



2020
1ST QUARTER

CURRENT ECONOMIC AND FINANCIAL MARKET CONDITIONS SUMMARY

PREPARED BY: INVESTMENT POLICY TEAM



Commerce Brokerage Services, Inc.
A Subsidiary of Commerce Bank



GLOBAL ECONOMIC GROWTH BEGINS TO REBOUND

Lowering the probability of U.S. recession even further

ECONOMY

Solid forward progress with upside surprise possible, as fears of recession abate

Despite global economic growth slowing once again in 2019, the longest U.S. economic recovery on record soldiered on (10½ years and counting). We believed the likelihood of a recession last year was low, especially with the Federal Reserve (Fed) delivering a third "insurance policy" rate cut at the end of October, on top of the two rate cuts they made in the third quarter. This year the probability of a recession is even lower. Last year's cooling-off was driven by a myriad of interconnected causes, primarily the slowdown in China spurred along by the trade war, a global manufacturing recession that still lingers, an exceptionally weak Europe and the overhang of presidential impeachment proceedings.

Fortunately, the Fed transitioned from 2018's tighter monetary policy to one of accommodation. Credit markets improved, unemployment dropped steadily to a 50-year low, and stock prices rebounded with virtually all domestic equity indices reaching record levels. While it was rather obvious that activity would slow from 2018's 3% pace, the fear of impending recession proved overblown. Ultimately, the trade war and domestic politics took less of a toll than had been subjectively discounted by market pundits and the media. For all of 2019, growth fell toward the 2.3% range, better than many anticipated. This year the consensus forecast for growth is a modest 1.6% to 2.0%, but we believe the surprises will still be to the upside. Employment growth should remain positive, putting more spending money in consumers' pockets. Low interest rates are breathing late-cycle signs of life into the housing market, and we're bound to get a boost from all of the wealth created last year, providing a tailwind to keep our economic momentum moving forward.

We expect economic growth over 2020 will be approximately 1.9% to 2.4%. The key drivers of this growth will be:

- Interest rates that are 0.75% lower than at the beginning of last year
- An accommodative Fed with a bias toward holding short-term rates steady
- Increasing employment levels and record-low unemployment, which translate into a rise in personal income and steady consumer spending
- Surprisingly benign global inflation that affords continued global central bank accommodation
- Record corporate profitability fueling record stock prices and tighter credit spreads
- Reasonably low energy prices
- A tailwind from the positive wealth effect of an \$11 trillion annual increase in U.S. household net worth from record financial asset prices and home values
- A truce in the U.S./China trade war as the "Phase One" agreement is adopted

Global growth, too, will benefit from the lagged effect of nearly every central bank's easing last year. This positive global backdrop, combined with our resilient yet non-inflationary labor market, suggests our record expansion could continue for many quarters to come. While chronologically old, economically we are still middle-aged...perhaps just approaching retirement with those "twilight" years still remaining. Optimistically we could envision this expansion lasting for at least three more years, a highly out-of-consensus forecast.

Still, this virtuous business cycle won't last forever. As the Fed helped extend the recovery, our biggest worries remain sluggish growth overseas, geopolitical flare-ups and heightened political dysfunction in Washington as the campaign season moves into full swing. As a result, investors will stay focused on global issues and become increasingly interested in the 2020 election outcome, which no doubt will introduce an entirely new set of anxieties that could begin to weigh on markets over the second half of the year.

EQUITY MARKETS

We have remained firm in our commitment to stocks and risk assets

When 2019 began, we noted how valuations for the domestic equity market had improved dramatically, supporting our very positive outlook for stocks last year. The S&P 500 Index median P/E (price/earnings ratio) had fallen to 16.4 times at the end of 2018, levels last seen in 2014. But last year's outsized returns were primarily driven by multiple expansion; earnings increased only 2% to 3%, which now places the median P/E into overvalued territory. Fortunately, with the continued backdrop of moderate economic growth and an accommodative Fed, we believe earnings should catch up a bit this year and post mid- to high-single digit growth this year, providing a positive backdrop for this somewhat overvalued market.

Why are we positive this year after last year's huge gains? Simply put, after large "up" years there tends to be follow-on momentum in stocks...as long as there is no recession. Last year's gain of 31% for the S&P 500 marked the 12th time since 1950 that the market gained over 30% in a single calendar year. In the 11 previous instances, performance was positive in nine of the following years (year two) and negative in only two instances. In the positive years, double-digit returns were the most common. In the negative years, returns were only down in the low single digits.

As for pockets of value and the relative bets we are making, we continue to stick with a tilt toward growth stocks, an overweight to domestic stocks versus international stocks, and a slight overweight to emerging market stocks within international equity. Our international positioning comes at the expense of international developed market equities. The U.S. technology sector has provided the leadership for the S&P 500 Index over the last decade, and 2019 was no exception, rising over 50%. Until this trend changes, international stocks as represented by the MSCI EAFE Index are at a structural disadvantage. Technology represents 28% of the S&P 500 versus only 8% of the EAFE index.

FIXED INCOME MARKETS

A sharp decline in rates and credit spreads boosted returns in 2019

Returns for bonds in 2019 ranged from very positive to exceptionally positive. This was due to the falling interest rate environment, coupled with investors' "risk-on" appetite for yield. This result was in direct contrast to 2018, which saw rising rates and widening credit spreads deliver dismal returns for bonds (even negative in some sectors). Market action in 2018, especially the late December swoon experienced both in stocks and bonds, set up the fixed income markets for a much better 2019. Core investment-grade municipal and taxable bond funds posted returns in the 6% to 9% range, while higher-yielding non-investment-grade funds posted even better returns of roughly 12% to 15%. For 2020, with the Fed likely on hold for most of the year, we should have a much more benign interest rate environment. As such, bond funds should perform a bit better than the cash markets but probably no better than the low-single digit yields that most fixed income sectors currently offer.

Last year we made a slight reduction to our modest allocation to the riskier "plus" areas of the bond market (from 10% to an 8% weighting). Within the "plus" sector, we believe the best bond returns for 2020 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 this year as the business cycle progresses.

ALTERNATIVE INVESTMENTS

It was a banner year for public equities and fixed income in 2019, with a 60% S&P 500/40% Barclays Aggregate Bond mix returning in the low 20% range. Investors also benefited from the reappearance of negative correlation between stocks and bonds. The only two negative months for the S&P 500 (May and August) coincided with some of the best returns for fixed income. With such a strong showing for traditional investments, investors may question the need for alternatives as part of a diversified portfolio.

Our outlook for 2020 is for lower returns for both equity and fixed income investments. We see little room for multiple expansion in U.S. equities, and interest rates are near historic lows. This may be the time for alternatives to make a meaningful contribution. Constructing a portfolio with a diverse set of performance drivers takes on more importance in an environment of expected low returns for traditional assets. Conservative hedge funds may reduce volatility from the equity allocation, while REIT investments provide exposure to real estate and real assets.

Private equity is often classified as an alternative investment but is part of the equity asset class. It is characterized by a long investment horizon, lack of liquidity, and the potential for returns higher than those of the broad equity markets. Committing to a private equity fund forces an investor into a buy and hold discipline and places the exit decision in the hands of experienced professionals who are close to the underlying assets. Emotional selling during volatile markets is prevented due to the illiquid nature of the investments, which can keep an investor's strategy on course.

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