



MARKET PERSPECTIVES

APRIL 20, 2009

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Will We Have Inflation or Deflation? Yes.

Certain economic data, highlighted by the media, is propelling stocks and other risky assets higher. High yield bonds took the lead last week with a 3% return; domestic equities were close behind. The S&P, NASDAQ and Dow indices all rose 1-2% last week. Year-to-date, the NASDAQ index is up more than 6%, while the S&P is down only 3%. The Dow remains the laggard, showing a 6% loss for the year.

Bond and commodities exhibited marginally positive returns last week, although gold prices dropped by 4%. The three-month T-bill yield is still hovering around 0.1%, and the 10-year Treasury yield stands at just under 3%.

At the margin, many investors, including City National Asset Management's fixed income team, are migrating towards some very attractive opportunities in high-grade corporate bonds. Triple-A credits in the industrial and utility sectors are offering spreads of 3-5% over treasuries. Financial issues are showing even higher yields.

Lastly, the Dollar was mixed, losing roughly 1% versus the Yen and Pound, but gaining a percent against the Euro. Year-to-date, however, the Dollar remains up by 7-10% against the Yen and Euro, but has lost about a percent against the Pound.

Despite the somewhat improved tone of recent economic data, CNAM remains conservatively positioned in terms of asset allocation, sector selection and fixed income posture.

Acknowledging that certain economic data has shown a *deceleration* in negative growth (the so-called "second derivative"), most indications remain bearish, including the latest reports on retail sales, business inventories, industrial production, capacity utilization, housing starts and building permits. All of these are important leading or coincidental indicators and support the notion that caution is still warranted.

The monetary side of the equation is no less concerning, and brings to mind a passage from Greek mythology as relayed in *The Odyssey*. Scylla and Cherybdis, representing a wall of rocks and whirlpool, respectively, were the original inspiration for the proverbial "between a rock and a hard place." The consumer price index recorded its first annual decline in more than 50 years this past week, fueling fears of further deflation. There's no question that the Fed must navigate some very tricky waters to steer clear of an extreme recession and nasty deflationary cycle on one side of the monetary river, and an inflationary spiral on the other.

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So, let's consider the question: Will we have inflation or deflation?, We believe the most appropriate answer is "yes." In other words, we will experience a bit of both – first deflation, as we are now experiencing at the margin, and down the road, no doubt a dose of inflation. The Fed is more likely to fend off the former at the expense of the latter, and therefore, we are beginning to prepare investors' portfolios with inflation-hedging tools at the margin.

In sum, City National continues to believe there will be more attractive entry points over the coming weeks and month for those in a hurry to enter the risky markets. With first quarter earnings season upon us, and the looming credit crisis still not even sized, much less remedied – caution, not aggressiveness is the prudent move for the typical investor right now.

Lastly, the official CNAM performance figures are in for our individually managed client accounts for the quarter ending March 31, 2009 and the numbers are, once again, very strong and highly competitive on a national basis.

All strategies had highly competitive results in a market characterized by volatility and very low interest rates. Some highlights:

- Our balanced account composite for high net worth clients outperformed by 280 basis points, returning -2.9% vs. -5.7%.
- Our taxable short/intermediate fixed income composite outperformed by 50 basis points, returning 1% vs. 0.5%.
- CNAM's Core Equity accounts beat the S&P 500 benchmark by 160 basis points

in the first quarter, returning -9.4% vs. -11.0% for the index

- Small cap equities beat the Russell 1000 benchmark by 690 basis points, returning -9.9% vs. -16.8%
- The green equity strategy returned -5%, beating its benchmark by 550 basis points.
- The Multi-Asset Portfolio (MAP) Strategy lost -3.1% in the quarter, controlling losses in a challenging market.

Thank you all and have a good week.

Performance figures reflect total returns before any reduction of fees or taxes but reflect brokerage commission charged for trading activity. The composite returns are calculated using a time weighted basis with quarterly valuation and a dollar weighting of the underlying accounts within the composites. The underlying accounts are managed by City National Asset Management, a department of City National Bank, on a fully discretionary basis and have a minimum size of \$500,000. Accounts are added to the composite as of the beginning of the quarter following initial contribution. Equity and fixed income returns are determined using pure equity and fixed income accounts which may include a cash component. The returns reflect a settlement date basis for recording trades and income earned on an accrual basis prior to 2005. Beginning in 2005, returns reflect a trade date basis for recording trades and income on an accrual basis. Past performance is not an indication of future results. For more information on City National Asset Management's composites, please contact Deborah Rhoads at 619.645.6195.

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