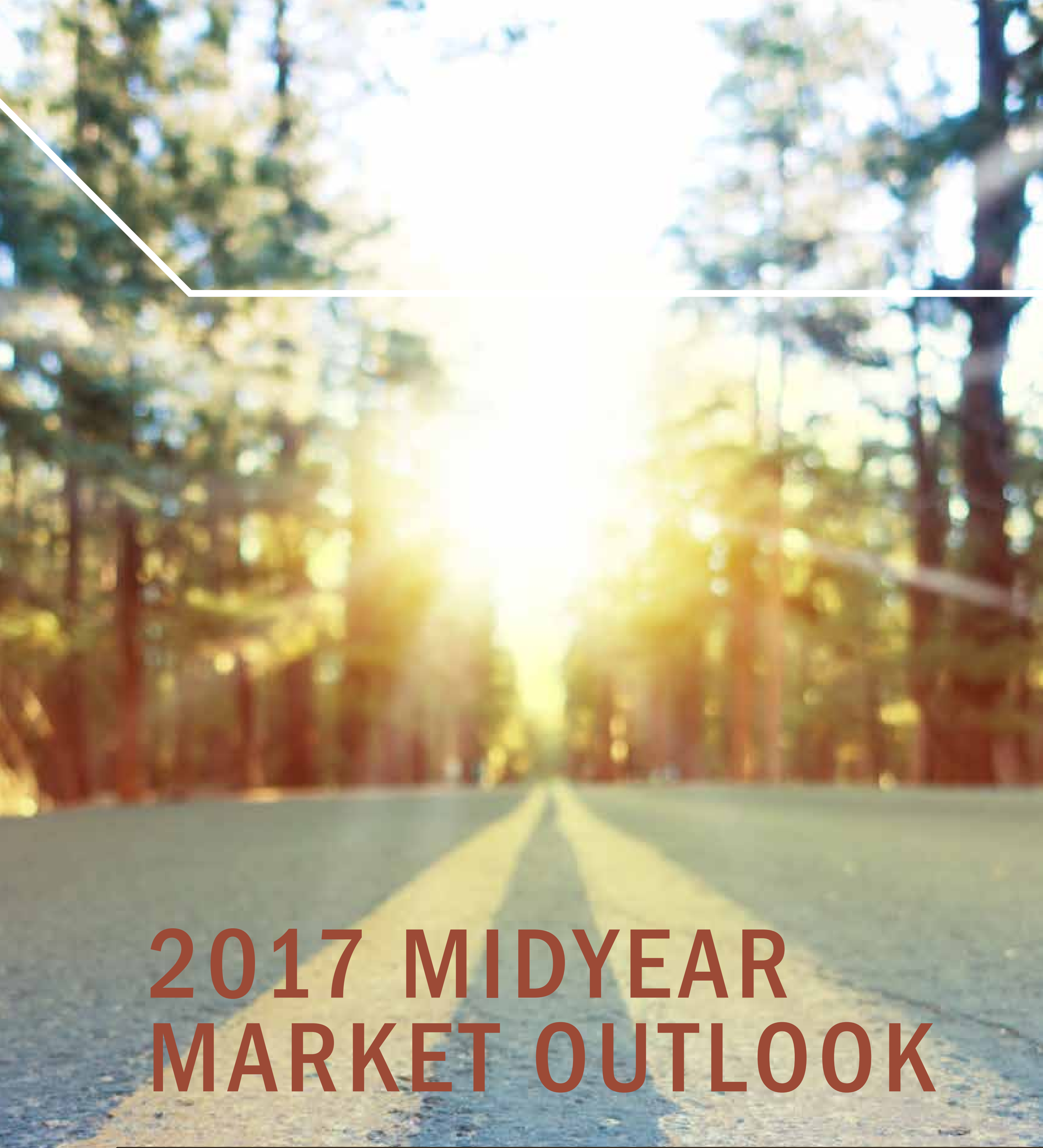


2017 MIDYEAR MARKET OUTLOOK

Commerce Trust Company

Wealth | Investments | Planning

2017 MIDYEAR MARKET OUTLOOK

RISING SHORT-TERM INTEREST RATES AND WASHINGTON POLITICAL CONTROVERSIES FAIL TO DISRUPT FINANCIAL MARKETS

Despite ugly politics in Washington in the first half of 2017, the financial markets have behaved with remarkable stability. The ongoing efforts on tax reform, health care, regulatory reform, and the nation's infrastructure will continue. All of these initiatives are on the negotiating table, but so far have encountered significant obstacles. Any progress in these politically charged areas would likely be a further positive influence on business confidence and future growth expectations. Even so, moderate underlying growth in the United States has continued to sustain the nearly eight-year-old economic expansion. Likewise, overseas economies and markets shrugged off political controversy and lingering conflicts, as generally positive data in both Europe and Asia were reported, which buoyed their markets as well.

MARKET SUMMARY

- With the equity market at all-time highs, now is a good moment for clients to consider if they are comfortable with their equity exposure levels.
- Sluggish GDP growth in the first quarter is likely to pick up in the second half of the year.
- The economy is nearing full employment, which could put inflationary pressure on wages as the labor supply tightens.
- If Congressional gridlock persists, the inability to make political progress on business-friendly legislation could take the steam out of the economy.

ECONOMIC OUTLOOK

In the face of the ongoing challenges in 2017, both the United States and the global economies continue to generate modest growth. Despite the softening of U.S. GDP growth during the first quarter of this year, we expect growth will pick up in the second quarter and carry into the second half of 2017.

Part of the first quarter's sluggish 1.2% GDP reading was due to lower rates of consumer and defense spending and a notable drawdown in inventories. However, the second quarter is likely to see a seasonal catch-up in consumer spending, gains in defense and business outlays, and a solid rebuilding of inventories. The combination should lift second-quarter GDP growth towards the 3% level. This will keep the United States in the 2% to 2.5% range for 2017, while overall global growth is forecast to stay in the area of 3%.

Supporting continued growth has been steady employment gains. In May, employment increased by 138,000 and the unemployment rate fell to 4.3%, the lowest level in 16 years. This payroll gain represented the 80th consecutive month of positive readings, a new record. In the three-months ending May, payrolls rose by an average of 121,000 per month. This compares to the six-month average of 161,000, and the 12-month average of 188,000. A slowdown in employment gains is to be expected as labor markets tighten. The average monthly change in nonfarm payrolls over the last three months of 121,000 is still well above the pace (approximately 75,000) that, over time, is consistent with steady absorption of labor supply.

ECONOMIC OUTLOOK

U.S. GDP IN SECOND QUARTER OF 2017

EMPLOYMENT GAINS

LOW INFLATION ENVIRONMENT

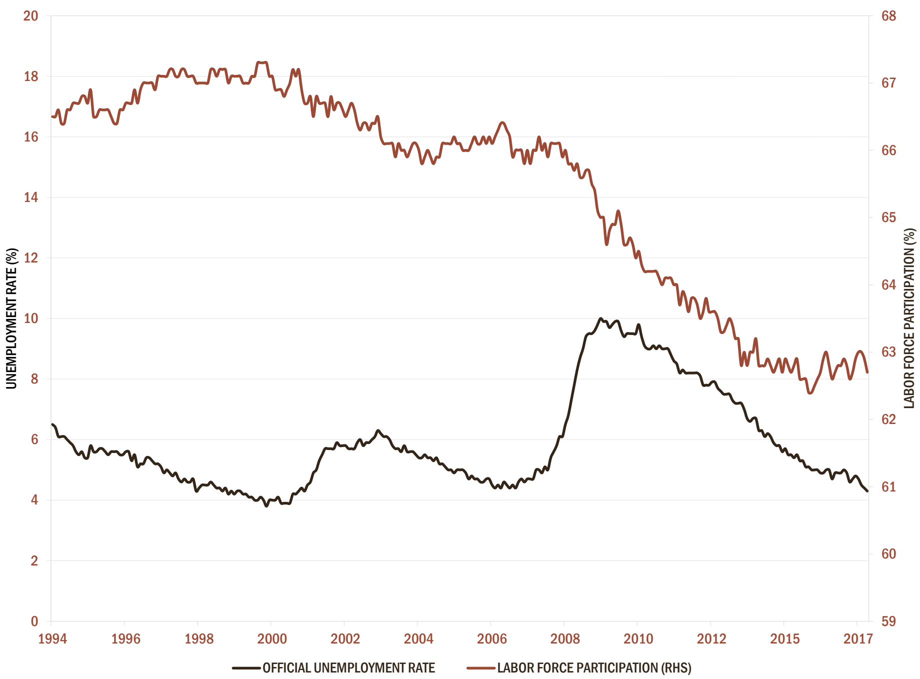
2017 MIDYEAR MARKET OUTLOOK

THE RECENT MODERATION IN INFLATION HAS LED TO THE BELIEF THAT THE FED CAN PROCEED EVEN MORE SLOWLY WITH INTEREST RATE HIKES THAN THE MARKET PREVIOUSLY BELIEVED, LEADING TO THE RECENT BOND RALLY.

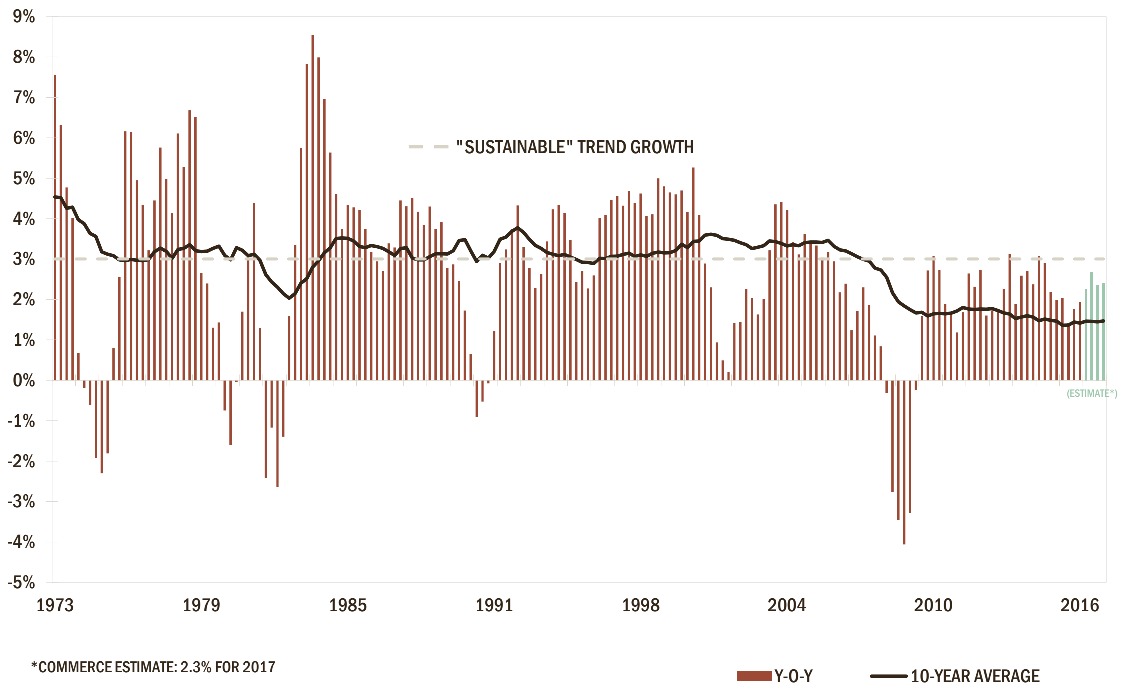
One of the enduring themes of this economic expansion has been very low inflation. However, as the business cycle moves towards the later stages, and full employment approaches, the economy is now reaching the point where some price increases and wage gains are beginning to appear. As such, the Fed moved to raise the Fed Funds rate another quarter point at its June meeting, following three very gradual interest rate hikes over the prior 18 months.

Of course, there are risks to this forecast of continued slow growth for U.S. and global economies. Headwinds may include a heating up of inflation and tighter Fed policy, the inability to make political progress on business-friendly legislation, and/or political, economic or military crisis abroad. But absent exogenous shocks like these, global economic growth is far from overheating and is poised to continue at least through this year and into 2018.

EMPLOYMENT



REAL GROSS DOMESTIC PRODUCT



EQUITY OUTLOOK

Domestic equity markets took a positive turn after the presidential election and have never looked back as we enter the summer of 2017. International equity markets also joined the rally this year, posting strong results after four years of dramatic underperformance to U.S. equities.

We continue to like International and Emerging Market equity markets. After the election, consumer and business confidences surged and are maintaining their high levels, last seen 15 to 20 years ago. Hope of less regulation, lower taxes and a stronger economy still linger even though the pace of Washington politics has been slow, to say the least.

With strong consumer confidence, money has been moving into equities from bond funds and money market funds. Historically, high consumer confidence is not necessarily a good omen for future stock prices. We believe equity exposure in equity mutual funds and index funds as a percent of total money invested in equity, bond and money market funds is approaching levels seen at previous tops in bull markets.

EQUITY OUTLOOK

↑ INTERNATIONAL & EMERGING MARKETS

↑ CONSUMER & BUSINESS CONFIDENCE

↓ POSSIBLE 5% OR 10% DECLINE IN SECOND HALF

2017 MIDYEAR MARKET OUTLOOK

WHILE TRYING TO PICK A TOP OF THE MARKET IS IMPOSSIBLE, IT IS MUCH EASIER TO ADJUST YOUR EQUITY EXPOSURE ON THE WAY UP THAN TRYING TO WAIT FOR THE ELUSIVE BOUNCE WHEN THE MARKET STARTS TO DECLINE.

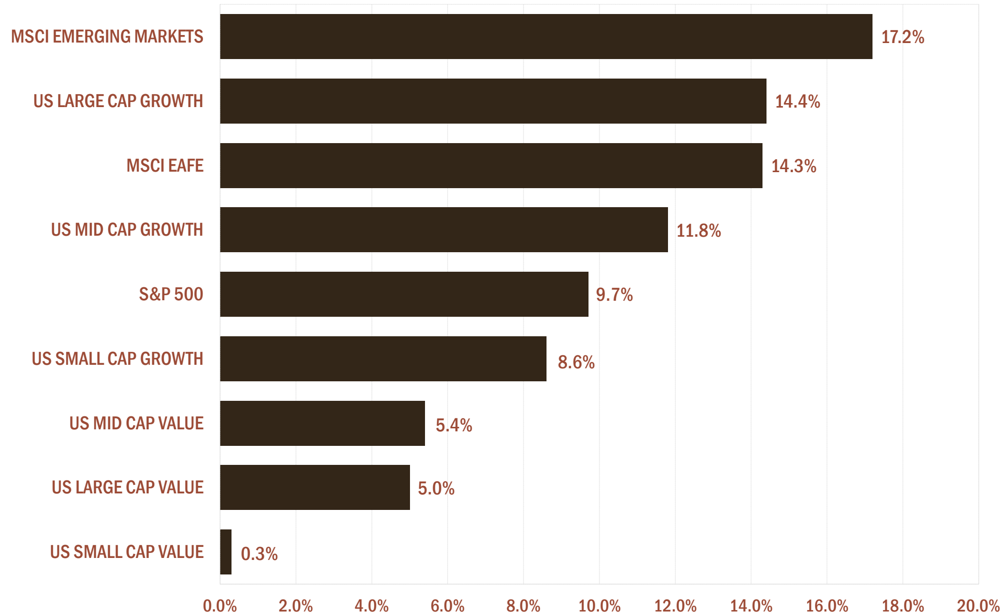
While the strength and persistence of the equity market rise has surprised many, we are becoming concerned we could be in store for some disappointments in the second half of this year, causing the first 5% or 10% decline in almost a year. We have been uneasy over the last year with the high valuation levels equities are trading at, but felt money would continue to flow from fixed income funds into equities. Many of the valuation measures we monitor are at levels last seen in the late 1990s, which ultimately did not have a good ending.

High valuation levels can be sustained with a strong economy producing accelerating earnings. The U.S. economy, unfortunately, is not accelerating as quickly as we thought a few months ago, which could raise doubts as the year progresses that earnings expectations are too high for the S&P 500 and will have to be reduced. Stocks also face the implications of rising short-term interest rates as the Fed tries to normalize short-term rates. While short-term rates are extremely low historically, equity advances have often stalled after the first few rate hikes by the Fed.

Over the last eight years the equity market has had quite an increase without experiencing a 20% correction (20% decline defines a bear market). Since 1925, the only longer stretch without a 20% correction was 1988 to 2000. We typically experience a 20% decline anywhere from every 2.5 years to 4.25 years depending on whether we are in a bear or bull market. With the equity market at all-time highs, now is a good time for clients to consider if they are comfortable with their equity exposure level and are willing to ride out the next bear market. While trying to pick a top of the market is impossible, it is much easier to adjust your equity exposure on the way up than trying to wait for the elusive bounce when the market starts to decline.

Of course, we could be surprised over the next six months that Congress could move quickly on passing a new health care bill, leading to an overhaul of the tax system. Lower corporate taxes will certainly increase earnings, helping bring down high valuations that could drive equity prices higher. We hope for this outcome, but recommend making any adjustment to the risk level of your equity exposure now, just in case legislation gets bogged down into 2018.

YTD EQUITY RETURNS
(AS OF 6/16/17)



ALTERNATIVE INVESTMENTS OUTLOOK

Alternative investments include strategies in the main categories of Hedge Funds, Real Estate, Infrastructure/Energy Master Limited Partnerships (MLPs) and Commodities. From a portfolio diversification standpoint, alternative investments may be attractive due to lower correlations to the traditional asset classes of stocks and bonds.

The range of investments in this asset class have return and risk profiles that vary from high return/high risk to low return/low risk. Real Estate Investment Trusts (REITs) and MLPs have high return/high risk profiles as they are a subset of the U.S. equity market. They have features that may be attractive during different economic cycles or inflationary periods. Hedge Funds are not a separate asset class, but represent manager skill in executing strategies in either a publicly traded or privately traded investment vehicle. There

ALTERNATIVE INVESTMENTS OUTLOOK

MLP SECTOR OUTLOOK

RISING INTEREST RATES COULD BE A HEADWIND

DECLINING COMMODITY PRICES

are a broad array of hedge fund strategies, although we prefer strategies that provide some protection to declining markets or behave differently than the rest of the portfolio.

We have a positive outlook on the energy MLP sector despite its lagging performance in 2017. We believe the expected ramp up in crude and natural gas volumes should lead to production recovery, drive strong operating leverage and increase cash flow. However, the performance of this sector will likely be driven by the direction of oil prices. If oil prices retreat toward $40/Bbl., energy MLPs will underperform. Rising interest rates could also be a headwind. Potential tax reform could have an impact, but the likelihood of significant tax reform getting passed has diminished.

Since the economic and market recovery in 2009, hedge funds have generally not kept up with equity and fixed income returns, and with their higher fee structure, investors have been re-evaluating these strategies. Despite the recent challenges, we believe that hedge funds have a place in portfolios as market conditions change and the appetite for risk declines.

FIXED INCOME OUTLOOK

The U.S. election results led to high expectations for an improving economy as 2016 concluded. Better growth from infrastructure spending and tax reform was anticipated to lead to higher interest rates and rising inflation. After the initial failure to pass health care reform, however, the chances of a significant

FIXED INCOME OUTLOOK

↑ FED FUNDS RATE HIKES

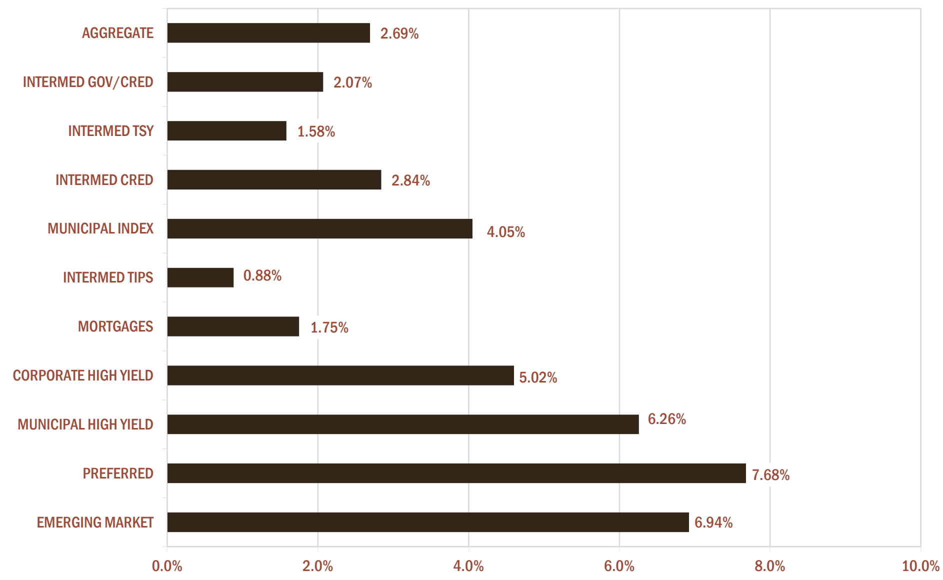
↑ CORPORATE BONDS ARE THE PERFORMANCE LEADER

↑ STRONG MUNICIPAL BOND PRICES

fiscal boost diminished. Interestingly, 10-year Treasury yields spiked after the U.S. election, increasing from 1.7% to 2.6%, at year-end.

FIXED INCOME SECTOR RETURNS

(AS OF 6/16/17)



As we continued along in 2017, Treasury yields have found a new trading range. The 10-year U.S. Treasury note yield spent the past five months range-bound between 2.6% and 2.2%, finishing May at the lower part of the range. But neither an uptick in economic growth nor an increase in inflation materialized. Yields on the short maturity end of the Treasury yield curve remain sensitive to expected changes in the Fed Funds rate. Yields rose for short maturities, while intermediate to long maturity yields decreased around 20 basis points (1% equals 100 basis points) year-to-date.

The Treasury curve remains flat, a common occurrence when the Fed is expected to raise rates. A flat yield curve can also indicate that expectations for future inflation are falling and in anticipation of slower economic growth. Slower consumer spending and a decline in commodity prices led to lower inflation, as reflected in the Consumer Price Index (CPI). Inflation-induced interest rate increases did not occur across the yield curve as anticipated. Bond returns for the major benchmarks benefited from the subdued move in inflation.

Steady investor demand and stable credit fundamentals helped drive positive returns across all of the fixed income sectors year-to-date. Lower-quality holdings on average outperformed higher-quality. So far this year, corporate bonds are the performance leader for the investment grade sector. The Bloomberg Barclays Aggregate Bond Index generated a 2.69% year-to-date return (through June 16, 2017).

The Bloomberg Barclays Municipal Bond Index is up 4.05% year-to-date, performing better than most of the taxable bond market. Slow progress on the Trump Administration's tax reform agenda led the market

2017 MIDYEAR MARKET OUTLOOK

to reassess the potential negative impact of tax reform. Year-to-date, municipal fund inflows have been healthy at $5.6 billion. This strong demand coupled with total new issuance being muted at 10% lower year-over-year through the end of May have provided a rather positive technical backdrop for the municipal market. Demand is expected to continue to be strong and net supply is expected to be negative over the next few months. Rising valuations may result for this sector.

The recent moderation in inflation has led to the belief that the Fed can proceed even more slowly with interest rate hikes than the market previously believed, leading to the recent bond rally. Slow but steady economic growth is favorable for company earnings and is a positive factor to help corporate bonds outperform Treasuries. The bond market is well on its way to producing low single-digit returns for 2017.

We plan to maintain an overweight position to the non-government sectors, while gradually improving quality and liquidity to the portfolios we manage. Portfolio durations are being modestly raised but still maintained slightly short to neutral relative to their corresponding benchmarks.

MIDYEAR NUMBERS

2-2.5%
2017 U.S. GDP GROWTH FORECAST

9.7%
S&P 500 YTD

4.3%
2017 MAY UNEMPLOYMENT

2.2%
10-YEAR U.S. TREASURY YIELD*

2.69%
BLOOMBERG BARCLAYS AGGREGATE BOND INDEX YTD RETURN**

4.05%
BLOOMBERG BARCLAYS MUNICIPAL BOND INDEX YTD RETURN**

*AS OF 5/31/17
**AS OF 6/16/17

CONCLUSION

2017 has been more a year of investment surprises and uncertainty year-to-date. Consider the following unexpected situations:

- The remarkable resilience and lack of volatility in stock markets in the United States and around the world given the rapid political changes from country to country.
- Despite the Fed's recent policy rate hike path upwards, 10-year U.S. Treasuries have actually declined from 2.6% to 2.2% since the beginning of the year.
- Top economists' opinions are mixed on annual growth. High estimates have growth up to about 3%, while others have low estimates at about 1.5%.
- The government dysfunction in bringing about business-friendly legislation for health care, infrastructure and tax law reform has so far created a stalemate for progress.

While we do expect the second half economy to plod forward, questions on interest rates, market resilience and government policy need to play out further before long-term direction can be assessed for the coming 18 months.

INVESTMENT POLICY COMMITTEE - JUNE 22, 2017

2017 MIDYEAR OUTLOOK
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