MARKET OVERVIEW Q3 2012

In the face of ongoing economic and political uncertainty, the stock market rallied throughout the third quarter as investor optimism led a bullish march following the selloff in May and June. The rally was primarily driven by anticipation of further accommodative monetary policy measures being taken by central banks around the world. The European Central Bank delivered with a large bond buying program in August, followed closely by our own Federal Reserve initiating another round of asset purchases in September. These easing policies coupled with some improving economic data points helped drive the rally in risky assets. The S&P 500 Index finished the quarter up 6.35%, bringing the year-to-date return to 16.44%, and leaving the index at levels not seen since early 2008. For fixed income assets, the taxable Merrill Lynch US Corporate & Government 1-10 Year Index rose 1.17% in the quarter, leaving it up 3.06% YTD, and the municipal Barclays Managed Money Short/Intermediate Index rose 1.53% on the quarter, bringing it to 2.90% for the year.

Despite a 50 basis point range across the curve during the quarter, Treasury rates remained mostly unchanged from the beginning of the period. Overall tempered relief from a lack of negative news out of Europe largely offset slowing growth in the U.S. and abroad. Municipals, typically in line with treasuries, outperformed during the quarter as refundings and continued positive fund flows led to strong demand. Corporate bonds also outperformed as new issuance continued to be oversubscribed.

With the “risk-on” trade prevalent most of the quarter, the economically sensitive Consumer Discretionary and Technology sectors of the equity market performed well, just behind the resurgent Energy sector. After trailing much of the year, Energy stocks rallied throughout the quarter as the price of oil rebounded during July and August. The more conservative groups, Utilities and Consumer Staples were among the laggards. Somewhat of a surprise was the Industrials sector lagging the general market, potentially a result of continued European concerns and fears of a slowdown in China dampening medium-term global order outlook.

Arguably, much of why investors have flocked towards the stock market of late could be simply chasing the best performing market segment. After all, there is further justification in that equity valuations are reasonable from a historical standpoint. However, underlying investor optimism has specifically been bolstered by the central banks around the world taking an accommodative stance. Neither the message of ECB Chairman Draghi’s speech nor U.S. Chairman Bernanke’s QE3 announcement in September was a surprise, but the open-endedness of their measures of easing was.

The fact that the Fed stated it will continue to be accommodative until well after the economy presumably picks up, is theoretically a promise of perpetual fuel for investor confidence if not corporate growth.
Draghi provided a similar guarantee that the ECB will buy any sovereign debt to essentially cap rates. We have noted in previous letters that much of what was/is ailing markets is a crisis of confidence. With these unprecedented measures of easing, central banks have placed a massive safety net under the markets and investors have responded very positively. In fact, over 90% of the most recent rally has occurred on only five trading days with each day’s catalyst being central bank news.

Dovish monetary policy obviously leads to eventual concerns about inflation, though currently this is arguably the lesser of two evils, and not an overwhelming threat. While commodity prices rose during the quarter, they are currently well off their mid-September peak. With drought conditions having passed, agricultural commodities have eased in anticipation of a better harvest and increased plantings for next season, while oil prices have fallen significantly from near $100/barrel levels in mid-September to less than $90/barrel levels given demand concerns. Add to this still meager wage growth, and we do not expect a significant inflation rise in the near-term.

Economic results were mixed over the third quarter. The two brightest spots include housing and auto sales. Home prices have lifted, as have building permits, builder confidence, and housing starts. Auto sales are up from a year ago, although much of that can be attributed to easier borrowing terms, as rates have continued to fall. Nevertheless, people are spending on big-ticket items. While still at relatively depressed levels compared to the historical average, the consumer confidence index rose to a seven-month high of 70.3 in September. Despite that confidence, hourly wages have been flat and household income has fallen to levels not seen since 1995. Two products of increased confidence in the face of lower income are a drop in the savings rate and an increase in credit. One certainty is that consumers can only dip into their coffers for so long. Despite gradually improving jobs numbers and unemployment reports, there is limited reason for optimism concerning any improvement in spending power without further fiscal action or economic improvement.

While monetary policy around the globe has consumers and businesses “able” to spend, it is the lack of fiscal policy that is preventing them from being “willing.” A lack of clarity on tax policy and potentially regressive tax increases need to be resolved if economic progress is to be had. Thankfully, what has been termed the fiscal cliff is now viewed as more of a fiscal slope. Most do not expect a lame duck Congress to allow the tax cuts to expire and the budget cuts to commence at the stroke of midnight on January 1st. Obviously this would be a major negative headwind for the economy and the stock market. At the least it is expected that a gridlocked Congress will “kick the can down the road” in the form of a temporary extension and push the debate off until mid-2013, leaving the new Congress to navigate the debt ceiling deliberations. While markets would likely celebrate a short term fix, we doubt the duration of the enthusiasm, as a punt here could trigger further actions from the ratings agencies to downgrade U.S. debt. Also, if there is no majority makeup and the House, Senate, and administration remain gridlocked, there is little reason to believe the stalemate to which we have grown accustomed won’t drag on into the new year.

Business confidence has suffered as result of the political gridlock. The uncertainty of the elections, and subsequently corporate tax rates and the fiscal cliff, has left companies flush with cash but reluctant to spend. Global mergers and acquisition activity in the third quarter registered $535.5 billion, the lowest quarterly total since 2009. Furthermore, hiring remains muted as longer-term planning is difficult when the government itself is short-sighted. As the election passes, we look for this overhang to be lifted to a certain degree, and even more so if some bipartisan cooperation can be fostered to further a viable budget/tax plan.

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While we are not out of the woods yet in regards to European recession and austerity concerns, as well as our own cloudy political and economic situation, the market is trading higher and confidence is up because worst-case scenario risk has been diminished by monetary policy actions. The next step is fiscal groundwork. The markets should hold course until the election results or some fiscal accord provide clarity. Our equity strategy remains to emphasize long-term growth opportunities, while monitoring the political environment and other risks that may threaten the recovery. The targeted interest rate range of the Fed should keep Treasury rates within a narrow band. High quality Taxable and Municipal bonds should continue to see positive dollar flows, offsetting expected increases in issuance.

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

September 30, 2012 DJIA: 13,437.13 S&P 500: 1,440.67

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