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Market OUTLOOK

Economic and Financial Market Outlook — January 2010

Fiscal and Monetary Medicine Revive Economy

INTRODUCTION

In many respects, 2009 was quite an amazing year. In the first quarter there was palpable fear that an economic meltdown might lead to another global depression. This near-panic was countered with the hope that political change would eventually calm the crisis. Since then, both the fear and the hope of several months ago have been tempered. Many economic and market measures have improved, some dramatically. At the same time, the daunting tasks of reforming our healthcare system, re-regulating our financial conglomerates and healing our housing markets have proven to be challenging endeavors, to put it mildly. That being said, most financial asset classes have had strong returns this year. **(Chart 1)** Let's begin to review the pieces of the puzzle to see where we go from here.

ECONOMIC OUTLOOK

The year of 2009 has witnessed a series of dramatic economic events and extraordinary policy responses. Governments around the world assumed a "whatever-it-takes" mind-set aimed at averting a financial meltdown and potential depression. So far, these actions appear to be working and we anticipate a slow but bumpy domestic recovery ahead.

The U.S. economy rebounded to a real annualized Gross Domestic Product growth rate of 2.8% in the third quarter. This followed four consecutive quarters of declining GDP. We expect the economy will have grown at about the same pace in the fourth quarter once the data is reported. Improvement has been seen in the rebound of a variety of economic indicators, as well as upward

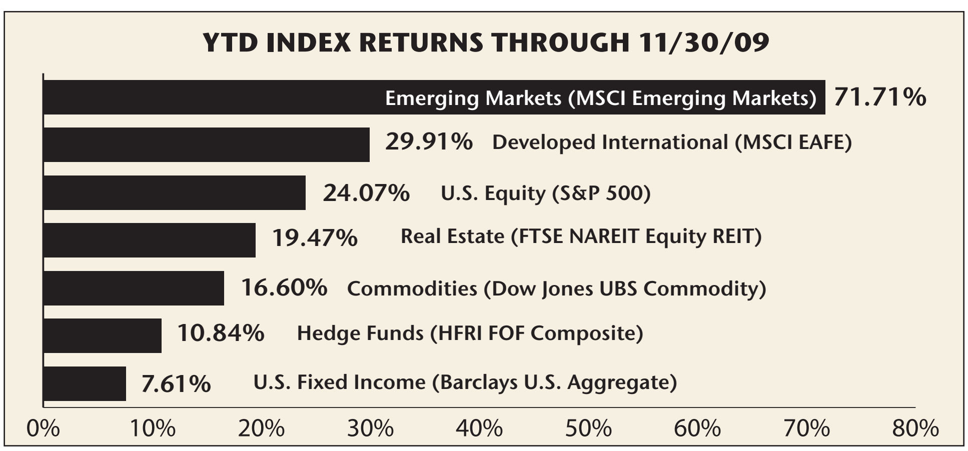

CHART 1
YTD INDEX RETURNS THROUGH 11/30/09
Strong reversal in returns for most asset classes relative to 2008.

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Inside:

The Commerce Trust Company
A division of Commerce Bank, N.A.

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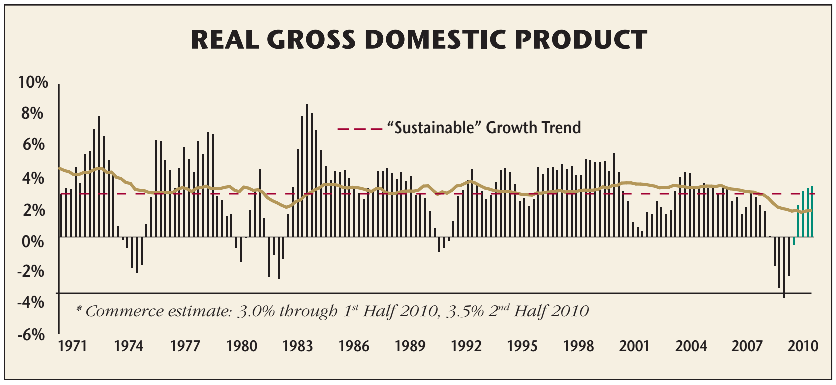

CHART 2
REAL GROSS DOMESTIC PRODUCT (in percent)
The economic recovery has begun after plodding through four consecutive quarters of declining GDP.

- ■ YEAR-OVER-YEAR
- ■ YEAR-OVER-YEAR (ESTIMATE)*
- — 10-YEAR TREND

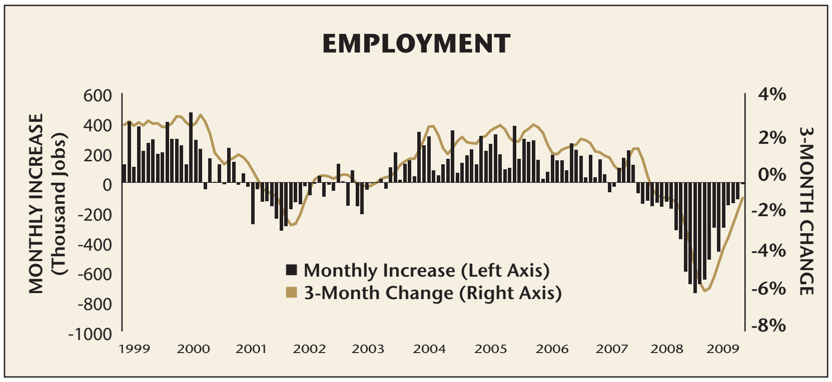

CHART 3
EMPLOYMENT
The job market is moving closer to a period of employment creation instead of losses.

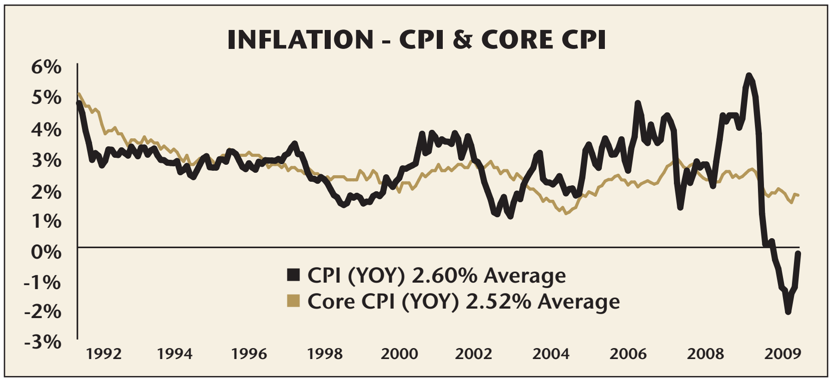

CHART 4
INFLATION —
CPI & CORE CPI
With substantial resource slack present, inflation is expected to remain subdued for some time.

profit revisions, propelled by extremely stimulative monetary and fiscal policies. But investors are anxiously awaiting signs that the economy is transitioning from a policy-driven expansion to one that is self-reinforcing. This will require a gradual strengthening in domestic demand, which we expect, but have seen little evidence of so far.

A normalized economic cycle begins as corporate profits increase, which drives an inventory replenishment and a subsequent capital expenditure expansion, and then comes employment growth that, in turn, revives consumption. In this cycle, corporate profits have been growing rapidly for the past three quarters, but inventory rebuilding has been muted. While inventories are near record lows, we expect the rebuilding cycle is about to begin. The current weakness in employment and consumption is a significant concern, but these two factors are "lagging" events that have always begun improving at the back-end of the cycle. Therefore, we would expect a generally traditional economic cycle will play out once again, albeit in a subdued and choppy pattern, with full-year 2010 real GDP posting in the 3-3.5% range, with the growth more back-end loaded. **(Chart 2)**

There is an intense ongoing concern about the current job situation. The "encouraging" news is that it appears to be getting worse at a slower pace. In fact, November payroll employment fell just 11,000 and the prior months were revised up, while the unemployment rate dropped to 10% from 10.2%. Household employment (focused on smaller businesses) also rose 227,000 after plunging the prior two months. Although not all the underlying data in the reports were positive, the overall direction was much better than expected and points toward a gradually widening recovery. **(Chart 3)**

Our concerns about inflation are limited as considerable slack has developed very quickly in the labor markets, while the housing component (measured by rents) is also falling. In most recoveries, the annual rate of core consumer price and wage inflation typically continues to decline for one or two years after the recession ends. It takes a period of revitalized economic growth before the slack in the resource markets tightens enough to again produce wage and price pressures. Even with the massive monetary and fiscal stimulus policies applied to date, it may take several more years of positive growth before any serious inflation risk emerges. **(Chart 4)**

The Fed's "credit easing" policy has been successful in reducing strains in credit markets and driving most private sector borrowing rates to low levels. However, liquidity injections into the banking sector have not yet triggered an expansion in money and credit. While the monetary base expanded by nearly $800 billion over the past year, bank loans have actually contracted by over $600 billion. The Fed will not consider tightening policy until credit begins to grow again. To this end, we expect that it will be well into 2010 by the time conditions have improved enough to warrant an exit from the Fed's current near-zero interest rate policy.

It is important to keep in mind that most economic policies have long lead times, with some only showing progress after periods of a year or more. Also, the effects of the policies typically show up on Wall Street before improving Main Street. There is considerable data showing that this scenario is playing out this time as well, as recently evidenced in positive GDP growth, rising profits, a bottoming in the housing market **(Chart 5)**, and an improved outlook seen in business surveys.

FIXED INCOME OUTLOOK

After a tumultuous 2008, the fixed income market gradually stabilized as the year progressed. It was a bumpy first quarter as the market was still dealing with the aftershocks of the post-Lehman Brothers meltdown in the financial markets. The U.S. government's fiscal and monetary stimulus began to take effect and helped initiate one of the most impressive performance rebounds of spread product (i.e., corporates, mortgage-backed securities, and agencies) in the history of financial markets. Bonds were also helped by investors transitioning from being risk-averse to being risk-seekers.

Bond markets were able to show improvement during the year in the face of rising default rates. According to Moody's, the default rate among U.S. speculative-grade issuers began the year at 4.5%. By third quarter of this year the default rate had reached to 12.9%. Moody's forecasting model predicts that the default rate will peak at 13.5% in the fourth quarter before declining sharply to 4.4% by the third quarter of 2010.

The Treasury yield curve started the year upward sloping, with the 10-year Treasury note yielding 145 basis points (a basis point is 1/100th of 1%) more than the two-year Treasury note. As we come to the end of the year, the yield curve has become steeper with interest rates down slightly in the short end of the yield curve and significantly higher in the long end. The yield difference between two- and 10-year Treasuries reached a record level of 275 basis points during May and finished the month of November at 254 basis points. **(Chart 6)** Concern about inflation diminished for the short-run but still remained a concern for the long-run (as reflected in 1.00% and 1.50% upward moves in 10-year and 30-year Treasuries, respectively). Looming over the market is the continuing threat that surging sales of U.S. debt will overwhelm the Federal Reserve's efforts to keep borrowing costs low.

Bond market returns saw a reversal from last year where high yield corporates were the laggards and Treasuries were the top-performing sector. For 2009, corporate bonds easily outperformed Treasuries and had double-digit returns in both high yield and investment grade holdings. Investment grade credit spreads (the difference between a specific risk sector's interest rate and a similar maturity Treasury issue) started the year wide and gradually tightened in the first three months and improved greatly during the spring and summer. The gap between yields of investment grade corporate bonds and those of Treasuries, according to Merrill Lynch's U.S. Corporate

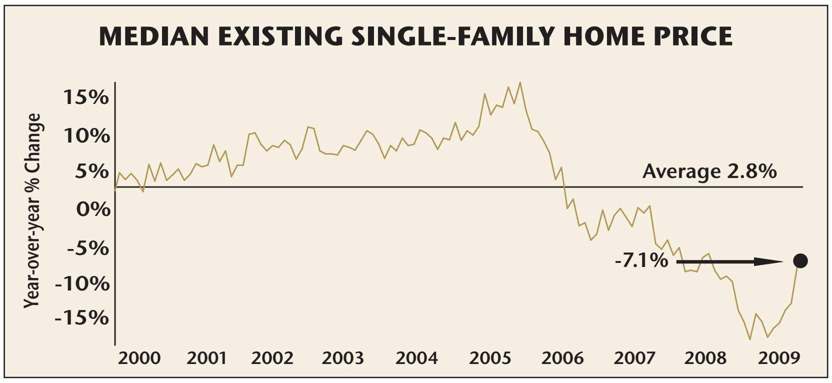

CHART 5
MEDIAN EXISTING SINGLE-FAMILY HOME PRICE
The decline in home prices has slowed as many purchasers take advantage of low mortgage rates and the first time home buyer tax credit.

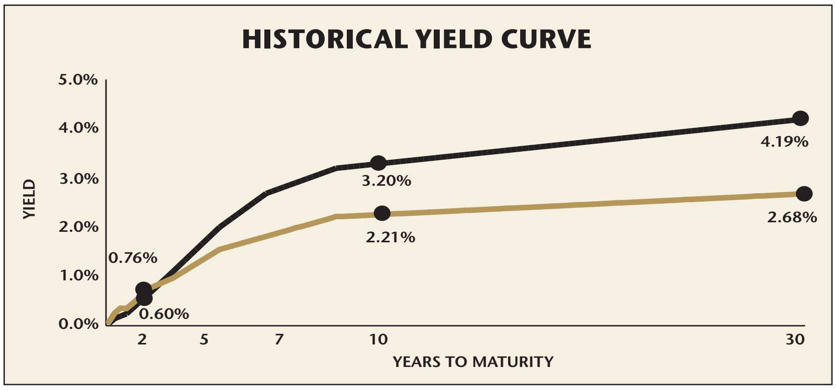

CHART 6
HISTORICAL YIELD CURVE
Rising yields for intermediate and long Treasuries have made the yield curve steeper.

■ 11/30/09
■ 12/31/08

Continued on page 4

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CHART 7
CORPORATE CREDIT SPREADS
12/31/91 - 11/30/09
Credit spreads for both high yield and investment grade bonds declined significantly in 2009 and are closer to their historic averages.

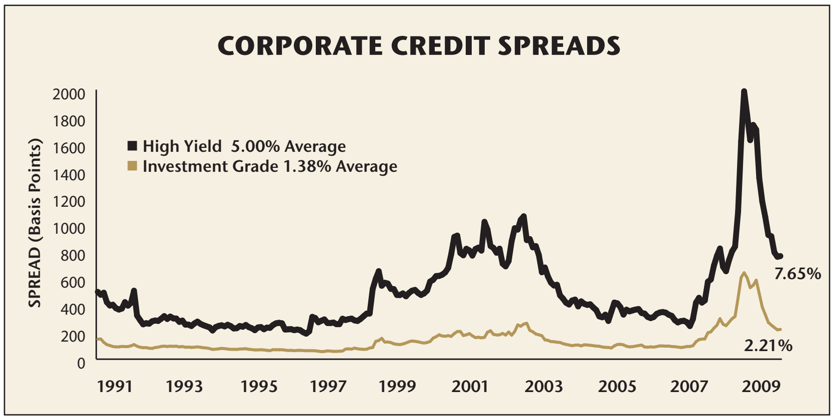
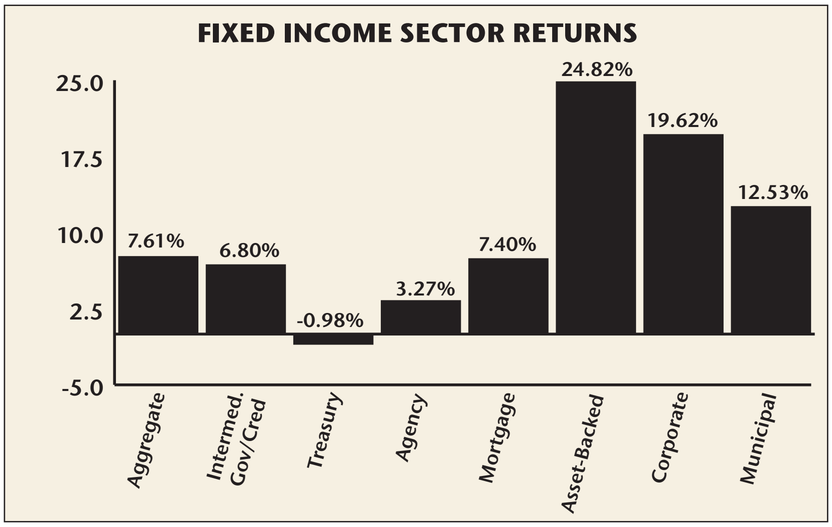


CHART 8
FIXED INCOME SECTOR RETURNS YEAR-TO-DATE (AS OF 11/30/09)
All fixed income sectors are expected to finish the year up, except for Treasuries, which are still negative for year-to-date.



Master Index, contracted from 604 basis points at the end of 2008 to 221 basis points by the end of November. **(Chart 7)** During just the latest 12 months, credit spreads have gone from post WWII record highs to historically normal levels today.

Spread tightening has helped all non-Treasury sectors (i.e., agency, mortgage-backed securities, asset-backed securities, and corporates) produce positive returns so far through November 2009. The bond market has benefited from the Fed's purchases of mortgage-backed securities and the rising demand from individuals seeking an alternative to money market funds. The overall U.S. bond market, as measured by the Barclays Aggregate Bond Index, has returned 7.61% year-to-date (11/30/09). Asset-backed securities led all investment grade sectors so far this year with a 24.82% return. **(Chart 8)** Treasury returns could finish the year in negative territory if interest rates do not decline from current levels.

Similar to Treasuries, the municipal bond market also saw its yield curve become exceptionally steep during the year. Despite confronting fundamental problems stemming from fiscal inefficiencies, overspending by states and local municipalities, and economic weakness, municipal bonds were able to produce positive returns. The Barclays Municipal Bond Index has increased 12.53% through November. Performance was helped by the growth in taxable municipal bond issuance associated with the Build America Bond (BAB) program, which contributed to a drop in tax-exempt bond issuance. The BAB program was able to attract nontraditional buyers such as foreign buyers, life insurance companies, and taxable bond funds. The ratio of 10-year AAA Municipal/Treasury yields declined from a remarkable peak of 146% at the start of the year to an overvalued trough of 76% in the third quarter. The flight to Treasuries we witnessed at the end of 2008 reversed and led to an overwhelming demand for municipal bonds through most of 2009, which was assisted by a growing concern about higher income tax rates in the future.

There are many challenges facing the bond market in 2010: high levels of government debt supply, rising inflation risk premiums, the risk of foreign investors reducing their Treasury debt purchases, and a struggling economy. In 2009 credit spread tightening more than offset the rise in interest rates, but the same may not be true in 2010. As the year comes to a close it appears that the rally in riskier bonds is losing momentum.

Given expectations for a slow and bumpy economic recovery in 2010, the risk for interest rates to move higher outweighs the benefit of rates moving lower. Interest rates will, in all probability, be higher at the end of 2010 than they are now.

With the significant tightening of spreads in 2009, the non-Treasury sectors have moved closer to fair value. Spreads will likely widen early next year for Agencies as the Fed ceases its purchases of Agency debt and FNMA's and FHLMC's funding needs increase. Later in the year this widening should be countered by tightening due to a decline in funding needs for FNMA and FHLMC, leading to shrinkage in supply. The Fed also expects to wrap up its acquisition of mortgage-related securities in the first quarter of 2010. There is concern that the absence of Fed purchases will cause a premature bond bear market.

An area which continues to show promise in 2010 is the corporate bond sector, particularly the financial intermediary companies. Their spreads had not tightened to the same extent as other fixed income sectors. We also like municipal bonds, especially for investors in high tax brackets who don't have short-term liquidity needs. The sustainability of the economic recovery will weigh heavily on the market as we progress through 2010. We plan to focus on security selection and diversification of the portfolios in order to generate attractive returns.

EQUITY OUTLOOK

U.S. stocks have staged a tremendous rally since the bottom on March 9, 2009. While the 60% move is large, it certainly is not unusual judging from past recessions. Looking at the previous nine recessions **(see table below)**, typically stocks bottom 5 months before a recession ends. This time stocks bottomed 3.7 months before the recession end (assuming the recession ended in June 2009). The Dow Jones Industrial Average rose 24.7% during those 3.7 months. The table also shows that for the six months following the end of a recession the Dow has always gone up for an average gain of 14.2%. This time, it appears from July to December the Dow will rise over 20%. The final column on the table looks at the next six months which would be the first half of 2010. The trend is for another 7% on the upside although there is a 25% chance it could decline.

What could push stocks higher in 2010? The individual investor was clearly traumatized in 2008 and 2009 as the financial system nearly collapsed, housing prices plunged, stock prices declined over 50% from their highs and unemployment soared past 10%. At the end of February 2009, money market assets as a percent of the stock market value soared to 47% as consumer confidence hit all-time lows and investors fled for safety. Typically, when investors panic they shift from risky investments to what they perceive to be the safest investments. At the stock market lows in 1982 and 2003 money market funds hit their previous panic highs of 24% of the value of the stock market. Normally it is in the 10% to 15% range. Since February, the 47% in money markets has declined to 28% (still higher than 1982 or 2003) or $3.3 trillion earning essentially nothing. While money has been moving out of money market funds, it hasn't been moving to stocks, but has been flooding into bonds. Interestingly, we have had record inflows into bond funds when interest rates are at 50-year lows and the difference between bond and stock returns over the last ten years is the largest in favor of bonds ever. Is this a speculative blow-off for bonds much like we saw in stocks in early 2000?

The fears investors had in 2009 certainly won't all go away in 2010. Concerns range from legislation on healthcare, the trend of the deficit, tax increases, another financial crisis and the possibility of rising interest rates late in the year. As we work through these issues maybe the outcome won't be as dire as we fear. As discussed in the *Economic Outlook* section, growth is going to be anemic in historical standards coming out of a severe recession in the United States. But let's not lose sight of the fact that the "emerging markets" economies showing strong growth will help sales for many U.S. corporations. Foreign sales account for over 30% of sales for the S&P 500 and a higher percentage of profits. We expect operating earnings for the S&P 500 to rise 20% to 25% in 2010. Companies took extraordinary cost-cutting measures last year and margins should expand as revenues increase. Profits should be better than analyst expectations for at least the first six months in 2010.

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DOW JONES INDUSTRIAL AVERAGE PERFORMANCE (DJIAP) IN RECESSIONARY PERIODS

Bear Market Trough	Recession End	Number of Months Until Recession End	DJIAP from Trough to Recession End	DJIAP 6-Month Period Following Recession End	DJIAP Next 6-Month Period
09/14/53	05/31/54	8.5 months	27.7%	18.5%	9.8%
10/22/57	04/30/58	6.3 months	8.6%	19.2%	14.8%
10/25/60	02/28/61	4.2 months	17.0%	8.7%	-1.6%
05/26/70	11/30/70	6.1 months	25.8%	16.4%	-8.4%
12/06/74	03/31/75	3.8 months	33.0%	16.4%	25.9%
04/21/80	07/31/80	3.3 months	23.2%	4.3%	2.2%
08/12/82	11/30/82	3.6 months	33.8%	18.3%	6.3%
10/11/90	03/31/91	5.6 months	23.2%	5.2%	7.2%
10/09/02*	11/30/01*	-10.3 months*	-24.9%	1.7%	-10.2%*
03/09/09	*06/30/09 (est)*	*3.7 months*	*30.3%*	*21.9% (Dow 10,300)*	—
	Averages**	**5.01 months****	**24.73%****	**14.32%****	**7.0%****

**Indicates special circumstances due to geopolitical instability surrounding the 9/11/01 terrorist attacks.*
***Excludes 10/09/02 numbers*

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While valuation levels for stocks look stretched at the current time, this should improve over the next year as earnings increase.

In 2010, we believe the U.S. equity market will trend higher for the first half of the year in the 5% to 10% range. For the second half of the year, we will reserve judgment until mid-year, expecting to then have better clarity on some of the concerns listed above. We still favor mid-cap stocks over large and small capitalized issues. Mid-cap stocks were the best performer in 2009. With interest rates so low, we could see an increased interest in higher dividend paying stocks from investors. With 15% tax rates on dividends (probably going to 20% in 2011) the after-tax return on dividends looks very attractive compared to most other investment choices.

INTERNATIONAL OUTLOOK

Synchronized public intervention by numerous governments around the world has lessened the impact of a deep recession, and global economic growth has once again turned positive. The government efforts have supported demand and provided a critical reduction in uncertainty, resuscitating financial markets worldwide and further encouraging economic activity.

Through November 24, the MSCI All Country World ex-US Index is up about 40% year-to-date. Worldwide, materials and technology companies are leading the stock markets year-to-date, while telecom and utility stocks are lagging. However, a new paradigm centers on the de-coupling of developed and emerging market economies. The MSCI EAFE Index of developed countries is up about 31%, while emerging markets, which were hit particularly hard in 2008, are up more than 75% so far this year. Certain regions are exhibiting particular strength, such as the BRIC countries (Brazil, Russia, India and China), up almost 94% year-to-date, and Latin America, up more than 100%. Since the beginning of 2008, emerging markets have outperformed developed markets, despite the dramatic underperformance of emerging markets in the second half of 2008.

While risk appetites can explain part of the emerging markets story, the rapid recovery of emerging market indices also can be explained by the higher levels of growth in these countries. Increasingly, economists are drawing distinctions between growth rates in emerging and developed markets. Emerging markets now represent more than 35% of world GDP expressed in real terms, up from about 29% in 2000. Emerging market growth is expected to continue to outpace world GDP growth, as resource-rich countries find robust demand from countries with expanding manufacturing sectors and growing populations.

> “Emerging markets now represent more than 35% of world GDP expressed in real terms, up from about 29% in 2000.”

The bifurcation of developed and emerging economies can be seen in the low single-digit economic recovery rates in Europe versus high single-digit (and some double-digit) rates in areas such as emerging Asia and Latin America. Clearly, emerging markets have led the global economic recovery. One of the bright spots in the developed world has been Australia, which enjoys a lively trade with Asia. Australia’s economic recession was much shallower than that seen in most of the developed world. Japan’s economy was hit hard, but industrial production there is now up sharply from its lows. Europe’s contraction is ending, but the region’s economy is fragile. In the third quarter, the U.K. posted its sixth consecutive quarter of negative GDP growth, surprising economists, who predicted the U.K. would follow on the second quarter positive growth seen in Germany, France, and Japan. Tight credit conditions in the U.K. make it difficult for even prospering companies to grow.

While the U.K. illustrates the tenuous nature of the developed world recovery, some signals are brighter. Europe’s purchasing managers index rose to 53 in October, above the level of 50 that generally indicates an expanding economy. In addition, business sentiment in Germany rose for the seventh consecutive month in October to a 13-month high. Growth rates in China are providing a boost to overall emerging markets growth, but many are questioning the sustainability of that country’s growth given the massive amount of government intervention there. Already many economists are predicting a credit bubble in China as the next disaster looming on the horizon. As we have seen over the past two years, leverage does indeed matter.

We continue to overweight emerging markets versus developed markets, but as a result of the brisk rally in emerging market stock indices year-to-date, we have trimmed our exposures. In addition, we continue to favor Asia and Latin America but view emerging Europe as less attractive.

Turning to the international bond market, it’s worth noting that in recent years there hasn’t been much difference among the local performance of various developed bond markets. Differences have mainly been due to changes in the value of the U.S. dollar. In fact the correlation between the dollar and the performance of the non-U.S. bond markets has been 0.92, which is extremely high. Further, from a yield perspective, movements across global bond markets have been highly, but not perfectly, correlated. Not surprisingly, movements among the top European countries' bond markets have been particularly close.

So our view is that it is more important to get the currency call correct than to analyze the nuances of local international bond markets. Considering the U.S. dollar is expected to remain weak for an extended period, we would recommend an allocation to foreign bonds where appropriate in client fixed income accounts. Tactically, we currently recommend exposure to both the international high-grade and local currency emerging markets sectors.

ALTERNATIVE INVESTMENTS OUTLOOK

Alternative investments typically include investment strategies in the main categories of Hedge Funds, Real Estate, Private Equity, and Commodities/Natural Resources/Real Assets. From a portfolio diversification standpoint, alternative investments may be attractive due to lower correlations to traditional asset classes of stocks and bonds. By introducing investments that behave differently from the rest of the portfolio, they can reduce portfolio risk (volatility) and potentially enhance long-term returns.

Hedge Funds

After a challenging 2008, alternative investments staged a strong rebound in 2009 and hedge funds were no exception. The HFRI Fund of Funds Composite Index year-to-date return was 10.84% as of November 30, 2009. Opportunistic equity, enhanced fixed income and absolute return strategies posted double-digit returns. The great economic crisis of 2008 and early 2009 paved the way for greater access to hedge fund managers that were previously closed. A positive development from the crisis is that hedge fund managers are employing less leverage and, therefore relying on their skill to execute their investment strategies successfully.

Commerce Trust focuses on conservative, multi-manager funds that employ little to no leverage. Several hedge fund strategies are available in a mutual fund structure that offers daily liquidity, manager transparency, low minimums and an attractive fee structure. The conservative funds we focus on may not capture as much return as a traditional equity investment in a rapidly rising market, but they can provide a cushion in a declining market environment.

Commodities

Commodities are an investment strategy for those seeking real return. Real return strategies focus on ways to preserve and enhance purchasing power and provide portfolio diversification from traditional stock and bond investments. Historically commodities are positively correlated to inflation and changes in inflation. After a volatile 2008, commodities participated in the rebound of 2009. The DJ-UBS Commodity Index returned 16.60% year-to-date as of November 30, 2009. However, the index is still below its peak of July 2, 2008 when oil topped $145 a barrel.

Commodities benefited from a general rise in risk asset prices, a weaker U.S. dollar and fundamental strength in the industrial metals, precious metals and soft sectors. The energy sector was mixed as natural gas prices were plagued by overproduction while crude oil prices increased to $75-$80 per barrel in the fourth quarter.

The outlook for commodity demand is positive. Commodity production and distribution capacity has suffered from years of underinvestment resulting in a supply constraint that may last for some time. Emerging economies such as China and India are experiencing improvements in their standards of living. Increased demand for durable goods and better food is expected, which will support raw material and commodity prices.

Real Estate

REITs positive performance in 2009 was driven by continued improvement in credit markets along with better than expected second quarter earnings reports that benefited from lower expenses. The MSCI US REIT Index returned 20.11% year-to-date as of November 30, 2009.

Positive economic releases throughout the third quarter along with asset sales announcements are suggesting that the bottom in both real estate values and fundamentals may be behind us. Furthermore, a number of REITs issued equity and these issuances were met with robust demand.

Real estate fundamentals typically lag the overall economy and the benefit of broader improvement will take time to filter down to the underlying cash flows of real estate companies. While the capital markets have improved, balance sheets still require equity issuance going forward. If economic growth is sustained, real estate fundamentals could improve sharply due to leaner supply pipelines and

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property development projects that have been abandoned. However, the prices of publicly traded REITs appear to have discounted much of the improvement in the real estate market.

Private Equity

Private equity moved beyond the stabilization phase as the volatility of late 2008 and early 2009 gave way to a gradual recovery. Only with the passage of time will we know how stable the current positive momentum will be.

Lack of liquidity is a serious issue in the industry and many participants got into a liquidity crunch and had to stop allocating to private equity or had to sell current funds at steep discounts. Fundraising for new private equity funds dropped dramatically in 2009. A bright spot is the venture capital market with opportunities developing as a result of emerging government policies in renewable energy, healthcare and programs to support small businesses.

> "The key factor for stocks next year will be the degree to which corporate earnings can meet or exceed current expectations."

CONCLUSION

As we end 2009, economies and markets are still digesting the hundreds of stimulative actions taken by governments around the world during the last several quarters. In the developed world, confidence is still low but improving. In the emerging markets, stimulation largely proved unnecessary and those governments are beginning to unwind the pump-priming in hopes of forestalling developing inflation.

We expect the market to advance interest rates by year-end 2010, but see the Fed only intervening as evidence of the sustainability of an economic recovery presents itself. We expect that returns among the various bond market sectors will be more homogenous than in 2008 or 2009.

The key factor for stocks next year will be the degree to which corporate earnings can meet or exceed current expectations. Our view is that profit margins and earnings will surprise on the upside, leading to a fairly normal market advance, at least through the first half of the year. We continue to prefer middle-sized companies in the domestic market and still view the foreign markets, particularly the emerging markets, as more attractive than our own, although our weighting would be slightly lower than last year. This is largely in recognition of the large performance differential seen in the last several months.

Lastly, we are actively adding a third major asset class – alternative investments, which includes real estate, commodities and hedge funds – to most portfolios that have previously been only in stocks and bonds. This is designed to provide both better overall diversification and reduced portfolio volatility with the potential to improve performance should inflation become a problem.

Investment Policy Committee
December 11, 2009

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