

2019 MIDYEAR OUTLOOK

The Ascent Continues



Commerce Trust Company

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2019 MIDYEAR OUTLOOK



ECONOMY SLOWS, BUT FORWARD PROGRESS CONTINUES IN LATE CYCLE EXPANSION

As we look into the second half of the year, we expect the U.S. economy to continue to grow in this late cycle expansion. However, the pace of growth will be lower than that experienced over the past year. The recent incoming data is generally solid and recession probability for the United States remains minimal through the end of the year.

MARKET SUMMARY

- While the U.S. economy may be decelerating, the financial and economic fundamentals are healthy, and the outlook remains positive.
- We view the underlying foundation for equities as much more supportive than in January or October of 2018.
- The longer international trade tensions persist, the bigger the impact on economic growth and consumer/business confidence.
- Low inflation expectations may put pressure on the Fed to start lowering interest rates before the end of 2019.



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In sum, we see global growth trending near 3.3% in 2019, down from 3.6% in 2018. Growth in the United States and China is moderating, while European economies continue to struggle.

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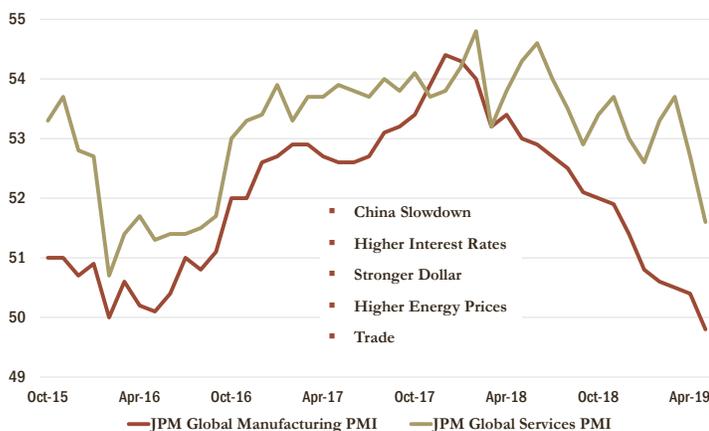
ECONOMIC OUTLOOK

After rising 3.0% in 2018, and at a 3.1% rate in the first quarter of this year, U.S. GDP growth is expected to slow to 2.0% in the second quarter and remain near that level over the latter half of 2019. The slowing from the first to the second quarter is more than accounted for by declines in net exports and inventory investment following increases in the first quarter. (Figure 1) Partially offsetting these declines is an expected step-up in growth in personal consumption from 1.2% growth seen in the first quarter, to 3% growth in the second quarter. For the full year 2019, U.S. GDP growth is expected to average near 2.25%.

On the other hand, there are significant headwinds and cross-currents to confront. As we see it, the main hurdles facing economic growth are a baked-in fiscal tightening, the lagged effects of the monetary tightening cycle, heightened tariff/trade war tensions, as well as political dysfunction in both the United States and Europe. In sum, we see global growth trending near 3.3% in 2019, down from 3.6% in 2018. Growth in the United States and China is moderating, while European economies continue to struggle.

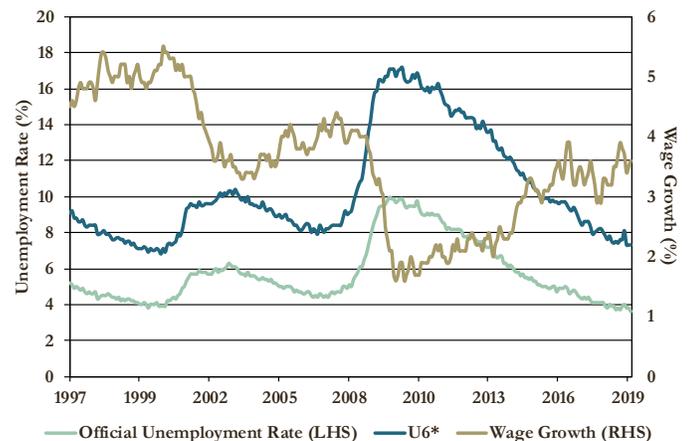
The unemployment rate is projected to reach a low of 3.5% this summer. (Figure 2) Nonfarm payrolls rose 75,000 in May, following a 224,000 gain in April, while the unemployment rate remained steady at 3.6%, the

GLOBAL PURCHASING MANAGERS' INDEX ROLLS OVER (FIGURE 1)



Source: Bloomberg

UNEMPLOYMENT FALLS – WHILE WAGES RECOVER (FIGURE 2)



Source: Bureau of Labor Statistics, Bloomberg

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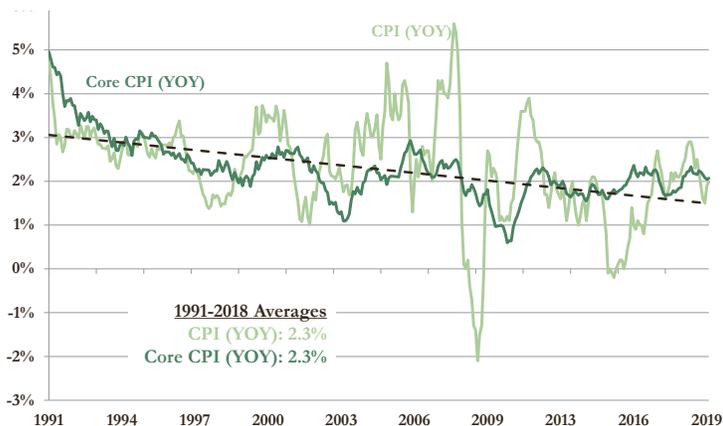


lowest since 1969. The six-month moving average of monthly payroll gains peaked last July at 236,000 per month and has been moving unevenly lower since then. Average hourly earnings climbed 3.1% from a year earlier. With the unemployment rate currently reported at 3.6%, we view the U.S. economy to be nearing full employment, leaving little room for the unemployment rate to decline much further, but staying near current levels.

Inflation will remain in check near 2% due to slow global growth and softer commodity prices. (Figure 3) Falling oil prices, a slowing in import prices, and other transitory factors helped to keep inflation low in 2018. These same factors have helped to contain inflation early in 2019. However, inflation fundamentals, including hourly earnings, are expected to gradually push core consumer price inflation back up to slightly above their 2% target over the next several quarters. Also, the Fed has recently indicated that they may tolerate mild overshooting of their inflation target to align price level policy goals with additional job creation. Longer term, inflation expectations remain generally well-anchored near 2%.

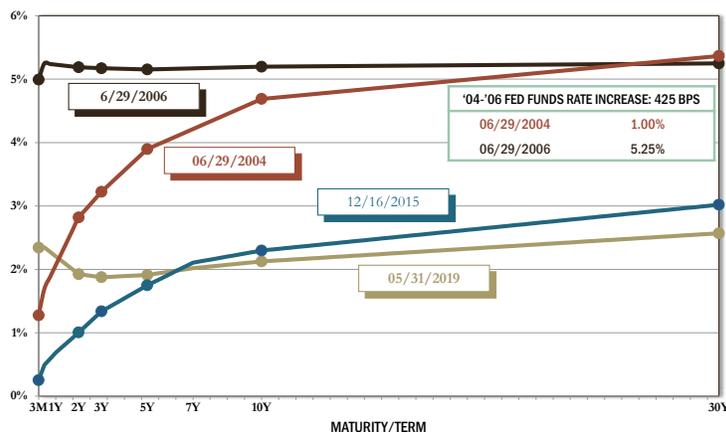
One financial condition that is weighing on the economy is an inverted yield curve. (Figure 4) It is well known that an inversion is a sign of an impending recession. This may be a necessary condition, but it is not enough to trigger economic contraction. It also takes high real interest rates (those adjusted to remove inflation), and today, real yields

INFLATION - BENIGN BUT TURNING UP FROM BOTTOM (FIGURE 3)



Source: Bloomberg

TREASURY YIELD CURVE CHANGES (FIGURE 4)



Source: Bloomberg



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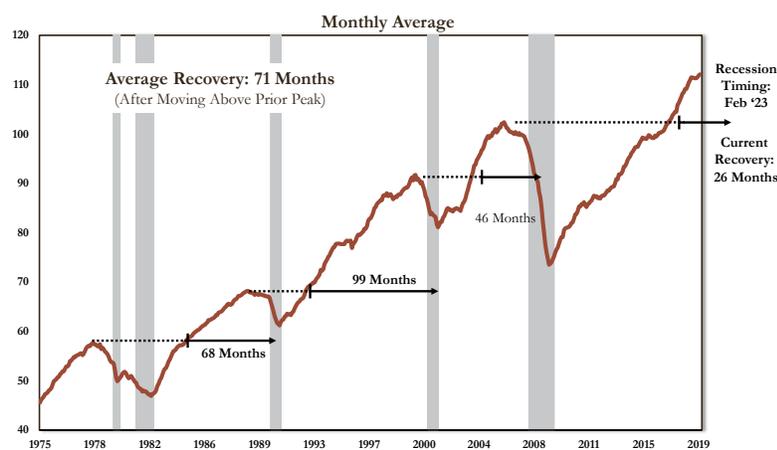
are still relatively low. Additionally, global demand for high quality, long maturity assets is elevated, as interest rates in many overseas developed markets are near zero, while some are negative. So, while there are some signs that the U.S. economy may be slowing, there are other signs that the financial and economic fundamentals are healthy, and the outlook still positive. Even so, the longer the curve remains inverted, the higher the likelihood of a recession on the horizon. As it stands now, we expect the Fed may be forced to cut the Fed Funds rate twice this year.

Perhaps the biggest concern facing the economy is the ongoing tariff/trade conflict. In fact, the trade war has recently spread beyond China. Mexico is now in the mix and India is about to lose its preferential status. These trade tensions will contribute to increased volatility and the longer they persist, the bigger the impact on economic growth and consumer/business confidence. Both sides are posturing that they are playing a long game and won't be pressured into a deal. So, without trying to forecast an unknowable outcome, our allocation recommendation is to maintain asset positions near neutral longer-term strategic targets, with a U.S. bias, while watching for rebalancing opportunities.

In summary, many positive economic signals are still in place. (Figure 5) Job growth continues, inflation and interest rates are low, corporate earnings are growing moderately, and the banking/financial system remains healthy, liquidity conditions have not deteriorated, the Fed is not too tight, and the dollar is not collapsing. As such, the U.S. economy

LEADING ECONOMIC INDICATORS

(FIGURE 5)



Source: Bloomberg

ECONOMIC
OUTLOOK

U.S. GDP IN
2019 UP

EMPLOYMENT UP

MODESTLY RISING
INFLATION

2019 MIDYEAR OUTLOOK



is likely to continue to generate its 2% growth rate. At the same time, there is a high level of economic and financial market uncertainty mostly surrounding the China trade/tariff situation, as well as other geopolitical hot spots. Although eventual resolutions may take longer than initially expected, it will ultimately lead to positive results for both the U.S. and Chinese economies.

EQUITY OUTLOOK

Tariffs and trade negotiations have certainly muddied up the outlook for the equity market. In early May, as trade talks with China came to a grinding halt, the S&P 500 average declined over 6% over the remainder of the month. As we enter summer we are faced with new tariffs on trade with Mexico, concerns about deteriorating world economic growth and an inverted yield curve in the United States. Are we setting up for another 19% plus plunge we experienced in the fourth quarter of last year?

In the face of these problems, year-to-date the S&P 500 average is still up low-double digits. We view the underlying foundation for equities as much more supportive than in January or October of 2018.

Let's start with valuation: We are going to look at the Value Line median estimated Price/Earnings ratio (Value Line index is comprised of 1,700 companies) in the chart shown on the following page. (Figure 6) At the end of January 2018, the median P/E was at 21 times, the highest valuation level over the last 39 years. At the end of May 2019, the median P/E is at 16.5 times, 20% cheaper than 15 months ago.

Rising interest rates were a real headwind for equity prices last year as the Fed increased the Fed Funds rate four times by a total of 1%. By early October 2018, the 10-year Treasury rate had hit 3.24%. Rapidly rising interest rates typically cause problems for stock prices regardless of the level of rates and the fourth quarter of last year was no exception.

EQUITY
OUTLOOK

GROWTH
OUTPERFORMS
VALUE

EQUITY VALUATIONS
LOOK ATTRACTIVE

DOMESTIC STOCK
OUTPERFORMS
INTERNATIONAL



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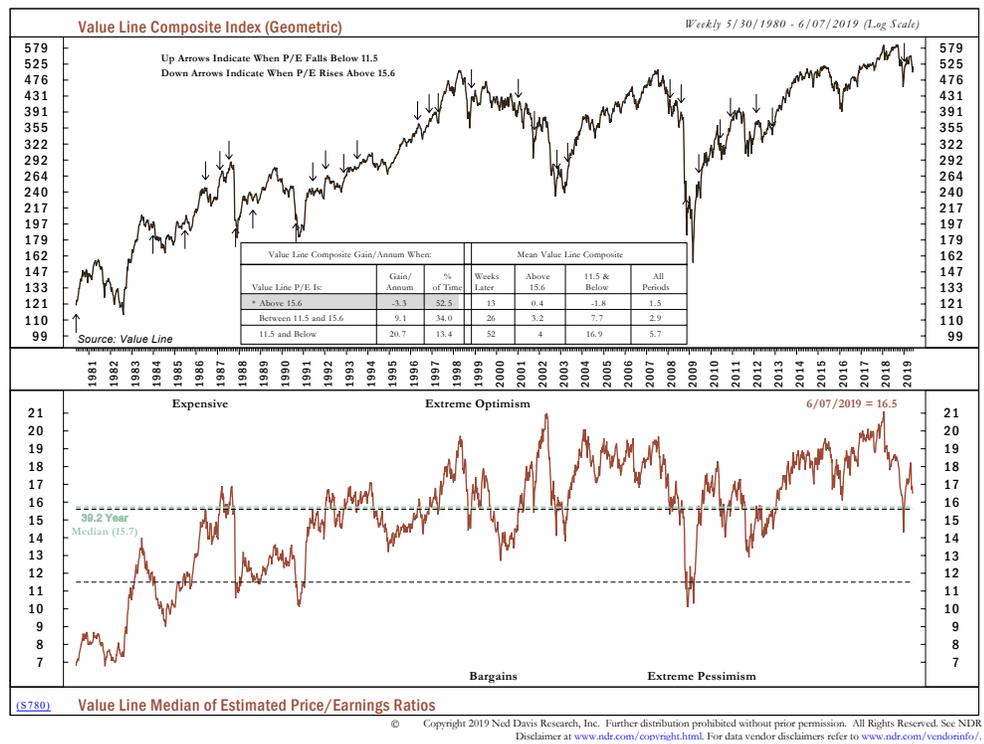
Funds continue to move out of equities into the fixed income market, which we believe could reverse later this year. While the public is selling, corporations continue to buy back their own stock at a record pace, which adds support to equity prices.

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Not surprisingly, falling interest rates are a strong tailwind for stronger stock prices, and they have certainly fallen. The 10-year Treasury rate is currently at 2.1%, more than 1% lower than eight months ago. Now the pressure is on the Fed to lower short-term interest rates.

Investor sentiment has clearly taken a turn for the worse in May, which we view as a positive for stock prices. Expectations for positive resolutions on the numerous trade and tariff threats are low, at least in 2019. Funds continue to move out of equities into the fixed income market, which we believe could reverse later this year. While the public is selling, corporations continue to buy back their own stock at a record pace, which adds support to equity prices.

VALUE LINE COMPOSITE INDEX / MEDIAN OF ESTIMATED P/E RATIOS MONTHLY DATA 1980-05-30 TO 2019-06-07 (FIGURE 6)



We believe domestic equities will continue to outperform international investments. Our recommendation is to underweight our long-term allocation exposure of 30% of your equity portfolio in International stocks. Foreign economies are considerably weaker than the United States, adding further downside pressure to international earnings.

With a positive outlook on the economy, falling interest rates and attractive valuations, equity prices should weather the ups and downs of trade and tariff negotiations. Day-to-day volatility will remain high, but we expect higher equity prices by year end.

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ALTERNATIVE INVESTMENTS OUTLOOK

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. These investments have expected returns and risks that may be higher or lower than stocks and bonds, and they often do not move in sync with traditional stock and bond markets.

Hedge funds are an area where we emphasize strategies that may provide protection in a declining market or behave differently than stocks and bonds. We expect that higher market volatility will continue into 2019. Conservative hedge funds, which have lagged stock and bond markets since the 2009 recovery, may have their day as investors seek capital preservation of the wealth they have built over that time.

Real Estate Investment Trusts (REITs) have been strong performers this year with the DJ U.S. Real Estate Index returning 17.03% through May. The backdrop for Real Estate remains favorable. Continued downward pressure on interest rates and yields should be supportive as should any incremental negative trade headlines.

Energy MLPs have also shown strong performance with the Alerian MLP Infrastructure Index returning 14.71% through May. The outlook for the North American midstream energy sector is positive given recent signs of stabilization in both company fundamentals and underlying commodity prices.

Commodities are being affected by opposing forces across the board and within sectors. The slowdown in China's growth prospects, and the U.S. escalation of the trade and intellectual property struggle with Beijing, are being offset by steady to robust growth in the United States and in several emerging market countries.

FIXED INCOME
OUTLOOK

1-2 POSSIBLE
FED FUNDS
RATE CUTS

DOWNSIDE RISK
WITH HIGH YIELD

EMERGING
MARKET DEBT
VOLATILITY



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Investors should consider moving up in credit quality within the tiers of the corporate and municipal bond markets. As growth slows and financial conditions tighten, credit spreads tend to widen to compensate for those rising economic risks, lowering prices.

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FIXED INCOME OUTLOOK

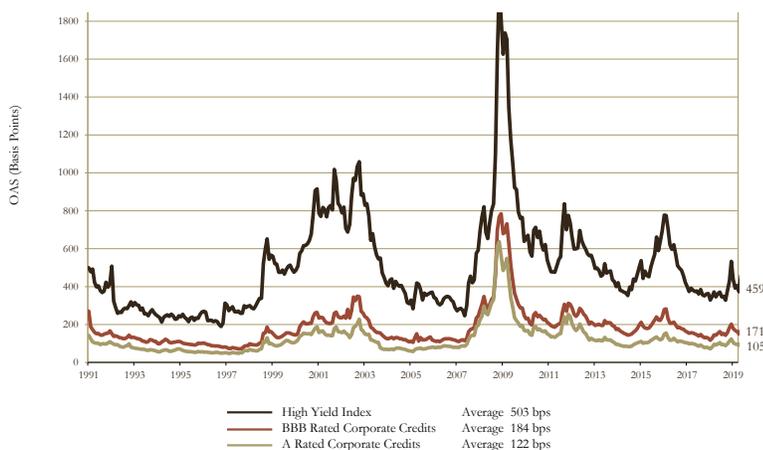
As we approach the mid-point of 2019, Treasury yields do not appear finished with their downward move. At the start of the year additional hikes in the Fed Funds rate were anticipated; however, none occurred as signs of a global economic slowdown began to appear and inflation remained subdued. Contrary to past experiences, the low unemployment rate has not translated into higher inflation. The Fed appears to have finished raising interest rates in this cycle, after making nine upward moves over the past 3½ years. The 10-year U.S. Treasury note yield began the year at 2.69% and has declined to a recent low of 2.14%, a level not seen since November of 2016. Treasury yields have declined 40 to 60 basis points (1% = 100 basis points) across the yield curve over the past five months.

Volatility picked up for investment markets as trade negotiations with China deteriorated. Across the Atlantic Brexit remained unresolved and contributed to investors' desire for safer holdings, driving yields down. Bond market returns year-to-date have rebounded from the flat to negative returns experienced in 2018. Lower yields and tighter spreads (the yield premium investors receive for investing in riskier bonds) have helped all fixed income sectors generate solid single-digit returns for year-to-date. (Figure 7) High Yield has been the top performer so far with the investment grade Corporate bond sector running close. Shorter high-quality holdings like Treasuries and Asset-Backed Securities (ABS) have trailed the other sectors. (Figure 8) The Barclays Aggregate Bond Index generated a 4.97% year-to-date return (as of 6/11/19).

The Barclays Municipal Bond Index is up 4.81% year-to-date (as of 6/11/19), as strong demand persists for tax-exempt holdings. Record mutual fund inflows for municipal bonds (nearly \$40 billion YTD) and lower supply have contributed to yields falling and Treasury ratios collapsing through 20-year lows. Municipal supply has yet to rebound from the elimination of advance refunding by the recent U.S. tax reform. With municipal bond tax exemption still in place, individual investor demand remains steadfast. The current lower yield environment portends

CORPORATE CREDIT SPREADS

1/31/91 THROUGH 5/31/19 (FIGURE 7)



Source: BBG Barclays, ICE BofA ML

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to weaker future performance from a total return standpoint. However, state and local issuers have enjoyed strengthening fundamentals due to the growing economy and tight labor market. Without a resurgence in new issue supply, the positive technical backdrop for municipal bonds should endure.

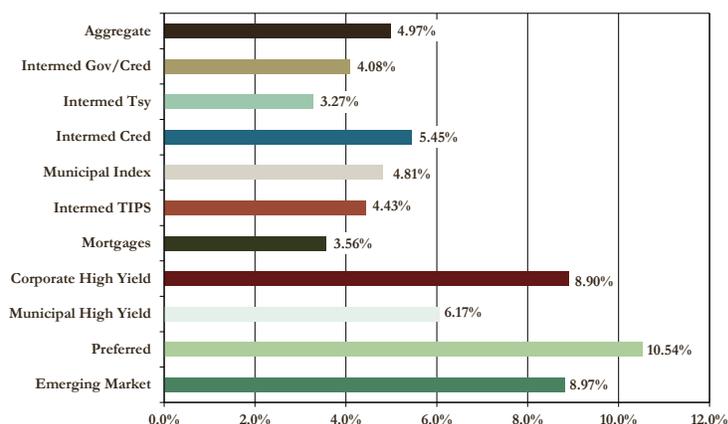
In the coming quarters, increased trade protectionism is considered the primary downside risk to economic growth. Recent tariff threats on Mexico have not helped calm the markets. With market volatility expected to remain, investors are anticipated to become more risk averse. Treasury yields have some room to move lower if trade tensions escalate. Under a growing trade war scenario, spreads would likely widen, offsetting price gains from lower yields. Additional gains for investment grade bond sectors may be minimal for the remainder of 2019. With a slowing global economy fueled in part by growing trade tensions, downside risk may grow in the High Yield and Emerging Market Debt sectors.

Low inflation expectations may put pressure on the Fed to start lowering interest rates before the end of 2019. The bond market is now pricing in two 25-basis point rate cuts by year-end, with an 80% chance of a rate cut as early as July. Very low rates in Europe will only help drive U.S. Treasury yields downward. However, by the fourth quarter of this year we may see hints of inflation trending upward, ceasing a further decline in yields.

Investors should consider moving up in credit quality within the tiers of the corporate and municipal bond markets. As growth slows and financial conditions tighten, credit spreads tend to widen to compensate for those rising economic risks, lowering prices. We plan to maintain an underweight to high yield bonds and improve credit quality among our investment grade holdings. As the bond market works through the uncertainty related to the impact of trade tariffs, portfolio durations should be maintained close to neutral relative to their corresponding benchmarks.

FIXED INCOME – YTD RETURNS

AS OF 6/11/19 (FIGURE 8)



Source: Bloomberg



CONCLUSION

The investment markets entered 2019 with hints of a slowing economy developing both domestically and globally. The benefits from tax cuts were waning and trade tensions were compromising business confidence. Despite these conditions job growth continued and inflation remained tame, leaving equity returns the chance to register double-digit gains year-to-date and fixed income returns approaching 5%. We believe 2019 will end up a good year for investors, even in the face of tweets from the President causing some day-to-day fluctuations.

We always like to close our newsletters by reminding our clients to consult with your financial advisors on a regular basis and be prepared to rebalance portfolios as needed.

INVESTMENT POLICY TEAM - JUNE 11, 2019

Disclosures: Past performance is no guarantee of future results, and the opinions and other information in the Market Outlook are as of June 11, 2019. The Market Outlook 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 Committee.

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KEY STATS

2.25%
2019 U.S. GDP GROWTH
FORECAST

16.18%
S&P 500 YTD*

3.50%
2019 UNEMPLOYMENT (ESTIMATE)

2.18%
10-YEAR U.S. TREASURY YIELD*

4.97%
BLOOMBERG BARCLAYS AGGREGATE
BOND INDEX YTD RETURN*

4.81%
BLOOMBERG BARCLAYS MUNICIPAL
BOND INDEX YTD RETURN*

* AS OF 6/11/19

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