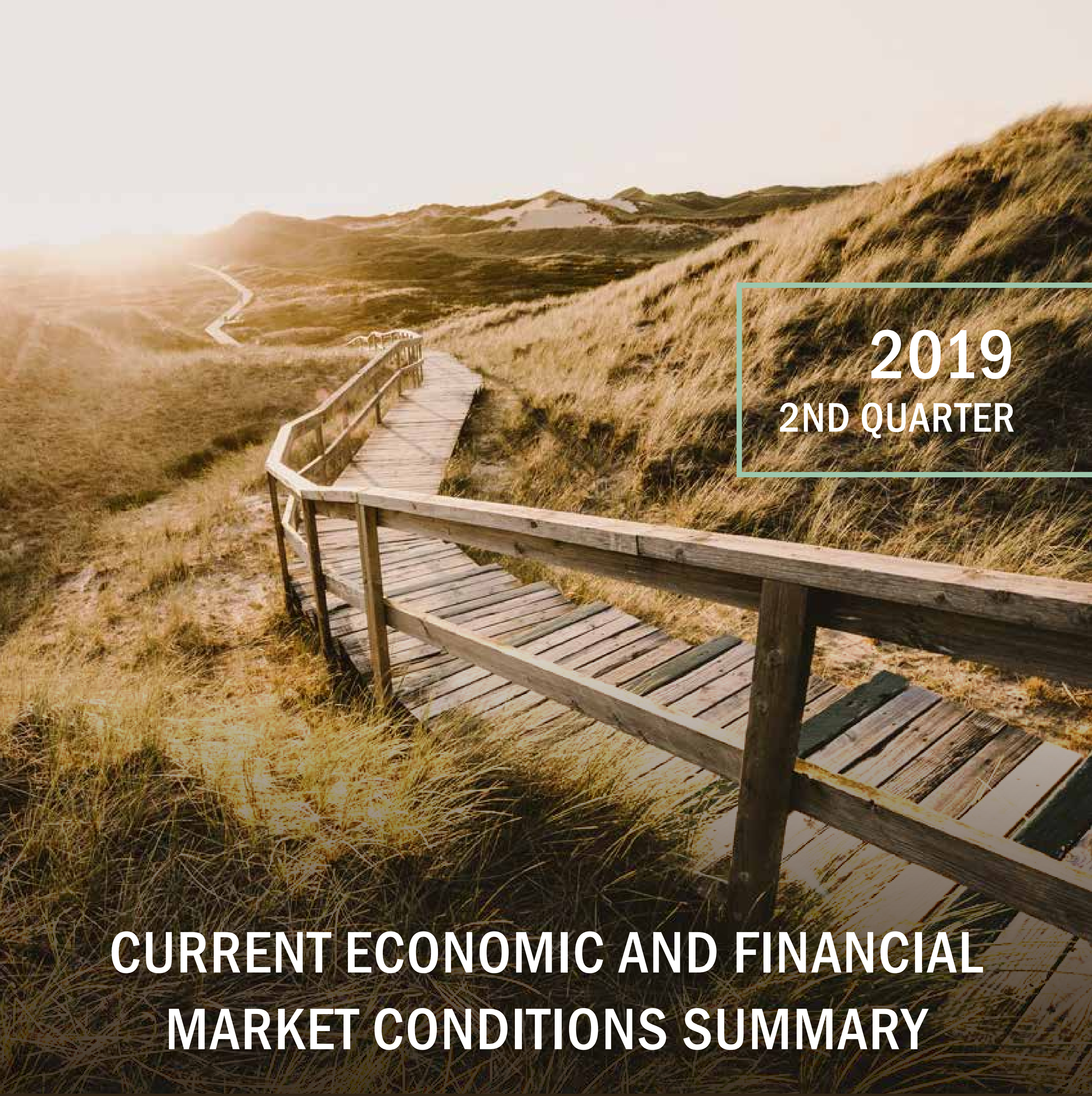

2019

2ND QUARTER

CURRENT ECONOMIC AND FINANCIAL MARKET CONDITIONS SUMMARY

PREPARED BY: INVESTMENT POLICY TEAM

Commerce Trust Company
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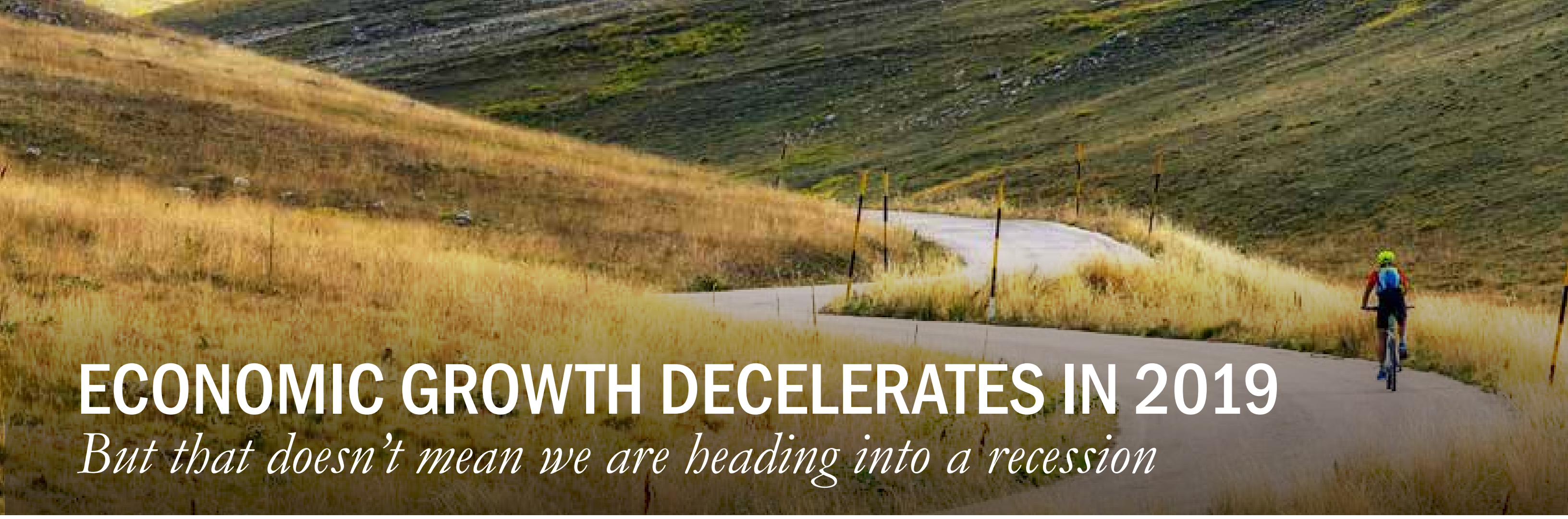


ECONOMIC GROWTH DECELERATES IN 2019

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

ECONOMY – *Still making forward progress*

U.S. economic growth has slowed in 2019, but a recession is not imminent. The U.S. slowdown is being driven by a myriad of interconnected causes, and the three main reasons are the lagged impact of higher short-term U.S. rates, an exceptionally weak Europe and a continued slowdown in China. By definition, the Federal Reserve's (Fed) tightening of monetary policy has led to tougher financial conditions, disrupted the credit markets a bit, tipped stock prices lower and pushed the dollar higher. Throw in the first-quarter government shutdown, unseasonably cold weather, fading fiscal stimulus, the U.S. trade skirmishes and Brexit, and it's rather obvious economic activity would cool from last year's relatively strong pace. Recall 2018 was the strongest calendar year for domestic growth (3.0%) so far in our post-crisis economic expansion, and that momentum is helping this expansion to continue. Simply put, we believe the late 2018 financial market turmoil afforded the Fed the cover to "pause and refresh," and that pivot will likely be the catalyst to keep our economic expansion on track.

We expect economic growth this year will be approximately 2%, plus or minus 0.5%. The key drivers to this growth are:

- An ongoing boost from the reduction in the corporate tax rate
- Increasing employment levels that translate into a rise in personal income and steady consumer spending
- Little or no acceleration in inflation
- Record corporate profitability that spurs reinvestment in productive capital equipment and software
- A positive tailwind from low energy prices and long-term interest rates
- A Federal Reserve that is on nearly permanent hold
- A bottoming of the U.S. equity market, accompanied by a marked improvement in credit spreads and risk asset pricing

Growth will remain positive despite last year's four rate hikes and the 20% dip in the stock market that has already come and gone. In fact, the turmoil in the financial markets placed the Fed on "perma-hold" until the yield curve begins to steepen and economic prospects brighten. This recovery (over 9¾ years old) will easily surpass our longest expansion, which lasted a decade from 1991 to 2001. In fact, we could envision this expansion lasting for up to three or four more years, an out-of-consensus forecast.

Still, the seeds of the end of this business cycle are clearly beginning to be sown, and last year's volatility in the financial markets acted as the proverbial canary in the coal mine and captured everyone's attention. As the Fed pauses, our biggest worry stems less from the political dysfunction in Washington and a bit more toward lack of growth overseas. While the divide between the Trump administration and the new Democratic-majority House remains irreconcilably wide, it appears that near-term presidential indictment and/or impeachment are off the table. As a result, investors will become increasingly focused on the 2020 election outcome, which no doubt will introduce an entirely new set of anxieties that could begin to weigh on markets as the year progresses.

EQUITY MARKETS – *We remained firm in our commitment to stocks and held steady through the correction*

When 2019 began, we noted how valuations for the market had improved dramatically since January 2018. The S&P 500 median P/E reached 20.2 times at the end of December, levels last seen in 2014. The strong surge in equity prices in the first quarter moved the median P/E just barely back into overvalued territory. With the backdrop of moderate economic growth, we believe earnings will grow in the 5% to 8% range this year.

Another problem the equity market faced last year was the acceleration in short-term interest rate hikes. Rising short-term rates had not been a problem since the beginning of this bull market in March 2009, at least not until early last year. In late December, the Fed shifted from a higher short-rate forecast to a wait-and-see approach before it raises rates in 2019. We believe that shift has accounted for most of the equity market strength this year.

As we entered 2019 there was a clear change in investor sentiment from an attitude of buying every dip (on the belief that the market always goes higher) to one of a more cautious nature. Typically, when equity markets surge 15%, investors quickly turn bullish again, but that has not been the case this year. Financial news continues to caution investors about a slowing global economy, an inverted yield curve and the prospects for earnings disappointments. Investors remain cautious, which we view as a positive for equity prices in the second quarter.

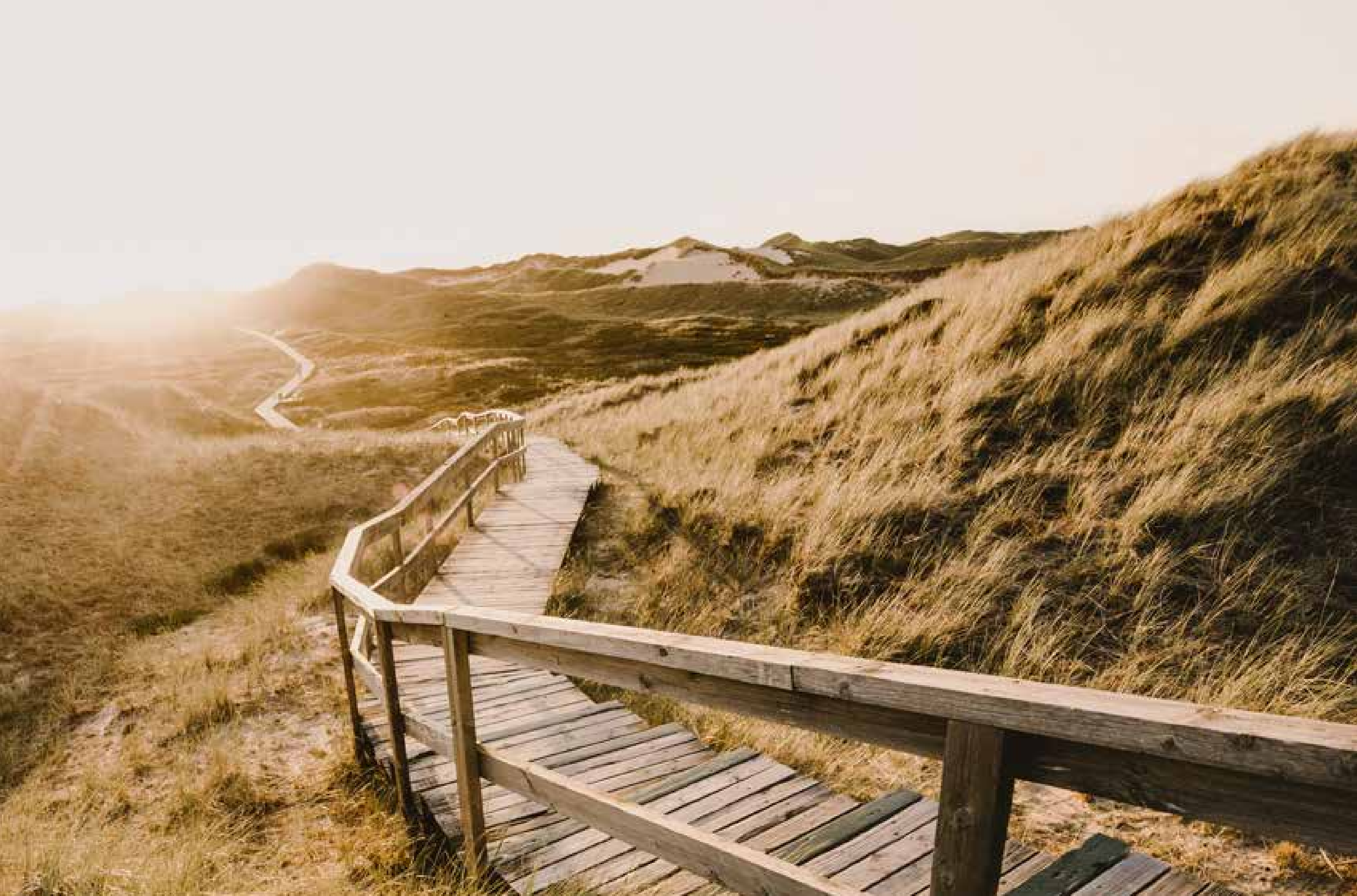
FIXED INCOME MARKETS – *A sharp recovery has front-loaded returns this year*

Returns for bonds in 2018 ranged from slightly negative to slightly positive due to the rising interest rate environment. Fixed income returns were paltry at best as the Fed's four rate hikes pushed yields higher and bond prices lower. Surprisingly, most of last year's weaker results were quickly offset in the first quarter this year as interest rates dropped and credit spreads improved. Core investment-grade municipal and taxable bond funds posted positive returns in the 2.5% to 3% range, while higher-yielding non-investment-grade funds posted even better returns of 5% to 7%. For the rest of 2019, as the Fed takes a break from its rate-hiking mission, bond funds should perform more closely in line with the cash markets. The good news is that so far this year bond returns have been higher than most were expecting, but those results are behind us, and all we are likely to earn the rest of the year are bond coupons.

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

ALTERNATIVE ASSETS

Alternative investments include strategies such as hedge funds, real estate, energy master limited partnerships (MLPs) and commodities. We include them in many client portfolios to either reduce volatility or provide diversification. Hedge funds are an area in which we emphasize strategies that may provide protection in a declining market or behave differently from stocks or bonds. We expect that higher market volatility will continue into 2019, and while the conditions that drive the prices of real estate investment trusts (REITs) and MLPs may differ, these two asset classes are a subset of the stock market. In addition, REITs and MLPs are sensitive to changes in interest rates. Although bonds also suffer during periods of rising interest rates, REITs and MLPs may not offer the same level of portfolio protection as bonds. Commodities tend to perform well in the late stages of economic expansions and early stages of recessions. With our view that the economic expansion can continue for multiple years, we are not allocating to commodities at this time.



INVESTMENT POLICY TEAM - APRIL 15, 2019

Disclosures: Past performance is no guarantee of future results, and the opinions and other information in the Current Economic and Financial Conditions Summary are as of April 15, 2019. This is a special report designed to provide investment information on economic markets for Commerce Trust Company's clients. It is intended to provide general information only and reflects the opinions of the Commerce Trust Company Investment Policy Team.

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