City National Rochdale
INVESTMENT MANAGEMENT

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Economic Perspectives

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- Long-term investors should be rewarded with higher equity prices

ECONOMIC PROSPECTS STILL BRIGHT

Although it appears the economy started off the year on a bad note, we continue to be upbeat about the prospects for the remainder of 2014. The unexpectedly large contraction in first quarter GDP was primarily due to temporary factors, such as the unusually severe winter weather, the adjustment to inventory buildup at the end of last year, and to a lesser extent, a slowdown in foreign trade. We expect growth will resume its upward trajectory, as the economy already appears to be snapping back from this weather-related slump. Job growth has picked up pace in recent months, and supported by a significant acceleration in the growth rate of bank loans, activity is rebounding across a number of economic sectors.

Manufacturing output has recovered strongly since the pullback last January and is now finally above pre-recession highs. Motor vehicle sales continue to be a bright spot for consumer spending, thanks to pent-up demand and the easing of credit standards. The unusually widespread improvement in the latest survey evidence suggests manufacturing could reach double-digit annualized growth rates soon. Now that capacity utilization is back at normal levels, manufacturers will need to invest in new equipment and labor to boost production further.

The fundamentals for the economy also look increasingly brighter and are now setting the stage for more sustainable growth ahead. In the very early stages of this recovery, the biggest obstacles to preventing faster economic growth were the ongoing credit constraints that remained after the financial crisis and the overhang of debt built up during the housing boom. The picture is markedly different now, with household debt down to a much more manageable 108% of disposable income – a decade low. In addition, the recent upsurge in bank loans is encouraging, as it suggests households are about to boost spending.

The true underlying momentum of the economy can best be seen in the labor market. Nonfarm payroll gains have been more robust, averaging 234,000 over the past three months, while job openings have soared to their highest level since September 2007. With wage growth also slowly picking up, the conditions for a sustained period of decent consumption growth are in place. Rising house and equity prices have boosted household net wealth to a record high of $82.6 trillion. Higher incomes mean that household debt and debt-servicing costs are at relatively low levels. With debt payments at favorable levels, households will be able to take on more mortgage borrowing, which should provide a much-needed boost to the housing market.

With growth prospects improving, the Fed appears ready to continue reducing its quantitative easing (QE) program as scheduled later this year, and discussion is now turning to the next step of normalization. Nevertheless, we anticipate monetary conditions will remain quite accommodative for some time. While its true signs of inflation are building, the Fed will need to see more evidence of wage pressures and improvement in the labor market before it becomes aggressive in withdrawing support for the economy.

For investors, the rise in the S&P 500 to yet another record high has left equity prices almost 20% above the level of a year ago. This appears consistent with the recent improvement in the economy, and while the possibility of a spike in oil prices caused by renewed Middle East tensions is a near-term concern, continued economic growth should be supportive of further market gains ahead.

THE FED – The Federal Open Market Committee (FOMC), the monetary policy making arm of the Fed, met in mid-June and noted that inflation was running below the Fed's long-term objective and that economic activity had rebounded in recent months, which is a reflection of the recent strength in the labor markets.

At the end of each calendar quarter, the FOMC publishes their expectations for various indicators. GDP growth this year has been revised downward to a range of 2.1% to 2.3%, which is a sharp adjustment from last quarter's estimate of nearly 3.0% for the year. This downward revision is due to the severity of the harsh winter weather in the first quarter that put a damper on growth, which cannot be fully recovered this year. Further out in the calendar, the Fed's forecast for GDP growth in 2015 and 2016 remains unchanged at an average of 3.1% and 2.8%, respectively. The unemployment rate is expected to be in a range of 6.0% to 6.1%, down a smidgen from last quarter's estimate, and probably reflects the FOMC's view that the recent decline in the labor-force participation rate will be permanent and not very likely to reverse soon. The inflation outlook for 2014 continues to be benign; it moved up a small amount and is expected to be in a range of 1.5% to 1.6%. The outlook for inflation in 2015 and 2016 is still below the target of 2.0%. The FOMC inched up their expectation of the federal funds rate to be 1.1% at the end of 2015 and 2.5% at the end of 2016. In addition, the FOMC reduced the size of their monthly purchases of bonds by another $10 billion, bringing it down to $35 billion in purchases each month. On the present course, the purchases should conclude by autumn.

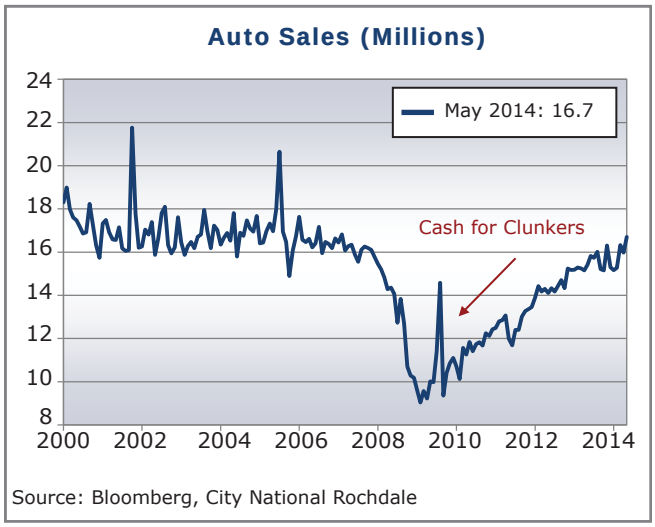
EMPLOYMENT – The labor force, which now stands at 138 million, is 98,000 above the previous peak before the recession. It took 51 months to claw back the 8.7 million jobs lost during the recession, making this the longest job recovery of all post-WWII recessions. Other good news found in the recent labor report states that we have encountered the fourth consecutive month of payroll gains above 200,000, making this the first time that has happened since January 2000. This consistent and stable growth of the labor force is welcome news. Since it began its recovery back in 2010, growth has been plagued by two or three good months of strong growth, followed by a month or two of weaker growth. While the unemployment rate held steady in May at 6.3%, over the past year it has fallen 1.2 percentage points. To a high degree, the unemployment rate has been falling because of the declining participation rate. In the same period of time, the participation rate declined from 63.4% to 62.8%. To date, wage growth remains stubbornly weak with average hourly earnings up just 2.1% and averaging just 2.0% since the end of the recession, thus failing to achieve upward momentum but instead serving to indicate a significant level of slack in the labor market.

INFLATION – Despite the Fed not commenting on the recent increase in prices, the big surprise to the market has been the increasing Consumer Price Index (CPI). In the past three months alone, the yearly change in CPI has jumped from 1.1% to 2.1%. Food and energy costs have been the main culprits. Food prices have had strong gains in the past four months, but are expected to fall in the future. However, given the drought in the West, prices are likely to remain elevated for at least the next several months. Energy prices have also been strong, and with the recent turmoil in Iraq, the risk of higher oil prices is expected.

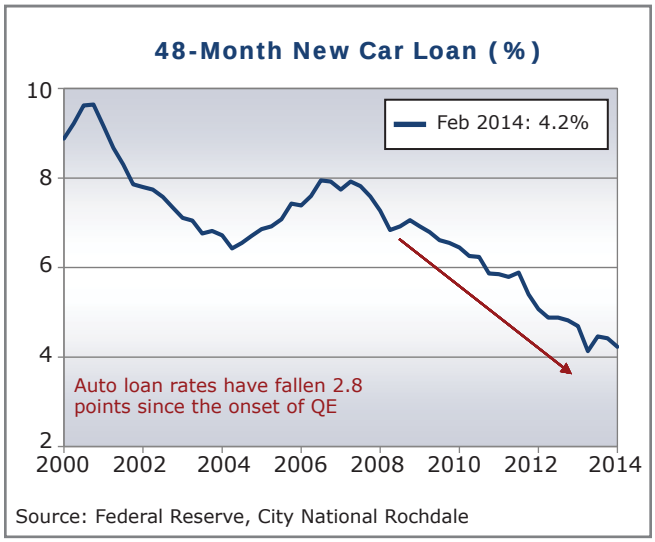
This upward move now places CPI near the Fed's target rate of 2.0%. The Fed is probably breathing a sigh of relief being that they had been spending the past couple of years fretting about inflation being too low. In addition, with Europe's current risk of deflation (inflation has been trending downward for two years and is currently at 0.5%), it appears that the United States does not have to worry about contagion. With that being said, the recent acceleration of inflation is something the Fed is watching. There are many measurements of inflation (CPI is probably the most popular), but the Fed's favorite is the Core PCE (personal consumption expenditures) price index, which is currently at 1.5%, still safely below their target. Furthermore, the Fed is not concerned with short-term blips in inflation; they are more concerned with long-term trends. The Fed strongly believes that long-term price inflation comes from wage inflation. They believe that the current slack in the labor market is creating the tame wages (the average hourly index is up only 2.1% in the past year), which is keeping price inflation low.

CHARTS OF THE MONTH – LIGHT VEHICLE SALES

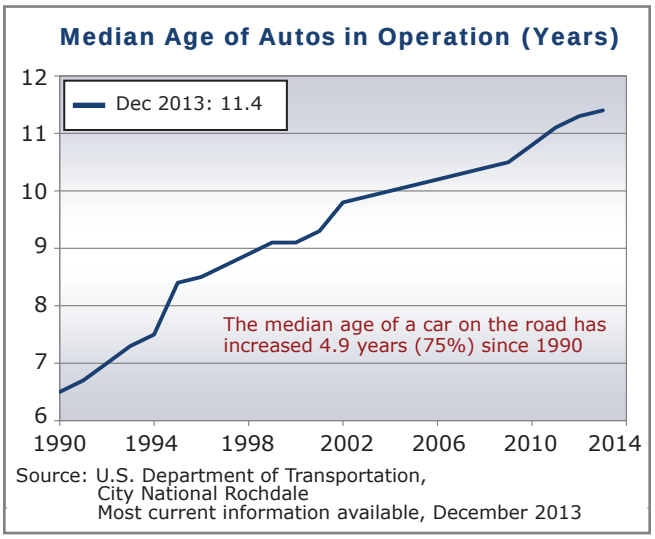
After plunging during the recession, light vehicle sales (autos and light trucks) reached 16.7 million (annual rate) last month, now equaling the average level of sales that were seen in the five years prior to the recession.



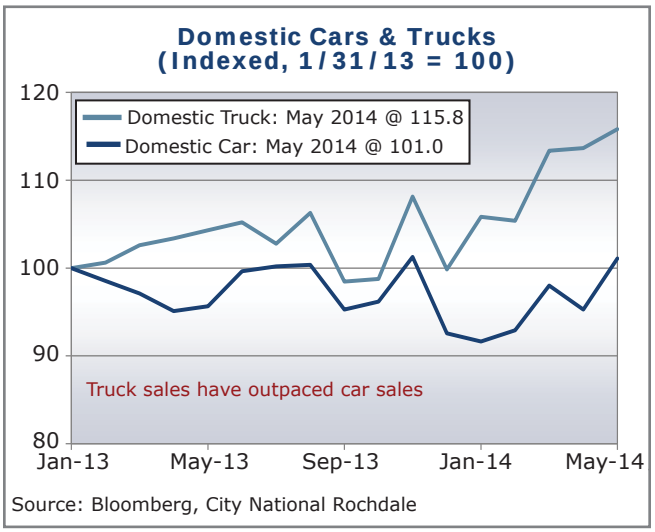
Sales got their initial boost from the $3 billion Cash for Clunkers program in 2009 (see above). The rebound got even more help from the Fed's quantitative easing (QE) bond-buying program, which helped push down interest rates, making lower financing costs available for car buyers.



Also, the age of the fleet of cars on the road has increased significantly, now making it time for many to replace their old vehicle.



Interestingly, recent light trucks have been outselling cars. It is believed that many who abandoned their construction job, or other job that required a truck, during the depths of the recession have returned to that occupation and have purchased trucks again.



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