

# 2023 Midyear Outlook



*Resilience During Uncertainty*



**Commerce Trust**

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**When we released our 2023 Outlook**, “Finding the Path Forward” this past winter, we noted the global economic and investment environment was surrounded by uncertainty. As we enter the second half of the year, some clarity has come into view, but a general feeling of uneasiness remains.

The Federal Reserve’s (Fed) aggressive strategy to curb inflation appears to be working. Still, inflation remains well above the central bank’s 2% target range. The robust labor market has buoyed the U.S. economy, which still shows signs of cooling. Having rebounded from 2022’s lackluster performance, the capital markets are generally in positive territory for the year, but market mechanics beneath the surface may tell a different story.

Despite the encouraging signs of resilience, the lingering possibility of recession casts a formidable shadow of doubt across the economic landscape.

Commerce Trust believes investors must remain resilient during periods of uncertainty like we are currently experiencing. Our investment professionals provide their views and forecasts for the remainder of the year throughout this commentary, aptly titled “Resilience During Uncertainty.”

History shows disciplined investors who work toward long-term goals may withstand periods of market unrest and be positioned to take advantage of the opportunities that can arise from the volatility.

Thank you,

David Hagee  
Chief Investment Officer  
Commerce Trust

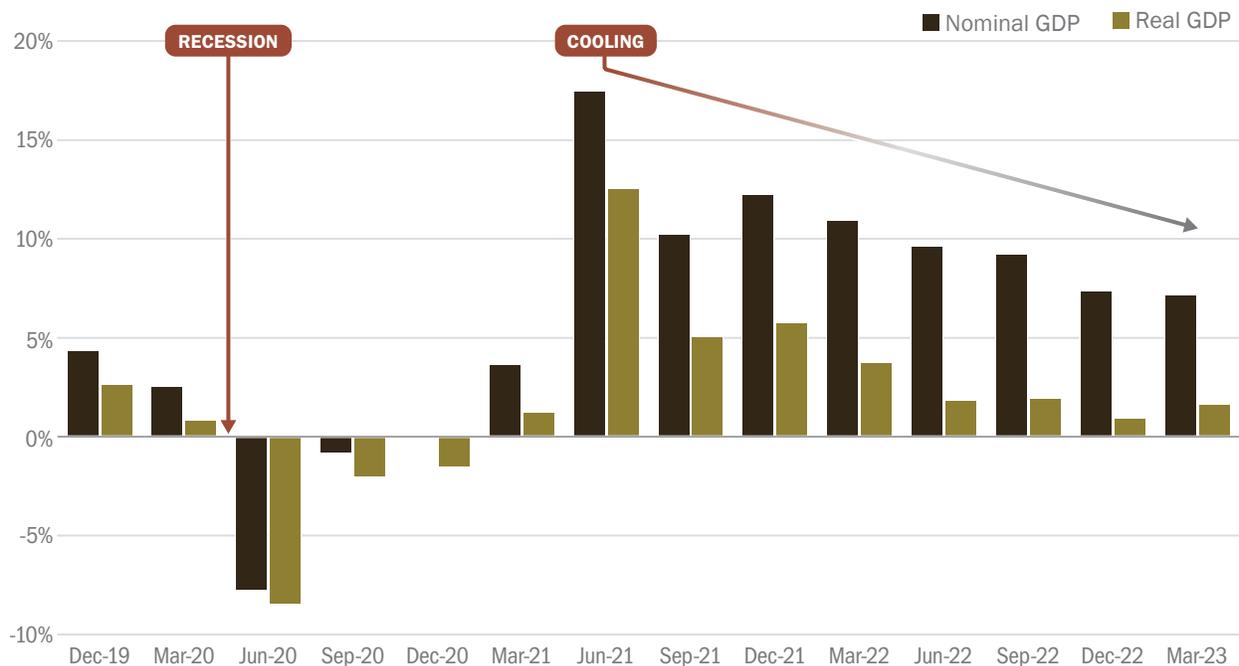
## Will We, Or Won't We?

Our outlook for the U.S. economy over the second half of 2023 represents a continuation of the declining trend of nominal growth, driven by the lagged effects of higher interest rates, a fading tailwind from pandemic-era fiscal stimulus, and a general tightening in overall financial market conditions. Offsetting these headwinds are the resilient job market, easing inflationary pressures, a buoyant housing market and a surge in corporate spending fueled by advances in artificial intelligence (AI). We believe these economic cross currents will likely answer the question looming over the financial markets: “Will we or won’t we have recession?” And that answer may be here before year’s end.

Looking at the chart of both nominal and real gross domestic product (GDP) growth rates it’s easy to see the declining trend in economic activity. The primary driver of this slowdown is the Fed’s rapid and aggressive policy to raise short-term interest rates up 5% over the past 15 months. These higher rates — 30-year mortgage rates more than doubling, floating rate loans 5%, investment grade corporate borrowing costs up 3% — act as a natural brake to slow forward momentum. In addition, rate hikes typically take 12–18 months to work their way through the U.S. economy, so the full effect of these higher interest rates has yet to be entirely absorbed.

Furthermore, the massive \$5.2 trillion of pandemic stimulus, which equates to roughly three months’ worth of the U.S. GDP, continues to diminish, providing less economic propellant as we distance ourselves from this bi-partisan deficit spending binge. Finally, given the rapid change

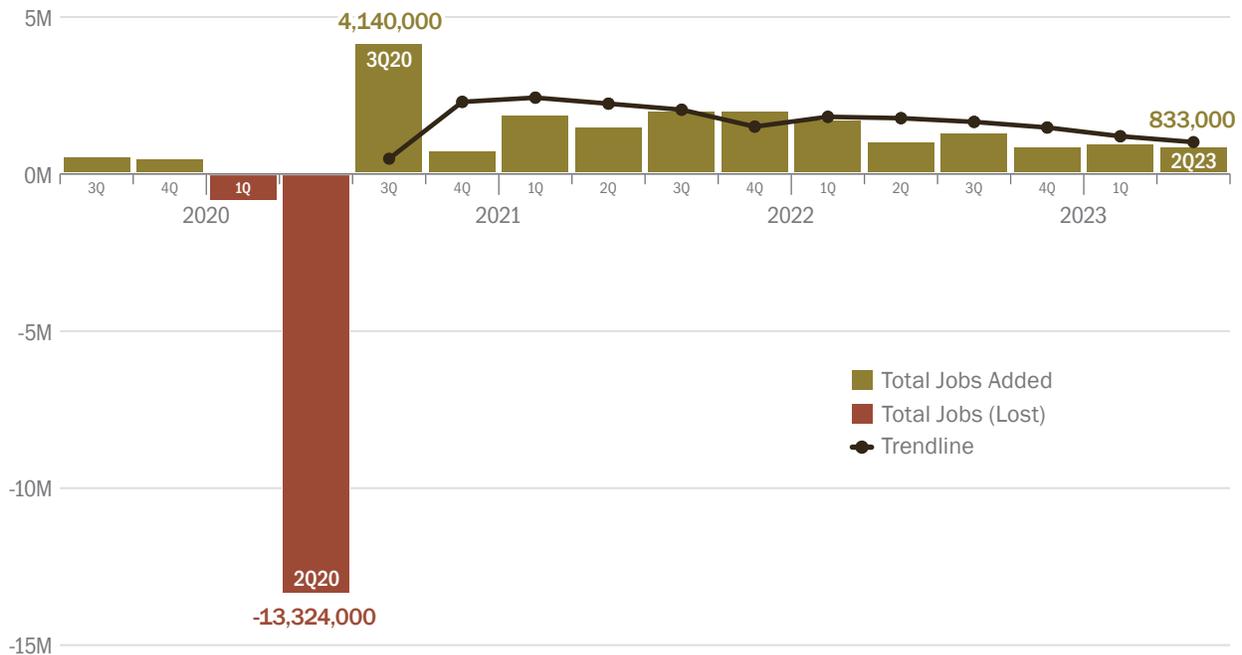
### Nominal And Real GDP Is Declining 12/31/19 through 03/31/23



Source: International Monetary Fund, Commerce Trust.

in the economic and financial landscape, cracks have started to appear. These fissures first surfaced in cryptocurrency markets, secondly in office-related commercial properties, and now more broadly in the banking sector with the rapid downfall of several regional banks that included three of the four largest U.S. bank failures.

## Employment Continues To Buoy The U.S. Economy



Source: Bureau of Labor Statistics, Commerce Trust

The resilience of the labor market has buttressed the U.S. economy against these considerable headwinds. In the decade that followed the Great Recession, employment growth from 2010–2019 tallied a relatively steady 183,000 jobs per month, according to the Bureau of Labor Statistics. And while the volatile swings in job creation witnessed during the pandemic have begun to calm down, the U.S. created nearly 5 million jobs in 2022, and has added jobs through the first five months of this year at an average clip of 314,000 a month.

Any employment growth combined with pay raises has always resulted in positive economic activity. Historically, the U.S. economy has never fallen into a recession while there is job growth. As we look under the hood of the employment engine, however, we find some signs of wear. Stresses include the slowing of the overall trend in job growth, a marked contraction in the length of the average workweek, a declining number of current job openings, cooling wage growth and an increasing number of individuals applying for unemployment benefits.

Fortunately, inflation has declined, as measured by both the consumer price index and the personal consumption expenditures index — the Fed’s inflation barometer of preference. Several factors are behind this ease in inflation, including energy prices that have come full circle, a 20% decline in broader commodity prices and a general decline in the prices of goods as China re-opened its economy, clearing some long-lasting supply chain bottlenecks.

Conversely, these deflationary pressures are being offset by sticky inflation in food and services pricing, as well as shelter costs that continue to climb roughly 8% higher on a year-over-year basis. These swings have been less dramatic on the core inflation basis (excluding volatile food and energy prices), but the current modest slowdown in core inflation could accelerate over the back half of the year as housing costs retreat. Ultimately, this slowdown in inflation afforded the Fed the opportunity to pause its interest rate strategy in June to assess the downstream impacts of this sustained series of rate hikes. We believe a July rate increase could still be on the table, however, an end to the rate hikes does present a modest possibility for the Fed to engineer a soft landing.

Still, the odds of a soft landing are slim. The aggregate decline of the ten leading economic indicators, including the yield curve inversion, has historically predicted past recessions. In addition, we have experienced the quickest and nominally the largest interest rate increase since 1980. While the Fed has engineered soft landings in the past, those occurred without such an aggressive interest rate policy and was followed quickly by a rapid reversal in rates. Given the persistence of the current inflationary backdrop, we think the Fed will be slow to lower rates even if the economy falters, as they almost “need” an economic contraction to bring inflation down to their 2% long-term target. In other words, while the Fed does not necessarily want to cause a recession, they are willing to lean that direction since their primary focus tilts more toward fighting inflation than supporting employment growth.

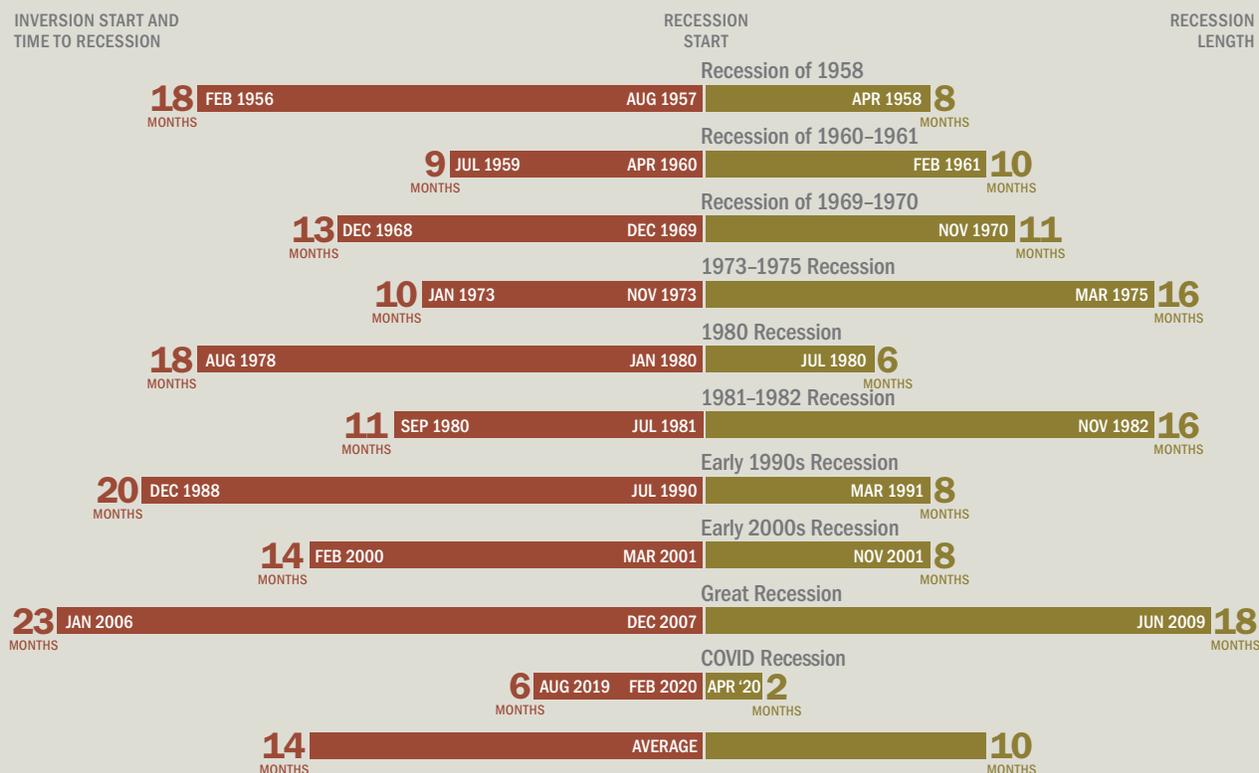


# Unraveling The Current Yield Curve Inversion

Market watchers are increasingly focused on the current inversion between the yield spreads of the 10-year and 2-year Treasury notes, which has been consistently inverted for almost a year. Every recession since 1955 has been preceded by an inversion of the 10-year/2-year slope, making this yield curve inversion one of the most reliable indicators of economic forecasting.

Our analysis largely confirms a growing consensus among investors that a recession is looming. Beyond the single variable of a yield curve slope, other key leading economic indicators — consumer expectations, new orders, building permits — also point to an impending downturn. In addition, the tightening of credit conditions since this year’s spate of regional bank failures has only added to the chorus of alarm.

## 10 For 10 And Counting A 10-year vs. 2-year yield curve inversion has preceded every recession since 1955.



Source: Bloomberg, NBER, Commerce Trust.

Unfortunately, the depth and duration of previous inversions offered no clues to the severity of the recessions that followed. Each business cycle is different, with specific causes for economic expansions and contractions. Likewise, every policy response from the Fed or other regulatory body in attempt to delay the inevitable recession is unique.

If there’s a silver lining to our current situation, it’s the employment picture. Employment is a linchpin when it comes to determining whether the economy is in expansion or recession. The resiliency of today’s labor market keeps alive the promise of the Fed’s ability to engineer a soft landing.

## Will The Narrow Market Rally In Equities Broaden?

At the start of 2023, the Commerce Trust equity team was assessing the possibility of the economy slipping into a recession at some point in the year and what the implications would be for earnings and stock prices. At the midyear point, the U.S. economy is still growing and the S&P 500 Index has advanced 9.6% year-to-date, as of May 31, 2023. Going back to the most recent low in October 2022, the index is up about 20%, which is hovering near bull market territory.

On the surface, the equity markets appear to be disregarding the economic forecasts. However, a closer look at the S&P 500 this year reveals an unusually narrow market. The index's top seven stocks, comprising mega-cap, mostly tech-focused companies, have collectively returned 34% as of May 31. The remaining 493 stocks in the index have produced a combined return of 1%. Narrow market rallies like this typically are not sustainable.

When taking a broader look across the equity spectrum for the remainder of 2023, we believe growth stocks will continue to outpace value. When considering market cap sub-trends, we prefer the higher profitability and stronger balance sheets of mid caps over small caps. We maintain a bias of domestic stocks over international. However, we are keeping an eye on what's happening within international equities, with a preference of developed markets over emerging markets.

While equity markets may not be considering the possibility of a significant economic downturn in the near term, we certainly are. Looking back at every recession dating back to 1946, equity markets on average begin to trend downward about two months prior to the start of a recession and continue to underperform for several months afterward. Historically, the stock market reaches its lowest point during a recession, not before the economic downturn begins. Yet, another potential downside risk for equities is that as economic uncertainty increases, investors typically pay lower multiples on earnings, pushing downward pressures of stock prices.

**As we look at how select sectors are performing at midyear, we remain resolute in the belief more selective opportunities will appear during the second half of 2023.**

- **Technology:** We believe technology stocks could continue to benefit from secular trends within the sector, such as the current AI euphoria.
- **Healthcare:** We like the defensive growth nature of the sector. Additionally, we see the opportunity for healthcare utilization to grow as more individuals become comfortable visiting the doctor for non-urgent care as pandemic-related health care priorities have waned.
- **Financial Services:** We believe the sector is headed for diminished credit availability due to tighter lending standards and more stringent liquidity requirements. In addition, the compression of interest margins will likely hurt profitability, and thus stock performance.
- **Consumer Discretionary:** Despite strong employment and excess savings, which continue to support the U.S. consumer, cracks are emerging among retail companies. We currently underweight the retail space.

## A Mega Turnaround

The headline story of the equity markets so far in 2023 is the performance of the mega-cap stocks. After an incredible near decade-long run, the companies once known by the “FAANG” acronym — Facebook (now Meta Platforms), Apple, Amazon, Netflix, Google (now Alphabet) — in addition to Microsoft, fell back to earth in 2022. The group posted an average share price loss of 42% for the year, leading some financial pundits to pronounce the FAANG’s collective slide was a sign of shifting market leadership.

Well, not so fast. This roster of tech titans, which now also includes Nvidia and Tesla, have rebounded mightily so far in 2023, proving these stocks may still have plenty of bite to them.

What’s behind these incredible reversals? The group’s lower valuations toward the end of 2022 certainly presented buying opportunities for investors. Individual company strategies came into play, too. However, macroeconomic conditions also factored into the overall group’s performance this year.

Persistently high inflation, woes in the banking industry and the looming threat of a recession are giving investors reasons to flock to the perceived safety of “bigness.” It is somewhat ironic as these one-time disruptors are now viewed as maturing businesses with strong margins, pricing power and diversified product portfolios.

### Mega Returns For Mega Caps

*(Total returns as of 05/31/2023)*

<b>Alphabet</b>	<b>39.3%</b>
<b>Amazon</b>	<b>43.6%</b>
<b>Apple</b>	<b>36.8%</b>
<b>Meta Platforms</b>	<b>120%</b>
<b>Microsoft</b>	<b>37.6%</b>
<b>Netflix</b>	<b>34%</b>
<b>Nvidia</b>	<b>159%</b>
<b>Tesla</b>	<b>65.6%</b>

*Source: Commerce Trust, Bloomberg*

## Fixed Income Returning To A Familiar Role

Bond markets through the first five months of 2023 have been confronted by a myriad of concerns, including the U.S. debt ceiling debate, the potential for the Fed to continue to hike rates and billions of dollars of bonds being force-liquidated from the portfolios of failed banks. Despite all the noise, all fixed income sectors have delivered positive returns so far in 2023, while lower-rated credits have outperformed higher-rated securities. Through the end of May, the broadest taxable investment-grade benchmark, as measured by the Bloomberg U.S. Aggregate Bond Index, has returned almost 2.5%, while high yield or “junk” bond returns have done even better, with returns in excess of 3.5%.

In a notable break from recent history, short maturity Treasuries have become attractive to yield-hungry investors. The rate on 3- and 6-month U.S. Treasury bills surpassed 5.0% in the first half of this year, levels not seen since 2007. The Fed's aggressive rate-hiking campaign to combat inflation can be credited with delivering this income-generating windfall to savers looking to park their cash.

While still positive, tax-exempt fixed income market returns have trailed their taxable counterparts, with the broad Bloomberg Municipal Bond Index up 1.7% through May 31. Hospital, transportation, lease, and limited tax sectors are leading the way so far in 2023, and like we've seen in corporate bonds, lower-rated municipal issues are outperforming higher-rated issues. New municipal bond issuance through May was around \$136 billion, which is -24.6% off from 2022's pace. With demand for tax-exempt income still quite strong, lower new issue supply should support municipal bond returns going into the second half of 2023.

We envision a relatively benign outlook for municipal credit, as most sectors largely improved or sustained credit fundamentals during 2022, with balance sheets and operations strengthening on outperforming revenues and more normalized economic activity. State and local government tax revenue growth is likely to slow during 2023, although key revenue sources such as property taxes will provide stability for localities. In addition, we anticipate robust state and local government reserves could soften the pressures of inflation-driven spending and revenue volatility.

After 2022's record poor performance, fixed income investments have returned to their historic role as a counterbalance to equities based on their performance through the end of May. As inflation continues its downward trend, bonds' negative correlation with stocks should come more into play, leading to our expectation for fixed income returns to finish the year in positive territory.

Credit selection and duration management are critical areas of focus for bond portfolios, especially as we enter a period where recession risks are growing, and the Fed is approaching the end of its rate-hiking cycle. In addition, the yield premiums, or spreads, of corporate bonds above Treasury yields are roughly at the same level as when the year began and remain close to their long-term averages.



## A Look At Alternatives

Commodities were one of the best performing asset classes in 2022, dominated by rising inflation and a strong U.S. dollar. However, commodity returns have regressed in 2023, underperforming both equity and fixed income returns. The Bloomberg Commodity Index returned -13.2% as of May 31.

Commodities generally act independently from other major asset classes like equity and fixed income through bull or bear markets. Cycles that have sustained periods of expansion are known as bull super cycles, and commodity markets often experience long periods of growth during them.

It's likely a new bull super cycle began in 2020, and despite being in early stages of this cycle, we believe underinvestment by commodity producers could have an effect for years to come. Without sufficient capital expenditures to create spare supply capacity, commodities are vulnerable to long run shortages, with higher and more volatile prices.

Real estate investment trusts (REITs) have made modest gains so far in 2023, as measured by the FTSE NAREIT Equity Index. However, secular trends in the commercial real estate space and diminishing access to credit are likely to create headwinds for office owners and real estate investors alike going forward.

We continue to favor an allocation to hedged equity and absolute return strategies for a portion of a balanced portfolio. Hedged-equity strategies have been very competitive with long-only equity strategies in 2023 despite their lower risk profile. Absolute-return strategies are employed to provide risk reduction to the equity and fixed income allocations, which may come into play if we have an economic slowdown in late 2023, or early 2024.

# Formidable Challenges Ahead For Commercial Real Estate

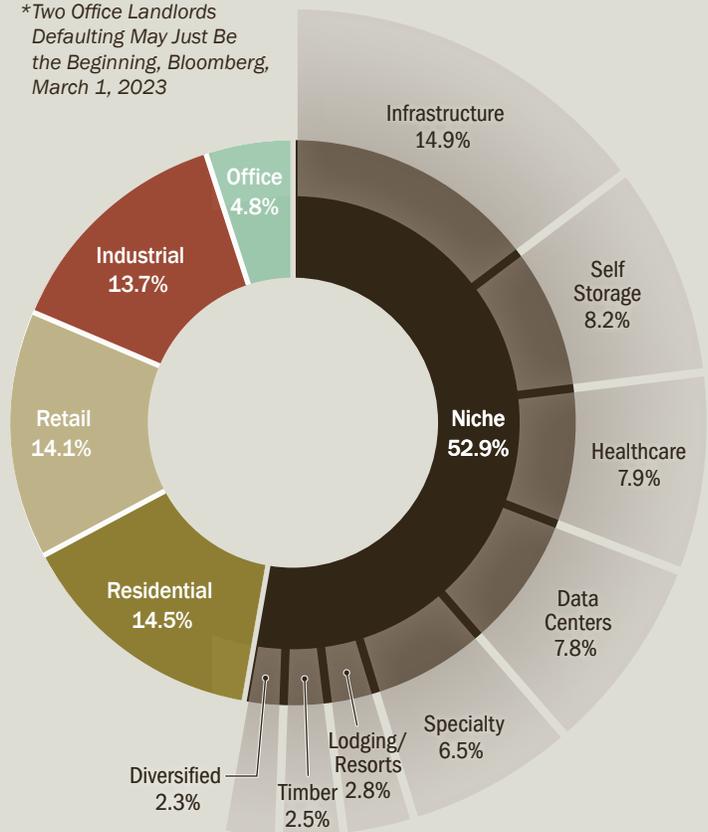
Evolving work trends, inflationary pressures and the Fed’s aggressive rate-hiking strategy set the stage for a turbulent commercial real estate sector as we head into the back half of the year. Office space owners face a dire reality. More than 17% of the entire U.S. office supply currently is vacant with an additional 4% available for sublease.

In addition, nearly \$150 billion in office building mortgages are set to mature over the next two years, according to the Mortgage Bankers Association.\* Most of that debt will need to get refinanced at higher rates with more stringent capital requirements from lenders. A similar surplus in multi-family housing potentially looms, and lack of inventory, adding pressure to the residential space.

Still, pockets of strength exist within the commercial real estate space. Industrial properties like warehouses and distribution centers may be somewhat insulated from the credit pressures facing other real estate sectors. Demand for warehouse space remains tight, keeping leasing prices elevated. Also, consumer spending remains steady, which could provide some support to retail properties.

## The Composition Of The U.S. Commercial Real Estate Sector

*\*Two Office Landlords Defaulting May Just Be the Beginning, Bloomberg, March 1, 2023*



*Source: NAREIT, Commerce Trust. The FTSE NAREIT All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs. It is not possible to invest directly in an index.*

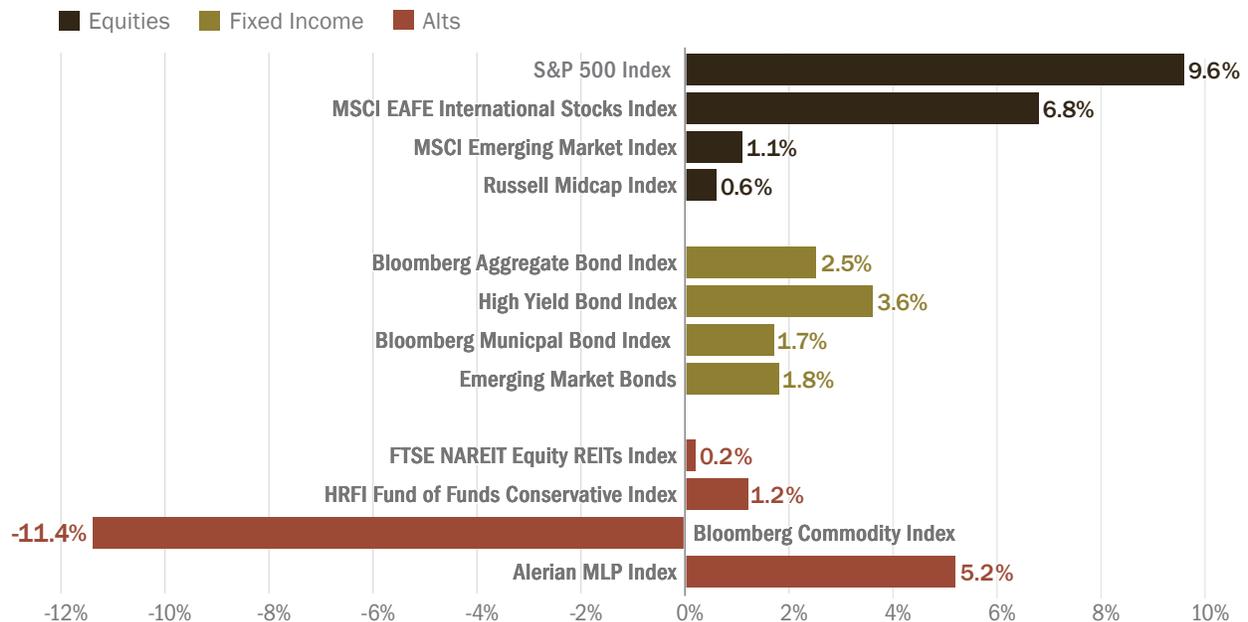
## How Commerce Trust Has Responded

From a portfolio management perspective, we maintain an underweight position to equities as we enter the second half of 2023. While the market may trade higher over the summer months, we believe these gains will likely be limited. If the economic picture starts to worsen in the fall as we believe, the equity market could start to discount a decline in earnings.

In addition, we continue to prefer domestic equities over international stocks. European stock performance has been surprisingly positive, even as economic conditions across the region deteriorate. Emerging markets continue to face headwinds, such as tighter global monetary policy.

On fixed income securities, we favor continuing to improve credit quality amidst the threat of recession-related spread widening. Relatedly, we also don't believe investors should simply "hide out" in the shortest end of the yield curve with their fixed income allocations. Investors need only look back a year or two to appreciate that strong yields in instruments like T-bills and money market funds can be fleeting and that maintaining exposure to bonds all along the yield curve can deliver superior income and diversification benefits over the long term.

### Year-To-Date Performance By Asset Class As of 05/31/23



Source: Bloomberg

# Our Forecast And Portfolio Biases

Highest  
Conviction

**1 Short-term interest rates will plateau this year, and bond returns could be positive for both taxable and municipal bond markets this year.**

- While we were 15% short our durational/maturity targets last year, we were much closer to even with our portfolio's benchmark maturity.
- We are also at a full allocation to bonds from an asset allocation perspective.

**2 We have added to growth exposure to neutralize last year's value overweight.**

- Early in a recovery, as expected, value dramatically outperformed growth. Now that the economy is slowing and earnings growth has moderated, growth is likely to re-bound.

**3 We remain slightly more defensive from an equity perspective.**

- We are holding some cash in most portfolios (about 5%), and are underweight our equity exposure a similar amount.
- We remain overweight to alternatives and used those proceeds to increase fixed income back to our targeted bond allocation, particularly as the odds of a recession this year are high.

**4 We maintain a reduced exposure to high-yield bonds.**

- We remain up in credit favoring investment-grade bonds and recommend minimal exposure to the riskier higher yielding sectors of the bond market.
- Higher quality typically outperforms in a slowing economy.

**5 Mid-cap stocks are likely to outperform both large-cap and small-cap stocks.**

- We prefer the higher profitability and stronger balance sheets of mid-cap vs. small-cap and the domestic orientation of mid-cap vs. large-cap equity.

**6 Domestic stocks are likely to continue to outperform international markets.**

- We are one-third underweight our International targets and expect the dollar to remain relatively firm.

**7 Within international equities, we favor developed markets to emerging markets.**

- 80% of our international allocation is in developed equity.

Lowest  
Conviction



## 2023 Midyear Outlook: Commerce Trust Authors

**Wm. Michael Cody, CFA®**

Senior Vice President,  
Director of Fixed Income Trading

**Cynthia Rapponotti, CFA®, CAIA®**

Senior Vice President,  
Senior Portfolio Manager

**Scott M. Colbert, CFA®**

Executive Vice President, Chief Economist  
and Director of Fixed Income Management

**Brent Schowe, CFA®**

Senior Vice President,  
Director of Investment Research

**David Hagee**

Executive Vice President,  
Chief Investment Officer

**Eric Simpson, CFA®**

Senior Analyst, Fixed Income Credit

**Don McArthur, CFA®**

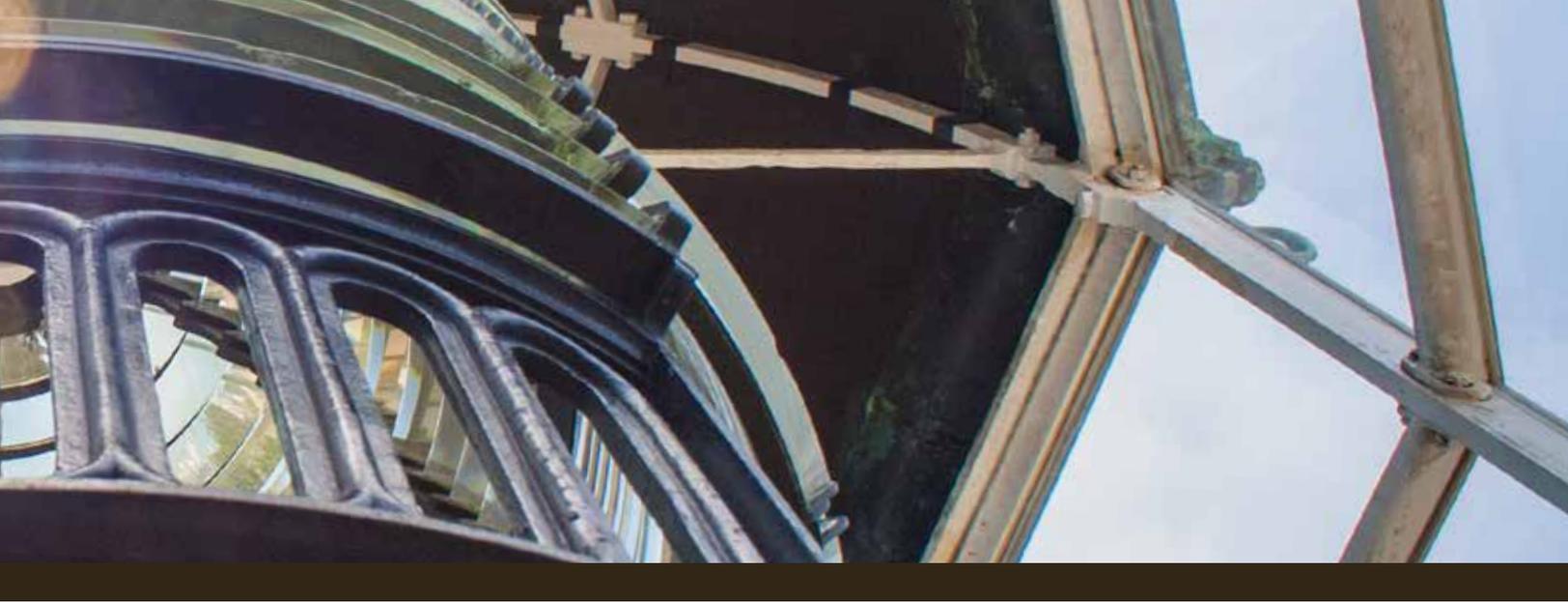
Senior Vice President, Senior Investment  
Strategist and Director of Equity Research

**Joseph C. Williams III, CFA®**

Executive Vice President,  
Director of Investment Strategy

**If you have any questions regarding the Midyear Outlook Report, please contact a Commerce Trust advisor.**

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<sup>1</sup> Assets under administration as of March 31, 2023.

<sup>2</sup> S&P Global Market Intelligence. Rankings of regulated U.S. depositories, including commercial banks, bank holding companies and credit unions as of Dec. 31, 2022.

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