When rates trend low, as they currently are, the Municipal market's rate moves are more a function of the influences by the Treasury market rather than the specific nuances of the Municipal market. There are several issues right now that are driving Treasuries lower, none of which are germane to the municipal market: (i) a Geopolitical risk driven flight to quality trade; and (ii) European and Asian Quantitative Easing. Although investors have been looking for rates to trend higher for the last 18 months, if not longer, they are now realizing that we could be down at these levels for a prolonged period and that "when" the Fed begins to increase rates, it will be a gradual process. Despite the volatility that will remain in the markets, staying the course is important for our clients' longer term goals. We have experienced and studied periods of prolonged rate hikes, such as the 2004-2006 cycle when Fed Funds Rates increased 4.25%. During this period, long term returns were positive each year; thus, over-reacting to news in the market place is not warranted.

Rate Outlook: "Low for Longer"

The general consensus in the Fixed Income markets that rates will stay "low for longer" is hard to dispute given the transparency of the central banks and the pockets of global weakness expected to persist for some time. From a market perspective, we are dealing with what Ernest Hemingway would call, *"A Moveable Feast."* Just as one large economic bloc recovers and the removal of monetary accommodation is considered (the US), other global regions embark on strategies to combat economic weakness and disinflation (the EU and Asia). All debt trades are on a relative basis in the new global world order. So with European and Japanese debt yields trading in the negative to 1.00% territory, it becomes difficult for the higher quality US Treasury debt to trade above 1.00% to 2.00%. It is with this backdrop that we must understand where the central banks are orchestrating the direction and magnitude of rate moves, and why the US rates, at least in the intermediate to long ends of the curve, may be locked up in a range for a considerable period.

Following the removal of "patient" from Fed language, the markets were quick to realize that while the language had changed, Fed policy did not. The Fed views the strengthening labor market as needing further improvement, and the prospects for getting within the general vicinity of the 2.0% inflation target are slim at best in 2015. Bottom line: The Fed's own forecast came closer to the market consensus, particularly in the area of the Fed Funds target, which was lowered dramatically. The year-end 2015 forecast was lowered from 1.125% to 0.625%, which is a meaningful change when one considers that the first quarter of the year is over. Appleton continues to believe that any rate move in 2015 would occur very late in the year, given that there are many signs, besides the poor winter weather, which indicate that economic growth is muted. Despite the futures market calling for a 2.00% funds rate in 2018, the Fed is still predicting a 3.75% funds rate. At some point, the Fed may also lower that forecast, and it is highly likely that the market reality will continue to lead the Fed lower.

While our Fed continues to monitor the economic pulse in Europe and Asia, the tentative nature of our own recovery will play a role as they determine the lift-off point for US rates. The term "data-dependent" gives the Fed leeway, based on just a few releases, to justify delaying their timing. The March employment data reported on April 3rd (payrolls increasing by 126,000 versus expectations of 245,000), is an example of a data point that could support and justify such a delay.

Refundings Help Drive Supply

Although it is still early, new issuance seems to be the story on the Municipal side in 2015. In QI 2015, issuance is almost 60% ahead of the same period in 2014; this is largely a function of the low interest rate environment driving refundings. With over $100 billion issued in the 1st quarter, the Municipal market is well on track to surpass the expected total issuance for the year of $350-380 billion. Refundings have accounted for 51% of the issuance year-to-date, compared to 31% of the issuance in QI 2014 and only an average of 28.6% over the past 10 years. Balancing this large increase in issuance and driving the tremendous demand we are encountering for deals 15 years and shorter, is the large amount of cash on the sidelines and the continued inflows that Municipal Mutual Funds are experiencing. Year-to-date, $10.4 billion has come into the funds, and despite fears of higher rates, flows are close to evenly split between long-term and intermediate funds. Deals remain multiple times oversubscribed, which, in the face of large issuance, is fortuitous for the market. If cash flows dry up and the demand side takes a pause, increased issuance could pressure the market. Based upon the amount of issuance in 2005, 2006 & 2007, which averaged $409 billion a year, with over 60% of that issuance new money (refundable), we anticipate refunding issuance to remain very strong, especially with our expectation for interest rates to remain low.

Headlines for Troubled Credits Continue

As we progressed through the quarter, we saw a number of credits highlighted in the news, and expect to see certain names continuing to grab headlines throughout the remainder of the year. The 4-year drought in California has led the state to implement its first ever statewide restrictions on water use. Cities and towns across the state are mandated to reduce water use by 25% over the next 9 months, impacting many things including public and private spaces, personal use and consumption, and agriculture. Despite the severity of the drought and its wide effects, we believe the economic impact will remain minimal at this time. While California is dealing with a drought, the state of

New Jersey and the city of Chicago are both suffering from severely underfunded pension systems which have seen some heightened press recently. Governor Chris Christie of New Jersey vetoed a pension payment this fiscal year, of $1.5 billion, which unions lambasted. The State Superior Court ruled that the nonpayment violated a 2011 state law. The state is currently appealing the ruling so the outcome remains unclear. Chicago and its related entities were hit with downgrades, some multi-notch, as the city struggles with deteriorating pension funding levels and lack of political will to take the necessary remedial actions. The City's school district now sits at the cusp of junk status and some necessary steps to solve the problem are tied to state legislative actions, which limit what Mayor Rahm Emanuel can accomplish.

Puerto Rico remains in the headlines, as the Puerto Rico Electric Power Authority (PREPA), the Commonwealth's junk rated electric utility, is working on a restructuring plan to transform the utility and to restore its finances. PREPA bonds have been trading at distressed levels for over a year, due to concerns of a payment default. While Appleton does not own any Puerto Rico or City of Chicago bonds, we continue to monitor these credit developments because of their possible impact on the broader market.

Performance Recap

Performance in the quarter was bolstered by both curve and credit selection, with the bulk of the quarter's return coming from the coupon as rates over the quarter ended relatively flat. A large rally to start the year was followed by a selloff in February and a slight retracement in March, bringing yields slightly lower at quarter-end than where they had started the year. Overall for the quarter, 5Yr and 10Yr AAA municipal yields were both down 8bps to finish at 1.24% and 1.96%, respectively, while 30Yr AAA municipal yields were down 6bps. This market movement is reflected in the Barclay's Municipal Index performance, as the Barclay's Long Bond Index (22 years and out) was the best performing index, returning 1.58% for the quarter and the 10 year index was a close second with a 1.26% return for the quarter. The Barclay's 1-year Index was the worst performing segment of the larger Barclay's Index, returning 0.23% over the quarter. Despite specific ongoing credit concerns, the higher carry yield in lower rated bonds offset spread widening. Within the larger Barclay's Index, lower grade sectors led performance, with Hospital, Industrial Development, and Resource Recovery being the three best performing sectors. Credit spreads tightened for lower grades with the 10Yr AAA-BBB credit spreads tightening 4bps from 97 to 93 and AAA-A spreads narrowing by 2bps.

The Fed is positioning for a rate increase, causing short term rates to rise. Historical data from 1994, 1999, and 2004-06, shows that in similar rising rate environments, the curve flattened significantly as the cycle played out. Going forward, we anticipate a similar scenario as rate increases become more certain. In 1994 and 1999, intermediate high grade municipal portfolios had slightly negative returns, only to rebound significantly in 1995 and 2000. For the period from 2004-2006, intermediate term municipals did not experience a down year. The gradual moves by the Yellen Fed to normalize rates will force rates higher over time, but will not mimic the extreme moves of prior cycles. The definition of "normalized" is changing in 2015 and 2016, and it is our job to continue to seek value in security selection and capitalize on supply and demand imbalances when opportunities arise. We will continue to "stay the course," and are comfortable maintaining the duration on our intermediate portfolios at 4.65 years.

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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