



Market BULLETIN

August 2011 Market Bulletin

A Correction or the Beginning of a Bear Market?

The Big Picture

The recent U.S. government showdown over the debt ceiling and the S&P downgrade of U.S. debt have re-ignited simmering investor anxieties about the global economic backdrop, particularly as it relates to fiscal imbalances in developed country governments. The financial markets are once again focusing on the potential for the obviously troubled European credits (Greece, Portugal and Ireland) to roil the larger and much more important economies of Spain and Italy, with bond yields in those two countries now having surpassed the 6% mark.

The S&P downgrade is a wake-up call, perhaps long overdue. The psychological damage from the downgrade is material, as it affects foreign as well as domestic consumer and business confidence in the stability of the United States. The action against U.S. debt also suggests the possibility of S&P downgrades of other AAA-rated countries (there are 15 currently at S&P) and is pressuring stock prices and credit spreads as investors embark on a flight to quality. In the long-term, the downgrade could have a positive effect if it motivates Congress to work together in a more timely fashion to address the long-term fiscal imbalances.

The reality is that two-thirds of the world's GDP (U.S., Europe and Japan) is likely to remain bogged down in a very slow-growth environment as we work through a three-step deleveraging process: first business, then the consumer and finally the governments. With regard to business, the deleveraging process has largely worked its way through most of the Large-Cap industrial companies. It has run its course through the U.S. banking system, but it is still in process in the undercapitalized European banking sector.

Consumers globally have probably completed a large part of the deleveraging needed but continue in the long process of repairing their balance sheets, which have largely been hurt by falling property values. Thus, the consumer is still rebuilding savings at the expense of consumption.

Finally, the U.S. Government debt debate highlights the rather intractable situation in which the developed world finds itself with regard to expenses that exceed tax collections. The deleveraging headwind will continue to blow, unemployment will stay elevated (with any gains barely keeping up with population growth), real estate prices will remain depressed until we work through the backlog in foreclosures, and economic growth will continue to be sub-par for a considerable period of time measured in years, not quarters.

So are we double dipping?

Despite these headwinds, we still believe growth will remain positive. Why? Employment is still growing, interest rates are at exceptionally low levels, and corporate profitability is at record highs. While the developed world slows, the developing markets will continue to grow at above-average rates as the new global consumers take a hand-off from tired American spendthrifts. No

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J.-J. Landers Carnal, CFA
Executive Vice President
Chief Investment Officer



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one likes to see stock prices falling; however, the break in commodity prices will be a welcome relief to those families pinched by higher food and energy prices.

What would likely cause us to be wrong?

Two major risks are European debt contagion and investor panic that takes markets down to levels that become self-reinforcing to the downside. The European debt situation is particularly concerning, given the dysfunctional interplay of one central bank and independent sovereign nations with their own fiscal policies.

Where are we on stocks?

The market volatility we've been experiencing is not inconsistent with the "two steps forward, one step back" type of slow-growth economic recovery we have been expecting. Stocks now appear somewhat undervalued, but with mixed economic data and political uncertainty, we would expect continued volatility. Bull markets typically experience periodic corrections of 10% or more. The current market retreat represents the first correction since the spring of 2010, which ironically was also precipitated by sovereign debt concerns.

With all of the bad news, one variable that could boost investor psychology is the potential for more U.S. government intervention. Unlike in 2008, the Federal Reserve has had time to consider its options, and further action could provide a needed spark. Similarly, the European Central Bank (ECB) appears ready to implement a second round of quantitative easing via purchases of Spanish and Italian bonds.

Areas of the stock market that could represent opportunities include the energy stocks. Emerging markets should continue to grow, and that should equate to higher demand for oil. After its increased government payout, Saudi Arabia needs to maintain higher oil prices to balance its budget, and we believe OPEC will cut production at current levels to support the price of oil. Consumer staples, defensive consumer discretionary names, and domestic telecommunication stocks, all with stable dividends, also look attractive.

What should we do with a balanced portfolio?

Market volatility invariably presents opportunities. Over the long run, a fully diversified portfolio can reap solid benefits from rebalancing, as outperforming asset classes are trimmed in favor of underperforming asset classes.

We also recommend that our clients employ alternative investments, such as hedge funds, commodities and REITs, as a way to mitigate stock market risk and achieve a more efficient portfolio. A basket of these alternatives has outperformed a typical balanced portfolio in recent weeks, as some of these investments have had positive performance over the past month.

The important point to keep in mind is that those investors who panic during times of market volatility stand the chance of losing the most. It's very difficult to time the market, and many investors who sell low are out of the market when it starts to rally. The buy-and-hold (or the buy-and-rebalance) investor can substantially outperform the average investor, and "staying the course" can be an effective strategy for achieving your long-term objectives. It is always important to make sure your long-term asset allocation is appropriate for your risk tolerance, tax situation, liquidity needs, and time horizon. At times like these, a professional advisor like The Commerce Trust Company can help you navigate through the markets and achieve your goals.

The Commerce Trust Company Investment Policy Committee August 8, 2011

For more information on this or on other topics important to you as an investor, please call your local Commerce Trust portfolio manager.

Disclaimer: Past performance is no guarantee of future results and the opinions and other information in this Market Bulletin is as of August 8, 2011. The 2011 Market Bulletin is a special report designed to provide investment information on economic markets for Commerce Trust clients. It is intended to provide general information only and is reflective of the opinions of the senior investment management committee.



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