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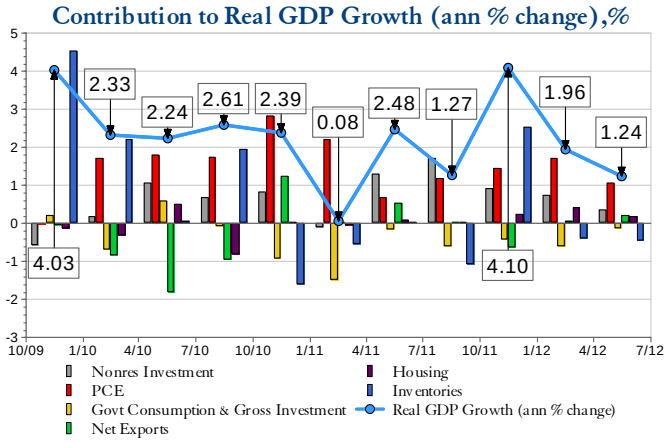
Market Review

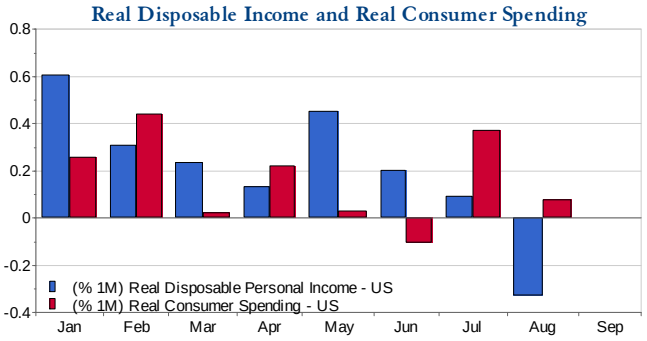
September 2012

Economic Review

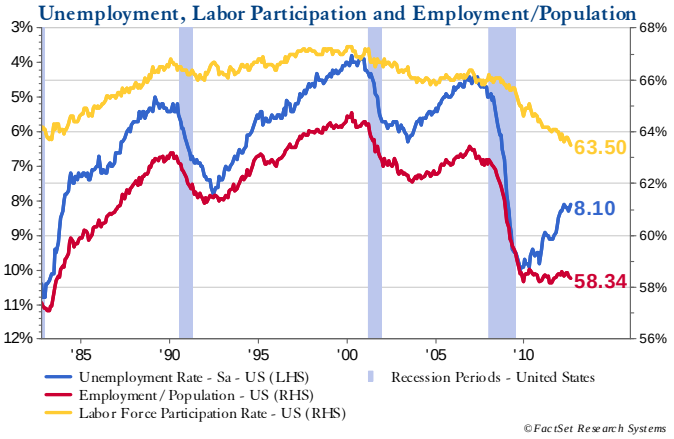
U.S. second quarter real GDP growth was revised down to an annual growth rate of 1.3% from the prior estimate of 1.7%, according to the third estimate from the Bureau of Economic Analysis. The consensus estimate was for GDP growth to remain at 1.7%. The slower growth reflected downward revisions in inventory investment, consumer spending, and exports.



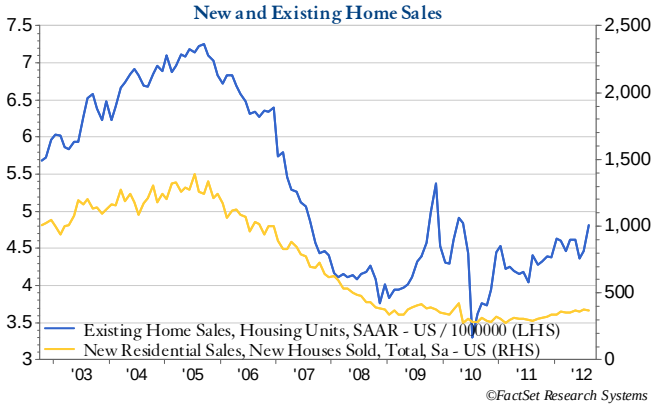
Industrial production dropped 1.2% in August. The rise in gas prices boosted retail sales to 0.9%. The rising gas prices also pushed the Consumer Price Index (CPI) 0.6% higher in August, the highest since June 2009. The CPI increased 1.7% year over year. The Core CPI (i.e., excluding food and energy) ticked up 0.1% and y-o-y Core CPI increased 1.9%, both rising less than expected. Durable goods orders plunged 13.2%, the most since January 2009. Excluding the volatile transportation sub component, durable goods orders dropped 1.6%. Capacity utilization came in at 78.2%, lower than the consensus estimate of 79.2%. Real disposable personal income decreased 0.3% in August, the first decline since November 2011. Real consumer spending increased 0.1%, compared to a 0.4% increase in July.



U.S. non farm payrolls added a disappointing 96,000 net new jobs in August, while the prior two months increases were revised lower. The unemployment rate fell from 8.3% to 8.1%. The decline was in part because of shrinking labor market as the labor participation rate fell to a thirty year low of 63.5%.



Housing data released in September were mostly better than expected. Home prices were up 0.4% for July and up 1.2% year over year according to Case-Shiller 20 City Home Price Index. Sales of existing homes climbed 7.8% from July to a seasonally adjusted annual rate of 4.82 million houses, the highest levels in two years. New housing starts rose 2.3%, while new home sales fell -0.3%, to a seasonally adjusted annual rate of 373,000.



The U.S. Federal Reserve delivered the much anticipated Quantitative Easing (QE3) by announcing an open ended program to purchase $40 billion worth of agency mortgage-backed securities per month and extending its Fed Funds target rate of 0-0.25% until at least mid-2015. The Fed indicated that it will continue the purchases as long as the outlook for the labor market does not improve substantially. The Fed also alluded to additional asset purchases and to

employing other policy tools if the current actions prove to be insufficient. The ongoing "Operation Twist" will also continue as planned until year end. The 5Y/5Y forward inflation break even rate spiked to nearly 2.9% immediately after the announcement and closed the month near 2.7%.

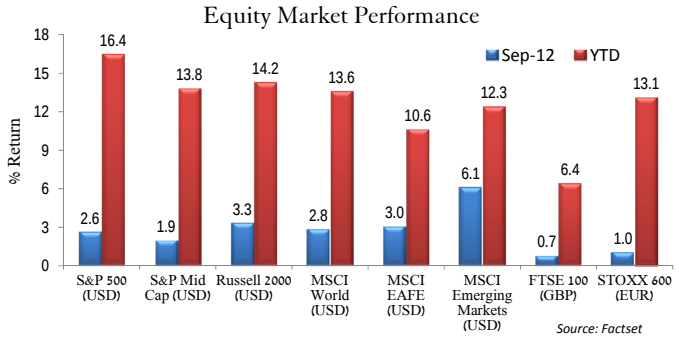
Headlines from Europe dominated the investment landscape in September. Early in the month, the European Central Bank (ECB) announced the Outright Monetary Transactions (OMT) program that is designed to lower borrowing costs of heavily indebted euro zone countries by allowing the ECB to purchase unlimited short term (1-3 years) government bonds. However, governments that want the ECB to purchase their bonds need to formally apply and will also be subject to fiscal oversight. The high court in Germany ruled in favor of the European Stability Mechanism bailout fund. Spain unveiled an aggressive budget cutting plan towards the end of the month, followed by protests against looming austerity measures. European Manufacturing PMI rose to a six month high of 46.1, but indicated the manufacturing sector continues to contract.

Geo-political risks spiked in Asia as China and Japan clashed over a group of islands in East China Sea, while tensions increased in the Middle East with the death of the U.S. Ambassador to Libya and continued anti-U.S. demonstrations in Muslim countries.

Chinese economic data showed further deceleration. The pace of industrial output growth in August was near three year lows, while exports fell sharply on tepid demand from Europe and the United States. The Chinese government unveiled a 156 billion USD infrastructure spending package which contributed to appreciation in Chinese stock indices and industrial metals.

Equity Markets

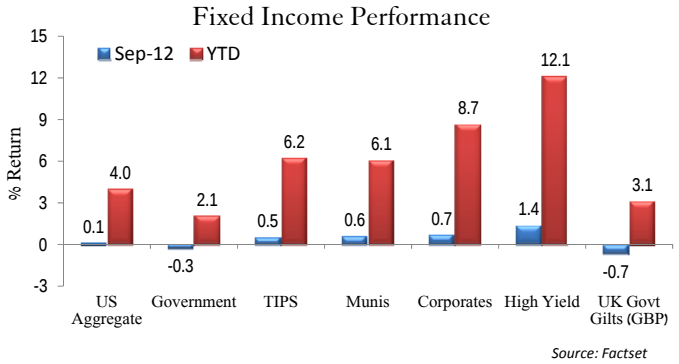
Equity markets continued to add to 2012 gains in early September as expectations for global stimulus consumed the market. After the announcement of such plans by ECB Chairman Draghi and Federal Reserve Chairman Bernanke, the equity markets pared gains to finish the month modestly higher. The S&P 500 gained 2.6% in September, giving back 30 points from the mid-month high, and is up 14.2% in 2012. European markets had mixed results, with the French CAC 40 down for the month, while the German DAX Index added over 4.5%. Overall, Eurozone stock indices added 1.0%, and the British FTSE gained 0.7%. Emerging markets continued to perform strongly, with the MSCI EM Index gaining over 6% in September.



Volatility picked up after the previous few months' doldrums, with 5.6% separating the September high and low for the S&P 500. Markets rallied into mid-month, with the S&P gaining 4.7% in the first two weeks, as expectations for global easing abounded on Wall Street. After the announcement of perpetual easing by the Fed, negative economic data continued to dominate headlines, sending the markets off the mid-month highs.

Bond Markets

The credit markets (corporates and high yield) had yet another decent month as the global central banks' extraordinary actions spurred a rally in risk assets. U.S. investment grade credit spreads tightened 14 bps last month. The Treasury yield curve steepened as 2-year yields were flat at 0.23%, 10-year yields finished 8 bps higher at 1.63%, and 30-year yields ended the month 16 bps higher at 2.83%.



The ECB's bond purchasing announcement improved market sentiment towards Euro-zone stability and drove down government bond yields (especially the short end of the curve) of embattled European nations. It had an opposite effect on U.S. and German government yields as they moved higher in the first half of the month. The Federal Reserve's announcement was immediately followed by a further spike in U.S. Treasury yields. The yield on the 30 year Treasury rose nearly 45 bps for the month by

September 14th. Doubts on the effectiveness of Federal Reserve's actions on stimulating growth increased demand for safe haven bonds and sent Treasury yields lower during the latter half of the month.

The UK 10-year GILT yield rose 17 bps to close at 1.73% while the German 10-year Bund yield increased 13 bps to close at 1.46 %.

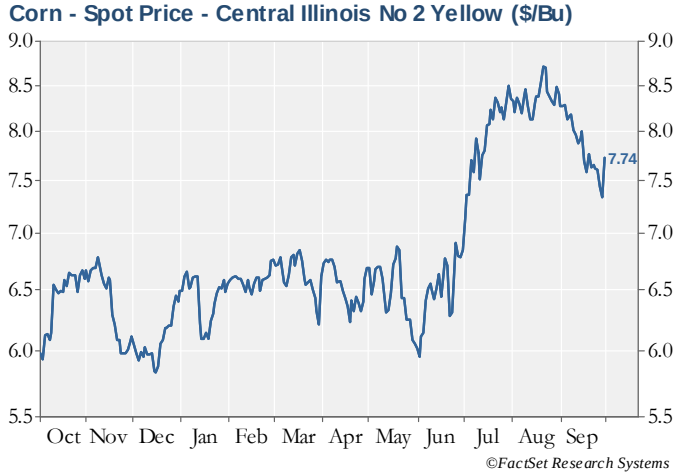
Currency

The US Dollar Index dropped 1.6% in September and is down 0.3% YTD. The US Dollar weakened against most major global currencies after the mid-month announcement of indefinite stimulus by the Federal Reserve. The Euro remained flat or advanced against most major currencies in September, albeit with significant intra-month volatility. After a sharp rally to start the month, the Euro gains were pared by negative Spanish bank data and comments by German Chancellor Angela Merkel on potential fiscal actions by the ECB. The Euro trended upward against the US Dollar in September, rallying 4.3% before slipping 2% to close the month at 1.2685 USD/EUR. The British Pound gained 1.6% on the US Dollar, and held flat against the Euro.

Commodities

The S&P GSCI fell by 1.4% in September, as agricultural commodities were hurt by slowing global growth and energy related goods fell. The Index is up almost 3.5% for the year, and all of the GSCI sub indices are in positive territory year to date, with the exception of livestock and softs.

Grain markets were among the worst performers in September, as Soybeans and Corn both pulled back over 8.5%. Several factors contributed to the weak performance in grains this month; slowing global economic growth has created demand concerns for grain exports, and supply worries have eased as weather conditions have improved in India, Southeast Asia, and the Americas. However, Soybeans and Corn have still posted torrid year to date gains, up 40% and 29% respectively. Wheat posted modest gains in September and is up 29.5% in 2012.



Industrial Metals were the top performing sector in the GSCI this month, as global stimulus sent the sub index up 10.2%. Copper prices soared 7% after China approved additional infrastructure projects to bolster its slowing economy. Lead, Nickel, Zinc, and Aluminum each added over 10% in September, on expectations for greater industrial demand. Precious Metals also rallied strongly in September, as the announcement of additional Quantitative Easing by the Federal Reserve increased demand for Silver and Gold. Silver gained 9.9% for the month and has posted gains of 22% for the year. Gold added 5.1% in September and is up 12.4% in 2012.

An interesting story has developed in the livestock markets in recent weeks. The impact of rising grain and feed costs on farmers' bottom line has forced more livestock to slaughter. This is causing the short term prices for cattle and hogs to fall; Live and Feeder Cattle both trailed the index for the month, with losses over 2.5% and Lean Hogs are down over 10% in 2012. Analysts are now concerned about the potential for a shortage of pork and beef next year.