



MID-YEAR REPORT, JUNE 2011

Market

Update

Economic and Financial Market Outlook — Mid-Year Update

Economic Recovery Hits Choppy Waters

MARKET SUMMARY

- Recent U.S. statistics point to a temporary deceleration in economic activity.
- The end of the QE2 program (on June 30) should not materially impact the financial system.
- Fixed income investments are expected to produce modestly positive returns until interest rates change direction; corporate bonds and other non-government sectors can continue to generate excess returns in this environment.
- Positive valuations and strong earnings have driven prices higher in the equity markets; however, we believe the upside versus the downside reward for equities is about equal now.
- While most commodity prices have moved lower recently as a result of slower growth projections, we remain positive in our longer-term outlook for this sector.

INTRODUCTION — A SLOWING IN THE RECOVERY PROCESS

At this time last year, the words “double dip” became a household term. Twelve months later, worries about another slowdown are at the forefront of investor’s minds. Rapid increases in commodity prices, a recent pause in employment growth, weakness in the stock market after May, continued financial turmoil in Europe, political infighting

and growing fears of an emerging market slowdown are more than reasonable cause for investor concern. Impacted by this mosaic of economic uncertainty, the U.S. economy, which grew at a 2.8% rate in 2010 (its best showing since 2005) has recently decelerated. **(Chart 1)** So the big question facing us today is whether private sector growth (via continued gains in employment, income and spending) can continue to sustain enough forward momentum to offset the de-leveraging process taking place as global stimulus lessens and domestic fiscal conditions tighten. More importantly for investors, how will this soft patch impact your financial assets? Our view is that recent weaknesses in economic data will likely be temporary and the modest slowdown will be insufficient to end the cyclically improving financial markets. But these headwinds do (and already have) warranted a pullback in our historic overweight to equities. And to mitigate risk, our equity reduction is accompanied by an increasing allocation to alternative investments, asset classes that have less correlation with the more typical stock and bond portfolio.

ECONOMIC UPDATE — A PAUSE THAT REFRESHES

We expect the world’s economic growth to remain choppy over the next few quarters but accelerate late in the year as we put the recent slowdown behind us. Transitory factors, including higher

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CHART 1
REAL GROSS DOMESTIC PRODUCT (in percent)
 After decelerating in the first quarter, the domestic economy is expected to grow at a 2.75% rate for the rest of 2011.

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

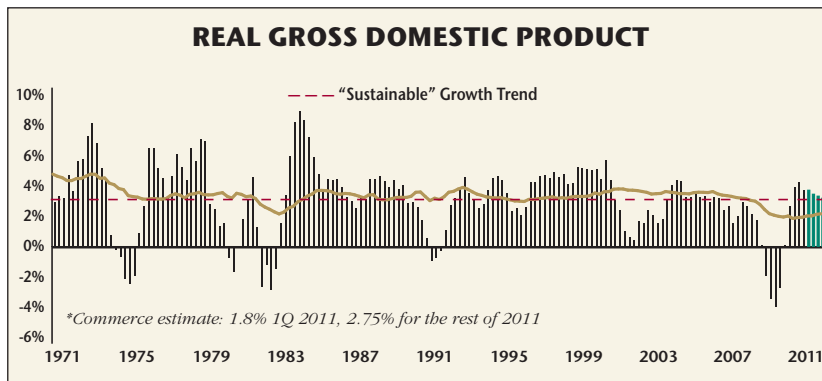
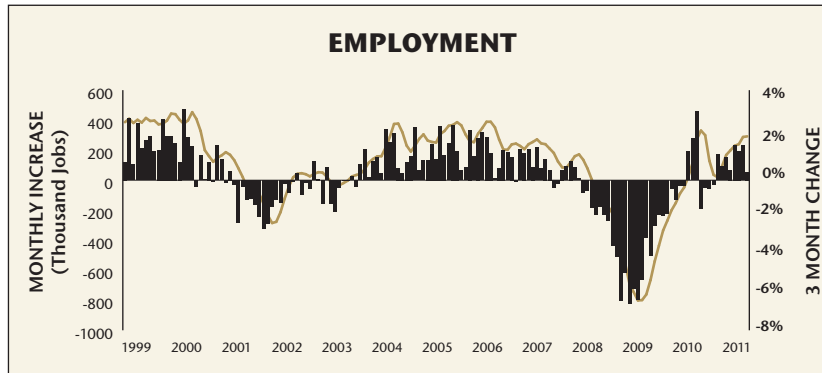


CHART 2
EMPLOYMENT
 The unemployment rate remains high as job growth struggles to gain momentum.

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



energy and food prices and the Japanese supply chain disruptions, are combining with longer term structural issues, like lower home prices and reduced government spending, to create an economic soft patch. The recent slowdown combined with worries about the end of the second Quantitative Easing (QE2) and a rekindling of European sovereign debt woes have caused investors to become justifiably wary as we move into the second half of the year.

Whether you think QE2 was positive or not, it's certainly coming to an end and the economic threshold for implementing QE3 is likely materially higher than in the past. We generally agree with Fed Chairman Bernanke that the end of the program should not have a major impact on the financial system. The Fed has been clear that QE2 is ending, so we believe that much of the impact is already priced into the market.

Higher oil prices (due in no

small part to the turmoil in the Middle East and North Africa) are clearly causing a braking effect. While oil demand is stagnant in North America and Europe, it continues to climb in China, Latin America and the Middle East. China reported its oil consumption up 9.2% in April on a year-over-year basis despite retail fuel prices rising significantly. Overall oil prices are 30% higher than they were last fall, and even though we expect some giveback, it will continue to weigh on the economy and profits in the coming quarters.

Housing has yet to find its painful bottom, but at least year-over-year comparisons are becoming less severe. While elevated inventory and foreclosures are nearly holding home building activity at post-WWII low levels, home affordability is at a record high. Most importantly, delinquencies are beginning to come down. Eventually, housing will add to GDP, probably sometime in 2012.

European sovereign debt woes are still front and center and are likely to remain so. While European leaders stall for time until 2013, the bond market is pricing Greece's sovereign bonds, and those of other peripheral countries, at levels that indicate they will eventually be forced into some form of restructuring. We believe debt restructuring will eventually take place, but it should have less and less impact going forward as the markets have largely priced in this outcome.

U.S. fiscal policy continues on an unsustainable path. Resolution to our fiscal imbalances present a rather perpetual growth headwind as taxes are likely to be raised and spending cut. Bipartisan agreement on a path toward fiscal sanity would go a long way to satisfy the markets and calm the market's uncertainty.

Recent employment data has disappointed (**Chart 2**) after picking up some speed earlier in the year. We expect payrolls to continue to grow, but they are not likely to grow at a pace to make much of a dent in unemployment. High levels of unemployment are holding back wage inflation. The most recent PPI and CPI data remain elevated with the CPI advancing at a 3.2% annual rate. Recent declines in commodity prices though will likely narrow that gap between top line and much lower core inflation. The combination of high unemployment and some commodity price moderation affords enough slack to allow the Fed to keep the fed funds rate near zero well into next year.

While it is usually easy to see the downside, successful investors must also evaluate what can break to the upside. Stock prices are up materially and household wealth has improved. Corporate profits are nearly back to record levels and credit conditions continue to

improve rapidly with interest rates at exceptionally low levels. Employment growth has been positive in the private sector for over a year, and household debt service is approaching a 25-year low. To the extent that oil prices moderate, employment growth continues, European debt problems resolve, and housing bottoms, the impact on the markets could be quite positive. Businesses have put their houses in order and the consumer has largely de-levered. We need to climb the final fiscal wall of worry to lock in a modest but likely self-sustaining economic recovery.

FIXED INCOME UPDATE – SURPRISINGLY POSITIVE RETURNS

Slower economic growth this year led to a decline in interest rates over the last two months. While economic worries and inflationary pressures abound, neither U.S. debt ceilings nor a government credit rating in jeopardy triggered a significant impact on interest rates or risk premiums within the bond market. Domestic corporations were able to issue debt with near-record low coupons for most of the year.

Specifically, Treasury interest rates have declined 10 to 31 basis points across the “yield curve” so far this year. (Chart 3) The yield curve also remained historically steep, with the difference between 2- and 30-year Treasury yields holding at nearly the same level as the start of the year. It paid to venture out into the intermediate area (2 through 10 years) of the yield curve, while those in money market funds suffered through essentially zero returns.

The gap between yields of investment grade corporate bonds and Treasuries represents the extra premium investors demand due to the greater risk associated with corporate bonds. This risk premium (i.e., spread level) tightened

in the first five months of the year despite threatening domestic and foreign fiscal problems. Average investment grade spread levels started the year at 166 basis points and declined to 156 basis points by the end of May. (Chart 4)

The overall U.S. bond market, as measured by the Barclays Aggregate Bond Index, returned 3.02% for the first five months of 2011. Tighter spreads and lower interest rates helped produce positive results across the various fixed income sectors. The High Yield bond sector finished with the best returns, with Agency debentures coming in as the laggard. (Chart 5)

The Barclays Municipal Bond Index was up 4.06% year-to-date through the end of May. Higher rated AAA/AA segments of the municipal bond market have done significantly better than the BBB and tax-exempt High Yield sec-

tors. The gloom and doom forecasts about vast number of municipalities defaulting failed to materialize; however, some concern remains with pension obligations. The year started with large fund outflows, but lately investors are getting more comfortable with adding funds back to the municipal sector.

During the month of May the U.S. Treasury Department announced the deadline to raise the debt ceiling was extended to August 2nd. So far bond investors have not shown much concern about the debt limit issue. Standard & Poor's reacted by placing the U.S. Government's credit rating on “negative outlook.” The U.S. government will need to start implementing measures to address the country's long-term fiscal pressures, or it could lose its AAA rating.

The end of QE2 is not expected to have an immediate impact on

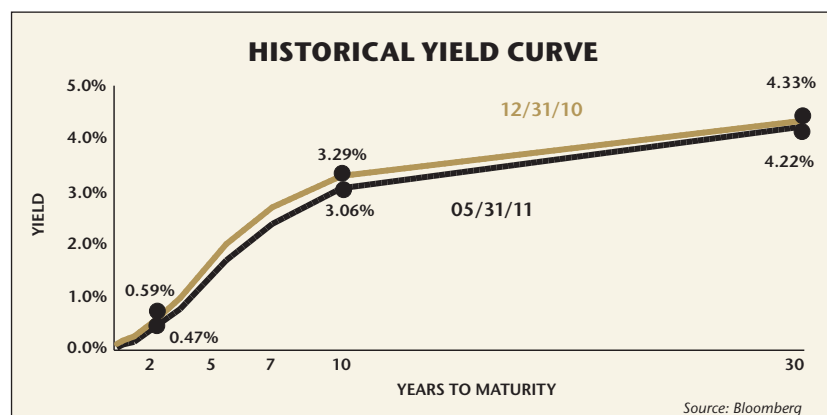


CHART 3
HISTORICAL YIELD CURVE
12/31/10 – 05/31/11
Interest rates declined across the yield curve and the curve's slope remains historically steep.

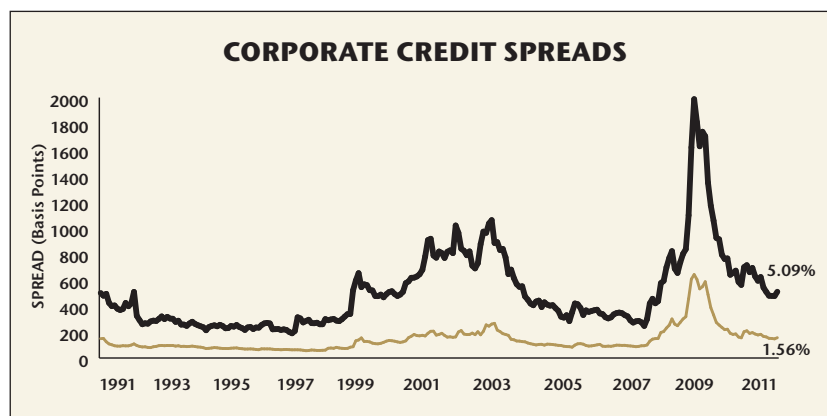


CHART 4
CORPORATE CREDIT SPREADS
12/31/91 – 05/31/11
After tightening most of this year, credit spreads started to widen in the month of May as euro zone debt problems grew.

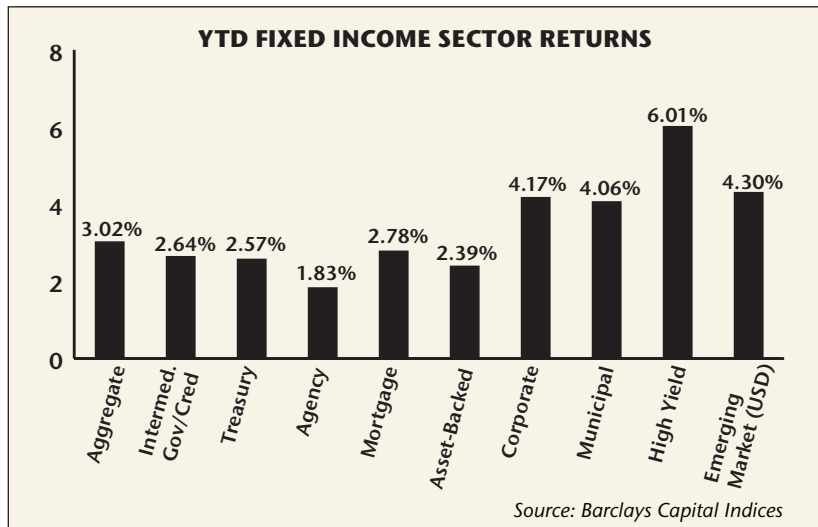
■ High Yield – 5.07% Average
■ Investment Grade – 1.41% Average

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CHART 5
YTD FIXED INCOME SECTOR
RETURNS (AS OF 05/31/11)
Tighter spreads and lower
interest rates helped produce
positive results.



interest rates. The program's end has already been largely discounted by the bond market. Also, the Fed indicated that it will continue a reinvestment program in which it buys fixed income assets to replace redeeming securities. Pressure on interest rates is not expected to begin until the Fed actually starts to shrink its balance sheet by allowing existing securities holdings to roll off rather than reinvest the proceeds.

Fixed income assets should continue to produce positive returns in this slow economic growth environment. This could change if growth significantly accelerates or inflation exceeds current expectations. However, if economic expansion remains on its current track, some additional spread-tightening is possible in the investment grade sector. While we are starting to move below historic spread level averages, there is still some room to move tighter before the markets reach the extremely narrow spread levels seen in 2007.

In the current environment of low yields, low default rates, and slow economic growth, credit selection is important. Excess returns can still be achieved, but outperformance will require both good credit stories and appropriate valuations. Combining these, we believe that

the High-Yield sector can still produce better-than-average returns.

After underperforming all this year, Emerging Market (EM) credits have recently started to outperform. The outlook for EM bonds is positive relative to Treasuries; however, upside is lower than during the past two years. Further deterioration in European debt market conditions, persistent EM inflation and any difficulties in the Chinese economy are likely to hurt the emerging market bond sector.

We still believe that the Fed's actions to improve the economy will lead to at least some modest inflation, causing us to anticipate moderately rising interest rates for the second half of 2011 and into 2012. Yield-hungry investors are likely to help contain the rise to 50 basis points for the short and intermediate portion of the yield curve. The next major move in the yield curve is likely to be a bear flattening (i.e., short-term interest rates increasing faster than long-term interest rates) as the Fed monetary tightening cycle approaches. As a result, we are maintaining a slightly shorter duration/maturity position relative to the benchmark.

EQUITY UPDATE – REDUCED EXPOSURE IN MAY, BUT VALUATION LOOKS GOOD

Equities have been strong from August 31, 2010 to April 30, 2011 with the S&P 500 posting a 31.5% gain before declining in May. At the end of April, valuation levels no longer supported a low-risk environment for equities and we reduced our equity allocation from an overweight exposure back to a normal exposure based on the portfolio's long-term asset mix. We now believe upside versus downside reward for equities is equal.

Strong corporate earnings growth has been the key driver behind rising stock prices. In 2010, the S&P 500 operating earnings rose 47% and analysts expect another 16% gain in 2011. Quarterly earnings announcements over the past two years consistently surprised analysts on the positive side, driving equity prices higher. In the first quarter of 2011 the number of positive surprises declined and we are concerned that expectations are too high for the remainder of the year. With economic growth in the United States moderating, a recession in Japan and the rapid growth in emerging markets slowing, earnings estimates could be at risk and affect equity prices negatively.

Emerging market economies have been an important influence on world growth and emerging stock market performance has been a good indicator of the near-term trend of world economic growth. To date, most emerging stock markets are down and we are concerned they are forecasting some unwanted surprises on the horizon. With the emerging market equity weakness we are taking the opportunity to slightly increase our exposure in portfolios.

Many of the problems mentioned in our 2011 Market Outlook are no closer to being resolved,

whether it is the European sovereign debt crisis, rising commodity prices or U.S. political gridlock on the budget deficit. In 2011, we added to the list. The ramifications of the earthquake in Japan and social unrest in Northern Africa and the Middle East have driven oil prices higher. Unfavorable developments in any of these situations could send equity prices lower. Of course, any progress made in resolving these concerns could be a boost to equity prices.

When we reduced our stock exposure in April we removed our preference for small- and mid-cap stocks over large-cap stocks. Small- and mid-cap stocks had a great performance since the bottom in 2009 and valuation levels look a bit stretched compared to large caps. We also increased our international exposure, which benefits from a declining dollar.

What could turn our outlook from neutral to negative after the tremendous upside move since the March 9, 2009 low? Rising interest rates are historically a headwind for stock prices. Everyone agrees that interest rates are at historic lows and at some point they will increase, but the question is whether it is three, six, 12 months or further into the future. When we start to see three- to four-year Treasury rates rising materially, we will determine whether to further reduce our stock exposure.

ALTERNATIVE INVESTMENTS UPDATE – A RISK REDUCTION STRATEGY

To mitigate risk, our equity reduction has been accompanied by an increased allocation to alternative investments, asset classes that have less correlation with stocks and bonds. These include commodities, conservative hedge funds, precious metals, and REITS. By employing investments that behave differently

from the rest of the portfolio, they can reduce portfolio risk (volatility) and potentially enhance long-term returns.

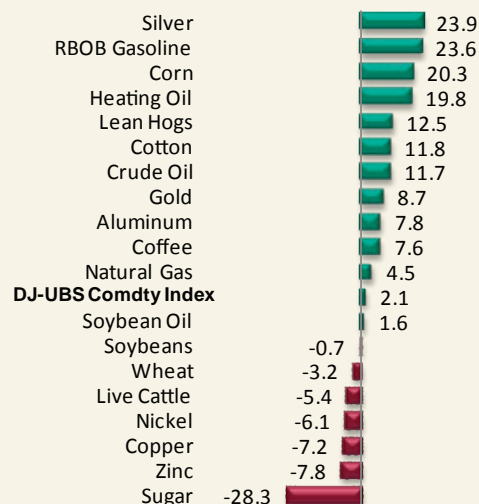
We continue to be positive on the long-term outlook for global commodity demand. Production and distribution capacity has suffered from years of under-investment resulting in supply constraints that may last for some time. Emerging economies with their improving standards of living are demonstrating strong demand for durable goods and agricultural products.

Commodities had been one of the best performing assets classes this year until a dramatic price correction that started in early May. While the DJ-UBS Commodity Index is still positive through May, the performance of various commodities is mixed. (Chart 6).

The commodities sector began a strong upward movement in September 2010. It is debatable whether the price movement since then is more speculative than fundamental, and whether this is a “crowded trade”. What could end the rally in commodities? The end of QE2, rising interest rates, a strengthening U.S. dollar, and a slowdown in the growth rate of the emerging economies could change the landscape.

Rising oil prices, which topped out at \$126.06 a barrel for Brent crude on April 29, have a negative impact on global economic conditions. While gasoline expenditures are stretching the consumer, they don't appear to be at the point of breaking the growth path of the global economy. Unrest in the Middle East and Africa, and the political uncertainty in those regions

COMMODITY SCORECARD 2011 Percent Returns Year-to-date



Source: Bloomberg Finance LP, Data as of 6/1/2011

continue to be a wild card that will affect energy prices.

Precious metals have benefited from low real interest rates and the weak U.S. dollar. The silver frenzy abated as prices collapsed from nearly \$50/ounce to the mid-\$30's in a few trading days. We continue to look for gold to move higher in the face of global uncertainty, low interest rates and a weak U.S. dollar. We will be more concerned about the outlook for precious metals once the Fed starts raising interest rates.

CONCLUSION

For the readers of Economic Mid-Year Update, we hope we have sorted through the tough economic issues that face us all in our respective companies, offices and homes. We appreciate your business and stand ready to answer any questions through the various Commerce Trust representatives listed on the back of this newsletter.

**Investment Policy Committee
June 10, 2011**

CHART 6

COMMODITY SCORECARD
While the DJ-UBS Commodity Index is still positive for the year, the performance of various commodities is mixed.



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DISCLOSURES

Past performance is no guarantee of future results and the opinions and other information in the Mid-Year Market Update are as of June 10, 2011.

The 2011 Mid-Year Market 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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