MARKET STREET
TRUST COMPANY

Investment Review | First Quarter 2012

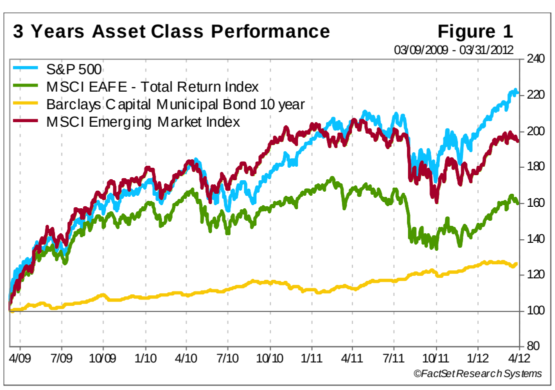
Detailed commentary on the first quarter of 2012 along with insight and an outlook from our investment team

IN THIS ISSUE

OVERVIEW

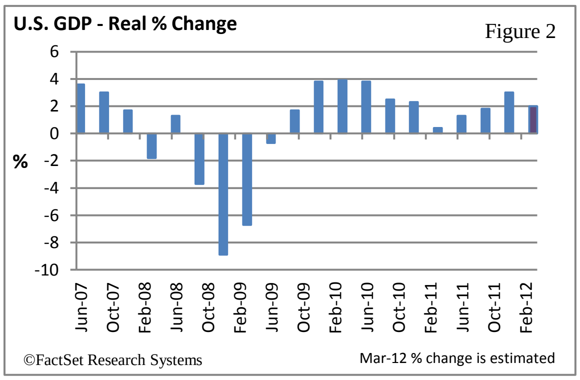
The first quarter of 2012 continued the strong market rebound from last summer's recessionary fears. The S&P 500 had its best first quarter since 1998, returning 12.6%, and international equity markets also delivered double digit returns. Mostly positive U.S. economic data, coupled with plenty of global central bank liquidity and continued low interest rates, encouraged investors to increase exposure to riskier assets.

In fact, with the S&P 500's 26% rise over the last six months, the U.S. equity market is now up over 100% from the recessionary lows of early 2009 (Figure 1). Factor in similar returns across the globe, as well as strong bond returns for the same period, and the last three years have seen returns in diversified, growth oriented portfolios approach 50%. On a total return basis, many investors are now above their portfolio high water marks of late 2007.



Market news and investor sentiment have improved. Recent European Central Bank actions ($1.3 trillion in low interest rate three year loans to European banks) as well as the Greek default non-event have calmed, but not solved, the European credit crisis for the moment. However, we continue to believe that many macroeconomic risks remain. While the U.S. economic picture has brightened, it remains the outlier, as Europe is in recession and Chinese growth has slowed considerably. Although the "Arab Spring" has not exploded further, tensions in the Middle East continue, notably in the form of the Iran/Israel nuclear confrontation and internal Syrian troubles. Additionally, domestic gasoline prices approaching $4 are beginning to put a damper on consumer purchasing power.

2010 and 2011 both started similarly, with strong first quarters followed by negative returns over the summer. The old cliché, "sell in May and go away," was an appropriate investment strategy for those years. The question is, will 2012 be any different? We cannot predict the future, but what we do see are many unresolved issues, which are already creating a high level of uncertainty and volatility in the markets.



Institutional investors are forward looking (about six to nine months), and will begin to focus on 2013 as we enter the summer. Many of the problems listed above have been with us for a while and may be priced into the market (although sometimes the severity of an event is not priced correctly). Analysts are beginning to be concerned that the United States will face a "fiscal cliff" at the beginning of 2013. Simply, the fiscal cliff is a reduction in Gross Domestic Product (GDP) due to the expiration of certain stimulative policies, such as the Bush-era tax cuts, the payroll tax holiday, and extended unemployment benefits, coupled with the start of contractionary ones, such as discretionary spending cuts (from the Super Committee) and increased taxes under the Affordable Care Act. Analysts estimate that the fiscal cliff may detract as much as 4% from GDP in 2013 if Congress takes no actions to mitigate some of these policies. In an election year, it would not be surprising if nothing (except finger pointing) is done until after November, and then Congress enacts some stop gap measures to lessen the impact to about a 2% reduction in 2013. With the economy barely growing above 2% now (Figure 2), a 2% drop in GDP could put the United States back into recession.

Our point is not to predict a recession, but to highlight a new list of uncertainties that are creeping into investors' minds. These new fears may lessen the euphoria of the market place, and lead to heightened anxiety and volatility.

We set forth our 2012 Outlook in our 2011 Annual Review, discussing risks in the markets. Negative risks such as European debt crisis, Middle East tensions, and United States deficits and politics were counterbalanced by more positive ones, such as good corporate results, strengthening consumer confidence and a benign inflationary environment.

With this in mind, we began the year more conservatively positioned, thinking that the downside risks outweighed any upside surprises. For a quarter at least, we are glad to say we were wrong. Market Street clients participated significantly in the strong quarter, with our managers' strong performance offsetting a conservative tilt. Our Absolute Return, Credit, Hedge and International Funds added significant value against benchmarks with the Real Assets Fund the only detractor.

Our overweight in high quality bonds (and conversely, underweight long only equities) also detracted from performance.

STRATEGY

With the strong returns over the last few months (Figure 3), we remind our clients that we remain long-term investors, searching for high quality investments that produce the best after-tax returns for a given level of risk. Currently, we remain in a lower risk taking mode, which does not mean we have no risk in portfolios. To achieve excess returns in today's world, you need to take some form of risk, and there are strategies where we are willing to do this. We remain committed to the credit space, particularly in high yield municipals (great after-tax returns) and structured debt (i.e., mortgages). We continue to add to the Master Limited Partnership (energy infrastructure) and high quality stock space, two areas where strong companies with stable businesses distribute significant cash to their investors. We also remain fully committed to investment grade bonds (municipal, corporate and non-dollar) to anchor portfolios and provide some downside protection should investor fear and volatility increase. Although the real after-tax returns from bonds may be limited, we believe it is an appropriate price to pay for safety in this environment.

Figure 3	Jan '12	Feb '12	Mar '12	YTD	2011
Fixed Income					
90-Day T-Bill	0.0%	0.0%	0.0%	0.0%	0.1%
Barclays Cap 1-10 Muni	1.1%	0.1%	-0.6%	0.5%	7.6%
Barclays Cap Aggregate	0.9%	-0.2%	-0.6%	0.3%	7.8%
Barclays Cap High Yield	3.0%	2.4%	-0.1%	5.3%	5.0%
JP Morgan EMBI Global	1.8%	2.9%	0.1%	4.9%	8.5%
Equities					
S&P 500	4.5%	4.3%	3.3%	12.6%	2.1%
NASDAQ	8.1%	5.6%	4.3%	19.0%	-0.8%
Russell 2000	7.1%	2.4%	2.6%	12.4%	-4.2%
Russell 3000	5.1%	4.2%	3.1%	12.9%	1.0%
Russell 3000 Growth	6.1%	4.7%	3.2%	14.6%	2.2%
Russell 3000 Value	4.0%	3.8%	3.0%	11.2%	-0.1%
Wilshire 5000	4.9%	4.2%	3.1%	12.8%	1.0%
DJCS L/S Equity Hedge	3.9%	2.6%	0.5%	7.2%	-7.3%
DJCS Global Macro Hedge	1.2%	0.8%	-0.4%	1.6%	6.4%
International					
MSCI ACWI Ex. US	5.8%	5.1%	0.7%	12.0%	-14.0%
MSCI EAFE	5.3%	5.4%	-0.9%	10.0%	-14.8%
MSCI EAFE (Local)	3.8%	5.3%	0.0%	9.3%	-14.8%
MSCI Europe	5.7%	6.7%	-0.7%	12.0%	-12.3%
MSCI Japan	4.6%	4.3%	1.6%	10.9%	-12.3%
MSCI Pacific ex Japan	9.8%	5.1%	-2.9%	12.0%	-14.1%
MSCI Emerging Markets	11.4%	6.0%	-3.3%	14.1%	-18.2%
Real Estate & Commodities					
S&P Global REIT	6.4%	0.8%	3.2%	10.7%	0.6%
S&P 1500 Energy	1.6%	6.0%	-3.5%	4.7%	4.7%
Oil	-0.4%	8.7%	-3.8%	4.2%	8.2%
Natural Gas	-17.0%	8.3%	-21.5%	-29.5%	-31.8%
Gold	11.1%	-1.7%	-2.3%	6.7%	10.2%

Sources: FactSet Research Systems & MSCI

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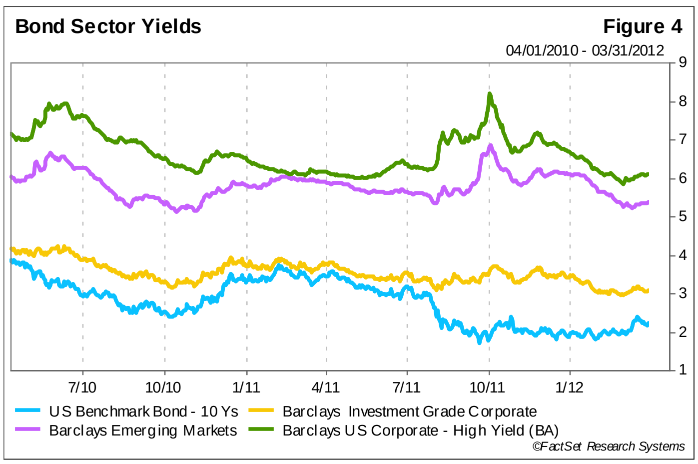
FIXED INCOME

The U.S. government bond market lost money during the first quarter as better economic growth, combined with an increase in inflationary expectations resulting from higher oil prices, encouraged investors to seek higher returns in more risky assets. Additionally, the stronger-than-expected improvement in the employment market dampened expectations of a further round of quantitative easing by the Federal Reserve. The 30-year U.S. Treasury bond lost 7.7%, although following an extremely strong 2011 the bond has still returned 24% over the last twelve months.



The benchmark 10-year Government bond lost 2.3% during the quarter and now yields 2.21%. Figure 4 shows how yields have moved for the main bond indices. (Yields are inversely related to price; therefore falling yields result in price gains.)

Municipal bonds were positive during the first quarter, outperforming U.S. Government debt. Their solid performance was aided by lower than normal issuance during the early part of the first quarter. However, as the quarter continued, issuance picked up and negative headlines increased investor concern regarding local government finances. Despite losses in March, the Barclays Capital Municipal Bond Index (1-10 year) gained 0.5% during the quarter. The high yield municipal debt market, as represented by the Barclays Capital Municipal High Yield Index, gained 5.4% during the quarter.

Within the corporate bond market, lower rated (riskier) debt performed best with AAA rated bonds losing 0.2% while high-yield BB rated bonds gained 4.4%. The top performing segment was the highly speculative CCC with a return of 8.2%.

The emerging market debt markets rallied after news that European Central Bank's bank-lending program would be larger than expected. The JP Morgan Emerging Markets Debt Index gained 4.9% in the first quarter. Local currency emerging market bonds performed even better, as emerging currencies strengthened against the U.S. dollar. The JP Morgan local currency index for emerging market bonds gained 8.3% during the quarter.

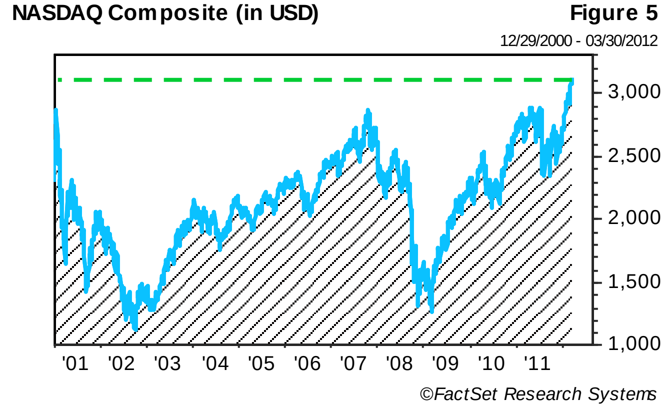
EQUITIES

Continuing its fourth quarter advance, the strongest first quarter rally in 14 years took the S&P 500 Index to its highest level since the start of 2008. U.S. equities rallied 13%, providing a first quarter gain in excess of most commentators' forecasts for the entire year. Through the first quarter, U.S. equity investors welcomed improved economic news, with consumer confidence improving and the unemployment rate continuing to decline, albeit at a much slower pace.

There was little variation in returns between large, mid and small-cap stocks, with each segment returning 12% to 14%. Notwithstanding this, micro-cap stocks performed very well with a return of 15%, although over the last year microcap stocks have returned -2% compared to large-cap S&P 500 Index return of 9%. There was also little differentiation between the returns of growth and value stocks.

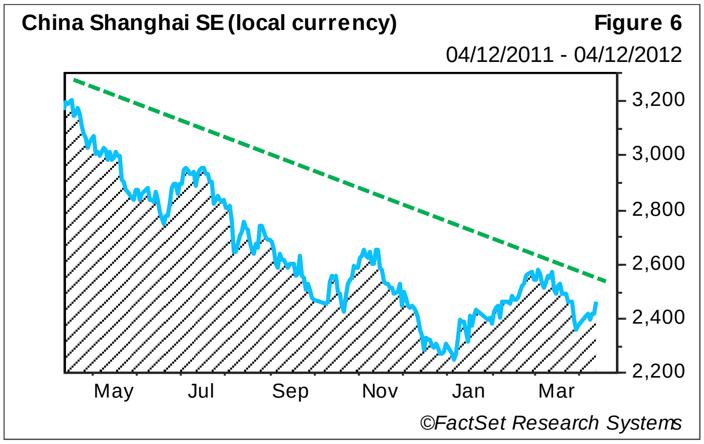
With improved sentiment among investors, the more economically sensitive S&P 500 sectors including Technology, Financials, Industrials and Consumer Discretionary outperformed the overall index during the first quarter. Reflective of this, the technology-laden Nasdaq Index advanced 19% during the quarter to reach its highest level since the burst of the dot.com bubble in 2000 (Figure 5). Bucking this trend was the Energy sector with a gain of just 4%. The more defensive sectors such as Healthcare and Consumer Staples underperformed the broader market. A reduction in sector correlations from historically high levels improved the ability of active equity managers to outperform.

NASDAQ Composite (in USD) Figure 5



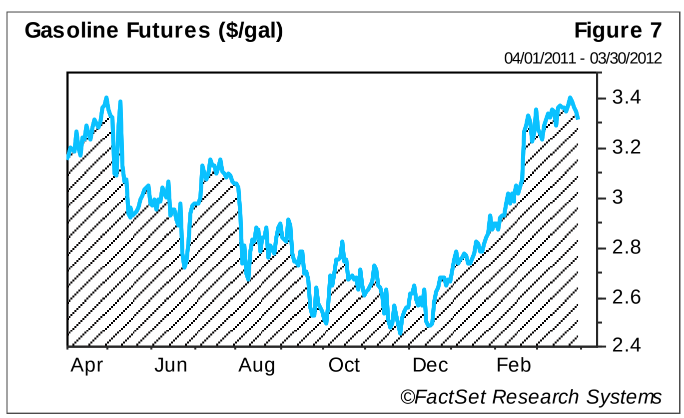
Internationally, the developed markets, as represented by the MSCI EAFE Index, again underperformed U.S. markets. European equity markets reacted positively to the stronger U.S. economic data as well as to a reduction in borrowing costs for Italy. Within Europe, the top performer was Germany with a gain of 21%. Greece managed to rally 13%, following last year's 62% drop, as its debt re-organization plan was approved. However, Spain and Portugal returned -3% and 1% respectively, as investors continued to focus on their ability to repay debt. In the Pacific region, Japanese stocks rallied 11%, with stock prices benefiting from weakness in the Japanese Yen.

Emerging Markets outperformed developed markets during the first quarter with a gain of 14%, reversing last year's underperformance. Among the individual countries, both India and Russia outperformed with gains of 20% and 19% respectively. The Chinese market was particularly disappointing, returning just 4%, on top of a 23% decline last year (Figure 6), amid continued fears of an economic slowdown. Elsewhere in Asia, Latin America and Europe, emerging market performances were generally around 14%, with the exception of Egypt which rallied 41% after the formation of its first parliament following the ousting of former President, Hosni Mubarak.



Despite their strongest first quarter in over a decade, hedged assets were unable to keep pace with the broader equity market, although they remain well positioned to protect capital during future stock market corrections. The Dow Jones Credit Suisse Long/Short Equity Index gained 7.2%. Global macro managers, as represented by the Dow Jones Credit Suisse Macro Index, gained 1.6% during first quarter.

REAL ESTATE AND COMMODITIES



Following on from a 25% rally in the fourth quarter of 2011, U.S. crude oil prices rallied a further 4% to reach $103 per barrel. Brent crude rallied 14%, with Europe having a greater sensitivity to a reduction in Iranian oil exports. Above average temperatures across the north-east United States, combined with continued over-supply, resulted in a further slump in natural gas prices. Having lost over 30% in 2011, the price of natural gas fell another 30% in the first quarter, ending at a decade low $2.13 per British thermal unit. Despite this good news for heating bills, gasoline futures continued to soar (Figure 7), translating to a national average of almost $4 per gallon at the end of the quarter. Among precious metals, gold gained 7% during a volatile first quarter to finish at $1672/oz. Having traded as high as $1788/oz. during February, gold declined as investors feared that there would not be another round of quantitative easing.

Global REITs, as represented by the S&P BMI Global REIT Index, rallied 11% during the first quarter and have now returned 21% over the last six months. Within the U.S. market, the REIT sector rallied 11% in the first quarter with performance led by Industrial REITs, up 23%. Industrial REITs were also the top performer last quarter and gained 47% over the last six months. International REITs as a whole performed similarly to U.S. REITs, although Asian REITs lagged European REITs, gaining 10% and 14% respectively. ■

As always, please feel free to contact us if you have any questions about Market Street's investment program.

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