APPLETON PARTNERS, INC.

THE FINANCIAL SECTOR: REVIEW & OUTLOOK
JULY 2014

GENERALLY CONSTRUCTIVE ON THE FINANCIAL SECTOR

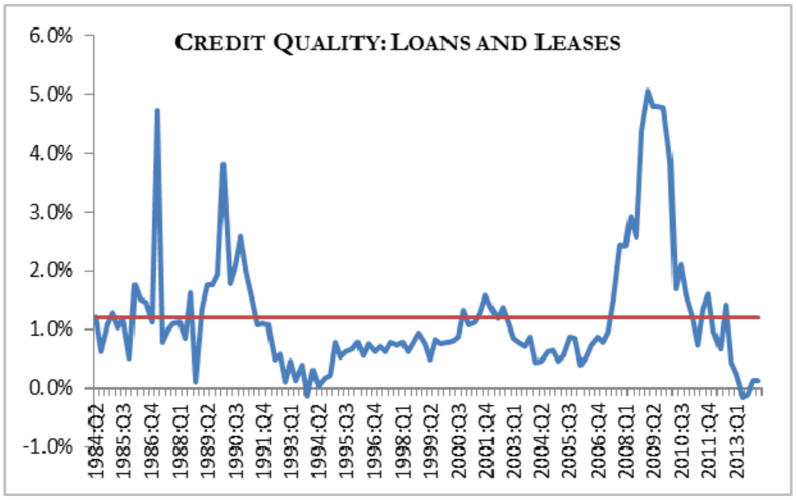
The financial services industry has emerged from the financial crisis in 2008-2009 with cleaner balance sheets, less trading-based revenue, and a greater emphasis on fee income. Increased regulatory scrutiny has not come without a cost, but the industry has absorbed the financial burden and adjusted business models accordingly. Going forward, we believe that the elimination of legal distractions, a rising interest rate environment, and a slowly improving global economic picture all bode well for the long-term fundamentals of the sector. We continue to monitor our recommended holdings in this sector and will be focused on a few key themes over the remainder of the year:

- *Credit cycle*- we've observed increasingly aggressive lending practices in the commercial segment, particularly in the "middle-market." We will be watching closely for any signs that the credit cycle may have turned.
- *Net interest margins*- our expectation is that NIMs are at or near trough levels- we will be on the lookout for additional NIM compression, which could impact our earnings outlook for the sector.

CREDIT: CYCLE COULD BE NEARING AN INFLECTION POINT; RESERVE RELEASES

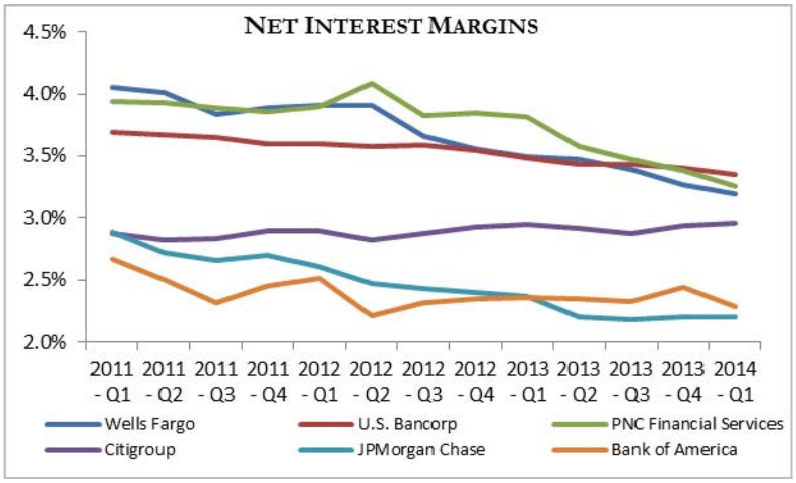
While there may be some modest incremental improvement in credit quality of loans and leases over the course of 2014, we suspect that we are approaching an inflection point in the credit cycle. In particular, we are mindful of the increasingly competitive market environment that is pressuring price and underwriting standards in commercial lending. Nearly two-thirds of leveraged loan issuance this year has been structured as "covenant-lite", i.e. without restrictive financial covenants, which provides some support for this position. Regardless of when the cycle turns, we expect that, as banks build reserves for new loans, the pace of reserve releases (or reserves held against expected future loan losses), which have been a key profit driver over the last several years) will continue to decline over the course of 2014.

The chart to the right displays the formation rate of nonperforming loans*, which we view as one of several key indicators of credit quality in banks' loan and lease portfolios. This measure is currently well below the long-term average of 1.21% and in fact is at its lowest level since 1994. Given the fierce competition for new assets amongst banks and other lending vehicles, we anticipate credit quality will deteriorate and revert towards the mean in the near-to-medium term.



MARGIN TRENDS: NIM SHOULD STABILIZE, GRADUAL IMPROVEMENT GOING FORWARD

Net interest margins (NIM) at the largest banks continue to grind lower. While the yield curve has remained steep over the course of 2014, yields still remain near record lows on an absolute basis. Furthermore, intensifying competition for new loan assets appears to be more than offsetting any steepening in the curve. A combination of loan growth (discussed below) and continued compression in NIM margins has resulted in flattish net interest income over the last several quarters.



Sources: FDIC, Standard & Poor's, and Company Filings

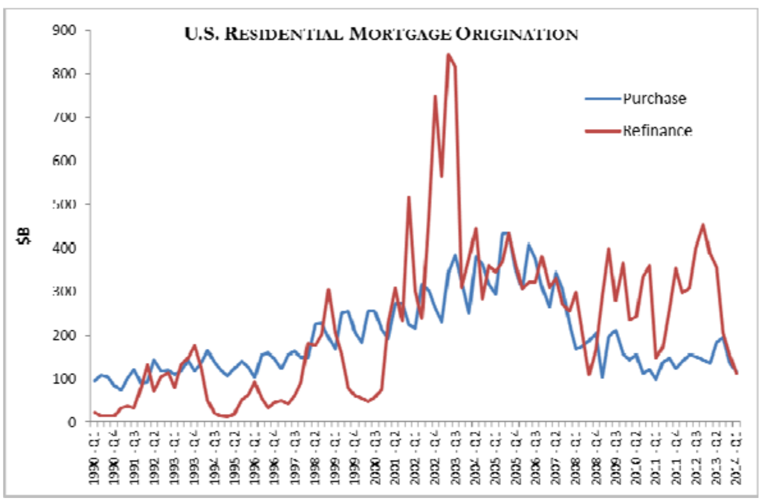
Going forward, we expect that NIM will stabilize as continued tapering by the Fed should result in a gradual rise in long-term interest rates with the yield curve remaining steep for some time.

LENDING: LOAN GROWTH TRENDING ABOVE EXPECTATIONS FOR 2014

While Net Interest Margin remains compressed and should remain so for some time, we believe this will be somewhat offset by accelerating lending activity. The latest Fed Survey seems to confirm this. The Fed's May report indicated loan growth in April was trending at an 8.2% annualized rate, similar to levels in February (8.5%) and March (8.9%). This trend remains well above the rating agencies' expectations for the year (closer to 3-4%). Perhaps more encouraging than the absolute growth rate is the fact that lending growth in April was broad based. Commercial and Industrial (C&I) led the way with 12.5% annualized growth, and real estate lending grew at 1.2% annualized, the fourth month of modest growth after contracting each of the last five years. Lastly, April saw one of the largest expansions in credit card and other revolving debt that has been seen in the last 5 years. At this point, we remain optimistic that this trend reflects a strengthening in consumer confidence and healthier household balance sheets rather than a weather-driven aberration.

MORTGAGE ACTIVITY: REFINANCINGS WANING WITH A GRADUAL REBOUND IN PURCHASES

Over the last eighteen months, the mortgage origination market has slowed dramatically. With the mortgage business a key profit generator for many global and domestic banks, this is an area of significant risk for the financial sector. According to estimates from the Mortgage Bankers Association (MBA), after growing more than 40% in 2012, mortgage originations dropped 14% in 2013, reflecting a mid-year spike in borrowing costs. The drop accelerated in 1Q'14 with MBA estimates suggesting a 57% year-over-year decline led by a 71% decline in refinancing volume.



This year is expected to represent a cyclical trough in mortgage originations as purchase-related mortgages increasingly offset weakness in refinancing volume. While underwriting standards remain tight, continuing employment gains should accelerate household formation, and slowing home price appreciation should improve affordability conditions, increasing aggregate new mortgage demand. Refinancing activity is unlikely to rebound anytime soon as rates will continue to rise over the next few years as the Fed shifts to less accommodative monetary policy, and the eligible pool of mortgages to be refinanced has been greatly reduced.

Mortgage Banking Revenue

(Mil. $)	2012	2013	% of Revenue	Y/Y (%)
Wells Fargo & Co.	$ 11,638	$ 8,774	10.5%	(24.6%)
Fifth Third Bancorp	$ 845	$ 700	10.3%	(17.2%)
BancorpSouth Inc.	$ 57	$ 45	6.7%	(20.9%)
U.S. Bancorp	$ 1,937	$ 1,356	7.0%	(30.0%)
M&T Bank Corp.	$ 349	$ 331	7.3%	(5.1%)
SunTrust Banks Inc.	$ 603	$ 401	5.0%	(33.5%)
Associated Banc Corp.	$ 64	$ 49	5.1%	(23.1%)
BB&T Corp.	$ 840	$ 565	5.9%	(32.7%)
Trustmark Corp.	$ 41	$ 34	6.0%	(18.3%)
JPMorgan Chase & Co.	$ 8,687	$ 5,205	5.4%	(40.1%)
Bank of America Corp.	$ 4,750	$ 3,874	4.4%	(18.4%)
PNC Financial Services Group	$ 284	$ 871	5.4%	206.7%
Citigroup Inc.	$ 2,580	$ 1,716	2.2%	(33.5%)
Total/ Average	$ 32,675	$ 23,921	6.2%	(26.8%)

Source: Mortgage Bankers Association, Standard & Poor's

The impact of the mortgage banking slowdown has been extensive. On average, mortgage banking revenue declined 27% between 2013 and 2012, with further declines anticipated in 2014. Declines in revenue have forced many banks to trim staff and cut other costs to keep revenue and expenses aligned, but profitability has certainly been impacted.

Longer-term, we will be monitoring developments with the GSEs (Fannie Mae and Freddie Mac) and assessing the impact that political and regulatory decisions may have on the health of the mortgage industry.

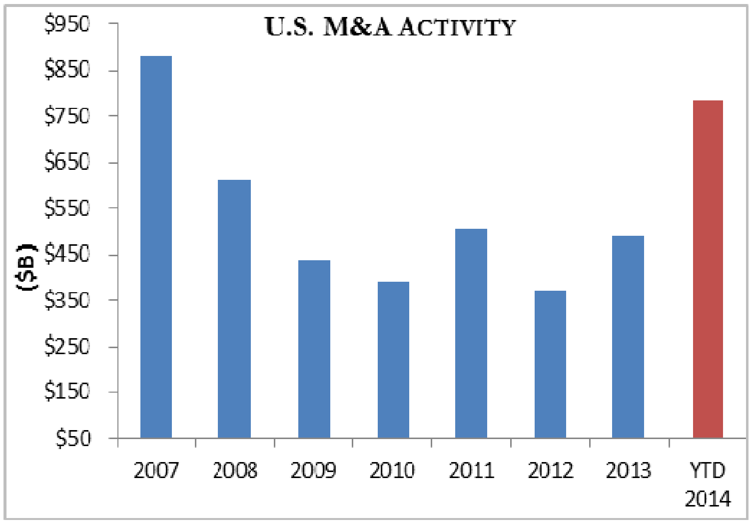
CAPITAL MARKETS & INVESTMENT BANKING: M&A ACTIVITY HELPS TO OFFSET WEAKNESS IN FIXED INCOME SALES & TRADING

A combined lack of market volatility and low trading volume continue to pressure fixed income sales and trading revenue. Equity sales and trading revenue remained strong for most banks, helping to offset weakness on the fixed income side. We anticipate general capital markets revenue at the largest banks will be down in the mid-to-high single digits this year. While additional cost reduction actions are possible, they are likely to be limited given the scale of headcount and overhead cuts that have already been made. We also note that banks with the greatest focus on trading, like Morgan Stanley and Goldman Sachs, had the most significant "burn down" in capital under the Fed's stress tests - likely a reflection of trading shocks and counterparty default assumptions (see Regulatory & Capital section for more detail).

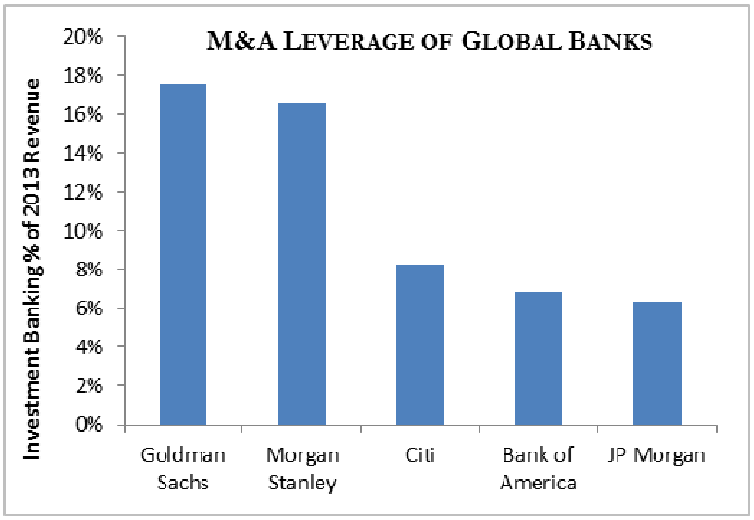
One of the brightest areas for global banks has been this year's spree of merger and acquisition (M&A) activity. Through June, year to date M&A volume of close to $800 billion is already *almost double that of all of last year*. U.S. corporations appear to be taking advantage of significant cash stockpiles and lofty stock prices to grow through M&A and we anticipate this trend to continue over the near to medium term.

In order to better understand which banks would be best positioned to benefit from this M&A tailwind, we compare the "league table" of top M&A advisors with the banks that have the highest revenue exposure to investment banking. The clear overlap comes with Morgan Stanley and Goldman Sachs, which are both top three M&A advisors and have significantly more leverage to investment banking revenue then do their peers.

In particular, we would highlight the strength of Morgan Stanley this year, growing by close to 250% year-over-year. Morgan Stanley's success can be partially attributable to its sole advisory role in Facebook's $19 billion acquisition of WhatsApp earlier this year, although even ignoring this deal M&A revenue has increased by more than 200%. Morgan Stanley revamped its M&A leadership team in Europe and North America late last year, a move that seems to have paid dividends in Q1.



Global M&A League Table		1Q'14			1Q'13
($B)		Deal	Y/Y%	Deal	Deal
Ranking	Company	Volume	Change	Count	Volume
1	Morgan Stanley	$ 216.1	244.1%	54.0	$ 62.8
2	JP Morgan	$ 178.0	32.8%	51.0	$ 134.0
3	Goldman Sachs	$ 135.6	4.7%	72.0	$ 129.5
4	Barclays	$ 124.1	110.7%	45.0	$ 58.9
5	Citi	$ 122.4	114.7%	37.0	$ 57.0
6	Bank of America	$ 114.0	26.8%	48.0	$ 89.9
7	Centerview Partners	$ 89.6	86.3%	8.0	$ 48.1
8	Allen & Co.	$ 84.8	2928.6%	5.0	$ 2.8
9	Credit Suisse	$ 69.5	(6.0%)	38.0	$ 73.9
10	Deutche Bank	$ 68.1	64.9%	31.0	$ 41.3



Sources: Dealogic, MergerMarket, Appleton Partners, Inc, and Company Filings

CAPITAL REQUIREMENTS & REGULATORY OVERSIGHT: BANK CAPITAL LEVELS ARE WELL POSITIONED TO MEET REGULATORY REQUIREMENTS

The largest banks have invested significant resources (both from raising capital and through overhead) ahead of additional restrictions and scrutiny under Dodd-Frank, Basel III, and other regulatory bodies. Several recent data points that suggest the majority of firms appear to be headed in the right direction:

- Estimated regulatory Basel III Tier 1 common ratios for all banks were at or adequately above their required minimums through the first quarter, according to S&P.
- In aggregate, Basel III Tier 1 Common Equity ratio for the 30 bank holding companies tested in the Fed's Comprehensive Capital Analysis and Review (CCAR) aka "stress test" has more than doubled to 11.6% in the 4th quarter of 2013 from 5.5% in the first quarter of 2009- a more than $500 billion increase in Tier 1 common equity.
- After factoring in the Fed's stress scenarios and the banks' capital return plans, all but one (Zions) had a comfortable cushion to minimum capital thresholds. The most significant year-over-year improvement came from American Express, Wells Fargo, Ally Financial, and Goldman Sachs.

Fed's Severely Adverse Scenario 2014 (with Proposed Capital Plans)

	Stressed Capital	"Cushion"
STT	13.3%	8.3%
DFS	13.2%	8.2%
BK	13.1%	8.1%
AXP	12.1%	7.1%
NTRS	11.7%	6.7%
RBS Citizens	10.7%	5.7%
KEY	9.2%	4.2%
PNC	9.0%	4.0%
RF	8.9%	3.9%
STI	8.8%	3.8%
CMA	8.6%	3.6%
BBVA	8.5%	3.5%
BBT	8.4%	3.4%
FITB	8.4%	3.4%
USB	8.2%	3.2%
WFC	8.2%	3.2%
UnionBanCal	8.1%	3.1%
COF	7.8%	2.8%
BMO	7.6%	2.6%
HBAN	7.4%	2.4%
Santander	7.3%	2.3%
C	7.2%	2.2%
GS	6.9%	1.9%
HSBC	6.6%	1.6%
Ally	6.3%	1.3%
JPM	6.3%	1.3%
MTB	6.2%	1.2%
MS	6.1%	1.1%
BAC	5.9%	0.9%
ZIONS	3.6%	-1.4%
Median bank	8.2%	3.2%

Source: Standard & Poor's

Despite improvements in capital levels, most banks appear to be taking a conservative approach to capital returns to shareholders. We suspect this is due to the opaqueness of the Fed's stress testing and the public backlash of a potential stress test failure. The total payout for the thirty banks based on 2014's CCAR request totaled 65% of 2013 earnings versus 72% of earnings for the banks tested last year. Higher share buybacks remained the favored form of returning capital, as many banks are already at or close to the Fed's unofficial comfort level of 30% payout ratio.

We should note that while all the global banks cleared their quantitative stress tests, the Fed rejected Citi's capital plan due to deficiencies in "capital planning activities" and later required Bank of America to suspend its capital plan after a capital calculation (overstatement) was discovered.

RATING AGENCY OUTLOOK: AGENCIES ANTICIPATE LESS GOVERNMENT SUPPORT IN FUTURE CRISES

Last year, both Moody's and Standard and Poor's expressed doubt that the government would be open to a level of support similar to that provided during the latest financial crisis. Both agencies noted that given changes in Dodd-Frank, creditors would be much more likely to bear the brunt of losses in a distressed scenario. In June of last year, S&P put J.P. Morgan on negative outlook, on par with the other banks it deemed "systematically important" and less likely to receive government aid (Bank of America, Goldman Sachs). Last November, Moody's took a more aggressive stance, removing its "uplift

Current Ratings for Top Financials

	Mooodys	S&P
Bank of America	Baa2	A-
Citigroup Inc.	Baa2	A-
Goldman Sachs Group, Inc.	Baa1	A-
JPMorgan Chase & Co.	A3	A
Morgan Stanley	Baa2	A-
PNC Funding Corp.	A3	A-
Wells Fargo & Company	A2	A+
General Electric Capital Corp.	A1	AA+
American International Group, Inc.	Baa1	A-
Berkshire Hathaway Finance Corp.	Aa2	AA

Source: Bloomberg

from U.S. government support" from its rating, resulting in one notch downgrades for Morgan Stanley, Goldman Sachs, JP Morgan, and The Bank of New York Mellon. The rating agency decisions center on Dodd-Frank regulation that provides the ability to implement an Orderly Liquidation Authority, imposing losses on US bank holding company creditors to recapitalize and preserve the operations of systematically important subsidiaries. The risk to holding company creditors is partially offset by the fact that such an orderly liquidation may enhance recoveries in the event of a default.

LEGAL RESERVES: HURDLES REMAIN, BUT BANKS ARE BETTER PREPARED TO WEATHER THE STORM

Since 2009, the largest U.S. banks together have paid or reserved for more than $45 billion in representation and warranty issues, have incurred roughly $30 billion in expenses and modifications related to mortgage servicing issues, and have spent roughly $50 billion in combined legal expenses. While many feel that the bulk of the mortgage liability is finally behind them, S&P estimates that the large U.S. banks may need another $55 to $105 billon to settle mortgage-related issues.

Overall, we feel that despite the major headwind from legal issues the large U.S. banks are well positioned to weather the legal risk. Together, they have an aggregate cushion of $95 billion (reserves and capital above regulatory requirements) to absorb additional losses stemming from legal issues. Furthermore, banks have been able to absorb the increase in legal expenses and for the most part earn a positive return; through September 2013, legal expenses only comprised 28% of combined pre-tax earnings for the banks that disclose these expenses.

(Bil. $)

Bank	Total Legal Exposure (Base Case)	Estimated Legal Reserve	R&W Reserve	Capital Cushion	Legal Exposure "Coverage"	2013 Pretax Earnings
Goldman Sachs Group	$0.9	$1.2	N/A	$14.2	1711%	$11.7
Wells Fargo & Co.	$2.4	N/A	$1.4	$20.7	921%	$32.6
Citigroup	$2.4	$5.5	$0.3	$11.1	704%	$19.5
Morgan Stanley	$3.0	$0.9	N/A	$6.6	250%	$4.5
JPMorgan Chase & Co.*	$20.3	$23.0	$2.2	$10.3	175%	$25.9
Bank of America Corp.	$27.6	$10.9	$14.1	$22.3	171%	$16.2
PNC Financial Services	N/M	N/A	$0.5	$2.3	N/A	$5.6
U.S. Bancorp	N/M	N/A	$0.2	$7.1	N/A	$7.8
Total	$56.6	$41.5	$18.7	$94.6	273%	$123.8

*Total exposure is not in addition to the DOJ settlement. Includes Washington Mutual, some of the obligations of which JPM is disputing.

Source: Standard & Poor's, Company Filings

With that said, we are on high alert for potential new sources of litigation, including private label mortgages, monoline insurers, and the Federal Housing Finance Agency (FHFA), the conservator for Fannie Mae and Freddie Mac. We are also cognizant of potential non-housing related liabilities including LIBOR and FX fixing litigation. However, the implementation of the Volcker Rule reduces potential exposure to trading and transactional issues, likely reducing future legal risk.

INSURANCE SECTOR: POSITIONED TO BENEFIT FROM AN INCREASING INTEREST RATE ENVIRONMENT

Due to the growing systematic linkages between the banking and insurance industries, a review of the financial sector would be incomplete without a discussion of issues facing the insurance industry. With investment losses from the financial crisis behind them, most insurers have been facing a common headwind: globally low interest rates that have reduced investment returns from policy proceeds. The impact has been most painful for life insurance operations due to the longer duration contracts compared to Property & Casualty (P&C) and other insurance contracts, which tend to be shorter duration liabilities. Despite the headwind from interest rates, large insurers have been proactive in tackling areas that they can control, reducing exposure to capital-intensive products, diversifying globally, cutting costs, and improving the strength of their balance sheets. We're also encouraged to see that non-life premiums have continued to rise over the last year, although there is variation by product line. As discussed previously, we anticipate a gradual increase in long-term interest rates which should ultimately benefit insurance profits.

Within the broader insurance universe, we feel the global multiline insurers have the stronger credit profiles. The global multilines generally are more diversified (both by product and geography), have very strong capital positions, and can take advantage of pockets of favorable pricing conditions. Over time, global multiline underwriting performance has consistently exceeded the industry averages - likely due to a combination superior cycle management, pricing power, economies of scale and significant diversity.

Further, we expect that the larger more diversified insurers will be able to expand into non-life products faster than smaller peers, given the formers' established global presence, reputation, and sophisticated pricing capabilities.

Lastly, we would note that a handful of global insurers have been designated Global Systemically Important Insurers (G-SIIs) by the Financial Stability Board, including AIG, Allianz, Aviva, AXA, Generali, Metlife, Prudential Financial and Prudential PLC. While specific details of capital requirements are still uncertain, any incremental restrictions are unlikely to be imposed before 2019 at earliest. While increased oversight and higher capital restrictions may impact earnings generation in the short term, we believe a G-SII designation will be a net credit positive for insurers over the long run, given the likelihood of improved balance sheet strength and the beneficial perception in the marketplace as more reliable counterparties.

FINAL THOUGHTS

While the banks have been faced with a number of non-fundamental issues including legal and regulatory distractions, they continue to work through these issues and appear to have an ample cushion to support additional expenses in these areas. We're generally encouraged by the higher than expected rate of loan growth and merger activity in 2014. The banks will continue to face pressure from a declining residential refinancing market and lackluster fixed income capital market activity, but that should be at least partially offset by steady growth in fee-based businesses like asset management, M&A advisory, and equity underwriting. With credit improving substantially over the last several years and competition for new loan assets heating up, our sense is that we may be approaching a turn in the credit cycle and will be monitoring credit conditions closely. Lastly, given our expectation for gradually rising interest rates, we believe both banks and insurance companies are well positioned for an earnings tailwind in the future.

Investment grade financials continue to play a key role in client portfolios, offering deep liquidity, efficient execution, and the potential for spread compression. We continue to re-position within the sector as opportunities arise or as the value proposition changes for specific issuers. Our preference for higher coupon global issues largely restricts us to the secondary market at this time, which makes broad market access more valuable than ever.

JASON COOK,
RESEARCH ANALYST

*{Growth in non-performing loans + gross charge offs}/ average loans

As always, we welcome your comments and questions.
Please contact us if there are any changes to your financial situation or investment objectives.