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MID-YEAR REPORT, JUNE 2009

Market Update

Economic and Financial Market Outlook — Mid-Year Update

Green Shoots Sprout on the Economic Landscape

INTRODUCTION

After a firestorm of financial problems befell the investment markets last fall, 2009 began with the Fed and the Treasury hoping to extinguish the flames by raining dollars on the investment markets. Assorted nutrients also were added to jump-start economic growth. It wasn't until spring that we started to see some "green shoots." Investors seem to be somewhat comforted by the glimmers of hope that have sprouted as both equity and fixed income markets have started to recover from last year's crisis.

ECONOMIC UPDATE

The U.S. recession is not yet over, but there has been a growing sense that the worst of the economic storm has passed. While unemployment is rising and final demand remains subdued, recent economic data releases are looking a bit more encouraging. Most of the numbers are coming out slightly better than expected, and the pace of the decline appears to be decelerating. This should underpin the improving confidence evident in the capital markets over the past few months.

The massive amounts of global monetary and fiscal stimulus put in place over the past 18 months are truly unprecedented. There is no blueprint for the colossal package of policy initiatives, but it is at least in part responsible for the green shoots that have been sprouting up. Current policy seems designed to force investors to move out of safe havens like government securities and take more risk, even in the face of economic uncertainty.

Housing has been a big problem for more than three years following the peak in sales measures reached in mid-2005. Attempts to reach equilibrium occurred several times over this period until new stages of the financial crisis developed. Record low mortgage rates and falling home prices have pushed the Realtor's Affordability Index to record levels. Government intervention has also helped to stabilize the home sales pace so far in 2009. As such, U.S. housing activity shows a good probability of bottoming or rising from present low levels, and may contribute a slight positive before the year is through. However, non-residential and larger multi-family construction will very likely represent a meaningful drag on the economy, offsetting any rebound in single-family housing going forward. **(Chart 1)**

The employment situation is the key to a sustainable economic recovery. We have lost nearly six million jobs since the recession began in late 2007. The unemployment rate has moved up to 9.4%. This has had a devastating effect on economic activity and consumer confidence. However, over the past four months, the severity of the decline in

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Inside:

The Commerce Trust Company
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CHART 1
MEDIAN EXISTING SINGLE-FAMILY HOME PRICE
The slump in housing prices is extending into its fourth year.

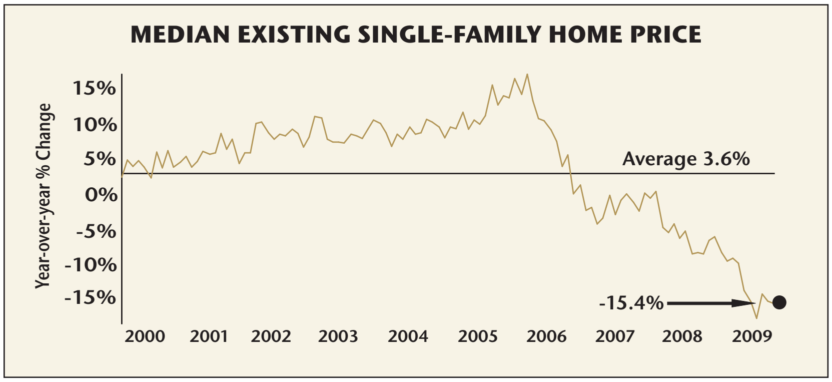


CHART 2
EMPLOYMENT
Over 6 million jobs have been lost since the recession began in late 2007.

- Monthly Increase (left axis)
- 3-Month Change (right axis)

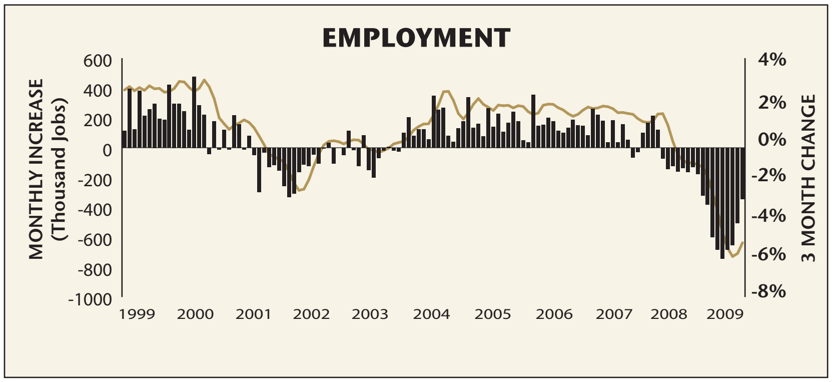
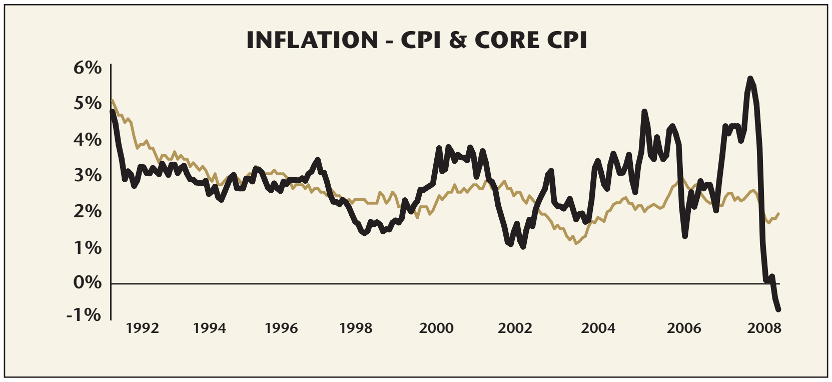


CHART 3
INFLATION –
CPI & CORE CPI
Consumer demand has been too weak for most businesses to find any success in pushing through price hikes.

- CPI (YOY) 2.71% Avg.
- Core CPI (YOY) 2.54% Avg.



payroll employment has slowed by roughly 400,000 from -741,000 to -345,000. The May job loss was the smallest decline since last September, and suggests that employment declines may continue to moderate. **(Chart 2)** However, the end to the rise in the unemployment rate is not yet in sight.

A stiff headwind facing the economy is the relentless de-leveraging taking place in the household sector (translation – consumers are paying down debt in record amounts). The domestic consumer represents a 70% share of the U.S. economy and 16% of global GDP. Outstanding consumer credit has contracted for six of the past seven months, with the last three months' percentage drop the most ever since June 1980. The personal savings rate recently reached a 15-year high of 5.7%, and is expected to stay on a clear uptrend. Thus, consumer de-leveraging will remain a drag on consumption for some time as households work hard to repair their balance sheets.

Another hot topic of late has been inflation, especially with the massive monetary and fiscal stimulus being put into the system. When activity virtually came to a standstill late last year, many investors were concerned the economy was heading into a deflationary spiral, similar to the Great Depression. But as the economy has shown signs of stabilization, inflation expectations have rebounded. At this point, there is considerable and persistent slack in our outlook, which should exert downward pressure on inflation into 2010. A challenge for Fed policymakers, of which they are well aware, will be to prevent inflation expectations from gaining speed as deflation risks recede. Bernanke has stated that eventually they would need to start raising rates and draining reserves at a point when less accommodation is needed. The tricky part will be the timing. **(Chart 3)**

The Federal Reserve's "unconventional" policies to create easier credit conditions have been largely successful. Moving forward, the focus will be on the continued implementation of the previously announced policies and the ongoing assessment of their effectiveness. We see a bottom in GDP forming, and look for a modest decline of 1%-2% in the second quarter followed by moderate growth in the second half. The aggressive monetary and fiscal policy responses under way and the success in efforts to recapitalize the banks (including sufficient capital buffers) will continue to help the economy rebound. Additional assistance will be provided by the diminishing drag from housing and credit concerns, and a rebound in equities that is already underway. **(Chart 4)**

FIXED INCOME UPDATE

Last September's collapse of Lehman Brothers sent shock waves through the financial markets, but the bankruptcy and its fallout are fading away. After becoming nearly completely frozen, the fixed income market thawed as spring came upon us. Indicators, including falling money market rates, reduced mortgage costs and more corporate bond sales, all point to an economic recovery.

Since March, the economic backdrop has improved, thanks in part to the huge amount of funds injected into the system by the Treasury and the Federal Reserve. While the improving backdrop has certainly helped fixed income markets, the banking system remains capital-constrained, and it will be many months before we can be sure that the credit crisis has been successfully resolved.

Evidence that the government's effort to pump money into the economy is helping can be seen in the fixed income market. The liquidity premium associated with the non-government sectors of the bond market showed a large decline in the first half of this year. This is reflected in lower credit spreads (the difference between a specific non-Treasury sector's interest rate and a similar maturity Treasury issue). However, the risk premium still remains high relative to historical averages and will remain high until the economy shows further improvement.

The Treasury yield curve started the year upward sloping, with the 10-year Treasury note yielding 145 basis points (a basis point is 1/100th of 1%) more than the 2-year Treasury bond. As we come to the mid-point of the year, the yield curve is steeper and interest rates are significantly higher across the range of maturities. The 2-10 year yield difference reached the record level of 275 basis points and finished the month of May at 254 basis points. **(Chart 5)** Growing concern about inflation, a deluge of government debt flooding the market, and the threat of a sovereign credit rating downgrade have driven Treasury yields higher.

At the start of past economic recoveries, Treasury yields have increased temporarily 59 to 387 basis points. This may be what is happening again. At the start of recoveries, risk-aversion decreases and concerns regarding inflation, Fed tightening, and deficit financing all increase.

Investment grade credit spreads started the year wide and gradually tightened in the first three months and improved greatly in April and May. **(Chart 6)** The credit markets are more orderly and are working better. High yield corporates were the biggest beneficiary of the spread tightening, with many showing double digit returns through May. Treasuries, on the other hand, reached overvalued levels and have been negatively

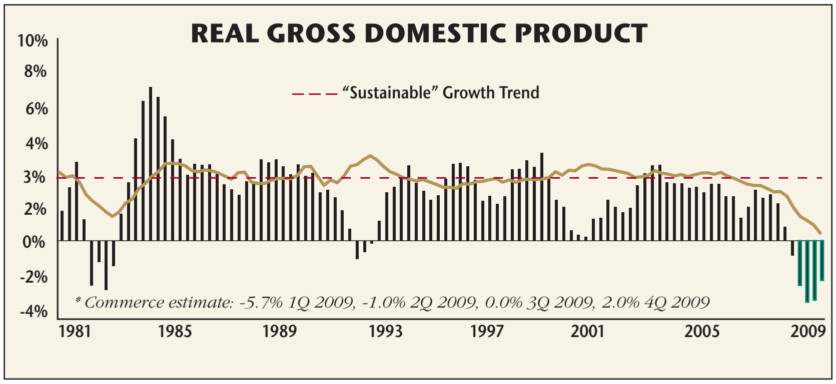


CHART 4
REAL GROSS DOMESTIC PRODUCT (in percent)
The economy continues to contract, but at a somewhat slower pace.

- YEAR-OVER-YEAR
- YEAR-OVER-YEAR (ESTIMATE)*
- 10-YEAR TREND

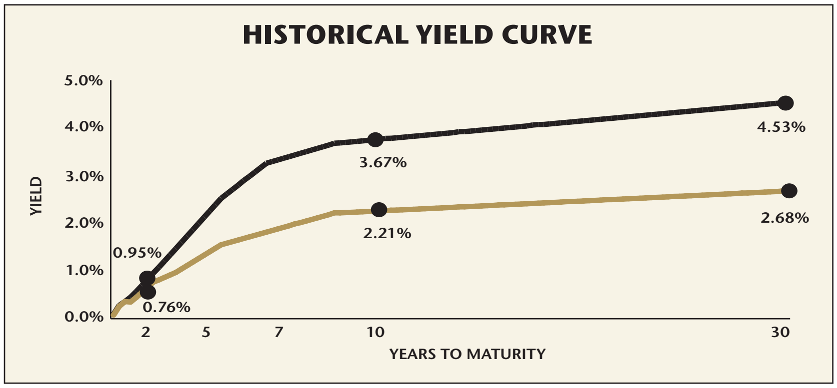


CHART 5
HISTORICAL YIELD CURVE
Inflation concerns and the threat of massive government debt issuance have left interest rates higher across the yield curve.

- 05/31/09
- 12/31/08

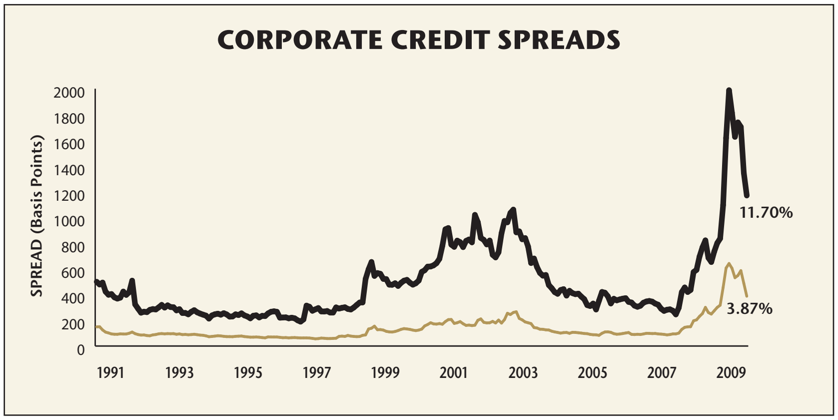


CHART 6
CORPORATE CREDIT SPREADS
01/31/91 - 05/31/09
Credit spreads for both high yield and investment grade bonds have tightened dramatically this year.

- High Yield – 4.90% Avg.
- Investment Grade –1.35% Avg.

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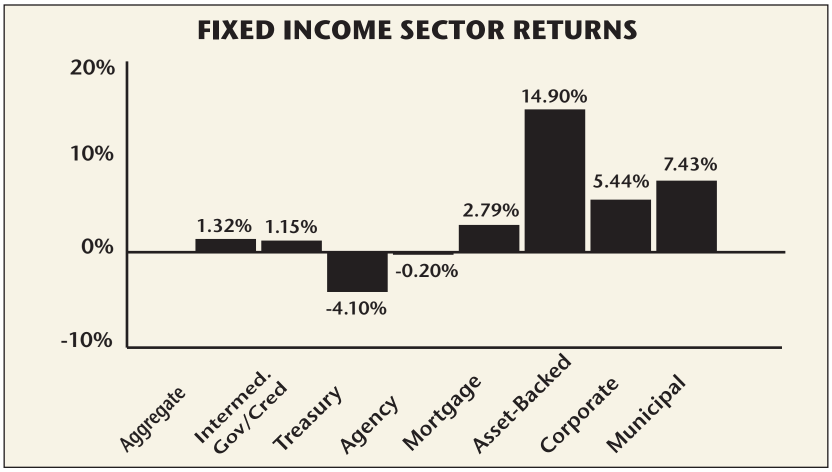
CHART 7
FIXED INCOME SECTOR RETURNS YEAR-TO-DATE (AS OF 05/31/09)
All non-government fixed income sectors are on their way to positive returns for the first half of this year.



impacted by the rise in interest rates. This is a reversal from last year where high yield corporates were the laggards and Treasuries were the top-performing sector.

So far this year, tighter spreads have been able to offset the drag on performance caused by rising interest rates. Through May, the Barclays Aggregate Bond Index returned 1.32%, while the return on the Barclays Intermediate Government/Credit Index was 1.15%. All non-government fixed income sectors are on their way to positive returns for the first half of this year, with asset-backed securities leading the pack. **(Chart 7)**

Municipal bonds have been doing well as investors become more comfortable with their credit risk. Also, their performance has been helped by a lack of tax-exempt new issue supply. The drop in supply has been due in part to the Build America Bond (BAB) program enacted by Congress earlier this year, which provides a significant subsidy for municipalities to issue taxable bonds.

As investors buy up tax-exempt bonds the ratio of municipal to Treasury bond yields has been contracting. The Barclays Municipal Bond Index has increased 7.43% through May.

In the second half of 2009, the Fed will be watching Treasury yields closely. Too fast a rise in Treasury yields, and in turn mortgage rates, could sow the seeds of a growth disappointment for the economy and a pullback in risk assets.

The Fed is expected to buy large amounts of government debt in order to keep mortgage rates down and help stimulate the real estate market. The investment markets will probably test the government's resolve. Real interest rates will probably rise until the Fed can't stand it any longer and then the Fed will make more purchases. It is a tough balancing act. The Fed worries about buying enough government debt to prevent a deflationary depression, while also being concerned about the impact of its purchases on the U.S. dollar and inflation. The Fed will tolerate the backup in Treasury yields as long as it does not interfere with the decline in private sector borrowing rates.

Treasury issuance is expected to increase in the coming months due to the government's need to finance Fed programs and run their stabilization programs such as the TARP (Troubled Asset Relief Program). There is concern that a sudden increase in the supply of Treasuries will put upward pressure on yields (downward pressure on prices). Corporate issuers will be competing with this swelling supply of U.S. government debt and also an abundance of issuance from around the globe.

Taxable bond investors will likely move out of low-yielding asset classes as the credit crisis concerns diminish. Sectors like corporates, asset-backed and mortgage-backed securities should be the beneficiaries. This increase in demand for yield will help push bond prices up. However, a rising deficit, a growing supply of Treasuries, and an improving economy are factors that are expected to push Treasury yields higher. This will place a drag on rising bond prices.

Tax-exempt bond investors may see municipal bonds outperform Treasuries for the balance of the year. New supply could become limited if more issuers opt for taxable bonds through the BAB program. Also, with the expectations of higher marginal tax rates in the coming years, interest and demand for munis should rise and allow them the possibility of outperforming Treasuries. The ratio of municipal to Treasury bond yields would then continue to grind lower toward its long-term average in the range of 85-90%.

EQUITY UPDATE

The stock market's roller coaster ride of the last couple of years continues. The S&P 500 declined 57% from its October, 2007 high, reaching a low on March 9, 2009. Since that low, the market has rebounded 41%. While 41% is impressive, that still leaves us 40% short of the high that occurred eighteen months ago. While the rally has been a welcome relief — where do we go from here?

Over the last few months, consumer confidence, the key measure in our market outlook, has rebounded nicely from the abysmal level of February (the lowest point in the 41-year history of the survey). While stocks have rallied, investors are still shell-shocked and have been slow to jump on board. Typically, after a strong rebound investors turn optimistic more quickly. Not this time. In fact, if we go back and look at major stock market bottoms over the last 40 years, investors are presently the second most pessimistic for this stage of a rally. The only time investors were more pessimistic was during 1987's decline and subsequent recovery.

This ongoing fear can be confirmed by the large amount of assets still parked in money market funds at very low yields. Total dollars held in money market assets typically run between 11% and 17% of the Wilshire 5000 Stock Index. In early March, money market funds were 48% of the value of the Wilshire Index. The two previous highs were 28% in 2003 and 24% in 1982. Since March, the level has declined to 40% – still very high from a historical standpoint.

At the March lows, many of the valuation measures we monitor reached levels we have not seen in twenty years, but have since rebounded back to normal levels. For example, the worldwide economic recession has been devastating to corporate earnings. S&P 500 operating earnings (excluding non-recurring items) declined 40% in 2008 while reported earnings plunged 77%. Currently, the consensus expectation is that operating earnings will increase 9% in 2009 and another 36% in 2010. At current levels, we think stocks are fairly valued based on trailing earnings and now we look for earnings to recover faster than expected in 2009.

While the U.S. markets appear fairly valued, we do believe there is further upside ahead for the emerging international markets. China seems to be leading the world out of recession. As China's economy has accelerated, commodity prices moved higher. This has been particularly positive for Latin American countries as they are rich in materials. Domestic materials stocks look attractive as well. Other trends we think will continue are growth stocks outperforming value stocks as well as mid-cap stocks performing better than large-cap stocks.

INTERNATIONAL UPDATE

The market rally in the second quarter of 2009 has brought relief to investors globally following the fresh lows that were reached in the first quarter. As of early June, the MSCI All Country World Index ex-U.S. was up more than 16% and has outperformed domestic markets year-to-date. Confidence in developed markets has been boosted by tentative signs that the downturn is abating, such as the Halifax House Price Index, which showed that UK housing prices unexpectedly jumped in May by the most since 2002. International small cap and emerging markets have fared even better year-to-date, making up much of the ground lost to domestic markets in 2008. As of May 31, the S&P Developed Ex-U.S. Small Cap Index was up 17.7% while the MSCI Emerging Markets Index was up a vigorous 37.9%.

In addition to other powerful forces that are being marshaled to aid the world economy, much focus has been directed toward the role that China is now playing in the global economy. Paving the way to renewed optimism has been the recognition that, despite China's symbiotic relationship with developed countries in the form of exports, the country's own economy is continuing to exhibit positive growth. China's new status as a world economic force has been bolstered by its position as one of the few large countries with the capital resources sufficient to sustain its own domestic needs as well as supply the capital needs of other countries.

Stock markets of the four BRIC countries (Brazil, Russia, India and China) have experienced a significant bounce after dismal performance in 2008. Brazil's market has rallied on higher commodity prices and the Brazilian government's announced plans for a $152 billion home building program for the country's poor and increased unemployment benefits for employees in industries suffering the most from the economic crisis. Russia's market is benefiting as commodities have rebounded off their lows, although other eastern European markets have not participated in the strong rally. Eastern Europe is dependent on the flagging western European economies for trade, and currency declines have hurt eastern Europe's markets. We are optimistic on emerging markets in Asia and Latin America, but are taking a more cautious approach toward eastern Europe until signs of strength appear.

ALTERNATIVE INVESTMENTS

Alternative investments also are faring better after the challenging events of 2008. Hedge funds, which saw some of the worst returns in their history, are generally exhibiting positive year-to-date returns. The Hedge Funds Resource, Inc. Fund Weighted Composite Index is up 9.4% as of May 31, with some (but not all) of the worst performing strategies in 2008 exhibiting double-digit returns year-to-date in 2009. The industry has experienced significant outflows and fund attrition as

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leveraged strategies in particular were faced with government intervention, a global margin call, and frozen debt markets. As if that were not enough, news of massive fraud in a few large funds rocked the industry and investors alike. The global markets may have stabilized, but continued areas of displacement in various markets provide a favorable environment for hedge funds. We continue to believe that conservative, well-managed, multi-strategy hedge funds can provide an attractive source of risk-adjusted returns with low levels of correlation to traditional stock and bond markets.

In 2008, commodities gave up virtually all of their gains from the preceding five years as measured by the Dow Jones-USB Commodities Index. In 2009, commodity markets are up as renewed optimism about global demand has buoyed prices in certain sectors. Oil prices have strengthened off their earlier lows, and most (but not all) non-energy sectors have turned positive. Growth in large emerging market economies, such as China and India, provide a favorable demand backdrop for commodities, although event-driven disruptions, such as that caused by the swine flu scare, will undoubtedly fuel volatility in specific sectors.

Real estate as measured by the Dow Jones U.S. Real Estate Index finally rebounded, but returns remain in negative territory year-to-date as of early June. Rising unemployment and muted consumer spending translate into a challenging market for demand and reduced operating incomes. Debt financing remains scarce and expensive. However, some REITs have been able to raise equity capital, albeit dilutive to shareholders, and the market has rewarded companies that have been proactive in de-leveraging their balance sheets. For many REITs, survival is still the focus, and the industry may be characterized by consolidation over the next couple of years. Private equity has continued to experience a supply/demand imbalance, as suppliers of capital have pulled back while tight liquidity has increased opportunities, but anecdotal evidence indicates that the imbalances may be abating.

Our focus on hedge funds remains in conservative, multi-manager funds and unlevered single-manager hedge strategies. We note that some hedge funds strategies are now available in mutual fund structures. This makes hedge fund strategies accessible to virtually all investors and the funds can provide an important source of diversification. While the conservative funds we employ at Commerce Trust may not participate fully in a rapidly rising market, they can provide a cushion in falling markets. Also in the alternatives arena, we continue to view commodities favorably given current valuations.

CONCLUSION

When the fall of Lehman Brothers hit the investment markets, the financial and economic world changed. Gradually, both financial and economic conditions are heading back to pre-Lehman collapse readings.

We are not out of the woods yet. Rising unemployment and substantial underemployment will undermine confidence and drive a continued increase in the savings rate. Ongoing foreclosures and the overhang of housing units will keep pressuring real estate markets. Tighter capital requirements and sensitivity to losses will keep a lid on bank lending. Higher taxes and charges as local and state governments address budget shortfalls will constrain spending. With all these headwinds, going forward we appear to be facing a weak economic recovery. Inasmuch as we characterize the recovery as weak, it is good after a long series of setbacks to say the markets have finally bottomed.