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Quarterly Update

Economic and Investment Management Perspectives

THIS ISSUE

City National Rochdale
INVESTMENT MANAGEMENT

From the Desk of

GARRETT D'ALESSANDRO

Investors are – as they should be – clearly focused on the future, ignoring what turned out to be a dismal first quarter and instead recognizing widespread signs that the economy is picking up strength. Such strength and momentum is the cornerstone of our Gaining Altitude thesis. Investor focus was reflected in a 5.2% gain for U.S. equities in the second quarter (S&P 500), with a number of other asset classes also advancing. Companies are hiring, fostering increased confidence among consumers who have largely repaired their personal balance sheets and are increasing their spending; manufacturing output is up, credit growth is accelerating, interest rates are at historic lows, and the world's central banks remain accommodative. Perhaps best of all, we believe this economic expansion still has plenty of room to run.

Of course, equities have already posted a remarkable advance over the past five years, with the S&P 500 essentially tripling off its 2009 low, which naturally raises the question of whether stocks are currently overvalued. While a market correction is likely at some point, we do not think stocks are at unreasonable levels, provided investors maintain a long-term focus and stay within their personal tolerance for risk. In fact, we see attractive opportunities in a number of areas, including certain sectors of the high-yield arena as well as among technology firms that are at the forefront of what has been termed the "digital revolution." With technology, as with all companies, careful stock selection driven by in-depth fundamental research is crucial.

In addition to insightful reviews of the current economic outlook and overall investment environment, this issue of the *Quarterly Update* also delves deeper into the digital revolution, examines potential opportunities in corporate credit and emerging market debt, and answers questions we are hearing from clients about the municipal high-yield sector, which has attracted interest among investors impacted by higher tax rates.

Our relationship with you is very important to us. If there is something you would like to discuss, please contact your advisor or portfolio manager. If I can be of assistance to you, please contact me directly at garrett.dalessandro@cnr.com.

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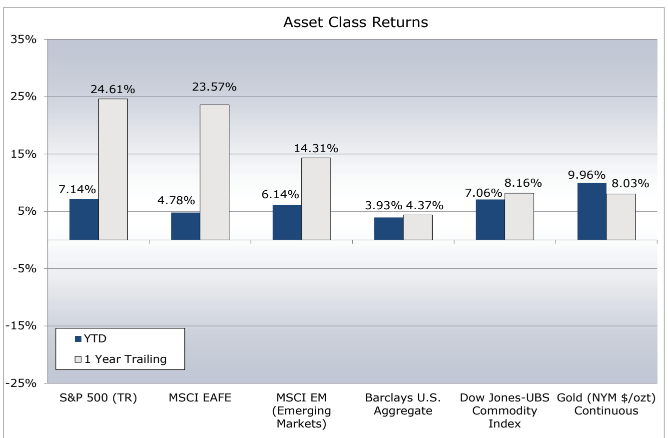
Stocks Regain Footing to Post Second-Quarter Gains

By Bruce Simon

After a lackluster first quarter, equity markets rebounded in the second, leaving the broad averages with solid gains for the first half of 2014. The gains were widespread across all asset classes. In fact, for the first time since 2003, six major asset classes (U.S. stocks, developed market equities, emerging market equities, U.S. Treasury bonds, gold, and commodities) all posted positive returns for the first half of the year (see chart below). The broad gains reflect optimism about the continuation of the current environment of low interest rates, accommodative central bank policies, and improving global economic momentum.



Source: Factset, June 30, 2014

Among major geographic regions, the United States equity market (S&P 500) gained 5.2% in the quarter and 7.1% for the year (including dividends), outpacing the rest of the developed markets' (MSCI EAFE Index) 4.8% year-to-date gain. Europe remains threatened by deflation, prompting renewed efforts on the part of the European Central Bank to stimulate growth. In spite of aggressive monetary policies engineered by the Bank of Japan, Japanese stocks were one of the worst performers in the first half.

Emerging market stocks posted a strong 6.6% rebound in the second quarter (MSCI Emerging Market Index), leaving the index up 6.1% for the year. Fund flows to emerging markets have picked up in recent months, fueled by stabilizing growth rates and new political leadership in India. However, concerns remain over mounting economic excesses in certain parts of the Chinese economy, such as real estate.

Within the U.S. market, the emphasis was on defensive sectors, led by utilities' 18.7% rise in the first half. The severe winter weather across much of the country boosted heating demand and sparked a big jump in utility company profits. Other interest-sensitive securities, such as real estate investment trusts (REITs) and preferred stocks, also posted double-digit returns. After a stellar run in 2013, small-cap stocks were outpaced by larger companies with more diversified and predictable revenue sources.

At the start of the year, we felt that the combination of an improving U.S. economy and the gradual reduction of the Fed's bond-buying activities would lead to upward pressure on interest rates in 2014. However, rates have actually fallen so far this year, leading to solid gains for bond investors. Despite a recent uptick in inflation fears, U.S. interest rates remain at historically low levels, providing little competition to equities for investor dollars.

Bearish investors point to the disappointing first-quarter GDP, the weak economic signals coming from the bond market, high price-earnings ratios, and the market leadership of defensive groups, such as utilities, as evidence of trouble ahead. The absence of a market pullback of more than 10% in almost three years incites further concern. While a market correction could occur at any time, those who have waited on the sidelines for a better "entry point" have missed a rally in which the S&P 500 has nearly tripled in the last five years.

Our views have been unchanged for well over a year now: we believe the weight of the evidence supports continued forward progress of the U.S. economy. In an environment supported by low interest rates, adequate liquidity, and reasonable valuations, we believe the stock market remains one of the most attractive asset classes for long-term investors. We reject the notion of selling stocks solely on the basis of recent past performance. At the same time, it is natural to be skeptical of further gains after such a strong run. In the current environment, we urge clients to understand their risk exposures and avoid assuming risks beyond their comfort level.

What the Digital Revolution Means for Equities

By Tom Galvin

City National Rochdale's Core Equity Strategy is positioned for our "Gaining Altitude" thesis, whereby we believe that the economy is likely to experience a modestly higher growth rate within the next twelve to eighteen months. This has resulted in overweighted positions in cyclical industries such as capital goods, banking, and tech hardware. Additionally, we have been emphasizing cyclical themes that are important beneficiaries of the Gaining Altitude thesis, such as a stronger consumer, industrial renaissance, beneficiaries of Fed policy, and "Obamacare/Golden Age of Biotech." Embedded within these cyclical themes is an exciting secular growth theme that we call the digital revolution.

Over the millennia mankind has created innovative products and techniques that have vastly improved the quality of life and enhanced economic prosperity. Since the ENIAC (Electronic Numerical Integrator and Computer) first arrived on the computing scene in 1946, sparking the Information Age, digital technology has been moving beyond the data center into new applications and solutions that cuts across many sectors and industries. Transformative in nature, the digital revolution has the potential to generate robust revenue growth, meaningful levels of profitability, and above-average returns for a select group of stocks in client portfolios.

Our positioning for the digital revolution adds an element of capital appreciation potential not typically found in other core equity strategies. Foremost among these themes within the digital revolution are:

The Mobile Internet

As the economy has recovered and the financial condition of the consumer has gotten stronger, demand for access to and use of the mobile Internet has been very high. We believe it is likely to remain strong. Approximately two billion people around the world currently have access to the Internet. This market is expected to grow to between five and six billion in coming years due to increased adoption of smartphones, tablets and wearable devices. This growth presents great opportunities for social networking, advertising, mobile payments, "video anywhere," and voice interaction. In addition, these features will likely enable companies to create and/or heighten brand loyalty, drive traffic gains, and retain a differentiated position and a competitive advantage that has a strategic path seemingly better than merely cutting prices. It is important to note that we believe many of these opportunities are still in their early stages. For example, in the next few years, the ability to watch live video, such as the World Cup, or recordings of your favorite shows, wherever you are is expected to increase dramatically. "Video anywhere" should provide consumers with a more satisfying media experience and provide a select group of companies with revenue and earnings growth potential.

Golden Age of Biotech

Advances in computer technologies such as processors, software, and 3-D imaging, combined with next generation genomic sequencing and informatics, are coming together to enable biotechnology companies to create breakthrough compounds with societal benefits and sizable market opportunities. For example, a cure for hepatitis C has been developed, resulting in tremendous market acceptance and revenue generation. There are many other applications as well, such as certain compounds being able to directly target the defective genes in a cancer cell and destroy it without the use of radiation or surgery.

Digitizing Our World

Technological advances have increased our ability to monitor and measure the world around us. For example, in the automotive industry, the combination of sensors, cameras, semiconductors, software, and wireless technology has enabled increased safety through collision avoidance and connectivity to the Internet. In industrial applications, wireless transmission of data gathered by sensors can improve manufacturing and energy efficiency in a broad range of areas. In the energy industry, production of shale oil and gas has been enhanced by innovative broadband precision technology that analyzes reservoirs and identifies the correct spot to release a "smart pill" that is mixed with fracking sand and propellants to expand the size of microchannel cracks in the rock formation, which dramatically increases the flow of oil and gas.

We believe the future of the digital revolution is very bright because of the potential for revenue growth and profitability. Drawing on our in-depth research and stock selection process, we believe we have positioned our Core Equity Strategy with some of the highest-quality companies, selling at reasonable prices, to take advantage of this opportunity.

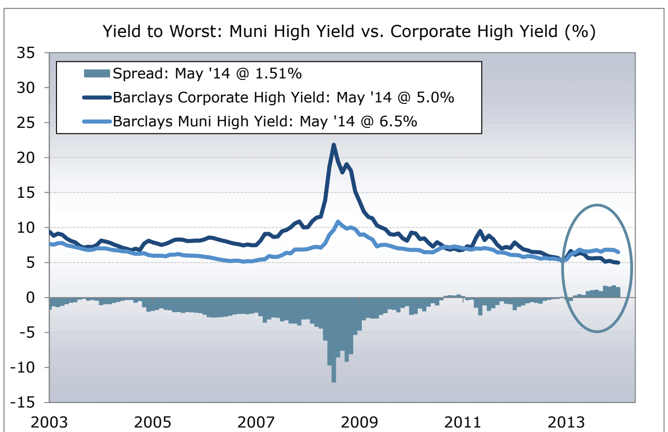
Outlook for Municipal High Yield Still Favorable

By Gregory Kaplan

Municipal high yield (HY) has been a top performer in 2014, with the Barclays Municipal High Yield Index returning 7.53% for the six months through June 30, 2014. The sector's strength was primarily due to falling Treasury rates, increased demand for tax-sensitive income, and improving credit quality. Investors have returned to HY municipal bond funds after heavy outflows last year. Below, we answer some of the most common questions we have been hearing from investors.

Q: Investors around the globe have reached for yield, driving yields and credit spreads down and prices up. Does municipal HY remain attractive, especially after such strong performance year-to-date (YTD)?

A: While we expect rates to rise as economic fundamentals improve, we do not expect a sharp move upward. Although the factors that have driven much of the YTD performance will most likely stabilize, the tax-adjusted income opportunity remains steady and the relative value proposition compared to corporate high-yield and investment-grade fixed income remains compelling (see chart below). April 15 made tax-sensitive investors acutely aware of the full brunt of recent tax increases. Not only did the top federal income tax rate return to 39.6%, but the 3.8% Medicare surtax on passive income became effective on all investment income except municipal bond interest. These tax hikes have significantly increased the value of the tax exemption and have pushed taxable-equivalent yields near 8% for many investors.



Source: Barclays, City National Rochdale

Q: The Fed recently upgraded the longer-term growth outlook and expects to start raising the overnight Fed Funds rate by the second half of 2015. Municipal HY has a long duration; should I be concerned?

A: Yields do not typically move evenly across the maturity spectrum, which suggests that an increasing Fed Funds rate does not automatically mean a matching rise in long-term market rates. We believe that while the Fed may begin raising short-term rates next year, inflation will remain low, likely keeping longer-term rate increases more subdued. City National Rochdale does not expect a sharp increase in long-term inflation expectations.

Q: Detroit's bankruptcy and Puerto Rico's fiscal stress make me nervous; should I be concerned about credit quality?

A: Although Detroit and Puerto Rico have generated headlines, we believe investors should focus on broader credit trends, which have been quietly improving. Tax receipts, which are highly correlated to broader credit trends, have been growing for four years, according to the Rockefeller Institute. There have been only twenty-two first-time defaults through mid-June 2014, down from thirty-three and forty-four during the same period in 2013 and 2012, respectively, according to Municipal Market Advisors. Meanwhile, the ratio of rating upgrades to downgrades by the major rating agencies continues to improve. It is also important to note that historical municipal default rates, according to Moody's, compare favorably to corporate bond defaults for similar rated debt and have higher recovery rates.

Q: Under what conditions would we expect to reduce/eliminate our exposure to this asset class?

A: While we view an allocation to municipal HY as a long-term, income-oriented investment, there will be times when we may recommend reducing exposure. Some possible reasons may include a significant negative change in credit trends, a sizable increase in inflation expectations (the enemy of all fixed income), and/or a change in the relative attractiveness to other asset classes. City National Rochdale does not anticipate any of these occurrences in the foreseeable future.

If you are interested in learning more about high-yield municipal bonds, please contact your advisor or portfolio manager.

Economy on Solid Footing as Second Half of Year Begins

By Steven Denike

After a disappointing start to the year, we are encouraged to see the economy beginning the second half of 2014 on a high note. Business surveys have improved, auto sales have soared, employment has picked up, and credit growth, a key signal of economic confidence, has accelerated. All of this evidence suggests that the sharp drop in GDP during the first quarter was more a temporary blip due to the unseasonably harsh winter and businesses drawing down their inventories, rather than anything indicative of underlying economic weakness.

Perhaps the most encouraging trend has been the recent improvement in employment conditions, with nonfarm payrolls expanding by an average of 272,000 jobs per month during the second quarter, up from 190,000 jobs per month in the first quarter, and the continued decline in the unemployment rate. Companies add to their workforce when they are confident about their business prospects, and stronger employment numbers in turn provide the support for better wage growth ahead. This should stimulate household buying and unleash pent-up demand for big-ticket items – a powerful force for cyclical recovery.

Business Confidence Rising

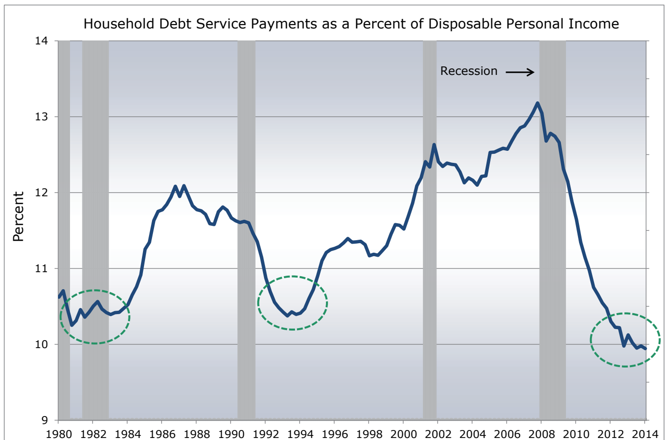
The recent acceleration in capital expenditures is another sign that businesses are feeling more confident about the future. Until now, business investment has been a key missing ingredient in the economic recovery. Companies have not needed to purchase new equipment and structures because their existing capacity was not being fully utilized. However, with capacity now at more normal levels and new orders in both manufacturing and nonmanufacturing industries accelerating over the last several months, we anticipate a resurgence in business investment as firms run out of other options for boosting production.

With the fundamentals suggesting that the U.S. economy is improving in a sustainable fashion, we expect the Fed to continue drawing down its stimulus while slowly turning its attention to the timing and pace of short-term interest rate increases. The Fed has kept short-term rates near zero since December 2008, and is not likely to start raising them until mid-2015, despite some signs of price increases at the consumer level. After the economy's many fits and starts, the Fed will likely err on the side of caution until it is convinced that genuine economic improvement has been made – particularly in job and wage growth – before it begins to withdraw monetary support.

Economic Cycle Still Young in Many Ways

So, after five years of economic growth averaging just over 2%, is the economy finally ready to turn the corner? We believe the answer is yes. By many measures, the U.S. economy is still in the early stages of this economic cycle, with few excesses and plenty of room left to expand. One reason growth has been so slow is that households have been paying down the extraordinary levels of debt accumulated before the recession.

While this has been a strong restraint on spending and investment, it appears that the process of deleveraging has finally run its course. In fact, the burden of U.S. household debt service payments to disposable income has now fallen to a thirty-year low (see chart below). The last time the debt burden approached these levels was in the early 1980s and 1990s – and in both instances, the economy went on to have its longest expansions in the post-war era. Only time will tell whether or not that will be the case for this economic cycle, but we believe the improvement in household balance sheets, coupled with low interest rates and accumulated demand, all have the makings of an economy with sustainable, multiyear growth still ahead of it.



Source: Board of Governors of the Federal Reserve System, Federal Reserve Bank of St. Louis, January 1, 2014 (most current data available)

Corporate Credit and Emerging Market Debt Offers Opportunities

By David Krouth

Opportunistic asset classes continue to perform well. Emerging market (EM) debt led the second quarter, returning 6.26%, followed by returns on domestic high yield (HY) of 2.41% and leveraged loans of 1.40%.

City National Rochdale continues to have a positive view on corporate credit. Overall credit quality for non-investment-grade issuers has improved over the past five years, with defaults expected to remain near 2% (below the long-term average rate of 4%) for the next several years. HY issuers have benefited greatly from the ongoing low rate environment by refinancing previous expensive sources of credit (outstanding bonds, syndicated loans, term loans, etc.) into new, less expensive bonds and loans. These lower-cost sources of financing have helped bolster margins and profitability. Many HY issuers have also refinanced into new maturities in the three- to five-year range, which mitigates potential defaults by pushing the need to refinance or pay off a pending maturity further out in the future. HY issuers' lower cost structures, relatively longer maturities, and continued margin growth, as well as City National Rochdale's outlook for continued slow-but-positive economic growth, support our thesis for continued credit strength.

From a valuation perspective, City National Rochdale remains moderately positive on HY bonds and leveraged loans. Spreads on the Barclays U.S. Corporate High Yield Index were 373 bps at the end of the quarter, 239 bps tighter than the 10-year mean and 120 bps higher than their all-time lows. The index has traded below 300 bps before, most notably in early 2005 and late 2006 through mid-2007. Spread levels in the 300+ bps range, coupled with our benign default rate environment expectations, support an allocation to this asset class (see chart at right).

Opportunity in High-Yield Loans

The Barclays U.S. High Yield Loan Index ended the quarter with a spread of 441 bps, which is 209 bps above the all-time low and nearly 100 bps above the 10-year mean. Because loans are more likely to be better than bonds in their corporate capital structure and have low duration, they are generally viewed as safer credit risks than HY bonds. In the current market environment, where loans are being priced cheaper than bonds, we see an opportunity to overweight loans relative to HY bonds.

EM/HY bonds continue to provide strong returns despite the headline risks of slower growth in China, a Ukraine/Russia conflict, and turmoil in the Middle East. EM assets continue to be lumped together instead of being more accurately portrayed as the independent opportunities they truly are. As seen in the chart below, EM debt spreads have historically traded inside of domestic high yield spreads. This dynamic reversed in early 2013 as the domestic default rate remained near 2% while EM default rates spiked. The 2013 spike in EM default rates warranted the increased risk premium for this asset class. That said, the differential between EM/HY and domestic HY has persisted for too long, given the improvement in EM issuers' balance sheets.

Fundamental and technical factors continue to support our exposures to U.S. HY, leveraged loans, and EM debt. With the continued tightening of U.S. HY and loan spreads, we are relatively overweight EM/HY debt, as this asset class is expected to continue to produce strong returns, provide global diversification, and reduce sensitivity to changes in U.S. interest rates.

Source: Barclays, Moodys, City National Rochdale, as of June 30, 2014

Important Disclosures

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 on the date of this document and are subject to change.

All index returns include reinvestment of dividends. The MSCI index returns include the reinvestment of dividends net of withholding tax. International Index returns are stated in U.S. dollars. Indices are unmanaged and one cannot invest directly in an index. Index returns do not reflect a deduction for fees or expenses.

There are inherent risks with equity investing. These risks include, but are not limited to stock market, manager, or investment style. Investing in international markets carries risks such as currency fluctuation, regulatory risks, economic and political instability. Emerging markets involve heightened risks related to the same factors as well as increased volatility and lower trading volume.

Bonds and bond funds are subject to interest rate risks and will decline in value as interest rates rise. High yield bonds offer a higher yield and carry a greater risk of loss of principal and interest and an increased risk of default or downgrade than investment grade securities. Investments in EM 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. 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.

As with any investment strategy, there is no guarantee that investment objectives will be met and investors may lose money.

Past performance is no guarantee of future performance.

The MSCI EAFE Index (Europe, Australasia, Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the US & Canada. As of June 2007 the MSCI EAFE Index consisted of the following 21 developed market country indices: Australia, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Hong Kong, Ireland, Italy, Japan, the Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, and the United Kingdom.

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The Standard and 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 Barclays Aggregate Bond Index is comprised of U.S. government, mortgage-backed, asset-backed, and corporate fixed income securities with maturities of one year or more.

The 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 Barclays U.S. High-Yield Loans Index, also known as the Bank Loan Index, provides broad and comprehensive total return metrics of the universe of syndicated term loans. To be included in the index, a bank loan must be dollar denominated, have at least $150 million funded loan, a minimum term of one year, and a minimum initial spread of LIBOR+125.

The Dow Jones-UBS Commodity Index is a broadly diversified index that allows investors to track commodity futures through a single, simple measure.

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