MARKET STREET
TRUST COMPANY

Investment Review | Third Quarter 2012

IN THIS ISSUE

Detailed commentary on the third quarter of 2012 along with insight and an outlook from Market Street's investment team

OVERVIEW

Michael Eisner, Chief Investment Officer

Returns for the quarter were strong as investors tended to focus on positive news rather than the usual worries. Many asset classes appreciated 5% - 6%, bringing year to date returns for many equity indices to the low to mid-teens mark. Even high quality bonds, in a more modest fashion, participated in the rally, with quarter and year to date returns at 1.4% and 3.2%, respectively (Barclays Municipal 1-10 Year Index). Please see Figure 5 on page 3 for more index performance information.

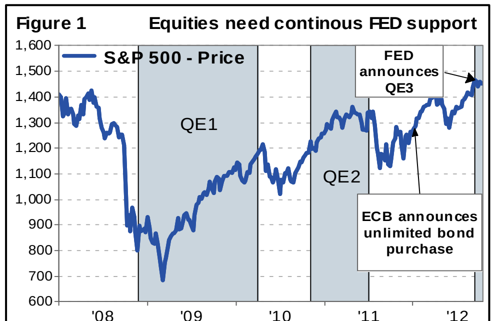
This quarter was shaped by the same overriding themes that influenced the first half of 2012. But with the VIX Index (a measure of market expectations of risk) reaching 5 year lows, investors seem to have developed a level of complacency, even disinterest, in these issues:

ISSUE		MARKET VIEWPOINT
Central Banks Statements and Actions	→	They will come to the rescue when needed
European Debt Issues	→	They are no longer surprises
Economic Data	→	Meeting our very low expectations
China's Economy	→	Definitely landing – won't be surprised by a hard landing
U.S. Fiscal Cliff	→	Of course we're going over, but just a little bit
Mid-East Tensions	→	Happens all the time

The point is not that these concerns have disappeared, but that they have been around long enough that the "surprise" factor is gone. Will anyone be shocked if Greece has to exit the Eurozone? Or if Spain follows? Probably not. In fact, if this were to happen, a precedent could be set, providing a road map on how the Eurozone could solve its issue for the long-term. One could even make the case that a relief rally might ensue, as markets say "Thank goodness, we finally know how this is going to play out!"

In addition, investors' addiction to monetary stimulus was strengthened further with a third, unlimited round of quantitative easing (QE3). In September, the Federal Reserve announced it would purchase $40 billion of mortgages a month for an indefinite period. Combined with the approximately $40 billion in Treasuries they are still buying through Operation Twist, this $80 billion monthly stimulus will keep interest rates low for an extended period of time. But like any addict, the market needs a bigger "hit" of stimulant to continue to enjoy a high. While the anticipation of QE3 led to a nice relief rally, asset appreciation will most likely "peter out" even more quickly than QE1 & QE2, unless sustained economic growth is achieved (see Figure 1). For now though, the immediate threats of recession and renewed financial crisis have receded.

Figure 1 Equities need continous FED support



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Unfortunately, when risk expectations are low, unforeseen events can shock the markets. The VIX Index in the beginning of 2007 was at a 13 year low, reflecting a market view that was completely unprepared for the financial disaster that was upon us. According to Ned Davis Research, since 1996, whenever the VIX Index has been below 28.5 (83% of the time), the average annual gain in the S&P 500 has been negative. Even though many of the returns in this timeframe were positive, the markets inability to foresee large tail-risk events led to sub-par returns. With the VIX Index around 15 today, we believe some of this short sighted thinking is prevalent in the market today.

FIXED INCOME

Robert White, Investment Manager

During the quarter, the Federal Reserve (Fed) announced a third round of quantitative easing that involves the purchase of $40 billion of mortgage backed securities (MBS) per month. The Fed also indicated that it was likely to keep interest rates low until at least mid-2015. While these actions appear supportive of bond prices, improved economic growth prospects coupled with greater investor concern regarding the inflationary outlook a few years hence, caused the 30-year U.S. Treasury bond to lose 0.3% during the third quarter. The benchmark 10-year Government bond rallied 0.9% during the quarter and now yields just 1.63%, virtually unchanged from its 1.65% yield at the end of June, but down from 1.9% at the start of 2012. Figure 2 highlights the jump in five-year inflation expectations following the QE3 announcement.

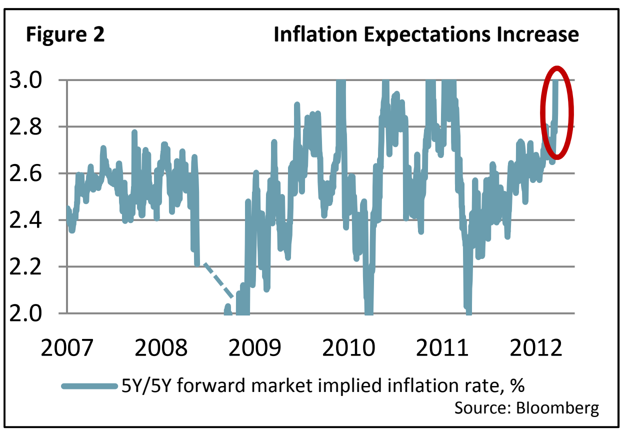


Figure 2 **Inflation Expectations Increase**

Municipal bonds again outperformed U.S. Government debt, with all maturities providing a positive return. The Barclays Municipal Bond Index (1-10 years) gained 1.4% in the third quarter and is now up 3.3% over the year to date. Municipal debt prices continue to be bolstered by a combination of rising state tax revenues and declining budget deficits. The sector has also been supported by low supply, with most new issuance a result of refinancing old bonds rather than the issuance of completely new debt. The high yield municipal debt market, as represented by the Barclays Capital Municipal High Yield Index, performed well with a 3.9% gain during the third quarter, resulting in a year to date gain of nearly 14%.

The corporate bond market continued to rally in the third quarter, with investors attracted by the higher yields relative to government debt. Moreover, investors remain comforted by high yield defaults that hover around historically low levels. Encouraged by the extension in monetary easing, investors sought lower quality issues with their even higher yields. During the third quarter, lower rated CCC bonds performed best gaining 4.8%, while higher rated AAA rated bonds gained just 0.9%.

Emerging market debt also continued to rally, with investors chasing the relatively high yields. Emerging market countries generally benefit from lower government debt to GDP ratios coupled with stronger economic growth prospects, making this an attractive investment. The Barclays Emerging Markets Debt Index gained 6.8% in the third quarter, and is now up 14.2% year to date.

EQUITIES

Investors in the U.S. equity market enjoyed a strong third quarter, with stock prices supported by the anticipation of further monetary easing in the U.S. coupled with an improvement in the sovereign debt crisis in Europe. For the quarter, the S&P 500 Index gained 6.4%, and is up an impressive 16.4% year to date.

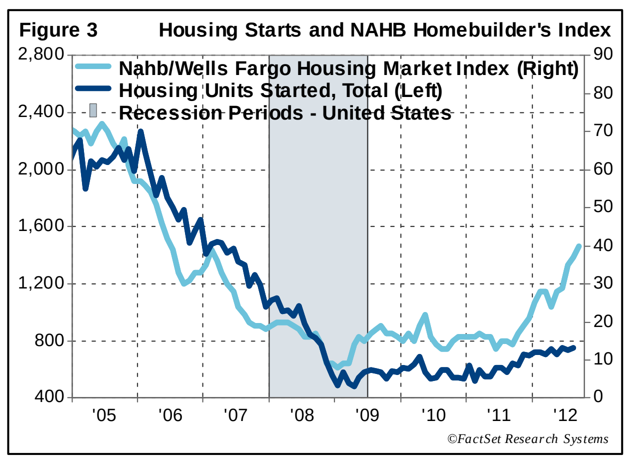


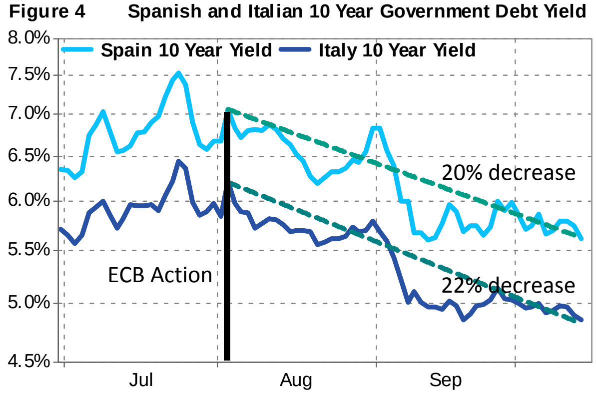
Figure 3 **Housing Starts and NAHB Homebuilder's Index**

Large-cap stocks outperformed this quarter with a gain of 6.4%, while mid- and small-cap stocks lagged with gains of 5.6% and 5.3% respectively. Within each market capitalization segment, value stocks outperformed growth stocks, boosted by investors' continual demand for yield.

Despite the looming Fiscal Cliff, during the third quarter, investors welcomed a sustained improvement in the housing market (see Figure 3) and stronger than expected retail sales. The Federal Reserve's extension of Operation Twist (buying long-dated bonds to depress long-term interest rates) and its announcement of QE3 prompted a rally in the more cyclical and economically sensitive sectors. The Energy sector performed best with a gain of 10.1%, while Consumer Discretionary, Financial and Technology stocks also outperformed the broader market. It was the more defensive sectors such as Utilities, Consumer Staples and Healthcare that underperformed, with Utility stocks providing a small negative return.

Internationally, the developed markets, as represented by the MSCI EAFE Index, again underperformed U.S. markets, although for U.S. investors a weakening dollar resulted in international equities outperforming domestic stocks. Despite the onset of recession, European equity markets rallied as the European Central Bank (ECB) announced a further loosening of monetary conditions with the commencement of unlimited bond purchases. This attempt by the ECB to solve Europe's liquidity problems prompted investor cheer, with yields on Spanish and Italian sovereign debt falling drastically to more tenable levels. The Spanish 10-year Government bond yield declined from 7.6% in July to 6.0% at the end of September (see Figure 4), and Eurozone banking stocks rallied over 50%. However, even after these gains, recent research by Morgan Stanley suggests that European stocks trade at a 30% valuation discount to U.S. equities. Elsewhere in peripheral Europe, following a 28% decline during the second quarter, Greek equities lost a further 1%, with investors doubting both the nation's willingness and ability to repay its debt.

Figure 4 Spanish and Italian 10 Year Government Debt Yield



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Emerging market stocks outperformed developed markets during the third quarter with a return of 7.9%. Year to date, emerging market equities have rallied 12.3%. Regionally, the EMEA (Europe, Middle East & Africa) region has led returns during both the recent quarter and year to date. Egypt has been the top performing emerging market since the start of the year, with a return of 66.6%. With Chinese growth expectations ratcheted down towards 7%, the Chinese market was one of the world's weakest with a negative return of 6.6% during the quarter.

Despite a continued increase in net equity exposure, as represented by the correlation of the HFRI Equity Hedge Index with the S&P 500 Index, hedged assets again underperformed the broader equity market. The Dow Jones Credit Suisse Long/Short Equity Index gained 3.7%, during the most recent quarter and has now returned 6.0% over the year to date. Global macro managers, as represented by the Dow Jones Credit Suisse Macro Index, gained 3.1% during third quarter and are up 3.3% since the start of the year.

REAL ESTATE AND COMMODITIES

Inflation sensitive commodities rallied during the third quarter in anticipation of further quantitative easing from the Federal Reserve. U.S. crude oil prices rose 8.5% over the quarter to $92 per barrel, up from $85 at the end of June, with investors also concerned about rising tensions between Iran, Syria and Israel. During 2012, oil has fallen 6.7% from a starting price of $99 per barrel. Natural gas continued to rally from the decade-long lows hit earlier this year, with the price rising 18% during the third quarter to $3.32 per British thermal unit. The commodity is now up 11% since the start of the year. The demand and supply balance for natural gas has improved, and while storage levels will reach records in October, it is now unlikely that the maximum storage capacity will be breached. Unfortunately for consumers, gasoline prices rose 13% to a national average of around $3.80 per gallon at the end of the quarter. Precious metals also benefited from renewed quantitative easing with gold gaining 11% to end the quarter at $1,774. Over the year to date, gold has rallied 13%, but at the end of September it was still slightly below its February high of $1,788/oz. While few commodities declined in the third quarter, lean hogs and sugar lost 11.3% and 6.3% respectively.

Figure 5	1H '12	Jul	Aug	Sep	Q3	YTD
Fixed Income						
90-Day T-Bill	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%
Barclays Cap 1-10 Muni	1.8%	0.9%	0.0%	0.5%	1.4%	3.2%
Barclays Cap Aggregate	2.4%	1.4%	0.1%	0.1%	1.6%	4.0%
Barclays Cap High Yield	7.3%	1.9%	1.2%	1.4%	4.5%	12.1%
JP Morgan EMBI Global	7.5%	4.0%	1.2%	2.6%	4.8%	12.1%
Equities						
S&P 500	9.5%	1.4%	2.3%	2.6%	6.4%	16.4%
NASDAQ	12.7%	0.2%	4.5%	1.7%	6.5%	20.7%
Russell 2000	8.5%	-1.4%	3.3%	3.3%	5.3%	14.2%
Russell 3000	9.3%	1.0%	2.5%	2.6%	6.2%	16.1%
Russell 3000 Growth	10.0%	1.1%	2.8%	2.0%	6.0%	16.6%
Russell 3000 Value	8.6%	0.9%	2.2%	3.2%	6.4%	15.6%
Wilshire 5000	9.2%	1.1%	2.4%	2.6%	6.2%	15.9%
DJCS Equity Hedge Index	2.2%	0.5%	1.5%	1.6%	3.7%	6.0%
DJCS Global Macro Index	0.1%	2.1%	0.4%	0.6%	3.1%	3.3%
International						
MSCI ACWI Ex. US	3.3%	1.3%	2.2%	3.9%	7.6%	11.1%
MSCI EAFE	0.8%	1.1%	2.4%	2.6%	6.1%	7.0%
MSCI EAFE (Local)	2.0%	1.4%	1.3%	1.2%	3.9%	6.0%
MSCI Europe	3.7%	1.1%	4.4%	3.3%	9.0%	13.0%
MSCI Japan	3.2%	-2.3%	-0.7%	2.4%	-0.6%	2.6%
MSCI Pacific ex Japan	5.2%	6.1%	0.4%	4.1%	10.9%	16.7%
MSCI Emerging Markets	4.1%	2.0%	-0.3%	6.1%	7.9%	12.3%
Real Estate & Commodities						
S&P Global REIT	14.1%	3.2%	0.3%	-0.2%	3.3%	17.9%
S&P 1500 Energy	-9.2%	4.2%	2.3%	3.4%	10.2%	6.9%
Oil (WTI)	-14.0%	3.6%	9.6%	-4.4%	8.5%	-6.7%
Natural Gas	-5.6%	13.6%	-12.8%	18.6%	17.6%	11.0%
Gold	2.4%	0.7%	4.5%	5.1%	10.6%	13.3%

Global REITs, as represented by the S&P BMI Global REIT Index, rallied 3.3% during the third quarter and have returned 17.9% so far this year. Within the U.S. market, the REIT sector stalled during the third quarter, posting a small loss of 0.3%. U.S. REITs have gained 14% since the start of the year, with performance led by Industrial and Retail REITs, up 24% and 22% respectively. International REITs outperformed U.S. REITs during the third quarter, led higher by Asian REITs, up over 10%, and European REITs, up over 7%.

AN UPDATE ON THE EUROPEAN SOVEREIGN DEBT SITUATION

During the third quarter, certain announcements provided optimism to the markets that the European financial crisis could be stabilized for the longer term.

- In July, European Central Bank (ECB) president Mario Draghi announced that the ECB would “do whatever it takes” to preserve the Euro, sparking a rally in equity markets.
- In September, the ECB’s governing council agreed to a bond purchase program, helping to allay fears that a struggling country would not be able to rollover its debt. Additionally, the ECB made it clear that bonds it purchases will be pari passu with private claims if there were to be a debt restructuring. This provides some confidence to private investors and may encourage them to participate in buying sovereigns.
- The September 6th ECB meeting also made its bond buying program conditional on a country’s request that it enter into a Memorandum of Understanding (MOU), which makes clear that policy prescriptions must be undertaken for ECB assistance.
- In late September, Germany finally ratified the European Stability Mechanism (ESM), which provides an additional $700 billion financing facility to Eurozone members in financial need. The ESM comes on-line on October 8.

These actions provide some assurance to the market place that a seizure in the financial markets due to illiquidity in the credit space is less likely. As you can see in Figure 4 on page 3, the above announcements have pushed sovereign debt rates much lower, providing more reasonable funding levels for nations in need. This provides time for some of the struggling Eurozone nations (Greece, Italy, Spain, etc.) to take measures to fix their economies. Whether these fixes work is another story.

OUTLOOK

Even with such uncertainty, many markets have rallied strongly into the fourth quarter. It remains somewhat puzzling to us though, that the world continues to shrug off bad news. In the face of slowing global growth, continued high unemployment and debt issues, certain markets are only a few percentage points off record highs. In the United States, a very close Presidential election, as well as uncertain congressional control, provides no insight into what business, regulatory or tax policies investors should expect in the future. With a fiscal cliff of massive tax increases and spending cuts looming, the economic environment awaiting us is unknowable.

While we are long-term investors, it is impossible to ignore some of the current weaknesses that are present throughout the financial markets. We continue to be wary of macro risks and believe with modest returns in our future, we will not be compensated for increased risk. None-the-less, we have positioned portfolios neutral relative to long-term targets, adjusting slightly within asset classes to capture more attractive opportunities.

During the quarter, and coming on the heels of a market sell-off in the May/June timeframe, we added to assets we felt could participate in a market rally while faring better if the economy deteriorated. Therefore, we increased our equity exposures by adding to a long/short equity manager and a long only, high quality value manager (U.S. equities). In addition, we continued to add to the MLP space, where yields and return potential remain solid. These positions were funded from a mix of cash and short-term corporate bonds. Also, we started adding (small amounts so far) to two of the worst performing asset classes over the last five years (non-U.S. equities and non-U.S. REITs) as we find these areas have more attractive valuations than their U.S. counterparts.

Going forward, clients should see a continuation of the following themes:

- Add to assets that have underperformed and have attractive valuations and return potential.
- Maintain low volatility assets, such as high quality bonds and cash, at target allocations, to dampen overall portfolio volatility.
- Let certain equity winners grow during liquidity fueled rallies, but trim if positions get too high relative to our neutral target allocations

Given the continued macroeconomic risks mentioned above, we believe this strategy and positioning will enable clients to capture further market advances while protecting against increased volatility.

As always, please feel free to contact us if you have any questions about Market Street’s investment program or family office services.

Market Street Trust Company
80 E. Market St., Ste. 300
Corning, New York 14830
607.962.6876

Marianne W. Young
President
myoung@mstcny.com

Beth A. Landin
Vice President, Client & Strategic Relationships
blandin@mstcny.com

Michael R. Eisner CFA
Chief Investment Officer
meisner@mstcny.com

Keith D. Horn
Chief Operating Officer
khorn@mstcny.com