Market Street Trust Company

Third Quarter Investment Review | 2015

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Overview

Equity Markets Enter Correction Territory. Equity investors contended with the first 10% correction since 2011 during the worst quarter in four years. Within the S&P 500 Index, over half the stocks entered into bear market territory (20% decline) during the quarter, led down by energy, natural resource and biotech stocks. While the impetus for the global slump was China's currency depreciation, the U.S. Federal Reserve's decision to delay raising interest rates further unsettled investors.

While bonds and utility stocks benefited from a more risk averse environment during the quarter, equities saw steep declines, with the S&P 500 Index down 6.4%. International developed markets fared even worse, with the MSCI EAFE Index down around 10%, while emerging markets plummeted 18%. The commodity market and related equities also suffered significant losses during the quarter, with oil down 25.4%, industrial metals down 9.5%, and the S&P Energy sector down 17.3%.

Foreign News Dominates Q3. Greece's possible exit from the Euro spilled over into July, but was largely resolved by the end of the month. Despite winning a referendum in June on a ticket rejecting austerity, Greek Prime Minister Alexi Tsipras agreed to an even harsher austerity plan, which included pension cuts, tax hikes and increased international oversight of its finances. In return, Greece received its third bailout package, as well as an easier repayment schedule for its debt. A potentially disastrous exit from the European single currency was averted, although many analysts fear that the day of reckoning has only been delayed.

While the Greek resolution temporarily calmed investors, China provided the largest knock to global investor sentiment after it allowed the yuan (also known as Renminbi or RMB) to depreciate, having previously been pegged in a tight trading range to the U.S. dollar (see China sidebar on page 2). A currency depreciation makes China's exports cheaper and imports from other nations more expensive. Investors took the move as an indication that growth in China was weaker than official figures suggest. Fears of slower growth, bolstered by poor Chinese manufacturing numbers had a knock-on effect in the commodity markets.

Although U.S. exports became more expensive and thus less competitive as a result, China only accounts for 0.5% of U.S. corporate profits according to Goldman Sachs. The greater impact was felt by members of the Federal Reserve Board who, looking at softening global economic growth and the deflationary pressures resulting from both lower commodity prices and cheaper Chinese exports, opted to delay raising U.S. interest rates.

Unemployment has generally remained a bright spot at 5.1%

U.S. Economy Continues Slow Growth Trajectory. The U.S. economy continues to chug along slowly with generally mixed economic data. Of particular note, second quarter real GDP growth was revised up from 2.3% to 3.9%. Despite this, the Federal Reserve Bank of Atlanta's GDPNow model is forecasting third quarter real GDP growth of just 0.9%, a level at which the Federal Reserve may remain nervous about raising interest rates. On the other hand, unemployment has generally remained a bright spot, with the unemployment rate of 5.1% very close to the 4.9% level at which the Federal Reserve considers the economy to be at full employment. Despite this, the labor market surprised and disappointed investors in September with only 142,000 new jobs reported, missing analyst estimates by 64,000. This soft labor report, coupled with weaker economic growth in China and the broader emerging markets, has reduced the market implied probability of an increase in rates at either the October 27th or December 15th Federal Reserve meetings to just 36%.

China Currency Update

In an attempt to allow its currency to move more freely, the Chinese government is implementing structural reforms and utilizing monetary policy to open its capital markets up to international flows. On August 11th, the People's Bank of China announced that the official daily exchange rate, also known as the 'fixing', would be determined by supply and demand rather than remaining pegged to the U.S. dollar. There are several underlying reasons behind China's desire to have a floating currency rate, including its ambition to be part of the International Monetary Fund's (IMF) special drawings rights (SDR) basket of global currencies and to combat the slowdown in the growth of the its economy.

The SDR was created by the IMF in 1969 to support the Bretton Woods system of fixed exchange rates and to supplement countries' official foreign-exchange reserves. The SDR basket consists of the U.S. dollar, Euro, Japanese yen, and British pound. One would argue that the yuan is moving towards becoming a more freely usable currency which is one of the criteria to join IMF's SDR basket.

China's official de-pegging from the U.S. dollar began in 2005. However, recent moves caused the currency to fall to a four-year low, disrupting global equity markets. The U.S and Chinese economic environments have diverged as the U.S. steadily recovers, while China struggles to maintain the government's economic growth target. Thus, China needs additional monetary policy tools to stimulate economic growth.

Foreign direct investment into China has been open for decades, albeit with an approval process and restrictions on many sectors. Trade credit and offshore borrowing are relatively accessible. However, one of the largest restrictions remains on individual foreign currency exchange. Chinese citizens are only allowed to purchase $50,000 of foreign currency from banks per annum.

The IMF has indicated that there are no Board-approved criteria, nor a limit on the number of currencies in the SDR basket. However, it remains to be seen whether the recent attempt to move towards a freely usable currency and how the implementation of the reforms will enhance China's opportunity to join the SDR basket.

The Markets

Developed bond markets rallied as global economic concerns and headlines led to a global risk-off trade. Investors have been focusing on China and what the Federal Reserve (Fed) would do at its September meeting. After China devalued its currency in August and the Fed left U.S. rates unchanged, investors presumed that the global recovery was not as strong as originally thought. Bond returns moved positively, primarily in longer maturities, after their poor second quarter. German, British and U.S. sovereign yields all fell by at least 20 basis points (bps). However, most sovereign bond yields remain little changed from where they started this year (Figure 1).

Municipal bonds rallied with U.S. Treasuries on the flight-to-quality trade. Municipals have navigated their own obstacles through the year with pension and budget issues in Chicago, New Jersey, Illinois and Puerto Rico. However, despite these issues, municipal bonds have remained resilient and have generated positive returns in the third quarter and for the year. High-yield municipals followed investment grade municipal and Treasuries higher, as investors continued to search for higher yield with less risk. High-yield municipals remain attractive relative to high-yield corporates.

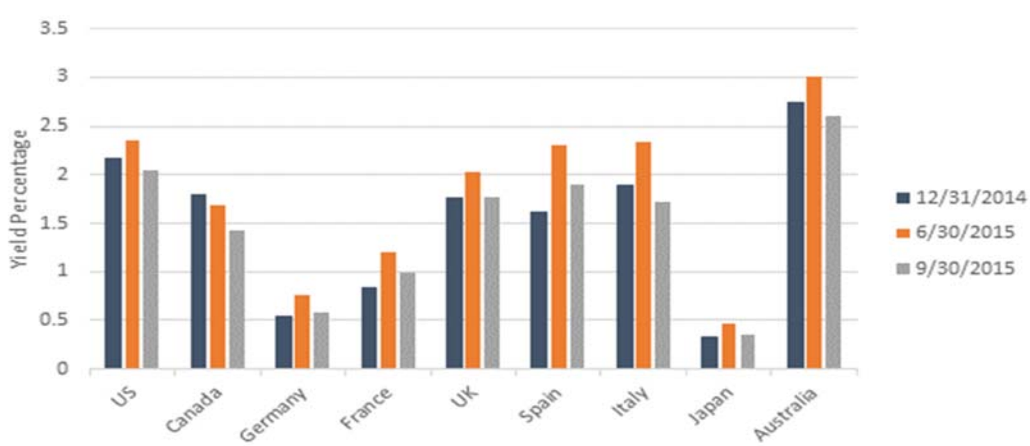
High-yield corporates performed poorly during the quarter, as spreads widened and default concerns spiked. The high yield market sold off as the energy industry struggled with subdued oil prices, increasing the risk of bond defaults. Having been in a low rate environment for so long, many high-yield companies became over-levered. Now, as the commodity boom comes to a crushing halt and earnings growth dissipates, energy companies are showing signs of difficulties in meeting current and future bond payments.

International developed bond markets did not feel the brunt of the global risk off -trade, but did see a small impact, as international bond yields rose on economic concerns amid weak data from parts of the Eurozone and China. Emerging markets sold off significantly, as investors became weary of a contagion effect from China's slowdown. This was primarily felt in the Southeast Asian countries, such as Malaysia, that have China as a primary trading partner.

Global equities had one of the worst quarters in years, as every market turned negative for the year to date in a matter of just six weeks. Developed market equities had been generally range bound for the first eight and half months of the year. However, global equity markets slumped after China devalued its currency, and they continued to fall through September.

Sovereign bond yields remain little changed from where they started 2015.

Figure 1: Global Bond Yields



Source: Bloomberg

Figure 2: Russell YTD Returns

Index	YTD
Russell 1000 Growth	-1.5
Russell 1000	-5.2
Relative	**3.7**
Russell 1000 Growth	-1.5
Russell 1000 Value	-9.0
Relative	**7.4**
Russell Midcap Growth	-4.2
Russell Midcap	-5.8
Relative	**1.7**
Index	**YTD**
Russell Midcap Growth	-4.2
Russell Midcap Value	-7.7
Relative	**3.5**
Russell 2000 Growth	-5.5
Russell 2000	-7.7
Relative	**2.3**
Russell 2000 Growth	-5.5
Russell 2000 Value	-10.1
Relative	**4.6**

Source: Bloomberg

U.S. equity markets also fell as global growth concerns arose. U.S. economic data came in better than expected as second quarter GDP growth was revised up to 3.9%. As a result, U.S. companies should see some benefit in their quarterly earnings. However, analysts have estimated third quarter earnings to be down 3.7%, so we may continue the 2015 trend of companies beating depressed earnings estimates. Equities will need to generate fundamental earnings growth, as the days of high equity returns from multiple expansion are coming to an end.

While equities sold off during the third quarter, market capitalization and style remain a big factor. Large and mid-cap stocks outperformed small and micro-cap stocks during the quarter and for the year so far. Year to date, style remains an important difference in relative returns across all capitalizations. Large-cap growth has outperformed value by 742 bps, mid-cap growth beat value by 350 bps and small-cap growth outperformed value by 459 bps (See Figure 2).

International equities fared much worse than the U.S. equity market as Europe struggled with mixed economic data of its own. Europe is seeing a slow recovery, thanks to the continued easing by the European Central Bank (ECB). Spain, Italy, and Germany have led the region in economic expansion. The ECB remains supportive, stating that it will continue its bond buying program after September 2016, if necessary, to ensure an economic recovery.

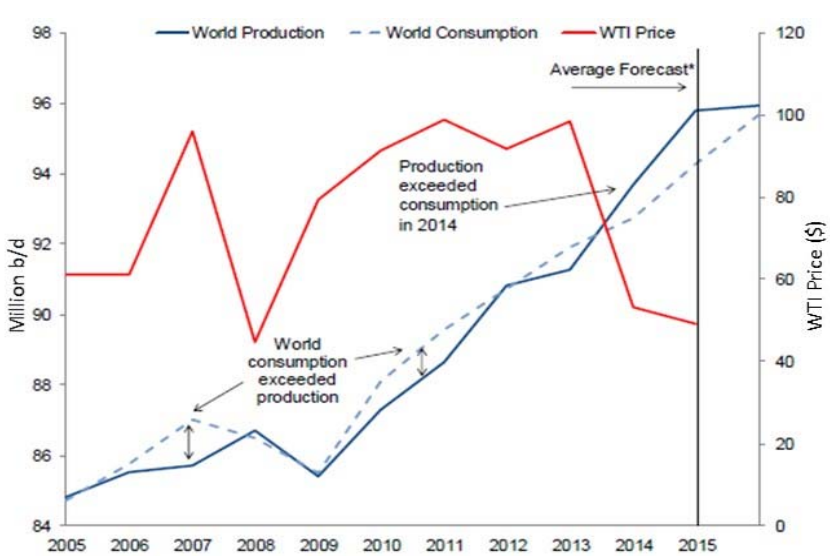
Developed and emerging markets in Australasia fared poorly during the third quarter. Japan and Australia, two of the biggest developed Pacific markets, had the weakest performance. Japan struggled due to domestic economic issues, such as mediocre growth and low inflation, while Australia had to contend with its heavy reliance on commodity based exports. Emerging Asian markets also performed poorly, as China's slowing economy led to contagion concerns and significant investor outflows.

Emerging Latin American markets were the poorest performing region for the quarter. Brazil continues to navigate a difficult recession coupled with high inflation, a highly contentious political scene and a rapidly depreciating currency. As oil prices remain subdued and range bound, countries such as Venezuela and Colombia, where oil exports make up a significant amount of their revenue, have struggled. Latin American markets are relying on the catalyst of economic reforms to alleviate the dependency issues of commodity exporting countries.

The commodity market ended the third quarter with the worst decline since 2012. Cyclicality in the commodity market is expected, and while not enjoyable, the down-market is normal. Currently, we are faced with a supply glut (See Figure 3) following several years where prices were above the marginal cost of supply. Furthermore, China, as one of the largest commodity consumers in the world has created demand uncertainties due to its economic slow-down. The price of oil has been cut in half compared with a year ago, to $45 from $87, and is down more than 60% from its peak in the mid-2000s.

MLPs have lost 30.7% year to date as their short-term performance has been

Figure 3: Crude Oil Production & Demand



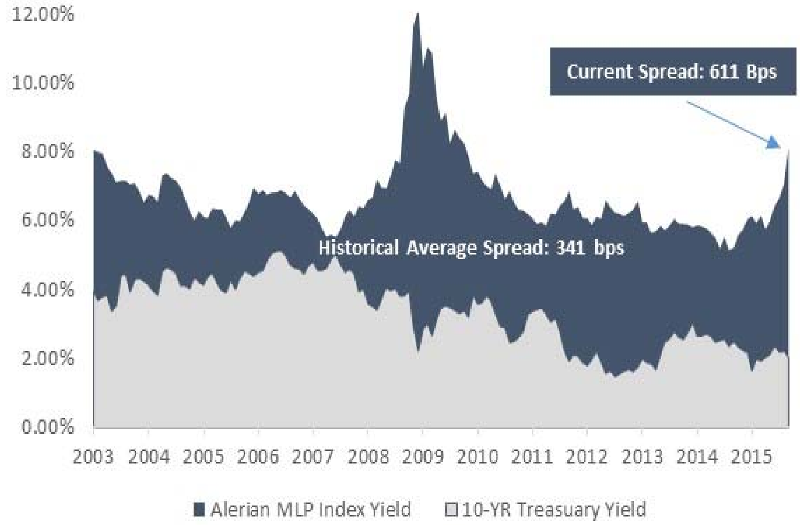
Source: Bloomberg, Goldman Sachs

highly correlated with the price of oil. A significant number of MLPs in the Alerian Index currently offer a rich yield of more than 10%. In the history of MLPs, yields over 10% have never lasted more than a few months. Market Street continues to view the MLP space as an attractive, long-term investment opportunity, as current spreads to 10 year Treasuries are above historical norms (See Figure 4).

Overall, precious metal returns remained negative for the third quarter of 2015. However, during the month of September, palladium, which is used in catalytic converters, recorded the best weekly gain in four years thanks to the Volkswagen emission control scandal. Gold gained momentum as the Fed's interest rate hike became more uncertain again.

During the quarter, REITs delivered positive returns. Prime real estate in most developed markets have largely recovered back to the 2007 pre-crisis peak due to a combination of rental income growth and higher occupancy.

Figure 4: Alerian Index Yields v. 10-Yr Treasury



Source: Bloomberg, Harvest

Volatility in the U.S.A.

U.S. Equity markets had a rough run over the last month and a half. One may ask "Why are stocks down? The U.S. is the strongest economy!" While this is true, the U.S. stock market is not as domestically focused as one would think. As global concerns weigh on investors, a "risk-off" trade, where investors sell stocks and move to safe-haven assets like U.S. Treasuries, results. The panicked trading of late can be measured by the VIX Index, a gauge of volatility in the equity markets. In Figure 5, one can see what has caused both market volatility and the S&P 500 Index to move as they have over the last eight years. Thanks to the support of low interest rates and an accommodative central bank, the only recent bouts of volatility came from international risks.

The big takeaway is that we have been here before. This is not a new market environment but a re-emergence of an old friend (volatility) that has been absent for quite some time. At a time when low rates and easy money rules equity markets, risk concerns are subdued. As the Federal Reserve looks to hike rates and tighten monetary policy, the U.S. stock market will lose that support. As China slows, commodity markets struggle with a supply glut, and the Fed looks to tighten monetary policy, increased volatility will likely persist. While its easy to equate volatility with poor equity returns, that is not always the case. As in the past, as markets normalize, volatility will move with investor concerns. At this time, however, investor concerns are focused primarily on international issues rather than domestic.

Outlook

After a rough 3rd quarter, and four consecutive down months, are markets headed further down or is the correction over? There are positive and negative aspects to the global economy and markets, with an equal case to be made for both sides. The more "optimistic" case states:

- The U.S. continues to grow around 2.5% annually. Unemployment stays low, inflation remains non-existent and housing continues to strengthen.
- In Europe, economic trends remain positive, supported by continued massive ECB stimulus.
- A strengthening dollar makes imports relatively cheap and foreign company's goods more attractively priced for U.S. consumers.
- Energy and other commodity prices have plummeted, acting like a huge tax cut for consumers in commodity importing countries, which includes much of the developed world.
- After "bear" market declines in some foreign markets and a "correction" in U.S. markets, stocks are at most fairly valued, and attractive in certain markets.

The "pessimistic" view states:

- Economic growth globally continues to be below the trend one would expect after the deep recession in 2008, particularly if one adds in the massive monetary stimulus provided.
- Further global Central Bank activity reflects a fear of deflation. The precipitous decline in commodity prices portends a slowdown in economic activity and possible deflation.
- China is faced with a slowing economy, a huge debt overhang and strong government intervention that doesn't seem to help. A "hard landing" (unexpected slowdown in Chinese growth) if it happens, would be stressful on all markets.
- An increase in rates by the Federal Reserve would cause further dollar strengthening, weakening emerging market currencies and continuing the capital outflow from these countries.

In our opinion, it seems as investors are putting equal weight on both of the above views, hence an increase in volatility and very little return. After long periods of strong returns, it is only natural to have a period of consolidation in the market. We believe we are in a mid-cycle economic slowdown rather than spiraling towards recession. Therefore, we have not been defensively positioned, but rather have been adding periodically to areas where market sell-offs have made assets attractive.

Figure 6 depicts a sample Growth Account's current positioning. During the year, we have slowly added to foreign equities, as their valuations became more attractive and the strengthening dollar made foreign companies more competitive. We have reduced exposure to hedge funds as their after-tax risk/return profile has become less attractive.

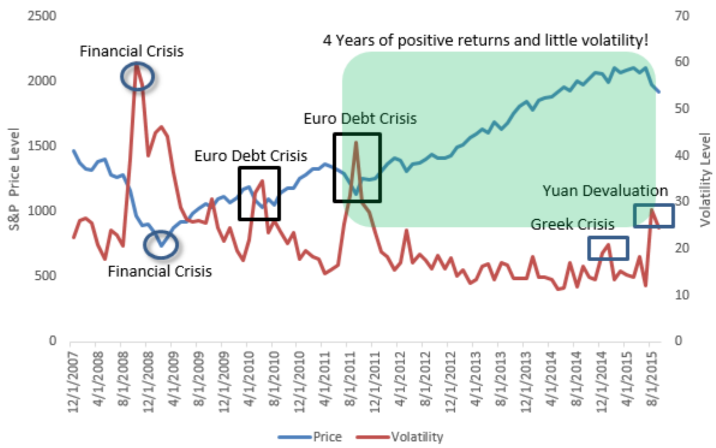
Despite the recent sharp correction in MLPs last quarter, our long-term view on this asset class remains positive. We believe the short-term dislocation in the MLP space is a buying opportunity. Therefore, we will be increasing our allocation to MLPs over the coming months.

Market turbulence and sell-offs are always unsettling for clients, as they are for the Market Street investment team. No one likes to see their asset balances decrease during the quarter. But increased volatility and sharp sell-offs (especially indiscriminate selling), can provide more attractive buying opportunities, allowing patient investors to benefit even more in the long run. We remain optimistic that the short-term pessimism we are seeing currently will, in the end, put us on a path to much better returns.

Mike

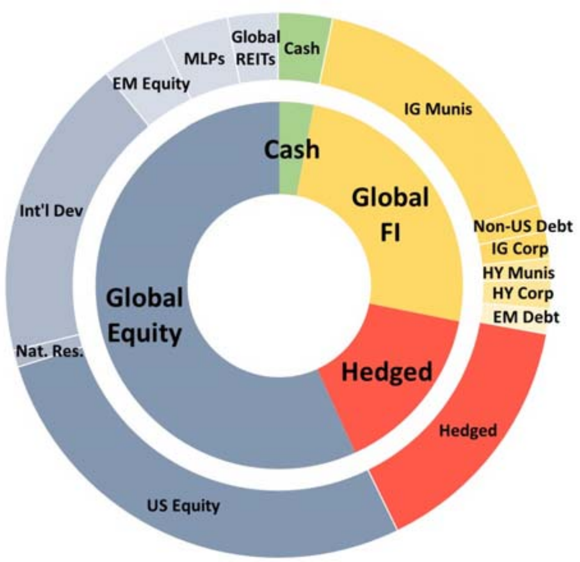
Michael R. Eisner
Chief Investment Officer

Figure 5: Historical Volatility



Source: Bloomberg

Figure 6: Sample Market Street Growth Account Asset Allocation



Market Data

EQUITIES	Q3 '15%	YTD%	1 YR%	3 YR%
S&P 500	(6.4)	(5.3)	(0.6)	12.4
Russell 1000	(6.8)	(5.2)	(0.6)	12.7
Russell Midcap	(8.0)	(5.8)	(0.2)	13.9
Russell 2000	(11.9)	(5.8)	(0.2)	13.9
Wilshire 5000	(6.9)	(5.4)	(0.4)	12.4
MSCI ACWI ex. US	(12.2)	(8.6)	(12.2)	2.3
MSCI EAFE	(10.2)	(4.9)	(8.3)	6.1
MSCI Japan	(11.8)	0.2	(2.2)	9.0
MSCI EM	(17.9)	(15.5)	(19.3)	(5.3)
S&P Global REIT	(0.3)	(4.4)	5.2	7.9

FIXED INCOME	Q3 '15%	YTD%	1 YR%	3 YR%
Barclays Municipal	1.3	1.6	2.2	2.1
Barclays Municipal HY	2.0	0.0	1.2	3.7
Barclays Corp. HY	(4.9)	(2.5)	(3.4)	3.5
JPM EMBIG (LC)	(2.0)	(4.4)	5.2	7.9

ECONOMIC DATA	Sept	Aug	July	June	May
Unemployment Rate	5.1%	5.1%	5.3%	5.3%	5.5%
Nonfarm Payrolls Net	142k	136k	223k	245k	260k

Retail Sector	MoM %	YoY %
Retail Sales	0.2	2.2
Retail Sales ex. Autos	0.1	1.3

Global Macro Data	9/30	1 Mo%	YTD%	1Yr%
U.S. CPI Index	237.9	-0.1	0.7	0.2
U.S. Unemployment	5.1%	-0.2	-0.5	-1.0
U.S. Real GDP ($billion)	$16,334	0.0	1.1	2.7
LIBOR (3 month)	0.33%	0.0	0.07	0.09
VIX (S&P 500)	24.5	-22.0	27.6	46.6

COMMODITIES	9/30$	YTD%	1Yr%
Gold	1.115	-5.9	-8.2
Silver	14.63	-6.9	-14.9
Oil	48.77	-24.7	-49.8
Natural Gas	2.81	-7.3	-31.6

CURRENCIES	9/30	1 Mo%	YTD%	1Yr%
Euro/ U.S.	1.12	1.5	8.5	13.2
Sterling / U.S.	1.51	1.1	2.9	7.0
U.S. / Yen	120.21	0.7	0.4	10.4

Source: Morningstar, Bloomberg

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Please visit our website, **www.MarketStreetTrust.com** for more information and as always, please feel free to contact us if you have any questions about the investment program.

80 E. Market Street, Suite 300 | Corning, New York 14830 | 607.962.6876 phone | 607.962.6709 fax
499 Park Avenue, 26th Floor | New York, New York 10022 | 212.400.9070 phone | 607.962.6709 fax
www.MarketStreetTrust.com

Michael R. Eisner CFA®	Robert J. White CFA®, CFP®	Ross Miller, CFA®	Bulezim Azemi	Amy R. Sydlansky
Chief Investment Officer	Director of Investments	Senior Investment Analyst	Investment Analyst	Investment Associate