We ask, listen and solve.

Market Update

Economic and Financial Market Midyear Update — June 2014

Staggered but Steady Growth Keeps Economy Moving Forward

Market Summary

- *U.S. economic growth is forecasted to average near 3% for the second half of 2014.*
- *Equities are expected to outperform bonds as domestic returns could reach 10% to 15% by year end.*
- *Corporate earnings are projected to show moderate growth of 8% to 10% from first-quarter levels.*
- *Interest rates have fallen this year despite the Fed's tapering of its bond-buying program.*
- *Positive economic fundamentals provide favorable backdrop for above-trend economic growth through the remainder of 2014.*

INTRODUCTION

Since mid-2009, the U.S. economic recovery could largely be characterized as a case of two-steps-forward, one-step-backward. This staggered pattern of growth was certainly evident once again when abnormally severe winter disruptions caused demand to falter in a decidedly weak first quarter. In fact, real GDP for this year's first quarter was revised down to a -1.0% annual rate (Chart 1). Fortunately, normal weather has returned and several other factors that restrained first-quarter growth are dissipating. Thus, we expect economic growth to rebound toward 4% in the second quarter, and average close to 3% for the second half of 2014. Our overall outlook for equities remains favorable following the 32% gain in 2013.

ECONOMIC OUTLOOK

Fading fiscal drag (with no looming budget cuts of a year ago), a positive stock market, some inventory rebuilding, the continued recovery in the housing market and easing financial conditions provide favorable tailwinds for above-trend growth through the rest of 2014. This growth should occur even as the Federal Reserve (Fed) continues with its expected "tapering" of bond-purchasing plans. Current measures of U.S. economic activity support this view. In May, the data for growth in employment, manufacturing, business confidence, home prices and wages pointed upward. Strong corporate balance sheets will support both expenditures and future investment for growth, while merger and acquisition activity and stock buybacks continue to bolster equity prices. While housing activity was sluggish last winter and into the spring, the waning impact of last year's rise in mortgage rates, accompanied by modest new household formation, point toward further progress.

Most importantly, recent data also point toward momentum in employment. In the three months ending in May, payrolls rose by an average of 234,000 per month. **This payroll increase represents a notable acceleration in**

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CHART 1
REAL GROSS DOMESTIC PRODUCT

After a weather-related drag on GDP in the first quarter, economic growth is expected to rebound in the second half of 2014.

- Year-over-Year (YOY)
- YOY (Estimate)*
- 10-year Trend
- Sustainable Growth Trend

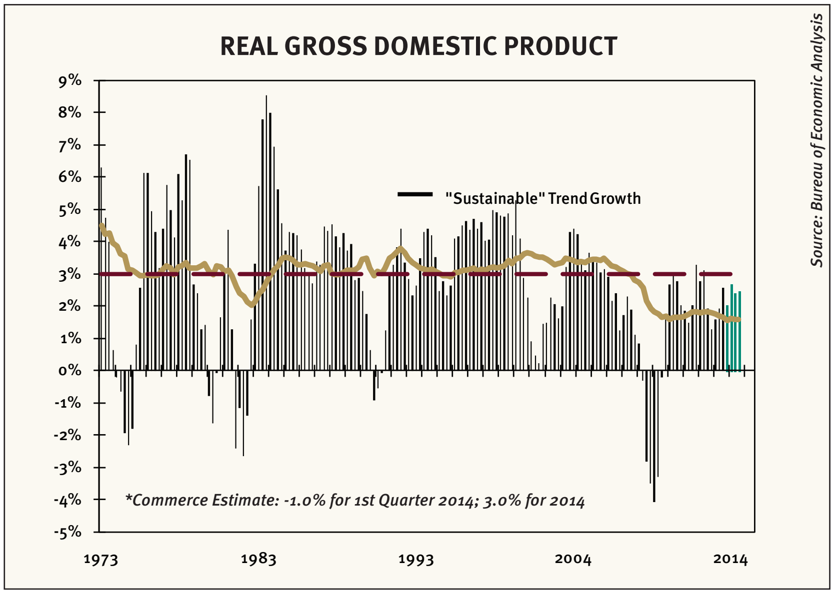


CHART 2
EMPLOYMENT

Positive trend developing in payroll employment in 2014.

- Monthly Increase (Left Axis)
- 3-month Change (Right Axis)

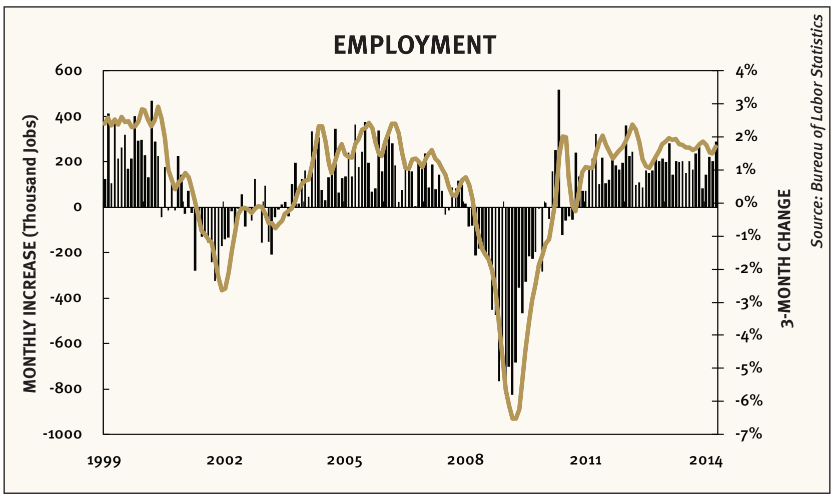
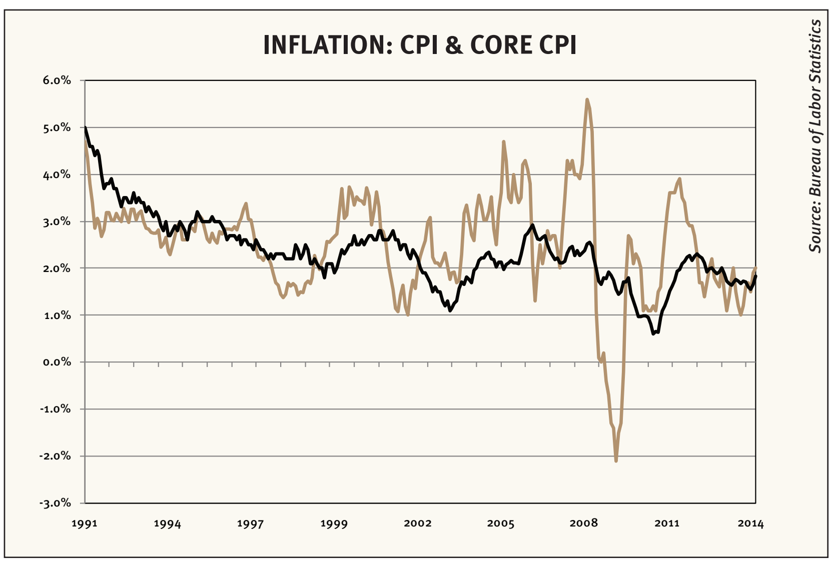


CHART 3
INFLATION: CPI & CORE CPI

Inflation is starting to rise, but Core CPI remains below the Fed's 2.0% target.

- Core CPI (YOY): 2.34% Avg.
- CPI (YOY): 2.50% Avg.



quarterly employment from March's three-month trailing average of 190,000 per month and February's 150,000 per month. Clearly, weather served as an impediment to hiring. The six-month average monthly gain of 200,000 jobs per month is likely a better gauge of the underlying trend in job growth (Chart 2).

Oddly, employment participation rate — which is the percentage of working-age persons who are either employed or unemployed and job hunting — continues to shrink faster than what most would consider consistent with demographic trends. This decrease has helped drive the unemployment rate down to 6.3% from its peak of 10% in 2009. Still, unemployment remains above the Fed's desired longer-term level. So, with inflation running below its targets, the Fed is expected to continue its accommodative policy for quite some time before it attempts to normalize short-term interest rates. Regular readers know we have been calling for lower rates longer than what most investors expected.

With a stated Federal Open Market Committee 2% inflation target, price pressure remains surprisingly subdued. Low inflation has been helped along by a slowdown in China and a still-stagnant European economy. Even so, the Core Personal Expenditure Index, the Fed's favored inflation measure, has likely bottomed (1.2% last year), and recently increased to 1.4% as of the April report. Similarly, the Core Consumer Price Index (Core CPI) has also moved up in tandem this year from 1.6% to 1.8% (Chart 3). While we still expect inflation to remain below the Fed's 2% target for the intermediate term, all of the money-printing and zero percent interest rate policies are beginning to gain some traction. As unemployment continues to decline, we should begin to see modestly higher wages. Eventually, as this happens there will be slow but steady price pressures, finally reaching and eventually surpassing 2% in 2015.

Worries about the European economy have persisted this year. Even with a disappointing 0.2% first quarter growth rate in the eurozone, there are signs of better growth ahead in some parts of the region. Consumer spending is beginning to pick up in conjunction with a measurable improvement in industrial and manufacturing activity. Both the U.K. and Germany, two of the continent's biggest economies, appear to be doing relatively well and have forecasted growth rates in 2014 of 3.4% and 1.8% respectively.

France, Italy and Spain have been lagging, but all have been moving toward potential improvement with new growth initiatives. In fact, the presidents of both Italy and France recently appointed reform-oriented and market-friendly prime ministers. While the European difficulties are not completely resolved, bond yields across the continent have moved down to near-historic lows, and we expect some additional extraordinary support from Mario Draghi and the European Central Bank, including perhaps negative interest rates.

China continues its transition from an investment-driven economy to a consumption-driven economy, while simultaneously enforcing greater controls over its shadow banking system. As China slows its torrid borrowing pace, turbulence is to be expected. While recent economic activity has cooled, China continues to grow at twice the pace of the rest of the world. And there are signs that the pace of its slowdown is moderating, and the second quarter may bottom out in the near term. Despite negative headline news and general investor skepticism toward China, we believe the recent slowdown is a healthy occurrence and that recent reforms have actually improved the quality of future growth.

Pulling it all together, we see that global fundamentals are still generally sound and likely to improve as we move through 2014. While risks abound in Ukraine, Europe and China, demand is improving in a number of business and consumer sectors. Global inflation remains exceptionally subdued. As such, the Fed and almost all other Central Banks are likely to stay on an accommodative course for the immediate future. Therefore, after a slow start to the year, acceleration in growth is the most likely path through the remainder of 2014, especially in the United States.

EQUITY OUTLOOK

The "slow start" occurred in January when the S&P 500 kicked off 2014 with a sharp downturn. However, this dip proved to be a short breather as the S&P 500 recovered quickly in February, hitting new all time highs in the spring. In early June, the S&P 500 posted a 5% total return. International stocks have also participated with the MSCI EAFE (Europe, Australia & Far East) Index rising 4% and Emerging Markets increasing 3.5%, after a dreadful year in 2013. We continue to recommend overweighting equities in portfolios, where appropriate, as we believe that by the end of the year, domestic returns could reach 10% to 15%, following the 32% gain in 2013.

At the end of May, the S&P 500 Price/Operating Earnings Ratio (P/E) was at 17.7 times, approaching 18 times — which has signaled a market that was becoming expensive and could be susceptible to a decline. As the economy strengthens over the last three quarters of this year, we project corporate earnings will show moderate growth, posting 8% to 10% gains from first-quarter levels. The increase in earnings allows the market averages to move higher before valuation levels become a concern.

As P/E levels approach the higher end of their historical range, we would not be surprised if they stay at elevated levels as long as the environment of low interest rates and inflation persists. As consumer confidence continues to increase, investors will feel more comfortable adding to their equity exposure. Fixed-income investments have had surprisingly competitive returns with equities through May, a trend we do not expect will continue into year-end. The S&P 500 dividend yield is 1.9% — a competitive yield with the 10-year Treasury at 2.5%.

In the domestic equity market, mid-cap stocks have been the best performers, a trend that should continue. Mid-cap stocks have been attractive targets for large-cap companies looking for ways to deploy the record amount of cash on their respective balance sheets. Small-cap equities have experienced a rough couple of months in the spring, as valuation levels became extended in biotech and internet-related technology stocks, which are heavily represented in small-cap indexes. During the second half of this year, we expect small-cap stocks to resume their strong performance exhibited in 2013.

The MSCI EAFE Index is keeping up with domestic markets this year after underperforming the S&P 500 by 10% last year. From a valuation measure, large-cap international stocks sell for 15.5 times earnings versus 17.7 for the S&P 500. International stocks also support a higher dividend yield over domestic stocks. We recommend that 30% of an equity portfolio be invested in international securities. One shift made earlier this year was to reduce our exposure in Emerging Markets back to developed international markets. Emerging Market countries are especially affected by the slowing Chinese economic growth rate. Emerging Market economies supply much of the raw materials that have been used over the past decade as China built out its infrastructure.

The S&P 500 average has risen

on a price basis alone 188% from the March 9, 2009, low and has not experienced a 10% correction in two years. Our position is to resist the temptation to reduce equities and let the market work higher this year. At some point, the market will become overvalued, and we will remove our overweight recommendation on equities.

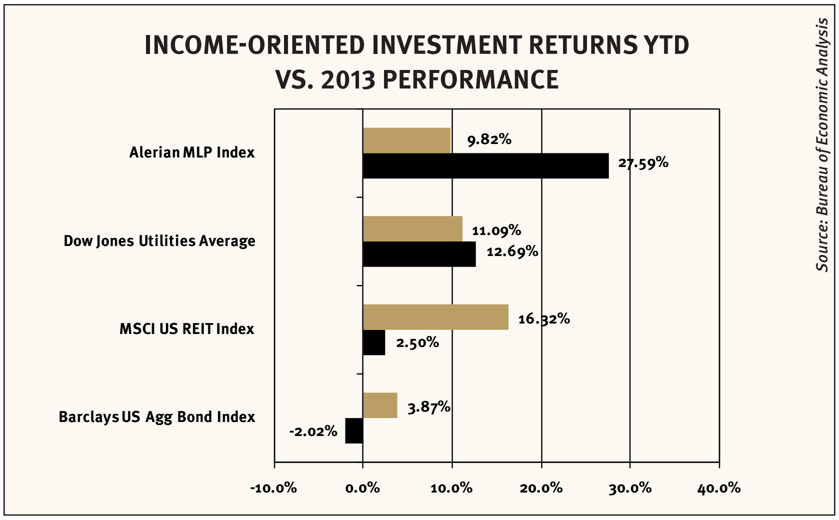


CHART 4
INCOME-ORIENTED INVESTMENT RETURNS YTD VS. 2013 PERFORMANCE (AS OF 5/31/14)
Renewed interest in income-oriented investments boosted MLPs and REITs.

- 2013 PERFORMANCE
- YTD 2014 PERFORMANCE

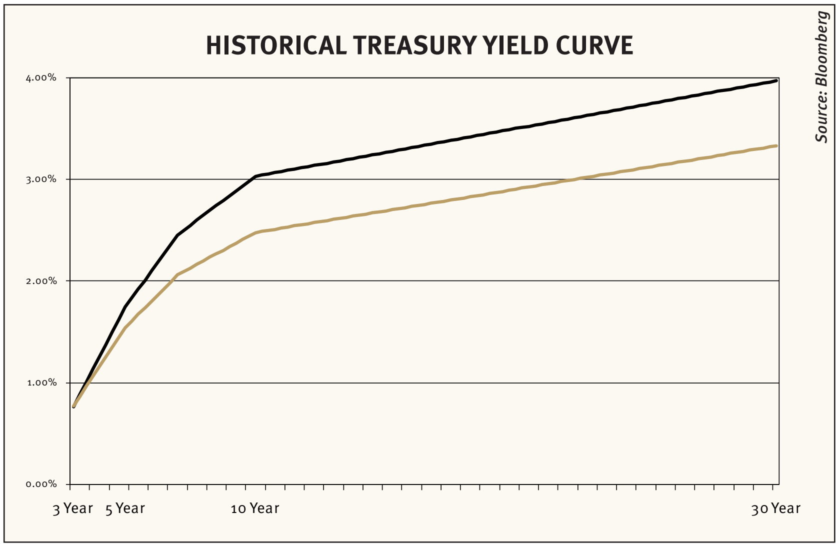


CHART 5
HISTORICAL YIELD CURVE (12/31/13– 5/31/14)
Treasury yields have declined year-to-date, despite the Fed's tapering of its bond purchase program.

- 12/31/2013
- 5/31/2014

ALTERNATIVE INVESTMENTS OUTLOOK

In addition to the equities discussed in the previous section, The Commerce Trust Company considers Alternative Investments a very important component of a properly diversified portfolio. These investments include strategies in the main categories of Hedge Funds, Real Estate, Infrastructure Master Limited Partnerships (MLPs) and Commodities/Natural Resources/Real Assets. Alternative Investments may be attractive due to lower correlations to traditional asset classes of stocks and bonds.

Multi-Strategy, or Fund of Fund, Hedge Fund strategies are slightly positive on a year-to-date basis. The HFRI Fund Weighted Composite Index year-to-date returned 1.99%, and the HFRI Fund of Funds Conservative Index returned 1.77% through May 31. Individual strategy Hedge Fund returns varied, with event-driven and relative value delivering the highest returns, followed by Equity Hedge, Macro and Emerging Markets.

A flight to quality with the sell-off of momentum stocks and a renewed interest in income-oriented investments boosted Real Estate Investment Trusts (REITs) in 2014. The MSCI US REIT Index is up 16.32% through May 31, following a subdued performance in 2013. The outlook for the U.S. real estate market is for above-average cash flow growth despite a slow economy.

Infrastructure MLP investing is gaining more acceptance as an asset class. Investors seeking income along with growth potential allocated more to this sector throughout the past several years. This increase is reflected in the Alerian MLP Index return of 27.59% for 2013. In 2014, the index is up 9.82% through May 31 (Chart 4).

Commodity index returns in 2014 are also strong, with the DJ UBS Commodity Index returning 6.45% through May 31. Agriculture, livestock and natural gas have been strong.

In the near term, oil prices are reasonably well-supported by tight supply — but oil supplies potentially could increase over the next year. Gold prices have been range-bound, caught between the opposing forces of U.S. dollar weakness and a renewed slump in U.S. real interest rates.

FIXED-INCOME OUTLOOK

Remember last year's talk of a bond market bubble? At least for a time, the predictions appear to be unfounded. Despite the Fed's tapering this year (announced in December 2013), which slowed and should eventually stop its quantitative easing, domestic interest rates have fallen, and the bond market has generated surprisingly positive returns.

How could these results have happened? With hindsight as a guide, we can point to a combination of four likely reasons. First, rates had already risen considerably, and no

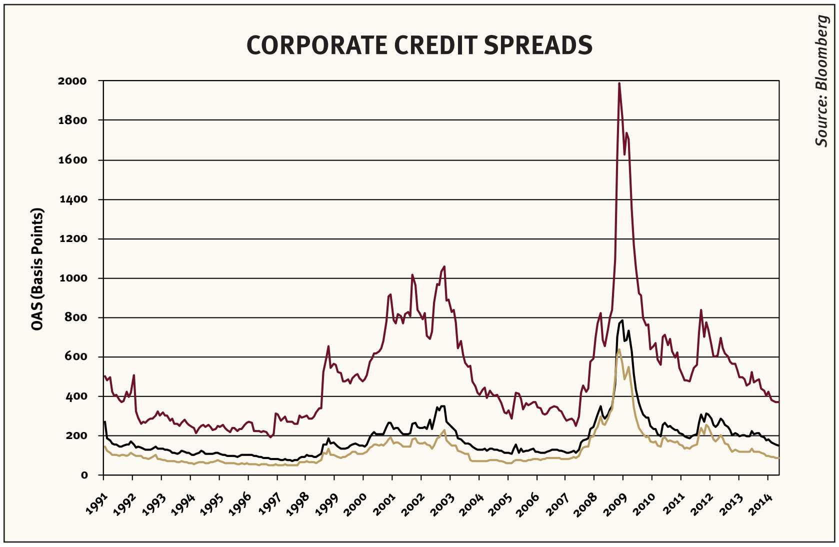


CHART 6
CORPORATE CREDIT SPREADS
(12/31/1991 – 5/31/2014)
Corporate spreads continue to tighten, but still have room to go lower.

- High-Yield Index: Average 512 bps
- A-Rated Corporate Credits: Average 126 bps
- BBB-Rated Corporate Credits: Average 186 bps

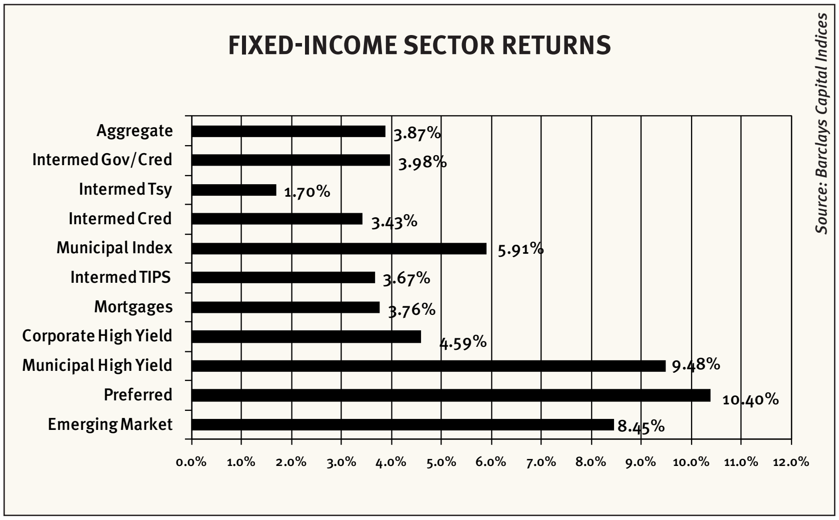


CHART 7
FIXED-INCOME SECTOR RETURNS YEAR-TO-DATE
(AS OF 5/31/2014)
All fixed-income sectors are generating a positive return year-to-date.

investment moves in one direction last forever. Last year, the 10-year Treasury rate moved up from its low of 1.40% in 2012 to a year-end high of 3%. As rates began to fall early in the year, the crowded, one-way bet got squeezed and buyers were forced back in to cover their negative bond market bets. Second, when U.S. growth came to a standstill during the winter, the equity market faltered and turned negative for a time, prodding investors to remember the relative safety of the fixed-income markets. Third, global rates were declining. With German, French and Japanese rates well below 2%, a 3% yielding Treasury began to seem like a relative bargain (Chart 5). And fourth, inflation remained surprisingly muted, driving real yields higher and bond market value up a bit.

Riskier bond assets continue to do well. The gap between yields of investment-grade corporate bonds and Treasuries represents the extra premium investors demand due to the greater credit risk associated with corporate bonds. This risk premium (i.e., spread level) gradually tightened over the first five months of the year. An improving outlook for the economy, along with stronger corporate balance sheets, led spread levels to move from 118 basis points (100 basis points in terms of percentage is 1%) to 105 basis points, based on Merrill Lynch's U.S. Corporate Master Index. This level is just below the index's 20-year long-term average and is still well above 2007's low spread levels, which reached 86 basis points prior to the financial crisis — suggesting there is still room to improve (Chart 6).

The High Yield sector continues to be supported by the nearly ideal environment of slow but steady economic growth, investors' continued appetite for risk, and tremendous investor liquidity. In addition, the default rate is predicted to remain low. Moody's forecasting model projects the global speculative grade default rate to finish in 2014 at 2.3% — which if realized, would be lower than 2013's year-end rate of 2.9%.

While there is still some relative value to be squeezed from investment-grade bonds, the High Yield market is at the upper end of valuation. Historically, High Yield bonds have afforded 5% to 6% extra yield to make up for their default risk. Today, it is much closer to 3%. Nominal yields are exceptionally low, having spent most of this year below 5.50%. And for the first time since 2005, High Yield no longer enjoys a yield advantage over Emerging Market debt. The yields on these two sectors are roughly equal — another indicator that High Yield is getting expensive.

One small pocket of value that our core plus strategy tactically added to this year has been Emerging Market debt. Last year, these bonds were pummeled as China slowed and Emerging Market equities fell. This year, returns have been positive as the equity markets stabilized.

As Chart 7 indicates, the overall U.S. bond market, as measured by the Barclays Aggregate Bond Index, returned a surprisingly positive 3.87% for the first five months of 2014, with risky assets doing even better than Treasuries. Quietly, though, municipal bonds have done even better.

The Barclays Municipal Bond

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Index was up 5.91% through the end of May, following a -2.55% decline last year. In 2013, the municipal bond market posted its worst year in almost two decades, driven down by the flight out of bonds in general, plus the credit anxieties sparked by the Detroit bankruptcy, restructuring concerns in Puerto Rico and pension costs in Illinois. But a combination of lack of new supply and growing investor demand for tax-free income contributed to the rebound, not to mention dramatic improvement in tax revenues for most municipalities. Headline risk remains though, particularly in Puerto Rico (despite its successful debt sale) and Illinois in general.

So far, the dark lining though to this year's silver cloud remains the low absolute level of today's interest rates. Over time, all bond investors can expect to earn is their coupon, which is simply the interest rate stated on a bond when it is issued. Because rates rebounded and sparked a reversal to last year's negative returns, we still expect an improving U.S. economy, latent inflation and a rebound in Europe and the Emerging Markets to put upward pressure on interest rates. With risk assets grossly outperforming, there is less and less room for error. Accordingly, we are likely to remain short on the average maturity of the market and emphasize higher quality non-government assets. And while we expect this economic expansion to continue to run at least several years, over time we will slowly take a bit of credit risk off the table in our most risky pockets, as the market becomes increasingly priced for perfection.

CONCLUSION

We may be entering the classic mid-cycle phase of an economy that has finally shaken off its 2009 financial recessionary hangover, just before central bankers start setting their sights on restraining potential inflationary trends that can come with an expansion.

This phase has taken a long time to arrive, but the economic measures certainly support a dose of optimism relative to a modest expansion, barring unforeseen world conflicts.

The fundamental building blocks of a healthy economy — including diminished fiscal drag and decreased congressional wrangling over sequestration cuts, a positive stock market, surprisingly favorable bond market returns, the continued recovery in the housing market, strong corporate balance sheets, acceptable stock valuation levels and employment rate gains — provide more favorable tailwinds for above-trend growth through the rest of 2014.

These anticipated economic conditions are likely to benefit equities more than fixed income.

INVESTMENT POLICY COMMITTEE
JUNE 6, 2014

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