Markets continued to rise throughout the second quarter of the year as stocks extended their rally to new highs, and demand for yield drove fixed income prices higher. The S&P 500 finished each month of the quarter with positive returns, bringing the winning streak up to five months. The index was up 5.23% for the second quarter, and 7.14% for the year through June 30. Municipal fixed income as measured by the Barclays Managed Money Municipal Short/Intermediate Index finished the quarter up 1.53%, bringing the year-to-date return up to 2.93%. Taxable bonds as measured by the Merrill Lynch US Corp/Gov't 1-10 Year A or Better Index returned 1.13% for the quarter to bring its year to date return up to 2.02%.

Many of the factors that have contributed to the rally in stocks have been in place for over a year now. Central banks around the world remain accommodative, macroeconomic data has moderately improved, merger and acquisition activity is at its highest level since 2007, earnings have been better than feared, and companies continue to return cash to shareholders through buybacks and dividend increases. The advance in stocks has come on below-average trading volume and little volatility, exemplified by the VIX finishing the quarter near a 7-year low. With interest rates remaining subdued, investors' appetite for dividend stocks remained healthy. Utilities continued to perform well, ending the first half of the year up nearly 19%, but the strongest performer of the second quarter was the Energy sector, finishing the period up over 12%. Interestingly, these two sectors were the bottom two performers of 2013. We believe that the market narrative will continue to support stocks advancing gradually, and would expect a pick-up in volatility as investors balance expectations for accelerating earnings growth with concerns over a continued expansion of stock valuations.

As we suspected when we penned our last quarterly letter, benchmark yields have trended below the 3% threshold that Wall Street pundits have fixated on. We would highlight several reasons why the 10Yr finished the quarter almost exactly where it started (2.6%). First, a weak first quarter that included a 2.9% drop in GDP contributed to a mixed read on the health of the U.S. economy. Additionally, low sovereign yields globally are likely putting a cap on how far U.S. yields can rise on a relative basis. Lastly, Fed President Janet Yellen continues to support the notion of low short-term interest rates for the foreseeable future. At Appleton, we continue to focus on credit as the most pressing risk to the fixed income component of our portfolios. For example, stock buybacks and cash dividends reached $241 billion during the first three months of the year, exceeding the previous record of $233 billion set in the fourth quarter of 2007, according to S&P Dow Jones Indices. With this record in mind, our fixed income research team continues to look for companies with management teams that weight the interests of equity and bondholders equally.

The economy is showing signs of snapping back following a weather-induced weak first quarter. Inflation seems to have bottomed, and the labor market has improved, both developments that could encourage the Fed to raise rates sooner than anticipated. While the headline data is undeniable, we're not quite ready to sound the "all-clear" quite yet. Though the unemployment rate has dropped, the labor participation rate has remained stubbornly unchanged and most of the pickup in jobs has been of part-time variety. Troubling still, wage growth remains lackluster, continuing to dampen a healthy level of inflation. Though certain measures of inflation have picked up over the past several months, they still remain shy of the Fed's stated target. Below target inflation levels and the Fed's recent decision to lower their 2014 GDP forecasts from 2.8%-3.0% down to 2.1%-2.3% suggest that, while the economy is gradually moving in the right direction, the Fed will most likely stick to their script and keep rates "low for long." Meanwhile, consumers may not be significantly increasing their spending, but they do appear to be allocating more to their investing in an attempt to increase their below average retirement account balances. Beyond faith, this may explain why the markets are trending stronger than the economy.

Geopolitical tensions continued to grab headlines throughout the second quarter and could continue to make investors nervous heading into the second half of the year. We continue to monitor "hot spots" in Ukraine, Iraq and Syria, and most recently in Israel and Gaza. The price of oil moved up throughout May and June as threats to supply worried the market, but tailed off after reaching a high of $107 per barrel. It will be worth watching whether these tensions shake investor confidence or raise the risk premium on oil, in essence imposing an added tax on the domestic economy.

Looking ahead to the second half of 2014, we continue to anticipate modest but not stellar improvement in the U.S. economy which should lead the Fed to prudently ratchet up short-term interest rates in 2015, assuming the inflationary environment remains stable. For stocks, a continued commitment by the Fed to keep short-term interest rates low into 2015 or beyond and the prospects for modest profit growth could set the table for additional gains, albeit not at the pace we saw last year. This all, of course, assumes no “tail risks” arise from one of the hot spots (or other unforeseen risks) we mentioned earlier.

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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