CITY NATIONAL ROCHDALE
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On the Radar

FAQS ON THE MARKETS AND ECONOMY

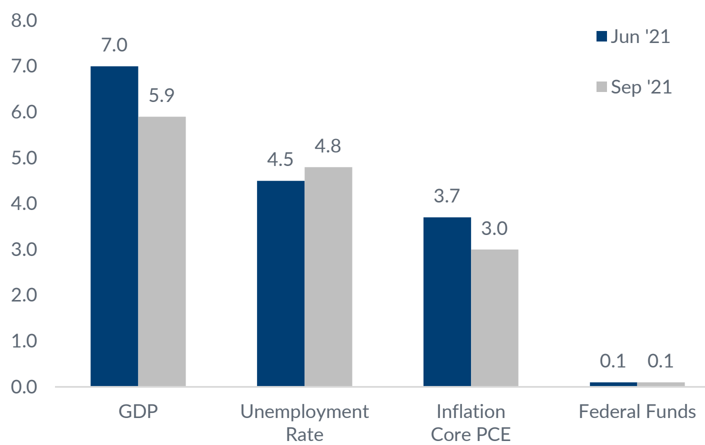
What did the Fed decide at their recent monetary policy meeting?

It was an important meeting. The Fed has increased their optimism about the U.S. economy. It looks like they will soon begin to ease off some of their stimulus by reducing the size of their bond-buying program. Since May 2020, the Fed has been buying $80 billion in Treasuries and $40 billion in mortgage-backed bonds each month to help push down longer-term interest rates and add liquidity to the market. At their next meeting in November, they plan to announce a tapering of those bond purchases and begin the process shortly afterward. They will end it in mid-2022, assuming the economy stays on track.

The Delta variant appears to have altered the Fed's outlook for economic growth. Since their last projection in June, they have reduced their view of GDP growth for this year to 5.9% from 7.0%. This is likely due to the reduction in the pace of growth in consumer spending this summer, while COVID-19 cases were increasing. Some of that shortfall has been pushed into next year. They upgraded their 2022 GDP forecast to 4.8% from 4.5%.

The Fed increased its outlook for inflation this year. They now project it to be 3.7%, an increase from June's 3.0%. The rise in COVID-19 cases, domestically and internationally, continues to strain supply chains. The narrative on the higher inflation appears to be changing from "it's transitory" to "inflation is high for reasons that are transitory." It is subtle but important for explaining why price pressures have not fallen quickly. Many of the shortages and bottlenecks in the supply chain that are causing the higher prices are taking much longer to correct than previously thought.

FOMC - Summary of Economic Projections
2021



Source: Federal Reserve.

KEY QUESTIONS

Is Evergrande the next Lehman?

Is a market correction possible?

Are EM Asia equities still attractive?

Is the consumer still an important part of this expansion?

Is Evergrande the next Lehman?

A potential default of Chinese property developer Evergrande was the catalyst for the S&P 500's first intraday 5% pullback in almost a year. With a $300 billion debt load, an amount equivalent to around 2% of China's GDP, Evergrande's size triggered fears of financial contagion at a time when growth in the world's second-largest economy is decelerating, and authorities are working on deleveraging the country's bloated real estate sector.

An announcement that the company settled its domestic bond payment late last week sparked a relief rally, but questions remain about interest payments on dollar-denominated bonds and how a potential debt restructuring will look.

Although these developments have been a source of volatility for broad global markets, we think fears of a broader global financial contagion are overblown given the Chinese government's interests and level of control, the quality of the company's collateral, and the limited exposure to a possible default outside of China.

Unlike Lehman, most of Evergrande's debt is in global mutual funds, ETFs, and some Chinese companies, not banks or other important financial institutions. Additionally, Evergrande has tangible assets like buildings and land that can be sold off to settle financial obligations, unlike Lehman's derivatives book and global counterparties.

Most importantly, though, in our minds, has been the People’s Bank of China injection of 90 billion yuan into the banking system to prevent a funding squeeze. This likely removes the worst-case tail risk in the near term and sends an important signal to markets. The government may want to make an example of Evergrande, but they also don't want to structurally impede the industry and hurt consumers, nor do they want to risk a banking crisis. Though we remain watchful, measures of risk in both the Chinese and broader global banking system have reassuringly not indicated any meaningful stress so far.

While many structural issues and policy questions remain to be addressed, we believe Chinese officials will be able to successfully navigate the property market challenges ahead and adopt supportive policy measures in the coming weeks and months.

However, it will take time for the restructuring of Evergrande's assets to unfold, so investors should expect negative headlines to remain a headwind for Chinese financial markets in the near term and a possible source of further volatility for global markets in general.

Citi Emerging Markets Asia Financial Conditions Index

Weekly

Source: Bloomberg.

Is a market correction possible?

In our minds, the fundamentals for equities remain favorable. The U.S. economy is poised to deliver its best rate of annual growth in nearly 40 years, S&P 500 earnings are expected to reach all-time highs, and the combination of central-bank and government stimulus will remain a tailwind.

However, equity markets have also been on an unprecedented run since last year's pandemic lows, and much of this robust outlook has already been priced in. Valuations have been stretched somewhat, and pockets of euphoria do exist, especially in speculative emerging technology companies.

This means that even small shocks or disappointments have the potential to undermine markets, at least temporarily. While difficult to time, we think a correction in risk assets is probably overdue with unexpected policy developments, inflation worries, and COVID-19 related setbacks, among other worries as potential triggers.

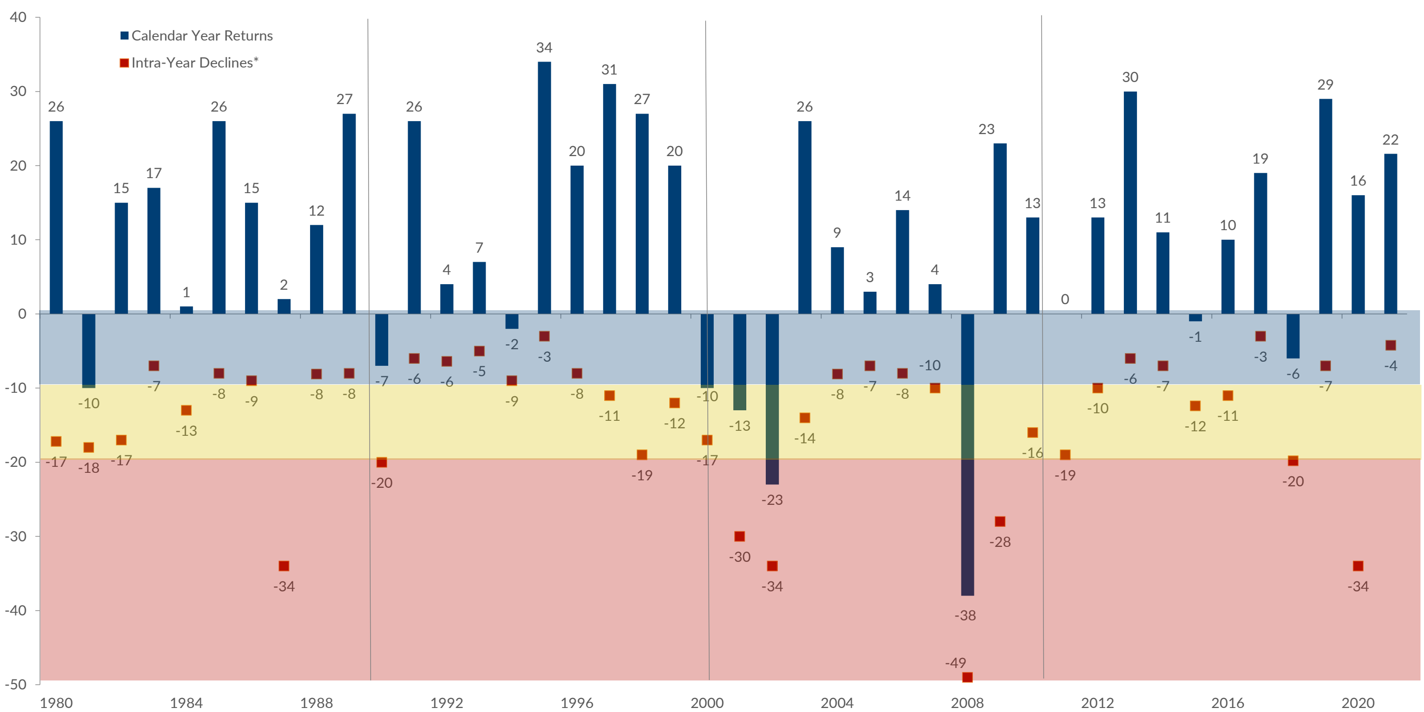
Still, it is important to recognize that corrections are not uncommon. Since 1980, the S&P 500 has experienced an intra-year decline of 10% or more 23 times, yet the index has nevertheless finished with a positive return in the vast majority of those years.

Indeed, corrections are often healthy events, helping to eliminate excesses that have built up after extended runs of market optimism and setting a firmer foundation for future gains. Should a correction unfold over the coming months, we would view it as buying opportunity.

So far, markets have remained resilient despite concerns about the Delta variant, weaker-than-expected economic data, Fed policy uncertainties, and most recently, worries over Chinese regulatory actions and property markets. A continuing robust earnings outlook has helped support a steady rally in the S&P 500 this year with 54 new closing highs and only two 4% pullbacks. However, Q3 is expected to mark the deceleration in profit expansion this cycle, which historically suggests higher volatility and more modest equity returns ahead.

S&P 500 Return

%



Source: FactSet. As of September 2021.
*Intra-year declines are the largest declines within the calendar year.

Are EM Asia equities still attractive?

The last few months have been challenging for EM Asia equity investors. Chinese equities have experienced a dramatic correction with China's regulatory scrutiny of tech, education, and online platforms rattling investors, as well as recent concerns regarding overleveraged property markets.

The developments reflect renewed focus from policymakers on their long-term strategic goals, with particular efforts to curb inequality and ensure healthy competition across all sectors.

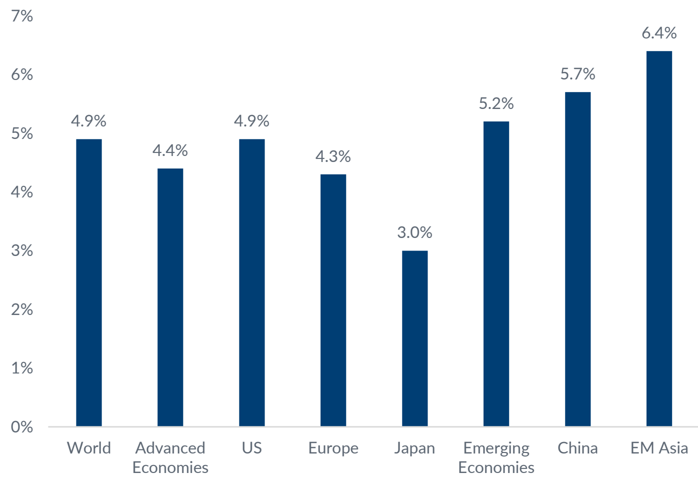
Given the uncertainty caused by government action and their potential to cause headwinds for profitability, productivity, and innovation, we have updated our proprietary 4Ps regional equity analysis to reflect recent developments and place EM Asia equities on watch.

Still, we think the long-term investment case remains strong for Chinese and Emerging Asia equities more broadly given the region's outlook for superior structural growth, supported by a high investment rate, a rising middle class, and robust urbanization trends that should fuel domestic consumption.

In the near term, EM Asia ex-China appears at a positive inflection point for growth. With virus outbreaks in retreat as vaccination rates rise, mobility trackers have started to rebound as recent restrictions ease. Indeed, expectations are still for the region to meaningfully outpace the rest of the global economy over the next year with a forecasted 6.4% GDP growth rate in 2022.

However, sentiment may remain vulnerable until the breadth and duration of China's regulatory actions become clearer. Investors will need to take a patient approach, but many excellent companies appear to be oversold and are now trading at significantly discounted valuations.

IMF 2022 GDP Growth Forecasts



Source: International Monetary Fund.

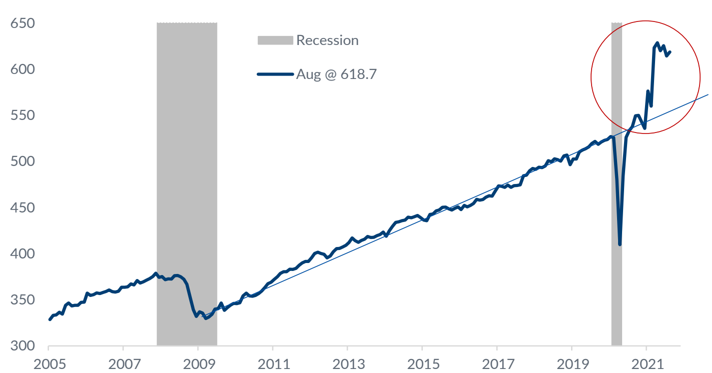
Is the consumer still an important part of this expansion?

Yes, they are. But the pace of consumer spending has been far more erratic than in past recovery/expansions. Due to social distancing requirements, many transactions in the service sector have fallen to the wayside. At the same time, the sale of goods has exploded as families had been spending more time at home together.

Even with this being the new norm, trying to forecast retail sales has been difficult. Retail sales in August unexpectedly increased +0.7% vs. the forecasted -0.7%. It is an example of consumers not always doing what they say. In August, there were significant declines in consumer confidence/ sentiment, with the University of Michigan's sentiment at the lowest level in about 10 years. Combine that with fading stimulus, weak vehicle sales, and an increase in COVID-19 cases, and you have a recipe for forecasting of weaker sales. Instead, it showed the consumer with the firepower of their strong balance sheet (cash on hand and access to credit) is still willing to spend. Spending since the pandemic has been well ahead of the previous trend.

Retail Sales

monthly value, seasonally adjusted, $, billions



Source: U.S. Census Bureau.

Index Definitons

The S&P 500 Index is a market-capitalization-weighted index of the 500 largest publicly-traded companies in the U.S.

The Financial Conditions Index (FCI) is a comprehensive index which is constructed based on the combination of some variables, such as currency price and asset price. FCI has become an important reference index in financial analyzing and policy making in some central banks and international institutions.

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