



2020 MIDYEAR OUTLOOK

CLIMBING OUT



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2020 MIDYEAR OUTLOOK

PANDEMIC ROCKS ECONOMY, YET MARKETS ANTICIPATE RELATIVELY SHORT-DURATION RECESSION

It's apparently hard to keep a good economy down, even when flattened by a deadly virus. The pandemic's damage to the economy is certainly structural and the near-term could be financially painful for many Americans. Civic unrest grows and a presidential election looms. But clearly a resurgence in recent jobs data shows a recovery is coming, and it will likely build slowly each month.

Economists debate on whether the recovery will be “V” shaped, where the economy rebounds sharply after hitting the bottom, or “U” shaped, where it might linger on the mat until it regains more strength. We think of it as something closer to the shape of a reverse square root sign, with an initial favorable bounce, but a challenging trudge to fully “re-open” the economy.

MARKET SUMMARY

- The current recession will be our shortest, and it is likely the recovery will happen more quickly than many first envisioned.
- Unprecedented government fiscal stimulus and quick monetary policy intervention by the Federal Reserve are now taking effect to fight off possible insolvency and unemployment issues. More help may be coming.
- Investors seem willing to write off 2020 and are now justifying stock valuations on 2021 earnings potential.
- As many as 30 million people who at least temporarily lost their jobs this spring will be looking for work in the post-COVID economy.
- Contrary to the economic crisis of 2008, Americans remain generally optimistic on six-month forward expectations despite April's plummet in consumer confidence.



ECONOMIC OUTLOOK

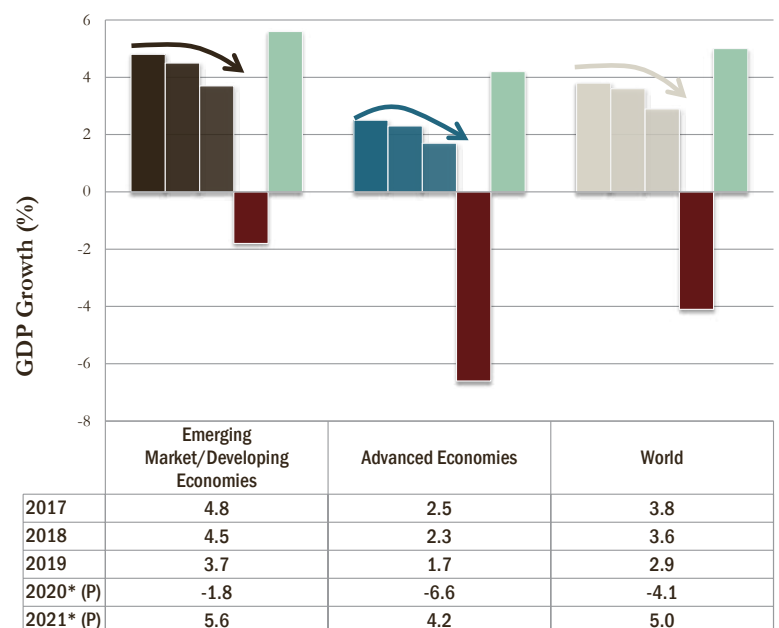
The COVID-19 epidemic initially spilled onto our economic shores before it officially made land early in the year. Supply chain disruptions in China and a sharp decline in oil prices foreshadowed what became strict social distancing here in March, and the biggest decline in U.S. quarterly GDP...ever. And despite massive government stimulus both here and abroad, the COVID crisis has resulted in a deep global contraction of uncertain depth, duration and unprecedented proportion.

How bad is it? The International Monetary Fund and the World Bank predict global growth will be -3% to -5% this year, and anything less than +2.5% growth is typically defined as recessionary (Figure 1). And as presaged in the lead-in, most economists are still guessing at the likely impact to the U.S. economy this year, with consensus estimates ranging from -6% to -10%. To put that into perspective, the Great Recession from 2008-2009 lasted 18 months and had a 4% cumulative contraction. In other words, the recession we are currently in is likely to be about twice as deep as the worst one we've had since World War II.

Fortunately, this recession will also be our shortest, and it's likely the recovery will happen more quickly than many first envisioned. It turns out a lot of government stimulus and a little "re-opening" went a long way. The average recession lasts about 11 months and amazingly this one already bottomed in late April. Forward progress was made in May and June as the economy slowly came back to life.

GLOBAL GROWTH HAS COLLAPSED

(FIGURE 1)



Source: International Monetary Fund, World Bank
 *Projections based on average of both sources

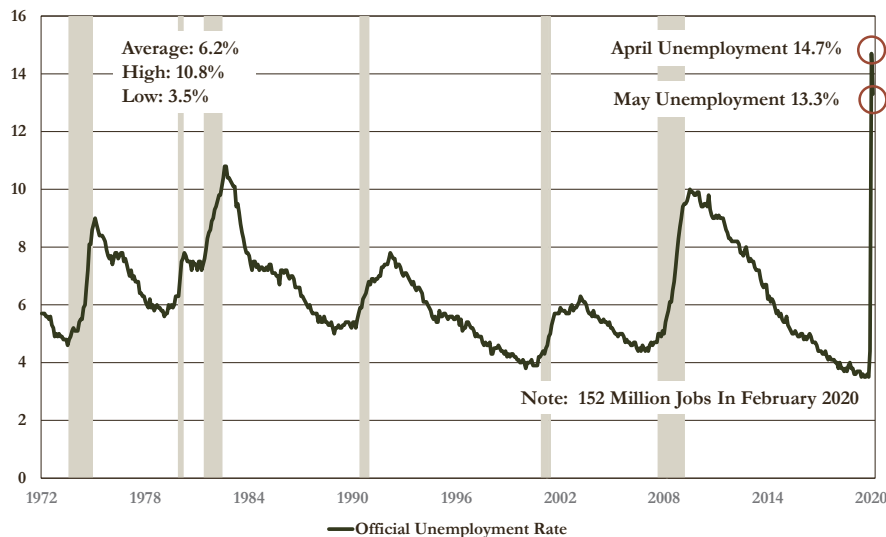
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We can't imagine 3rd and 4th quarter GDP won't show signs of improvement off the horrendous 2nd quarter bottom as the economy transitions toward "something resembling normalcy" this summer, schools open in the fall and retailers start to gear up for Christmas. And yes, there might be a second coronavirus wave coming, but we'll be better equipped to handle it. Whatever rebound we do have won't be met with the sledgehammer of a full-on government-mandated shutdown, but with a much defter tactical policy having gained nearly a year's worth of global perspective on how to fight the disease.

Why so short? Three reasons: First, the coronavirus case count peaked in early April¹ and has been in decline ever since. Second, massive government fiscal stimulus helped build a bridge to the other side of this economic chasm, while extraordinary monetary policy (which works with a lag) has eased credit conditions, providing liquidity and lending to fight off insolvency issues. And finally, the financial markets have picked up significantly, recognizing that in the long run therapeutics and a vaccine will eventually come along. Several years from now we'll be able to look back and wonder how all of this could have ever happened.

Are we out of the woods? Not yet. While the actual unemployment statistics are cloudy, it is likely as many as 30 million people at least temporarily lost their jobs this spring, resulting in unemployment levels in the 15% to 20% range. Historically, peak post-World War II unemployment in our country was 10.8% in 1982 and 10% during our last recession (Figure 2). We are likely to get a short-term quick bounce off the bottom. But it is not hard to envision real unemployment (once

OFFICIAL UNEMPLOYMENT RATE
(FIGURE 2)



Source: Bloomberg

¹ New York Times and WorldInData



those temporary job losses disappear) remains stubbornly high by the end of the year.

To “V”, or not to “V”, that seems to be the question. At least initially, we think it is a "V" shaped recovery off the bottom. And with that will eventually come the typical slow grind to full economic recovery we saw in our last “Great Recession” as businesses still shell-shocked are slow to hire and invest, consumer spending remains subpar, and the financial system fights through the rising delinquencies, repossessions, foreclosures and charge-offs associated with any historical recession. But full recovery will still take two-plus years. So, think of it something closer to a reverse square root sign, with an initial bounce but a long hard slog we have yet to confront just to get the economy back to even.

EQUITY OUTLOOK

Over the last four months we have experienced the shortest bear market with the S&P 500 declining 35% in 40 days, and then one of the fastest recoveries of 40% off the March lows in a little over two months. All this within a backdrop of the sharpest economic recession since the 1930s, trying to restart the world economy and corporate earnings after collapsing 30% in 2020. The magnitude of the equity market rebound has certainly surprised us. Investors seemed to have written off 2020 and are now justifying stock valuations on 2021 earnings potential.

Liquidity is being poured into the economy by the Federal Reserve and the Treasury with some of it finding its way into the equity market. Net worth of Americans is headed for a new high at the end of June. While consumer confidence plunged in April for the current condition outlook, Americans remain optimistic on six-month forward expectations. That was not the case in the 2008 financial crisis when expectations were falling faster than the current conditions, creating fear and panic among investors. It will be interesting when the June numbers are

KEY TAKEAWAYS: ECONOMIC

- This recession will also be our shortest, and it's likely the recovery will happen more quickly than many first envisioned.
- While unemployment has peaked, we are likely to get a short-term quick bounce off the bottom. But it is not hard to envision real unemployment (once those temporary job losses disappear) remains stubbornly high by the end of the year.
- At least initially, we think it is a “V” shaped recovery at least off the bottom. But full recovery will still take two-plus years.

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released whether the latest round of social unrest will affect the view of the future.

Are investors buying stocks because of lack of other options? Short-term investments are returning nothing and Treasury Note yields are less than 0.85% for 10-year or shorter maturities. The S&P 500 Index does not look cheap on a valuation basis, but most companies offer future earnings growth along with a 2% dividend yield.

Looking out over the remainder of the year, there are many events that could derail the equity market rally. A second wave of infections, the presidential election, Chinese tensions increasing and the unintended financial implication of shutting down the world economy for two months, to name a few. Being nimble in this time of uncertainty is going to be important.

The equity investment themes we had at the beginning of the year have worked out well. The first was to overweight Growth over Value stocks. Growth stocks are typically technology, health care and consumer-related stocks providing less cyclicality in earnings. Value stocks are dominated by financial, industrials, utilities and material issues. These sectors are more exposed to the cyclicality of the economy. As of early June, Growth indexes were 18% higher than Value indexes, year-to-date.

We also favor Domestic stocks over International. This again goes back to favoring Growth over Value. The International index (EAFE) is much more heavily weighted to value, which has put them at a structural disadvantage over the last 10 years. In early June International stocks lag Domestic stocks by 8%. The U.S. dollar has been showing signs of weakening against foreign currencies, which will provide a short-term boost for International returns. In March, we eliminated our exposure to Domestic and International small-cap exposure in portfolios and hold the proceeds in cash. We were concerned about the financial viability of smaller companies that

RUSSELL® STYLE INDEX YTD RETURNS AS OF 6/5/2020 (FIGURE 3)

	VALUE	BLEND	GROWTH
LARGE	-9.31%	-0.06%	8.64%
MID	-11.21%	-4.45%	5.81%
SMALL	-17.18%	-9.12%	-1.37%

Source: Commerce Trust Company Market Tracker



had less opportunity to raise additional capital if needed. In late May we started to redeploy some of the cash back into equities, as we felt mid-cap companies looked particularly attractive versus large- and small-cap issues. Mid-cap stock returns were trailing large caps by 7%, and we felt that gap would close as the economy recovers. We remain concerned with the financial viability of some small-cap stocks, especially in the value area.

ALTERNATIVE INVESTMENTS OUTLOOK

Private investments are often classified as an alternative investment but are part of the equity and fixed income asset classes. They are characterized by a long investment horizon, lack of liquidity, exclusivity, and the potential for returns higher than the broad equity or fixed income markets. Committing to a private investment fund forces an investor into a buy and hold discipline and places the exit decision in the hands of experienced professionals who are closest to the underlying assets. Emotional selling during volatile markets is prevented due to the illiquid nature of the investments and keeps the investment strategy on course. With the market downturn in the first quarter, investors could not liquidate their private investment holdings, and had to ignore the market volatility and maintain their positions.

The economic stress and dislocation due to COVID-19 provides opportunities for distressed investing. Private investment managers can pivot to distressed and rescue capital investing and move capital to these opportunities. A flexible investment capital approach includes both debt and equity securities, including rescue capital, distressed-for-control, control buyouts and growth equity. Rescue capital investments provide capital to stressed companies through structured deals, from senior loans to preferred equity, while distressed-for-control includes investments where the investment manager buys debt at a discount and looks to take equity ownership after a restructuring. Control buyout investments take majority ownership of firms and look to improve operations and/or growth in order to sell for a profit several years later, while growth equity investments take minority stakes in established firms that need additional capital to grow.

KEY TAKEAWAYS: EQUITY

- The magnitude of the equity market rebound has certainly surprised us. Investors seemed to have written off 2020 and are now justifying stock valuations on 2021 earnings potential.
- We remain concerned with the financial viability of some small-cap stocks especially in the value area.



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KEY TAKEAWAYS: FIXED INCOME

- The return outlook is cloudy. As businesses start to re-open, economies are expected to show some gradual improvement.
- Many developing countries have taken action to help calm the investment market by buying up government debt, which helps keep interest rates low.
- All of the fiscal and monetary stimulus has the chance of triggering inflation... but more so in 2021.

In seeking out these opportunities, investors should look for managers with experience in distressed investing. This includes a track record of investing through economic cycles and downturns and up and down capital structures and across industries.

FIXED INCOME OUTLOOK

At the start of this year no one was predicting the amount of market turbulence we have seen over the past few months. There is no smooth way for markets to work through a global pandemic.

The Federal Reserve (Fed) went into crisis mode and initiated a massive bond buying program. Instability was reduced, liquidity was improved, and most sectors rebounded or recovered a portion of their previous losses.

For fixed income investors in investment grade sectors, returns have been good year-to-date...but not so good for below-investment-grade sectors (i.e., High Yield and Emerging Market Debt). Large declines in Treasury yields across all maturities (2- through 30-year) helped higher quality sectors post reasonable positive gains. The Bloomberg Barclays Aggregate Bond Index has generated a 5.37% year-to-date return (as of 6/9/2020) with Treasuries being the top-performing fixed income sector.

The future returns outlook for fixed income is cloudy. As businesses start to re-open, economies are expected to show some gradual improvement. Credit spreads currently are above their historic averages and can tighten further as economies improve, helping to support bond prices. This favorable scenario disappears if COVID-19 has a resurgence. All credit sectors would be negatively impacted by a second wave. Spreads would widen and bond prices would fall. However, Treasuries would be positively impacted by a flight to quality.

As a global recession continues this year, the High Yield default rate is expected to surge to 10% by year's end. At the end of 2019 the 12-month projected default rate was 3.1%. The financial health of lower-rated companies

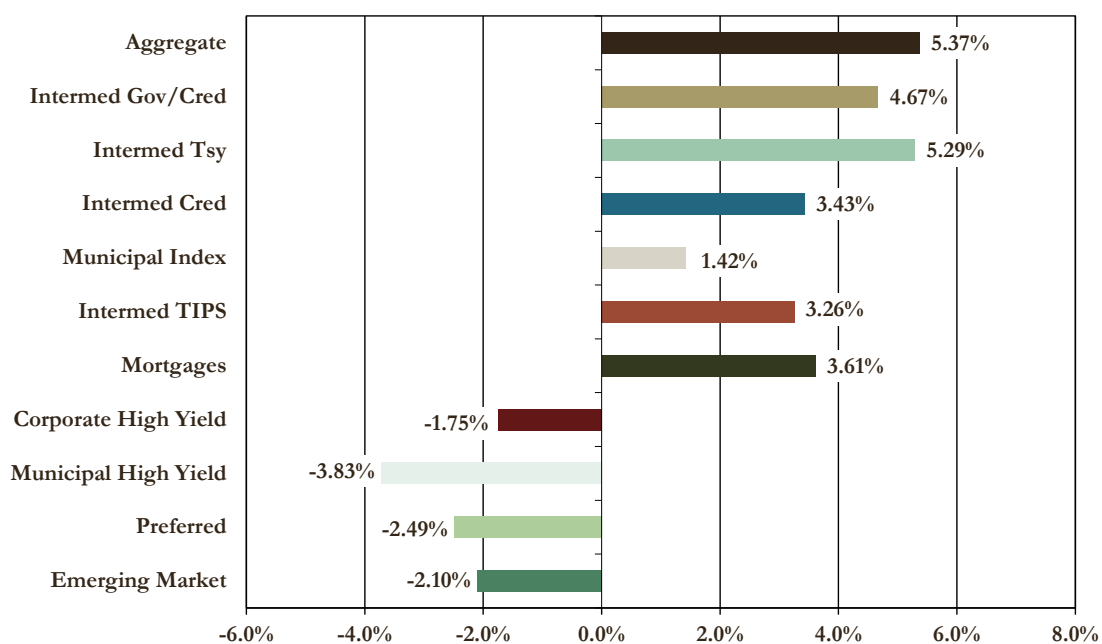


is struggling with the pandemic. According to S&P Global Ratings, the corporate default rate could even jump to 13% if containment of the virus becomes a long-drawn-out ordeal. With earnings already on the decline, further improvement in the High Yield sector will be difficult in the short run.

Emerging Market Debt also faces numerous challenges due to the global economic slowdown. Many developing countries have taken action to help calm the investment market by buying up government debt, which helps keep interest rates low. This is adding an extra layer of risk where currencies are fragile. Flooding their monetary system with newly created cash could revive inflation.

Municipal Bond market performance has also struggled with the impact of COVID-19 on state and local municipalities. Municipal Bonds made it through historic liquidations in the spring in response to the economy

FIXED INCOME YTD RETURNS (AS OF 6/9/2020)



Source: Bloomberg



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essentially shutting down. The Bloomberg Barclays Municipal Bond Index is up 1.42% year-to-date (as of 06/9/2020). Lower quality bonds underperformed their higher quality counterparts as safe-haven assets were in favor. Municipal bonds are expected to be resilient as we navigate this current recession. Default rates on investment grade issuers will move higher but likely stay well below 1%. Local governments that have a high reliance on sales taxes are a concern. Bonds issued by them are more volatile than revenue derived from income or property taxes. More concerning is the incentive for cities to fund local economic development projects to boost those sales taxes. If these projects fail to generate cash flow, this can put significant pressure on a city's finances.

The bond market continues to be on the mend with several threats to its on-going recovery. COVID-19 still has the potential to flare up again. U.S.-China relations have been deteriorating. Whatever goodwill came from the Phase 1 trade agreement seems to have been lost amid mutual recriminations. All of the fiscal and monetary stimulus has the chance of triggering inflation...but more so in 2021. Forecasting bond market performance as a result has become extremely difficult because of so many potential unknowns. Most of these unknowns are likely to have a negative impact. Some comforting news is that the U.S. economy is resilient and was in good shape before COVID-19 sent it into a tailspin. The pandemic triggered an unprecedented amount of fiscal and monetary relief. The Fed and Treasury took quick actions that showed some immediate assistance (improving liquidity) and is expected to benefit companies over the long run. The tailspin has stopped, and the economy is in recovery mode.

High quality bonds (Treasuries, MBS, and Corporates) should be able to finish the year in positive territory for performance, but not much higher from where they are now. This will be dependent on avoiding a COVID-19 resurgence. High Yield and Emerging Market Debt are currently in negative territory and may be able to cut some of their losses by year-end if global economies are able to benefit from all the fiscal and monetary stimulus that has been poured out to counter the slump caused by the pandemic. While not expected, if default rates start trending well above 10% before year-end, then further price declines may occur in these speculative grade sectors. Limited improvement for the Municipal Bond sector is expected in the short run and yields could face some upward pressure as overall issuance increases and the full impact of the coronavirus fallout becomes known. With so much uncertainty, portfolio duration targets are being maintained close to neutral relative to their corresponding benchmarks.

CONCLUSION

Why do we think the recovery will be quicker than in the past? First, the contraction was so fast. We are literally making forward progress just two months into this recession, while it took 18 months during the Great Recession. From that perspective, we have a 16-month head start. Second, government fiscal stimulus, like the Paycheck Protection Program, has been more than double the past Great Recession's, and the Fed was quicker to react. Finally, the financial markets are clearly signaling a faster recovery as well.

We believe the key event in indicating the market bottom was when the rate of acceleration of new coronavirus cases began to decline on a day-over-day basis. That happened in early April. And right on cue, the risk markets appeared to bottom as well. However, markets are likely to remain highly volatile for some time. We are optimistic that the equity market's recent rotation toward more-cyclical sectors confirmed the worst is behind us. Still, we can't help but worry the markets have moved much more quickly than economic fundamentals would dictate.

The world has never "re-opened for business" in the same way before. New hard lessons abound every day. But make no mistake, the first halting steps toward recovery are already in place and more are coming at lightning pace.

INVESTMENT POLICY TEAM - JUNE 9, 2020

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KEY STATS

-6% TO -10%

2020 U.S. GDP GROWTH
FORECAST

0.16%

S&P 500 YTD*

13.3%

2020 UNEMPLOYMENT YTD**

0.8%

10-YEAR U.S. TREASURY YIELD*

5.37%

BLOOMBERG BARCLAYS AGGREGATE
BOND INDEX YTD RETURN*

1.42%

BLOOMBERG BARCLAYS MUNICIPAL
BOND INDEX YTD RETURN*

* AS OF 6/9/20

** AS OF MAY 2020

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