QUARTERLY MUNICIPAL REVIEW – QIII 2013

What felt like a reprieve from the selling pressure that opened the 3rd Quarter was fleeting and the market continued to experience outflows and increasing yields through the first week of September. We discussed in July that the concerns overhanging the capital markets could lead to increased volatility and that belief was substantiated over the last three months. Appleton's strength has been our ability to build portfolios that withstand this increased volatility. Buying large liquid deals and names that are widely held and have enough bonds outstanding to enhance liquidity are a staple to our buying process. Doing so in the intermediate part of the yield curve, which in our opinion is the best performing segment of the market over time, offers a suitable exposure to the municipal market with potential competitive returns and long-term price stability.

The overarching theme for the 3rd quarter, and the year for that matter, was when and if the Fed will begin to "Taper" the monthly purchase of $85 billion in mortgages and Treasuries. The hint of a tapering instigated the sell-off in May and the sell-off only accelerated when Chairman Bernanke discussed it at the June meeting. The fear of the Taper drove rates higher over the 3rd quarter, only for that fear to ultimately not be realized. As we have been highlighting for some time, the economy is weak and ultimately the economic data did not support a Taper.

Economic growth remains low, with real GDP for the 1st half of 2013 at less than 2% and expectations for QIII not materially higher. With the September employment report being delayed due to the Government shutdown, the most recent employment report through August came in at 169k, below the 200k threshold needed for growth. Meanwhile, the two prior months' reports were revised down and August labor participation rates remain historically low. Hints of a housing turnaround are increasingly mixed, home values have been rising only to hit headwinds, and ultimately slowing down as mortgage rates jumped up with the increase in Treasury rates. Refinancing applications have dropped 60% while new purchase applications are off too. As we enter the 4th quarter, the Fed's decision not to taper increasingly looks pragmatic as the debt ceiling overhang led to a government shutdown, which along with further Sequestration cuts in FY14 could cause further drag on the economy. Fortunately, President Obama was able to cross one item off the list of concerns for the market when he nominated Janet Yellen as the new Fed Chairman to follow Ben Bernanke when he steps down in 2014. Markets were generally pleased with this announcement as she is expected to maintain Bernanke's more dovish approach.

Municipal outflows continued in the 3rd quarter. In fact, we experienced outflows every week of the quarter, although levels retreated a bit as the quarter came to a close. YTD through the first week of October, over $41 billion has been redeemed from municipal bond mutual funds with the majority coming from Long Funds. With a 4-week moving average of $2.2 billion in outflows, there was a marked slow down in the last couple of weeks with $159 million and then $794 million. Despite this slow down, we do anticipate continued outflows as the retail mutual fund buyer grapples with credit concerns in Detroit and Puerto Rico. As we have indicated before, the forced selling by mutual funds has provided opportunity to find value in the municipal market.

As outflows continued, pressure on the muni market was fortunately offset by the decline in new issuance, as normal levels of issuance combined with the outflows would have pressured the market even further, likely leading to wider bid/ask spreads and widening credit spread. We just experienced the lowest September issuance since 2001, with total issuance at $19.4 billion, down 26% from the same period in 2012. Total issuance YTD is down 12% to $294 billion. As rates increased through the summer, refinancings became less economically feasible and were down 59% in September over 2012 and YTD refundings are down 30% over 2012. We are seeing new money issuance increasing, as fiscal austerity measures are beginning to decline and capital and infrastructure development is starting to come back.

During the first week of September, after experiencing 3-4 months of rising rates, yields finally peaked and buying picked up across the curve led largely by crossover buyers like Sovereign Funds and Hedge Funds. When ratios were close to 110%, these 'crossover' buyers started buying municipals in earnest searching for value in the Municipal Market. The increased buying and the subsequent lack of Taper led to a September rally that all but erased the sell-off we experienced in the first 2 months of the quarter. Essentially, after yields increased 20 to 50 bps out through 12 years, the ensuing September rally left rates mostly unchanged for the quarter in the 6-12Yr part of the curve.

APPLETON PARTNERS, INC ONE POST OFFICE SQ, BOSTON, MA 02109 TEL. 617.338.0700 WWW.APPLETONPARTNERS.COM

This part of the curve remains very steep with the spread between 2Yr AAA munis and 10Yr AAA munis at 218 bps, after starting the quarter at a spread of 214 bps.

The steepening of the municipal yield curve continues as the long-end has continued to sell-off while yields were lower in the 2-5Yr part of the AAA municipal yield curve. This put further pressure on longer duration bonds, hurting performance while credit spreads widened slightly leading lower-grade credits to underperform higher-grades in the quarter. The Barclay's Long Bond Index, again, was the worst performing segment of the market, down 2.14% for the quarter and 6.13% YTD. However, the 5Yr Barclay's Index was the best performing segment for the quarter, at 0.87%, while the 3Yr index has the best YTD performance at 0.73%. High grades outperformed lower investment grade over the quarter, with the AAA index up 0.49% and the BBB index off 4.38%. In light of this, our longer intermediate exposure negatively impacted our performance in the quarter. In addition, our exposure to A rated bonds detracted from performance, as volatility led to wider credit spreads in the first two months of the quarter followed by some tightening in the September rally.

Fortunately for the municipal market, the credit story at the state and local level continues to improve as state revenues continue to increase. With multiple quarters of year-over-year state revenue growth, the market's attention seems to have channeled more towards Detroit's bankruptcy and frequent Puerto Rico headlines. Both are quite important to market participants as Detroit is the largest US city to file for protection and the outcome, while probably many years in the making, will be closely monitored as they will be dealing with issues such as pension obligations and bondholder rights and protections. Puerto Rico, widely held by many mutual funds and individuals for its tax specialty nature, has been in the press due to its mounting debt pressures, as well as recent economic activity measures that showed a 5% drop in July's economic activity over July 2012. While Appleton does not own any Detroit paper, we do have exposure to the senior lien Puerto Rico COFINA bonds, which are secured by a legally protected lien on sales tax receipts and offers debt service coverage approaching 3 times. Both of these stories are evolving and are critical to the municipal market and we will continue to follow their respective stories very closely.

The volatility is here to stay and will be part of the investment process going forward. It is our goal to manage the increased volatility and incorporate it into the portfolio management process. The economy's headwinds are driving our expectations for interest rates to remain in a trading range for the foreseeable future, and are forcing the Fed to keep the Fed Funds Rate anchored at 0-.25%. The curve will remain steep and could potentially get steeper, pressuring the longer end of the yield curve. With this in mind we continue to find value in the 5-9Yr part of the curve and will continue to manage to our duration target of 4.7 years. Diligence from a credit standpoint remains important and, as mentioned above, we will follow the case studies in Detroit and Puerto Rico closely.

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