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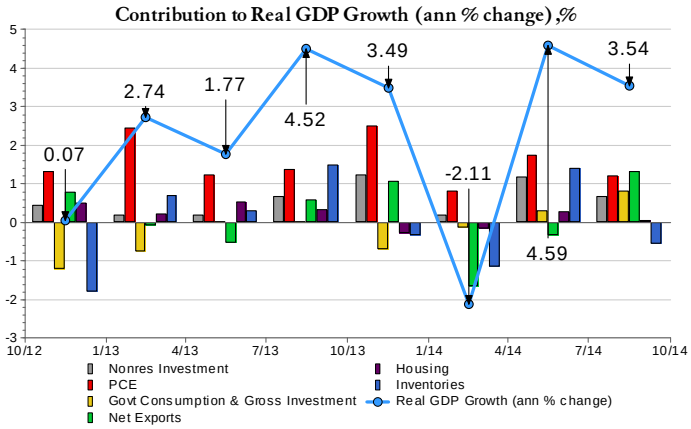
Market Review

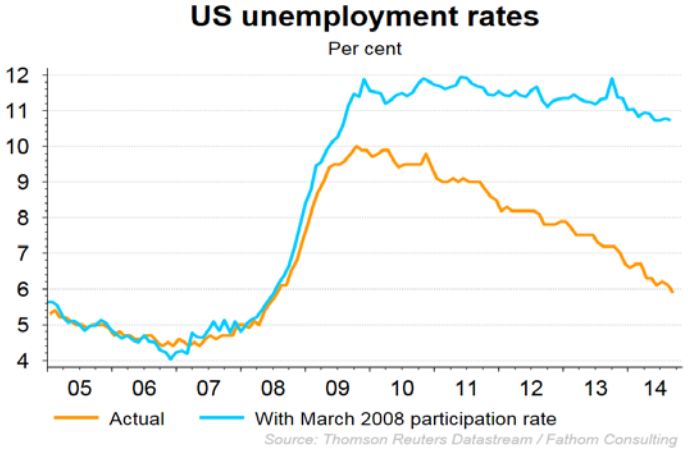
October 2014

Economic Review

The advance estimate of U.S. third quarter real GDP growth came in at a +3.5% annual rate (a.r.), higher than the expected 3.1%. The growth was less than the second quarter's 4.6%, but stronger than the -2.1% during the first quarter. Net exports and personal consumption were the largest contributors to growth during the quarter adding 1.32% and 1.22%, respectively. An unusual increase in defense spending also helped boost GDP growth. Domestic final sales (GDP less next exports and change in inventories), increased+2.7% a.r., and would have been around 2.0% without the boost from defense spending. Fourth quarter GDP is expected to be in the 2.5% to 3.0% range by market consensus.

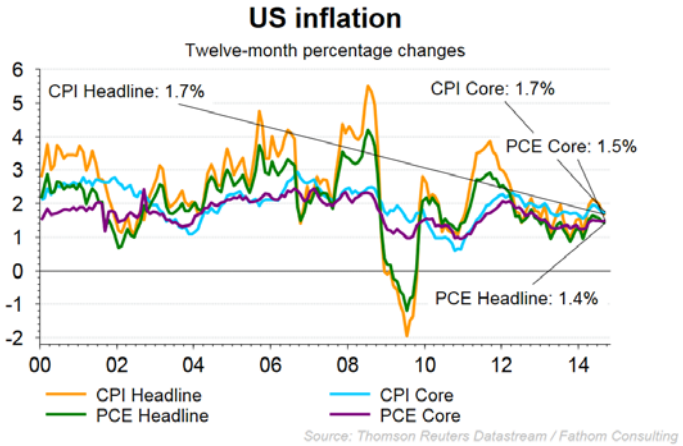


Total nonfarm payroll employment increased 248K in September and the unemployment rate fell to 5.9%. The unemployment rate fell below 6.0% for the first time since July 2008. The civilian labor force participation rate, declined to 62.7%, the lowest level since 1978. If the participation rate was kept constant at the March 2008 level, the current unemployment rate would be 10.7%.



U.S. regional and national manufacturing data were slightly weaker than expectations. Capacity utilization increased to 79.3%, from 78.8% in August, higher than the consensus expectation of 79.0%. Industrial production also exceeded expectations, rising +1.0% Month over Month (m/m), the largest increase since November 2012. Retail sales came in at -0.3%, weaker than the expected -0.1%, triggering a rally in U.S. government bonds.

The headline Consumer Price Index (CPI) rose 0.1% m/m in September and increased +1.7% Year over Year (y/y) as declining energy prices continued to put downward pressure on headline inflation. Core CPI also rose 0.1% m/m and +1.7% y/y. Breakeven measures of inflation declined for the second consecutive month. The 5 year/5year forward breakeven inflation rate declined 5 bps to 2.11%



Housing data continue to indicate a slow recovery. S&P/Case Shiller Home Price Index declined for the fourth consecutive month. Existing home sales rose 2.4% to 5.17 million annualized rate (a.r.), above the 5.1 million expected. New home sales came in at 467K a.r., slightly below the expected 470k. Housing starts rose by +6.3% m/m to 1.02 million a.r. in September, up from 957k in August. Building permits rose by +1.5% m/m to 1.02 million a.r. in September.

The Federal Open Market Committee (FOMC) announced the conclusion of its asset purchase program as expected. In their statement, the FOMC reiterated that it will likely maintain a 0% to 0.25% target range for the overnight Fed Funds rate for a considerable time. Mr. Bullard, the St. Louis Fed president and a non-voting member of FOMC, had suggested earlier in the month that the FED should consider delaying its plans to end the bond-buying program. The FOMC meets again on December 16th/17th.

The International Monetary Fund (IMF) released its World Economic Outlook in October, and the report contained many downward revisions to global growth estimates. Most notably, the IMF cut its 2015 outlook for Eurozone GDP

growth to 3.8% from 4.0% and cited deterioration in Germany, France, and Italy as reasons for the downgrade, albeit partially offset by surprising strength in Spain. In addition, the IMF doubled its probability that the Eurozone enters a recession in the next six months. As a remedy, the fund urged the European Central Bank (ECB) to purchase assets from struggling member-states to juice inflation, and advised Germany to stimulate its wavering economy through infrastructure spending. The fund also cut forecasts for several emerging market economies, including Brazil, Russia, and China.

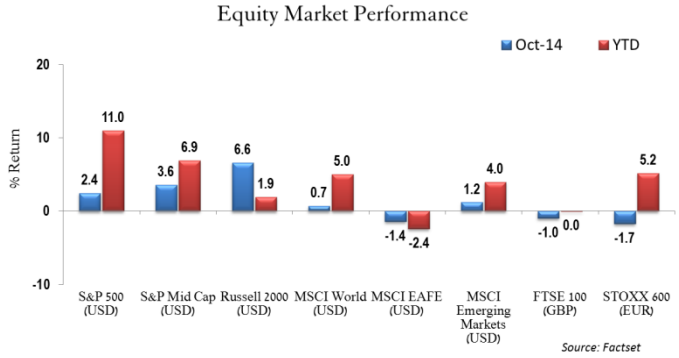
In Europe, second quarter 2014 GDP growth for the 18-country Eurozone was revised up to 0.10%. The revision, however, was driven by a change in calculation methodology by Eurostat. The new method takes into account R&D spending and government expenditures on weapons, which were not previously included. Eurostat's estimate for the Eurozone's September unemployment rate was 11.5%, flat compared to the previous month but a 0.5% improvement over the same period in the previous year. The labor market in the Eurozone continues to be mixed by country, with Germany and Austria reporting unemployment rates near 5%, while Greece and Spain struggle with crippling unemployment near 25%.

In the U.K., the Office for National Statistics released the country's third quarter GDP growth flash estimate as 0.7% quarter-over-quarter. The 0.7% growth rate is lower than the previous quarter's 0.9% rate. Coupled with below-expected inflation, the tepid growth has fueled speculation that the Bank of England will delay raising benchmark interest rates. The labor market in the U.K. continues to show signs of strength; the jobless rate has fallen to 6% while the number of unemployed has fallen below 2 million for the first time in 6 years.

The Bank of Japan (BOJ) surprisingly announced additional stimulus measures in October, as policymakers look to tame recessionary pressures and deflation concerns. In addition to large, long-dated government debt purchases, the BOJ will also triple its purchases of exchange-traded-funds (ETFs) and real-estate investment trusts (REITs). The panel overseeing Japan's Government Pension Investment Fund (GPIF) has also approved plans to double its holding in Japanese equities. In China, the Purchasing Managers' Index (PMI) fell to a five-month low of 50.8, which was below analyst expectations of 51.2. China continues to face weak foreign demand as global growth wanes; the New Export Orders sub-index, a gauge of foreign demand, showed a contraction-level reading of 49.9 in October.

Equity Markets

Global equities ended October mostly positive, though markets experienced significant intra-month volatility. The MSCI World Index gained 0.7% and is up 5.0% in 2014. Domestic large cap stocks, as measured by the S&P 500, rose 2.4% in October despite a -5.5% drawdown through the middle of the month. Domestic mid-cap stocks, as measured by the S&P 400 returned 3.6% while the Russell 2000 small-cap index gained 6.6%. The headline indices for Europe (STOXX 600) and the U.K. (FTSE 100) lost -1.7% and –1.0%, respectively. The MSCI Europe, Australasia, and Far East Index (EAFE) lost -1.4% in October and is down -2.4% in 2014.



The S&P 500 traded down through the first two weeks of October and was down 5.5% through October 15. The index then reversed sharply to finish the month in positive territory. Market volatility, as measured by the CBOE Market Volatility Index (VIX), spiked to an intraday high of 31.06 on October 15, which was the highest intraday VIX reading since November 2011. The VIX then traded downward for the remainder of the month, closing at 14.03 after ending September at 16.31. The 14.03 monthly close is well below the long-run average of 20. Volatility of European stocks, measured by the Euro Stoxx 50 VIX Index, finished October modestly higher at 20.32 after closing September at 17.85.

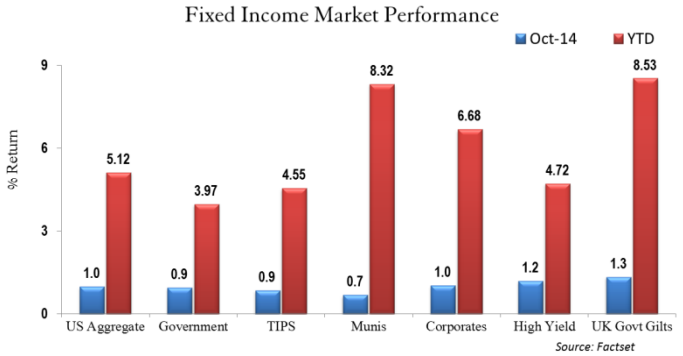
Bond Markets

Volatility returned to broad asset classes as renewed concerns about global growth, weak inflation and headlines related to Ebola weighed heavily on the markets. Merrill Lynch Treasury Option Volatility Index, a measure of volatility in fixed income markets, hit multi-year highs during the middle of October. The 10-year Treasury bond yield dropped nearly 40 bps in a few hours on October 15.

The U.S. bond market, as measured by Barclays U.S. Aggregate Index, increased 1% and is up 5.1% YTD.

Investment Grade Credit spreads widened 5 bps for the third consecutive month during October (as measured by Barclays Option Adjusted Spread) on expectations of heavy supply.

The 30-year U.S. Treasury bond yields fell 15 basis points to close at 3.06% while the 10-year U.S. Treasury bond yields declined 18 bps to close at 2.33% last month. The U.K. 10-year benchmark gilt yields also declined 18 bps to close at 2.24%. The yield on German 10-year benchmark bonds fell 10 bps to close at 0.799%.

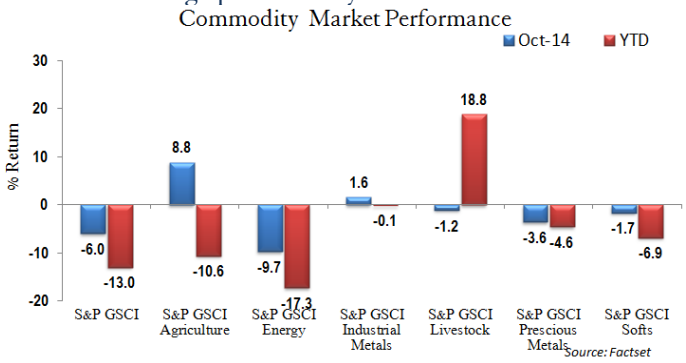


Commodities

The S&P GSCI Total Return Index, a headline index of 24 commodities, fell -6.0% in October, and is now down 13% in 2014. The Agriculture sub-index was the best performer in October, gaining 8.8% for the month. The sub-index had been a weak performer in 2014, but several underlying commodities, including Corn [17.5%], Soybeans [13.9%], and Wheat [11.5%], posted strong gains in October. Corn and Soybean prices have risen despite a projected record U.S. production in 2014. One driver of prices is the record high meat price, which increases the demand for livestock feed. The S&P GSCI Livestock sub-index is up 18.8% in 2014, though the sub-index posted a small loss in October.

The Energy sub-index continued to decline in October, posting a -9.7% loss to add to year-to-date losses. The sub-index is now down -17.3% in 2014, pushed lower by a stronger US Dollar, oversupply concerns, and a forecasted shortfall in demand as global growth wavers. In recent weeks, a split has emerged within the member-states of the Organization of the Petroleum Exporting Countries (OPEC). Fiscally challenged countries, such as Venezuela, are pushing for a reduction in oil production to drive prices higher. Saudi Arabian and Kuwaiti officials, on the other hand, have indicated a willingness to accept lower prices in the short term.

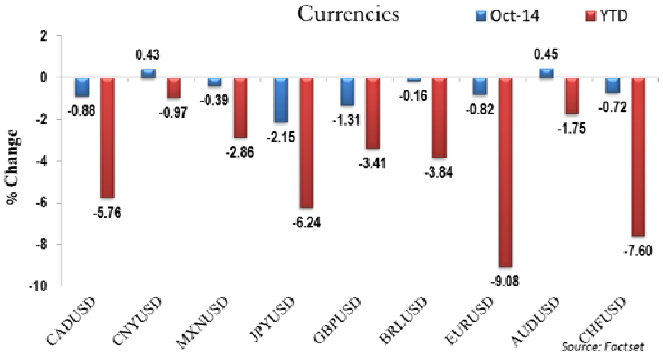
West-Texas Crude Oil ended September at $91.32/bbl, and traded down most of the month, closing October at $80.70/bbl. Refined products also struggled in October, lead lower by Gasoline [-10.5%], Gasoil [-8.6%], and Heating Oil [-5.4%]. The U.S. average retail price for regular gasoline was $3.06 per gallon in the last week of October, the lowest average price for any week since December 2010.



Currency

The US Dollar rallied for the fourth straight month in October against a basket of peers, primarily due to uncertainty around the European economic recovery and divergence of U.S. monetary policy from Europe and Japan. The US Dollar index appreciated 1.15% in October.

The Euro declined for the fourth month against the US Dollar on expectations of further monetary easing by ECB due to weak growth and low inflation prospects in the Euro area. The Euro declined -0.82% against the US Dollar to close at 1.253 USD/EUR, the weakest level in over two years. The British Pound depreciated -1.3% against the US Dollar in October to close at 1.599.



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