City National Rochdale®
AN RBC/CITY NATIONAL COMPANY

Quarterly Update

ECONOMIC & INVESTMENT MANAGEMENT PERSPECTIVES

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IN THIS ISSUE

★ Mid-Year Edition ★

From the Desk of
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The Key to Prosperity: National Competitive Advantage

The trade war with China, the Fed's inability to bring interest rates to normal levels, the declining share of income earned by labor, the rising national debt — all are manifestations of short-term policies that undermine the U.S.'s long-term competitiveness and future economic growth. We believe different strategies are required if we expect our standard of living to rise. We see the path to this goal originating from long-term policies that have repeatedly been proven to drive growth, that increase national productivity, and that encourage the development of world-class, globally competitive industries.[1] Tariffs, interest rate changes and higher taxes will not achieve these goals.

The U.S. has averaged GDP growth of 2.2% during the current expansion, which is better than Europe or Japan. However, compared to China and India, which recorded average GDP growth during the same timeframe of 7.8% and 7.5%, respectively, U.S. growth looks modest.

Two challenges the U.S. faces are declines in the share of income going to workers and in some sectors' industrial competitiveness. Both contribute to income inequality and are at the root of the current trade war. We do not see compelling evidence that tariffs lead to sustainably competitive manufacturing unless there is a plan in which the government works collaboratively with these industries. Labor market dynamics and accelerating technological change are two reasons why the U.S. should not seek to upgrade its competitive position relative to large-scale global manufacturing companies.

The current conflict with China is rooted in the long-held belief that each nation should dedicate its resources to industries that can excel globally. The U.S. has many successful manufacturers producing in higher-value and more sophisticated industries. Long ago, the U.S. decided not to compete in sectors where China, India and Vietnam had innate advantages. This was due to their focus on low-value manufacturing sectors, which results in greater productivity and lower labor costs.

Going forward, the U.S. government needs to develop new policies that can manage the challenges we face with a future whereby jobs will be impacted by robotics, artificial intelligence and other technologies that will again change our economy dramatically.[2] We should be:

1. Creating policies that fully support important industries that can be globally competitive
2. Creating job skills that help workers adapt to changes throughout their careers
3. Improving our education system
4. Developing policies to support individuals and industries adversely affected by transition periods

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Chief Executive Officer

[1]Porter, Michael E. "National Competitive Advantage in Services." The Competitive Advantage of Nations, Apr. 1990, pp. 239–273, doi:10.1007/978-1-349-11336-1_6.

[2]Frey, Carl Benedikt. The Technology Trap: Capital, Labor, and Power in the Age of Automation. Princeton, NJ: Princeton University Press, 2019.

The Late-Cycle Playbook

Matthew Peron
Chief Investment Officer, Senior Managing Director

Introduction

These are tricky days for investors. As economic growth downshifts and corporate earnings slow, mounting evidence suggests we are now heading into the last phase of what has been a long period of expansion. After more than 10 very rewarding years investing in the financial markets, we do not think the global business cycle is finished just yet. But as it matures, late-cycle conditions of lower returns, higher volatility and greater policy risk will require those who wish continued success to change their investment approaches and become more selective in their portfolios.

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**. Portfolios that served investors well during the steady ascent of risk assets could now be exposed and will have to work harder to generate returns than they have in previous years.

Faced with growing uncertainty, it may be tempting to take risk off the table altogether. However, doing so could harm purchasing power over time and jeopardize long-term financial goals. Indeed, although the late cycle often has featured more limited overall upside for a diversified portfolio, returns for most asset classes have been positive. Still, we believe investors should not be taking excessive risks for lower returns.

"The investment environment has shifted, and the era of easy money is over."

With an active approach, it is possible to remain invested while limiting your portfolio's exposure in a decline. The fundamental challenge of a maturing cycle is to maintain exposure to risk assets without losing control of overall portfolio risk. In a late-cycle period, active investing is not just a defense against an anticipated deterioration in the economic outlook; it also provides the opportunity to be

Our Late-Cycle Playbook In Action

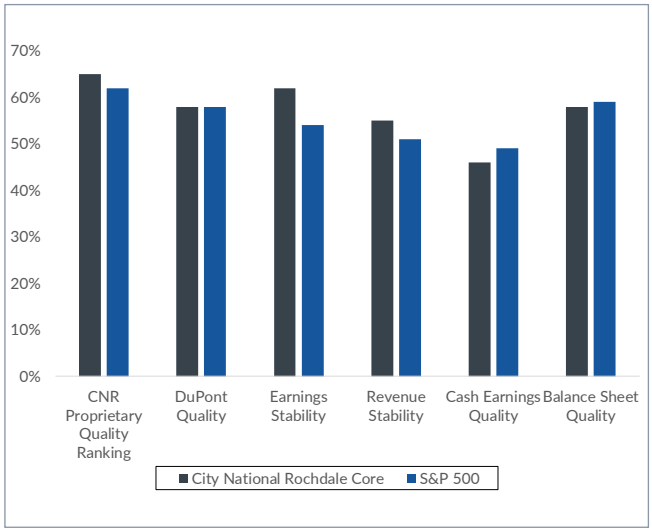
Asset Class	Recent Changes
U.S. Equities	• Increased exposure to lower P/E, higher-quality franchise stocks • Reduced exposure to cyclical and export-oriented sectors most affected by trade/ global headwinds • Reduced MSC
Dividend & Income Equities	• Increased our aggregate dividend growth level, while maintaining a focus on valuation, aggregate yield level, and safety of the dividend
International Equities	• Reduced Developed Markets (DM) exposure • Favor domestically focused Emerging Markets (EM) Asia equities
Core Fixed Income	• Increased credit quality in recognition of late-cycle indicators • Favor municipals for tax haven and lower volatility
Opportunistic Fixed Income	• Favor short-duration EM debt and bank loans • Lowering local currency exposure in favor of USD bonds • Reducing U.S. & EM Fixed Rate HY exposure
Alternative Investments	• Recommending non-correlated diversification options in less-liquid areas of the market, which can provide high yields, strong fundamental quality and price stability, as well as boosting long-term performance (CLOs, reinsurance, capital leasing investments, etc.)

proactive during periods of higher volatility and correlations in asset classes.

The good news? There are concrete actions investors can take now to get their portfolios ready. City National Rochdale's Late-Cycle Playbook involves taking deliberate and measured steps to improve the quality, yield and sources of diversification in portfolios we manage. By focusing on high-quality U.S. stocks, selected areas of the credit markets and niche alternative investments, **we have already positioned our portfolios to be able to help withstand volatility and minimize risk yet continue to participate in gains.**

A late-cycle environment like this one is undoubtedly more challenging, and investors should brace themselves for lower market returns, more volatility and bigger tail risks. Should conditions deteriorate more than expected, City National Rochdale stands ready to further reduce risk to protect client portfolios. But, in our view, it is not yet time to step away. Though the current cycle may be entering its twilight, **there are still potential rewards ahead for investors who can proactively respond to changing investment conditions.**

U.S. Core Equity:
Emphasis on Quality



Source: FactSet as of 7/2019.

Equities: Focusing on Quality and Dividend Payers

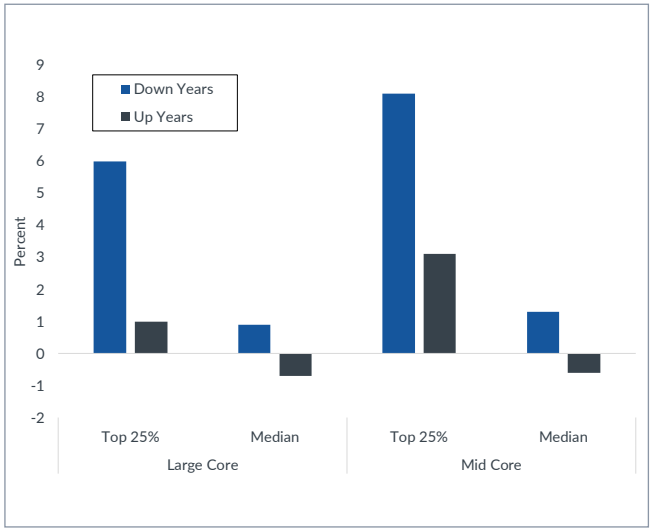
"Age typically has little to do with why a bull market ends."

As the ongoing bull market continues to set records in terms of length, questions naturally arise as to its sustainability. Yet **age typically has little to do with why a bull market ends**. We believe U.S. fundamentals continue to support the case for modest economic expansion and corporate profit growth. As long as they do, the market should provide modest gains, and while corrections are inevitable, bear markets outside of recessions are rare.

Identifying the end of a bull market isn't easy, because it typically reaches its peak before the business cycle does. Indeed, late-cycle periods can last for an extended period of time, and **investors should be wary of making a premature exit from equities, as that could be detrimental to long-term returns and personal financial objectives**. Stocks typically perform relatively well in the latter stages of the economic cycle, and we see potential for this cycle to stretch further, with central banks' continued willingness to underwrite the expansion. The challenge for investors is to remain watchful about risks that accompany the later stages of a bull market while also taking advantage of the potential for further gains.

If there is one lesson to be learned from past cycles, it's that successfully navigating financial markets will require more thought and selectivity from here on. As the end of a cycle nears, investors have rarely been rewarded for just

Active Managers Perform Well in Down Markets
Large and Mid Core U.S. Equity Mutual Funds
20-Year Period Ending 12/31/16 Annualized Excess Returns



Down year defined as S&P 500 return of -5% or less. / Up year defined as total return of S&P greater than zero.
Source: Morningstar & Morgan Stanley. As of 12/31/2016. Large core and mid core represented by Morningstar.
Returns include dividends reinvested

taking beta risk — that is, for passively holding a portfolio with broad market exposure. Historically, it's been active managers who have benefited the most toward the end of the cycle, when market participants start to differentiate between companies that are sustaining earnings growth and those that have just come along for the bull market ride.

"We have carefully and methodically lowered our risk exposure."

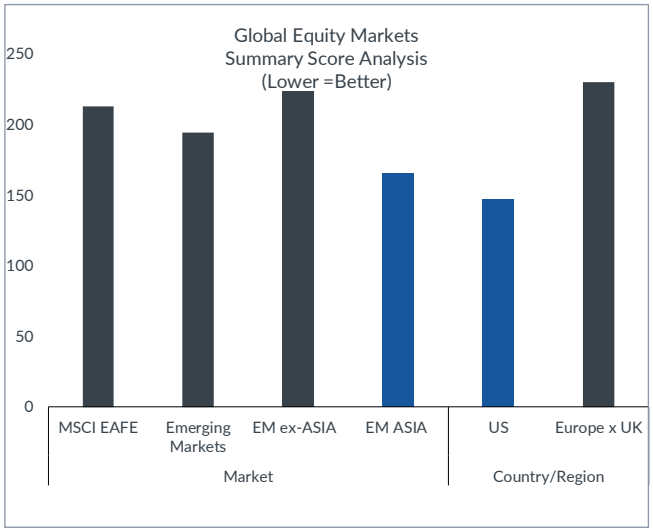
That may be especially true this time around. After years of central banks providing abundant liquidity and more investors invested in riskier assets than usual, the difference in the performance among sectors and stocks this cycle has been lower than the norm. As the investment environment shifts, valuations become stretched and price dispersion increases, active strategies that focus on factors that underpin the sustainability of investments and minimize the risk of sharp downturns in markets will have an increasingly important role to play.

For example, volatility tends to flare up late-cycle as financial markets increasingly reassess the risks of a recession. This suggests investing with a quality bias, selecting companies that can better withstand volatile episodes. Another strategy is to focus on companies exposed to secular growth (such as healthcare and consumer staples), as opposed to more cyclical sectors of the market (such as autos and semiconductors) that are at greater risk from deterioration in the overall economic outlook.

Investors today are challenged by powerful crosscurrents. On the one hand, monetary policy has pivoted toward easing, U.S. economic fundamentals remain generally healthy and valuations, while high from a historical perspective, still look reasonable compared to fixed income. On the other, the expansion is showing signs of aging, global conditions have weakened and policy uncertainty is rising; all of which argue for a conservative and deffensive approach. This is why **we prefer equities in the U.S., where, based on our proprietary 4Ps framework, we find more companies with attractive growth prospects** than in other developed economies, such as those in Europe, which face systematic constraints. Valuations also aren't much richer than other major markets when viewed on a sector-adjusted basis.

At the same time, we continue to like Emerging Asia equities. While EM Asia has not been immune to trade tensions and slowing global demand, policy across the region is turning more supportive this year. The region's strong long-term growth outlook remains robust, supported by rising income growth, healthy demographic trends, and high investment rates. Our focus is on domestic sectors and companies in EM

City National Rochdale Proprietary 4Ps Analysis Framework



Source: City National Rochdale as of 7/2019.

Asian economies that should benefit from these structural tailwinds and have greater resilience to weakness abroad.

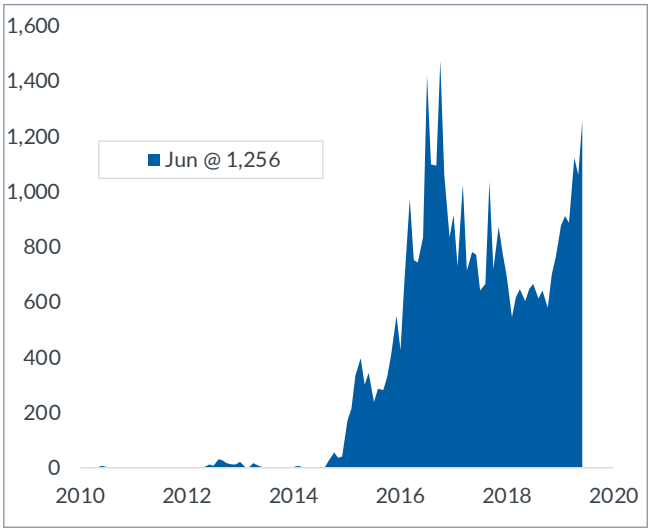
In our U.S. equity portfolios, **we have carefully and methodically lowered our risk exposure**. Our focus is on higher-quality companies with lower price-to-earnings ratios and strong balance sheets and earnings visibility. We have recently lowered exposure to MidSmall Cap equities, which tend to perform best at the beginnings of economic expansions and are more vulnerable in a market downturn. At the same time, we have reduced exposure to cyclical and export-oriented sectors most vulnerable to the effects of a maturing business cycle and global headwinds, with notable underweights in commodities, machinery, tech hardware and semiconductors.

In our equity income strategy, we are focusing on companies that can consistently and predictably grow their dividends, which provide income and can help bolster returns in times of market stress. Our research has found that dividend stocks can do well in a slower growth environment and can be less impacted than companies with more growth-oriented business. In past late-cycle periods, this has resulted in reduced volatility versus broader equity indexes.

Fixed Income and Alternative Investments

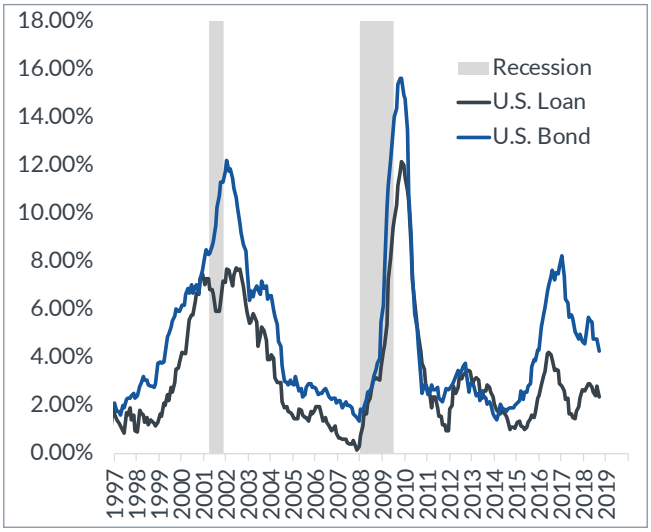
As the business cycle matures, investors are grappling with a combination of slowing economic growth and elevated valuations across core asset classes, creating a difficult environment for generating strong investment returns.

Negative Yielding Debt is Growing
Value of Negative Yielding Sovereign Debt ($ bil.)



Source: Bloomberg/Barclays Index as of 6/2019.

U.S. Speculative-Grade Bond vs. Loan Default Rates



Source: Moody's Investor Service as of 6/30/2019.

This challenge could be especially acute this cycle. During the late stages of past cycles, government bond yields have tended to be high, but a decade of central bank intervention and concerns about long-term growth and inflation have left them low or even negative.

"We believe select areas of credit and alternative investments can help counter potential equity volatility."

Traditional fixed income may continue to offer safe harbor in a recessionary environment, but with low interest rates and a potentially dovish Fed, it may be tempting for investors to increase equity exposure. However, **we believe select areas of credit and alternative investments can help counter potential equity volatility** and supplement core fixed income by adding additional streams of income and sources of price appreciation.

While this recovery has been longer than most, the excesses typically seen at the tops of previous credit cycles have yet to materialize. Broadly speaking, credit fundamentals remain healthy and default rates are low. With this in mind, we think opportunistic income continues to offer pockets of value. At the same time, we are nudging quality higher across our various strategies in response to late-cycle indicators and prefer asset classes with seniority in the capital structure at current market valuations.

In the context of risk-adjusted returns, both leveraged loans and high yield bonds are historically less volatile and experience less dramatic drawdowns than equities. Positions in these asset classes are likely to exceed returns from traditional investment grade fixed income in an expansionary environment, while limiting the downside if growth slows. We also believe that credit alternatives with lower correlations to U.S. markets, such as emerging market high yield and local currency investments, not only offer a yield advantage, but also provide reduced interest rate exposure and higher covenant quality compared to the U.S. domestic market.

In the late stages of the business cycle, investors struggling to source diversified sources of return can also benefit from careful consideration of alternative investments. A common concern among investors today is that, with the combination of low interest rates and high valuations, fixed income asset classes may not provide the same level of income and diversification from equities as in the past. **Alternative investments offer the ability to increase returns and manage**

Is there a Risk Correlation to Market Fluctuations?

Risk Factor	Public Equity	Fixed Income	Insurance Linked Securities
Corporate Earning	✓	✓	✗
Credit Spread	✗	✓	✗
Interest Rate / Duration	✗	✓	✗
GDP/Macro Pressures	✓	✓	✗

risk. However, not all alternatives are positioned to thrive in the current environment and investors should be highly selective.

We believe that alternative investments offer a source of stable income that is less prone to bouts of volatility during times of market stress. Beyond liquid alternatives, investors in search of non-correlated diversification have options in less-liquid areas of the market, which can provide high yields, strong fundamental quality and price stability. For instance, returns in the reinsurance market do not rely on economic cycles and business fundamentals. Similarly, capital leasing investments, such as railcar and aircraft, are historically stable across environments and offer tax-advantaged returns with low correlations to public asset classes.

"Alternative investments offer the ability to increase returns and manage risk."

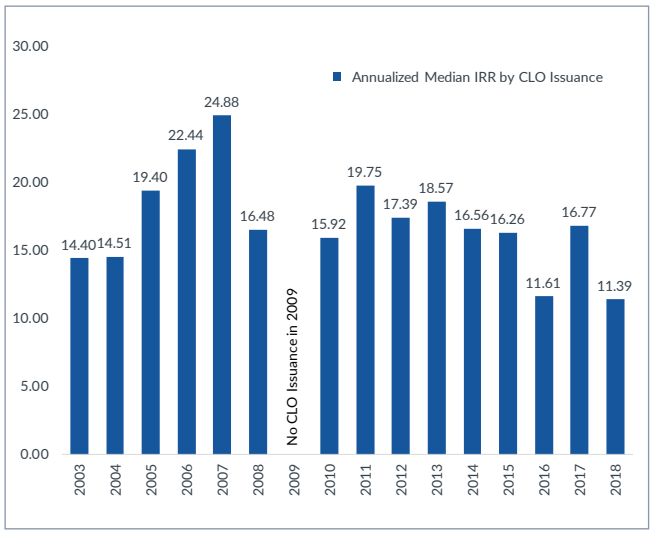
Although late-cycle volatility can be viewed negatively, it may also provide buying opportunities. For investors with liquid assets looking for strong returns over long periods of time, investments in CLO equity tranches can benefit from volatile credit markets, allowing the purchase of loans at substantial discounts to par while providing leveraged exposure upon economic recovery. These discounts can significantly improve long-term performance and shield investors against increased default rates that can occur during recessionary periods. For instance, equity investments in CLO vintages just prior to the great recession had stronger performances versus other vintage years pre and post the 2008 downturn.

While we believe these niches are compelling, investors should be wary of "traditional" alternatives, such as many private equity and hedge funds, understanding that not all alternatives are positioned to thrive in the current environment. These investments often charge excessive fees and, in many cases, offer returns highly correlated with core asset classes, thereby presenting the same risks based on elevated valuations presently seen in debt and equity markets. Investing in these strategies may also carry negative tax consequences, especially with the high turnover found in many hedge funds.

Yield Comparison

Yields shown are Yield to Worst: The rate of return anticipated if a bond is held until the next call date.
Source: Bloomberg. U.S. Corporate High Yield: Bloomberg Barclays U.S. Corporate High Yield Index, Emerging Markets High Yield: Bloomberg Barclays EM High Yield Index as of 6/30/2019.
Index returns are for illustrative purposes only. Index returns do not reflect any management fees, transaction costs, or expenses. Indexes are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.

2007 Issued CLOs Outperformed All Other Time Periods (Despite Significant Markdowns in 2009)



*Source CreditFlux CLO-i Database, City National Rochdale. As of June 30, 2018.
IRR: The internal rate of return is a method of calculating rate of return. The term internal refers to the fact that the internal rate excludes external factors such as inflation, the cost of capital, or various financial risks. It is also called the discounted cash flow rate of return.
Past Performance Does Not Guarantee Future Returns, and the returns shown will not necessarily reflect returns to the Fund or to particular investors. Illustration shows yearly vintage performance over time.
For example CLOs issued in 2003 had a median annualized return of 14.4% and were no longer in the market after 2015.
CLOs do not have identical life spans due to different tenors and circumstances.

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 ISM Manufacturing Index is based on surveys of more than 300 manufacturing firms by the Institute for Supply Management (ISM). The ISM Manufacturing Index monitors employment, production, inventories, new orders and supplier deliveries. A composite diffusion index monitors conditions in national manufacturing and is based on the data from these surveys.

The ISM Non-Manufacturing Index is an index based on surveys of more than 400 non-manufacturing firms' purchasing and supply executives, within 60 sectors across the nation, by the Institute of Supply Management (ISM). The ISM Non-Manufacturing Index tracks economic data, like the ISM Non-Manufacturing Business Activity Index. A composite diffusion index is created based on the data from these surveys, that monitors economic conditions of the nation.

CreditFlux maintains a comprehensive database of credit fund returns. The CreditFlux CLO Index is a collection of funds categorized based not on their current investments but on their investment mandate, CLOS, showing the median monthly return of funds in the category.

ICE BofAML 0-1 Year Emerging Markets Corporate Plus Index tracks the performance of short maturity U.S. dollar (USD) and Euro denominated Emerging Markets non-sovereign debt publicly issued within the major domestic and Eurobond markets

The MSCI EAFE Index (Europe, Australia, and Far East) is recognized as the pre-eminent benchmark in the United States to measure international equity performance. It comprises the MSCI country indices that represent developed markets outside of North America. The MSCI EAFE Index consists of the following 21 countries: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Hong Kong, Ireland, Israel, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, United Kingdom.

The Bloomberg Barclays U.S. Municipal Index is a market-value weighted index that covers the U.S. dollar-denominated, long-term tax-exempt bond market and has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds.

The Bloomberg Barclays U.S. Government Index is comprised of the U.S. Treasury and U.S. Agency Indices. The U.S. Government Index includes Treasuries (public obligations of the U.S. Treasury that have remaining maturities of more than one year) and U.S. agency debentures (publicly issued debt of U.S. Government agencies, quasi-federal corporations, and corporate or foreign debt guaranteed by the U.S. Government). The U.S. Government Index is a component of the U.S. Government/Credit Index and the U.S. Aggregate Index.

The Bloomberg Barclays U.S. Credit Bond Index measures the performance of investment grade corporate debt and agency bonds that are dollar denominated and have a remaining maturity of greater than one year.

The Bloomberg Barclays U.S. Corporate High Yield Index covers the U.S.-dollar denominated, non-investment grade, fixed-rate, taxable corporate bond market and includes securities with ratings by Moody's, Fitch and S&P of Ba1/BB+/BB+ or below.

The Bloomberg Barclays Emerging Markets High Yield Bond Index tracks the performance of the below-investment-grade U.S. dollar-denominated emerging market sovereign and corporate bond market.

Indices are unmanaged and one cannot invest directly in an index

Important Information

The information presented does not involve the rendering of personalized investment, financial, legal, or tax advice. This presentation is not an offer to buy or sell, or a solicitation of any offer to buy or sell, any of the securities mentioned herein.

Certain statements contained herein may constitute projections, forecasts, and other forward-looking statements, which do not reflect actual results and are based primarily upon a hypothetical set of assumptions applied to certain historical financial information. Certain information has been provided by third-party sources, and, although believed to be reliable, it has not been independently verified, and its accuracy or completeness cannot be guaranteed.

Any opinions, projections, forecasts, and forward-looking statements presented herein are valid as of the date of this document and are subject to change.

There are inherent risks with equity investing. These risks include, but are not limited to, stock market, manager, or investment style. Stock markets tend to move in cycles, with periods of rising prices and periods of falling prices. Investing in international markets carries risks such as currency fluctuation, regulatory risks, and economic and political instability. Emerging markets involve heightened risks related to the same factors, as well as increased volatility, lower trading volume, and less liquidity. Emerging markets can have greater custodial and operational risks and less developed legal and accounting systems than developed markets.

There are inherent risks with fixed-income investing. These risks may include interest rate, call, credit, market, inflation, government policy, liquidity, or junk bond. When interest rates rise, bond prices fall. This risk is heightened with investments in longer-duration fixed-income securities and during periods when prevailing interest rates are low or negative. The yields and market values of municipal securities may be more affected by changes in tax rates and policies than similar income-bearing taxable securities. Certain investors' incomes may be subject to the Federal Alternative Minimum Tax (AMT), and taxable gains are also possible. Investments in below-investment-grade debt securities, which are usually called "high yield" or "junk bonds," are typically in weaker financial health and such securities can be harder to value and sell, and their prices can be more volatile than more highly rated securities. While these securities generally have higher rates of interest, they also involve greater risk of default than do securities of a higher-quality rating.

Alternative investments are speculative, entail substantial risks, offer limited or no liquidity and are not suitable for all investors. These investments have limited transparency to the funds' investments and may involve leverage which magnifies both losses and gains, including the risk of loss of the entire investment. Alternative investments have varying, and lengthy lockup provisions.

Investments in emerging market bonds may be substantially more volatile, and substantially less liquid, than the bonds of governments, government agencies, and government-owned corporations located in more developed foreign markets. Emerging market bonds can have greater custodial and operational risks and less developed legal and accounting systems than developed markets.

As with any investment strategy, there is no guarantee that investment objectives will be met, and investors may lose money. Returns include the reinvestment of interest and dividends. Investing involves risk, including the loss of principal. Diversification may not protect against market loss or risk. Past performance is no guarantee of future performance.