



2019
4TH QUARTER

CURRENT ECONOMIC AND FINANCIAL MARKET CONDITIONS SUMMARY

PREPARED BY: INVESTMENT POLICY TEAM



Commerce Brokerage Services, Inc.
A Subsidiary of Commerce Bank



ECONOMIC GROWTH CONTINUES TO DECELERATE

But we still think we can squeak by a recession

ECONOMY

Still making forward progress, but the backdrop is clearly looking a bit more ominous as growth slows to 1.5% pace

Despite global economic growth slowing in 2019, we have now entered the longest U.S. economic recovery on record (10¾ years and counting). Importantly, we believe the likelihood of a near-term recession at this point is still low, especially with the Federal Reserve (Fed) poised to deliver a third "insurance policy" rate cut at the end of October, on top of the two rate cuts they made in the third quarter. A fourth rate cut at its December meeting is also a distinct possibility. Our current slowdown continues to be driven by a myriad of interconnected causes, primarily a slowdown in China spurred along by the escalating trade war, a global manufacturing recession, an exceptionally weak Europe, and now the possibility of a presidential impeachment. Fortunately, the Fed is transitioning fairly rapidly from monetary tightening to monetary easing, the credit markets have shown gradual improvement, unemployment has dropped to a 50-year low, and stock prices have proven to be surprisingly resilient. While it was rather obvious economic activity would cool from last year's 3% pace, economic growth has slowed even more than we expected as the trade war and domestic politics have taken their toll. For the first half of the year, growth averaged 2.5%, but our second half will average less than 2%. Fortunately, employment growth remains positive and salaries continue to increase, putting more spending money in consumers' pockets. It is helpful that ultra-low interest rates are also breathing late-cycle signs of life into the housing market, providing an additional boost that should keep our economic momentum moving forward.

We expect economic growth over the second half of the year will be approximately 1.5% to 2.0%. The key drivers of this growth are:

- An accommodative Fed likely to provide another 0.50% of short-term interest rate reductions this quarter
- Increasing employment levels and record low unemployment that translate into a rise in personal income and steady consumer spending
- Surprisingly benign global inflation that allows central banks to lower short-term rates further
- Record corporate profitability spurring record stock prices
- A positive tailwind from low energy prices and long-term interest rates
- The wealth effect from a recovering U.S. equity market and a late-cycle boost in home prices
- The potential for a limited "truce" in the U.S./China trade skirmish as negotiations continue

Growth will remain positive despite weakness overseas, trade issues that clearly cloud the economic outlook and the contentious U.S. political backdrop. Global weakness and the lack of inflation pressures have pushed nearly every central bank into an easing mode. We believe the Fed will cut interest rates until the yield curve regains some steepness and economic prospects brighten. This looser monetary policy stance, combined with a resilient yet non-inflationary labor market, suggests our record expansion could continue for many quarters to come. While chronologically old, economically we are only middle-aged...perhaps just approaching retirement. Optimistically we could envision this expansion lasting for up to three more years, a highly out-of-consensus forecast.

Still, this business cycle won't last forever, and last year's volatility in the financial markets acted as the proverbial canary in the coal mine and captured everyone's attention. As the Fed helps extend the recovery, our biggest worries remain the trade war, sluggish growth overseas and recently heightened political dysfunction in Washington. As a result, investors will stay focused on global trade issues and become increasingly interested in the 2020 election outcome, which no doubt will introduce an entirely new set of anxieties that could begin to weigh on markets.

EQUITY MARKETS

We have remained firm in our commitment to stocks and risk assets

When 2019 began, we noted how valuations for the domestic equity market had improved dramatically since January 2018. The S&P 500 median P/E fell to 16.4 times at the end of December, levels last seen in 2014. The strong surge in equity prices in the first nine months has moved the median P/E slightly below the overvalued territory. With the backdrop of moderate economic growth and an accommodative Fed, we believe earnings will post low single-digit growth this year.

Another problem the equity market faced last year was the acceleration in short-term interest rate hikes. Rising short-term rates had not been a problem since the beginning of this bull market in March 2009, at least not until early last year. In late December, the Federal Reserve shifted from a higher short-rate forecast to a wait-and-see approach and since July has been reducing short rates. Falling interest rates are a real positive for continued equity market strength.

As we entered 2019, there was a clear change in investor sentiment from an attitude of buying every dip (in the belief that the market always goes higher) to one of a more cautious nature. Typically, when equity markets surge 20%, investors quickly turn bullish again, but that has not been the case this year. Financial news continues to caution investors about a slowing global economy, an inverted yield curve, the on and off Chinese trade negotiations and the prospects for earnings disappointments. Investors remain cautious, which we view as a positive for equity prices.

FIXED INCOME MARKETS

A sharp decline in rates has boosted returns this year

Returns for bonds in 2018 ranged from slightly negative to slightly positive due to the rising interest rate environment. Fixed income returns were paltry at best as the Fed's four rate hikes pushed yields higher and bond prices lower. Surprisingly, most of last year's weaker results have been totally offset this year as interest rates dropped and credit spreads improved. Core investment-grade municipal and taxable bond funds have posted positive returns in the 7% to 9% range, while higher-yielding, non-investment-grade funds posted even better returns of roughly 10% to 12%. For the rest of 2019, as the Fed likely reduces short-term rates, bond funds should perform more closely in line with the cash markets. The good news is that this year bond returns have been far higher than most were expecting, but those results are behind us, and all we are likely to earn the rest of the year are the bonds' coupons.

In April, we reduced our modest allocation to the riskier "plus" areas of the bond market (from 10% to an 8% weighting). Within the "plus" sector, we believe the best bond returns for the rest of the year are likely to be provided by emerging market debt and high-yield municipal bonds, which should enhance the more modest returns in the investment-grade sector. We will likely trim this riskier exposure even further as the business cycle progresses.

ALTERNATIVE INVESTMENTS

Alternative investments include strategies such as hedge funds, real estate, energy master limited partnerships (MLPs) and commodities. We include them in many client portfolios to either reduce volatility or provide diversification.

We expect higher market volatility to continue through year end. Conservative hedge funds, which have lagged stock and bond markets since the 2009 recovery, may have their day as investors seek preservation of the wealth they have built over that time.

Real estate investment trusts (REITs) have been strong performers, with the DJ US Real Estate Index returning 27.9% through September. The backdrop for real estate remains favorable. Continued downward pressure on interest rates and yields should be supportive, as should any incremental favorable trade headlines.

Energy MLPs gave up some ground in the third quarter, but the Alerian MLP Infrastructure Index is still up 11.6% year to date. The outlook for the North American midstream energy sector is positive, given recent signs of stabilization in both company fundamentals and underlying commodity prices.

Commodities are being affected by opposing forces across the board and within sectors. The slowdown in China's growth prospects and the U.S. escalation of the trade and intellectual property struggle with Beijing are being offset by steady growth in the United States and several emerging market economies.

INVESTMENT POLICY TEAM - OCTOBER 15, 2019

Current Economic and Financial Market Conditions data and information is intended to provide general information only and is reflective of the opinions of the Commerce Trust Company Investment Policy Committee.

The Commerce Trust Company is a division of Commerce Bank. Commerce Brokerage Services, Inc., member FINRA and SIPC, and an SEC registered investment adviser, is a subsidiary of Commerce Bank.

This material is not a recommendation of any particular security, is not based on any particular financial situation or needs, and is not intended to replace the advice of a qualified attorney, tax advisor, or investment professional.

Commerce does not provide tax advice or legal advice to customers.

Consult a tax specialist regarding tax implications related to any product and specific financial situations.

Past performance is no guarantee of future results.

Investment products are: Not FDIC-Insured - May lose value - No bank guarantee



Commerce Brokerage Services, Inc.

A Subsidiary of Commerce Bank

commercebank.com/brokerage

1.800.772.7283