MARKET STREET TRUST COMPANY

# Investment Review | Second Quarter 2013

IN THIS ISSUE



*Detailed commentary on the Second Quarter of 2013 along with insight and outlook from Market Street's investment team*

## OVERVIEW

*Michael R. Eisner*
*Chief Investment Officer*

After a spectacular 16-month run up, the market rally came to an abrupt halt in mid-May (Chart 1). The combination of slowing emerging market growth (mainly China) and fear of an earlier tapering of quantitative easing in the United States exposed the interconnected fragility of global financial markets. We still firmly believe the known "tail risks" that could lead to a financial meltdown or recession have been considerably reduced by global central bank actions. But the six week sell-off across all markets since the middle of the quarter is a good reminder that quite a bit of the rally has been liquidity induced.

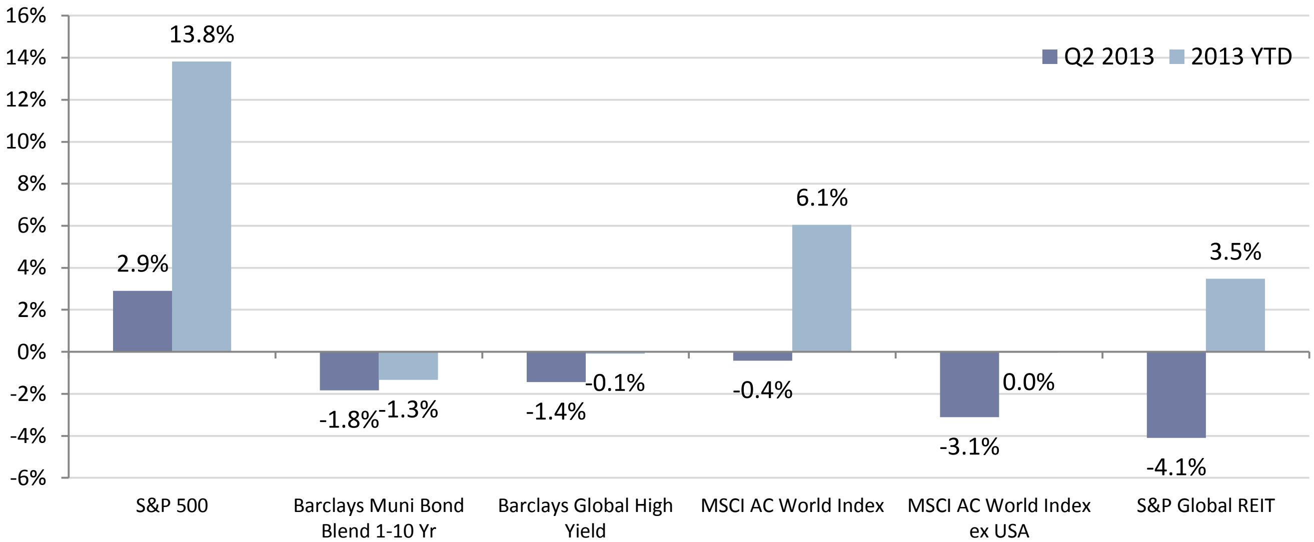
**Chart 1: Cumulative Index Returns Pre and Post Mid-May**

| Index | 1/1/2012 – 5/21/2013 | 5/22/13 – 6/30/2013 |
|---|---|---|
| Barclays Global High Yield | 24.87% | -4.12% |
| JP Morgan Emerging Debt | 17.99% | -7.80% |
| Russell 2000 | 37.46% | -1.93% |
| Wilshire 5000 | 37.04% | -3.47% |
| MSCI All Country World ex U.S. | 28.04% | -8.07% |

Mohamed El-Erian, in PIMCO's May Secular Outlook, aptly states that we should "not lose sight of the extent to which asset prices have been disconnected from fundamentals, and thus, require major eventual validation by fundamentals." The second quarter turbulence reminds us that investors have been pushed into riskier assets due to global central bank actions and may not have the conviction to stay invested when the easing comes to an end. After five years of easy monetary policy, solid investment results will only be achieved through real economic growth, not just hoped for economic growth.

Is this the end of the equity bull market? Is the Federal Reserve ending its quantitative easing program which has reflated the markets since the Great Recession? Is the stunning performance in the United States markets, which has led the rest of the world's markets, coming to an end? In our opinion, the answer is an unequivocal no.

**Chart 2: General Market Returns**




Most of the 20% increase in market risk during the second quarter (as reflected by the VIX index, a measure of expected future volatility) can be attributed to two comments by the Federal Reserve Chairman, Ben Bernanke.

1. At a meeting with lawmakers on May 22, Bernanke noted that **withdrawing monetary stimulus prematurely could slow or end the economic recovery**. Unfortunately, the Fed minutes released later that day showed **some** members were willing to reduce the amount of bonds the Fed was buying sooner than the market was expecting. Markets sold off only about 1%, but bonds tumbled, with rates on the 10-year Treasury jumping 12 basis points (0.12%).
2. A few weeks later, at a June 19 news conference, Bernanke again reiterated that **the Fed had no intention of raising rates before its unemployment and inflation targets are met (sometime in 2015).** During his comments though, he did mention that if incoming data are broadly consistent with the Federal Open Market Committee's economic forecast, then it could be appropriate to moderate the pace of purchases (known as tapering) later this year. Additionally, if data remained consistent with the forecast, purchases would be reduced further during 2014 and possibly end all together by mid-2014.

We believe Bernanke's comments were completely consistent with the message the Fed had expressed previously. Although the Fed provided some rosier economic forecasts, they have consistently overestimated GDP by an average of 1.35% (ISI). Unfortunately, the global financial markets responded poorly to these comments and in our opinion, overreacted to a non-event. Bond prices fell quickly, and bond yields across the board increased about 1% (Chart 3). In our view, nothing much in the economic outlook has changed, other than the interest rate environment has moved up about 50 to 75 basis points higher (from a 1.75% average to about a 2.25% - 2.50% yield on the 10-year Treasury).

**Chart 3: Global Bond Rates Prior to and after Bernanke's Testimony**

| | 5/20/2013 Yield % | 6/30/2013 Yield % | 6 Week Price Return % |
|---|---|---|---|
| 10 Year US Treasury | 1.9 | 2.5 | -4.85 |
| 10 Year Japanese Gov't Bond | 0.9 | 0.8 | 1.79 |
| 10 Year UK Gilt | 1.9 | 2.5 | -4.32 |
| 10 Year German Bund | 1.4 | 1.7 | -2.62 |
| EM Debt (USD denominated) | *5.2 | 6.0 | -7.80 |

*Yield as of 5/31

Our economic outlook remains consistent.

- The U.S. economy is growing modestly, inflation is tame, unemployment is slowly falling, housing is recovering and the manufacturing and service sectors are steady. The Fed will remain accommodative, keeping interest rates attractive and forcing investors into riskier assets (good for the stock market).
- Europe remains mired in a recessionary environment, although there is hope for improvement in the second half of the year. Germany's unemployment rate ticked down again and Eurozone confidence has been increasing as of late. This is only the beginning and there will be continued hiccups as Europe mends.
- Japan's quantitative easing program is just getting started. Its stock market is volatile, but up significantly. Japanese government bond yields have risen considerably and the population's optimism is increasing. Nevertheless, this is a new experiment in Japan and although there have been short-term benefits, we have no idea where this goes or how long it lasts.
- China's economy, which has a big impact on emerging economies, has been weakening. Growth has been below expectation and some poorly worded government statements have not helped its banking sector. The Shanghai index is approaching 2008 recessionary lows, although according to ISI, credit conditions seem to be easing.

Given our views above, we are favorably inclined towards risk assets, as liquidity remains high and economic conditions remain stable while slowly improving. Specifically, we remain overweight higher volatility assets, while underweighting cash and fixed income. Our benchmark weight exposure to global equities, overweight to Master Limited Partnerships (MLPs), significant underweight cash and high quality bonds and excellent manager performance in our hedged asset strategies have provided our clients with solid returns during the first half of 2013. The rapid increase in bond yields over the last six weeks have significantly increased the volatility of returns, but we believe that for those who can stay the course, the payoff will be worth it.

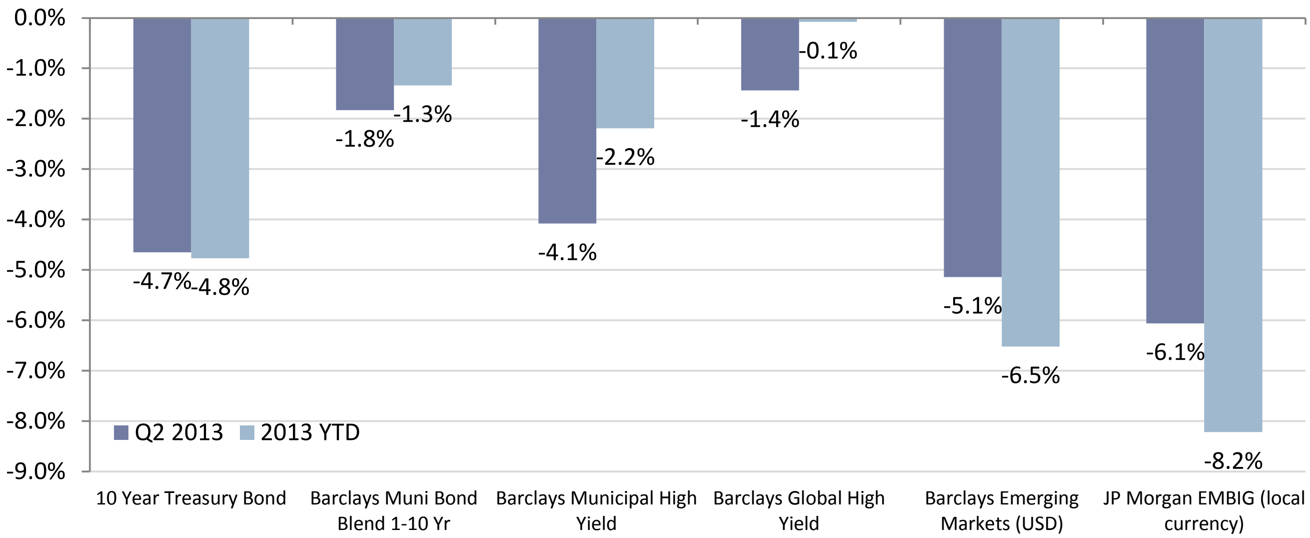
# FIXED INCOME

*Robert White, Investment Manager*

As discussed in the Overview, bond markets reacted adversely to comments by Federal Reserve Chairman Ben Bernanke in the latter part of the quarter. June saw massive bond mutual fund outflows, ending 21 consecutive months of net inflows. Yet, the quarter as a whole saw net inflows to bond funds as investors continued to be attracted to income producing assets. U.S. Government debt suffered losses for the third successive quarter, with the benchmark 10-year Treasury bond losing 4.7%, while the more interest-rate sensitive 30-year Treasury lost 6.1% during the quarter. Over the year-to-date, the 10-year and 30-year bonds have lost 4.9% and 9.0%, respectively. The 10-year Treasury ended the quarter yielding 2.49%, up from 1.85% at the end of the first quarter and from 1.65% this time last year.

While still negative, high quality municipal bonds outperformed U.S. Government bonds during the second quarter, with the Barclay's Municipal Bond Index (1-10 years) returning -1.6%, while the broader Barclay's Municipal Aggregate Index lost 2.8%. Despite these losses, municipal bonds remain historically cheap relative to taxable Treasury bonds: the ratio of the 10-year Barclays Municipal Bond yield to the 10-Year Treasury bond yield rose to 111% compared to an average since 2001 of 92%. After moderate gains in April and May, the high yield municipal debt market, as represented by the Barclay's Capital Municipal High Yield Index, lost 5.1% as spreads widened during June to end the quarter with a 4.1% loss. The Index has declined 2.2% over the year to date.

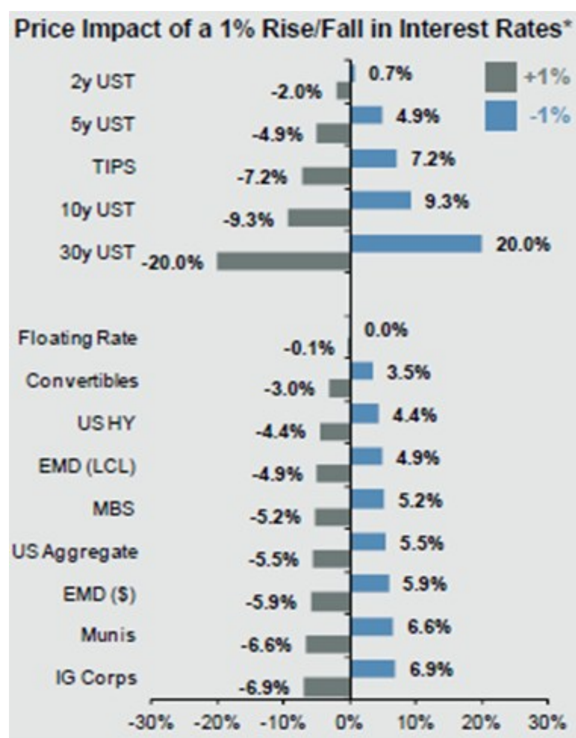
**Chart 4: Fixed Income Index Performance**




While higher U.S. Treasury yields make other fixed income securities assets relatively less attractive, the higher yields available from corporate, emerging market and securitized bonds helped these alternatives to outperform Treasuries. Chart 5 highlights the sensitivity of different types of bonds to changes in the yield curve (interest rates), and explains much of the reaction to the increase in U.S. Treasury yields. The corporate high yield bond market lost 1.44% during the second quarter, with the entire loss a result of the June sell-off. Structured products such as Mortgage Backed Securities and Asset Backed Securities also declined over the quarter, as investors feared that the Federal Reserve's bond buying program that currently accounts for around 50% of the monthly gross issuance of all mortgage-backed securities would taper off. Asset Backed Securities lost 0.8% during the quarter while Residential and Commercial Mortgage-Backed Securities declined 2.0% and 1.4% respectively.

Accompanying the broad equity market sell-off in May, Emerging Market debt also suffered substantial losses as risk appetites waned. This was compounded by ongoing strife in some of the individual countries. The Barclay's Emerging Market Debt Index (US $ denominated) lost 5.1% during the quarter, and is down 6.5% over the year to date. Index heavyweight Venezuela saw its bonds sell off sharply after S&P downgraded the country's credit rating to 'B' status with a negative outlook, a consequence of deteriorating economic conditions. The J.P. Morgan Emerging Local Debt Index (local currency) lost 7.0% last quarter, for a year to date decline of 7.2%. In Brazil, which accounts for around 10% of this index, large-scale civil protests resulted in the Brazilian Real losing 10% of its value against the U.S. dollar during the quarter.

**Chart 5**




Source: J.P. Morgan

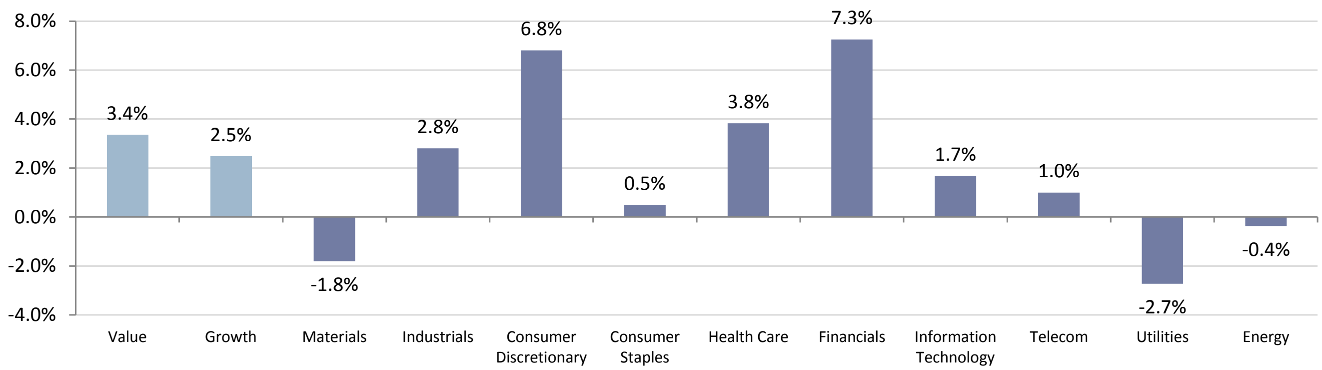
# EQUITIES

*Anastasia Smith*
*Investment Analyst*

Global equity markets suffered a pullback in the second quarter as investor fears spiked due to concern over a possibility of monetary tightening later this year. The MSCI All Country World Index finished the quarter down 0.4%, bringing its year to date return to 6.0%. Returns were led by the U.S. markets, as represented by the S&P 500 Index, which were up 2.9% over the quarter and are now up 13.8% year to date. Global growth remains muted, with areas such as the Eurozone posting a 1% real GDP decline year-over-year at the end of the first quarter. The peripheral nations, such as Greece and Portugal, had the most pronounced declines with year-over-year contractions of 5.6% and 4.0% respectively.

Within the U.S., small and mid-cap companies continue to outperform their large cap counterparts. Microcap stocks, as represented by the Russell Microcap Index, performed particularly well returning 5.1% over the quarter. Both micro and mid cap companies are now outperforming large cap companies by more than 5% over the past 12 months.

**Chart 6: S&P Style & Sector Returns**



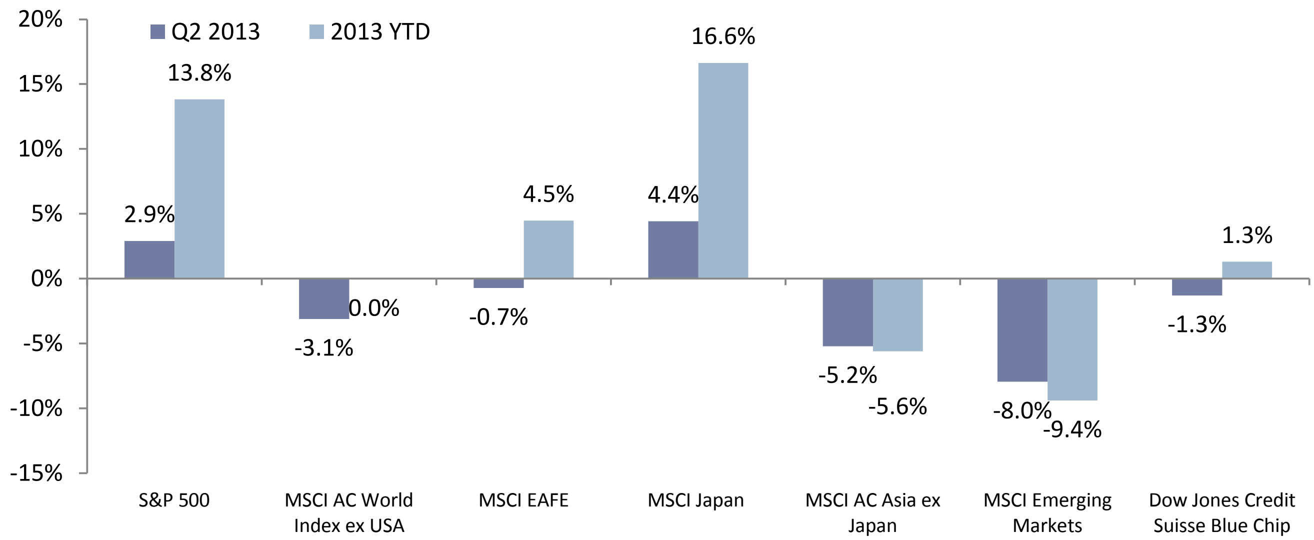

Among the S&P 500 Index sectors, performance over the quarter was led by the cyclical Consumer Discretionary and Financial sectors, up 6.8% and 7.3% respectively (Chart 6). Cyclical stocks benefited from the improvement in home prices and household assets that consequently boosted consumer spending and borrowing. The worst performing sector was Utilities, down 2.7%, negatively affected by rising bond yields. The Energy and Materials sectors also posted negative returns for the quarter, negatively impacted by the large declines in commodity prices.

International equities have underperformed U.S. markets significantly so far this year, lagging by nearly 14%. Developed markets, as represented by the MSCI EAFE Index, ended the quarter down 0.7%, bringing the year to date gain to 4.5%. International returns were led by Japan, which rose 26.7% to a peak in late May as investors were encouraged by the progress of "Abenomics," a term used to describe Japan's reflationary policy. However, there has since been a sharp stock market correction due to concerns over slowing growth in China and Prime Minister Shinzo Abe's reform agenda, bringing the year to date return to 16.6%. Indicators such as retail sales, bank lending, housing starts, and property prices all indicate that Japan's growth rates will remain robust.

Emerging markets have suffered the greatest losses over the year to date, down 9.4% after losing more than 6.0% in June. Emerging market returns have been hurt by concerns over lower commodity market growth and, in particular, fears of a more significant slowdown in China's growth. However, returns were greatly differentiated by country even within regions; for instance Hungary was up 9.3% after stronger than expected growth and policy rate cuts while Turkey was down 16.9% due to concerns over civil unrest.

Hedge funds continue to maintain their low net equity exposure, causing them to underperform the U.S.

**Chart 7: Global Equity Market Performance**



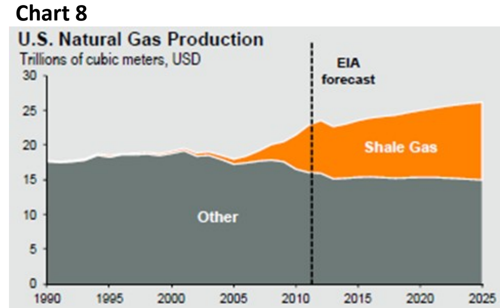

equity market during recent rallies. During the pullback late in the quarter, hedge funds did not protect as well as would be expected. The Credit Suisse Blue Chip Index lost 1.3% during the quarter and is now up 1.3% over the year to date. So far this year, the long/short equity and event driven managers have performed best while short-biased, managed futures and equity market neutral managers have performed the worst.

# REAL ESTATE AND COMMODITIES

*Bulezim Azemi*
*Investment Analyst*

The price of U.S. crude oil slipped 0.7% in the second quarter to $96.56 per barrel, but remains up 5.9% year to date. Prices this year have benefited from improving prospects for economic growth in both Europe and the U.S, as well as continued geopolitical issues that now include Egypt and the access to the Suez Canal it provides for oil and gas pipelines. Fortunately, gas prices declined during the quarter, with the national average price at the pump falling 5% to $3.41 per gallon. However, gas prices remain 5% higher than at the start of 2013, and around 4% higher than this time last year. Despite natural gas prices declining 11.4% during the quarter, the Master Limited Partnerships (MLPs) that build and maintain energy infrastructure in the U.S. had another positive quarter, benefiting from continued anticipation for new infrastructure requirements in the shale gas regions. Chart 8 illustrates the forecasted growth in U.S. natural gas production over the next 12 years. With investors continuing to enjoy their high yields and strong dividend growth prospects, the benchmark Alerian MLP Index actually gained 3.1% during the tumultuous month of June, resulting in a 1.9% gain for the quarter and increasing its year to date performance to 22.1%.

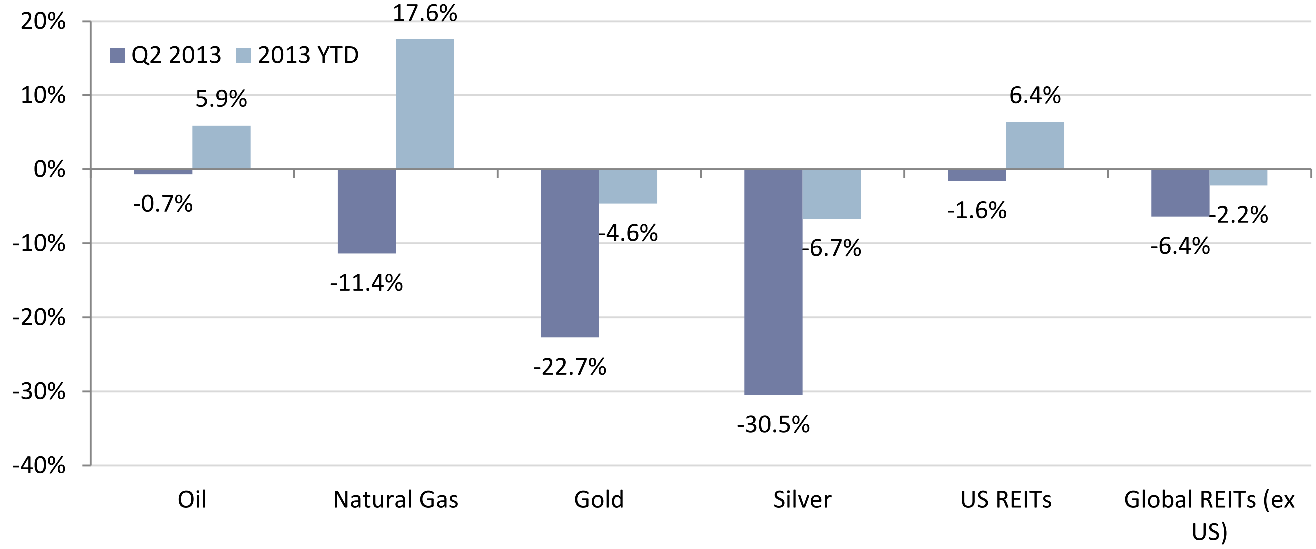
**Chart 8**




Source: J.P. Morgan

Precious metals suffered steep losses following Bernanke's speech, underperforming almost all other equity and bond markets. Gold prices lost 23% during the second quarter, the largest loss since 1971, and are now down 27% over the year to date. Silver suffered even worse with a quarterly loss of 31% that brought the first half decline to 36%. Industrial and agricultural commodities also suffered steep losses as investor concern regarding Chinese and Emerging Market growth prospects deepened.

Chart 9: Real Estate and Commodity Returns




Global REITs, as represented by the S&P BMI Global REIT Index, lost 4.1% during the second quarter and are now up just 3.5% year to date. The UK was one of the top performing markets, up 6%, boosted by the high quality London market that continued to attract international investors. Asian markets suffered most during the quarter, losing 7.8% in aggregate, led lower by Japanese REITs which fell 19%. Hampered by rising Treasury yields, U.S. REIT sector also had a difficult second quarter with the MSCI US REIT Index losing 1.6%. Over the first six months of the year, the Index has lagged many other asset classes with a gain of just 6.4%.

# OUTLOOK

We remain in a constructive investment environment. Even with all the recent volatility in the marketplace, U.S. stocks are only 3.3% off their record highs. Bonds of all types have sold off, but mispricing in certain fixed income markets due to the dearth of dealers (buyers) and liquidity has provided for opportunity. We believe once investors realize an early exit of monetary easing will not occur, many of the sectors that sold off precipitously (emerging market bonds, high yield municipals) will rebound. Foreign markets have had a much more difficult time than U.S. markets, but we believe valuations, especially relative to U.S. ones, make these markets much more attractive, providing opportunities for our managers to produce better returns than benchmarks.

Given our optimism, we remain conscious of the myriad of risks still remaining. Unemployment remains high, especially in Europe. Chinese economic growth has slowed sharply, with the talk of a "hard landing" back on the table. European debt issues remain and the U.S. debt ceiling will be hit in the fall. Geopolitical risks are too many to name, but are always present. Finally, after what happened in the second quarter, markets reactions to further statements made on the timing of monetary tightening are unpredictable.

We position clients' portfolios based upon our view of risks and opportunities, and overall, the data we see leads us to be optimistic about long-term investment returns. Given the list of issues noted above, we were never believers in the low risk message the VIX was broadcasting as it neared historic lows in the first quarter. But having increased levels of volatility does not mean we cannot achieve good returns. We think investment returns will be attractive, but investors need to be mindful that the market will most likely be more volatile (as in May and June) in the future.

**Please visit our website, www.marketstreettrust.com to view the June 30, 2013 Investment Fund Updates for more detailed information on the funds. These will be posted by the end of July.** As always, please feel free to contact us if you have any questions about the investment program or your personal portfolio.


**Market Street Trust Company**
**80 E. Market Street, Suite 300**
**Corning, New York 14830**

**607.962.6876 phone**
**607.962.6709 fax**
**www.marketstreettrust.com**

**Michael R. Eisner CFA®**
**Chief Investment Officer**
**meisner@marketstreettrust.com**

**Robert J. White CFA®, CFP®**
**Investment Manager**
**rwhite@marketstreettrust.com**

**Anastasia L. Smith**
**Investment Analyst**
**asmith@marketstreettrust.com**

**Bulezim Azemi**
**Investment Analyst**
**bazemi@marketstreettrust.com**



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