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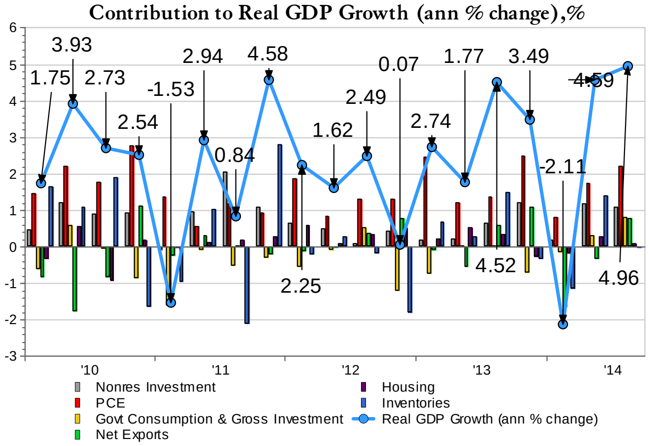
Market Review

December 2014

Economic Review

After contracting 2.1% during the first quarter, the U.S. economy registered its strongest quarterly growth in 11 years during the third quarter. Third quarter real GDP growth was revised to 5.0% annual rate (a.r.) by the Bureau of Economic Analysis (BEA), citing stronger consumer and business spending than previously assumed. Substantial revisions to economic data are not unusual as later estimates are calculated using more complete data. The U.S. economy grew at a 4.6% a.r. during the second quarter. Despite strong back-to-back quarterly growth numbers, GDP growth is only up +2.7% year-over-year (YoY).

Contribution to Real GDP Growth (ann % change),%

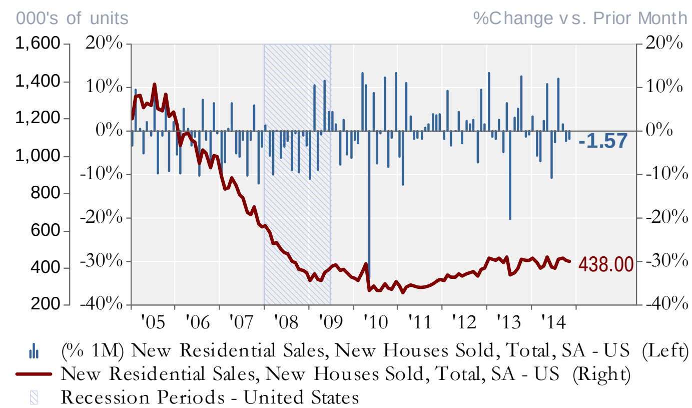


According to the household survey, the month of November brought little change to the unemployment rate, which remained at 5.8% with the number of unemployed persons slightly changed at 9.1 million. The unemployment rate has declined 1.2% over the past twelve months. The civilian labor force participation rate held at 62.8% and has remained unchanged since April. Total nonfarm payroll employment increased by 321,000 in November, compared with an average monthly gain of 224,000 over the 12 months prior.

Inflation continues to remain well under historical averages. The headline Consumer Price Index (CPI) declined -0.3% Month over Month (MoM) and rose 1.3% over the last twelve months as stronger dollar and declining energy prices continued to apply downward pressure. Core CPI rose 0.1% MoM and +1.7% YoY. Breakeven measures of inflation declined for the third consecutive month. The 5 year/5 year forward breakeven inflation rate declined 7 bps to 1.91%. The Producer Price Index, for final demand, fell 0.2% in November.

The U.S. housing recovery may be slowing based on the data in December. The S&P/Case Shiller Composite Index of 20 metropolitan areas gained 4.5% in October from the prior year, compared with a revised 4.8% increase in September. Existing home sales fell 6.1% MoM to 4.93 million a.r. during November, notably sales of both single family and condo/co-op units were weaker than the prior month. Existing home sales are up 2.1% YoY. The current inventory of existing homes remained at 5.1 months. New home sales fell for the second consecutive month, declining 1.6% MoM to 438K a.r. during November while Housing starts declined 1.6% MoM to 1.03 million a.r.

US New Home Sales



U.S. manufacturing activity in November was better than expected for the most part. Manufacturing activity expanded for the 18th consecutive month. The ISM Manufacturing Index declined slightly from 59.0 to 58.7 but remained above the expansion level of 50. The ISM Non-Manufacturing Index rose 2.2 points to 59.3 on strong business activity and new orders. Retail sales increased 0.7% MoM and +5.1% YoY. Excluding automobiles, retails sales were still up +0.6% MoM.

In a statement released after the December meeting, the Federal Open Market Committee (FOMC) reaffirmed its view that the current target range (0-25 bps) for the federal funds rate remains appropriate. It is anticipated that the first rate hike will happen between June and September of 2015. The FOMC next meets on January 27 and 28.

Eurostat's final estimate of Eurozone third-quarter GDP growth was unchanged at 0.2% over the previous quarter. The Eurozone grew 0.8% in 2014, led by stronger than expected readings from peripheral countries Romania, Poland, Greece, and Slovenia. Inflation in Europe continued to be weak; headline CPI dipped to 0.3% in November, matching expectation but slightly lower than October's 0.4% reading. Month-over-month, the headline CPI was -0.2%, driven mostly by plummeting energy prices. European Central Bank (ECB) President Mario Draghi released a statement indicating that the ECB would not tolerate persistently low inflation, though he stopped short of introducing additional stimulus measures. Forecasts for 2015 are more optimistic; Ernst & Young's projection for Eurozone growth in 2015 is 1.2%, bolstered by higher exports due to a weaker Euro. The ECB, on the other hand, has forecasted 2015 growth of 1% and inflation of 0.7%. The ECB has downgraded its growth forecast for three consecutive meetings.

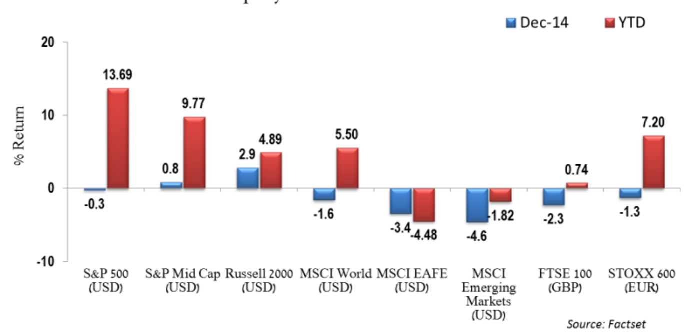
In the UK, the Office for National Statistics (ONS) released the country's third quarter GDP growth final estimate as 0.7% quarter-over-quarter. This growth rate is lower than the previous quarter's 0.9% rate, but remains unchanged from the estimates released in October and November. In annual terms, growth was revised down to 2.6% from 3%, driven by lower investment and net exports. The ONS also released the UK's current account deficit for 2014, which stands at a record-high £27 billion. Inflation slid to a 12-year low, driven by falling oil and food prices. The benign inflation and moderate growth environment has eased pressure on the Bank of England to raise rates, though the Monetary Policy Committee's latest interest rate meeting showed division within the committee.

In Asia, third quarter Japanese GDP was revised down to -1.9% YoY, driven by an adjustment to inventories. Economists project a return to growth for Japan in the fourth quarter. Prime Minister Shinzo Abe dissolved parliament in December and called for a snap election; many analysts believe Abe wants to use the snap election as the declaration of a mandate for his monetary easing and tax policies. In China, the HSBC Purchasing Managers' Index (PMI) fell to 49.6 from 50 the previous month, signaling the first contraction in 7 months and an 18-month low.

Equity Markets

Global equities ended December mixed, as the MSCI World lost -1.6% for the month. After gaining over 27% in 2013, the MSCI World Index finished 2014 with a 5.5% gain in USD terms. Domestic large cap stocks, as measured by the S&P 500, lost -0.3% in December, but finished 2014 up 13.7%. Domestic mid-cap stocks, as measured by the S&P 400 gained 0.8%, while the Russell 2000 small-cap index finished the month up 2.9%. The headline indices for Europe (STOXX 600) and the UK (FTSE 100) declined -1.3% and -2.3%, respectively. The MSCI Europe, Australasia, and Far East Index (EAFE) lost -3.4% in December and ended the year down -4.5%, while Emerging Markets also posted negative returns. The currency impact on the MSCI EAFE and Emerging Markets indices was substantial, as each posted modest gains in local currency terms, but had negative returns in USD terms.

Equity Market Performance



Source: Factset

The S&P 500 traded choppily in December, as the impact of falling oil and forecasts of Fed tightening weighed on the market. The S&P 500 lost -4.5% through the first two weeks of trading, before a year-end rally took the index into positive territory until the final trading day of the month. Market volatility, as measured by the CBOE Market Volatility Index (VIX), finished the month higher, closing at 19.20, up from 13.33 at the end of November. The VIX had four moves of over 15% in December, including a 20% spike on New Year's Eve. The 19.20 monthly close is just below the long-run average of 20. Volatility of European stocks, measured by the Euro Stoxx 50 VIX Index, also trended higher throughout December, closing at 26.19, after closing November with an 18.03 reading.

Bond Markets

U.S. Treasury yields declined in December. Bond investors cited concerns about the effects of declining oil prices on oil exporting economies, especially Russia, the slowing Chinese economy and a stagnant Europe facing looming political uncertainty in Greece. The U.S. Treasury yield curve continued to flatten as the 2 year-30 year spread narrowed 38 bps in December to finish 2014 approximately 150 bps flatter. The U.S. bond market, as measured by Barclays U.S. Aggregate Index, increased 0.1% and is up 6.0% for the year. Credit spreads, as measured by the Barclays Credit Index Option Adjusted Spread widened 7 bps during December and 14 bps for the year.

The 30-year U.S. Treasury bond yields declined 16 basis points to close at 2.75% in December. The 10-year U.S. Treasury bond yield closed at 2.17% last month, 3 bps lower than November's closing yield of 2.20%. Yields on 30-year and 10-year Treasury bonds declined 119 bps and 84 bps respectively during 2014. The UK 10-year benchmark gilt yields declined 18 bps to close at 1.75%. The yield on

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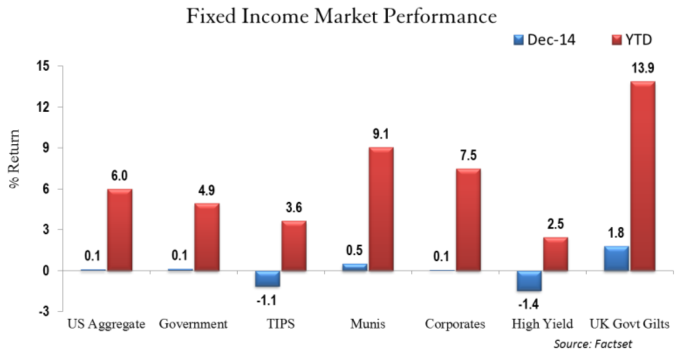
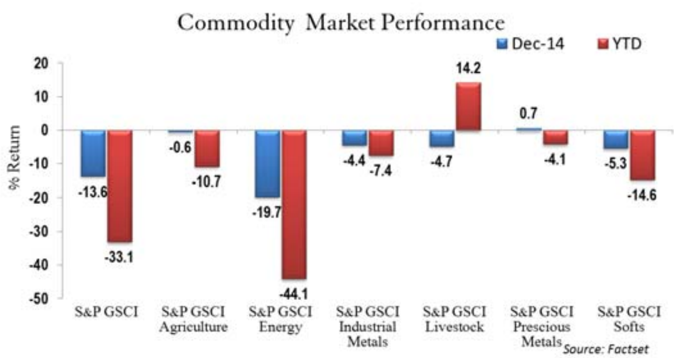
German 10-year benchmark bonds fell 13 bps to close at 0.53% in December. The UK and German 10 year yields fell 127 and 141 bps respectively over the past twelve months.



Commodities

The S&P GSCI Total Return Index, a headline index of 24 commodities, continued to slide in December, losing -13.6% on the month to finish 2014 down -33.1%. Of the six major sub-indices, only the Precious Metals sub-index finished the month in positive territory. The Livestock sub-index was the only sub-index to finish 2014 with positive returns, gaining 14.2% for the year due to the spreading of the PED virus (in hogs) to North America, rising production costs, and increasing global demand for meat.

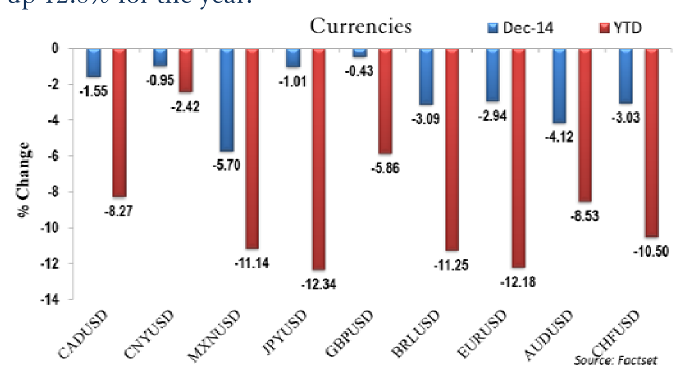


Agricultural commodities, represented by the GSCI Agricultural and Softs sub-indices, experienced a whipsaw year. After rising approximately 20% in the first 4 months of the year, the indices reversed sharply to post negative 2014 returns; the Agricultural sub-index lost -10.7% in 2014, while the Softs sub-index declined -14.6%. Sugar [-30.9%], Cotton [-21.2%], Corn [-13.3%], and Wheat [-9.4%] all posted substantial losses in 2014. Agricultural commodities were significantly impacted by global drought concerns, which were high in the early months of 2014, only to wane in recent months, causing prices to tumble as estimates for crop production were revised upward.

The Energy sub-index continued its dizzying slide, posting a -19.7% return for the month adding to significant year-to-date losses. The sub-index lost more than -44% in 2014, pushed lower by a stronger US Dollar, oversupply concerns, and a forecasted shortfall in demand as global growth wavers. West-Texas Crude Oil opened the month at $65.99/bbl and traded down most of the month, closing December at $53.71/bbl. The S&P Crude Oil sub-index declined -19.7% for the month, and lost -42.6% in 2014. Refined products fell sharply in December, led lower by Gasoil [-22.1%], Gasoline [-20.0%], and Heating Oil [-14.0%]. After rising slightly in November, refining margins contracted sharply in December, further pushing lower the prices of refined products.

Currency

The US Dollar extended its gain against a basket of peers for the sixth straight month in December. Boosted by falling oil prices and expectations of higher domestic interest rates, the US Dollar Index appreciated 2.3% in December and is up 12.8% for the year.



The Euro declined for the sixth month against the US Dollar on expectations of further monetary easing by the ECB due to weak growth and low inflation prospects in the Euro area. The Euro declined -2.94% against the US Dollar to close at 1.210 USD/EUR. The British Pound depreciated -0.43% against the US Dollar in December to close at 1.5592.