



Market OUTLOOK

2008 Economic and Financial Market Outlook — January 2008

“It was the best of times; it was the worst of times...” (Charles Dickens)

U.S. Economy Hopes to Steer Past Turbulence

INTRODUCTION

The past year was one of extremes. The economy started the year very slowly, showed strong growth during the summer, only to end the year on a much weaker note. The stock market, after four years of unprecedented low volatility, resumed its more typical roller coaster ride. Although stocks look to finish the year in positive territory, they tested investors' mettle by correcting nearly 10% on two occasions. As we approach year-end, the housing downturn remains everyone's primary concern as it continues to gradually spill over into broader parts of the economy. While we think the economy will be able to skirt a recession, the downside economic risks have clearly increased.

To this extent, financial problems and recessionary predictions have grabbed the headlines recently. We like to point out that historically there are two causes of recession. One cause is a period of overly accommodative monetary policy followed by an abrupt turn toward policy restraint. The other is the result of adverse shocks to the system, severe enough to seriously impact aggregate demand. It would be easy to argue that both of these conditions were and

are present as it pertains to housing and the mortgage market, but less so relative to the overall economy. Fortunately, the Federal Reserve has begun to recognize that the chill from the housing crisis is much closer to turning into a full-blown cold, if not pneumonia. To prevent these ill effects, they are likely to err more on the side of easing credit. Lower interest rates are the general prescription to ward off the recessionary symptoms, which have included a consumer spending slowdown, financial market turmoil and credit problems in the banking sector.

ECONOMIC OUTLOOK

We end the year 2007 in similar fashion to the way we ended 2006, with the U.S. economy downshifting from above-trend growth to much slower growth, while the emerging world economies mostly continue to expand. **(CHART 1)** This should persist for at least the first half of 2008, if not the entire year, as the economy grapples with the ongoing housing recession (which we expect to bottom in mid-2009). In the meantime, the housing crisis continues to unfold in unprecedented fashion. It's accompanied by increasing mortgage delinquencies, massive subprime losses, foreclosures

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The Commerce Trust Company

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CHART 1
REAL GROSS DOMESTIC
PRODUCT (in percent)
GDP is expected to decline to
1.0% in the fourth quarter.
Below-trend growth rate of
1.5% is expected for the first
half of 2008.

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



that will reach record levels, large swaths of unoccupied inventory, and -- for the first time since the Great Depression -- falling average home prices nationwide. We find it hard to believe that this housing shock, which has already begun to modestly spill over into the broader economy, won't continue to remain a headwind throughout all of 2008 and into 2009. While third-quarter Gross Domestic Product (GDP) posted resilient growth, led by exports and an inventory build-up, the fourth quarter is likely to have slowed closer to a stalling speed.

As if housing were not enough, the U.S. economy also continues to confront the ongoing headwind of rising commodity and energy prices (CHART 2), and a brand new problem, access to credit that has become more difficult and expensive to obtain.

Despite the obvious problems, we think a recession can be avoided. Amazingly, employment growth remains positive, albeit at a slower trend. With corporate profits still near record highs, businesses continue to hire more workers than they fire. We've never had a recession without negative job growth!

(CHART 3) The Federal Reserve (Fed) has already cut short-term rates by 1%, and they have room to do more. Treasury rates are already exceptionally low and mortgage rates have started to modestly decline. We believe that the Fed will maintain a proactive stance as they are facing less inflationary angst as the economy cools. After reaching a high of 2.9% last September, core CPI inflation (excluding food and energy) has trended lower to 2.2% as of October. (CHART 4) And despite all the hand-wringing accompanied by the falling dollar, export prices are now much more competitive and our export machine is running on all cylinders. Recent measures of export growth have offset the economic impact of the collapse in residential construction nearly dollar-for-dollar.

While we can't rule out an economic contraction, many of the normal recession predictors are missing. We face significant challenges to continued growth, but we believe the economy will avoid an outright recession primarily due to (1) the resilience of the U.S. economy; (2) strong corporate profits; (3) foreign growth and a weak dollar that support exports;

(4) a consumer that won't go into hibernation if they are employed; and (5) a Fed that will continue to deliver additional rate cuts as needed.

FIXED INCOME OUTLOOK

The year started out calm for the bond market and is finishing with a significant degree of turbulence. Questions remain on the depth and breadth of the subprime mortgage problem. (CHART 5) Who will ultimately bear the losses on these bad mortgages and all of their mutant offspring of acronyms (ABCP, CDOs, SIVs, etc.)? What will Federal Reserve Chairman Bernanke do to help matters? When will the write-downs end?

Despite higher levels of anxiety and the widening of yield spreads during the year, 2007 returns for the bond market were much higher than last year's 4.33% return (as measured by the Lehman Aggregate Index). Declining interest rates have largely offset the negative impact of credit spread widening.

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 mid-year the inversion was gone, and a more traditional upward sloping yield curve formed. (CHART 6) As we end the year, the upward slope remains with yields down significantly across the yield curve. After hitting a five-year high of 5.29% in June, the 10-year Treasury has recently bottomed at 3.84%.

Around mid-year, the yield premiums enjoyed by holders of non-Treasury bonds had tightened to historical lows. Investors desperate for yield chose to ignore rising risks. When subprime problems were revealed, investors became alarmed and liquidity began to dry up. The problems at the nation's leading financial companies, and fear of further write-downs and larger losses related to subprime mortgages, remained at the core of the market's nervousness. Wider spreads resulted, as investors began to demand a greater risk premium. (CHART 7) Credit spreads have moved to their widest levels since 2002.

During the later part of the summer, the Federal Reserve acted to ease concerns by cutting the discount rate and reducing the Fed Funds rate. The Fed was pushed to act when subprime mortgage problems filtered into the \$1 trillion asset-backed commercial paper (ABCP) market and liquidity pressures mounted in the banking industry.

Despite all of these negative developments there is some positive news. Most financial institutions (especially banks) are well-capitalized and therefore reasonably well-positioned to ride out this storm. The sizable amount of new issuance from the

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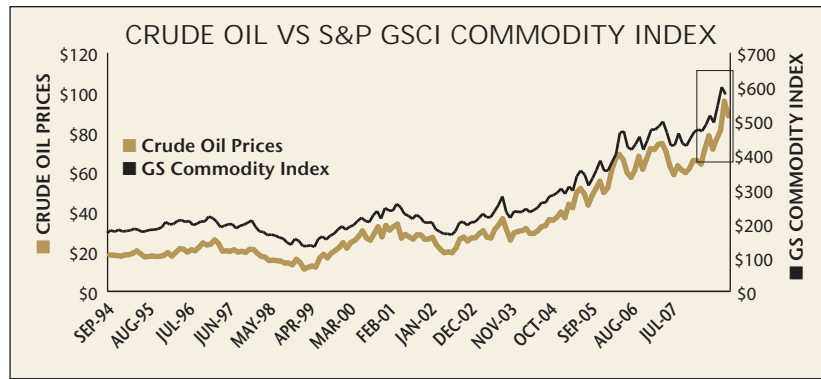


CHART 2
CRUDE OIL VS S&P GSCI
COMMODITY INDEX
Energy prices resumed their upward trajectory in the second half of 2007.

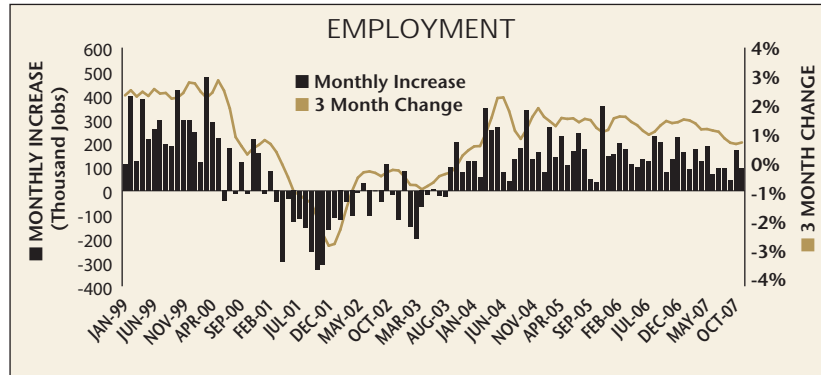


CHART 3
EMPLOYMENT
Employment growth remains positive and this should help reduce the chances of a recession.

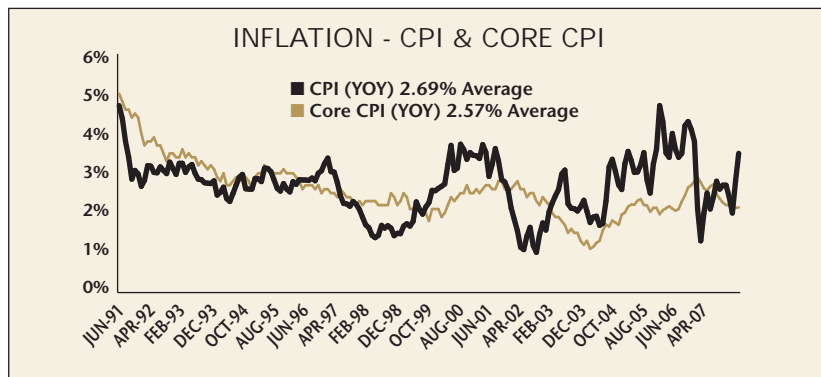


CHART 4
INFLATION —
CPI & CORE CPI
Recent declines in "core" inflation have eased pressure to raise interest rates.

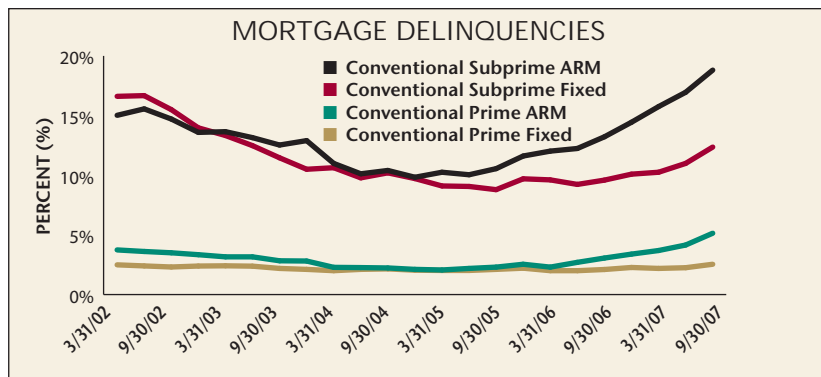


CHART 5
MORTGAGE DELINQUENCIES
Mortgage delinquencies have dramatically increased in the last six months.

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investment grade bond market has been able to pick up the slack from the shrinking commercial paper market. Corporate balance sheets in general are healthy and are not searching for as much external financing.

For 2007, Treasuries finished as the top-performing fixed income sector. Risk aversion caused corporate bond and mortgage-backed securities to lag well behind Treasuries. Lower interest rates, helped in part by the Fed's rate cuts, pushed bond prices up for all fixed income sectors.

Municipal bonds did not fare as well this year relative to taxable fixed income sectors, but they managed to have positive coupon-like returns for the year. The ratio of municipal to Treasury bond yields was close to its five-year moving average of about 87% for the first half of the year; however in the second half it had climbed close to 100% across the curve. Municipal bonds became cheaper due in part to concerns over the underlying strength of the financial guaranty firms that insure a large

portion of the municipal market. Additional downward price pressure came from heavy new supply, with 2007 on pace to break the new issuance record set in 2005. Low current valuations help make the coming year look promising, and we expect municipal bonds to outperform Treasuries.

As we enter 2008, the taxable bond market seems likely to remain volatile as financial intermediaries work through the liquidity crunch and economic growth slows. As a result, credit spreads are also likely to remain wide in the near-term. Longer-term, a reduction in market fears and volatility should allow spreads to partially recover, which will help both mortgage-backed securities and corporates outperform Treasuries. Fewer leveraged buyouts (LBOs) and better underwriting should also help both of these sectors. Our fixed income strategy is to look for opportunities in the finance sector, in particular, and across the entire investment grade credit spectrum. To manage risk we will continue to focus on diversification and avoid interest rate

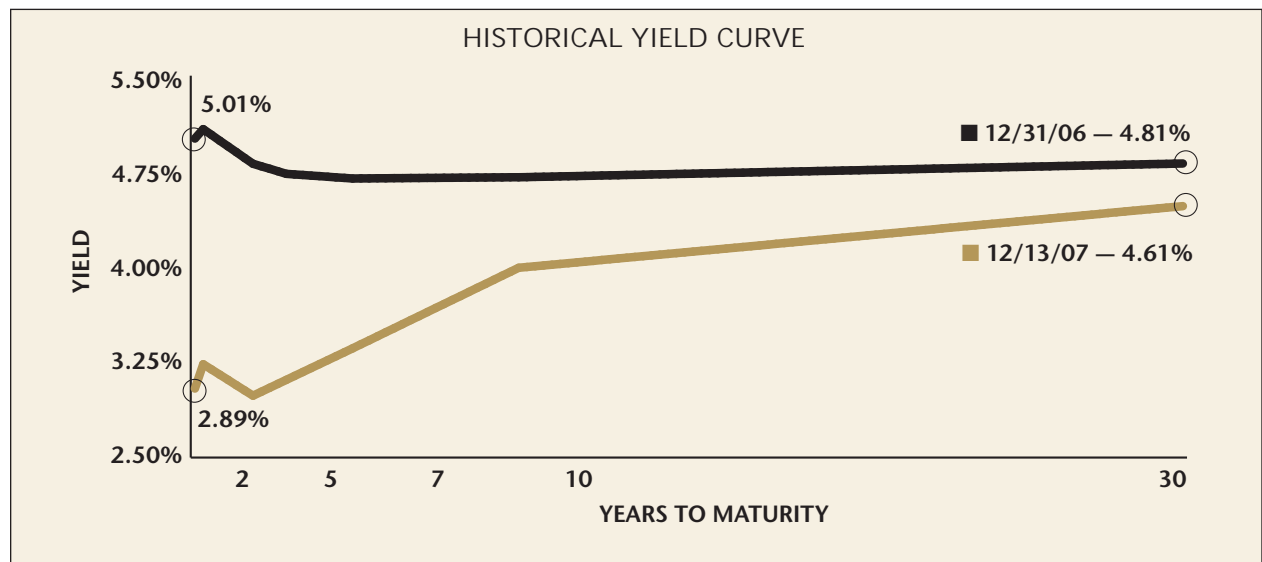
timing in order to generate consistent outperformance relative to our peer group and benchmarks.

EQUITY OUTLOOK

Now that you have reached the equity segment you have probably learned more than you ever wanted to know about subprime lending. Over the last several months, the Standard & Poor's 500 Stock Index has suffered both a 9.5% correction and a 10.1% correction only to stabilize and recover. This occurred as investors tried to quantify the ultimate losses in the financial markets caused by subprime securities and the resultant tightening of the credit markets. Our 2008 equity outlook assumes the financial system will work its way through the current issues. We enter 2008 recommending a tactical overweighting of stocks relative to bonds compared to the client's strategic target allocation, but admit we could change quickly if the credit crisis further intensifies.

At the start of 2007, we believed the stock market was undervalued using the "Rule of 20".

CHART 6
HISTORICAL YIELD CURVE
12/31/06 - 12/13/07
Interest rates have declined and a more traditional upward sloping yield curve has formed.



We are again revisiting the “Rule of 20” (R20) to measure valuations as we enter 2008. (CHART 8) As a reminder, the rule simply states that the Price/Operating Earnings ratio (P/E) of the S&P 500 plus the rate of inflation should average a 20x multiple over time. We ended 2006 with a multiple of 16.9x, the lowest level in more than ten years, although 1994 and 1995 were close.

Low valuation levels have helped cushion the financial trauma over the last six months. We anticipate that the R20 multiple will rise to 20.3x at year-end 2007, as financial company earnings have plunged, causing overall corporate operating earnings to increase only 1.5% instead of the 9% investors had been expecting earlier in the year. The financial sector is a key because it normally makes up 30% of the S&P 500 earnings. Another factor driving the R20 multiple higher has been surging oil prices, which have driven top-line inflation to 3.5% on a year-over-year basis through October.

We have made the following assumptions for the “Rule of 20” in 2008. S&P 500 operating earnings will increase 15% and inflation will decline to 2.5%. If the S&P 500 Index sees price increases of 10% in 2008, the R20 multiple would decline to 17.4x by year-end, implying a currently still-undervalued market. These assumptions assume slow growth for the U.S. economy, but no recession and oil prices not rising materially above \$100 a barrel.

In our 2007 Outlook, we re-emphasized our belief that growth stocks looked more attractive than value stocks -- and for the first time in eight years, growth issues have outperformed value by over 10% year-to-date. Our work suggests that this trend will remain intact in 2008 as value stocks (heavily dominated by financials) face continued headwinds from the subprime fall out. In our view, successful stocks will continue to be companies whose revenue is generated largely outside the United States. While the economies in the United States, Europe and Japan

all appear to be slowing, emerging markets continue to boom. Emerging markets economies now account for roughly 30% of the world economy. Many of these countries’ economies are growing 6% to 12%. Technology, materials, energy and health care companies have heavy exposure overseas. Retailers, homebuilders and financials, each heavily dependent on the U.S. consumer, will likely continue to struggle. Lastly, we expect the trend of Large Cap stocks outperforming Small Cap stocks will continue as their international revenue exposure is greater.

INTERNATIONAL OUTLOOK

Non-U.S. equity markets have gained 13.7% during the year-to-date period ending November 30th, as measured by the Morgan Stanley EAFE international index in dollar terms. Overall, stocks were buoyed by positive corporate earnings, strong global economic growth and rising commodities prices. During late summer, however, equity

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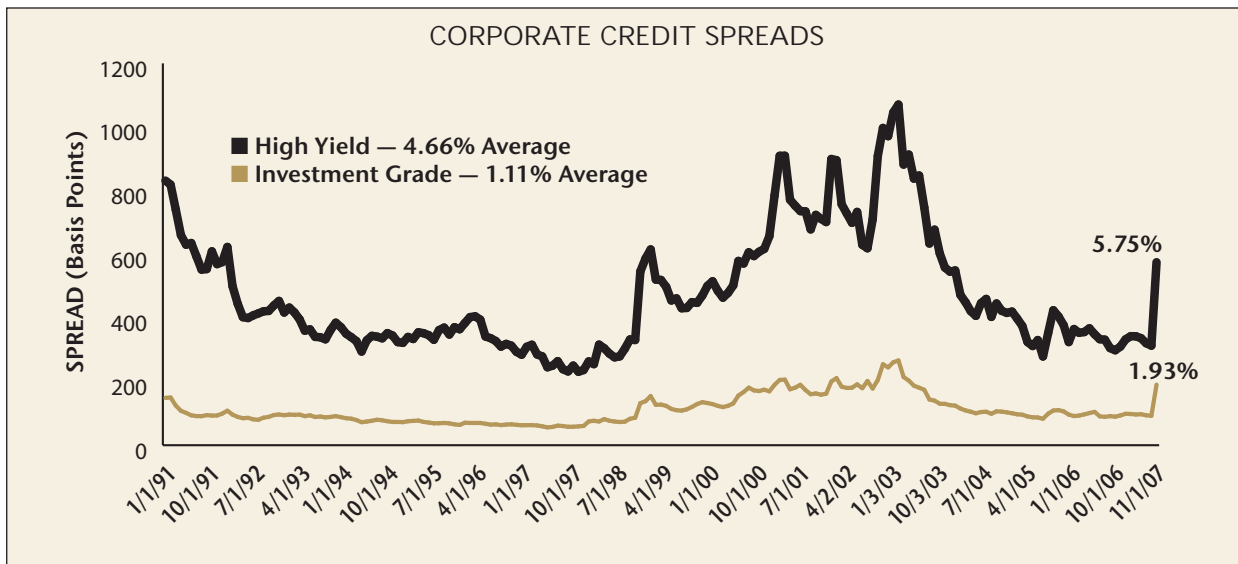


CHART 7
CORPORATE CREDIT SPREADS
12/31/90 – 11/30/07
Credit spreads moved to their widest levels since 2002.

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volatility rose back in line with historical averages due to concerns about the U.S. subprime mortgage market. This caused credit markets and other asset classes to deteriorate. Meanwhile, a contraction in risk-appetite and global liquidity in mid-August prompted several central banks to inject additional funds into their respective banking systems.

Two successive interest rate cuts by the U.S. Federal Reserve in September and October helped equity markets recover somewhat. Still, continuing concerns about the subprime mortgage sector hurt stocks in November, especially after several financial companies announced significant write-downs of assets. In addition, a downward revision of 2008 growth by the Fed weighed on investor sentiment.

In hedged terms, most sectors gained during the eleven-month period, led by the materials sector, which was buoyed by robust demand for metals. On the other hand, the financials sector underperformed. Growth stocks held up better than value stocks, as the MSCI EAFE Growth index gained 19.0%, compared to an 8.5% advance by the MSCI EAFE Value Index in dollar terms. The growth style's resurgence reflects investors' renewed appreciation of superior earnings growth potential after a long period when widespread strong earnings made it seem not worthwhile to pay a premium for superior growth.

POLITICAL OUTLOOK

Even though we are still a few weeks away from the first Presidential primaries, it is likely that 2008 will be even more affected by political cross-currents than is usual in the four-year cycle. While not a forecast, it is certainly possible that a Democrat will be inaugurated in January, 2009 as the 44th U.S. President. Moreover, our working assumption is that the new Presi-

CHART 8
"RULE OF 20"
The Price/Operating
Earnings ratio (P/E) of the
S&P 500 plus the rate of
inflation should average
20.0x over time.

YEAR	AVG PX S&P 500	S&P 500 OP EPS	AVG P/E +	CPI =	TOTAL
1967	89.0	5.33	16.7	3.0	19.7
1968	98.1	5.76	17.0	4.3	21.3
1969	97.7	5.78	16.9	5.5	22.4
1970	81.4	5.13	15.9	5.8	21.7
1971	97.5	5.70	17.1	4.2	21.3
1972	110.4	6.42	17.2	3.3	20.5
1973	106.2	8.16	13.0	6.3	19.3
1974	81.0	8.89	9.1	11.0	20.1
1975	82.8	7.96	10.4	9.1	19.5
1976	99.4	9.91	10.0	5.8	15.8
1977	98.9	10.89	9.1	6.5	15.6
1978	97.0	12.33	7.9	7.6	15.5
1979	103.7	14.86	7.0	11.3	18.3
1980	119.4	14.82	8.1	13.5	21.6
1981	125.5	15.36	8.2	10.4	18.6
1982	122.7	12.64	9.7	6.2	15.9
1983	155.5	14.03	11.1	3.2	14.3
1984	159.1	16.64	9.6	4.4	14.0
1985	187.9	14.61	12.9	3.5	16.4
1986	228.8	14.48	15.8	1.9	17.7
1987	280.4	17.50	16.0	3.6	19.6
1988	263.2	24.12	10.9	4.1	15.0
1989	317.6	24.32	13.1	4.8	17.9
1990	332.2	22.65	14.7	5.4	20.1
1991	364.3	19.30	18.9	4.2	23.1
1992	417.9	20.87	20.0	3.0	23.0
1993	450.0	26.90	16.7	3.0	19.7
1994	459.1	31.75	14.5	2.6	17.1
1995	540.4	37.70	14.3	2.8	17.1
1996	677.8	40.63	16.7	2.9	19.6
1997	860.4	44.01	19.6	2.3	21.9
1998	1085.0	44.27	24.5	1.5	26.0
1999	1326.9	51.68	25.7	2.2	27.9
2000	1427.4	56.13	25.4	3.4	28.8
2001	1193.8	38.85	30.7	2.8	33.5
2002	995.3	46.04	21.6	1.6	23.2
2003	964.9	54.69	17.6	2.3	19.9
2004	1131.1	67.88	16.7	2.7	19.4
2005	1207.3	76.45	15.8	2.9	18.7
2006	1307.8	87.72	14.9	2.0	16.9
2007	1465.0	89.00E	16.5	3.8	20.3E
AVERAGE			15.2	4.7	20.0
2008	1617.0E	102.00E	15.8E	2.5E	18.3E

dent will be working with a still Democrat-controlled Congress. In that event, virtually every facet of the domestic economy and foreign policy will be up for review and serious change considered. The Iraq and Afghan conflicts, tax policy and health care are three major topics that come immediately to mind.

Investors need to pay very close attention to what changes are being proposed for future capital gains and dividend tax rates, both currently at 15%. We are beginning to see competent analysts forecast that under a fully Democratic party-controlled government, capital gains rates could move as high as 28% and dividend tax rates move all the way to the ordinary income tax rate, eliminating any special treatment. If this view becomes more likely as the year progresses, we plan to review portfolio positions with large capital gains to see if it makes sense to begin taking some capital gains at the lower current rate. Partially offsetting these possible tax rate increases, we expect serious consideration of eliminating the alternative minimum tax and replacing it with some form of regular tax rate treatment of "carried interest" income earned by hedge fund and venture capital managers.

CONCLUSION

World financial markets have been very volatile in the last half of 2007 due primarily to the uncertainty caused by the shattering of the U.S. subprime mortgage

market. We believe that the housing and mortgage markets will continue to be a major headwind throughout 2008 and well into 2009. Partially offsetting this constraint is the effect of the weak dollar, which is making exports much stronger than usual. Today, there is widespread anticipation of a 2008 recession for the U.S. economy. While certainly possible, that is not the highest probability in our view. We see slower GDP growth for 2008, perhaps in the area of 1.5% with reasonable inflationary prospects.

In the fixed income markets, we expect both municipal and corporate bonds to outperform Treasury issues in 2008. Credit spreads will remain wide, but investors should be able to begin identifying undervalued issues. Diversification will continue to be a key tactic for success.

In the equity market, our forecast is that the trends currently well underway will persist for much of the year. Among those are growth issues beating value, large companies beating medium and small, international beating domestic and developing international markets beating developed country markets.

Lastly, no Presidential election year can ignore politics. This one will be no different. Our working assumption is that Democrats will continue to control Congress and win the White House this coming November. We will be focused on the various tax proposals that will be run up the flag pole during the

election season. Accordingly, we will consider recommending that clients take gains in 2008 in anticipation of higher gains tax rates in 2009 and beyond.



Market **OUTLOOK**

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