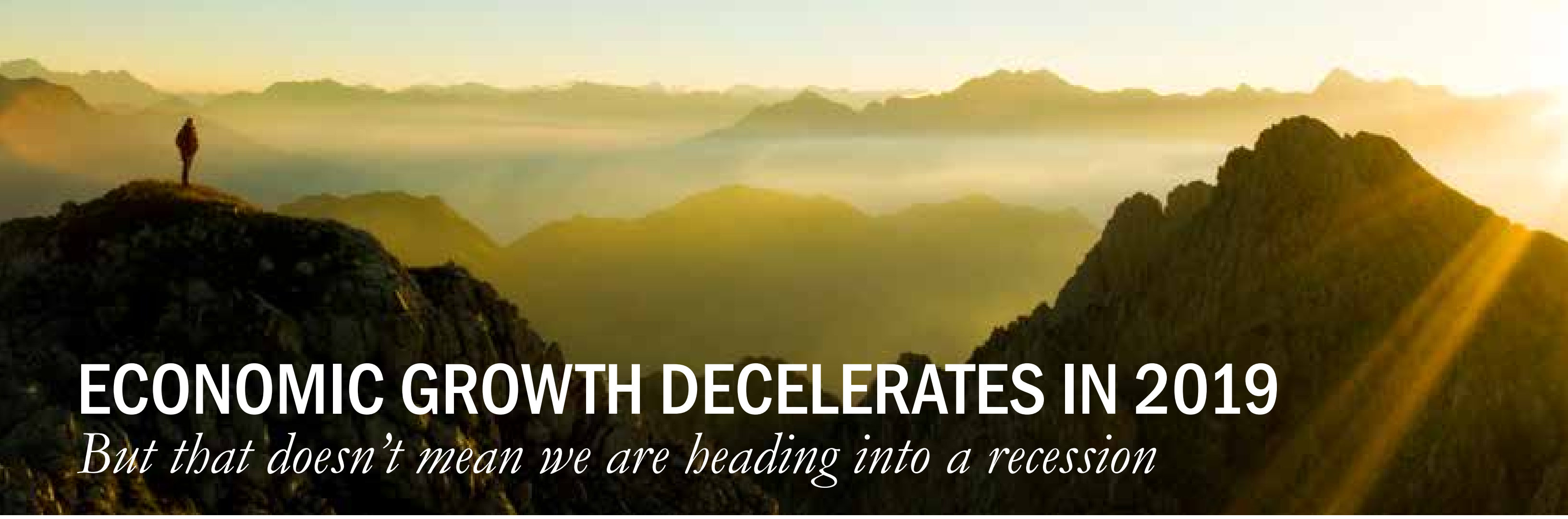
2019
3RD QUARTER

CURRENT ECONOMIC AND FINANCIAL MARKET CONDITIONS SUMMARY

PREPARED BY: INVESTMENT POLICY TEAM

Commerce Trust Company
Wealth | Investments | Planning®



ECONOMIC GROWTH DECELERATES IN 2019

But that doesn't mean we are heading into a recession

ECONOMY – *Still making forward progress*

Despite global economic growth slowing in 2019, we have now entered the longest U.S. economic recovery on record (10 years and counting). Importantly, we believe the likelihood of a near-term recession at this point is unlikely, especially with the Federal Reserve (Fed) poised to take out an "insurance policy" on this recovery with an interest rate cut in late July (likely to be followed by another in September). Our current slowdown has been driven by a myriad of interconnected causes, primarily the lagged impact of last year's higher short-term U.S. rates, an exceptionally weak Europe and a continued slowdown in China spurred along by escalating trade tensions. The Fed's tightening of monetary policy last year led to tougher financial conditions, disrupted the credit markets, pushed stock prices down and strengthened the dollar. Throw in a month-long government shutdown, unseasonably cold weather followed by a soggy spring, fading fiscal stimulus and tremendous angst with regard to our trade skirmish (near war) with China, and it's rather obvious economic activity would cool from last year's 3% pace. Fortunately, the late 2018 financial market turmoil gave the Fed the cover to stop raising rates, effectively a "pause that refreshed" the economy. That pivot was the catalyst that kept our economic expansion on track, and the Fed's recent move toward monetary accommodation will likely afford an additional boost that keeps our economic momentum moving forward.

We expect economic growth this year will be approximately 2% to 2.5%. The key drivers of this growth are:

- An accommodative Fed likely to provide at least 0.50% of short-term interest rate reduction this quarter
- Increasing employment levels that translate into a rise in personal income and steady consumer spending
- Surprisingly benign inflation
- Record corporate profitability spurring reinvestment in productive capital equipment and software
- A positive tailwind from low energy prices and long-term interest rates
- The wealth effect from a recovering U.S. equity market, accompanied by a marked improvement in credit spreads and risk asset pricing
- The recent "truce" in the U.S./China trade skirmish as negotiations continue

Growth will remain positive despite weakness overseas and trade issues that clearly cloud the economic outlook. The global weakness and the lack of U.S. inflation has pushed the Fed into an easing mode. We believe the Fed will cut interest rates until the yield curve regains some steepness and economic prospects brighten further. This looser monetary policy stance, combined with a robust yet non-inflationary labor market, suggests our record expansion should continue for many quarters to come. In fact, we could envision this expansion lasting for up to three or four more years, a highly out-of-consensus forecast.

Still, this business cycle won't last forever, and last year's volatility in the financial markets acted as the proverbial canary in the coal mine and captured everyone's attention. As the Fed helps extend the recovery, our biggest worries remain the political dysfunction in Washington and sluggish growth overseas. As a result, investors will stay focused on global trade issues and become increasingly interested in the 2020 election outcome, which no doubt will introduce an entirely new set of anxieties that could begin to weigh on markets as the year progresses.

EQUITY MARKETS – *We have remained firm in our commitment to stocks and risk assets*

When 2019 began, we noted how valuations for the market had improved dramatically since January 2018. The S&P 500 median P/E fell to 16.4 times at the end of December, levels last seen in 2014. The strong surge in equity prices in the first half moved the median P/E slightly below the overvalued territory. With the backdrop of moderate economic growth and an accommodative Fed, we believe earnings will continue to grow this year, supporting the rebound in stock prices.

Another problem the equity market faced last year was the acceleration in short-term interest rate hikes. Rising short-term rates had not been a problem since the beginning of this bull market in March 2009, at least not until early last year. In late December, the Federal Reserve shifted from a higher short-rate forecast to a wait-and-see approach and in July to reducing short rates. Falling interest rates are positive for continued equity market strength.

As we entered 2019, there was a clear change in investor sentiment from an attitude of buying every dip (on the belief that the market always goes higher) to one of a more cautious nature. Typically, when equity markets surge 20%, investors quickly turn bullish again, but that has not been the case this year. Financial news continues to caution investors about a slowing global economy, an inverted yield curve and the prospects for earnings disappointments. Investors remain cautious, which we view as a positive for equity prices.

FIXED INCOME MARKETS – *A sharp recovery has front-loaded returns this year*

Returns for bonds in 2018 ranged from slightly negative to slightly positive due to the rising interest rate environment. Fixed income returns were paltry at best as the Fed's four rate hikes pushed yields higher and bond prices lower. Surprisingly, most of last year's weaker results were quickly offset this year as interest rates dropped and credit spreads improved. Core investment-grade municipal and taxable bond funds have posted positive returns in the 5% to 6% range, while higher-yielding, non-investment-grade funds posted even better returns of roughly 10%. For the rest of 2019, as the Fed likely reduces short-term rates, bond funds should perform more closely in line with the cash markets. The good news is that this year bond returns have been far higher than most were expecting, but those results are behind us, and all we are likely to earn the rest of the year are the bonds' coupons.

In April, we reduced our modest allocation to the riskier "plus" areas of the bond market (from 10% to an 8% weighting). Within the "plus" sector, we believe the best bond returns for the rest of the year are likely to be provided by emerging market debt and high-yield municipal bonds, which should enhance the more modest returns in the investment-grade sector. We will likely trim this riskier exposure even further as the business cycle progresses.

ALTERNATIVE INVESTMENTS

Alternative investments include strategies such as hedge funds, real estate, energy master limited partnerships (MLPs) and commodities. We include them in many client portfolios to either reduce volatility or provide diversification. Hedge funds are an area in which we emphasize strategies that may provide protection in a declining market or behave unlike stocks and bonds. We expect that higher market volatility will continue into 2019. Conservative hedge funds, which have lagged stock and bond markets since the 2009 recovery, may have their day as investors seek preservation of the wealth they have built over that time. Real estate investment trusts (REITs) have been strong performers, with the DJ US Real Estate Index returning 18.63% through June. The backdrop for real estate remains favorable. Continued downward pressure on interest rates and yields should be supportive, as should any incremental trade headlines. Energy MLPs have also provided strong performance, with the Alerian MLP Infrastructure Index returning 16.24% through June. The outlook for the North American midstream energy sector is positive, given recent signs of stabilization in both company fundamentals and underlying commodity prices. Commodities are being affected by opposing forces across the board and within sectors. The slowdown in China's growth prospects and the U.S. escalation of the trade and intellectual property struggle with Beijing are being offset by steady to robust growth in the United States and several emerging market economies.

INVESTMENT POLICY TEAM - JULY 15, 2019

Commerce Trust Company
Wealth | Investments | Planning®

1-855-295-7821 | commercetrustcompany.com