City National Rochdale®
AN RBC/CITY NATIONAL COMPANY

Developed Markets Equity Positioning

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Introduction

Over time, City National Rochdale has held a view that Developed Markets like Europe and Japan have been structurally challenged from an economic perspective and that this, in turn, would lead to secular subpar returns. Over the last five years, this view has clearly been validated (see Figure 1). It is a foundation of our asset allocation process to revisit our long-term thesis to revalidate, adjust or replace it with a new long-term outlook. We have updated and augmented our macroeconomic analysis with the latest data, supplemented by recent research from our research team, as well as the international research and academic community. This approach is represented by our proprietary 4Ps framework:

POLICIES

Monetary, regulatory, trade-related—how well these create and sustain economic growth

POPULATION

The demographic profile that is the foundational building block for economic growth

POTENTIAL

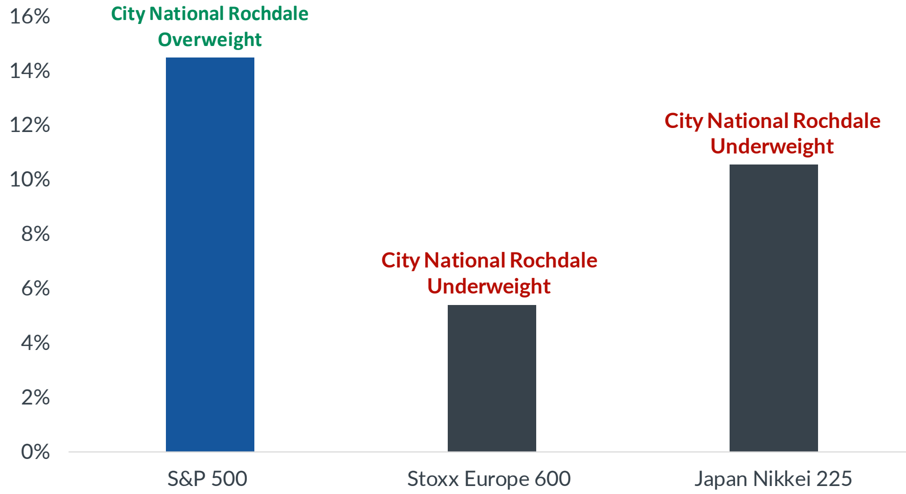
Assess the relative and absolute drivers of innovation

PROFITABILITY

The ability to convert growth into shareholder returns by assessing the divergence of GDP and corporate growth among regions

Our conclusion is that Developed Markets (DM) remain challenged. Not much has changed in terms of Policies, Potential, and Profitability, whereas the Population backdrop has worsened. While the dividend yields of other Developed Markets, especially in Europe, are attractive, our overall recommendation to clients remains intact: structurally underweight non-U.S. Developed Markets, noting that any cyclical excess returns will likely come from currency movements or exposures elsewhere and can therefore be captured via more intentional and direct exposure to other regions. It is our belief that the common perception that investments in non-U.S. DM equities are good diversifiers is misplaced.

FIGURE 1
U.S. Equities Have Outperformed Europe and Japan
(5-Year Annualized Total Returns)



Source: FactSet as of 8/31/2018

We are reiterating our meaningful underweight in non-U.S. Developed equity markets and our overweight in U.S. equities. Over the last five years, our clients have meaningfully benefited from this view and over the next several years, our positioning will continue to drive positive relative returns. As illustrated in Figure 1, the U.S. has strongly outperformed Europe and Japan in dollar terms.

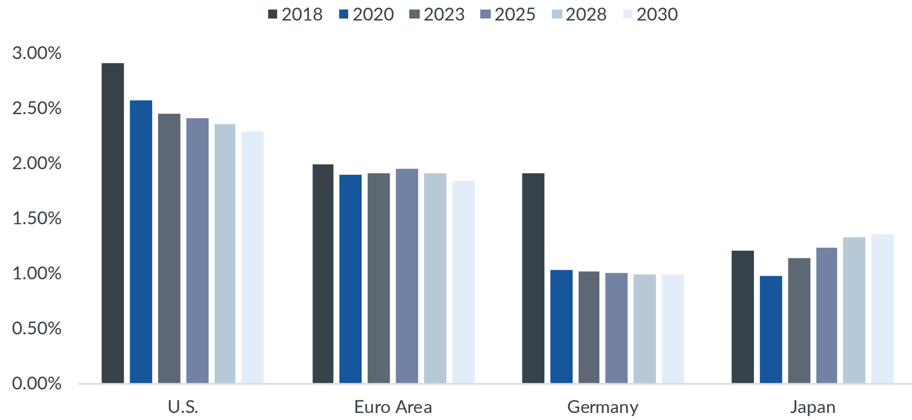
Despite a meaningfully larger economy than other developed markets, the U.S. has delivered faster real GDP growth over the last five- and 10-year periods than other regions (see table below).

	2017 REAL GDP LEVEL	5-YEAR ANNUALIZED GROWTH (%)	10-YEAR ANNUALIZED GROWTH (%)	2018 GROWTH
U.S.	17.3 T	2.2	1.4	2.9
GERMANY	3.9 T	1.7	1.2	2.0
EUROPE X UK*	13.7 T	1.5	0.6	2.0
JAPAN	6.2 T	1.3	0.5	1.1

*Europe excluding the United Kingdom
See sources on the last page.

Additionally, over the next 10 years, the expected U.S. growth rate is expected to be higher than Western Europe and Japan as well (see Figure 2.)

FIGURE 2
Long-Term GDP Forecasts



Source: OECD

Our long-held view that the U.S. maintains a significantly more compelling framework for generating economic and profit growth—and, ultimately, stock performance—remains intact. This is illustrated by what we like to refer to as the 4Ps:

POLICIES to support economic growth and prosperity;

A **POPULATION** that is younger and growing more rapidly with higher levels of productivity;

The **POTENTIAL** for greater innovation in industries of high intellectual property that generate above average secular growth and returns;

A superior **PROFITABILITY** profile of the publicly traded companies.

We believe the U.S. is meaningfully stronger in these critical factors for long-term growth, which are also highly likely to continue in the future.

Policies

In relation to **POLICIES**, we include eight factors. We have examined the effectiveness a government provides to its country via the World Bank's Governance Indicators, as well as the degree of support an economy receives from its monetary and fiscal authorities. We also look at real GDP growth over a 10-year period, government spending and debt levels as a percentage of GDP, as well as its position in the global economy by examining its current account balance and debt held by foreigners. We have reviewed the data and ranked each country versus this cohort, adding together the relative positioning to arrive at a total unweighted score. Under our approach, a lower score is better.

As illustrated below, the U.S. is a leader in our overall ranking, with a score of 16—ahead of Germany at 17, Japan at 21 and Europe ex-UK at 26. We separate Germany from Europe ex-UK as we believe Germany is the strongest economy within the EU and to provide a relative frame of reference for Japan, which is comparable in size.

POLICIES

	GOVERANCE INDEX	SUPPORTIVE FISCAL POLICY	SUPPORTIVE MONETARY POLICY	DEBT AS % OF GDP	GOVERNMENT SPENDING AS % OF GDP	CURRENT ACCOUNT BALANCE % GDP	DEBT HELD BY FOREIGNERS	REAL GDP GROWTH 10-YEAR ANNUALIZED	TOTAL
U.S.	3	1	1	3	1	4	2	1	16
GERMANY	1	2	3	1	3	1	4	2	17
EUROPE X UK	4	3	4	2	4	3	3	3	26
JAPAN	2	4	2	4	2	2	1	4	21

See sources on the last page.

When pursuing investments on a global basis, it is vitally important to consider how countries are organized and run. The World Bank has an index based on its worldwide governance indicators, which include political stability, rule of law and regulatory quality, among others. In the most recent survey, Germany was ranked the leader—ahead of the U.S. and Japan, and well ahead of its other European counterparts.

We believe the structure of the EU is suboptimal, as it is a confederation of countries instead of a true union of states with coordinated fiscal and monetary policy actions at the federal level (such as the U.S.). The member states of the EU are guided by a focus on austerity and are beholden to budget deficit restrictions that inhibit proactive policies to accelerate growth on a country-by-country basis. The EU also has a more restrictive lending environment. Its banking system is much stronger than it was during the financial crisis, but capital reserve ratios are still being increased to comply with Basel banking guidelines, thereby limiting the availability of capital flowing through to the EU economy.

Germany holds an advantage over the U.S., with a government debt to GDP ratio of 68% versus 105% in the U.S. Japan's ratio, at 253%, is exceptionally large, limiting the government's ability to pursue meaningful pro-growth fiscal policies. Government spending as a percentage of GDP in Europe is 48%. In Japan, it is 39%, close to the U.S. at 38%. While economists differ as to opinions about the impacts of government spending on the economy, we concur with recent articles published by the St. Louis Fed indicating that the multiplier impact is less than 1. We believe spending by government generally produces lower-return investments compared to commercial enterprises, so economies in Germany and Japan are held back by this government spending.

Given the global nature of economies around the world, we believe it is important to assess a country's current account balances as a percentage of GDP, as well as debt held by foreigners. Germany is very much an export-oriented economy, has a surplus in its current account position and is ranked first, with the U.S. behind both Japan and Europe ex-UK. As a result of all these factors, real GDP growth over the last 10 years has been the strongest in the U.S. among the developed markets. Our collective rankings of the Policy factor show the U.S. to be the leader, slightly ahead of Germany, with a large advantage over Europe ex-UK and Japan.

Population

The second P we think is vitally important for successful economic growth is related to the **POPULATION** dynamics of a country, especially its growth and productivity levels. We use six components in this factor. Total population growth is often a leading indicator for growth in the working-age population. This is important because there is a high correlation between growth in individuals in the 20-65 age group and the demand from this cohort for goods and services. With a recent pickup in population growth, the U.S. leads Germany and Europe ex UK. Japan is actually in negative territory in these measures. In looking at growth in the working-age population, the U.S. is the leader, followed by Germany.

Another important demographic component is the percentage of the population that is over 65. This is important because wage growth declines in this age bracket, and the need for health care and other services increases and must be supported by the rest of the population, constraining the ability of the economy to grow. Japan has the highest percentage of the population over 65, at 27%; the Europe ex UK is 20%; and the U.S. is the lowest at 15%.

The final important aspect in evaluating a country's population and its impact on the economy is how productive the work force is. Over the last 10 years, productivity in the U.S. has been above that of Europe 73% of the time. In comparisons of the 10-year annualized growth of the working-age population and the 10-year growth in productivity, the U.S. handily beats Germany, many European countries and Japan by a wide margin.

It is also important to assess the savings rate of a country, as that has an influence not only on willingness to spend, which benefits economic activity, but also on the ability to fund overall debt levels from internal sources. In this regard, Europe is a bigger saver than the U.S. Finally, we believe the higher the degree of economic freedom enjoyed by individuals, the greater the propensity for spending and investments, because sentiment and confidence in the future is higher. For this metric, we look at the Economic Freedom Index produced by the Heritage Foundation, which generally reflects better regulations for business and stronger protections of property rights. In this measure, the U.S. is the top-ranked country, Germany second and Europe ex UK fourth.

In our combined rankings of the Population factor, the U.S. is the clear leader of the pack (see table below).

POPULATION AND PRODUCTIVITY

	GROWTH RATE	WORKING-AGE GROWTH	PRODUCTIVITY OF WORKERS	OVER 65 %	SAVINGS % INCOME	ECONOMIC FREEDOM INDEX	TOTAL
U.S.	1	1	1	1	3	1	8
GERMANY	2	2	2	3	1	2	12
EUROPE X UK	3	3	3	2	2	4	17
JAPAN	4	4	4	4	4	3	23

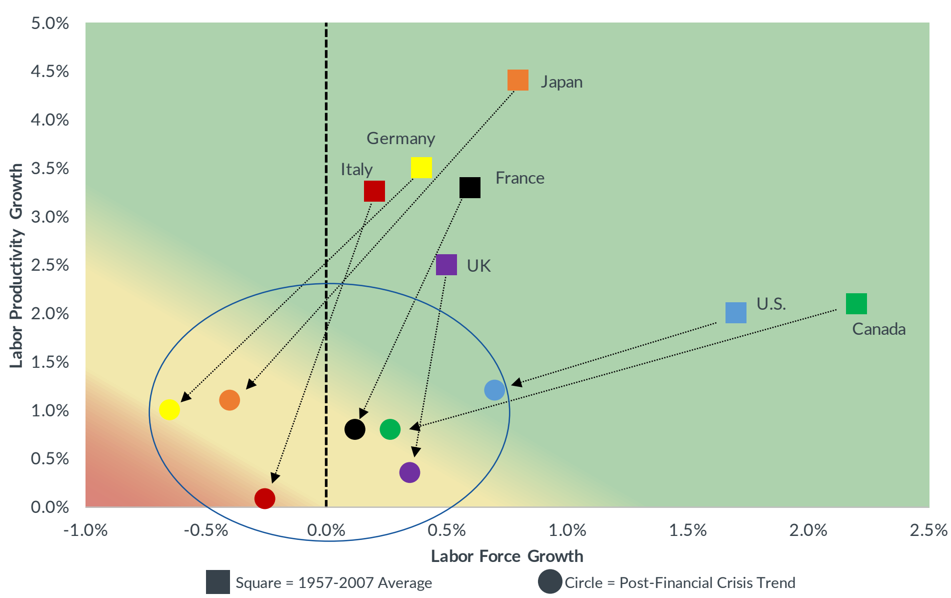
See sources on the last page.

A nation's economic potential is ultimately a product of its labor force's growth and productivity. The math is simple: more workers plus higher output per worker equals stronger economic growth.

The chart below (Figure 3) adds up productivity growth and labor force growth. For each G-7 economy, the starting coordinate is the 1957-2007 average for productivity growth and labor force growth. The ending coordinates (near the arrowheads) mark the average productivity growth over the past six years and potential labor force growth for the next six years.

The key here is the slanting lines. In terms of the basic building blocks of economic growth, every advanced economy is heading in the wrong direction, but the U.S. is expected still to enjoy a significant positive growth differential over the next decade.

FIGURE 3
G-7 Potential GDP Growth Is Slowing



Source: International Monetary Fund

Potential

Our third P is the **POTENTIAL** for innovation in industries of high intellectual property. This is important because these industries tend to have higher growth, higher profitability and provide higher wages to their employees. To determine this, we look at a number of variables. Cornell University has a Global Innovation Index that includes items such as venture capital deals, online creativity, R&D, patents and knowledge creation. By this measure, the U.S. is first, followed by Germany and Japan. Leadership in spending on R&D as a percentage of GDP varies among countries. Japan and Germany spend more on R&D as a percentage of GDP, but the U.S. has the lead in absolute dollars spent. The U.S. is ahead on patents granted and royalties received by intellectual properties and, when measured by technology sales as a percentage of total worldwide sales, is also the leader (according to Goldman Sachs).

Prior to the financial crisis, the U.S. experienced strong labor force growth. While Germany does spend more on R&D as a percentage of GDP, the U.S. comes in second and has the lead in absolute dollars spent. Since the financial crisis, all regions have experienced a slowdown in this metric for all developed markets; nevertheless, the U.S. maintains the advantage.

All innovation does not come from government policy and spending. A country's venture capital community and technology-focused universities, combined with the creative spirit of innovation, are important factors. In venture capital, the U.S. has a 60% market share of the largest 25 firms, and also has more leading universities in technology-related fields. Lastly, we include the Ease of Doing Business Index developed by the World Bank as a measure of determining the ability of great ideas to be translated into business success.

Using all these factors, we believe the U.S. is the undisputed leader, as our combined Potential score illustrates.

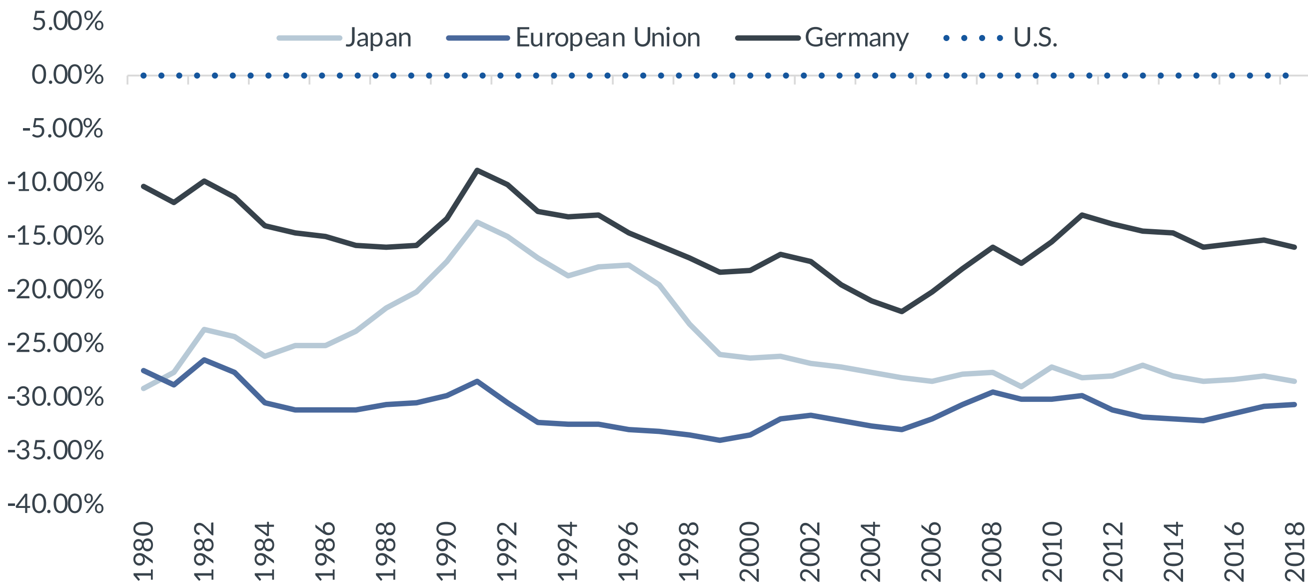
POTENTIAL FOR INNOVATION

	GLOBAL INNOVATION INDEX	R&D % GDP	PATENTS	VENTURE CAPITAL	UNIVERSITIES	EASE OF BUSINESS INDEX	TOTAL
U.S.	1	2	1	1	1	1	7
GERMANY	3	1	3	4	2	2	15
EUROPE X UK	4	4	4	3	3	4	22
JAPAN	2	3	2	2	4	3	16

See sources on the last page.

In the first three Ps—Policy, Population and Productivity, and Potential for Innovation—the U.S. has a strategic advantage. This is perhaps best illustrated by Figure 4, which shows the strong advantage that the U.S. has on a per capita income basis. This figure shows GDP per capita since 1980, with the U.S. as the baseline level. During early 1990, both Japan and Germany experienced improvements in this metric. The narrowing of the gap proved short-lived, and the U.S. maintains a sizable advantage.

FIGURE 4
GDP/Capita Compared to U.S.



Source: International Monetary Fund

Profitability

Our final P is the overall **PROFITABILITY** of companies in a country. We believe the higher level of growth and profitability increases the amount of resources available to invest in the future, thus enhancing the economic outlook.

We use the DuPont model, which evaluates the financial performance of companies on measures such as Asset Turnover, Pretax Margins, Debt Levels and, ultimately, Return on Equity. For ROE, we use recent returns as well as long-term averages. Asset Turnover is a ratio of a company's sales to assets. The U.S., using the S&P 500 benchmark as the proxy, is ahead of the MSCI Europe ex UK and Japan Indices. Pretax margins indicate how much money a company makes per dollar of sales, before taxes. U.S. companies are higher, at 12% recently, and 10% on average since 2001, than their counterparts in Germany and Japan (in the 7-8% range recently and 5-6% longer term).

U.S. corporations have modestly higher debt levels than Japanese firms but rank lower than German companies. U.S. ROE, at 16% recently and 15.6% on a median basis, is meaningfully higher than 11% for Germany and 9% for Japan.

Our combined rankings once again place the U.S. as the clear leader as shown below.

PROFITABILITY

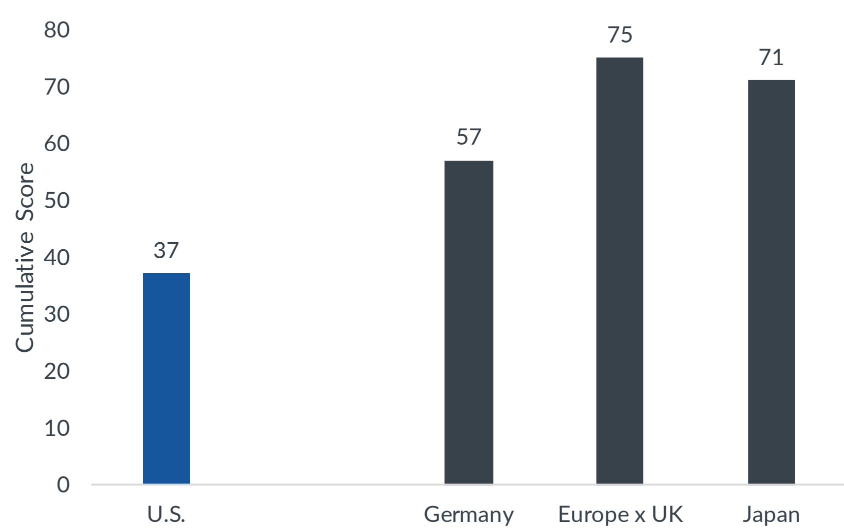
	ASSET TURNOVER	PRETAX MARGIN	DEBT	ROE	TOTAL
U.S.	1	1	3	1	6
GERMANY	2	4	4	3	13
EUROPE X UK	4	2	2	2	10
JAPAN	3	3	1	4	11

Summary

In summary, using our multifactor 4Ps framework, we strongly believe the U.S. is far and away the best country in which to find economic and profit growth, which ultimately drives stock returns. After reviewing the data and ranking each country versus this cohort, we've added together the relative positioning to arrive at a total unweighted score (the lower the score, the better).

Our final scores:

4Ps TOTAL DEVELOPED MARKET

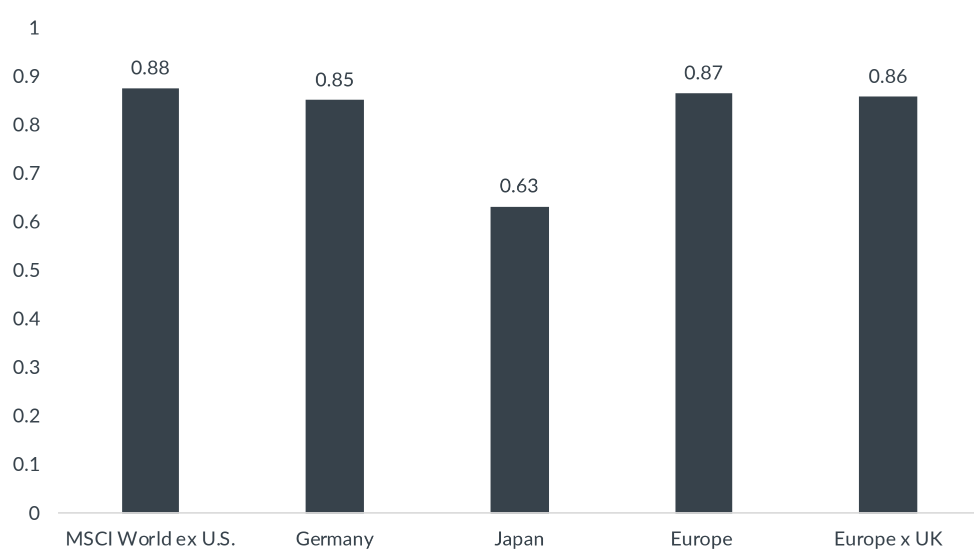


Avoiding the Common Pitfalls

We believe investors mistakenly believe that country indices are all the same. This couldn't be further from the truth. Equity Indices in the U.S. are dominated by high-intellectual property industries such as technology and health care—industries with above average growth rates and profitability. Technology and health care comprise approximately 40% of the S&P 500. The U.S. has the best companies in these sectors, especially in technology. European and Japan indices are dominated by financial, industrial, energy and materials-related companies, which comprise approximately 40% of the indices. These industries need above-trend growth in economic activity and inflation to do better. In other words, the U.S. is more secular in its growth profile, while Europe and Japan are more cyclical.

Investors also mistakenly believe that non-U.S. DM is a good diversifier. As the chart below shows, there is a high correlation of returns over the last 15 years. Over the last 25 years, our analysis of rolling three- and five-year returns (in U.S. dollar terms) shows that the U.S. has a 65% win rate over Germany and 81% compared to Japan. So, for approximately 75% of the time, the U.S. is outperforming these other indices. In addition, the correlations are such that an investor gets more downside risk than upside participation. Lastly, since 1990 Europe has had 14 bear markets compared to six in the U.S.

FIGURE 5
Correlations of Various Indexes to the S&P 500



Source: FactSet, Bloomberg

FIGURE 6
Bear Markets (Defined as -20% Reversals)

S&P 500 Index						MSCI Europe Index (USD)			
High Date	High Price	Low Date	Low Price	% Gain	# Days	High Date	Low Date	% Gain	# Days
						7/31/1990	9/28/1990	-20.93	59
						7/20/1998	10/5/1998	-26.18	77
3/24/2000	1527.48	4/4/2001	1103.25	-27.77	376	3/24/2000	3/22/2001	-31.37	363
5/21/2001	1312.83	9/21/2001	965.8	-26.43	123	5/1/2001	9/21/2001	-29.06	143
1/4/2002	1172.51	10/9/2002	776.76	-33.75	278	1/3/2002	7/24/2002	-24.8	202
						8/27/2002	3/12/2003	-23.14	197
10/9/2007	1565.15	10/27/2008	848.92	-45.76	384	10/31/2007	1/23/2008	-20.69	84
11/4/2008	1005.75	11/20/2008	752.44	-25.19	16	5/19/2008	10/10/2008	-46.43	144
						10/14/2008	10/27/2008	-23.11	13
						11/4/2008	11/21/2008	-24.81	17
1/6/2009	934.7	3/9/2009	676.53	-27.62	62	1/7/2009	3/9/2009	-30.55	61
						11/16/2009	5/25/2010	-24.6	190
						5/2/2011	10/4/2011	-31.53	155
						7/23/2014	6/27/2016	-29.26	725
			Mean	**-31.09**	**207**			**-27.6**	**174**
			Median	**-27.69**	**201**			**-25.5**	**144**

Source: Ned Davis

Conclusion

We remain overweight U.S. equities and underweight other developed markets. We believe the U.S. will be able to maintain the numerous structural advantages it has over other developed markets in relation to Policy, Population and Productivity, Potential for Innovation and Profitability. Nevertheless, we remain vigilant and watchful for potential meaningful shifts in our 4Ps rankings and in relative economic growth opportunities.

Sources for 4P Data

BCA Research

Bloomberg

Bureau of Labor and Statistics

CEIC Data

CIA World Factbook

Cornell University

FactSet

Global Innovation Index

Goldman Sachs

Heritage Foundation

Insead

International Monetary Fund

Ned Davis Research

OECD

SC Johnson College of Business

St. Louis Federal Reserve

tradingeconomics.com

WIPO

World Bank

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