Market Update

Economic and Financial Market Midyear Update — June 2015

Six-year U.S. recovery still choppy, but good enough to lead global economies

Inside:

Market Summary

- *The highly anticipated rise in interest rates was postponed in the first half of the year, but Federal Reserve (Fed) signals to bump rates upward before year's end remain in place.*
- *The U.S. economy is healthy, supported by rising home prices, solid auto sales, and steady business investment, as well as improving household balance sheets and shrinking debt.*
- *Solid job increases should result in the unemployment rate declining to near 5% by the fourth quarter of this year.*
- *Market volatility is expected to increase over the next few months due to the looming Fed rate hike.*

INTRODUCTION

The six-year-old economic recovery seems to have developed a persistent pattern of advancing at a two-steps-forward, one-step-backward pace. As we move through 2015, we may see more of the same. Although these swings may be less pronounced, the choppiness in some consumer and industrial markets could keep growth moving back and forth within a range of 2%–3% over the next year.

ECONOMIC OUTLOOK

Similar to last year, the first quarter of 2015 had its share of winter storms and frigid temperatures. This was partly to blame for the surprisingly weak first-quarter report of -0.7% for Gross Domestic Product (GDP), the market value of all goods and services produced by the U.S. economy. However, we see several reasons to discount the anemic first-quarter growth and expect a healthy rebound in growth in the second quarter of around 2%, with a further step-up to near 3% in the second half of the year (Chart 1).

Leading the upturn in growth is a strengthening in consumer spending with support from firming expansion of nonresidential investment and housing. Also, some unwinding of the sharp drop in net exports that occurred in the first quarter (due to a West Coast port labor strike) is expected to boost growth slightly over the balance of this year.

Our expectation of improved consumer spending is supported by a number of favorable developments. Solid employment gains appear back on track after a temporary slowdown in the first quarter. Gradual improvement in wage growth implies solid growth of labor income.

House prices have continued to show modest gains, and as equities have pushed to record highs in the stock market, there has been continued overall improvement in

CHART 1
REAL GROSS DOMESTIC PRODUCT
Strengthening in consumer spending should help foster a healthy rebound in GDP growth in the second half of 2015.

- Year-over-Year (YOY)
- YOY (Estimate)*
- 10-year Trend
- Sustainable Growth Trend

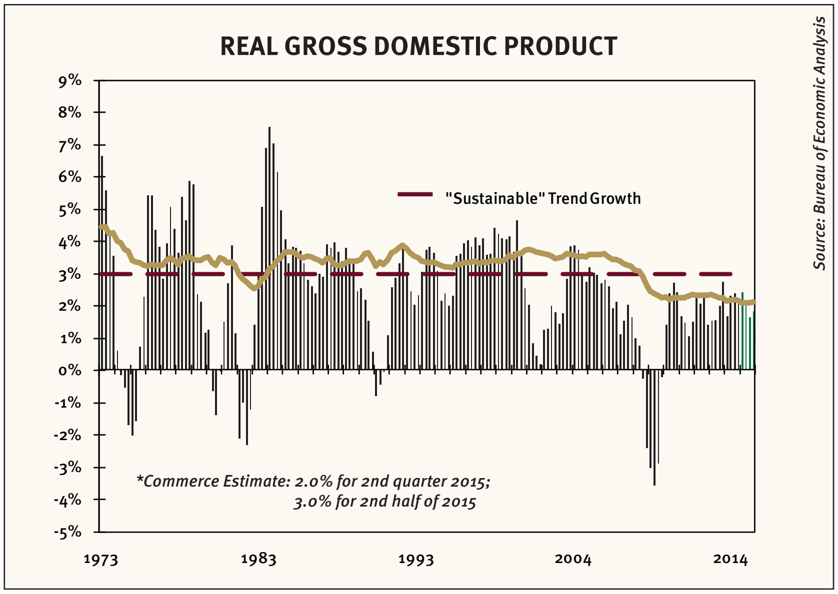
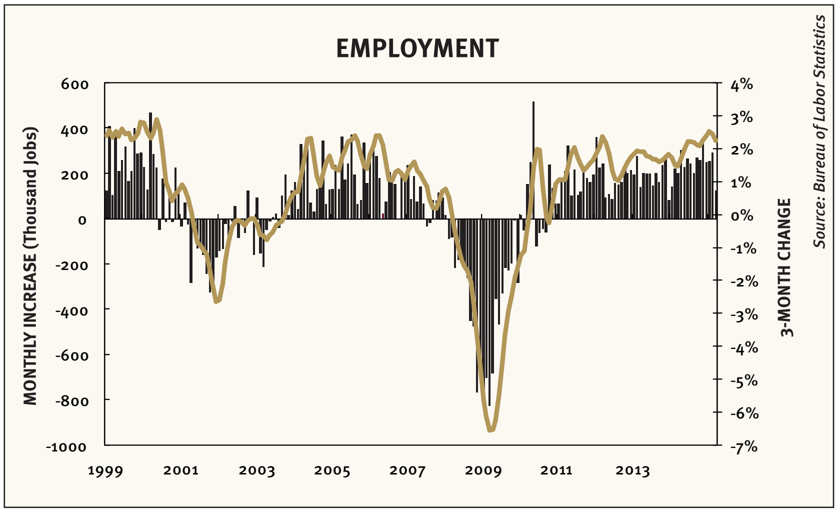


CHART 2
EMPLOYMENT
Payroll employment is expected to rise by an average of 225,000 per month for the rest of 2015.

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



household balance sheets. So confidence remains elevated despite some recent retrenching, supported by continued job gains and an unemployment rate of 5.5% that is near its best mark during this expansion cycle.

A closer look at the labor situation shows that payroll employment rose 280,000 in May, near the consensus estimate. Going forward, we expect payroll employment to rise by an average of about 217,000 per month from June through December, up from the 194,000 averaged over the first five months of the year, reflecting a rebound in GDP growth. These solid job increases should result in the unemployment rate declining to near 5% by the fourth quarter of this year (Chart 2).

On a related note, productivity has been soft recently, but we expect some improvement. According to the U.S. Bureau of Labor Statistics, productivity (output per hour in the nonfarm business sector) declined at a 1.9% annual rate in the first quarter. Some of the softness in that figure surely reflected the decline in output in the GDP in the first quarter. Given our projection for output growth to recover, we expect productivity to mend as well, to an average of 1.5% during the second half of 2015.

Overall, the U.S. economy is healthy, supported by rising home prices, solid auto sales, and steady business investment, as well as improving household balance sheets and shrinking debt service. Also, lower energy prices, which can be a double-edged sword depending upon where you are in the energy industry chain, have put extra income into consumers' pockets and should support growth.

On the weaker side, the eurozone economy is sluggish and the situation in Greece is yet unresolved, but recent economic data is still consistent with gradually improving growth (helped by the European Central Bank's easing of interest rates). The main risk to global growth is China. Most Chinese economic data remains in a declining trend and may indicate that growth will fall below the government's hoped-for 7% GDP figure. But this has resulted in recent fiscal and monetary easing moves recently put in place, which we believe will moderate the pace of China's slowdown.

So on balance, global growth is projected to continue at 3.5%. As we discussed in our 2015 Annual Outlook publication last December, our ongoing theme of the U.S. economy "decoupling" from other global economies remains in place. This view continues to support the basis of our investment recommendations.

EQUITY OUTLOOK

Stock prices have moved higher in 2015 in the face of little economic growth and stagnating corporate earnings. We have been overweight stocks since October 2012, during which the S&P 500 posted a total return of 54.7%. In Spring 2015, as the equity market moved higher, the S&P 500 Price/Operating Earnings Ratio (P/E is one measure of a stock's valuation) crossed over into what we judge to be an expensive valuation range.

Over the last 50 years, the average P/E ratio has been 16.03 and history suggests P/E levels above 18 become expensive. At the end of May, the P/E for the S&P 500 was 18.9. However, valuation alone is not a perfect indicator as equity markets can stay overvalued for years, but it does raise a red flag that if an unfavorable economic event occurs, equity prices could be vulnerable.

So what could upset the market and cause the first 10% correction since 2011? We believe the Fed could trigger some problems for equities when it finally decides to increase short-term interest rates. Some market pundits may say that the Fed raising rates will not make much difference since rates are essentially zero, but we beg to differ. History has shown that when you have a change in the direction of interest rates (which have been declining since 2009), stock prices do not fare well until rates stabilize. We know the Fed wants to increase rates, but the exact timing is still uncertain.

Equity prices have gotten a nice boost over the last several years as money has moved out of money market funds (with no return) and bonds funds (with low returns) into stocks. In our view, equity exposure is getting close to levels that in the past indicated maximum exposure for investors. As a result, future equity demand is limited. But that doesn't mean stock prices can't move higher this summer as corporations continue to announce a record number of mergers and stock buybacks.

We expect sometime in 2015 that our overweight position in equities will be reduced. In our equity portfolios, we remain underweight to international and emerging markets. Despite getting off to a strong start this year, we believe structural issues facing many international and emerging markets justify our underweight allocation.

ALTERNATIVE INVESTMENTS OUTLOOK

Alternative investments include strategies in the main categories of Hedge Funds, Real Estate, Infrastructure MLPs and Commodities. From a portfolio diversification standpoint, alternative investments may be attractive due to lower correlations to traditional asset classes of stocks and bonds.

A blend of alternative investments (30% NAREIT Equity REITs, 10% Bloomberg Commodity Index, 30% Alerian Infrastructure MLPs, 30% HFRI FOF Conservative Hedge Funds) outperformed either the S&P 500 Index or the Barclays Aggregate Bond Index in 14 of the last 19 years (Chart 3). This is why we have an ongoing 10% commitment to this asset class. With interest rates as low as they are today, we are recommending a 12% tactical allocation to alternative investments at the expense of fixed income.

THE CASE FOR ALTERNATIVES

	Winner		Loser
1996	27.18%	22.96%	3.61%
1997	33.37%	20.89%	9.68%
1998	28.58%	8.67%	-8.15%
1999	21.05%	4.54%	-0.83%
2000	27.26%	11.63%	-9.10%
2001	17.78%	8.42%	-11.88%
2002	10.27%	4.35%	-22.10%
2003	31.31%	28.69%	4.11%
2004	19.29%	10.88%	4.34%
2005	10.37%	4.91%	2.43%
2006	23.55%	15.80%	4.33%
2007	6.96%	5.49%	2.51%
2008	5.24%	-30.85%	-37.00%
2009	39.08%	26.46%	5.93%
2010	21.98%	15.06%	6.54%
2011	7.84%	5.19%	2.11%
2012	16.00%	7.93%	4.21%
2013	32.39%	10.62%	-2.02%
2014	13.69%	10.11%	5.97%

CHART 3
THE CASE FOR ALTERNATIVES
A blend of alternative investments outperformed either stocks or bonds in 14 of the last 19 years.

- STOCKS
- BONDS
- ALTS BLEND

Commodity prices were in a general uptrend from 1999 to 2011 (except for the financial crisis), nearly doubling over this time. The bull and bear market cycles for commodities are typically long, lasting as many as 20 years. While we think energy prices have bottomed, we are bearish on commodities in general and not likely to allocate to this sector any time soon.

FIXED-INCOME OUTLOOK

Weak economic growth and low inflation helped keep interest rates from accelerating upward. As we progressed through the first half of the year, expectations for the Fed to raise the Fed Funds rate in June diminished and "policy normalization" appears to be postponed until September of this year.

Inflation, as measured by the Consumer Price Index (CPI), has been tame, due to a decline in energy prices at the end of last year. However, core-CPI (excludes food and fuel price changes) has started to rise and is gravitating closer to the Fed's goal of about 2% (Chart 4). This may enable the Fed to introduce its first interest-rate hike since 2006.

The 10-year U.S. Treasury note yield has been range-bound for the first five months of 2015, hitting a high of 2.29% and finishing May close to the 2.17% yield recorded at the start of the year.

U.S. Treasury yields for the intermediate portion of the yield curve were down modestly, while the long end saw a small rise of 13 basis points (1% equals 100 basis points) for the 30-year Treasury. Such results defy forecasts made at the start of the year for higher yields. The European Central

CHART 4
INFLATION: CPI & CORE CPI

Energy price declines at the end of 2014 helped keep inflation tame for the first half of 2015.

- ■ Core CPI (YOY): 2.32% Avg.
- ■ CPI (YOY): 2.44% Avg.

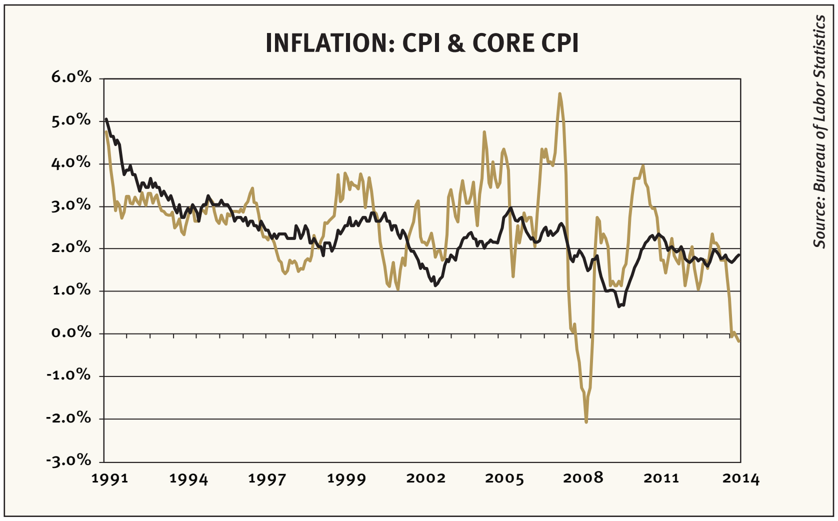
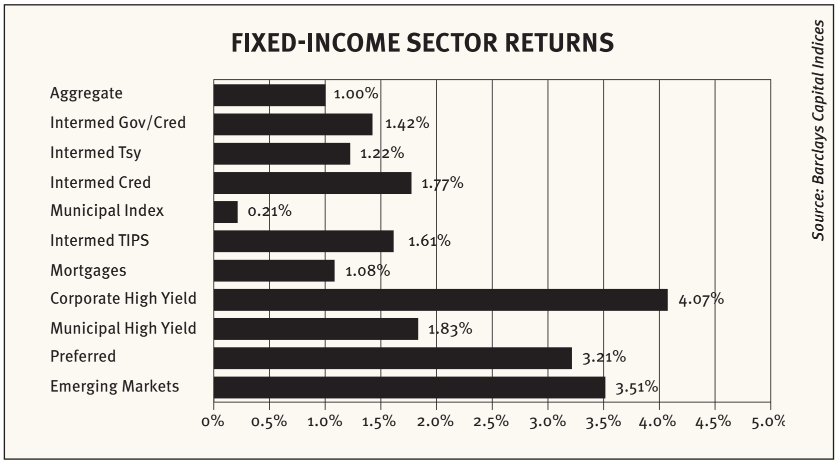


CHART 5
FIXED-INCOME SECTOR RETURNS YEAR-TO-DATE (AS OF 5/31/2015)

All fixed-income sectors are generating a positive return year-to-date.



Bank's long-awaited quantitative easing program that began in March and slow economic growth domestically contributed in part to the lower than expected yields in the U.S.

Corporate spreads have moved little year-to-date (through 5/31/15). The Bank of America/ML Corporate Master Index declined slightly from 144 basis points at the start of the year and finished May at 137 basis points. The combination of lower Treasury yields and tighter spreads helped the Barclays Aggregate Bond Index generate a 1.00% year-to-date return. The High Yield sector, assisted by low default rates and the stabilization of oil prices, outperformed the investment grade corporate sector (Chart 5).

The Barclays Municipal Bond Index is up 0.21% year-to-date. Municipal bonds continue to be attractive on a tax-adjusted basis relative to other fixed-income alternatives. So far, the pickup in new issuance has not been overwhelming to the market. State tax revenues have been increasing and an improving U.S. economy has led to a favorable credit quality outlook for municipal bonds.

Concern has grown in the bond market about the significant decline in liquidity in the wake of the 2008 financial crisis. New government regulations (i.e., Dodd-Frank) have made it less desirable for financial institutions to carry an inventory of bonds. If interest rates rise sharply and investors seek to move out of the bond market, a shortage of liquidity could worsen market dislocations.

CONCLUSION

In the coming months, market volatility is expected to increase due to the looming Fed rate hike and possible deterioration of financial conditions in Greece. As the Fed gets closer to implementing its interest rate policy normalization plan, the built-in spread cushion for bonds to counter rising interest rates continues to shrink. Municipal bonds are likely poised to benefit from increased volatility in the taxable fixed-income market. Stocks are reaching the upper ends of their valuations and could remain so for some time unless a global shock or event puts unforeseen stress on the markets.

INVESTMENT POLICY COMMITTEE
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COMMERCE TRUST INVESTMENT CONTACTS

Christie Cody, CFA
(816) 234-2415

Mike Cody, CFA
(314) 746-8551

Scott Colbert, CFA
(314) 746-8557

Cynthia Rapponotti, CFA
(314) 746-8794

Joe Williams, CFA
(816) 234-2564

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