



MID-YEAR REPORT, JULY 2008

Market Update

2008 Economic and Financial Market Outlook — Mid-Year Update

'May you live in interesting times'

U.S. Economy is Holding on for Rough Ride

INTRODUCTION

Like it or not, we are living in interesting times as the Chinese curse above suggests. Oil prices are hitting record highs, the worst housing slump since the Depression is in full force, and a crippling credit crisis still hampers the financial sector. These are the kinds of interesting times we could surely do without. While the storm of negative events has lightened up recently, we may only be half way through the deluge and could be hit by another downpour from further loan write-offs, deteriorating employment figures and rising inflation concerns. Keep your umbrellas handy, as it may be a few more quarters before the sun comes out again and economic growth moves back to its historical average.

ECONOMIC UPDATE

It has now been nearly a full year since the beginning of the current financial crisis. What started in the summer of 2007 with the mortgage-related money market turmoil intensified at year-end with enormous and ongoing charge-offs in the banking sector, and appeared to culminate with the Fed-orchestrated J.P. Morgan Chase rescue of Bear Stearns in mid-March of this year. These waves hit the markets hard, disturbed valuations and then largely subsided. This back-

and-forth market activity has shaken the confidence of both consumers and investors.

Financial institutions have taken a severe beating, and the markets have gone through a most painful period. This has caused institutions to remain cautious on lending practices. While the Fed's aggressive rate cuts (325 basis points over an eight-month period) have cut the cost of credit, they can't directly influence the availability of credit. At the moment, banks are focused on rebuilding their depleted capital base to guard against future losses. This has caused one of the most rapid tightening of credit conditions the economy has witnessed in a long time. With banks cutting back on new credit extension, the economic headwinds may remain in place for some time.

Along with lowering rates over the last several quarters, the Fed has also taken important and unconventional actions. These steps have included a series of new Fed lending facilities for depository institutions and primary dealers to slow the evaporation of liquidity in the interbank financial markets. The effect has been a meaningful improvement in the functioning of the credit markets, evidenced by narrowing corporate and mortgage bond spreads, as well as a recent increase in new debt issuance. While

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CHART 1
REAL GROSS DOMESTIC
PRODUCT (in percent)

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

Full-year 2008 GDP is
expected to grow at a below-
trend rate of 1.50%.

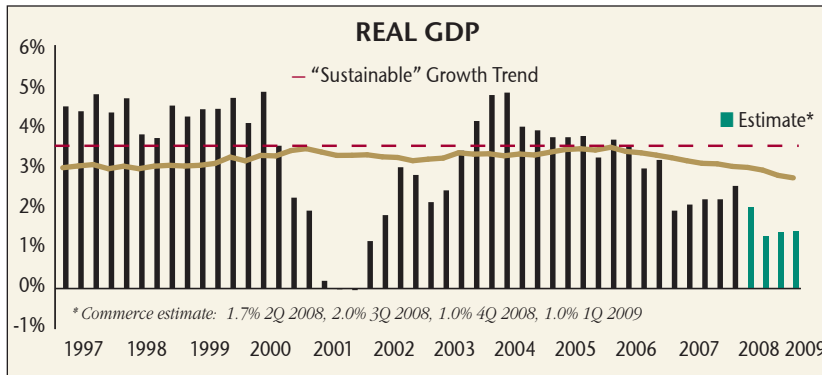
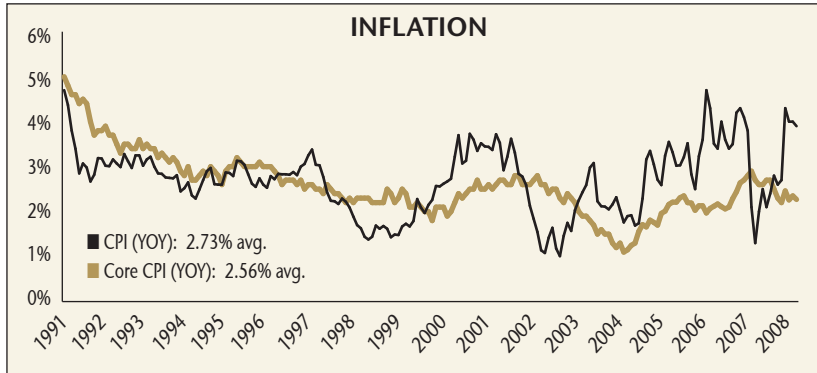


CHART 2
INFLATION:
CPI & CORE CPI

Inflation expectations have
been rising.



this ongoing healing is welcome, the markets are not yet functioning normally, as spreads are still historically wide and may remain so until the economy gains more traction.

Real GDP grew at only 0.9% in the first quarter of 2008 and is expected to grow at 1.5% in the second quarter. Economic growth has been held back by the ongoing housing recession. In fact, housing starts are at their lowest level since 1991. After subtracting a percentage point from GDP growth in 2007, residential investment is forecast to have shaved 1.2% from annualized growth during the first half of 2008. This drag is expected to last until mid-2009 when we expect a gradual recovery in housing starts to begin. There may be some mid-year positive effects of the government stimulus checks, but full-year 2008 GDP growth is only expected to grow

at a sub-par 1.5% rate. (CHART 1)

Employment figures are signaling that the U.S. economy is stalling. The unemployment rate soared to 5.5% in May from only 5.0% in April, the biggest jump in more than two decades. Payroll figures show that the economy has shed over 324,000 jobs so far this year, the worst start to a year since 2002, when the nation was still dealing with the aftermath of a recession. Such figures suggest we are still teetering on the verge of a recession.

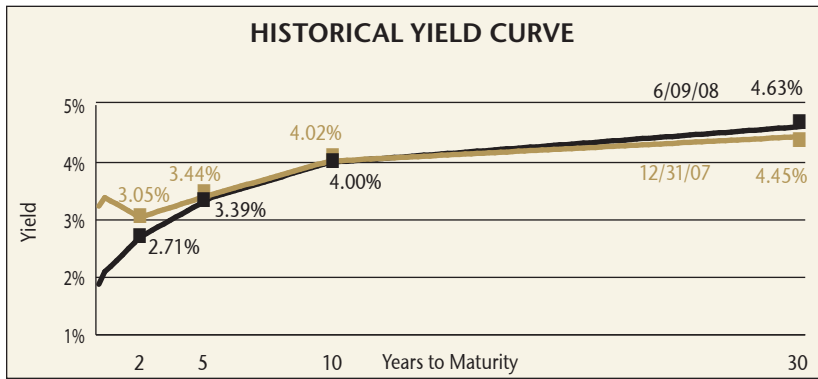
The Fed has recently turned its attention towards inflation expectations, especially in light of firming import prices and the seemingly relentless surge of energy prices. Fed Chairman Ben Bernanke recently noted that high food and energy inflation may lead to expectations of higher long-term inflation overall. This obser-

vation has been reflected in recent consumer surveys. The full CPI (including food and energy) is running at 3.9%, while the Core CPI is holding at a more subdued level of 2.3%. (CHART 2) Still, these levels are certainly higher than the Fed would like to see. These statistics have provided evidence, further reflected in the April Federal Open Market Committee minutes, that the Fed may be on hold at a 2.0% Fed Funds rate for an extended period, barring another wave of crisis to appear.

FIXED INCOME UPDATE

The financial woes that plagued the fixed income market in 2007 remained present well into the first half of 2008. The Federal Reserve worked diligently to confront the onslaught of liquidity and credit problems in the finance sector. However, solvency issues for the financial system persisted. Besides rate cuts, the Federal Reserve provided additional assistance to the markets by extending its "lender of last resort" services to broker/dealers, expanded the list of allowable collateral to include some non-Agency instruments, and assumed direct credit risk by backstopping the deal to save the struggling Bear Stearns. Despite the Fed's efforts to calm the market, investors remained risk-averse and sought the comfort of Treasuries for most of the first six months of 2008. Only recently have they started to transition out of Treasuries and into credit-related securities (i.e., corporates, mortgage and asset-backed, etc.).

So far this year, Treasury yields have declined in the short end of the yield curve, and rose about 20-25 basis points in the long end.



(CHART 3) The yield curve steepened as the difference between 2-year and 30-year Treasury yields increased from 140 basis points to 226 basis points. Interest rates trended down for the first three months of the year as a result of the flight to quality. Thereafter they began to rise, with 10-year Treasury yields approaching the level at which they began the year.

While Treasury rates were declining in the first few months of this year, corporate spreads (the risk premium provided to investors) were widening, from levels that were already unusually generous. By the end of the first quarter, in all but the highest quality sectors, spreads to Treasuries were as wide as the peak spreads in the 2001-02 period. (CHART 4) Current spreads appear too wide, relative to past cycles, since corporate balance sheets are far healthier than

in 2001. More recently, as credit crisis concerns diminish, spreads have begun to tighten and are off their peaks for the year.

With mixed interest rate movements and widening credit spreads, the bond market has still managed to produce some positive returns. Through mid-June, the Lehman Aggregate Bond Index returned 0.40%, while the return on the Lehman Intermediate Government/Credit Bond Index was 0.91%. Recent market stability has allowed mortgage-backed securities to edge out Treasuries and take the lead as the top-performing fixed income sector year-to-date.

Municipal bond performance year-to-date has moved ahead of the taxable investment grade bond market. After starting the year with several months of negative news about the bond insurers, the tax-exempt market rebounded

strongly in April. Record high municipal-to-Treasury yield ratios in the first quarter sparked significant new demand from individual investors. Year-to-date intermediate municipal bonds are up 1.63% while the broader based longer maturity municipal bond index has risen 1.04% (as of 6/10/08).

Going forward, we expect some further deterioration in the corporate default rate in the coming months. However, as long as the bond market continues to stabilize and the economy avoids a severe recession, both investment grade corporates and mortgage-backed securities should do well relative to Treasuries. We suggest remaining moderately short on average maturity relative to market benchmarks until inflation pressures subside. Bond total returns for 2008 are expected to finish the year in positive territory, but are likely to be less than their coupons.

EQUITY UPDATE

At the beginning of the year, we were hopeful that stock prices would improve during the year as the market worked through the financial problems that had been building since the middle of 2007. With the collapse of Bear Stearns in March, we believed the stock market hit its low for the year when the Dow Jones Average closed at 11,740. Stocks then had a nice rebound from the lows, but now appear to be running into some new resistance. Financial sector reported losses (now over 17% year-over-year) have grown dramatically and we still have no end in sight. This makes them far and away the poorest performing of the economic sectors.

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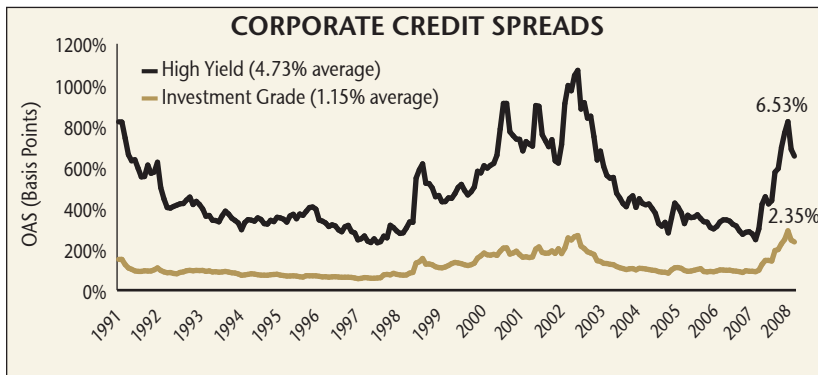


CHART 3
HISTORICAL YIELD CURVE
12/31/07 – 6/09/08

The yield curve has steepened as rates have risen on the long end.

CHART 4
CORPORATE CREDIT SPREADS
12/31/90 – 5/31/08

Credit spreads remain well above their historic averages, but are off their peaks for the year.

Locations

ILLINOIS

Belleville
Bloomington
Peoria

KANSAS

Leawood
Wichita

MISSOURI

Kansas City
Springfield
St. Joseph
St. Louis

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Compounding the financial woes are booming commodity prices, especially oil. Rising fuel and food prices, in combination with declining home prices, have sent consumer confidence plummeting to levels last seen in 1990. These same phenomena are slowing foreign economies as well. Up to now, foreign economic growth and a falling dollar have saved the earnings of many U.S. companies. As the summer progresses, we think earnings expectations will decline, limiting the upside for stock prices. We are quite aware that stock prices typically bottom well before the economy rebounds, but the likely continuance of strong headwinds over the next several months has caused us to be neutral on the stock market outlook.

Several of the market themes we suggested at the start of the year remain in place. Growth stocks continue to outperform value stocks and we believe that trend has staying power. We still like technology, energy, industrial and material companies with their heavy exposure overseas. Retailers, homebuilders and financials, each heavily dependent on the U.S. consumer, will likely continue to struggle. We believe the health care sector will remain under pressure as both Presidential candidates have platforms that will raise questions on the future profitability of the sector. One area to which we are warming up is Small-Cap stocks. Small-Cap stocks have been lagging their Mid- and Large-Cap counterparts over the last year. Their valuation levels are now more attractive than any time since 2003.

INTERNATIONAL UPDATE

Through the end of May, foreign equity exchanges are still providing better performance than the U.S. domestic benchmarks in a difficult market. The MSCI World Ex-USA Index provided a net total return of -2.15% year-to-date compared to the U.S.-only return of

-3.56%. The overall developed foreign markets, as measured by the EAFE Index were similar to the U.S. at -3.03%. Emerging markets were somewhat stronger, coming in at -1.56%. The real story is that the leadership in the emerging markets has clearly shifted away from China and India, which were down -16.2% and -27.1%, respectively, to Latin America, which collectively was up 18.4%. In fact, four of the top five countries in the world were Argentina, Brazil, Colombia and Peru. Concern in Asia, of course, centers on the expectation that post-Olympic China will prove mediocre relative to its scorching strength over the last few years. Overall, we still think portfolios should maintain their exposure in foreign equities.

CONCLUSION

For 2008, the U.S. economy is projected to have a well below average 1.5% real growth rate. The Federal Reserve continues to provide critical care to a weak financial sector, but now is also concerned with a growing future inflation risk. For the second half of 2008, we see the bond market providing low single-digit total returns with investment grade corporates and asset-backed securities doing better than Treasuries. Within the equity market, we like growth over value, Small Cap over Mid Cap and suggest very selective industry exposures. Our work continues to suggest that overall foreign exposure improves results and that significant emerging markets exposure is warranted and beneficial.



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