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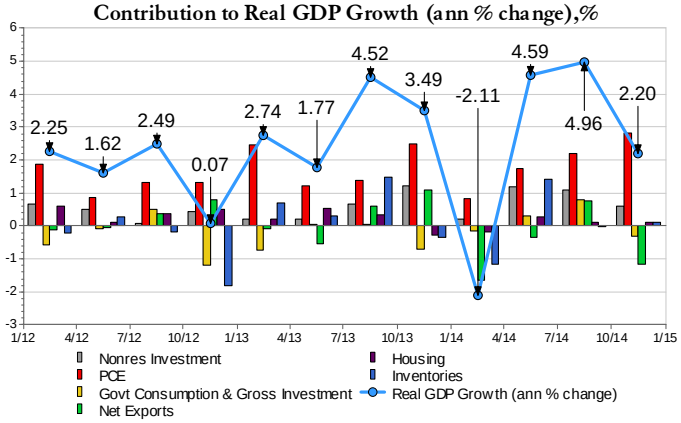
Market Review

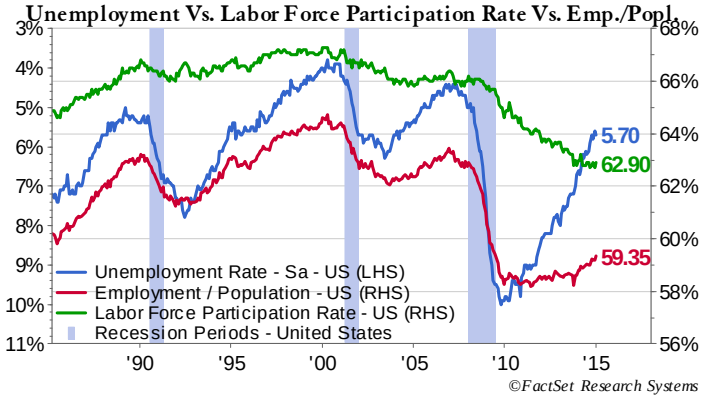
February 2015

Economic Review

Real GDP grew 2.2% in the fourth quarter of 2014 according to the revised estimate released by the Bureau of Economic Analysis compared to the original estimate of 2.6%. Growth was weaker than previously estimated as private inventory investment increased less than previously estimated while non-residential fixed investment increased more. Real GDP increased 2.4% during 2014 compared with a 2.2% increase during 2013.

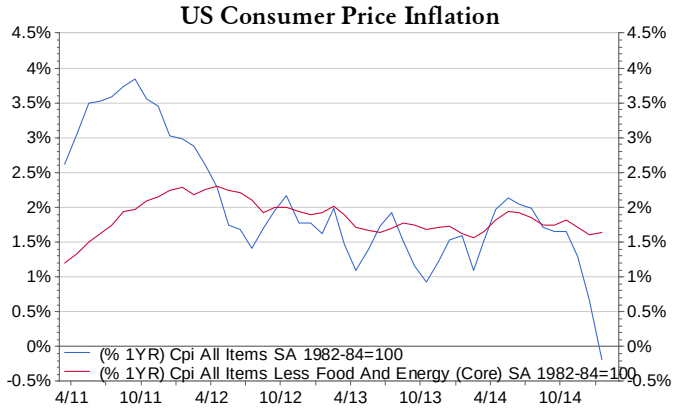


Nonfarm payrolls increased 257,000 during January, exceeding most analysts' expectations. After incorporating net upward revisions for prior two months, the monthly job gains averaged 336,000 over the past three months. Despite the strong job gains, the unemployment rate increased to 5.7% from 5.6% as the labor force participation rate increased by 0.2% to 62.9%. Average hourly earnings increased by 12 cents to $24.75 in January vs. a decline of 5 cents in December. Average hourly earnings increased +2.2% over the year.



February housing data saw an increase in home prices while existing and new home sales decreased. The S&P/Case-Shiller Home Price Index rose 0.87% month-over-month (MoM) on a seasonally adjusted basis during December and is up +4.46% year-over-year (YoY). Existing home sales fell 4.9% MoM in January to an annualized rate (a.r.) of 4.82 million units. Existing housing inventory represents 4.7 months of supply at current sales levels. Housing starts decreased 2.0% MoM during January to a.r. of 1.07 million. Building permits fell slightly by -0.7% to a.r. of 1.05 million. New home sales were also little changed during January as total sales came in at 481,000 units.

Inflation continued to decline in January. The headline CPI declined 0.7% MoM in January and is now down -0.1% YoY. Core CPI, which excludes food and energy costs, rose +0.2% in January and 1.6% YoY. Breakeven inflation increased for the first time since July. The 5 year/5 year forward breakeven inflation rate increased 14 bps, to 1.98%.



The Federal Open Market Committee (FOMC) voted unanimously to keep the Federal Funds Rate at its lower bound according to the January FOMC minutes released on February 18th. Few members expressed concerns about weak inflation. Fed Chair Janet Yellen gave a testimony to Congress at the end of the month briefly bringing some volatility to the Treasury bond market as traders tried to discern the timing of the much anticipated rate hike.

Eurostat estimated Q4 2014 Eurozone real GDP growth at 0.3% quarter-over-quarter; economists had predicted growth of 0.2%. Germany and Spain led the way with 0.7% growth, while Greece shrank for the first time in three quarters. On an annual basis, fourth quarter GDP growth in the Eurozone was up 0.9%, from 0.8% in the third quarter. Eurozone headline CPI for January was -0.6%, lower than the -0.2% reading in December; the recent decline is largely explained by declining energy prices. Core CPI, which excludes food, energy, alcohol, and tobacco costs, rose by 0.6% in January, meeting forecasts and unchanged from an initial estimate. The European Commission, European Central Bank (ECB), and IMF, collectively known as "Troika" are involved in tense negotiations with Greece's new government which is seeking to amend terms of its bailout by further extending the timeline before austerity requirements and interest payments are due.

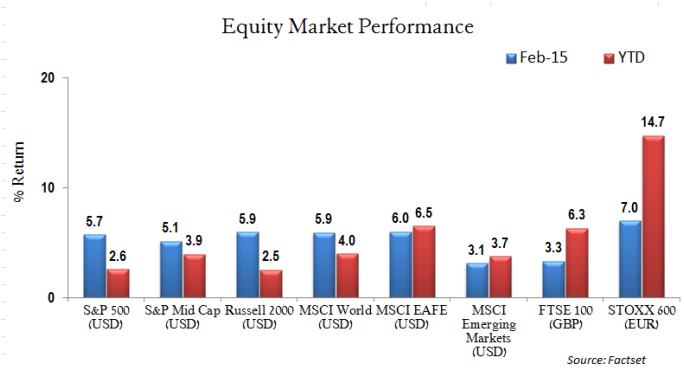
In the UK, the Office for National Statistics' (ONS) estimate for January inflation was 0.3%, lower than the 0.5% reading in December and the slowest pace since 1989. Similar to European inflation, the lower than expected reading in the UK was largely driven by weak energy and food prices. The ONS forecasted that inflation could turn negative in the coming months, which would mark the first negative headline inflation reading for Britain since 1960. In response to disinflation concerns, the Bank of England (BOE) released a statement signaling a willingness to cut interest rates if low inflation persists. BOE governor Mark Carney, however, said that strong consumer demand and economic growth should stave off the persistent deflationary pressures that have plagued other parts of Europe. The UK is showing textbook signs of "beautiful deflation," during which incomes hold steady as prices slow down or fall, leading to greater buying power for the consumer.

The Japanese economy pulled out of recession, albeit with slower growth than expected. Japan's GDP grew at an annualized rate of 2.2% in the fourth quarter, well below the 3.6% growth forecast by economists. Exports rose 2.7% from the previous quarter, as a weakening Yen has finally driven exports higher. Exports to the U.S. reached ¥1.4 trillion, the most since 2007, while Japanese exports to China totaled ¥1.27 trillion, the highest since late 2010. In China, the People's Bank of China (PBOC) further cut interest rates, slashing the short-term commercial lending rate to 5.35% and the one-year deposit rate to 2.50% in an effort to boost growth. This is the second time in three months that the PBOC has cut rates, as part of their effort to stimulate the economy, which has also included tax reductions among other measures. In early March the National People's Congress announced that China's 2015 growth forecast had been cut to 7%.

Equity Markets

Global equities ended February uniformly positive, as the MSCI World Index gained 5.9%. Domestic large cap stocks, as measured by the S&P 500, rose 5.7%, on the strength of a rebound in energy commodities and an improving labor market. Domestic mid-cap stocks, as measured by the S&P 400 returned 5.1%, while the Russell 2000 small-cap index finished the month up 5.9%. The headline indices for Europe (STOXX 600) and the UK (FTSE 100) gained 7.0% and 3.3%, respectively.

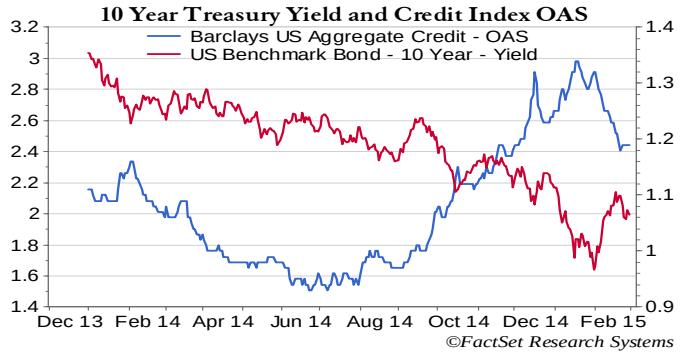
At the domestic sector level, Consumer Discretionary and Technology led the rally, each finishing February with over an 8% gain. The Energy Sector, which had been under significant pressure in recent months by plunging oil prices, rallied 4.1% in February. Utilities, which have traded with bonds as income-sensitive investors search for yield, lost -6.4% for the month.



The S&P 500 traded nearly straight up throughout the month, with only one drawdown of more than 60 basis points. The index was up 6.26% through February 24 before falling 51 bps over the last three days to close out the month. Market volatility, as measured by the CBOE Market Volatility Index (VIX), fell sharply during the month, closing at 13.34, down from 20.97 at the end of January, and below the long-run average of 20. The volatility of European stocks, measured by the Euro Stoxx 50 VIX Index, fell substantially lower throughout the month, closing February at 17.75, down from 24.73 at the end of January.

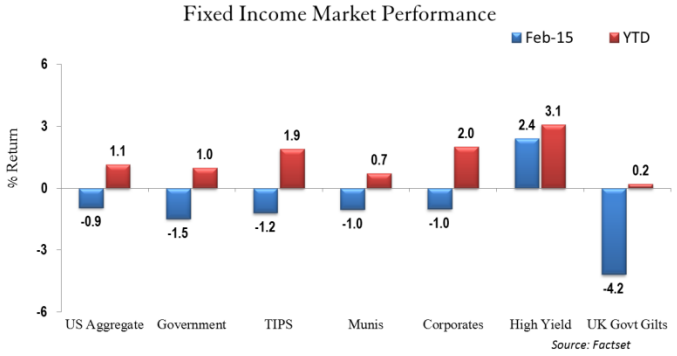
Bond Markets

Better than expected U.S. employment data, speculation of a rate hike later this year and an agreement on Greek aid extension resulted in risk assets rallying and Treasury yields moving higher. Credit spreads tightened last month as demand for credit improved. The Treasury yield curve steepened as short rates did not increase as much as long rates. The Credit Index Option Adjusted Spread narrowed 13 bps in February to close at +119 basis points.



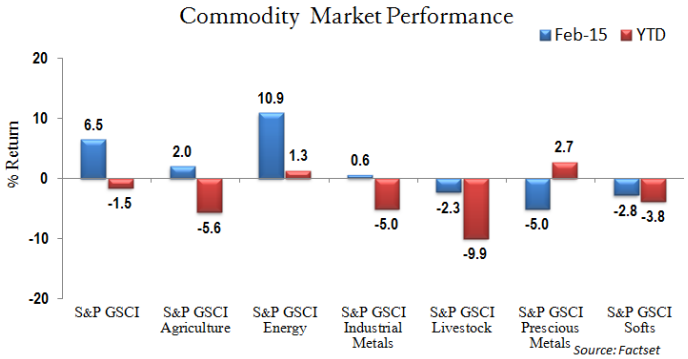
The 30-year U.S. Treasury bond yields climbed 34 basis points after declining 49 bps in the prior month to close at 2.60%. The 10-year U.S. Treasury bond yields also increased 32 bps to close February at 2.0%. The UK 10-year benchmark gilt yields reversed Januarys move to climb 42

bps, closing at 1.795%. The yield on German 10-year benchmark bonds was almost unchanged, closing February at 0.28%.



Commodities

The S&P GSCI Total Return Index, a headline index of 24 commodities, gained 6.5% in February and is now down 1.5% through the first two months of 2015. The six major sub-indices finished the month mixed, with three sub-higher while the other three posted negative returns. The Precious Metals sub-index gave back some of January's gain, losing 5.0% in February after rallying over 8% in the previous month. After reaching a near-term peak of $1,300/oz. on January 22, Gold fell over $85/oz. to close February at $1,213/oz. The Softs sub-index lost -2.8% in February, led lower by Coffee, which fell -14.7% after announcements of improved weather in Brazil and a higher than expected crop forecast by the International Coffee Organization.

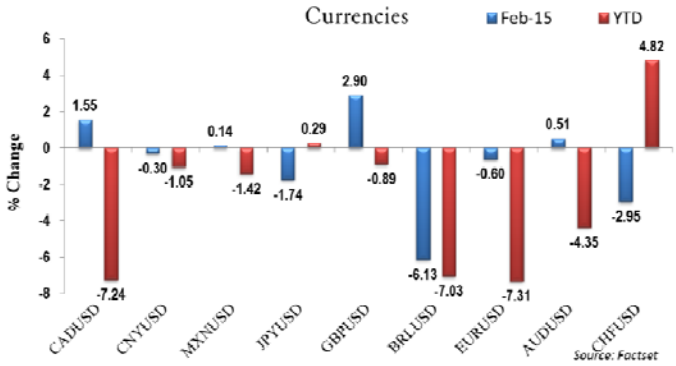


The Energy sub-index reversed January's losses, gaining 10.9% in February; the sub-index has gained 1.3% year-to-date, but has lost -44.3% over the last 12 months. West-Texas Crude Oil opened the month at $48.24/bbl and traded choppily most of the month, closing February at $49.52/bbl. Brent Crude, however, fared much better in February, as the global oil benchmark rallied from January's close of $56.05 to end February at $63.98. Brent's relative outperformance was driven by supply disruptions from Middle East exporters Libya and Iraq, while U.S. crude prices have been impacted by rising domestic inventories. U.S. Commercial Crude inventories reached 444.4 million barrels in February, the highest total in more than 80 years.

U.S. refining margins continued to expand in February, as Refined Products rebounded substantially more than Crude Oil on average. Gasoline [15.9%], Heating Oil [17.9%], and Gasoil [22.3%] all posted large gains in February. The price of WTI Crude Oil [1.4%] and Brent Crude [14.9%] increased less than refined products. The average price of gasoline in the United States increased nearly $0.30/gal. to $2.32/gal., as only two states (Idaho and Utah) finished February with average gas prices under $2.

Currencies

The US Dollar continued to rally for the eighth consecutive month against a basket of peers in February. The US Dollar Index appreciated 0.4% in February and is up 5.5% for the year. USD appreciated 12.8% during 2014.



The Euro has declined for eight straight months against the US Dollar. The Euro fell -0.6% against to close at 1.1216 USD/EUR. The British Pound rallied against the US Dollar, reversing the move in January. The Pound appreciated 2.9% against the US Dollar in February to close at 1.5454.