Commerce Trust 2024 Economic Outlook

Discovering Opportunities Amid Uncertainty

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In our 2023 Midyear Outlook, entitled "Resilience During Uncertainty," Commerce Trust noted the global economic and investment environment was surrounded by a general sense of uneasiness, yet still showed signs for growth.

In the face of continued slowing economic conditions and market volatility, which we cover in the following pages of the report, economic resilience proved to be a recurring theme in 2023 with the surprisingly strong third quarter economic report, the consistent pace of consumer spending fueling that economic growth, and the emergence of a late-year rally in the stock market after months of volatility.

Now, as the new year approaches, Commerce Trust believes uncertainty stills casts a formidable shadow over the economic landscape despite the signs of encouragement seen over the past 12 months. However, we look ahead to 2024 with confidence in Commerce Trust's team of seasoned wealth management professionals and their ability to help clients navigate the near-term market conditions that may lie ahead to focus on their longer-term financial goals.

It is with this mindset that the Commerce Trust Investment Management team provides our views in the **Commerce Trust 2024 Economic Outlook: Discovering Opportunities Amid Uncertainty.**

If you have questions whether your financial goals are aligned to withstand today's economic environment, the Commerce Trust team is here to serve you.

Thank you,

David M. Hagee
Chief Investment Officer

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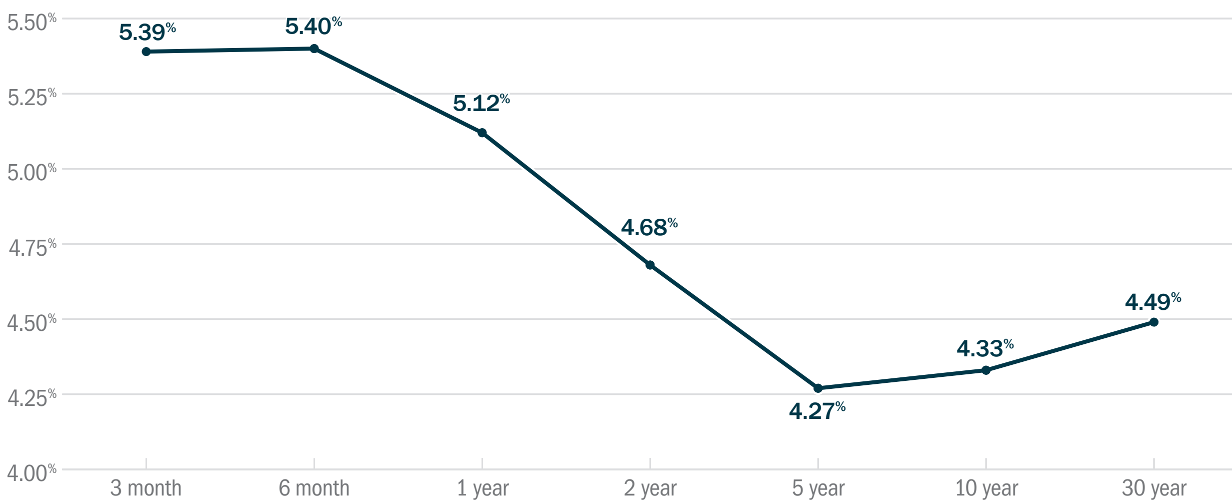
Do recessionary conditions finally catch up to the U.S. economy?

In our Midyear Outlook, Commerce Trust was concerned that aggressive Federal Reserve (Fed) policy, the inverted yield curve (Chart 1) and falling leading economic indicators were driving the U.S. economy into a marked slowdown, if not a recession arriving sometime in late 2023 or early 2024. Surprisingly, U.S. economic growth remained resilient, even accelerating, through the second half of 2023 despite steadily rising interest rates. We now estimate real gross domestic product (GDP) growth for 2023 will be close to 2.5% once the final numbers are tallied — much stronger than initially anticipated.

Chart 1: U.S. Treasury Yield Curve *As of 11/30/2023*



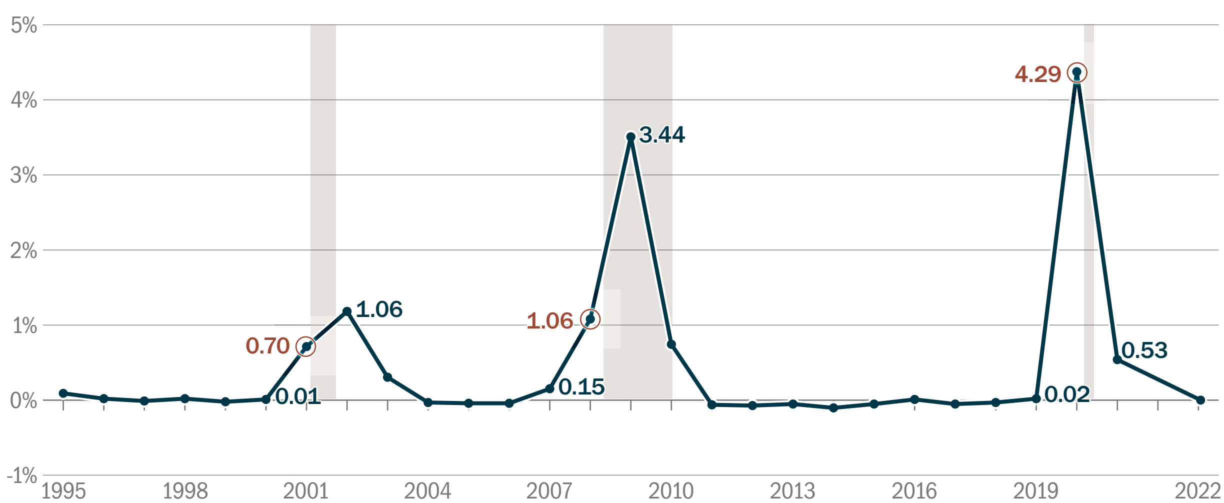
Source: Bloomberg, Commerce Trust.

We now believe the Fed is likely to adopt a position of holding interest rates steady for a longer period as the U.S. central bank assesses how the economy will ultimately react to its restrictive monetary policy stance. We still expect U.S. GDP to cool materially in 2024 due to the lagged effects of the Fed's aggressive rate-hiking policy, tighter bank lending standards and restrained employment growth, which are key drivers of incremental economic activity. However, the odds of a soft landing have increased as inflation cooled faster than expected in 2023. This disinflationary trend could be far enough along by next year to allow the Fed to ease its restrictive monetary policy were the economy to falter. While we expect strains to become much more noticeable as 2024 progresses, the Fed will probably be in position to combat a slowdown by lowering interest rates and bypass a potential recession.

Still, restrictive monetary policy becomes more impactful over time, offsetting continued resilience in the real economy. We believe 2024 GDP growth could slow toward 1.0% as the headwinds of higher interest rates, quantitative tightening, and distance from all the fiscal stimuli could hinder economic growth. As such, domestic demand faces crosscurrents, particularly if employment cools as we expect, and softer wage gains weigh on consumer spending.

From a credit perspective, bank lending continues to tighten as charge-offs increase and commercial office property continues to weigh down smaller lenders. Other drags could come from some fiscal restraint, a slowdown in non-residential construction and less availability of residential housing as home affordability just reached all-time lows. Adding back to growth will be exports, which could benefit from a weaker U.S. dollar, but will wrestle with the impact of China's slowing economy.

Chart 2: Sahm Rule Recession Indicator *(Unemployment rate three-month moving average, 1995–2022)*



KEY
- ○ *YOY increase in unemployment rate of 0.5% or greater*
- *U.S. recessions*

Source: Federal Reserve Bank of St. Louis, Claudia Sahm

Ultimately, labor demand is the key to unlocking the question of whether the U.S. falls into recession. While job growth is slowing, it has not experienced the precipitous drop that historically coincides with a recession. A continued increase in the work force participation rate and a rise in immigration will likely contribute to slightly lifting the unemployment rate in 2024.

However, unemployment is already slowly rising. One recession indicator, known as the Sahm Rule, signals the start of a recession when the three-month moving average of the unemployment rate climbs by at least one-half percent from its low during the previous 12 months (see Chart 2.) The low point for the three-month average of unemployment last year was 3.5% and has recently increased to 3.8%. Commerce Trust continues to monitor this moving average as a possible predictor of an economic contraction.

We think U.S. fiscal expansion has peaked for now. Recent drivers of the expanding federal budget deficit, most notably deferred tax revenues and boosts to infrastructure and clean energy spending, are likely to be in the rearview mirror in 2024. Any compromise by Congress in the near term to pass a budget will likely lean toward fiscal restraint, as the U.S. budget deficit has averaged an unsustainable 9.3% of GDP over the past four years.

U.S. fiscal expansion likely has peaked for now.

Fortunately, disinflation continues, led by outright core goods deflation in 2023 and a deceleration in services inflation against a backdrop of lower commodity prices, which have already moderated substantially. We see inflation, as measured by the core Personal Consumption Expenditures Price Index — the Fed's preferred measure of inflation — slowing from a 3.5% clip on a year-over-year (YOY) basis as of October 2023 to 2.4% by the end of 2024. While 2023 was a story of reconnected supply chains and tighter monetary policy delivering a pronounced decline in inflation of goods, we believe 2024 will represent a continuation of the downward trend in overall inflation, as exceptionally elevated housing prices continue to moderate.

Unless there is a recession, Commerce Trust believes the Fed will likely hold the federal funds rate steady at 5.25%–5.5% for most of 2024 and anticipate policymakers to deliver a rate cut sometime over the second half of the year in response to what we expect to be a slowing economy and a clear trend of disinflation.

Our base-case scenario has the U.S. economy slipping into recession at some point in 2024. The lagged effects of monetary policy and higher debt servicing costs will likely bite harder than they did in 2023, while financial conditions tighten much like what we saw in spring 2023 during the regional bank crisis.

In addition, China finds itself in an ongoing debt-deflation cycle, despite trying to stimulate its own economy and improve relations with Washington. This could keep Europe close to recessionary territory and might pull the U.S. toward it. U.S. exports to China and other emerging markets, which should grow given the weaker dollar, instead could likely begin to reverse, only partly offset by even lower commodity prices. Ultimately, the tighter financial conditions and weak growth could trigger a monetary policy response during the second half of 2024 that attempts to mitigate a mild recession.

While one could craft an even more pessimistic forecast, it's certainly possible the expansion continues to surprise on the upside — just as it did last year. The likely reasons for this are fourfold:

1. Demographics that afford little room for unemployment to rise as boomers continue to retire and the overall working population grows very slowly.
2. Aggregate debt servicing costs are slow to rise as consumers converted much of their debt during the pandemic into fixed rate loans at record-low interest rates. Many of these have yet to mature or reset. For example, the average rate on outstanding mortgages is 3.6%. Similarly, corporate treasurers face minimal near-term debt maturities, and the flush coffers of state and local governments limit the need for new borrowing. This positive backdrop is noticeably offset by the growing federal deficit and the U.S. government's rather rapid increase in borrowing costs.
3. As hard as it is to imagine, COVID-19 stimulus has yet to run its course. In addition, deficits are slow to fall as infrastructure and Inflation Reduction Act spending ramps up.
4. The average economic expansion since the early 1960s has lasted for six-and-a-half years, and we are only three-and-a-half years into this recovery. The historically rapid tightening of monetary policy we just endured may have served to only dampen, and not cut short, the strongest nominal recovery we've had in over a generation.

Commerce Trust believes it is unlikely the U.S. economy skirts past a recession next year.

Bottom line, the Commerce Trust outlook leans toward a mild recession sometime in 2024, but it's likely to be a close call. If we avoid one, it will likely be due to the Fed coming to the economy's rescue with some well-timed interest rate cuts.

Geopolitical risks on the rise

We would be remiss if we didn't recognize several geopolitical wildcards that could influence both the global economy and the financial markets in 2024.

The turmoil in the **Middle East** threatens to disrupt one of the region's oldest and most contentious geopolitical fault lines. Meanwhile, the devastating war between **Russia and Ukraine** will soon enter its third year with no sign of a resolution in sight.

While both conflicts have had significant economic impacts in their immediate geographies, the broader reaction of the financial markets has been somewhat muted. As the world adjusts to the initial shock of these conflicts, markets begin to smooth out and discount the effects of these events. However, if one or both battles escalate into wider regional conflicts, repercussions would ripple across the global markets.

Another potential wildcard for investors and the markets is the **2024 presidential election.** The political divide in the U.S. going into 2024 — between voters and the political parties themselves — appears to be as wide as we've seen for quite some time. Political issues traditionally become back-burner concerns once the presidential primaries begin. However, simmering tensions could boil over, which could lead to disruptions to both the election cycle and to appropriations of the $6 trillion U.S. annual budget.

Opportunities for equities despite heightened volatility

Equities, as represented by the S&P 500 Index, rebounded in 2023 after experiencing significant losses in 2022. Led by the “Magnificent Seven” mega-cap stocks — Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla — the S&P 500 Index had a total return of 21% as of November 30, 2023.

However, deeper analysis of the index that tracks the 500 largest public U.S. companies reveals a different story. On a cumulative basis, the Magnificent Seven delivered nearly 72% returns through the end of November, while the remaining 493 stocks in the index returned 8%. On an equal-weight basis, the S&P 500 advanced just under 7% over the same period. This narrowness within equities has been a constant theme of 2023.

When extending the view since the end of 2021, we see broader weakness across the equity spectrum. The S&P 500 is down 1%, with both growth and value style stocks down around 3%. Smaller companies during this time have fared worse, with mid-cap stocks down 10% and small-cap stocks down 17%. Lastly, international stocks in developed markets retreated 4% over the same period, while those in emerging markets fell 16%.

As we enter the new year, Commerce Trust anticipates equities will face some similar challenges in 2024, along with a few new uncertainties. Although the rate of inflation fell throughout 2023, there is still work to be done to get inflation to the Fed’s 2% target. Likewise, interest rates remain elevated and are likely to stay that way for the foreseeable future.

Then there’s the 2024 presidential election. Equity markets tend to be flat or underperform during the first half of the year of a typical election cycle as uncertainty abounds with political power hanging in the balance. As the year progresses to election day and beyond, the markets historically rally as the political picture becomes clear.

Opportunities for exposure to the broader equity spectrum could occur in 2024.

We believe the U.S. economy will slow in 2024, possibly falling into recessionary territory at some point in the year. In past recessions, equity prices typically peaked on average two months before the downturn began, then declined two months into the recession. Equity price declines have averaged 10% when there are recessionary conditions but varied widely depending on the nature of each recession and the impact to earnings expectations.

Still, Commerce Trust sees the opportunity for equities to deliver positive total returns, but it will come with a fair amount of volatility.

Hence, we have taken a more defensive position in general regarding equities, while holding some cash in most portfolios. Commerce Trust believes an opportunity for investors to increase equity exposure and risk in their portfolios will present itself at some point in 2024. The window of opportunity can be short-lived, however, as the average recession since World War II has lasted only 10 months.

Beyond the anticipated slowing of inflation, another potential positive for equities is the possibility that interest rates stabilize or decline in 2024. Typically, the threat of rising interest rates is not beneficial to equity returns. The Fed started its rate hiking cycle in March 2022, and equity prices were under pressure until the last rate increase in July 2023.

We expect the Fed to pivot and cut interest rates sometime in 2024. Historically, lower interest rates have been a tailwind for equity prices, giving us an opportunity to increase our allocation to risk-based assets.

Sector views for 2024

Does big tech continue to lead the market?

Commerce Trust firmly believes that positive opportunities will present themselves in 2024, with greater emphasis on the fundamentals and quality of asset classes and sectors.

We continue to be positive on **information technology** as new business models and the necessary infrastructure to support them will likely continue to take profits away from other areas of the economy. Excitement surrounding artificial intelligence and other technologies will likely continue this trend for the foreseeable future.

As we enter the new year, we are positive on **healthcare** as companies recover from residual impacts of the pandemic and its aftermath. In addition, the sector's defensive growth characteristics are favorable in the likelihood of slowing economic growth in 2024.

We believe **industrials** — particularly the defense industry sub-sector — could perform well in the near term given the current state of heightened geopolitical tension. Lastly, we remain cautious on **real estate,** particularly with commercial properties as occupancy rates continue a multi-year downward trend and the current interest rate environment makes refinancing much more expensive.

Time for greater fixed income exposure?

Following 2022's record poor performance for fixed income markets, Commerce Trust was optimistic that a rebound in performance was in order in 2023. However, generally good news for the U.S. economy year-to-date has translated mostly into bad news for bond investors, as rising rates negatively impacted the value of existing bond portfolios. Treasury yields have spent most of 2023 following the Fed's lead as it raised the overnight federal funds rate another 1.00% in its continued battle with inflation. For example, having started 2023 with yields of 3.88%, the 10-year Treasury briefly traded above the 5% yield level in late October, a level not seen since 2007. Treasury yields have since dipped lower, with the 10-year offering a 4.33% yield as of November 30, 2023.

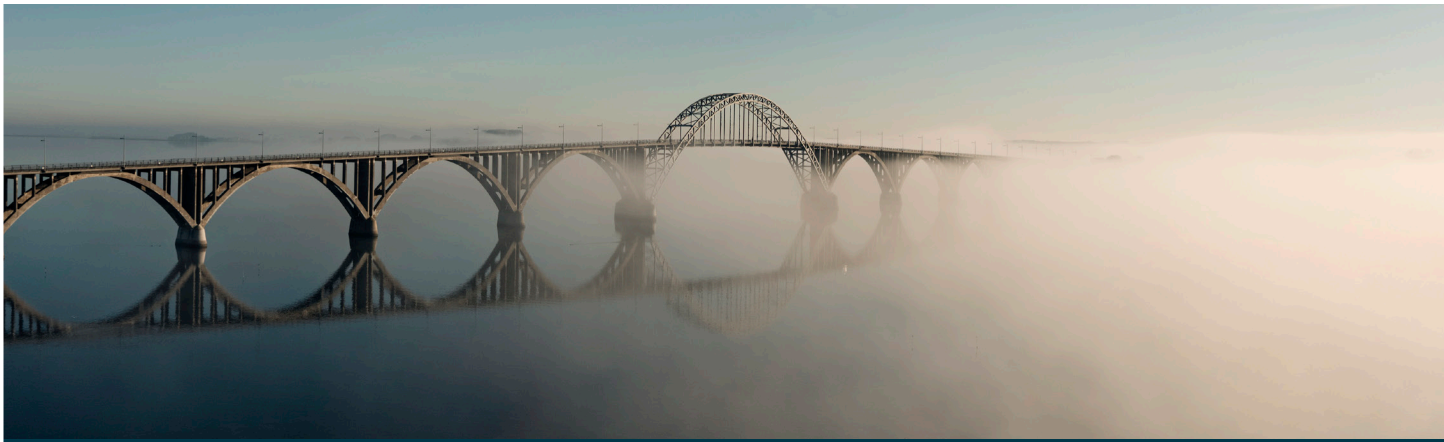
In October, the yield on the 10-year Treasury reached its highest level since 2007.

With the rising interest-rate environment as a backdrop, bond markets through November 2023 have delivered flat to modestly positive returns. Non-government sectors like corporate bonds — especially high yield "junk" bonds — and asset-backed securities have fared better than their U.S. Treasury and U.S. Agency-guaranteed counterparts. The broadest taxable investment-grade benchmark, the Bloomberg U.S. Aggregate Bond Index, has returned 1.64% through the end of November.

The tax-exempt municipal (muni) bond market has provided better returns than taxable bonds year-to-date, with the Bloomberg Municipal Bond Index up nearly 4%. The healthy economic backdrop has strengthened risk appetites in the muni market, with higher-risk revenue sectors outperforming general obligations and lower-rated securities outperforming higher-rated ones. Credit spreads have also been pushed tighter by a 13% YOY decrease in new muni bond issuance through the first three quarters of the year.

A notable silver lining to the Fed's aggressive rate-hiking campaign is that yields in the shortest end of the Treasury curve have become rather generous, with three- and six-month Treasury bills presently offering yields above 5%. But this windfall for yield-hungry savers also continues to flash a warning signal for the U.S. economy. Our Midyear Outlook delved into this indicator in more detail, but an inverted yield curve — where short-term rates are higher than longer-term rates — has preceded all 10 recessions the U.S. has experienced since 1955. While countervailing factors such as the surprisingly robust labor market and lingering fiscal stimulus suggest that a recession is not a slam-dunk this time around, we do believe the Fed has already made its last rate hike for the current cycle.

Therefore, whether an investor is looking to guard against the risk of recession or wanting to invest in longer-maturity bonds, which currently offer attractive yields, **Commerce Trust believes now could be an opportune time to build exposure to fixed income.**



A look at alternatives

When discussing hedge funds, keep in mind that they come in all types of different strategies and flavors. Some will have mostly equity exposure so they will have similar volatility and returns as the equity markets, while others will look to reduce risks and add diversification to a classic equity and bond portfolio with bond-like volatility. A host of others will be somewhere in between. While delivering negative returns in 2022, broad-based hedge fund indexes still outperformed the broader equity and bond markets. This year, the strategy has not kept pace with the strong equity market but has outpaced bonds as of November 30, 2023.

The interest rate regime experienced in 2023 is likely to carry through the first half of 2024. We believe this could bode well for hedge fund performance at a level not seen since after the Great Recession of 2007–2009.

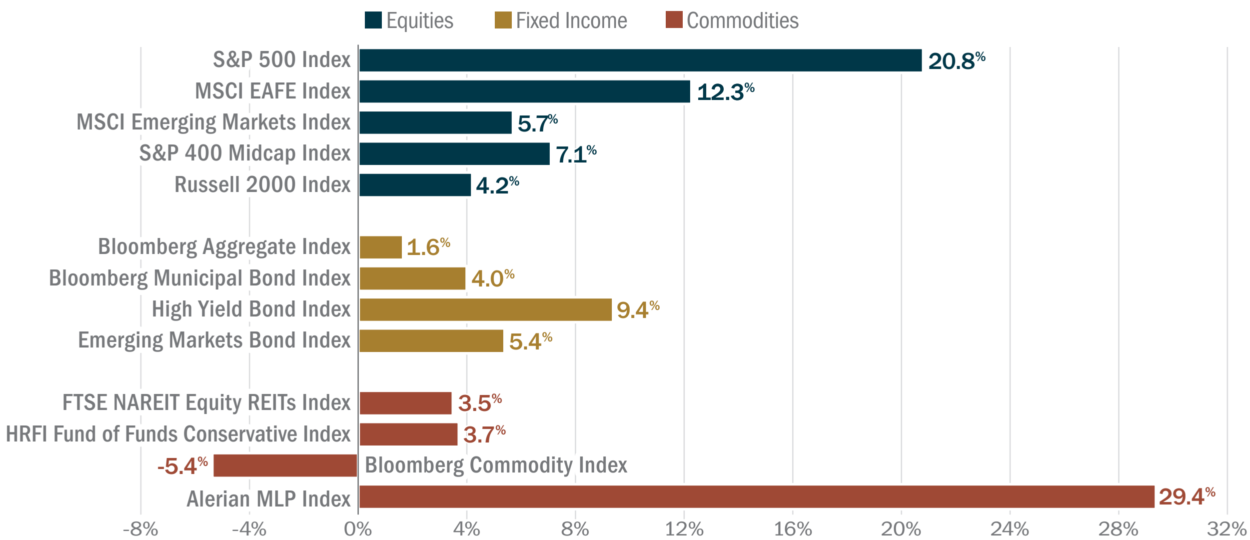
Commerce Trust continues to favor an allocation to hedged equity and absolute return strategies as a means of mitigating risk in an investment portfolio. Hedged equity strategies seek to improve the risk-adjusted returns of a diversified equity portfolio and have a lower risk profile than long-only strategies. Absolute return strategies, which seek to achieve positive returns regardless of the direction of the market, are employed to provide risk reduction to equity and fixed income allocations. The combination of these two strategies could provide some support to portfolios should there be an economic slowdown in 2024.

As with any investment portfolio, an allocation to hedge funds should be based on an individual investor's goals. At Commerce Trust, our financial planning and portfolio management officers work together as a team to ensure a client's investment portfolio is aligned with their unique comprehensive wealth plan.

How Commerce Trust has responded

From a portfolio management perspective, Commerce Trust continues to prefer domestic equities over international stocks. This is primarily due to the greater allocation within the S&P 500 Index to technology-oriented growth stocks (35%) in comparison to the international MSCI EAFE Index (8%.) We anticipate large-cap equities will outperform over the first half of 2024, with strong performance broadening out to mid- and small-cap stocks as the year progresses. Commerce Trust believes there are opportunities to be gained as this shift in market leadership unfolds.

Year-To-Date Performance By Asset Class *As of 11/30/2023*



Source: Bloomberg, Commerce Trust

Looking at investment style positioning for 2024, we find large-cap growth has outperformed value by 31% as of the end of November. However, those styles have had very comparable performance over a two-year span, which leads us to believe growth stocks are not as overvalued as some may think.

We believe emerging markets are likely to continue to underperform, primarily due to slowing economic conditions in China. As China comprises 30% of the country allocation to the MSCI Emerging Markets Index, this pressures other emerging market economies that supply raw materials to China.

Within fixed income, it's important to note that Treasury bond yields remain at levels not seen in more than 15 years. Commerce Trust believes investors could see bonds resume their role as a shock absorber for equity volatility in 2024. After a turbulent couple of years of high inflation and rising interest rates that challenged fixed income portfolios, bonds could again produce positive returns in the coming year.

Commerce Trust forecasts and portfolio biases

Highest Conviction

Short-term interest rates will plateau this year, and bond returns could be positive for both taxable and the municipal bond markets in this year.

- While we were 15% short our durational/maturity targets last year, we were much closer to even with our portfolio's benchmark maturity.
- We are also at a full allocation to bonds from an asset allocation perspective.

We have added to growth exposure to neutralize last year's value overweight.

- Early in the recovery, as expected, value dramatically outperformed growth. Now that the economy is slowing and earnings growth has moderated, growth is likely to re-bound.

We are slightly more defensive in general from an equity perspective.

- We are holding some cash in most portfolios (about 5%), and are underweight our equity exposure a similar amount.
- We remain overweight to alternatives and used those proceeds to increase fixed income back to our targeted bond allocation, particularly as the odds of a recession this year are high.

We maintain a reduction in high-yield exposure.

- We remain up in credit favoring Investment Grade Bonds and recommend minimal exposure to the riskier higher yielding sectors of the bond market.
- Higher quality typically outperforms in a slowing economy.

Mid-cap stocks are likely to outperform both large-cap and small-cap stocks.

- We prefer the higher profitability and stronger balance sheets of Mid Cap vs. Small Cap and the domestic orientation of Mid Cap vs. Large Cap equity.

Domestic stocks are likely to continue to outperform international markets.

- We are one-third underweight our International targets and expect the U.S. Dollar to remain relatively firm.

We are overweight international developed equity versus emerging market.

- 80% of our International allocation is in Developed Equity.

Lowest Conviction

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[1] As of Sept. 30, 2023

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