when consumption has been so low, there has been a rebound the following quarter.

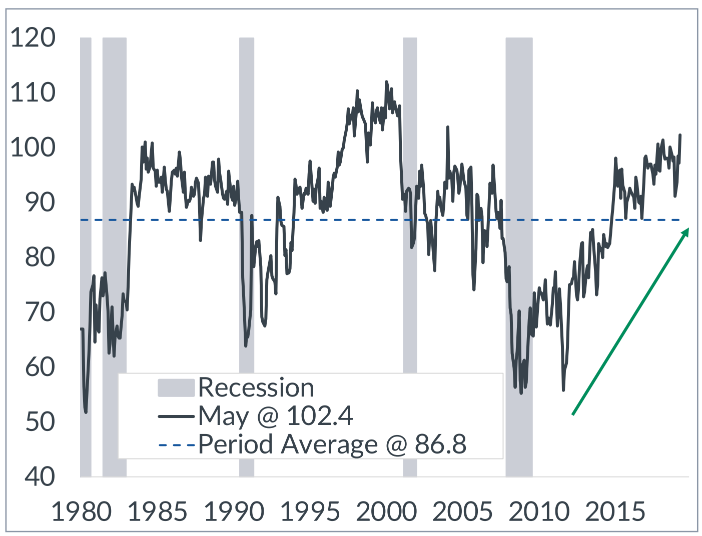
> “This report bodes well for a possible rebound in consumption this quarter.

> “The higher level of inflation caused by the tariffs will not tempt the Fed to make any changes in monetary policy.

An important caveat to this report was that responses were recorded before the collapse of the U.S.-China trade talks. At this stage, the impact from imposed tariffs has been small. It is something we are watching.

FIGURE 7

Confidence on an Upward Trend
University of Michigan Consumer Sentiment Index



Source: University of Michigan as of 5/2019.

Important Disclosures

Index Definitions

The Standard & Poor's 500 Index (S&P 500) is a market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.

The Michigan Consumer Sentiment Index (MCSI) is a monthly survey of U.S. consumer confidence levels conducted by the University of Michigan. It is based on telephone surveys that gather information on consumer expectations regarding the overall economy.

Indices are unmanaged, and one cannot invest directly in an index. Index returns do not reflect a deduction for fees or expenses.