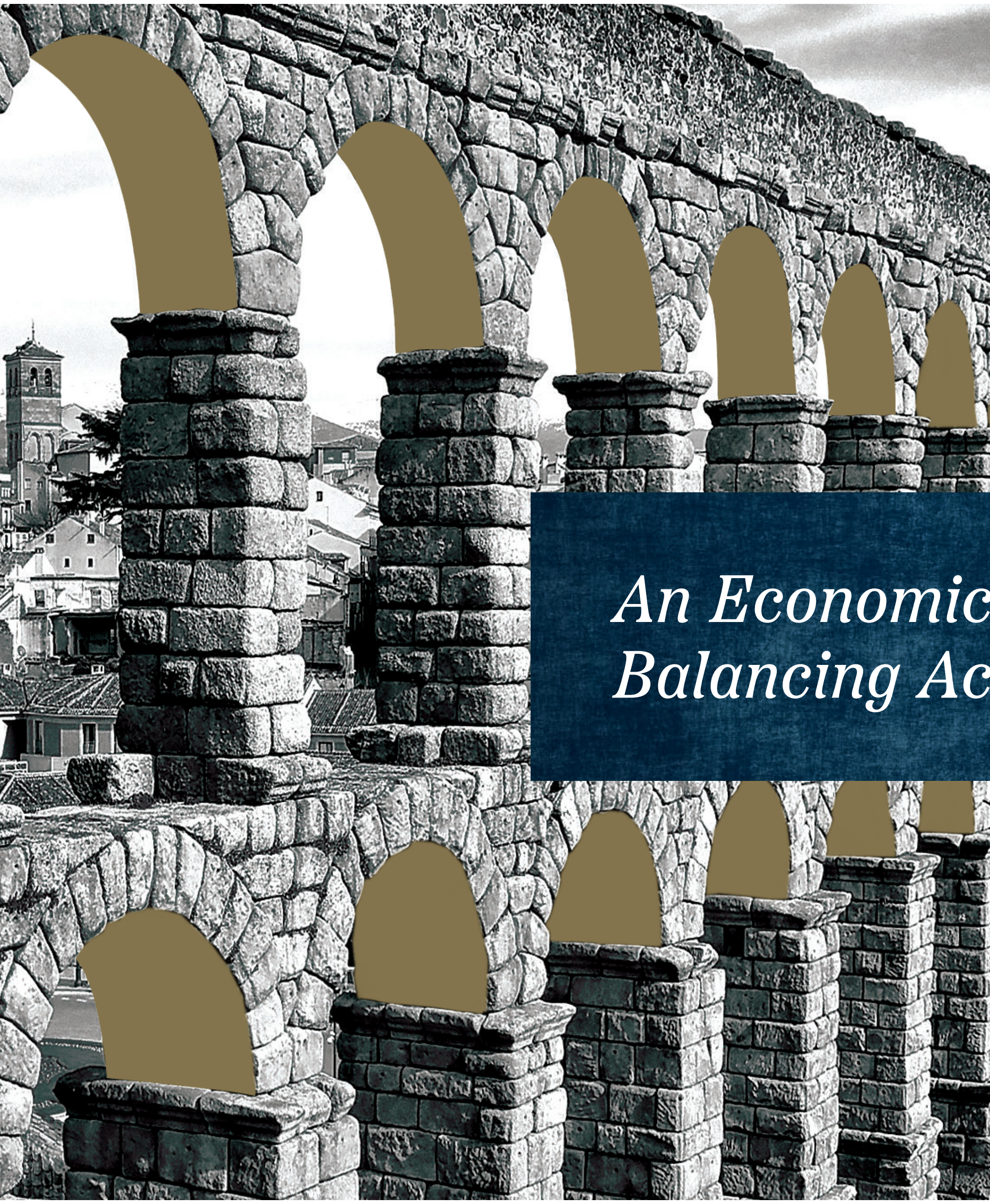

An Economic Balancing Act

OUTLOOK | 2025

Commerce Trust
Banking | Investments | Planning®

FROM THE COMMERCE TRUST CHIEF INVESTMENT OFFICER

In recent years, we witnessed a significant shift in the U.S. economy as it moved away from a stimulus-fueled expansion to a period marked by tighter monetary policy and rising interest rates. Recall that just four years ago, the U.S. economy was supercharged with fiscal and monetary stimulus needed to confront the pandemic-related shutdowns. This stimulus produced the elevated inflation we experienced in 2022 and 2023, which led to the Federal Reserve (Fed) aggressively raising short-term interest rates to curb inflation, slowing the economy as well.

What has since emerged is an economy seeking to regain equilibrium, alongside financial markets that are seemingly cheering it on. Inflation has subsided in most areas, declining from a Consumer Price Index (CPI) peak of 9.1% on a year-over-year basis in June 2022, to the most recent 2.6% pace this past October, according to the U.S. Bureau of Labor Statistics. Still, certain areas of the economy, particularly housing, and more volatile components like insurance and auto repairs continue to experience upward pressures.

Against this backdrop, the U.S. economy continues to support a strong, albeit slowing, job market. We are optimistic that the prevailing trend of steady employment will continue to meet our expanding economic demands.

The consumer, representing 70% of the total U.S. economic output, remains poised to drive our dynamic economy forward. With the Fed initiating its rate-cutting cycle, we believe the U.S. central bank is attempting to find a neutral interest rate range that neither accelerates nor restricts economic growth as it seeks to balance both inflation and employment. We anticipate lower interest rates could provide additional relief to many sectors of the economy.

Looking at the financial markets, it appears both fixed income and equity markets experienced an inflection point in July when inflation was viewed as becoming subdued. This spurred a transition inside the U.S. equity markets, with returns broadening out from large technology-oriented growth companies to other sectors and to smaller capitalization stocks. Within fixed income markets, we see solid potential, especially as we look at intermediate maturity bonds in the 3-year to 10-year range. In addition, we see opportunities within alternative investments.

As we approach 2025, we find the economic and market landscape has shifted again such that Commerce Trust believes we are entering a new environment: **an economic balancing act,** one supported by strong underlying fundamentals rather than lifelines of stimulus. We believe global financial markets offer ample opportunities for our portfolio managers to build customized investment portfolios designed to help you achieve your long-term goals.

We hope you find this report insightful and that it leads to robust conversations with your Commerce Trust team. I remain thankful to work with our seasoned team of investment professionals and grateful to our clients for the opportunity to work with you.

Best wishes in the new year,

DAVID M. HAGEE
Chief Investment Officer, Commerce Trust

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Executive Summary

As we conclude a very eventful year and look forward to one that promises to bring its own surprises and challenges, we find the U.S. economy continues to exhibit strength driven by low unemployment, robust corporate profits, and moderating inflation. The Federal Reserve's (Fed's) gradual monetary easing further supports our positive outlook. U.S. gross domestic product (GDP) is expanding at a steady pace, driven by strong consumer spending and business investment. Still, this growth trend could moderate slightly in 2025. Despite sporadic monthly fluctuations, the labor market remains strong with low unemployment rates and sustained job expansion. Prices continue to trend toward the Fed's 2% inflation target. Commerce Trust expects the Fed to continue its rate-cutting cycle in 2025, which could provide further support for economic growth.

Equity markets have seen significant gains, driven by healthy corporate earnings and declining interest rates. Although valuations remain elevated in the U.S. large-cap space, key sectors like technology and communication services continue to lead the charge, while other sectors are also posting solid returns. International equities, including emerging markets, have also shown significant improvement but geopolitical and regional economic risks could impact their performance. The prospects for U.S. equities in 2025 remain positive, driven by favorable economic conditions and supportive monetary policy.

Anticipation of the Fed's shift to a less restrictive monetary policy stance provided a boost to **fixed income markets** early this year, only for them to lose steam after the central bank delivered its first rate cut in September. Looking ahead, allocations to high-quality securities like investment-grade bonds and municipal bonds may make sense for fixed income investors. Commerce Trust favors a diversified approach to the fixed income allocation, including a mix of government, corporate, and municipal bonds, to help mitigate risk and optimize returns.

The **alternative investments** landscape holds promise for 2025 and beyond. Within hedge funds, hedged equity strategies continue to perform especially well, while real estate looks to be improving, supported by the Fed's rate-cutting cycle, as well as the data and computing infrastructure needs related to artificial intelligence or AI. Private credit continues to attract borrowers seeking alternative financing solutions, with the global private credit market expected to grow to $3 trillion by 2028.

Finding a new equilibrium

As the end of the year approaches, the economic climate appears remarkably upbeat. The U.S. economy continues to expand, buoyed by low unemployment, resilient corporate profits, a slowdown in inflation, and the "wealth effect" of record-high stock markets and home values. Nor are there any signs of imminent change in the economy's path toward the proverbial soft landing that the Federal Reserve (Fed) hopes to support with its gradual monetary easing.

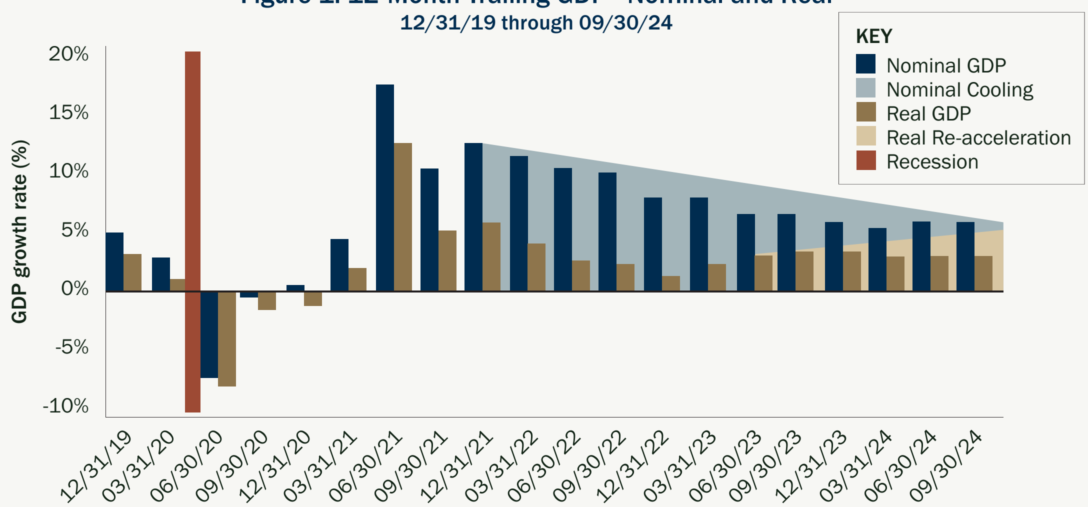
There are, however, potential risks embedded in the financial markets. Investors face high U.S. equity valuations driven by concentrated sector returns, as they must also digest the 2024 election results and ongoing geopolitical risks. In addition, after two consecutive years of exceptionally positive financial market returns, investors may have a sense of complacency as portfolio values have swelled.

Despite the ongoing challenges occurring within the economy and financial markets, we see opportunities for mutual stability between the two for 2025 as measured by the following key indicators.

Economic growth. Recently released third quarter real gross domestic product (GDP) data indicate growth this year is likely to be near 2.5%. This is modestly slower than last year's 2.9% but still nearly identical to the average growth rate during the nearly 11-year expansion that followed the global financial crisis. While real GDP growth remains above average, nominal growth continues to cool as we distance ourselves from some of the pandemic stimulus. The lagged effect of the higher rate environment has also taken a toll on the cyclical, interest-rate-sensitive sectors of the U.S. economy. We expect growth to continue to cool and trend a bit lower next year but remain positive at a healthy 1.5% to 2% pace. [Figure 1]

Figure 1: 12-Month Trailing GDP - Nominal and Real

12/31/19 through 09/30/24



Source: Bloomberg, Bureau of Economic Analysis

As usual, the most important driver of the economy is the strength of consumer spending, itself primarily a function of positive job growth, wage increases, and consumer confidence. Affluent households that have recently experienced significant gains in wealth have driven incremental additional spending throughout 2024.

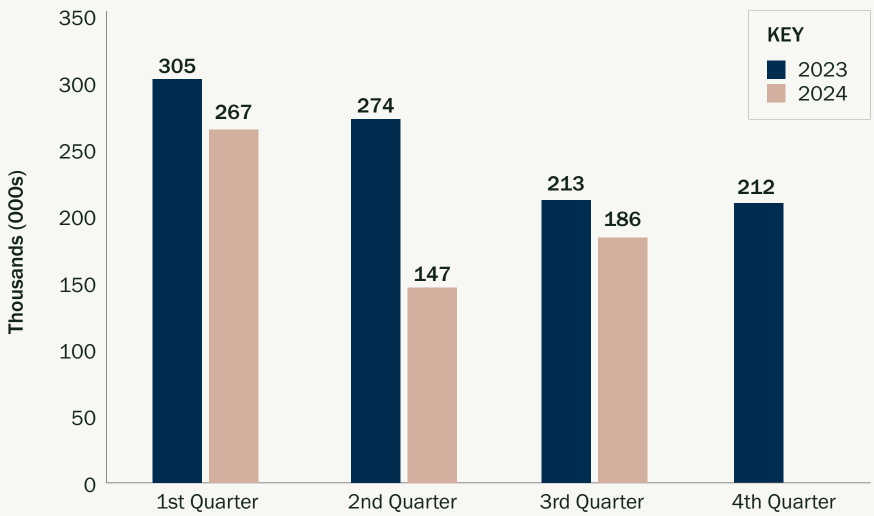
Employment. While recent jobs reports have been impacted by Hurricanes Helene and Milton, employment growth has averaged 180,000 jobs per month through the first 11 months of the year. While this is slower than 2023's 251,000 monthly gain, it's still higher than monthly employment averages just before the start of the COVID-19 pandemic, according to the Bureau of Labor Statistics. [Figure 2]

While there are modest cracks in the employment outlook, including fewer job openings, slightly higher initial unemployment claims, a shorter work week, and slowing wage growth, any positive employment growth typically supports positive GDP growth. Importantly, unemployment remains low (4.2%, as of November 2024) despite strong gains in labor force participation.

In addition, most businesses continue to express concern about the availability of labor, particularly as older workers retire and create a positive feedback loop for ongoing hiring. We expect GDP growth should be sufficient to hold the unemployment rate in check and add between 100,000 and 200,000 jobs per month into 2025.

Inflation continues to slow. Through October, the Bureau of Labor Statistics' trailing 12-month Consumer Price Index (CPI) has fallen to 2.6%, while the Personal Consumption Expenditures Price Index (PCE), the Fed's preferred inflation measure produced by the Bureau of Economic Analysis, has fallen to 2.3%, close to the Fed's long-term 2% target. [Figure 3]

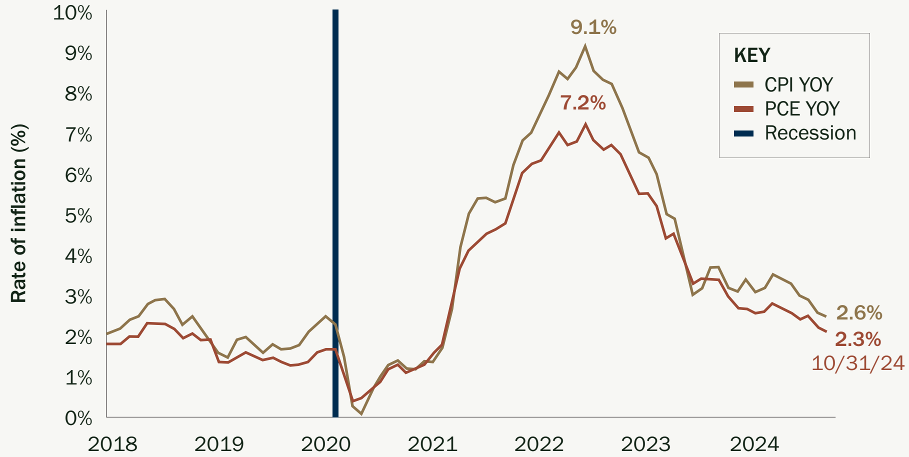
Figure 2: Monthly Average Job Growth by Quarter
2023 versus 2024



Source: Bureau of Labor Statistics; Bloomberg

Figure 3: Year-Over-Year Inflation

Consumer Price Index (CPI) vs. Personal Consumption Expenditures Price Index (PCE)



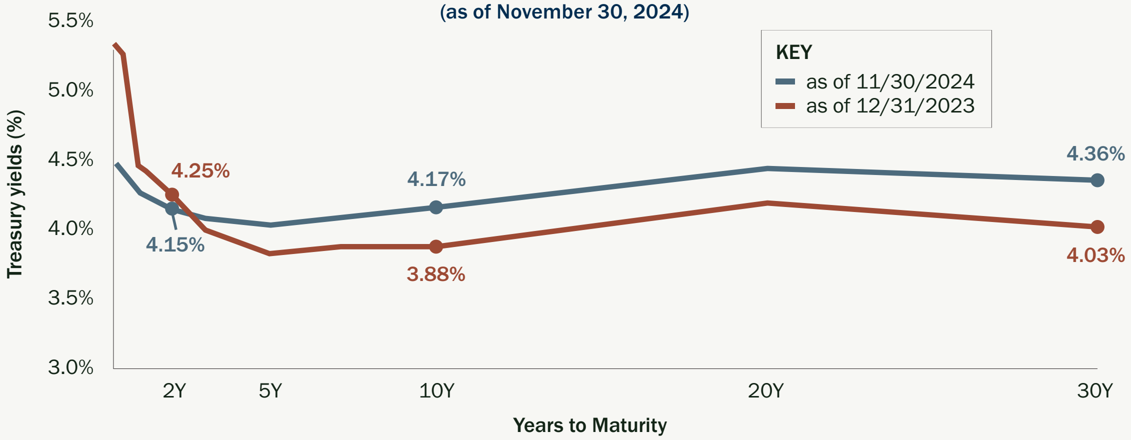
Source: Bureau of Labor Statistics, Bureau of Economic Analysis, Bloomberg.

We believe year-over-year inflation could fluctuate in the mid-2% range for the rest of the year and into 2025. It has proved difficult to hold inflation perpetually below 2%. Over the last five decades, only one decade (2010-2019) experienced inflation below the 2% Fed target as measured by both the CPI and PCE.

Interest rates. Before 2024 draws to a close, the futures market expects one additional rate cut of 0.25% from the Fed at its December meeting, following the cumulative 0.75% reduction delivered at the September and November meetings. With the overnight benchmark federal funds rate currently at a 4.50%–4.75% target range, investor sentiment is presently rather mixed regarding how far the Fed will go in its pivot toward a more neutral monetary policy in 2025. Interestingly, since the Fed initiated its first rate cut on September 18, interest rates across virtually the entire Treasury yield curve have risen as the markets discount higher odds of a soft landing and less need for the Fed to cut rates aggressively to ward off a potential recession. Over the course of the past year, the 2-year Treasury yield has remained relatively anchored in the 4% range, while the 10-year Treasury yield increased from 3.88% to start the year to 4.17% as of November 30, 2024. [Figure 4]

In 2025 the U.S. political environment is likely to represent a wildcard. Shifts in tax, trade, and border policy from a second Donald Trump administration could significantly impact individuals, businesses, and perhaps even monetary policy decision-making. As a result, Commerce Trust expects the Federal Reserve to be very deliberate about its rate-cutting pace next year as it closely watches for any signs of a resurgence in inflation. If the Fed feels fiscal policy is leading to higher federal deficits and supply-side constraints (such as tariffs) that could boost short-term inflation, the Fed will likely consider a pause in their easing plans. Those plans pre-election incorporated a median forecast of a federal funds rate of 3.25%–3.50% by the end of 2025. We would expect their forecast to move closer to 4% as the year progresses.

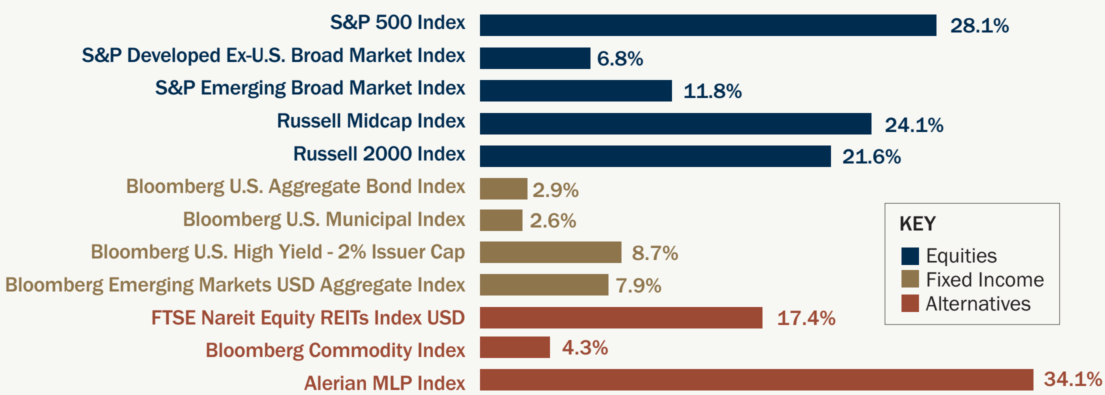
Figure 4: Year-To-Date U.S. Treasury Yield Curve
(as of November 30, 2024)



Source: Bloomberg

2024 has been a favorable environment for diversified investment strategies. Both equity and fixed income markets have produced positive year-to-date gains, while alternative investment strategies presented opportunities for qualified investors.

Figure 5: Year-to-Date Performance by Asset Class
(As of November 30, 2024)



Source: Bloomberg.

The broadening equity rally unfolds

A steady U.S. economy and easing monetary policy have fueled rallies throughout equity markets, most notably in U.S. large-cap technology stocks. As the Fed is expected to continue its rate-cutting cycle in 2025, we anticipate more balanced performance across market capitalizations.

Two years into the current bull market the S&P 500 Index has surged 70% since its October 2022 trough. In 2024, the S&P 500, widely considered the benchmark of the leading large-cap U.S. equities, set 43 new highs through the first three quarters of 2024, and has returned 28% as of November 30, 2024, with all 11 sectors that make up the S&P 500 Index posting positive gains.

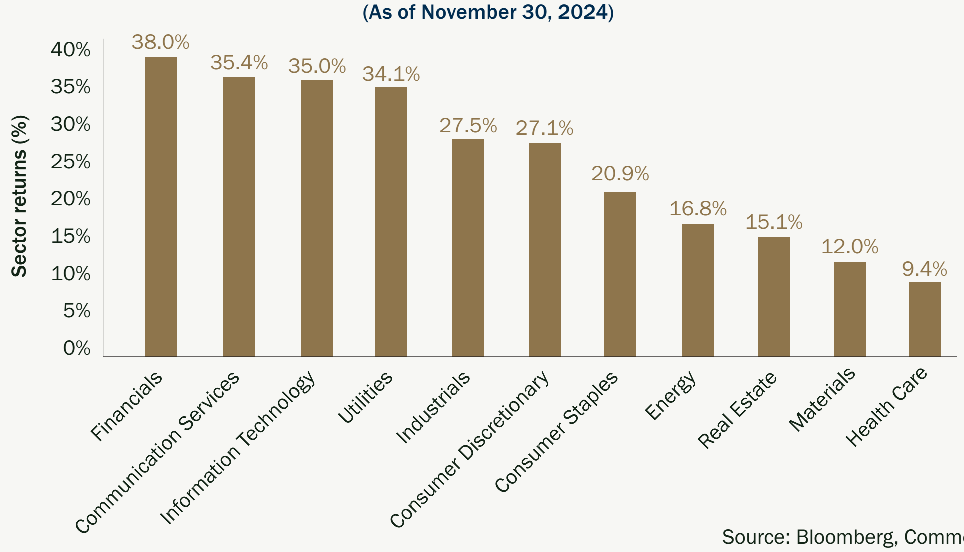
Information technology and communication services, which together comprise more than 40% of the index's weighting, were among the best-performing sectors. As the market priced in lower interest rates on the horizon, interest-rate-sensitive sectors within the index like utilities, financials, and industrials also performed well, with each sector producing returns north of 27% for the period. [Figure 6]

This positive momentum spread to domestic mid-cap and small-cap stocks, which both returned over 20% as of November 30, 2024. This performance aligns with Commerce Trust's long-held position that broadening stock market gains would occur across market capitalizations.

We attribute this equity expansion to three key factors:

A favorable macroeconomic backdrop. U.S. GDP growth expectations for 2024 are 2.5%,

Figure 6: S&P 500 Index Sector Returns
(As of November 30, 2024)



Source: Bloomberg, Commerce Trust.

slightly lower than last year's 2.9% pace. Even with cooling year-over-year GDP expectations, the economic environment continues to be supportive of revenue and earnings growth.

Corporate earnings and valuations. Following a two-year trend, valuations remain elevated. Operating earnings maintained a steady pace throughout 2024 and are expected to finish the year up about 10% on a year-over-year basis. Commerce Trust projects 10% earnings growth in 2025, driven in part by technology-oriented companies and ongoing investor enthusiasm for artificial intelligence (AI) innovation.

Significant declines in inflation. Year-over-year inflation as measured by the CPI, has dropped from a peak of 9.1% in June 2022 to its current 2.6% reading as of October. The continuing decline in inflation prompted the Fed to approve a 0.50% interest rate cut in September and a 0.25% cut at its November meeting. The Fed is projected to approve an additional 0.25% cut in rates by the end of the year, with further cuts anticipated into 2025.

How is year three of the bull market shaping up? Approaching 2025, S&P 500 earnings growth is extending beyond the Magnificent Seven mega-cap stocks to a wider range of companies. We anticipate the broad-based expansion to carry over into 2025, offering more balanced equity returns.

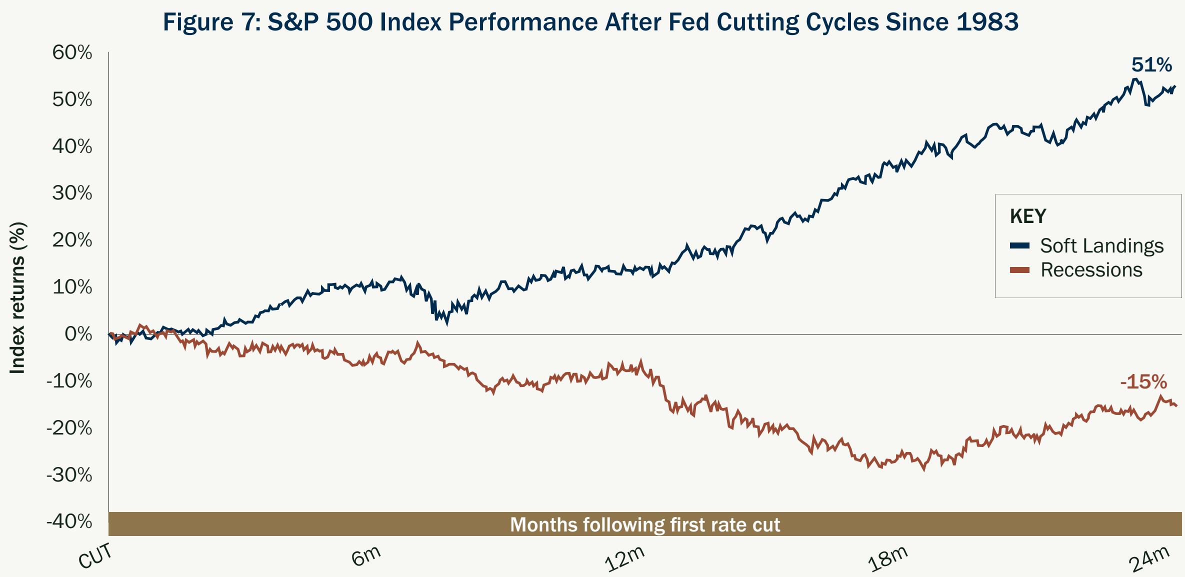
Further examination of domestic equities reveals mid-cap and small-cap stocks are making up ground against their large-cap counterparts as we approach the end of 2024. We believe outperformance of lower cap stocks could accelerate in 2025 as stock market returns broaden out from the tailwind of monetary policy becoming less restrictive.

The S&P 500 Index response to the Fed's normalizing efforts

Investors may be curious how equities have historically performed during Fed rate-cutting cycles given the expectation of multiple rate cuts by the end of 2025. Looking back at the six rate-cutting cycles the Fed has engineered since 1983, the S&P 500 Index performed quite differently depending on whether a recession ensued or was averted.

The Fed has cut rates and avoided tipping the economy into recession three times since 1983. During those rate-cutting cycles, the average return of the S&P 500 is roughly 14% one year after the first rate cut, growing to over 50% at the end of two years.

However, three times over the past 42 years, the Fed embarked on aggressive rate-cutting cycles where the economy did fall into recession. In those three instances the S&P 500 delivered significantly negative returns, experiencing an average drawdown of nearly 30% roughly 18 months after the initial rate cut. [Figure 7]



Source: Bloomberg, Commerce Trust. Initial rate cuts of soft landings: 10/2/1984, 7/6/1995, 7/31/2019. Initial rate cuts of recessions: 6/5/1989, 1/3/2021, 9/18/2007.

Although lagging their domestic counterparts, international equities also appear likely to finish 2024 with strong positive performance. The international developed markets as measured by the S&P Developed Ex-U.S. Broad Market Index returned 6.8% as of November 30, 2024. Likewise, emerging markets advanced in the second half of the year, returning 11.8% as of November 30, 2024. This performance was propelled by a series of stimulative measures China announced to boost its struggling economy and stock market. Chinese stocks comprise almost 30% of the S&P Emerging Broad Market Index weighting. Still, it is unclear whether China's stimulus efforts are enough to propel emerging markets returns upward in 2025.

Commerce Trust remains neutral weight in equities within our guidance portfolio. We continue to favor domestic stocks to international due to the moderating interest rate environment and steady economic growth outlook in the U.S., compared to lingering economic weakness in Europe and China.

There are a number of adverse scenarios that could hinder the stock market over the near term. Among these would be escalating geopolitical tensions or a reacceleration in inflation with correspondingly higher long-term interest rates. However, we approach 2025 with a fair amount of optimism for equity performance. Two potential tailwinds for equities are the Fed's ongoing progress in cutting short-term interest rates and further advancements in AI.

The Fed pivots and bond markets recalibrate

The Fed's decision to ease restrictive monetary policy in 2024 led to modestly positive returns for fixed income markets. Commerce Trust believes a balanced backdrop of steady economic expansion and continued Fed rate cuts in 2025 could support an allocation to investment grade bonds, including a mix of government, corporate, and municipal bonds.

The Fed cut its overnight federal funds rate by 0.50%, lowering the benchmark interest rate to a target range of 4.75% to 5.00% on September 18, 2024. This officially signaled the U.S. central bank's move away from the restrictive monetary policy stance it assumed since first raising rates back in March 2022. Bond investors had been anticipating this pivot for well over a year, poring over each month's inflation and employment data to try to pinpoint exactly when the Fed would deliver its first rate cut since the COVID-19 pandemic. As a result, the ride for bond investors so far in 2024 has been a bit of a roller coaster.

Unexpectedly high inflation reports through the first four months of the year saw Treasury bond yields move up and expectations for Fed rate cuts pushed back. The ensuing four months saw the opposite, however, as inflation resumed its rollover and the unemployment rate began to tick up. Having started the year at 3.88%, the yield on the bellwether 10-year Treasury bond surged to a high of 4.71% in April and then fell to a low of 3.62% on September 16, 2024, just two days before the Fed's decision to cut its overnight rate by 0.50%. Since then, the Fed delivered a smaller 0.25% cut to the overnight federal funds rate at its November meeting, yet longer-term rates have been on an uphill climb, with the 10-year Treasury yield reaching 4.17% as of November 30, 2024. The 2-year Treasury yield, which more closely follows overnight rates, has not risen as much as longer-term Treasury bonds and sits at 4.15% as of November 30, 2024, 0.02% less than the 10-year.

We specifically point out the difference in yields between the 10-year and 2-year Treasury because they were inverted, meaning the 10-year Treasury yielded less than the 2-year for a record 26 months that ended the first week of September. The presence of a yield curve inversion had long been a reliable predictor of a looming recession, but in our unusual post-pandemic economy, it proved to be a false signal.

The roller coaster of Treasury yields has translated into a similar pattern of returns for fixed income investors in 2024, as falling market interest rates deliver positive price performance on outstanding bonds and vice versa. After starting the first half of 2024 in negative territory, bonds staged a strong rally in the third quarter, only to give back much of that performance in the weeks following the Fed's mid-September rate cut. As of November 30, 2024, the broadest taxable investment-grade benchmark, the Bloomberg U.S. Aggregate Bond Index, has returned 2.9%, while its tax-exempt counterpart, the Bloomberg U.S. Municipal Index, produced a 2.6% return. Amid investor enthusiasm over the enduring strength of the economy, higher risk areas of the bond market have done better, including high yield bonds with a return of 8.7% and emerging market bonds, returning 7.9% as of November 30, 2024.

The outperformance of non-Treasury bonds over the last several quarters has been due to the steady tightening of credit spreads or yield premiums versus benchmark Treasuries. We do not disagree that the resilience of the U.S. economy has warranted a narrowing of credit spreads. However, we think spreads for the lowest quality segments of the bond market, like high yield corporates and high yield municipals, have narrowed to levels that suggest forward returns for those sectors over the intermediate term will be muted. [Figure 8]

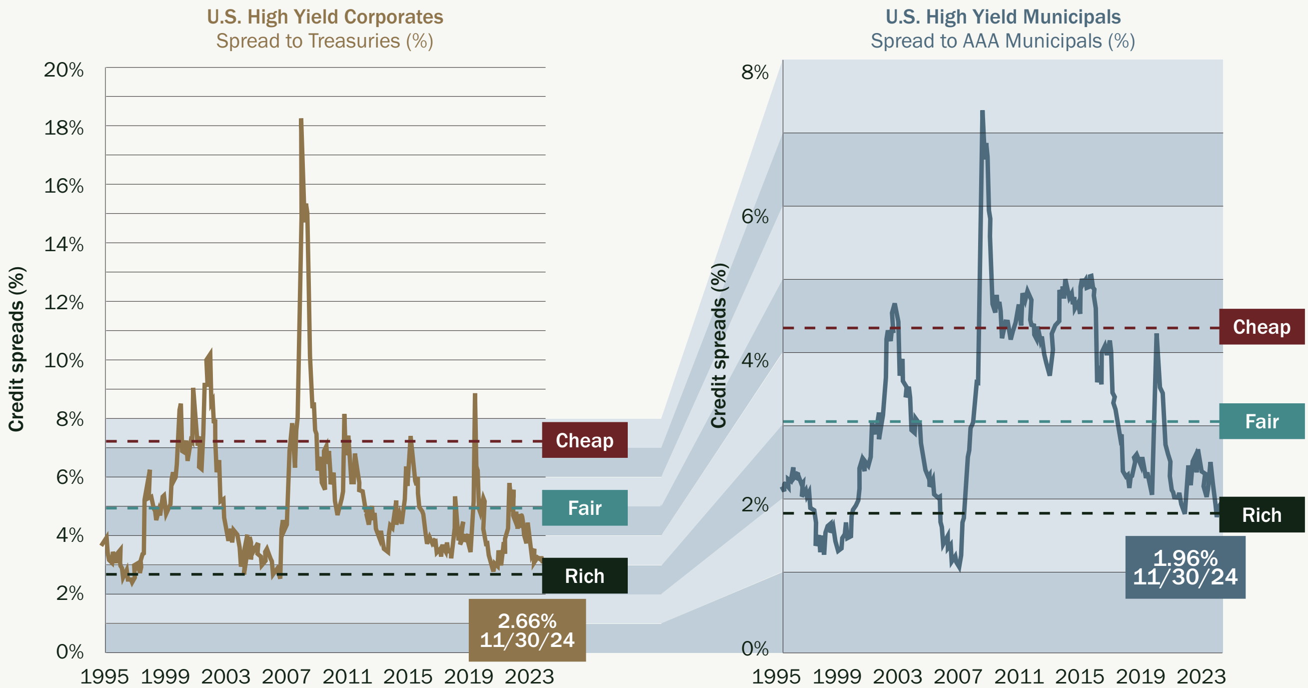
While also tight by historical standards, Commerce Trust believes spreads on investment grade corporate bonds and emerging market bonds can still offer investors reasonable excess returns over a portfolio of pure Treasuries.

Corporate borrowers remain in solid shape, and the prospect of additional Fed rate cuts bodes well for emerging markets. Lower U.S. rates tend to weaken the U.S. dollar, which is generally supportive of export-oriented emerging economies and their bond markets.

Turning our attention to the tax-exempt municipal market, issuance has been balanced by strong

Figure 8: High Yield Credit Spreads

Historically low reward for taking on higher risk



Source: Bloomberg, Commerce Trust. Benchmarks for above spreads: Bloomberg US Corporate High Yield Bond Index, Bloomberg Municipal Bond: High Yield vs. Bloomberg Municipal AAA Index. "Fair" represents the average spread over the time period, with "Cheap" and "Rich" representing +1/-1 standard deviations.

demand, particularly in states with high income tax rates. Post-pandemic tax revenues have normalized along with the economy, helping to support municipal credit stability. Many state and local governments now hold elevated cash balances and have received credit rating agency upgrades. Our outlook for the investment grade municipal bond market in 2025 is therefore positive, with yields offering compelling income opportunities on a fully tax-equivalent basis especially as one moves out into longer maturity bonds.

Overall, we expect fixed income markets to perform relatively well in 2025 but interest rate volatility could remain elevated, as bond investors grapple with how far and how fast the Fed will lower the federal funds rate in their push toward a more neutral monetary policy and what impact their moves will have across the rest of the yield curve. We reiterate that now does not appear to be the time for investors to take on deep credit risk in their bond portfolios. Instead, Commerce Trust encourages investors to consider the attractive yields available in higher quality securities, along with the added benefit that such bonds act as diversifiers that traditionally provide stability during turbulent times in the stock market.

ALTERNATIVE INVESTMENTS

Private credit poised for growth

In today's dynamic market, alternative investments can offer eligible investors a compelling opportunity for portfolio performance beyond traditional stocks and bonds. Commerce Trust assesses three alternative strategies we believe could help balance portfolios and mitigate risk in 2025 and beyond.

Within the hedge funds category, Commerce Trust continues to favor hedged equity and absolute return strategies. Hedged equity strategies offer downside protection in declining markets while still participating in potential upside. Absolute return strategies seek to generate positive returns regardless of market conditions, making them less volatile than traditional investments. These instruments performed positively in 2024, demonstrating their ability to deliver on their intended objectives.

The outlook for real estate in 2025 is improving due to the overall health of the U.S. economy and the Fed's shift on interest rates. Certain sectors, such as office and multi-family in specific regions, continue to face challenges like rising delinquencies, declining rents, and dwindling occupancy.[1] Despite these headwinds, the AI boom is creating interest in commercial and industrial real estate, as investors seek to capitalize on the infrastructure needs for data storage and energy consumption associated with AI applications.

Commerce Trust also sees compelling opportunities in private markets for 2025 and beyond. Lower interest rates could stimulate activity in leveraged buyouts within private equity, as evidenced by a recent uptick in merger and acquisition activity. Furthermore, AI innovation was a focus of venture capital activity in 2024, *With a current global value of $1.5 trillion, the private credit market is expected to nearly double to $3 trillion by 2028 according to Moody's.[3]*

suggesting potential for further growth if interest rates decline as expected.[2]

Private credit continues to attract borrowers seeking alternative financing solutions, along with investors seeking alternative sources of income in their portfolios. With a current global value of $1.5 trillion, the private credit market is expected to nearly double to $3 trillion by 2028 according to Moody's.[3] While banks have recently regained some ground in debt refinancing, the long-term outlook for private credit remains strong.

Commerce Trust views alternatives through the lens of how these strategies align with a client's investment strategy, risk tolerance, wealth plan, and overall financial situation.

It's important to understand alternatives are not suitable for all investors. These complex assets carry higher risks and may have more stringent eligibility requirements than traditional investments. Investors interested in alternatives should consult their wealth management team to determine if these assets are a suitable fit for their investment portfolio and wealth plan.

[1] *S&P Global: Real Estate Monitor - Rate cuts could spur sector recovery, September 11, 2024, www.spglobal.com.*

[2] *Ernst & Young: AI continues to drive venture capital activity, October 24, 2024, www.ey.com*

[3] *Moody's: Private credit to hit $3 trillion by 2028; Alternative Credit Investor, October 17, 2024, www.alternativecreditinvestor.com.*

The 2025 Outlook is the combined effort of the Commerce Trust investment leadership team, evaluating the opportunities currently available to our clients within financial markets.

We endeavor to articulate views combining our perspectives and deep experiences to form a position on both the economy and financial markets for the coming year.

We appreciate your continued confidence in Commerce Trust and look forward to serving your wealth management needs throughout 2025 and beyond.

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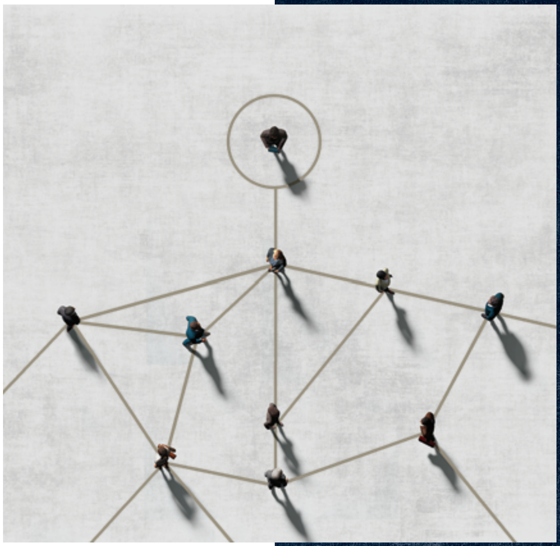

Protect your wealth with Commerce Trust

At Commerce Trust, our approach to wealth management is simple. It's advantageous to have a team in your corner. Because more collaboration and more perspectives from more disciplines converge to create a more personalized approach designed uniquely around your needs.

For more than a century, Commerce Trust has been a leading provider of financial and tax planning, investment portfolio management, private banking, and trust administration services. Our clients benefit from the insights gained from our experience administering over $73.7 billion in total client assets through all market cycles.[1]

Learn more about the Commerce Trust team-based approach to wealth management at commercetrustcompany.com.

[1] as of September 30, 2024.

Disclosures

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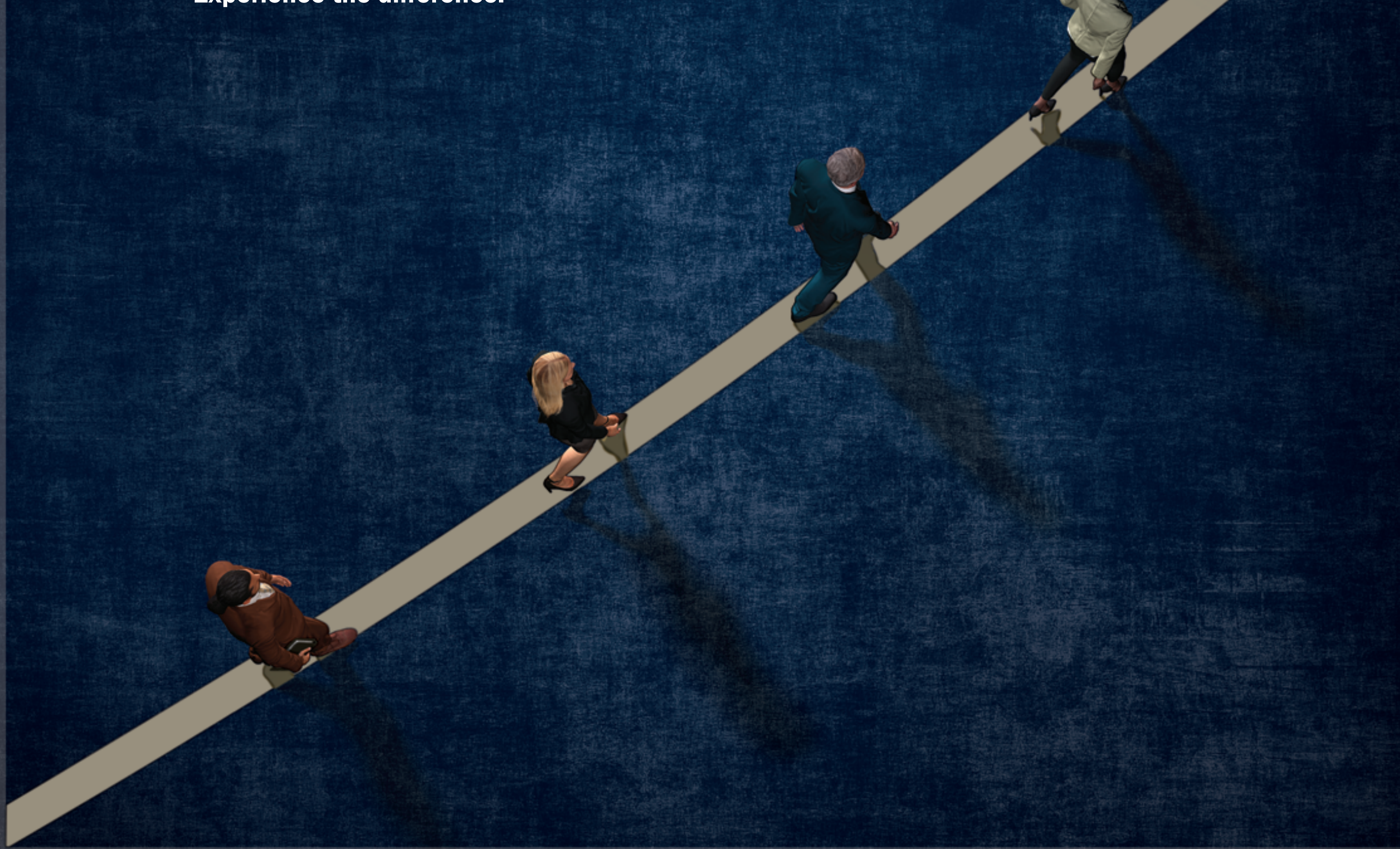

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