Market Street Trust Company

Fourth Quarter Investment Review | 2014

## In This Issue



# Overview

*By: Michael R. Eisner, Chief Investment Officer*

Investment returns in 2014 reflected economic divergence across the globe, as optimism of growth permeating many markets at the beginning of the year faded. Although overall results were generally positive, returns were not consistent during 2014 or shared across markets. The U.S. equity market, as represented by the S&P 500, was up almost 14% during the year, reflecting one of the best economies globally. Developed and emerging foreign equity markets started the first half of the year positively (both up 5%-6% by June 30th), but finishing the year down 5% and 2%, respectively, due to recessionary fears.

In general, weakness in global equity markets was a positive for bonds. In the second half of the year, European and Asian economies weakened, causing interest rates to fall and bond prices to rise. Detailed fixed income activity is noted on page 3, but with developed market bond yields dropping under 1%, investors flooded the more attractive U.S. Treasury market with capital, driving 10-year Treasury yields down 0.9% during the year (and prices higher).

Although high quality bond yields are very low, bonds remain a safe haven in times of stress. 2014 was a perfect example of the diversification benefits of fixed income, as bonds provided robust returns and outperformed stocks in many markets. (See Chart 1)

The big headline event during the year was the dramatic decline in energy prices, centered around a 42%

**Chart 1: 2014 Market Returns (Local)**

| | Equity [1] | Bond [2] |
|---|---|---|
| U.S. | 13.68% | 10.74% |
| Germany | 2.65% | 13.38% |
| Japan | 8.91% | 4.71% |
| Emerging Markets | -4.63% | 4.76% |
| Europe | 5.03% | 16.88% |

*Source: Bloomberg*

*1 S&P 500, DAX, Nikkei, MSCI EM USD, Euro Stoxx*

*2 U.S. 10-yr, Ger 7-10 Track, Jpn 7-10 Track, Barc EM USD AGG, EX 7-10 Track*

The average price of a gallon of gas dropped $1.08 in 2014.

drop in oil prices. Over the last six years, oil prices have averaged $87, which was 2.4 times higher than the average of the last 15 years. Given the anemic economic growth coming out of the Great Recession, and the United States' oil revolution, it was only a matter of time until supply/demand imbalances caught up with market prices. The precipitous drop in energy prices hammered energy sector stocks in the second half of the year, with indices in the sector off 18.4%. We believe, however, the positive effect of lower gasoline prices on consumers, will far outweigh the negative impact on the energy sector. The average price of a gallon of gas in the U.S. dropped in 2014 from $3.32 to $2.24 a gallon, which likely provides consumers with an estimated additional $200 billion of cash in their pockets. The recent highs in Consumer Confidence (see Chart 2), reflects this consumer optimism and has provided Main Street something to smile about. Given that approximately two thirds of our GDP is driven by the consumer, we think this bodes well for continued strength in the U.S. economy.

In 2014, we anticipated markets would take a breather from the high-flying returns of 2013, and volatility would pick up. Although favorable market results continued through the first half of the year, the second half reflected our views more closely. Over the last six months in 2014, volatility picked up significantly and overall returns were basically flat.

Fourth quarter returns for portfolios invested along our Moderate Growth and Growth guidelines, were generally up 0.5%, with year end returns in the mid-single digits, a solid result given the spectacular returns of the previous two years.

Our asset allocation decisions during the year were mixed. On the positive side, we over weighted equity markets during the first half of the year, and slowly reduced exposures during the second half, especially in foreign markets. We also reduced the small/mid cap bias we had in the U.S. equity markets and maintained an overweight in the MLP sector. Our overweight to energy, underweight to fixed income and target allocation to foreign markets detracted. Our thoughts for 2015 are detailed in the Outlook section on page 7.

**Chart 2: Consumer Confidence**


*Source: Bloomberg*

# Fixed Income

By: Ross Miller, Investment Analyst

The fourth quarter ended with global bond yields continuing their downward decline as equity markets extended their upward march. Global bond yields fell as the European Central Bank (ECB), Bank of Japan (BOJ) and the People's Bank of China (PBOC) maintained their respective versions of quantitative easing. The Bank of England and the Federal Reserve (Fed) have indicated that they will raise rates, but Janet Yellen, chairperson of the Fed, commented that the Fed will be patient, allaying investor concerns of a faster than anticipated rate hike.

U.S. 10-year Treasury yields continued to drop amid high inflows of foreign capital. U.S. GDP grew a strong 5% in the third quarter, providing a bright spot in a weakening global economy. The 10-year Treasury yield fell from 3% at the beginning of 2014, to 2.17% at year end, resulting in a 2014 return of 10.7% (See Chart 3). The highly rate sensitive 30-year Treasury began the year yielding 3.92%, before declining 117 basis points to finish the year with a yield of 2.75%. This provided investors with a 2014 gain of 29.4%!

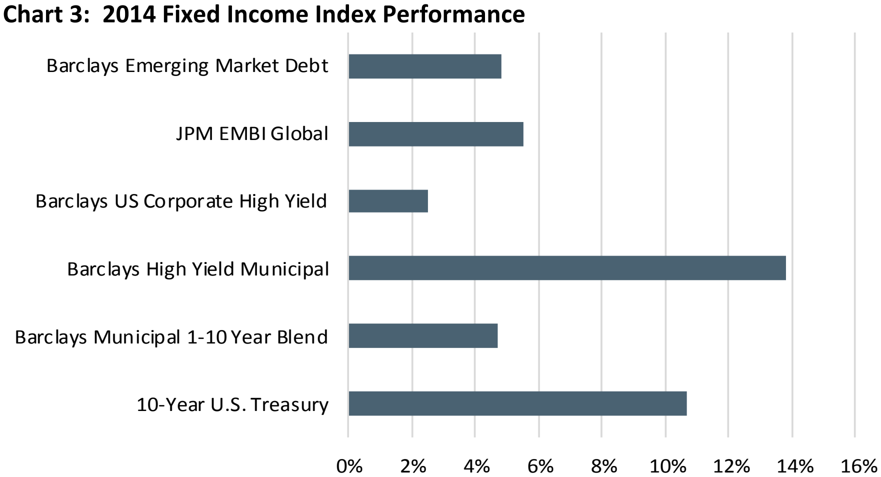
As the ECB continues to implement quantitative easing, it has begun discussing the possibility of purchasing the sovereign debt of ECB members in proportion to each country's GDP. Amid all the discussion and current asset purchases, Europe has seen a much more drastic decline in yields, with countries such as Germany and France seeing their 10-year government yields decline 141 and 143 basis points respectively, from the beginning of 2014. Few core European countries maintain a 10-year bond yield above 1%, with Portugal's 2.67%, making it one of the few Eurozone nations yielding above the U.S.

Amid negative sentiment at the start of 2014, the municipal market continued to outperform expectations through the year, with the Barclays 1-10 year index returning 0.6% in the fourth quarter and 4.7% for the year. The municipal market was more subdued in the fourth quarter as new issuance declined amid a seasonal lull, while investor demand in the quarter (and throughout the year) helped keep prices up and returns positive. Municipal yields declined but remain cheap versus U.S. Treasuries with the Municipal-to-Tb reasury ratio finishing the year at 93%, compared to the 2014 average of 97%.

High yield municipals continued their strong 2014 performance, with the Barclays High Yield Municipal index returning 1.2% for the fourth quarter and 13.8% for the year. High yield municipals performed well as credit spreads remained historically wide, defaults declined amid improving credit fundamentals, and demand continued to outpace supply.

Bonds had a good year, led by a 14% return in High Yield Municipals.

**Chart 3: 2014 Fixed Income Index Performance**




*Source: Morningstar*

Investor demand for municipals helped keep prices up and returns positive.

However, the corporate high yield market struggled in the fourth quarter, continuing its third quarter decline. The Barclays U.S. Corporate High Yield index returned -1% during the fourth quarter, bringing the 2014 return to 2.5%. Almost 25% of the issuers of the high yield market are from the energy sector, and as oil prices fell, high-yield energy companies followed suit.  The Barclays High Yield Energy sector index fell 10.6% for the fourth quarter, as the selloff was primarily commodity based.

Emerging market debt also had a tough fourth quarter as slow economic activity and lower commodity prices contributed to another quarter of negative returns. The Barclays Emerging Market Debt Index (USD denominated) declined 1.7% during the quarter, reducing its 2014 return to 4.8%. Slowing growth in China and Russia's economic turmoil were among numerous factors causing investors to sell and become more selective within emerging market credits. The JP Morgan index of local currency bonds declined 1.6% leading to a 2014 return of 5.5%. Local currency bond returns were hurt by the continued appreciation of the dollar. Emerging market debt, however, remains attractive given strong underlying fundamentals, attractive yields and wide credit spreads.

## Equities

*By: Robert J. White, Director of Investments*

While 2014 ended near record levels for U.S. equity markets, global equity markets did not fare as well.  As widely expected, volatility increased through the year, with the VIX Index increasing to 26.25 in October, its highest level since June 2012.  Investors had numerous reasons to sell during the year, with the Russian invasion of the Ukraine in March, heightened tensions in Israel, and an expanding ISIS threat in the Middle East.

U.S. equities once again provided the best results.

U.S. equity markets, as represented by the S&P 500 Index, gained around 5% (See Chart 4) during the fourth quarter to end the year up 13.7%.  In terms of market capitalization, there was a significant divergence in performance, with the Russell 2000 Index of smaller companies posting a return of just 4.9% for 2014 while the Russell Microcap Index gained only 3.7%. With respect to style, however, there was little differentiation between value and growth stocks.

Within the U.S. market, only energy provided a negative return in 2014, falling 10.7% in the fourth quarter to end the year down 7.8%.  The decline in energy stocks was a result of the plummet in oil, natural gas and gasoline prices during the latter half of the year (see Real Assets commentary on page 6).  Consequently, energy stocks such as Transocean, the world's largest offshore drilling contractor, were the worst performing, with a decline of 63%.  However, airline stocks soared with the top performer, Southwest Airlines, gaining 225% during 2014; oil generally accounts for at least 30% of airline operating expenses.

The top performing sectors during the year were Healthcare (up 25.3%) and

Information Technology (up 20.1%). The strong return from Healthcare stocks came despite a March sell-off of biotech stocks that was triggered by a Congressional letter complaining about the high price of a hepatitis C drug marketed by Gilead Sciences.

Developed international markets significantly underperformed U.S. indices through 2014, with the MSCI EAFE Index losing 3.5% during the final quarter to end the year down 4.5%. European markets were weak, with peripheral nations such as Norway, Portugal and Austria all suffering double digit declines. Portugal performed worst, down 38%, as investors feared for its financial solvency following the collapse of Banco Espírito Santo, the country's second largest lender. The core nations of Germany and France fared better but were still off nearly 10%. European investors continue to face recessionary levels of economic growth coupled with deflationary pressures; the annualized Eurozone inflation rate was just 0.4% in November and deflation has been reported in Spain and Switzerland.

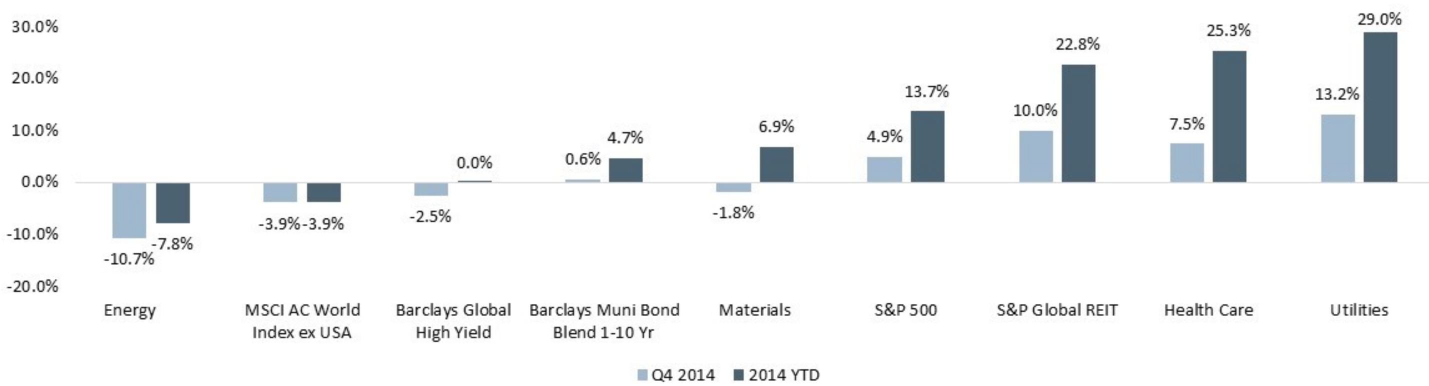
Falling oil price coupled with economic sanctions resulted in Russia's market declining by 12.1% during 2014. With a plummeting currency, the return for U.S. investors was -45.9%, making Russia the worst performing stock market. Lower oil prices also impacted the emerging markets in the Middle East, with Bahrain ending the year down 33% while the Dubai exchange relinquished a 58% gain to end the year up just 10%. Elsewhere, the oil sensitive Nigerian market also suffered with a 2014 decline of 26%, all of which occurred in the final quarter.

More positively, the emerging Asian markets generally performed well, with Indonesia, India and the Philippines all returning between 24% and 27% in 2014. Even China, which continued to be plagued by a slowing growth rate, provided investors with an 8.3% return.

Hedge fund returns were disappointing during the fourth quarter, with the Dow Jones Credit Suisse AllHedge Index up 0.1% to end the year up just 1.1%. Managed future performed best in the final quarter, up 13.7%, and increasing their 2014 return to 21.8%. Trend-following managed futures strategies benefited from outsized moves in commodity prices. The only other hedge fund strategies to provide positive returns in 2014 were emerging market, fixed income arbitrage and multi-strategy.

European investors continue to face recessionary levels of economic growth coupled with deflationary pressures.

**Chart 4: 2014 Returns**




*Source: Morningstar*

# COMMODITIES AND REAL ESTATE

*By: Bulezim Azemi, Investment Analyst*

The EIA, expects crude oil production for 2015 to increase, regardless of lower crude oil prices.

Commodity prices overall finished the year as the worst performing asset class. In particular, crude oil prices plummeted amid excess supply and slower growth in global demand. US crude oil (WTI) lost 40% for the quarter to finish the year down 42% at $53.27 a barrel. International crude oil (Brent) declined 40% during the quarter, down 46% for the year at $57.33 a barrel. (See Chart 5) The increasing production of natural gas combined with a mild winter resulted in the price falling from $4.36 per British thermal unit (BTU) at the start of 2014 to $2.89 per BTU at year-end. The national average gasoline price finished the year at $2.24 a gallon, down 33% from one year ago.

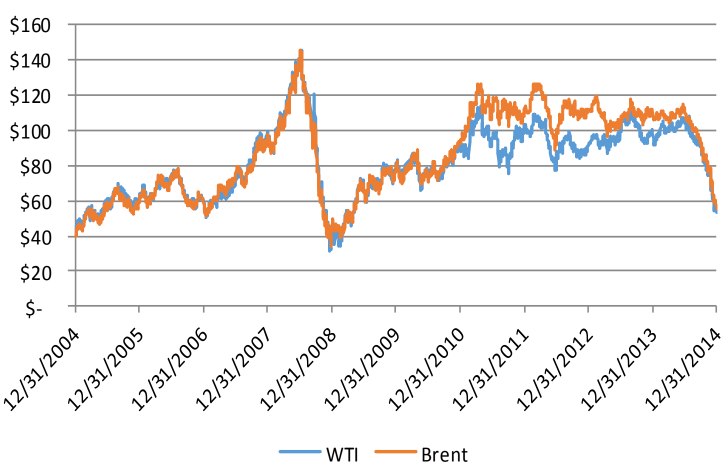
MLPs (energy infrastructure partnerships) suffered from tumbling crude oil prices and investors' rushing to realize losses for tax purposes by year end. Despite losing 10.3% in the fourth quarter, MLPs still ended the year up 7.6%. The drop in oil from $106 per barrel in June to just $53 per barrel at year end was the biggest decline since the 2008 global financial crisis.

To recap 2014, the United States shale industry reached record output levels, Saudi Arabia began to discount its crude oil to the U.S. and China and the International Monetary Fund announced slower global demand growth for 2015. The drop in oil prices created major headaches for Russia, Iran, and Venezuela, to name a few, and simultaneously impacted small and highly-leveraged fracking companies in the United States. While global demand for crude oil is about 90 million barrels per day, the current output is about 92 million barrels per day. In the U.S., the break even cost to provide a barrel of oil ranges from $65-$80 according to a report by Barclays. The U.S. Energy Information Administration, EIA, expects crude oil production for 2015 to increase, regardless of lower crude oil prices.

During 2014, precious metal returns were lackluster, with gold ending the year down 1.4% at $1,184.37/oz. while silver lost 19.3% to close at $15.71/oz.

Global REITS, as represented by the S&P BMI Global REIT Index, gained 10.0% during the fourth quarter to finish the year up 22.8%. US REITs finished the year as one of the best performing asset classes, gaining 13.9% in the recent quarter to end the year up 28.8%. International REITs gained 14.7% during 2014. In the U.S., REITs ended the year trading at an approximate 5% premium to their NAVs. Market values for high quality assets have fully recovered and are currently trading in excess of the 2007 peak.

**Chart 5: Brent vs WTI Price Difference* 2005-2014**




*Source: Bloomberg*
**Barrels per day*

# Outlook

*By: Michael R. Eisner, Chief Investment Officer*

Looking ahead, we believe the divergent economic outlooks of various regions will dominate headlines.

- In the U.S., the Federal Reserve's long awaited tightening of monetary policy will begin. In our minds, there is no difference between a 0.25% or 1% Fed Funds rate, but it is the idea that the era of easy money is coming to an end that may weigh on markets. Fortunately, this idea has been telegraphed ad nauseam for the last 18 months, and in our view should have little impact on the markets. Additionally, consumer confidence has accelerated due to the significant decline in gasoline prices. With a gallon of gas $1 less than last year, consumers have more money in their pockets, which should positively impact the growth rate of the economy over the coming year. All this should lead to a favorable environment for U.S. equities, while being less so for fixed income.
- In Europe and Japan, the opposite is occurring. Economic growth is anemic at best and the European Central Bank (ECB) and Bank of Japan (BOJ) are becoming more accommodative. Deflation is worrisome and unemployment (at 11% in Europe) remains serious. That being said, much of this malaise has been priced in already, as stocks of foreign companies have underperformed their U.S. counterparts by 11% per year for the last five years! Therefore, the opportunity for outsized returns in 2015 is available if these foreign economies can stem their slowdowns. We have not jumped in with both feet yet, but we will be watching how things unfold and continue to monitor the attractiveness of this opportunity.
- Possibilities and risks abound in Emerging Markets, as commodity exporters will struggle while manufacturers thrive. Favorable equity returns in these developing countries can be achieved through shrewd stock picking, not just market exposure. Market Street will be adding an investment manager with a research driven, fundamental stock picking approach to hopefully capture these opportunities.

Summing up, global economic and policy conditions should remain favorable for investors. The U.S. economy should accelerate as low gasoline prices engender a feeling of increased wealth and confidence, which will lead to increased consumption and growth. Additionally, we believe it more likely that strong U.S. growth lifts foreign economies, than weak foreign markets drag the U.S. down. Overall, central banks remain accommodative (a rise to a 1% Fed Funds rate is still accommodative) which will keep the lid on deep recessionary events.

Still, expect market volatility akin to the latter half of 2014 (which saw a 7% decline in under a month) than the beginning of the year (a time of record low volatility). The investment environment should remain favorable and provide opportunities for those with a long-term view.

Mike

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

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