Market OUTLOOK

Economic and Financial Market Outlook — January 2014

U.S. Economy Suggests 'Time to Taper'

Market Summary

- *Global growth for 2014 is projected to be near 3.5% with 3.0% GDP growth forecasted for the U.S. economy.*
- *Most investors are anticipating higher interest rates due to unwinding of the Fed's bond purchase program and stronger economy.*
- *Private sector credit is expanding again, boosting consumer and business confidence.*
- *Fiscal health of state and local sectors are also turning positive.*
- *U.S. equity markets' momentum of 2013 expected to carry into new year.*
- *Unemployment rate continues to drift down gradually, projected to fall from 7.0% levels to 6.7% toward the end of 2014.*

Inside:

INTRODUCTION

In the six months since our Mid-Year Outlook review was published in June, the U.S. economy has successfully weathered some turbulence. We endured a government shutdown, higher interest rates and a related downturn in consumer confidence. Even so, the U.S. economy has shown resilience and continued to press forward over the past two quarters. Recent data continues to suggest that the business expansion is proceeding ahead at a steady, yet still uninspired, pace heading into 2014.

ECONOMIC OUTLOOK

Even though we are now five years past the financial crisis, it continues to have its effects on policy settings, corporate frameworks and economic activity around the globe. Most major economies are still operating well below potential, and many central banks are continuing with large Quantitative Easing (QE) programs and zero interest rate policies. But there are signs of progress. Here in the United States, the stabilization of household balance sheets implies that the deleveraging process is nearing an end. Also, bank lending standards have been easing for some time, and it is a positive sign that private sector credit is growing again.

In Europe, as challenges persist, progress is being made. Austerity policies are gradually moving toward growth policies. In the Asian sector, Japan has instituted both macro policies to end deflation and supply side reforms to raise growth potential. Lastly, China has successfully navigated a soft landing and is emphasizing structural changes and reforms to enhance market vitality and maintain stable growth.

Global growth for 2014 is projected to be near 3.5%. Over the next year, the major growth components in this estimate are the United States at 3%, Europe at 1%

CHART 1
REAL GROSS DOMESTIC PRODUCT (in percent)
Economic growth is expected to be over 3.0% for 2014.

- YEAR-OVER-YEAR
- YEAR-OVER-YEAR (ESTIMATE)*
- 10-YEAR TREND
- SUSTAINABLE GROWTH TREND

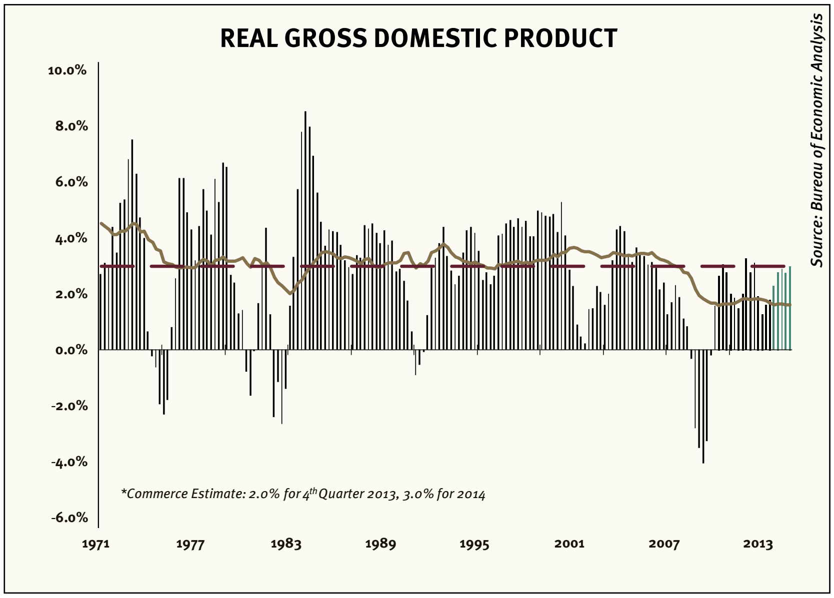


CHART 2
EMPLOYMENT
Monthly payroll employment gains are expected to exceed 200,000 per month in 2014.

- Monthly Increase (Left Axis)
- 3-Month Change (Right Axis)

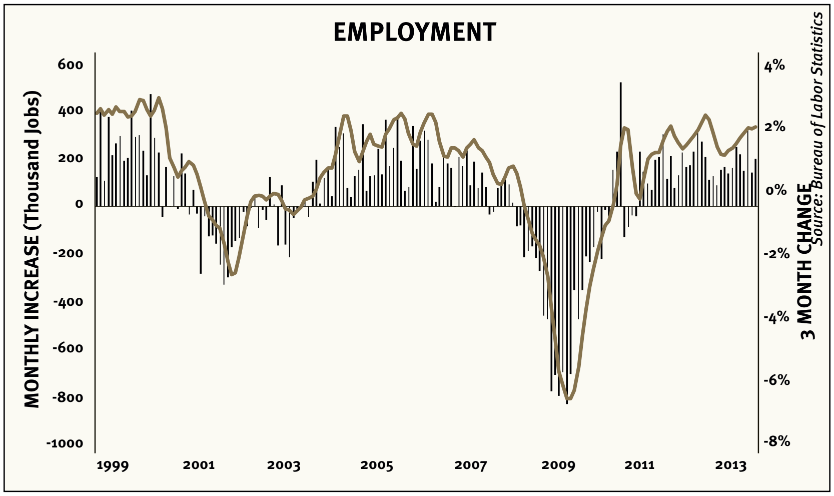
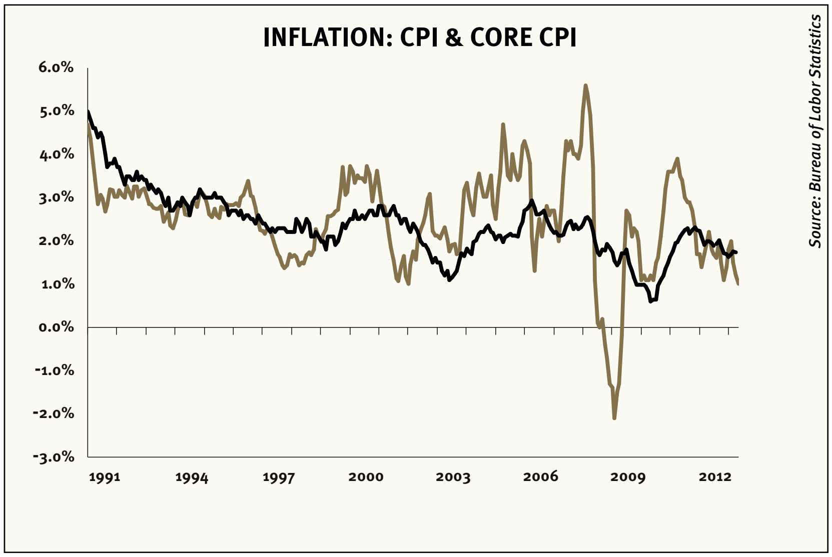


CHART 3
INFLATION: CPI & CORE CPI
Inflation is expected to remain below its historic average in 2014.

- CPI (YOY) - 2.52% Avg.
- Core CPI (YOY) - 2.36% Avg.



and emerging countries at 6%.

In a rare moment of congressional "compromise," a two-year budget deal was announced in December. It easily won passage in the U.S. House of Representatives, and as of this writing has moved on to the Senate. The deal avoids a government shutdown in January, as well as next October, and blunts automatic spending cuts (the sequester). It also, at least, lays the groundwork for a couple of years that should be free of funding crises, thereby supporting consumer and business confidence. However, this is a modest deal that makes no major dent in the U.S. deficit and also does not address the nation's debt ceiling (borrowing authority), which could still provoke a battle when it needs to be increased by Congress in late February or early in the spring.

It's also important to note that the fiscal health of the state and local sectors are turning positive. In aggregate, revenues are now growing faster than expenditures. The rise in home prices is significant, given that property taxes are the majority of local government revenues. These larger receipts will come into government budgets in 2014 and likely be spent.

Our expectation is that, when the final tally is in, U.S. GDP will have advanced at over a 2% rate in 2013. This is encouraging considering the estimated 1.5% drag from fiscal policy this year as well as the jump in long-term interest rates since May. Following second- and third-quarter growth of 2.5% and 3.6% respectively, fourth quarter GDP may dip under 2%, due to a decline in inventory investment. However, private final demand is projected to be roughly 3%. This resilience is due mostly to solid gains in home and equity values (household net worth) and some growth in disposable income since last year. Looking toward 2014, we expect U.S. GDP growth of over 3% (**CHART 1**).

Employment gains averaged 193,000 in the last three months (September through November), which is well above the three-month average at either of the last two Fed meetings (148,000 as of September and 143,000 as of October.) This suggests that the trend in employment has not softened (**CHART 2**). Our expectation is for monthly payrolls to average over 200,000 in 2014 and that the unemployment rate will drift down gradually from 7.0% (in November) to 6.7% toward the end of next year. An important level for Fed monetary policy, per the November FOMC's recent guidance, is an unemployment rate of 6.5%, which is expected to be approached by mid-2015.

Inflation remains under control. Core consumer price inflation bottomed at 0.6% in the second quarter and rose to 1.4% in the third quarter (**CHART 3**). Core Personal Consumption Expenditure (PCE) inflation is expected to have averaged just 1.2% over 2013, rising gradually to 1.6% in 2014, which is still well below the Fed's comfort range of 2-2.5%. Elevated economic slack (high unemployment) and a modestly stronger dollar (softer import prices) both combine to restrain inflation. As economic slack diminishes, inflation will accordingly move slowly higher over the next year.

One important area of concern on every investor's mind is: When will the Fed start the "tapering" process (i.e., the slowing/ending of their Quantitative Easing bond purchase program)? The Fed has stated repeatedly that a decision to slow/stop its QE activity will depend on economic improvement. The economic data has been and will likely continue to be mixed. So the market will continue to be driven by expectations about QE, as it relates to the incoming data. Right now, the employment numbers seem to be the Fed's primary area of focus.

Therefore, when the Fed decides to "taper," it will be due to a strengthening U.S. economy. A stronger economy usually means lower corporate default rates and tighter credit spreads. If the Fed chooses to delay tapering, the ongoing liquidity into the economy will continue to support asset prices, and bond credit spreads would be expected to tighten in this case as well. Finally, any tapering announcement will inevitably spark some volatility, although it should be less severe than was the case last spring/summer. We believe investors will be rewarded for riding out the turbulence.

FIXED INCOME OUTLOOK

Rising yields and growing uncertainties plagued the bond market in 2013. Questions on when tapering was to begin, who was to be the next Federal Reserve Chairman and how the debt ceiling debate was going to be resolved were some of the issues the market dealt with this past year.

Across the Treasury yield curve, interest rates were higher in 2013 (through November), with the 10-year Treasury yield rising by nearly 1.00%, ending the period at 2.75% (**CHART 4**). The year started with Treasury yields being range-bound and, as the topic of tapering by the Fed became headline news, yields rose rapidly. Over the summer, the debt ceiling debate pushed yields even higher, with the 10-year Treasury yield peaking near 3.00%. Uncertainty about Fed Chairman Ben Bernanke's replacement added to the volatility. Once assurances came that the Fed was not going to immediately start tapering and Janet Yellen became the frontrunner for the head Fed position, yields stabilized. Continuation of the Fed's bond purchase program kept rates depressed throughout the period.

The overall U.S. bond market, as measured by the Barclays Aggregate Bond Index, returned -1.47% year-to-date through the end of November. Slightly tighter spreads were not enough to offset the negative impact of higher interest rates. The bond market is on pace to have its first negative annual return since 1999. Over the past twenty years, the broad index has averaged one negative quarter a year; 2013 had two negative

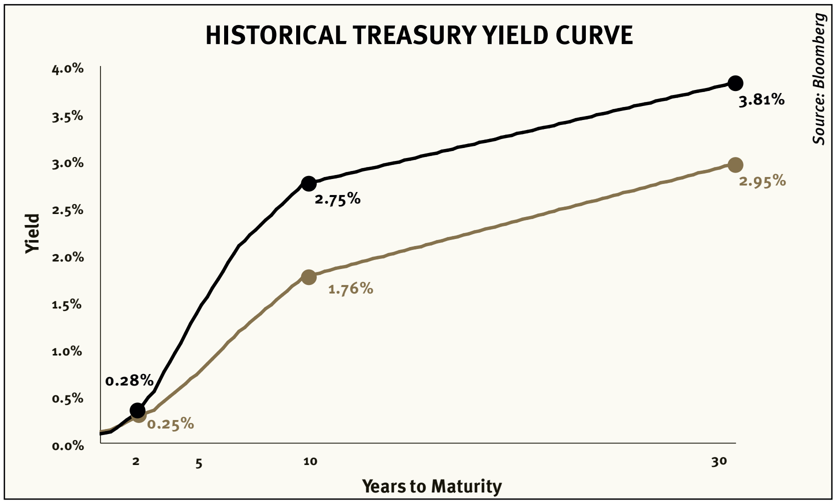


CHART 4
HISTORICAL YIELD CURVE
(12/31/12– 11/30/13)
Treasury yields increased in response to expectations about the Fed's tapering plans.

■ 11/30/2013
■ 12/31/2012

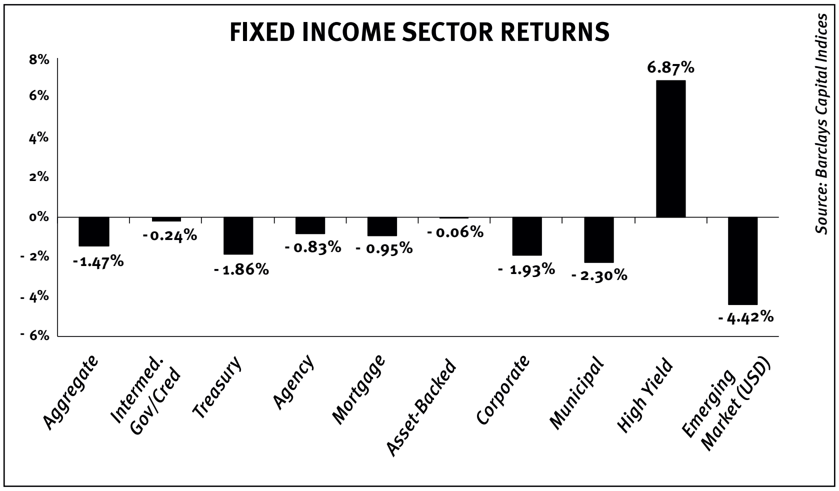


CHART 5
FIXED INCOME SECTOR RETURNS YEAR-TO-DATE (AS OF 11/30/13)
High Yield is the only fixed income sector generating a positive return year-to-date.

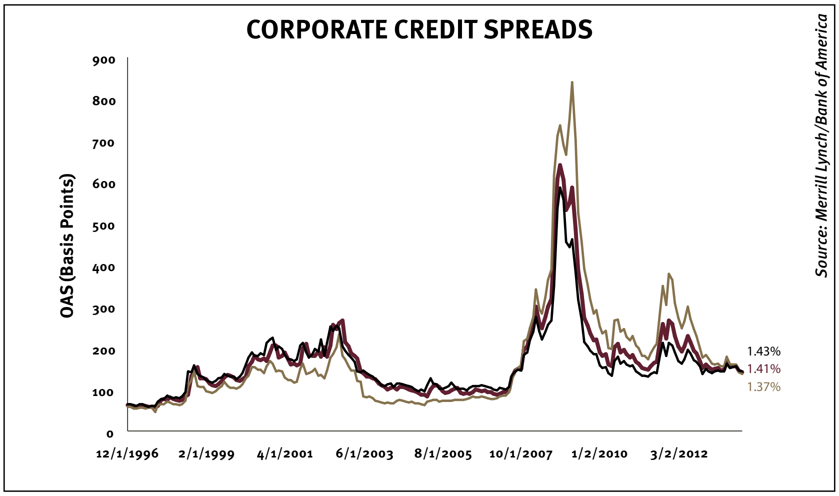


CHART 6
CORPORATE CREDIT SPREADS (12/31/96 – 11/30/13)
Finance sector spreads tightened and have returned to their pre-2007 relationship to the Industrial sector.

- Investment Grade Financial – 1.73% Average
- Investment Grade Corporates – 1.67% Average
- Investment Grade Industrial – 1.60% Average

quarters (1st and 2nd quarter at -0.12% and -2.32%, respectively).

Most bond sectors are on pace to finish the year in negative territory, with Emerging Market Debt bringing up the rear. An exception to this is likely the High Yield sector. Stronger corporate balance sheets helped High Yield to finish in the black and as the top performing fixed income sector for 2013 (**CHART 5**). Low default rates also aided performance. Moody's expects the global speculative-grade default rate to end the year at 3.0%. For 2014, default rates are projected to remain low by historic standards.

Investors became more cautious as the year progressed. Mutual fund outflows were prevalent, especially for fixed income funds focused on corporate bonds and emerging market debt. Within the Corporate bond sector financials may eke out a positive return. Spread tightening was greater in this subsector relative to utilities and industrials. Prior to the financial crisis in 2007, credit spreads on financials traded inside of industrials (i.e., financials were considered less risky than industrials) (**CHART 6**). This relationship had been in place for years and was broken when the mortgage meltdown hit banks and other financial institutions. The market is now back to the pre-2007 relationship where financial spreads are tighter than industrial spreads. Financial institutions have spent years repairing their balance sheets and reducing higher-risk business activity to get back to this point.

Municipal bonds struggled this year. The Barclays Municipal Bond Index was down -2.30% year-to-date through the end of November. The negative return was due in large part to rising market yields. Detroit's bankruptcy filing and an increased focus on Puerto Rico's fiscal health also contributed to the bearish investor sentiment. Heavy mutual fund outflows after these events placed more downward pressure on prices, despite most municipalities still showing good credit fundamentals.

For Emerging Market bonds, 2013 was a tough year due to the threatened shift in the U.S. Federal Reserve's monetary policy. Unwinding of the Fed's Quantitative Easing program remains a challenge for these markets. However, most emerging market economies are now better placed to withstand a less accommodative Fed than they have been in the past. Improvements in the U.S. and European economies are expected to continue in 2014, which will help support emerging market exports. Growing interest in allocating to this sector should help with demand, allowing for positive returns in the coming year.

The Fed appears ready to end its bond purchase program in 2014, with tapering likely to start by the end of the first quarter. Interest rates are expected to move upward as the Fed starts to unwind its Quantitative Easing program. Lethargic economic growth and continued subdued inflation could help dampen the upward pressure on yields caused by tapering. Some turbulence in the market may appear at the start of 2014 if a quick resolution to the debt ceiling debate is not found.

Corporate bonds (both investment grade and high yield) are expected to outperform Treasuries in the coming year. The oversold condition of the municipal bond market has created some opportunities and left yields attractive relative to Treasuries. Agency mortgage-backed securities and Treasuries, big beneficiaries of Quantitative Easing, are likely to suffer the most as the Fed unwinds its bond purchase program. Even with the past year's near 1.00% upward move on the 10-year Treasury yield to 2.75%, there is still room for rates to rise further. Since 1926, 10-year Treasury yields have averaged 5.07%. Low single-digit returns may prevail for the bond market if spreads tighten enough to help offset rising Treasury yields.

EQUITY OUTLOOK

2013 was a terrific year for investing in domestic stocks with the S&P 500 rising over 25%. Since 1897, stocks have risen annually 20% or more 38 times, surprisingly about once every 3.3 years on average. Since the 1930s, the S&P 500 increased at least 25%, thirteen times. So the natural question is what happens to the stock market the following year?

The results are mixed with five of the years declining and eight increasing (five of the eight years increased more than 19%). We have been overweight stocks in balanced portfolios for all of 2013 and continue to be as we enter 2014. Earnings for 2013 should increase 9% to 10% and projections are for the same magnitude of growth in 2014. What really propelled stocks higher in 2013 was the expansion of the S&P 500 Operating Price/Earnings (P/E) ratios from 14.5 times to 17.5 times, accounting for two-thirds of the gain.

Looking into 2014, we could see P/Es continue to expand to 18 or 18.5 times earnings before we would become concerned with valuations reaching excessive levels. Higher P/E levels can be sustained with the low inflation we are experiencing. With solid earnings growth and minimal P/E expansion, we could see stock gains for 2014 in the 5% to 15% range. If the market makes a strong surge in the first quarter and gets ahead of earnings growth, we will probably remove our overweight in stocks.

Consumer confidence in the United States remains at subdued levels even though we are in the sixth year of an economic recovery. Based upon mutual fund flows, over the last five years, investors have shied away from increasing their equity investments and shifted funds to fixed income funds, which had posted attractive returns until this year. With interest rates starting to increase from historically low levels, bond funds have posted negative returns in 2013. As investors first started to see negative bond returns last summer, they began liquidating their fixed income investments. At first, they moved to money market funds, but they started buying stock funds in October. We believe this new source of buying for stocks will add some support to the market over the coming year.

We continue to have a positive outlook for domestic equities, but probably will be looking for an opportunistic time to reduce our overweight position in 2014. Stocks continue to offer an attractive risk-adjusted return to fixed income and money market returns.

Moving outside the United States, the EAFE (Europe, Australia and the Far East) index posted strong returns, but still lagged the United States market by 10%. With improving economic conditions in Europe, an aggressive monetary policy in Japan, discounted valuation levels and attractive dividend yields, international equities could provide attractive returns this year.

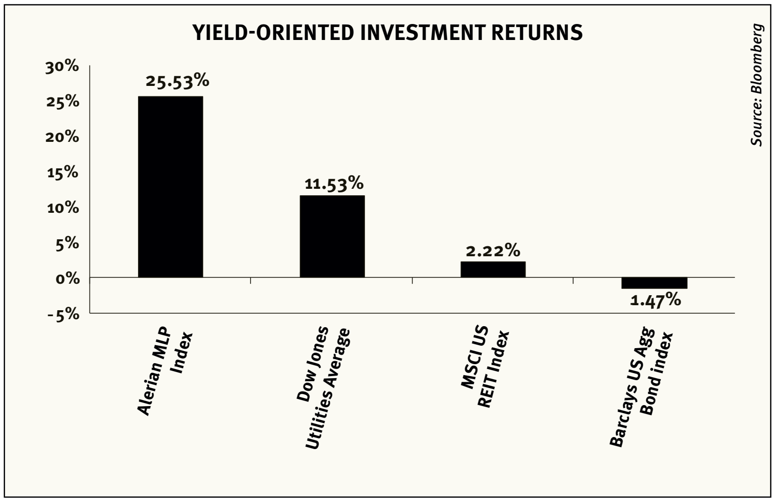
The real disappointment to equity investors has been the emerging markets, which have underperformed U.S. equities by as much as 30%. One thing we can count on when investing in emerging market stocks is a lot of volatility. Over the last 18 years, when we rank 15 types of investments on an annual basis from best to worst, emerging market returns are in the top two highest returns in eight of the years and in the lowest two for six of the years. From a valuation perspective, emerging markets sell at a 30% discount to U.S. stocks. While we don't know when the underperformance will end, we do know that when they do turn up, the upside returns could be quite large.

ALTERNATIVE INVESTMENTS OUTLOOK

Alternative investments include strategies in the main categories of Hedge Funds, Real Estate, Infrastructure MLPs 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, investors can reduce portfolio risk (volatility) and potentially enhance long-term returns.

Hedge fund returns were positive in 2013. The HFRI Fund of Funds Composite Index year-to-date return through November 30 was 7.47% and the HFRI Fund of Funds Conservative Index was 6.73%. While these returns trailed U.S. and Developed Markets Equity returns, they outpaced investment grade fixed income returns.

CHART 7
YIELD-ORIENTED INVESTMENT RETURNS (1/1/13-11/30/13)
MLPs outperformed other yield-oriented investments in 2013.



CTC INVESTMENT CONTACTS

Christie Cody, CFA
(816) 234-2415

Mike Cody, CFA
(314) 746-8551

Scott Colbert, CFA
(314) 746-8557

Doug Koester, CFA
(314) 746-7337

Cynthia Rapponotti, CFA
(314) 746-8794

Barbara Turley, CFA
(314) 746-8726

Joe Williams, CFA
(816) 234-2564

Real Estate Investment Trusts (REITs) were subdued in 2013. The MSCI U.S. REIT Index was up 2.22% through November 30. Compared to corporate bonds and private real estate, U.S. REITS are fair to attractively priced. Compared to U.S. equities, U.S. REITs are unattractive. The U.S. real estate market outlook is for above average cash flow growth despite a slow economy.

Infrastructure MLP investing is gaining more acceptance as an asset class. Investors seeking income along with growth potential allocated more to this sector throughout the year. This is reflected in the Alerian MLP Index return of 25.5% through November 30, which outperformed other yield-oriented investments such as REITs, utility stocks and taxable bonds (**CHART 7**).

Commodity index returns were negative in 2013 with the DJ UBS Commodity Index returning -10.68% through November 30. In the near term, oil prices are reasonably well-supported by tight supply. But over the next year, there is potential for the supply of oil to increase. Gold, copper and soybeans are vulnerable due to rising real interest rates, increasing copper supply and increased acreage for soybeans in Brazil.

CONCLUSION

Despite weathering a variety of storms, including a government shutdown, higher interest rates, challenges in Europe and slowing growth in the emerging economies, the U.S. economy continues its steady march forward. We anticipate U.S. economic growth of 3% in 2014, supported by private sector credit growth, improved personal balance sheets, continued gradual decline in unemployment and reduced policy uncertainty. Improved growth in Europe and a soft landing in China will also support economic conditions at home and abroad. Against this backdrop, we expect the Fed to begin reducing its accommodative stance beginning in the first quarter, which will put downward pressure on bond prices – particularly on Treasuries.

Investors in domestic equities were rewarded with S&P 500 gains in excess of 25% in 2013. We believe domestic stock prices have additional upside of 5% to 15%, supported by low inflation, reasonable valuations, and increased money flows into stocks from bond and money markets funds. Developed international stocks could provide attractive returns in 2014 as economic conditions improve abroad. Emerging market stocks trailed U.S. stocks by a wide margin, but now trade at a 30% discount to U.S. equities and offer significant upside when they turn. All in all, we remain steady as we head into 2014.

INVESTMENT POLICY COMMITTEE
DECEMBER 17, 2013

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