The Advisor
CITY NATIONAL ASSET MANAGEMENT

The Economic & Market Landscape

Volume 3 Issue 4

- The economy exhibited signs of moderate growth during the third quarter. The manufacturing sector rebounded and household spending increased over the past few months. *(see chart 1)*
- Gains in the labor market continue to be tepid, at best. It has been just over a year since monthly payroll gains have moved into positive territory. Despite this good news, gains have only managed to average about 125,000 new jobs over the past year. That is well below the 200,000 to 300,000 needed to quickly bring employment back to levels that were last seen prior to the onset of the recession. *(see chart 2)*
- Headline inflation has increased during the course of the year, with the CPI now more than doubling to its current level of 3.9%. Most of that increase reflects higher energy and food costs that occurred earlier in the year. With global demand slowing, inflationary pressures are expected to fall.

INVESTMENT OPPORTUNITIES

- Stocks remain cheap relative to U.S. treasuries and agencies. The safety of U.S. government securities, compared to those of other nations, is driving the compelling valuation for US equities.
- While there is a potential near-term solution to Europe's sovereign crisis, the environment is likely to remain bumpy. If risk abates over the coming months as expected, U.S. and emerging markets equities will benefit.
- The safety of cash comes with a negative real yield, due to inflation measures being between two and four percent.

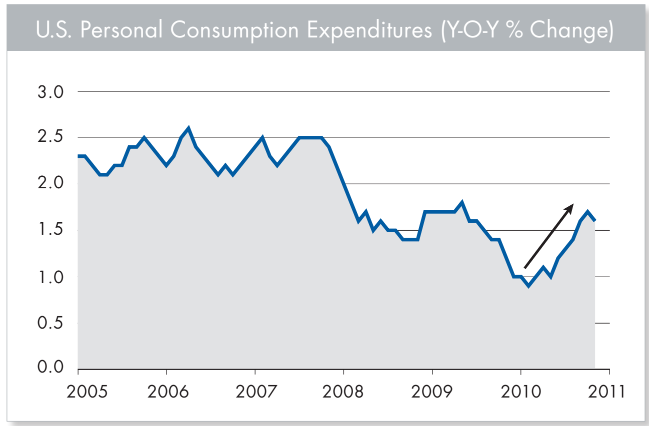

CHART 1

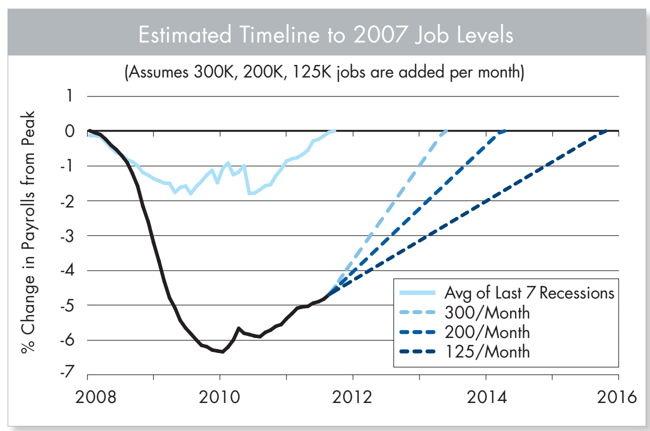

CHART 2

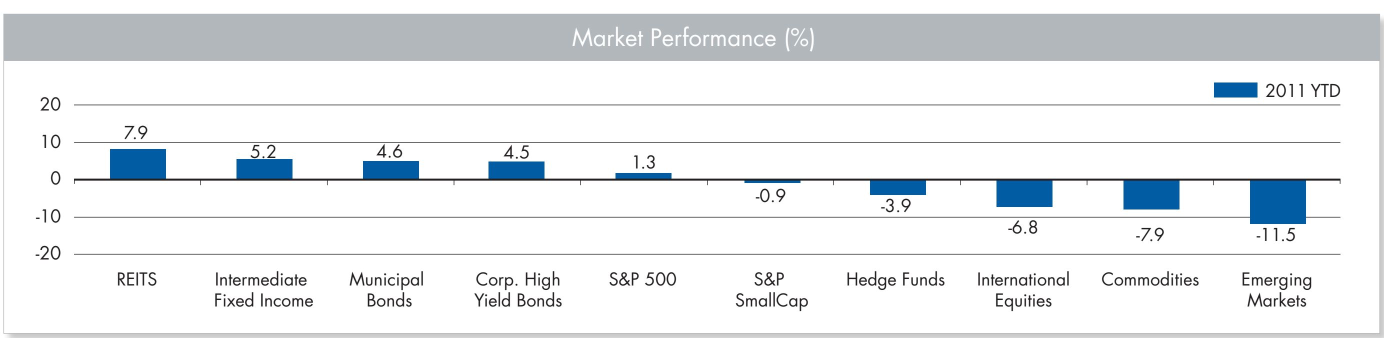

CHART 3

2011 YTD performance as of 10/31/11

THE FED

- The Fed continues to target the federal funds rate to trade in a range of 0% to 0.25%. It has been at this level since December 2008, and is expected to stay near this level until mid-2013.
- To support stronger economic growth, the Fed has entered into a strategy dubbed "Operation Twist"– selling short-term securities and purchasing longer-term securities in their place. This program – scheduled to be completed by the end of June, 2012 – should put downward pressure on longer-term interest rates and help make broader financial conditions more accommodative.

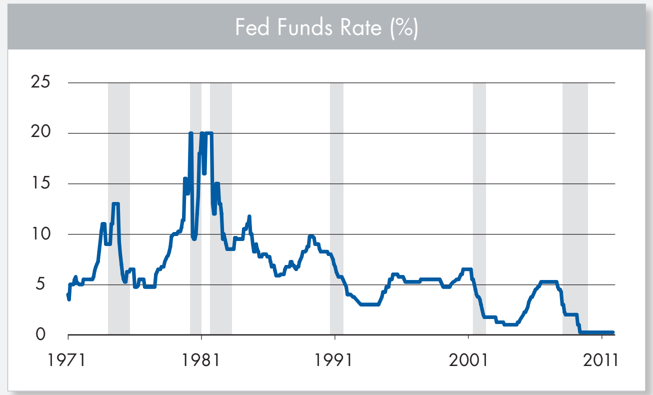

CHART 4

The Strategy

CORE FIXED INCOME

Taxable Portfolios

- Interest rates continued their downward course of the past five months as sovereign debt problems in Europe and slowing economic growth in emerging markets pushed many investors to the safety of U.S. dollar denominated assets.
- The Fed confirmed that short-term interest rates will remain at near zero. Intermediate and long-term rates remain higher, but the Fed will continue its efforts to suppress long-term interest rates through its continued acquisition of long-term Treasuries (dubbed "Operation Twist").
- **Average Duration:** Similar to, or slightly longer than, our target benchmarks due to the steep yield curve and low risk of a sharp rise in rates. Target Credit Quality is at AA+.
- **Sector Allocation:** *Underweight:* Treasury securities due to low absolute yields; *Overweight:* Government-backed Agencies (which offer greater yields than Treasuries without significantly higher credit risk), Corporates with higher credit quality, and High Yield for select accounts.

Municipal Portfolios

- Despite persistent global volatility, the municipal markets generated positive 3Q11 returns with the short-intermediate and intermediate indices returning .76% and 1.78%, respectively (3.07% and 5.21% YTD).
- The muni-to-treasury ratio, which gauges the relative value of munis vs. treasuries, has been trading at over 100% (the historical norm is closer to 80%). With ratios this high there is a built in cushion against any downward pricing pressure in the treasury market as these ratios normalize. *(see chart 6)*
- **Duration:** *Short-intermediate Strategy* remains long vs. the benchmark as the Fed is expected to keep rates unchanged through 2013. *Intermediate Strategy* remains neutral due to heightened volatility for longer maturities.
- **Sector Allocation:** Targeting an average portfolio credit quality of AA- with a bias towards essential service revenue bonds. For California residents, we continue to diversify with 20% allocated to select out-of-state issuers. Recent CA GO issuance provided the opportunity to add exposure at attractive rates.

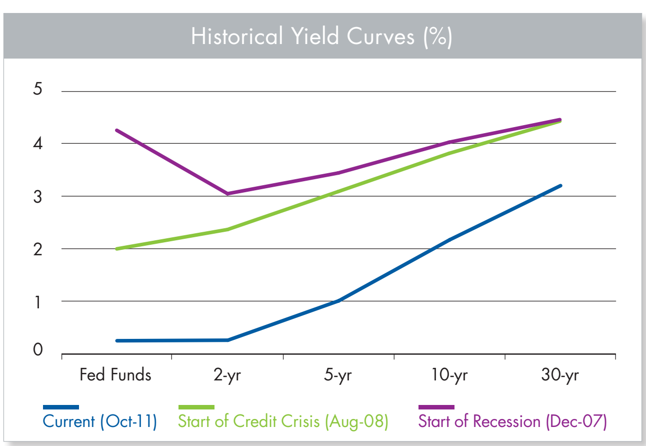

CHART 5

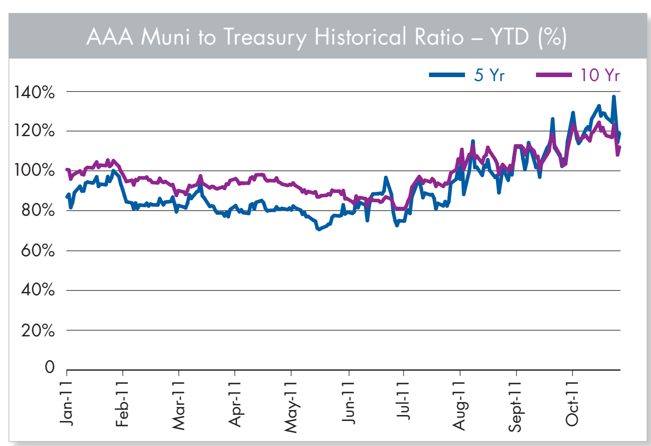

CHART 6

OPPORTUNISTIC CREDIT

- High Yield Bonds came under pressure during 3Q11, creating attractive relative value opportunities; default rates remained low with spreads widening to mid-2009 levels. Partly due to the realization of this opportunity, in October alone High Yield rallied 6% per the Barclays Capital High Yield Index. *(see chart 7)*
- Senior Bank Loan performance showed positive trends similar to High Yield Bonds, although the sector's October returns were smaller. With interest rates likely to remain low for an extended period, this sector's defensive nature may be less important to investors going forward.
- Emerging Market Bonds had strong returns for most of 3Q11. However, the global "risk-off" trade and US dollar rally in late September resulted in relatively flat performance over the previous quarter. October's performance turned positive in line with the broad market.

EQUITIES

- We remain overweight in the technology sector, with a corresponding underweight in consumer discretionary stocks. All other sectors are neutral to the S&P 500. Within each sector we are emphasizing large cap companies with strong balance sheets and a demonstrated ability to grow earnings irrespective of market conditions. This somewhat conservative posture should offer a measure of protection in a volatile market environment. *(see chart 8)*
- While employing a bias toward large cap stocks, we retain a modest allocation to small cap equities via diversified ETFs and mutual funds.
- Internationally, we continue to recommend allocations to both developed and emerging markets. The U.S. share of global GDP is approximately 20% and has been steadily declining over time. Therefore, it's important to maintain exposure to international markets for both geographic diversification and exposure to non-dollar assets.

MULTI-ASSET PORTFOLIO (MAP)

- **Bond Allocation:** We increased our allocation to fixed income, from approximately 50% to 62%, to reduce the strategy's overall risk profile. Given the paltry current yield on money market funds, we shifted the majority of our cash allocation to a high quality short-term bond fund with a 2% yield. We have also identified opportunities in high yield bonds and have added to those positions.
- **Equity Allocation:** We significantly reduced our equity exposure, as the strategy shifted to a more defensive posture. Within equities, we initiated a position in a large cap ETF that emphasizes dividend paying stocks. We also initiated a position in a preferred stock mutual fund.
- **Other Assets:** We reduced our position in international REITS, and liquidated our remaining position in timber.

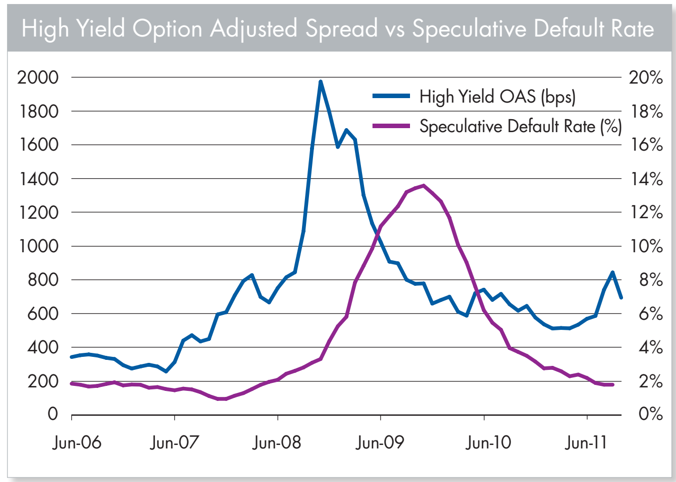

CHART 7

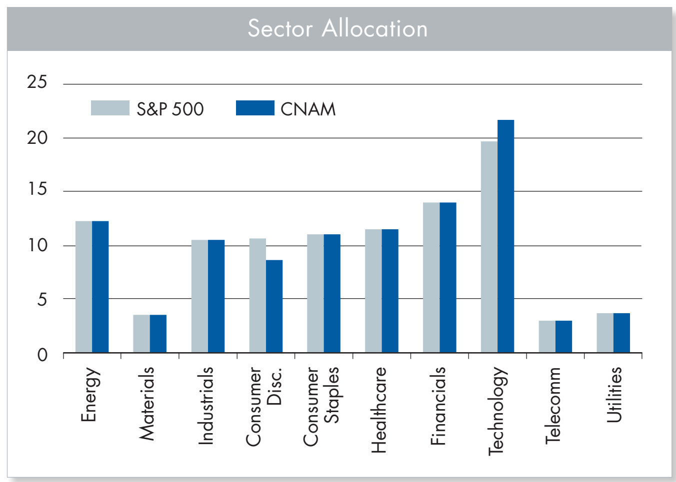

CHART 8

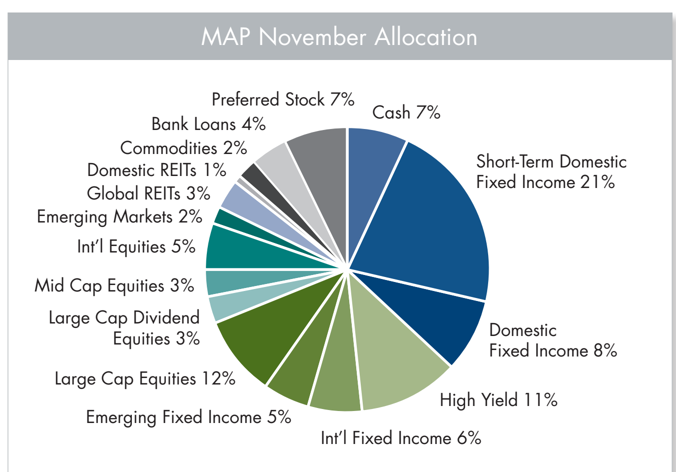

CHART 9

REAL ASSETS

- Real Estate Investment Trusts (REITs) fell sharply in 3Q11, as investors moved aggressively to reduce risk in their portfolios. The MSCI U.S. REIT Index declined 14.5% during the third quarter. However, in October risky assets returned to favor with REITs reversing course, returning 14.4%, and bringing the year-to-date return to 7.9%. All U.S. REIT sectors rose in October, with the sharpest increase registered by industrial and specialized REITs. International REITs followed a similar pattern, declining during the third quarter approximately 20% and bouncing back in October about 10%. Overall, most international REIT indices have fallen 10% this year, as weak share prices were magnified by an exodus out of emerging market currencies in favor of the U.S. dollar.
- Broad-based commodity indices also declined in the third quarter as fears of a sharp global economic slowdown intensified. Most commodities suffered double-digit declines in the trailing 3 months, and some are solidly in the red for the full year. Even gold momentarily lost its luster. The stalwart of the commodity markets fell from $1,900 per ounce and bounced off the $1,608 level. The combined threat of a double dip recession, a sovereign debt crisis and governments facing political pressure to restrain their currency-expanding ways resulted in vacillation for some owners of gold.

TACTICAL POSITIONING (Q4 - 2011)

CORE FIXED INCOME

TAXABLE

DURATION	SHORTER	LONGER

SECTOR ALLOCATION

ATTRACTIVE	UNATTRACTIVE
INVESTMENT GRADE CORPORATES	GOVERNMENT BONDS

TAX-EXEMPT

DURATION	SHORTER	LONGER

SECTOR ALLOCATION

ATTRACTIVE	UNATTRACTIVE
GOs ESSENTIAL SERVICE REVENUE BONDS PRE-FUNDED BONDS	SPECIAL ASSESSMENT BONDS AIRPORTS TOLL ROADS

OPPORTUNISTIC CREDIT

SECTOR ALLOCATION

ATTRACTIVE	UNATTRACTIVE
HIGH YIELDS FLOATING RATE NOTES EM CURRENCY	

EQUITIES

REGIONAL	U.S.	INT'L/EMERGING MKTS
SIZE	LARGE	SMALL
STYLE	GROWTH	VALUE

SECTOR ALLOCATION

ATTRACTIVE	UNATTRACTIVE
TECHNOLOGY	CONSUMER DISCRETIONARY

REAL ASSETS

COMMODITIES	OVERWEIGHT	UNDERWEIGHT
REAL ESTATE/REITS	OVERWEIGHT	UNDERWEIGHT

SECTOR ALLOCATION

ATTRACTIVE	UNATTRACTIVE
PRECIOUS METALS AGRICULTURE	

CHART SOURCES: All chart data is as of 10/31/2011 unless otherwise footnoted. U.S. Personal Consumption Expenditures: Bureau of Economic Analysis, City National Asset Management; Estimated Timeline to 2007 Job Levels: Bloomberg, Bureau of Labor Statistics, City National Asset Management; Market Performance: Bloomberg, MSCI, REIT.com, HFRI; Fed Funds Rate: Federal Reserve Board, City National Asset Management, NBER; Historical Yield Curves: Bloomberg, City National Asset Management; AAA Muni to Treasury Historical Ratio: Bloomberg; High Yield Option Adjusted Spread vs. Speculative Default Rate: Barclays, Moody's; Sector Allocation: Vestek, City National Asset Management; MAP November Allocation: City National Asset Management.

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