APPLETON PARTNERS, INC.

QUARTERLY MARKET OVERVIEW – QII 2013

The equity market continued its ascent to all-time highs in May before correcting in June on concerns of the Federal Reserve tapering off their asset purchasing/monetary easing program. Meanwhile, the previously range-bound fixed income markets witnessed a decline starting in May as interest rates on the 10-Year US Treasury rose nearly 100 basis points. The S&P 500 Index was up 2.91% for the second quarter, bringing year-to-date returns to 13.82%. The taxable Merrill Lynch US Corporate & Government 1 to 10-Year Index fell 1.72% in the quarter, while the municipal Barclays Managed Money Short/Intermediate Index fell 2.23%, bringing their year-to-date returns to -1.54% & -1.90%, respectively.

Economic data during the second quarter was mixed. Concerns of inflation remain benign as hourly wage growth is flat, and commodity prices, aside from oil, continued to decline. Home construction, existing home sales, and home prices all continue to improve, the later adding to the wealth effect and consumer confidence. The ISM Manufacturing Survey readings oscillated back and forth from 50.7, to 49.0, to 50.9 over the past three months, teetering between contraction and expansionary sentiment. Jobs' numbers have also been inconsistent, muddying outlook. The May non-farm payrolls report was in-line to slightly below estimates at 175,000, though better than April. Unemployment ticked up one tenth to 7.6%. The June report showed additions of 195,000 jobs, coming in above estimates, but with no change in unemployment. The Fed continues to target 6.5% as a trigger for altering policy, and it seems as if we have a ways to go with no consistent momentum in payrolls yet. Finally, we witnessed a significant downward revision in first quarter GDP from an initial 2.4% estimate, to a revised 1.8%. All this indicates that progress has slowed, the economy may have bottomed out, and that the recovery will likely proceed at a gradual pace, not a rapid one. As such, it seems easy monetary policy is likely to remain in place, which the markets should welcome, though speculation on the initiation of tapering is adding a dose of volatility.

Over the past several years, the summer months have proven to be volatile ones as concerns overseas roiled investors here in the U.S. While Europe remained relatively calm, Asian markets, particularly Japan and China, experienced choppy trading that grabbed our attention. Japan's stock market experienced a sharp correction after gaining over 50% on Japan's Prime Minister Shinzo Abe's accommodative economic policy platform known as "Abenomics."

In China, short term lending rates briefly spiked above 30% causing a liquidity crunch that sparked a selloff in their equity market. Add to this the social and political unrest in Turkey and Brazil, and emerging market securities came under pressure heading into the end of the quarter. While this volatility has raised some level of concern amongst U.S. investors, there has been nothing close to the responses we witnessed during periods of international turmoil back in 2011 and 2012. If anything, it has encouraged investment within U.S. markets rather than abroad. Still, the global landscape bears monitoring as flare ups such as the current government coup in Egypt could make U.S. equity markets more vulnerable to orderly corrections, though panicked volatility as witnessed in prior years is unlikely.

The main event of the past quarter was the June Federal Reserve report. With all the intrigue surrounding it, given the hot button topic of tapering and mixed economic data muddying the picture, traders used the release as a spring board for action – and spring they did. Fed Chairman Bernanke reiterated the intention to maintain the Fed Funds rate well into 2015, but indicated that the Fed is prepared to start winding down asset purchases as early as later this year, possibly ending the program by mid-2014 *if* the economic recovery gains enough strength. Bernanke was careful to state that no set decision is in place, and that they will continue to closely monitor the state of the recovery in reference to steering policy. Markets responded aggressively to the news as the 10-Year U.S. Treasury spiked to a 52-week high and the S&P 500 Index sold off. Over the course of a week, 10-Year yields climbed to 2.61%, while the equity market shed over 4%. The topic of tapering off asset purchases was clearly stated with qualifiers that the markets chose to ignore, and given that the Fed's thresholds of 6.5% unemployment and 2% inflation remain out of reach, we viewed the sell-offs as overreactions. The subsequent bounce backs in the markets at quarter end substantiate our view. Bernanke stated, "Our purchases are tied to what happens in the economy – if the economy does not improve along the lines that we expect, we will provide additional support." The initial market response was as if tapering by year end is inevitable. However, while the economy has shown some signs of stabilizing growth, fiscal policies resulting in increased taxes and spending cuts are still headwinds to contend with. In our opinion, there needs to be more substantial evidence of improvement before policy changes are initiated.

The buzz around the topic of tapering had already broken the fixed income markets out of their trading range and into a decline. The Fed meeting reaction compounded this, sending interest rates even higher and pushing bonds into a further correction. With short term rates anchored by a 0.25% Fed Funds Rate, the rise in rates came at the longer end, leading to a substantial steepening of the yield curve. Lower quality credits, and longer maturity bonds have seen the largest declines. Our intermediate duration, and high quality focus has subsequently become relatively more attractive. In addition to the potential for a relief rally retracing what in our opinion was an overreaction in rates, short and intermediate bonds in particular should continue to benefit from the roll down effect presented by the steep yield curve. We will continue to take advantage of this environment as a buying opportunity for the short-term as a positive market correction is now as likely, or more so, than a consistent climb to higher rates. When Fed actions do dictate a sustained rise in rates, we will be prepared to reposition along the curve.

Equity market leadership rotated away from the conservative, higher-dividend paying stocks that championed the first quarter, into more growth oriented cyclicals in the second quarter. The correction after the Fed release furthered this trend as dividend payers and other interest rate sensitive stocks such as home builders and REITs appeared relatively less attractive given higher interest rates. Financials, and in particular banks, have continued to outperform as their balance sheets have improved and they stand to benefit from improved net interest margins given the higher rates and steeper yield curve. We used the correction as a buying opportunity. Amidst near-term volatility, we view potential future pullbacks as opportunities as well as we are constructive on equities over the long-term. Though index returns are near all-time highs, P/E valuation levels are still below the long-term market average. Healthy balance sheets should lead to increased return to shareholders via buybacks, dividends, or accretive acquisitions. Add in a positive wealth effect, as well as a promise by the Fed that they will remain accommodative until the economy is truly improved, and it appears the path of least resistance is still upward. Furthermore, the consensus expectation of only 3% profit growth and 2% revenue growth for this quarter's S&P 500 earnings season, on the heels of downward guidance revisions, should also prove a low hurdle for companies.

The markets remain hyper-focused on Federal Reserve monetary policy. This may very well lead to choppiness and increased volatility as a result of pundits making headlines with their interpretation of the economic data and how the Fed might respond. We will continue to view any pullbacks as potential purchasing and reconfiguring opportunities in both the equity and fixed income markets in the near term. We will closely monitor economic and market signals that could coax the Fed into changing its purchasing program, as well as how the economy bears fiscal policy headwinds. In the meantime, the economy appears to be treading that middle ground where the Fed should be comfortable sticking to their plan.

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

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