



Market BULLETIN

August 2007 Market Bulletin

Dear Commerce Trust Client:

When economic market conditions from time to time become volatile, we like to share with our clients the considerable investment perspective developed by The Commerce Trust Company over a century of operations during many kinds of market cycles.

In short, we encourage all of our clients to continue to be steady, long-term investors and to work with an asset allocation that meets your particular long-term needs. At Commerce Trust, your portfolio is adjusted based on longer and intermediate-term market conditions, not just short-term price movement. While the recent fluctuations are more than what should normally be expected in the financial markets, these movements are closer to long-term reality than the extremely low volatility we have witnessed during the past several years. Complacency sometimes precedes a period of volatility – and this often reminds everyone that the principles of careful asset allocation and diversification, hallmarks of Commerce Trust's investment process, are timeless and simply good solid investment practice.

We are still positive on the stock market. Corporate earnings remain strong and the market is reasonably valued. It is difficult for any stock market to do well as a credit crunch unfolds, but once this cloud lifts, we believe stocks will have upside potential.

The following are the key points of our analysis of recent conditions:

- Both the Dow Jones and the S&P 500 have retreated from their all time highs of mid-July. The Dow and the S&P are testing their recent lows with both indexes about 7% off these recent highs.
- Most international stock markets have also fallen, with the Europe Australia Far East (EAFE) index down just under 10% as well. So from an equity perspective, the downdraft has impacted both domestic and international markets.
- The Dow is still up 6%, the S&P more than 3% year-to-date and the EAFE is up 2%.
- Although the recent point swings in the Dow seem large, these moves are still modest by historic standards. It has been an exceptionally long period of time (four and one-half years) since we've experienced even a 10% correction in our equity markets, which has historically occurred about once a year.
- Even with the recent continued downdraft, almost all stock markets still remain in positive territory for the year.

The Dow is still up 6%, the S&P more than 3% year-to-date, and the Europe Australia Far East index is up 2%.



The Commerce Trust Company

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- In order to provide liquidity to the credit market, the Federal Reserve has lowered the discount rate a half percent to 5.75%. This is the rate banks are charged by the Federal Reserve to raise capital pledging any type of collateral. Therefore, banks can now bring Mortgage-Backed Securities to the Fed to raise cash. So the Fed with this move is attempting to liquefy some of the assets sitting on bank balance sheets that have seen secondary markets frozen. This lowering of the discount rate has served to restore some calm to the financial markets.
- The downdraft in stocks and widening in credit spreads occurred primarily for two reasons: First and foremost is the continued problem in the sub-prime lending market and the direct impact on the financial sector. These troubles are real and are also impacting the macro-economy as sub-prime loans accounted for about one-eighth of all mortgages outstanding. This lending prop that was provided to the weakest borrowers (low FICO scores, bad credit histories, minimal documentation, etc.) has now evaporated and even borrowers with modest credit blemishes are finding it difficult to get a home loan. Secondly, the spread increase in sub-prime sparked a reassessment of all credit risks, primarily in the high-yield corporate sector, which has financed most of the recent LBO (leveraged buyout) activity. So large LBOs like Chrysler, First Data, SLMA, etc., are much more difficult to fund, and this has taken the “private equity” bid for public stocks away.
- The downdraft has continued and has been further exacerbated by recent concerns about liquidity, as holders of risky debt have faced continued margin calls and pressure to sell their bonds into a market with no particular buyers at this time. This forced selling was primarily driven by the initial downdraft in bond prices, which forced hedge funds to sell, and has now been compounded by investors simply asking for their money back. This liquidity crisis has forced the European Central Banks and our Federal Reserve bank to inject funds into the banking system just to keep short-term rates at their target levels.
- We think in the longer run, the financial markets (i.e., the major banks and brokerage firms) will be able to handle the challenges of the sub-prime mortgage market volatility. Ultimate investor losses could range between \$125 and \$200 billion, and while some of that has already occurred, much is occurring as we write this and even more is to come over the ensuing months as these mortgages default and homes are foreclosed on and liquidated. Fortunately, these losses have been and will continue to be distributed around the globe, much of it in the hedge fund universe, and somewhat less in insurance companies, pension portfolios, and in our banking system. While \$125 to \$200 billion seems huge, relative to today’s economy, this is the equivalent of about one-third to one-fifth the size of the late 1980s savings and loan crisis. Importantly, we at Commerce have no exposure to the sub-prime sectors that are imploding, and it’s one of the key reasons our relative returns in the fixed income area are extremely positive.

You are welcome to call your portfolio manager at any time with any questions you might have. You may find the information above helpful as we all weather the changes in the near-term market.

