QUARTERLY TAXABLE REVIEW – QIII 2013

As we approach October and the final quarter of 2013, the Fed is not at the center of the discussion for the first time in years. The markets are focused on the inability in Washington to deliver a budget and raise the debt limit by the third week in October to avoid a potential default situation. While much of what we hear is political posturing at this point, it does bring attention to the fact that there are risks that could derail our recovery. This same topic was front and center in August of 2011, and the lack of resolution resulted in a downward spiral in consumer confidence, a downgrade in US Treasury sovereign debt by S&P, and an equity market that lost 15% between July and September. The dysfunction we are dealing with today from a fiscal perspective will contribute to the economic headwinds that are already in play from the sequestration. With first half GDP averaging 1.8%, the second half, which had been predicted to rebound, should make it into the 2.0% range … but just barely. Critical releases like employment data and retail sales are being delayed due to the shutdown. The recent rise in longer term rates is reflected in a sharp decrease in mortgage applications, and the housing recovery, a critical component to sustaining consumer confidence, is feeling more fragile.

"All things are subject to interpretation. Whichever interpretation prevails at a given time is a function of POWER AND NOT TRUTH." Friedrich Nietzsche

THE ROLE OF THE FED, WITH A NEW LEADER AT THE HELM IN FEBRUARY, WILL REMAIN THE MOST CRITICAL DRIVER OF RATES

Subsequent to the June 19th press conference when Chairman Bernanke used the "taper" word, rate volatility in longer dated bonds created a historically steep yield curve. On May 1st, at the low in rates, the 2Yr to 10Yr spread in the Treasury market was 143 bps. As the market responded to the fear factor associated with the taper, the 2Yr to 10Yr curve widened considerably, peaking at 253 bps on August 19th. Bernanke's message had been that they would continue to analyze the data and respond accordingly with their balance sheet purchase program. In the June 19th FOMC statement, we heard: "The Committee is prepared to increase or reduce the pace of its purchases to maintain appropriate policy accommodation as the outlook for the labor market or inflation changes." The markets' initial vehement reaction to this possible reduction in the purchases, while overdone, was not surprising. A 1.50% 10Yr Treasury, for example, was too low. A 2.50% - 3.00% 10Yr Treasury is a much more reasonable range given where we are in the rate cycle. Over the longer term, bond portfolios will benefit from the steeper curve and the higher rate scenario. Additionally, as our rates rose in QIII and our sovereign debt had value on a relative basis, capital began to flow out of emerging markets, like Brazil and India, and back into the US, reinforcing our global position as the market of last resort.

The decision of the Fed on September 18th NOT to announce a taper caught the market off-guard and reinforced:

- The challenges in various sectors of the economy: manufacturing and potentially housing
- The Fed's focus on the weak participation rate in our employment growth picture and the challenges to generating meaningful full-time employment
- The realization that there is little or no inflation on the horizon in the intermediate term
- The risks associated with expanding the reach of the sequester in Fiscal 2014 and the budget and debt ceiling battles in Congress.

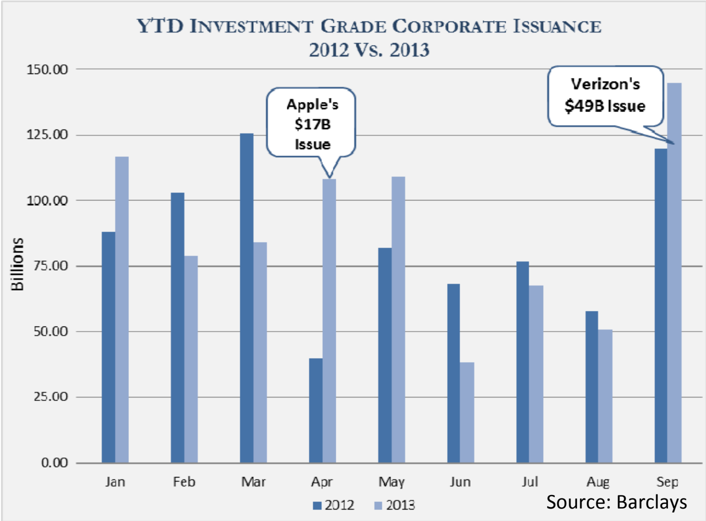
The effectiveness of the QE purchase program in delivering meaningful results in employment and economic growth remains in question. But Vice Chairman Janet Yellen has been appointed by President Obama to chair the Fed when Bernanke's term ends on January 31, 2014, and she has been a strong proponent of the program. While we know that the Fed will have to start winding down the purchases within the next two quarters, the funds rate will remain low for considerably longer. Janet Yellen will always be looking ahead and striving for at least a 2.0%-2.5% inflation rate and an unemployment rate that is approaching 6.5%. The Fed views 5.2%-5.8% as the target level which represents an efficient use of labor resources. The markets will be at least temporarily comforted by having Yellen, a Dove, at the helm. However, Fed presidents like Charles Plosser of Philadelphia and Jeffrey Lacker of Richmond will continue to voice concern over the potential pitfalls associated with too much accommodation. While the Chairman has strong influence, the committee format encourages internal debate which is ultimately made public in the release of the minutes. The debate around the balance sheet purchase program is undoubtedly getting more heated … and more public.

As we look at the next 12-24 months, under a Yellen Fed, there would be several ways policy might be adjusted:

- The initial phase would be a tapering of asset purchases. The execution should be straightforward – a reduction in Treasury purchases from $45 Billion/month to $30-35 billion/month. Monthly MBS purchases would initially continue at $40 billion/month as a means of indirectly supporting the housing sector.
- The current strategy calls for replacing run-off from Treasuries and MBS holdings. The Fed can stop replacing run-off as another subtle tool that would remove some accommodation without a major market impact.
- Raising the Fed Funds rate will likely be a 2016 event unless economic data forces them to change course, and by today's estimates, it will be a gradual move. Fed Funds Futures currently have a 1.00% funds rate priced in as of March 2016.
- Lastly, the Fed could execute sales in 2017 to shrink the balance sheet. The balance sheet is designed to shrink naturally by attrition, however, and there is a strong sense that the attrition route may be the path of least resistance – the Fed seems to embrace the path of least resistance.

SUPPLY AND DEMAND

Issuance of Treasury debt is shrinking due to sequestration, rising tax receipts, and increased payments from Fannie and Freddie. The CBO and the Treasury estimate that the annual issuance of Treasury debt will fall to approximately $600 Billion in 2013, versus 2012 issuance of >$1.1 Trillion. With the Fed continuing its purchase program, *from purely a technical perspective* there is little need in the near term for rates to trade measurably higher or to break out of the current range. Issuance of Corporate debt, however, ballooned in the past several months as issuers rushed to the market to beat the taper … and the potential for higher rates. Corporate supply surged to $301 billion in QIII versus $258 billion for the same period in 2012. A record $49 billion Verizon deal late in the quarter contributed greatly to the increase … and while VZ was priced to sell, it tightened quickly in the secondary. Industrial issuance far outpaced the financials in QIII ($126.6 billion versus $71 billion), and spread tightening in the financial sector had a positive impact on performance. Taxable mutual fund inflows, totaling $56.6 billion year-to-date, have contributed to the spread tightening as well, as fund managers are forced into the new issue market to stay invested.



CURVE REMAINS STEEP AND SPREADS TIGHTENED IN THE QUARTER

Interest rate volatility over the course of the quarter was incredibly active as the Fed's taper decision and market outlook was the focus of most market participants. This volatility sent the 10Yr Treasury to its highest level in two years (3.00% on September 5th). The low on the 10Yr during the quarter was 2.47%, which resulted in a 53 bps range, or nearly 20% on the quarter. The Fed's signal not to tapper resulted in a 2Yr-

10Yr Treasury curve that ended the quarter at +229 bps, just slightly steeper than where the relationship was as the quarter began. The shorter end of the yield curve continues to trade in a narrow range even in the face of this volatility. As long as the yields in the front end remain low, we will continue to benefit from the steeper curve.

On both a YTD and a QTD basis, the Financials have outperformed all other sectors in the investment grade space as spreads have continued to tighten. Over the quarter, the broad finance sector tightened by 23 bps to an average OAS spread of 137 bps. Taking that a little further to include the yield curve, it is very apparent that the 7-10Yr single A Finance sector was the largest contributor to the overall out-performance of that particular sector. Industrials continued on a steady path as the sector gained back some of the slight underperformance of the first two quarters. Again, the steepness in the 7 -10Yr part of the credit curve added to the steady pace of the sector. One of the largest stories of the quarter was the re-pricing of the Telecom sector in September as Verizon came to market with the largest deal in history, totaling $49 billion. The deal was met with great demand given its relative cheapness. The name was heavily traded in the aftermarket and spreads tightened an unprecedented significantly by the end of the quarter. Despite that temporary dislocation, the Telecom/Utility sector came back to end the quarter largely unchanged at +152 bps (Source: Goldman Sachs).

APPLETON PARTNERS TAXABLE FIXED INCOME STRATEGY

We continue to subscribe to the belief that the Treasury market has little room to appreciate in a meaningful way from these levels in the near term. The Agency sector is shrinking from an issuance perspective and liquidity is not deep, particularly on callable issues. Our current sector mix is high quality Industrials, Financials, and Taxable Municipals. We continue to leverage our expertise in the Taxable Municipal area to uncover value whenever there is opportunity. We are still significantly underweight Treasuries from the perspective of a Gov't/Credit benchmark, but our willingness and ability to find high quality value outside of the Treasury sector has benefited our clients. We were able to execute several swaps over the quarter that have shortened our overall duration to just under 4.0Yrs, bringing it very much in line with the benchmark.

Coupon structure makes a significant contribution during periods of rising rates, and adds more value as the coupon is allowed to build over the course of the year, not just a 1-2 month period. It is important to note that the benchmark coupons and yields have declined rapidly as this rate environment produces more and more new issues with 1.25%-2.50% coupons. Our composite coupon is currently 4.97% versus the Merrill GC 1-10Yr at 2.58% and the Barclays Intermediate GC at 2.61% both of which hold a heavy Treasury component.

Based on our outlook, we will look to maintain our Intermediate Duration target at 3.8-4.0 years, and continue to like the 5–7Yr part of the yield curve, taking advantage of the steepness. Additionally, we will exploit other credit spread opportunities that arise and uncover value as we approach year-end. From a credit perspective, the antics in Washington and expected rise in interest rates could modestly slow economic growth, but our focus on high-quality, investment grade issuers should insulate us from any meaningful deterioration in credit metrics. Furthermore, corporate balance sheets are flush with record levels of cash and access to the market remains very strong, as evidenced by Verizon's record $49 billion bond offering. Going forward we will be monitoring lofty earnings growth expectations for 2014 and continued shareholder-friendly activity by corporations. We continue to use market volatility as an opportunity to add sound credits with relative value to our portfolios.

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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