

MID-YEAR REPORT, JUNE 2010

Market Update

Economic and Financial Market Outlook — Mid-Year Update

Wary Investors Hope to Avoid 'Double-Dip'

INTRODUCTION

Recent events in Europe, particularly in its ailing countries, have highlighted the debt headwind that the developed world faces as it attempts to rebound from the depths of a “synchronized recession.” An overindulged consumer (particularly in the U.S. housing market) and poor management practices by large money center financial institutions tipped the world into recession. A focused combination of low short-term interest rates, extraordinary levels of central bank liquidity and government deficit spending ultimately stopped the downward GDP spiral and put the world back on a path towards near-average growth.

Fortunately, equity prices rebounded sharply from their lows of March 2009. Investors’ willingness to take risk revived and world economic growth got kick-started from a dead stall. But if drinking up too much consumer debt at the credit-market sub-prime party caused the world to fail its sobriety test, too much government debt today seems to be a cure leaving us with a hangover. This bad headache continues, calling into question the sustainability of all the recent progress made in the global recovery. Investors have been forced to reassess their risk appetites once again.

So what do we think this means for the world and financial markets in general? And what is our outlook for the investment landscape for the rest of the year?

ECONOMIC UPDATE

In the simplest terms the developed world (think U.S. and Europe) was living beyond its means for a number of years and pulled a lot of its growth forward by borrowing money from a developing world (think China and India) that was willing to save and invest more than they were consuming. Now that we are forced to begin to attack our debt burden, we should expect:

- subpar growth relative to historical norms in the U.S. and Euro-area going forward.
- short-term interest rates that remain lower for a longer time than most had anticipated (think Japan).
- slower growth that translates to a less than average return for financial assets, especially for fixed income investors, but better than average prospects in the emerging markets.
- a downward pull, like gravity, primarily on the Euro and secondarily on the dollar relative to hard commodity assets like gold and the developing world’s improving currency situation.
- a materially higher tax burden coupled with some fiscal retrenchment as financial markets force both politicians and spend-thrift consumers to address their debt burdens over the foreseeable future.

This doesn’t mean the United States faces the likelihood of a double-dip re-

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CHART 1
REAL GROSS DOMESTIC PRODUCT (in percent)
 The economy has grown now for almost a year at a 3.7% annualized pace.

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

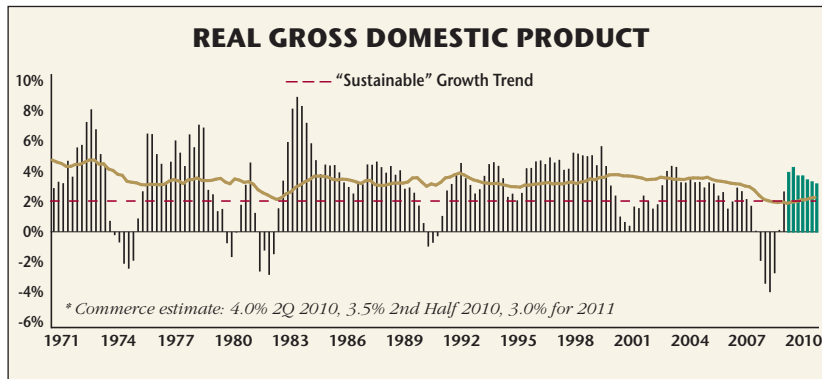


CHART 2
LEADING ECONOMIC INDICATOR
 These indicators suggest continued recovery somewhat better than the previous jobless recoveries, but not as strong as in 1975 and 1983.

■ Real GDP YOY (R)
 ■ Leading Indicator (L)

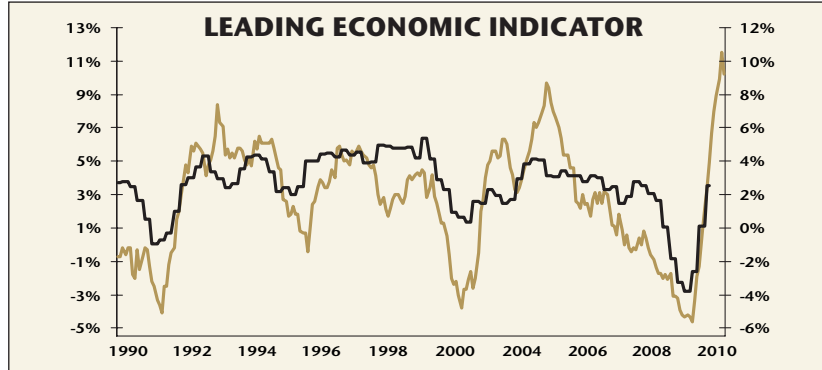
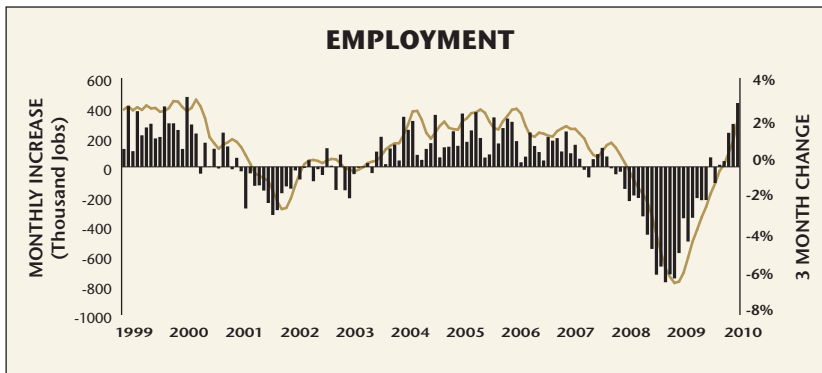


CHART 3
EMPLOYMENT
 Job growth turned positive in January and we expect this trend to accelerate.

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



cession any time soon. In fact, we would suggest another year of economic growth is almost a shoo-in here, maybe not what some would have described as “V” shaped, but positive growth solidly in the 3% or better range over the next year.

Where does this optimism come from? First, we note that we have already been growing at an above-trend rate. Economic growth after the recession (3rd quarter '09 through 1st quarter '10) has averaged 3.6% and we are currently tracking at near 4% annualized growth for the current 2nd

quarter of 2010. (Chart 1) In addition, positive market indicators include a near-zero short-term interest rate, corporate profits that have jumped almost 30% year-over-year, stock prices that are up materially from their lows, low inventories that are still getting drawn down, an average hourly workweek that has been increasing, employment growth that turned positive earlier in the year and vehicle sales and housing starts that have plenty of room to increase.

Most of these economic statistics are captured in the Conference

Board's leading economic indicator, which has soared from its lows of March 2009 and is increasing at a 10.2% pace. That portends a recovery faster than the previous jobless recoveries, but not as strong as the recoveries of 1975 and 1983. (Chart 2)

Most importantly, we won't double-dip if employment and incomes are rising, which they are. While this recovery still feels more “jobless” than robust, there are a few silver linings. Companies fired workers faster than in any other prior recession as CEOs looked into last year's recessionary abyss. While corporate top line revenue fell, it didn't fall as fast as most companies expected, and profits are recovering faster than many thought possible. As corporate prospects have improved, they have reacted rationally. Businesses have slowed the rate of firing and have begun to work their current employees a bit longer. And with a lag, the monthly “establishment” employment reports have turned positive, averaging 99,000 private jobs per month for the past five months. (Chart 3) In a separate survey of households (used to determine the unemployment rate), it suggests employment growth (excluding census workers) has been more than twice as fast as this headline-making “establishment” survey suggests.

Still, employment growth remains soft. The combination of unemployment (currently reported at 9.7%, down from its high of 10.1% in September 2009) and an excess of plant and equipment available at discounted prices has helped minimize inflationary pressure despite the accommodative interest rate environment. (Chart 4) We would caution those inflationary doom-sayers that inflation is following its normal cyclical pattern as global levels of high unemployment,

excess production capacity and an oversupply in housing are combining to drive prices for goods and services down, not up, throughout the developed world.

Of course there are risks to our rather sanguine outlook for the U.S. economy and we would have to say at this point they are more to the downside than the upside. And almost all of these risks are entirely debt-related. It's just at this point the effects of the European crisis have been offset by unexpected strength here in the U.S. At some point, if the debt crisis continues to spread, we will have to revise our outlook downward. Unfortunately, this dark cloud will hover over the U.S. economy and investment markets for most of the foreseeable future.

FIXED INCOME UPDATE

As financial markets began to heal last year, bond market investors took advantage of historically wide credit spreads. While that was great if you were fortunate enough to have participated in those markets (our Commerce Core Bond Strategy exceeded a cumulative 18% return from the 3/9/09 low through 5/21/10), it stranded today's bond investor with exceptionally low interest rates and modest prospects going forward.

The outlook for bond markets ultimately depends on whether market turmoil stalls the momentum of the global recovery. The recent European troubles have pushed riskier bond investments back up in yield a bit. **(Chart 5)** We view this primarily as a buying opportunity for those who have government debt in their portfolios, particularly given our benign inflationary outlook and the recent steepening in the credit curve.

In response to the European debt situation, policymakers an-

nounced a massive fiscal support package in an effort to end the crisis. This action has reduced the risk of a sovereign default in the next two years; however, European financial companies have been clobbered and measures of bank risk and funding strains have ramped up. This is likely because debt restructuring may be the only way out for Greece and perhaps some of the other related countries.

(Chart 6) While the direct losses facing U.S. banks would be fairly small, the damage to European banks could be severe if the local economies are forced to undergo a painful, deflationary adjustment.

So far this year, lower interest rates have been able to offset the recent drag on performance caused by credit spread widening. Through May, the Barclays Aggregate Bond Index returned 3.71%.

While the year-to-date returns of various fixed income sectors have been positive and generally

consistent across the board, May was especially volatile as credit spreads widened significantly versus Treasuries. Political, economic and renewed banking system risks have weighed heavily on the bond markets recently. However, the factors that led us to be bullish on spreads over the past year remain in place. Positive economic data in June and some improvement in Europe have helped bond spreads stabilize. We expect credit spreads to drift lower based on positive fundamentals, but risks will overhang the markets for some time.

We especially like emerging market non-dollar denominated debt and have been recommending this for our investors. We are less encouraged by investment-grade European debt and zeroed out our exposure to this relatively high quality sector at the end of April. Finally we are sticking with our slightly shorter than benchmark allocation to duration/maturity as we expect

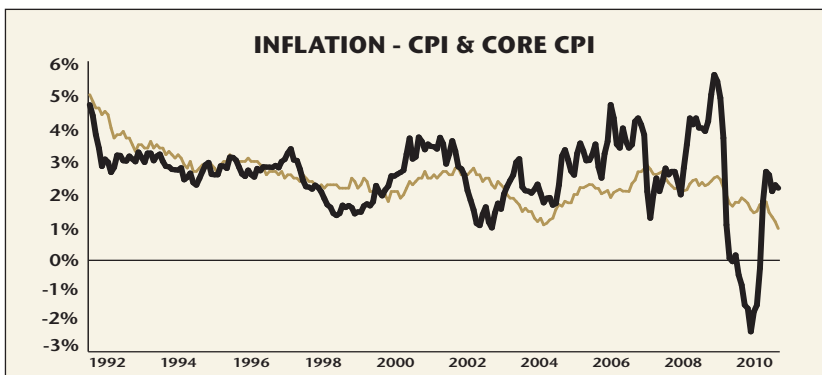


CHART 4
INFLATION –
CPI & CORE CPI
With substantial resource
slack present, inflation is
expected to remain subdued
for some time.

■ CPI (YOY) 2.59%
■ Core CPI (YOY) 2.49%

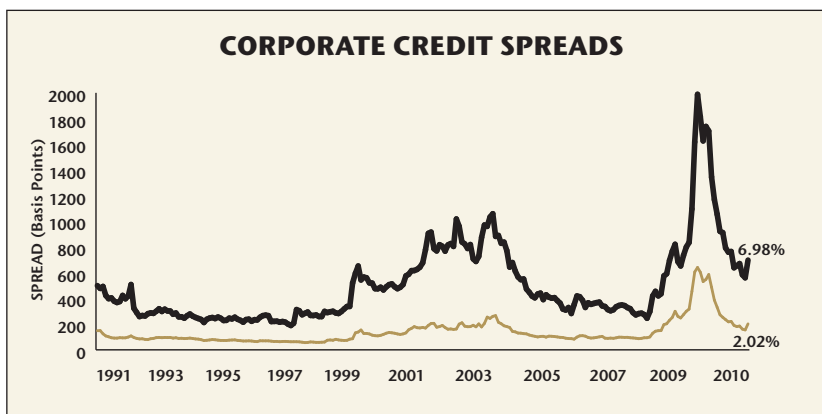


CHART 5
CORPORATE CREDIT SPREADS
12/31/91 - 05/31/10
Credit spreads for both high
yield and investment-grade
started the year tighter, but
spreads have recently begun
to widen out as market
volatility increases.

■ High Yield – 5.03%
■ Investment Grade – 1.40%

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CHART 6
EURO DEBT
 Heavy debt load hampers the recovery of these European countries.

EURO DEBT	Percent European GDP	Percent Debt/GDP	Percent Gov Debt/GDP	Budget Deficit
Greece	3%	193%	122%	-14%
Portugal	2%	239%	76%	-7%
Ireland	2%	261%	65%	-12%
Spain	12%	228%	52%	-8%
Italy	17%	204%	110%	-5%
Total/Average	36%	225%	85%	-9%
Germany & France (Avg)	49%	122%	75%	-5%

the recent global headwinds to gradually fade and intermediate interest rates to gradually rise as the global economic recovery slowly unfolds. For those investors who participated in the riskiest sectors of the bond market over the past year, we expect that at some point we will recommend reducing your allocation to high yield, but would still favor the bank loan sector over the more typical high yield bond fund investment.

The municipal market has continued to provide solid year-to-date returns (Barclays Municipal Bond Index has increased 3.25% through May), as it was largely unaffected by the flight to safety in May. Yields barely moved over the month, as coupon income accounted for nearly all of the total return. We remain favorably inclined toward municipal bonds, although we are also cautious on spreads. Headline risk around budget gaps and the status of extensions and potential expansion of the Build America Bond program are ongoing issues.

EQUITY UPDATE

Just as everyone expected (but nobody ever knows when), the stock market as measured by the S&P 500 incurred its first 10% correction since rallying 80% from the market low on March 9, 2009. (These corrections typically occur on average once every 11 months.)

We entered the year thinking the major stock averages would likely trade in a plus 10% to minus 10% range for most of the year. Upside was probably limited by stretched Price/Earnings and valuation ratios which would likely decline as the year progressed, having discounted the strong earnings reports that were likely to accrue. We also thought the downside was limited to a typical 10% correction by the combination of upwardly trending global growth (particularly in the emerging markets), accommodative interest rates and declining credit spreads.

In early January the market took an initial 8% plunge as the debt problems in Greece and southern Europe were first digested, similar to this latest correction. Also fueling recent investor fears has been the decline in the Chinese stock market (falling since last August) as the Chinese government tries to slow economic growth and cool inflationary pressure. If the Chinese economy were to slow too much it would certainly call into question our global expansion story.

And investors remain quite nervous after the roller coaster ride they took over the last several years. Wild daily swings in the market averages over the last few weeks certainly don't help and have elevated the S&P 500 Volatility Index (VIX). Fortunately the recent drop in prices and this elevated

sense of investor anxiety provides some upside potential. We would advise clients over the next several months to rebalance your equity exposure back to a more neutral stance, selling stocks when the markets are up 5% to 10% on the year while remaining committed when the averages are down 5% to 10% for the year.

We have also recently advised reducing exposure to developed international investments because of the financial problems in Europe and to a lesser extent in Japan, while maintaining our overweight exposure to emerging markets. We are also increasing the larger cap, less risky stocks as we reduce our mid-cap sectors' allocation.

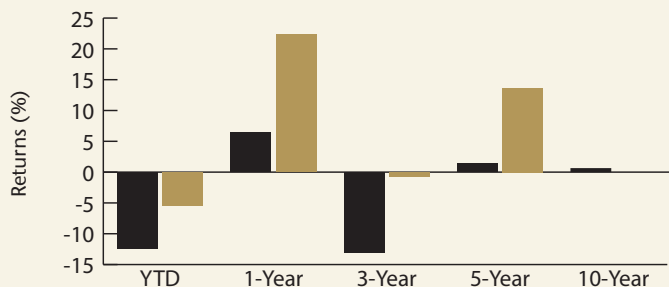
INTERNATIONAL UPDATE

Thus far in 2010, many of the biggest stock market headlines have centered on the international markets, particularly in Europe, where the news hasn't been good. Since the beginning of the year, developed markets excluding the United States* are down more than 12% in U.S. dollars, with the European countries alone down 15%. A rally in the dollar has weighed on returns, as local market losses have been somewhat less pronounced. Emerging Markets, down less than 6%, have outperformed developed international economies. **(Chart 7)**

The region that was hit the hardest was the European Monetary Union (EMU), down more than -22% due to the balance sheet crises of a number of constituents, including Greece, Portugal, Spain, Italy and Ireland. Much attention has been focused on planned initiatives of the International Monetary Fund, the European Commission, and the European Central Bank (ECB) to rescue Greece, while thousands of Greek workers protested planned austerity measures. A number of large European banks

**As measured by the MSCI EAFE Index, covering Europe, Australian region, and Far East*

DEVELOPED VS. EMERGING RETURNS AS OF MAY 31, 2010



Returns for developed regions represented by MSCI EAFE Index returns. Returns for emerging regions represented by MSCI Emerging Markets Index returns. Returns for periods greater than one year are annualized.

are significantly more leveraged than large American banks, and the ECB has warned that Euro-zone banks face more than \$225 billion in future writedowns. The European sovereign debt crisis has spurred purchases of U.S. assets by foreigners as investors have pulled out of European markets.

Although almost every major country in the world experienced negative stock market returns on a year-to-date basis through May 31, not all regions are experiencing economic turmoil. China's growth accelerated in the first quarter, with GDP up almost 11% over the previous quarter.

One bright spot in the developed world is Japan. Japan's GDP growth accelerated to an annualized 4.9% rate during the first quarter, outpacing the roughly 3% growth rate for the U.S. and the Euro-zone's overall rate of less than 1%. Japan is benefiting from a boost in exports to neighboring emerging markets and an increase in consumer spending.

ALTERNATIVE INVESTMENTS

Alternative investments staged a strong rebound in 2009 and continued that momentum through April 2010. However, the developments in the Euro-zone countries in May led to a decline in both traditional and alternative investments during

that month.

The Hedge Funds Resource, Inc. (HFRI) Fund Weighted Composite Index (**Chart 8**) returned 1.28% year-to-date as of May 31. The recent downturn in the markets and the increase in volatility provided opportunities for Short-Bias and Market-Neutral strategies to post positive returns in May. Other hedge fund strategies were down slightly in May, but much less than the stock market averages. As part of a diversified portfolio, hedge funds can provide a source of returns that are different from those of traditional stocks and bonds.

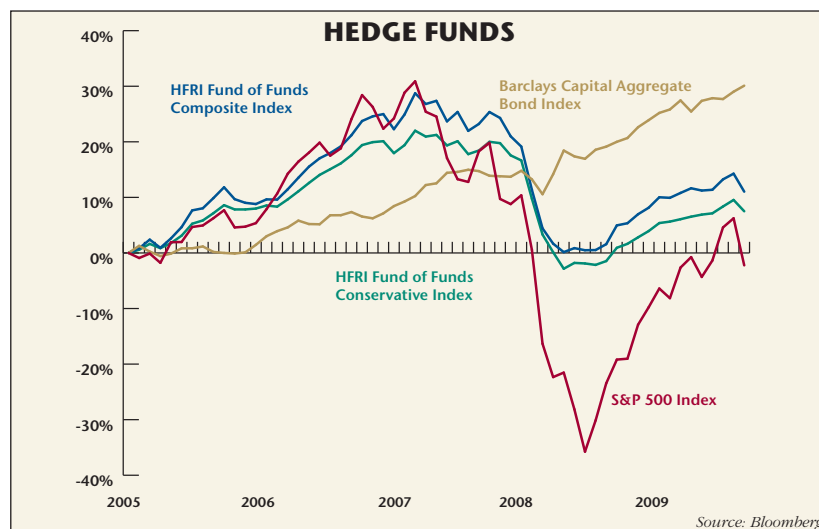
Real estate's positive performance in 2009 was driven by continued improvement in credit

markets, allowing many of the publicly traded REITs to recapitalize and strengthen their balance sheets. Rental rates, while down from the past year, appear to be stabilizing. Even with the recent market correction, REITs remain one of the best performing investment sectors both on a year-over-year and year-to-date basis. The MSCI US REIT Index returned 11.51% year-to-date as of May 31, 2010.

REIT mutual funds have seen strong inflows of cash from investors seeking dividends and income. Their higher current yield is enticing versus low money market yields. However, REITs seem to have discounted much of the improvement in the real estate market. From several valuation metrics, REITs seem to be a less-compelling investment versus lower-risk investments such as 10-year U.S. Treasury notes.

Commodities are an investment strategy for those seeking real return and provide diversification from traditional stock and bond investments. After rebounding in 2009, the DJ-UBS Commodity Index reversed direction and returned -9.9% year-to-date as of May 31, 2010. However, not all commodities behaved in the same manner. Oil, gas, agricultural products and industrial metals were down over

CHART 7
DEVELOPED VS. EMERGING
RETURNS AS OF 05/31/10
Emerging regions fared better
than developed regions.



Source: Bloomberg

CHART 8
HEDGE FUNDS
07/31/05 - 05/31/10
Hedge funds can provide
a source of returns that
are different from those of
traditional stock and bond
markets.

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Locations

ILLINOIS

Belleville
Bloomington
Peoria

KANSAS

Leawood
Wichita

MISSOURI

Columbia
Kansas City
Springfield
St. Joseph
St. Louis

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concerns about the outlook for global growth and the strengthening dollar. Gold and silver returned 10-11% for the year to date as they benefitted from investor fears and the desire to hold hard assets.

From a portfolio strategy perspective we added a 3% tactical increase in our alternative investments exposure at the expense of our overall stock allocation, emphasizing gold.

CONCLUSION

A steady diet of shocks to the world's economic systems has unfortunately prolonged a slow recovery. As this publication goes to press, the U.S. Gulf Coast is suffering through what could be the worst U.S. environmental disaster ever as the result of a still-spewing BP undersea oil well, and BP is experiencing an investor backlash that has halved its stock value in seven weeks time.

No doubt that today's markets test the mettle of even veteran investors hoping for order and at least brief stretches of stability. The weakness in growth in Europe, which represents more than a third of global GDP, has many nations concerned about a double-dip recession and deflation. We expect overall worldwide growth to be anemic and the currencies of the developed world to continue to depreciate relative to hard assets and emerging market currencies. We believe the U.S. dollar will appreciate further against the Euro. Our recommendation calls for continued emphasis on emerging markets, but we have reduced our exposure to developed international markets in both equity and fixed income. In the United States, our 3.6% average economic growth since the recession "ended" and near 4% annualized growth projection through the second quarter, along with our increased employment and incomes, holds out hope we can avoid the double-dip.

Stimulus remedies worldwide are running their course and nations are taking hard looks at debt, budgets and spending to keep their economic houses

in order. Clouds from the economic storm that started in 2008 stubbornly hover over many countries, states and municipalities. We recognize it will be many months before momentum favors global growth versus global uncertainty.

Investment Policy Committee

June 11, 2010

(The 2010 Mid-Year Market Outlook Update is a special report designed to provide investment information on economic markets for Commerce Trust Company 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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