2022 Midyear Outlook

Surging Inflation, Shifting Markets

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As we approach the second half of 2022, the global economic and investment environment has rapidly downshifted and faces a much more uncertain outlook than it did at the start of the year. Several factors have triggered this change, none greater than global inflation rates surging to levels not seen since the 1980s. Behind this inflationary curve, global central banks have been forced to consider more aggressive monetary responses while trying to avoid policy missteps that could hinder economic growth. These actions, along with Russia's brutal invasion of Ukraine and persistent COVID outbreaks that continue to hamper already strained global supply chains, have added to the economic tumult and uncertain investment landscape.

This combination of headwinds is making investors highly anxious, leading to the rare market phenomenon when year-to-date (YTD) returns for both equities and bonds are negative. These conditions admittedly are a challenge, testing the resolve of even the most seasoned investors.

Despite this current uncertainty, Commerce Trust Company believes this is time to remain resilient and focused on a longer-term investment strategy. History shows that patient investors who remain focused on the long term may be better positioned to withstand market swoons like we're currently experiencing and to look for opportunities that shifting markets can present.

A changing economic outlook, but signs of optimism

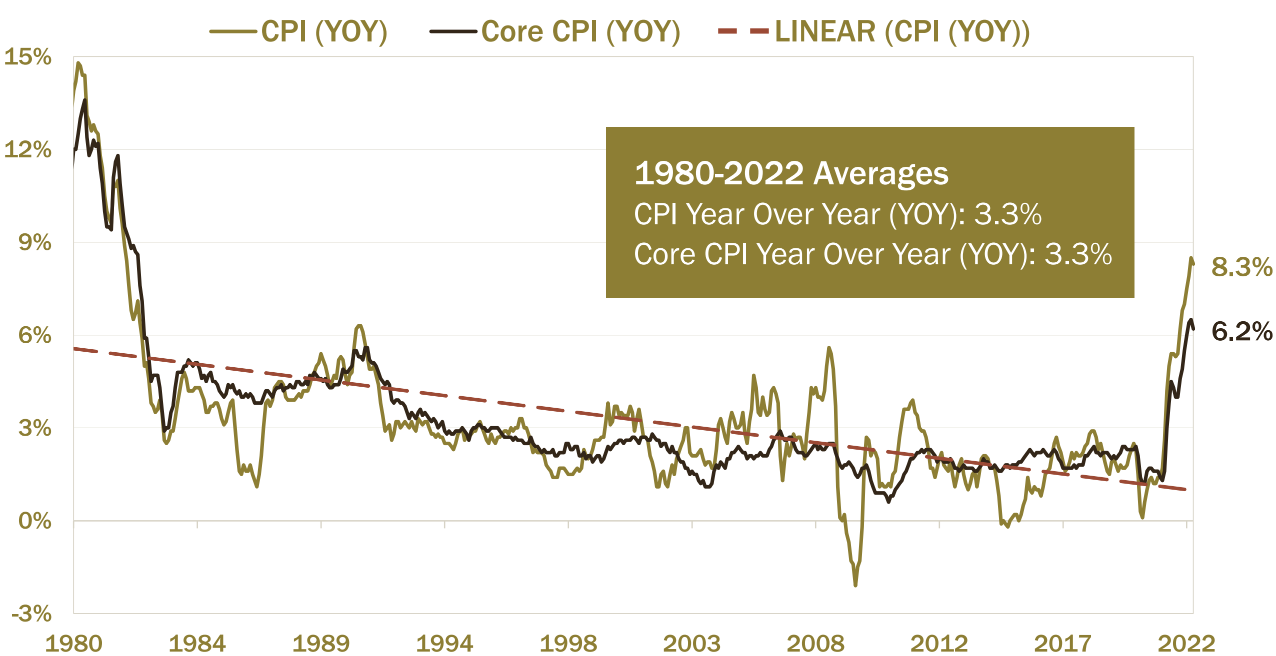
U.S. economic growth has cooled materially from last year. Real gross domestic product (GDP) for 2021 grew by 5.7%, the highest growth rate since 1984. Conversely, real GDP in the U.S. decreased at an annual rate of 1.4% in the first quarter of 2022.

Several factors are driving this slowdown. The 2021 rebound was fueled by the government's massive $5.7 trillion stimulus in response to the pandemic. Now, much of that fiscal support has faded. Inflation skyrocketed to a 40-year high, which caused the Federal Reserve (Fed) to abruptly pivot from its accommodative monetary policy and initiate a series of interest rate hikes. We expect the Fed to maintain its aggressive tightening stance through the summer, likely driving short-term rates toward a 2.5-2.75% range by the end of the year.

The U.S. central bank also signaled it would start shrinking its balance sheet by the second half of the year. This action is likely to add further interest rate pressure, as it could increase the supply of Treasury and mortgage bonds on the open market.

The Fed's hawkish moves in search of the elusive neutral rate — an interest rate level that neither spurs nor restricts economic growth — have tightened financial conditions on several fronts: surging U.S. Treasury rates, widening credit spreads and tumbling stock prices as investor anxiety rocked the equity markets.

Inflation Spikes to a 40-Year High



Source: Bloomberg

Meanwhile, geopolitical events sent shockwaves around the globe and further complicated the Fed's attempt to steer a soft landing of the U.S. economy. Russia's invasion of Ukraine triggered huge price spikes in commodities like energy, metals and foodstuffs, as well as muddled trade alliances and routes. In addition, China's "zero COVID" policy led to a two-month lockdown of Shanghai, the world's largest metropolitan area and busiest port, and further disrupted already strained global supply chains.

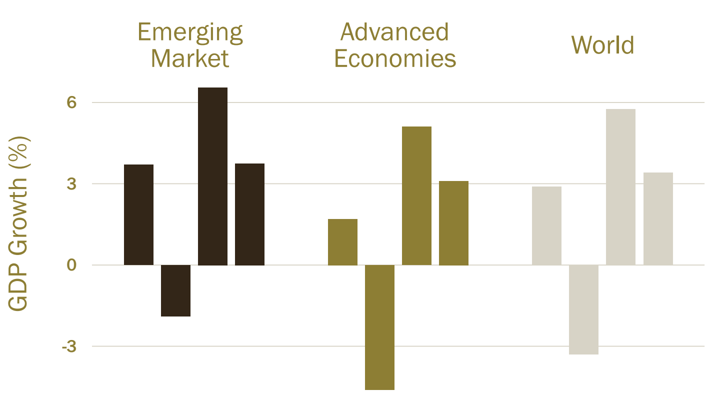
Domestically, residential real estate values continue to boom amid tight supply and extraordinarily high demand fueled by relatively low interest rates. In April, the median price of a U.S. home was a record $391,200 — up 46% over the past three years — according to the National Association of Realtors. However, some would-be home buyers have been pushed out of the market due to affordability challenges, particularly as interest rates climb, which in turn has led to the recent slowdown in home sales.

This combination of factors caused us to reexamine our economic forecast for the year. We now believe real U.S. GDP growth for 2022 is tracking at 3% or less, which is down from our initial estimate of 4% growth. Likewise, the World Bank and International Monetary Fund have cut their global economic forecasts.

Despite the somewhat uncertain economic picture, we believe there are signs for optimism. Inflation, as measured by the Consumer Price Index, possibly peaked at 8.5% in April and appears to be declining at a modest pace. Over the summer, we should see whether the Fed's plan to curb inflation is working.

U.S. employment remains surprisingly strong, and "help wanted" is still the mantra of our current recovery. Pent-up demand from consumers and high home equity values continue to spur consumption. Furthermore, the pandemic-induced, low-rate environment of 2020-21 allowed corporations to refinance debt service obligations and expand their bottom lines. While interest rates are on the rise, they are still low relative to historic longer-term averages.

Global Growth Cools During First Half of 2022



	Emerging Market	Advanced Economies	World
2019	3.7	1.7	2.9
2020	-1.9	-4.6	-3.3
2021	6.6	5.1	5.8
2022*(P)	3.8	3.1	3.4

Source: Commerce Trust Company, International Monetary Fund, World Bank

**Projections based on average of all sources*

Near-term recession? We don’t think so.

Some investors might assume a recession could be right around the corner. We don’t think a near-term recession is likely for three reasons:

Jobs, jobs, jobs. The U.S. unemployment rate was a healthy 3.6% as of May 2022, and the jobs market is still expanding. Historically, the U.S. has never entered a recession while we are growing jobs. While not impossible, it’s hard to believe employers could abruptly swing from hiring thousands of workers every month to reducing payrolls.

Solid economic indicators. The leading economic indicators — a combination of 10 underlying measures of economic activity that include building permits, money supply, the average workweek and stock prices — expanded 4.7% year-over-year through the end of April. On average, a recession starts six to 12 months after the leading indicators fall into negative territory.

Steep yield curve. Arguably, the bellwether predictor of a recession is a yield curve inversion, where the yield of a 3-month Treasury bill is greater than the yield on the 10-year Treasury bond for at least two months. The past eight times this has happened, a recession occurred on average one year following the inversion. The yield curve has flattened but has a greater-than-average upward slope of 1.8%, or 180 basis points, as of May 31, 2022. Simply put, we don’t believe we’re there yet.

Equities: Balancing volatility and perspective

There’s no easy way to put it: the global equity markets have been dismal so far in 2022. Most indices have posted double-digit negative returns, as anxious investors come to grips with our shifting economic backdrop. The S&P 500 Index is down almost 14% from its January high. Of the 11 major sectors the S&P 500 follows, energy has delivered the most significant gains for the year and is up 58% as of May 31, 2022. Utilities is the only other sector in positive territory over the same period.

So, what are our expectations for the remainder of 2022? The level of market turbulence we’re seeing currently suggests this drawdown has yet to run its course. Still, we think much of the pain has already been felt, and further downside is likely to be limited.

We expect corporations will need to continue to battle rising costs as they navigate tight labor markets and ongoing supply chain disruptions. Nonetheless, we don’t foresee a near-term collapse in economic growth, so we anticipate corporate earnings to remain relatively strong, making for attractive valuations.

However, it is our position that inflation needs to retreat before the equity markets start moving higher on a sustainable basis. U.S. inflation has dipped from its high in April, and we hope it continues to roll over sooner rather than later. We expect the markets to remain choppy until we see how the Fed’s inflation fight works out and commodity prices begin to taper. Our analysis suggests the rate of inflation needs to decline to around 7.75% before we see the equity markets materially stabilize.

A closer look at the S&P 500 Index

We believe it's important to provide some historical perspective on the declines we've seen in equities this year. Over the past 100 years, stocks have delivered to investors an average annual return of around 10%. Along that growth trendline, the markets on average experience a decline of between 15-20% roughly every two years. In addition, we have seen market corrections of 20% or more approximately every three years.

To further illustrate this trend, let's look at market activity over the past few years. An investor who was in the S&P 500 from Dec. 31, 2017, through May 31, 2022, has experienced the following:

- A 20% correction in 2018
- 2020's pandemic-fueled 35% nosedive
- The current decline of nearly 14%

Over that same time, the S&P 500 has delivered a total return of nearly 67%, with an annualized rate of return of 12.4%. In addition, we experienced the fastest market upturn ever following the trough in March 2020, and the quickest doubling of stock prices. While market downturns are never pleasant, it's important to put this current version into context. We appear to be giving up some of the large and somewhat unexpected upside performance delivered over the past two years.

S&P 500 Index

Source: S&P 500

Bleak forecast for fixed income, but areas of opportunity

The bond market has been pummeled this year, with surging inflation being the primary culprit for the market's poor performance. Factor in previously described economic shocks, and this is a bond market that has delivered negative returns on a scale never seen in modern history.

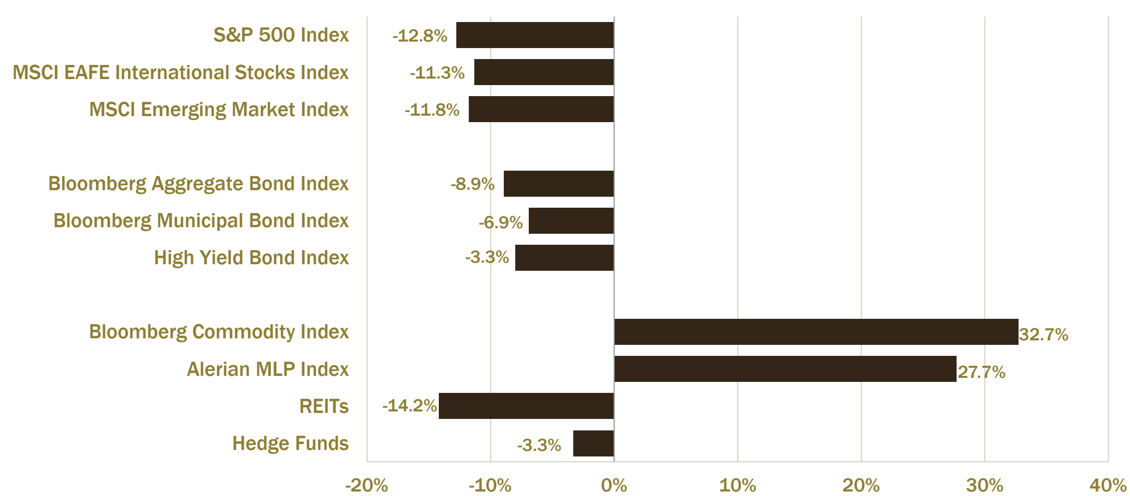
We believe uncertainty about the Fed's inflation policy has supercharged volatility in the bond market. The perception that bonds behave as a consistently safe counterbalance to equities has been dealt a big blow in 2022, and demand has suffered.

All fixed income sectors are reporting deeply negative returns so far this year. Through the end of May, the Bloomberg Aggregate Bond Index has returned -8.9% YTD. Corporates bonds have been the laggard of the investment-grade market, as increased risk aversion led to credit spread widening and additional price depreciation. As one might expect in an environment of rising interest rates, longer maturity bonds suffered the most. For example, intermediate investment-grade bonds with maturities of less than 10 years have fallen -6.3% as of May 31, 2022, while those with longer maturities have dropped -19.5% over the same period.

Municipal bond returns have fared similarly. The Bloomberg Municipal Bond Index delivered a YTD return of -6.9% as of May 31, 2022. Last year, investors flocked to munis to avoid what many thought would likely be higher tax rates. This pushed their relative valuation to rich levels in comparison to taxable bonds. However, the current rate environment has generated a pronounced selloff of munis, with YTD outflows approaching $55 billion. Nonetheless, the municipal bond market appears to be strong from a credit standpoint, as state and local balance sheets are fortified with higher-than-expected tax revenues.

Year-to-Date Performance Across Asset Classes

As of 5/31/22



Source: Bloomberg

The view on alternatives

One of the only positive areas of the capital markets so far in 2022 are alternatives, which include commodities and energy infrastructure.

Commodities performed strongly in 2021 and have built upon that momentum this year. Energy and agricultural prices, already on the rise due to strong demand and supply chain issues, shot even higher because of the Ukraine conflict. The Bloomberg Commodity Index, which is composed of 23 exchange-traded contracts on physical commodities, returned nearly 33% as of May 31, 2022.

As persistent inflation and higher interest rates pressure equity and fixed income investments, we continue to recommend an allocation to hedged equity and absolute return strategies for a portion of a balanced portfolio. Hedged equity strategies YTD have performed better than equity indices and in-line with aggregate bonds. Absolute return strategies, which have a lower risk and return profile than hedged equity, have outperformed both broad equity and bond indices.

How Commerce Trust Company has responded

As our economic outlook for 2022 has moderated, we have adjusted our investment allocations and biases accordingly. We entered the year with our equity portfolio equally allocated between growth and value stocks. We shifted our bias in February in response to the evolving market environment, reducing our growth position and increasing our international exposure while remaining underweight in our position to the category. This "addition by subtraction" approach led to our current equity allocation of a 55/45 overweight to value.

We also reinforced our domestic equities bias by maintaining our underweight position in international holdings. While this change has had a negligible impact on performance so far this year, we favor a domestic portfolio relative to global markets. We believe the dollar will continue to strengthen, which likely dampens foreign market returns for the U.S. investor. In addition, U.S. equities have less energy sensitivity than global holdings, which can position them to respond more favorably to supply line and market pressures.

On the fixed income side of the equation, we anticipated interest rates would start to rise in 2022 and reduced the duration on our diversified mix of bond funds. This position is shorter than we've ever been and currently stands at about 85% of the benchmark. Despite being down for the year, this positioning resulted in outperformance relative to the benchmark.

In addition, we exited our positions in preferred stock and emerging market bond funds in February while adding to our positions in floating-rate bond funds. Although all sectors of the bond market have delivered negative YTD returns, the floating-rate bond funds have outperformed both preferred stocks and emerging market bonds, which have experienced double-digit declines in 2022.

Our Forecast and Portfolio Biases

Highest Conviction

Interest rates will continue to rise, and bond returns could be negative for both taxable and the very rich muni market

We have shortened our durational/maturity target to 85% of the portfolio's benchmark.

We have reduced growth exposure and are overweight value

As interest rates rise, value typically outperforms growth. Structurally, we still like growth longer-term.

Slightly more defensive in general

We are overweight defensive stocks relative to our historic growth bias, underweight our fixed income targets, and have used the underweight in bonds to allocate to the alternative sectors.

High yield outperforms investment grade taxable bonds

Move down in credit favoring Bank Loans and Corporate Bonds with no exposure to Preferred or Emerging Market debt.

Mid Cap stocks should outperform both Large and Small Cap stocks

We prefer the higher profitability and stronger balance sheets of Mid Cap vs. Small Cap.

Domestic stocks should continue to outperform international markets

We are one-third underweight our International targets and expect the 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

Conclusion: A time for perseverance

We recognize it can be hard to remain levelheaded when the markets are unsettled. As long-term investors, it's important to not only remain resilient, but also willing to look for opportunities of value when markets fall. A review of the U.S. stock market performance over time reveals a constant theme: good years eventually catch up to the bad.

Your investment timeline probably extends beyond next week and more likely years into the future. We hope you recognize that many of the recent concerns about the markets have already been materially discounted. More importantly, we don't believe wholesale changes to your current investment posture are necessary at this time.

Our investment team uses a disciplined, collaborative research process to monitor global trends and identify potential opportunities that changes may introduce. We encourage you to work with your Commerce Trust Company advisor to create a plan that can help you find the right opportunities for your long-term goals.

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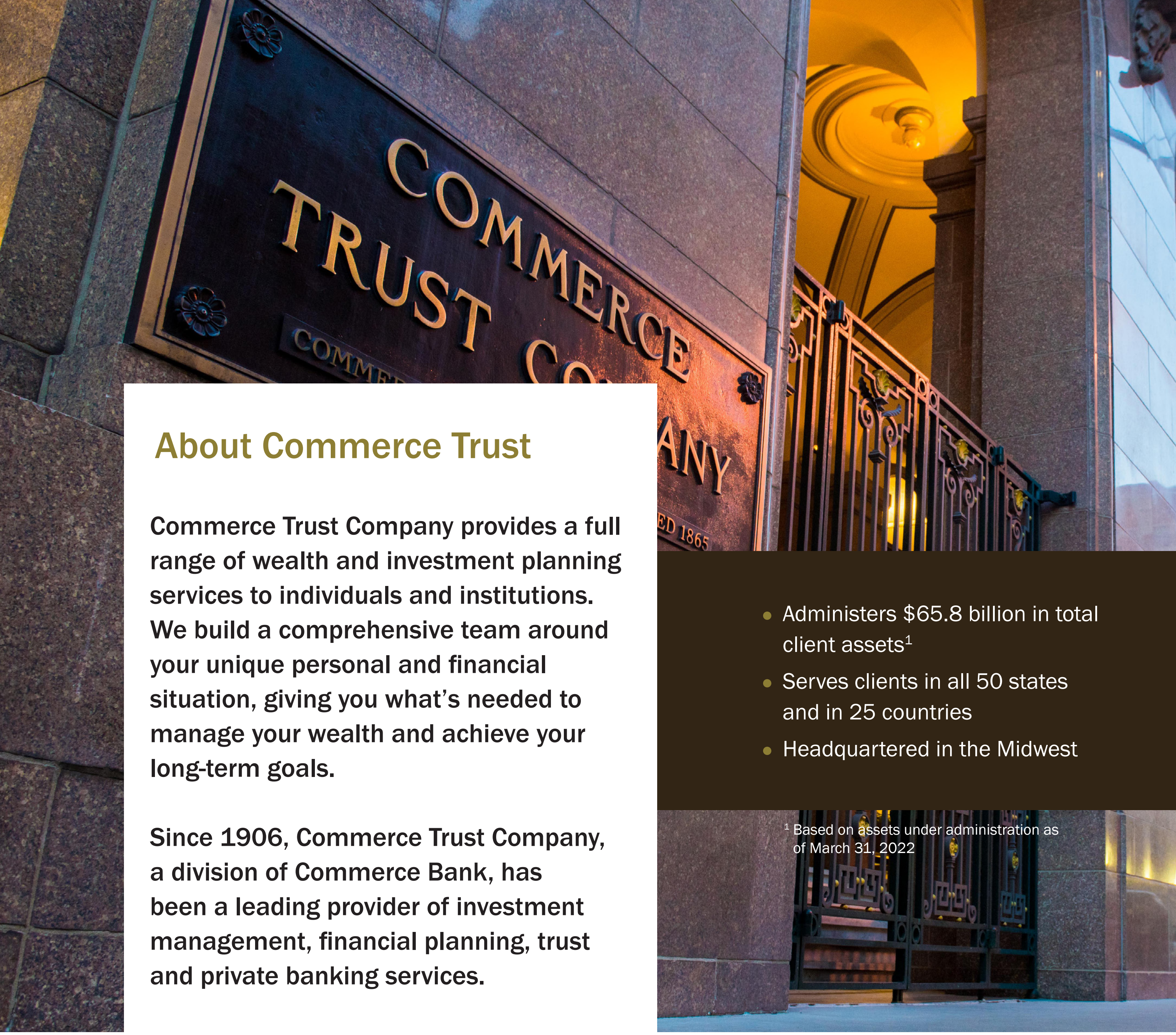

About Commerce Trust

Commerce Trust Company provides a full range of wealth and investment planning services to individuals and institutions. We build a comprehensive team around your unique personal and financial situation, giving you what's needed to manage your wealth and achieve your long-term goals.

Since 1906, Commerce Trust Company, a division of Commerce Bank, has been a leading provider of investment management, financial planning, trust and private banking services.

- Administers $65.8 billion in total client assets[1]
- Serves clients in all 50 states and in 25 countries
- Headquartered in the Midwest

[1] Based on assets under administration as of March 31, 2022

If you have any questions regarding the Outlook Report, please contact a Commerce Trust advisor.

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