



MID-YEAR REPORT, JULY 2007

# Market Update

2007 Economic and Financial Market Outlook — Mid-Year Update

## Housing Troubles Restrain Economic Growth

### INTRODUCTION

As we reach the midpoint of the year, our forecast of six months ago seems to largely have been on target. At the end of 2006, we had projected that the Federal Reserve would be leaning toward lowering short-term interest rates to accommodate a slowing economy in late 2007. However, while housing-related activity continues to be a meaningful drag on Gross Domestic Product (GDP), the balance of the economy has not been that weak. Unemployment is relatively low, and while inflation remains somewhat elevated, it is not enough to raise long-term concerns. Consequently, there has simply been no trigger to require the Fed to nudge the economy forward by lowering short-term rates. Our current view is that they will hold rates steady for the balance of the year.

### ECONOMIC UPDATE

After a very anemic 0.7% GDP growth reading in the first quarter of 2007, the economy looks to be returning to a higher (but still below-trend) growth rate for the remainder of the year. During the first quarter, declining residential construction continued to restrain growth as it subtracted 0.9 percentage points from GDP. Additionally, sharp declines in inventory investment and net exports also acted to reduce the growth rate. While housing will continue to be a brake on

the economy through the end of the year (and even into next year), some firming in inventory investment and improving exports are expected to offset a deceleration in consumer spending. We project that GDP will bounce back at a 3.0% rate in the second quarter before settling into a below-trend growth rate of roughly 2.5% for the remainder of 2007. **(CHART 1)**

As we head into the second half of 2007, we expect that the Federal Reserve will remain on hold, keeping the fed funds rate unchanged at 5.25% through the rest of the year. Despite continuing weakness in housing, the Fed will remain vigilant on the inflation front. As growth improves through the second quarter and beyond, the Fed will feel little need to ease rates. At the same time, while “core” inflation has not yet fallen into the “comfort zone” of 1% to 2%, recent declines from last year’s elevated levels have eased pressure to raise rates. **(CHART 2)** This balanced risk assessment will likely translate into a “steady-state” Fed that will not be inclined to raise or lower rates anytime soon.

While inflation has cooled somewhat, the job market remains in surprisingly healthy shape, although we predict job growth will decelerate as well. Corporate profits continue to grow, albeit below their recent double-digit pace. Healthy stock market gains have underpinned growing household net worth and con-

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CHART 1  
REAL GROSS DOMESTIC  
PRODUCT (in percent)

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

GDP will bounce back at a 3.0% rate in the second quarter. Below-trend growth rate of 2.5% is expected for the remainder of 2007.

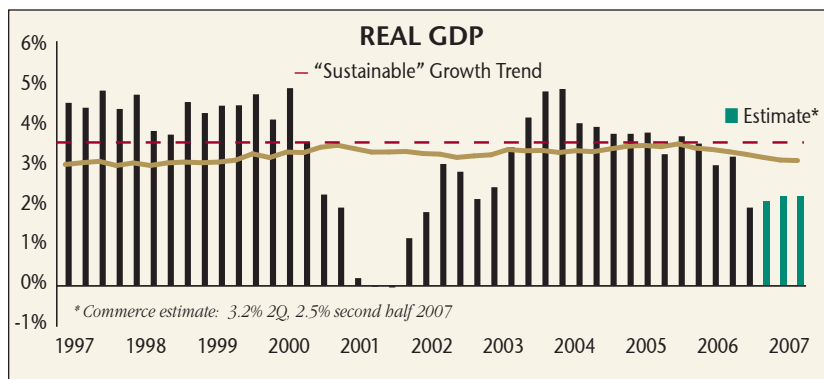
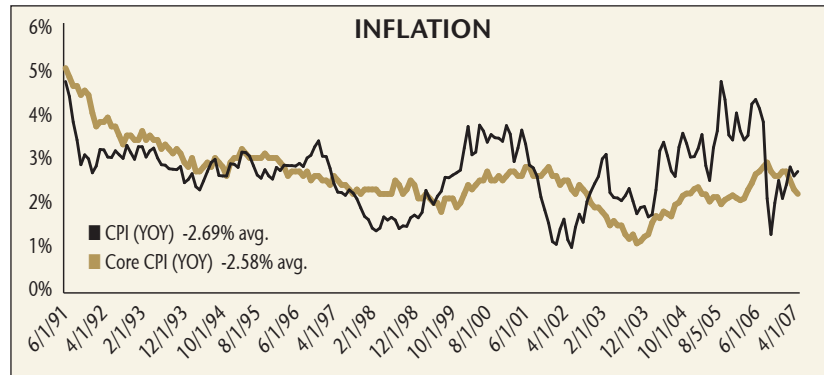


CHART 2  
INFLATION:  
CPI & CORE CPI

Recent declines in "core" inflation have eased pressure to raise interest rates.



sumer confidence. While housing has continued to struggle (it's not too late to sell your condo in Miami), and gasoline prices have remained near record-breaking levels, these have had less an impact on consumption than generally anticipated. Although domestic economic risks remain elevated, we view the odds of a U.S. recession as relatively low. Importantly, despite sub-par domestic growth, worldwide growth remains strong. For the first time in recent economic history, global growth is helping propel U.S. growth.

#### FIXED INCOME UPDATE

The broadest measure of the bond market barely managed to generate positive returns over the first half of the year as bond investors confronted a cross-current of negative events ranging from an increase in leveraged buyouts to

problems in the subprime mortgage market. Additional waves of worry were caused by a crisis at two Bear Stearns hedge funds. Despite these negative domestic events, global growth remained strong, and with inflation remaining slightly above the Fed's comfort range, expectations for an interest rate cut faded.

In fact, these events pushed interest rates up slightly, which cut into coupon returns. Through mid-year, the Lehman Aggregate Bond Index returned 0.98%, while the return on the Lehman Intermediate Bond Index was 1.44%. For taxable bonds, asset-backed securities were the best performing securities, followed by agencies. The corporate bond sector underperformed relative to Treasuries for the six-month period.

Municipal bonds have lagged taxable bonds so far this year. Intermediate municipals are up

0.63% while the broader based longer maturity municipal market was nearly flat at 0.14%.

It is becoming increasingly clear that the era of "cheap" money is likely over. Global interest rates continue to gradually rise (even in Japan) as worldwide growth led by the emerging markets remains strong. Treasury rates had been suppressed in part because foreign central banks and investors were investing their surplus savings back into the U.S. bond market. Today, these overseas investors (think China and the oil exporters) are both increasing their investment spending and diversifying their holdings away from the dollar. Treasury yields, in turn, have risen in order to remain attractive to foreign investors.

Recent events in the subprime mortgage market may be the harbinger of a broad-based tightening in lending standards. Subprime mortgages, loosely defined as home loans to borrowers with less-than-pristine credit histories, have been widely available for the past decade. These mortgages only recently began grabbing headlines as their growth in popularity collided with the current housing downturn. Delinquencies on subprime mortgages have now reached record levels (typically 10% to 15% on recent originations), and dozens of subprime mortgage lenders have closed their doors. While alarming in its severity, the meltdown in subprime lending is likely limited in its immediate scope. These lower quality mortgages represent just 14% of all U.S. mortgage debt outstanding, and their investor base is globally diversified. The dilemma financial markets now face is whether the weakness in sub-

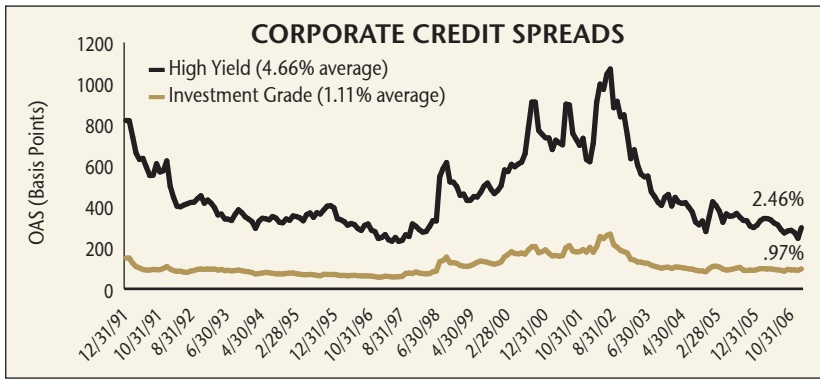


CHART 3  
CORPORATE CREDIT SPREADS  
12/31/90 – 6/30/07

We continue to expect credit spreads to widen from their recent lows.

prime mortgages is 1) merely a late knock-on effect of a U.S. housing slowdown that is already well underway or 2) an ominous precursor to a broader reassessment of credit risk across the globe. While we continue to believe that the direct economic impact of subprime mortgage losses on the U.S. will be limited, we do view recent events as a long-overdue wakeup call to those bond investors who have chased higher yields at the price of higher risk. Simply put, credit spreads are likely to widen from their recent lows. (CHART 3)

Changes in Treasury interest rates drive short-term bond returns. The Treasury yield curve started the year slightly inverted, with the two-year Treasury note yielding 11 basis points more than the 10-year Treasury bond. By the end of the second quarter the inversion was gone, and a more traditional

upward sloping yield curve had formed. Both short and long rates have risen over the last six months, with the long end rising more than the short end. Two-year Treasury yields were up five basis points and 30-year Treasury yields rose 31 basis points. (CHART 4) Interest rates were range-bound for the first four months of this year, but started an upward move in May which continued into June, with the 10-year Treasury yield hitting a five-year high of 5.29%.

Going forward, we are very cautious when it comes to taking credit risks. This is reflected in our investment stance with minimal BBB-rated exposure and higher than average overall credit quality. We expect inflation fears to gradually abate and the yield curve to become grudgingly steeper. However, the Fed is likely to keep short-term interest rates pegged at 5.25%

for the rest of the year, keeping the yield curve flatter than historical norms. Bond returns for 2007 should finish the year in positive territory but are likely to be lower than their coupon yield.

**EQUITY UPDATE**

So far so good! The S&P 500 is on target to achieve our expected low double-digit returns for the year. In the first half, the market experienced a few brief sharp declines caused by a sell-off in the Chinese market, subprime lending concerns, and an abrupt rise in interest rates in June. These declines led to quick recoveries, sending the averages to new highs in June. While the resiliency of the market has surprised many investors, the psychology of the market remains on the skeptical side. Investors are cautious about increasing their equity positions with most major markets around the world having risen over 20% a year ago. Despite that, we believe the outlook for equities remains quite positive and have recently suggested increasing the weighting in equities in portfolios nimble enough to take advantage of shorter-term opportunities.

Why are we positive? First, the market appears undervalued at the current P/E levels with inflation in the still moderate 2% to 3% range. Barring any big jump in inflation, we see a probable 10% further appreciation before becoming fairly valued. Over the last several months interest rates have been creeping higher and the yield curve has moved from being inverted to having a positive slope (short rates lower than long rates).

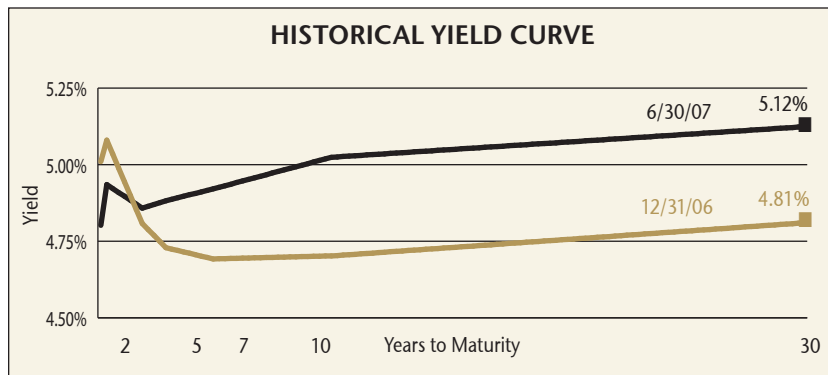


CHART 4  
HISTORICAL YIELD CURVE  
12/29/06 – 6/19/07

Both short and long rates have risen over the last six months, with the long end rising more than the short end.

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A positively sloped yield curve is historically favorable for stocks.

The supply and demand equation also looks positive for stocks. Demand seems to be increasing as money is channeled away from real estate and commodities as prices for both seem to be rolling over. These two asset classes have attracted a lot of capital over the last few years. On the supply side, the amount of stocks available is shrinking rather than growing. Between mergers and company buybacks of their own stock, over \$123 billion of stock market value was retired in the first quarter alone. The total value of the U.S. market is 15 trillion; so a little less than 1% of the supply of stocks was eliminated in 3 months. Since June of 2004, over \$993 billion of stock has been retired. Shrinking supply and rising demand bodes well for higher prices.

Within the stock market, growth stocks continue to look more attractive than value-oriented issues for the rest of the year. Growth has slightly outperformed value for the first six months of the year, but with technology stocks starting to act better, we believe the difference will widen further. Over the last year there has been little difference in returns between large-, mid- and small-cap stocks. While mid-cap stocks look expensive relative to large cap, that's not to say large caps will outperform.

#### INTERNATIONAL UPDATE

Foreign equity markets gave investors a bumpy ride earlier in 2007 but have regained their composure as the year has progressed. The international market reaction to concerns about potential Chinese government investment controls, possible widespread unwinding of yen-carry trades, and rising delinquency rates on U.S. subprime mortgages appears to have been excessive. Investor complacency in recent years has been the result of a sustained period of strong global economic growth with low inflation, strong market returns with

low volatility, and exceptionally strong and widespread corporate profitability. Apparently expecting most companies to maintain profitability at this extraordinarily high level, global investors have been pricing most stocks similarly, regardless of country, sector, risk or future earnings growth potential, and the result has been a significant compression in overall valuation spreads.

But the consensus among economists now calls for global economic growth to slow in early 2008. Earnings forecasts for the stocks in the MSCI EAFE Index are also decelerating. History suggests that as overall earnings growth falls and strong earnings growth becomes harder to find, valuation spreads will widen between companies with strong long-term earnings growth prospects and those trading at cyclical peaks. Until investors begin pricing stocks in line with more differentiated expectations of earnings growth, compressed valuation spreads make the international growth opportunity attractive while calling for caution in regard to the relatively weaker opportunity in international value stocks.

#### CONCLUSION

We remain generally upbeat on the global financial markets. In the fixed income markets we expect credit spreads to widen from their unusually tight levels. Thus, investors should maintain portfolio credit quality well above average levels. Bond returns are expected to be positive, but slightly lower than their stated coupon rates as yields move gradually higher. Our view of the stock market remains as positive as it was at the beginning of the year. We expect that the broad U.S. stock market averages will move toward the low double-digit positive return range. Within the equity market, our tactical overweight of growth over value stocks remains appropriate, as does a solid position in foreign companies, both in the developed and emerging markets.

## Locations

#### ILLINOIS

Belleville  
Bloomington  
Peoria

#### KANSAS

Leawood  
Wichita

#### MISSOURI

Kansas City  
Springfield  
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