QUARTERLY MARKET OVERVIEW
QIII 2015

Worries about a Chinese economic slowdown and speculation about the timing of a Fed rate hike sparked a sharp uptick in volatility and defined the third quarter of 2015. This past quarter's performance was the worst in four years for U.S. stock markets as the S&P 500 experienced a loss of 6.44% to bring the year-to-date performance down to -5.29%. Fixed income markets fared better as interest rates trended lower throughout the quarter with the 10-year U.S. Treasury yield dropping 32 basis points to 2.04% to close September. Municipal fixed income as measured by the Barclays Managed Money Municipal Short/Intermediate Index finished the quarter up 1.55% to bring its year-to-date return up to 1.92%. Taxable bonds, as measured by the Merrill Lynch US Corp/Gov't 1-10 Year A or Better Index gained 1.14% for the quarter, bringing their year-to-date total return to 2.03%.

As of the second week of June, Chinese stocks had achieved year-to-date gains of anywhere from 60%-122% depending on the exchange. Much of the run-up in stocks was attributed to various forms of government stimulus, and due to the volatile nature of the emerging Chinese market the gains were widely considered tenuous. As Chinese markets declined from these overbought levels, investors around the world began to fear that the weakness would stifle the Chinese economy despite the lack of a substantial link between the two. The concern of a "hard landing" of the Chinese economy has been debated going back to 2011, so we were surprised by the violent reaction in our domestic stock markets. The correction, a term commonly used for a 10% decline from a recent peak, in U.S. stocks was swift and indiscriminant. Historically, after such a sharp decline in a short amount of time, stocks are apt to bounce back after retesting the initial low. As of quarter end, we believe we are in the process of retesting that low and would look for stocks to modestly rebound, albeit it with heightened volatility.

Stocks are likely to experience choppy, sideways trading and could struggle to regain the level they achieved over the summer by the end of the year. Uncertainty surrounding the Fed's plan for rate "liftoff" is likely to keep both companies and investors from sounding the "all-clear" signal. As we look out into early 2016, once we gain clarity from the Fed on the path of interest rates, we believe that stocks have the potential to recapture their upward momentum. Even after a hike, central bankers around the world will likely remain accommodative as the absolute level of interest rates remains historically low. This rate environment should continue to favor increased mergers & acquisitions and share buyback activities. The domestic economy continues to show signs of improvement and valuation levels are well off their recent highs, removing an arrow from the bears' quiver. The upcoming earnings season could prove pivotal in determining the direction of trade for the balance of the year. Once again, Wall Street analysts have reduced earnings expectations heading into the reporting period and we have confidence that stocks could beat their lowered hurdles. Given the opaqueness of economic data coming out of China, the team at Appleton will be focused on the performance and outlook of U.S. companies that have significant operations in China, e.g. Apple, Yum Brands, Tiffany's, etc. These companies with "boots on the ground" in China will be a far better tell than the Chinese government.

The Fed, sticking to its "data-driven" guns, surprised some by not raising the Fed Funds rate at its September meeting. Despite steady improvement in the jobs picture, the absence of inflation or upward pressure on wages gave the Fed cover to further delay a "liftoff" in rates. The voting members seemed to be concerned about mixed economic data outside of the job market and the impact of volatility in global markets on the domestic economy. Expectations for a rate increase have been completely reset, with the market pricing in a 37% probability of rate increase by the end of the year, down from 64% the day prior to the Fed's policy announcement. With mixed economic data and turbulence overseas, benchmark yields grinded lower throughout the quarter in a flight to quality, leading to positive returns in both municipal and investment grade corporate fixed income. Concerns about the impact of emerging market turmoil and the domestic outlook for corporate earnings did pressure credit spreads during the quarter with single-A rated corporate credit spreads increasing about 20 basis points since the end of June. To date, the turmoil in the high-yield market (credit spreads up approx. 300 basis points in the quarter) has not spilled over to the investment grade segment, but we will continue to monitor the situation closely.

As we look ahead to the remaining months of 2015, we remain constructive on both stocks and bonds. Though we believe that equity markets in aggregate should continue to rebound, certain sectors will be challenged. Energy and materials stocks may continue to face headwinds from an abundance of supply and a stronger U.S. dollar. Although short term opportunities could present themselves in those areas as traders look for a bounce from the bottom, our longer term view advises caution. Certain healthcare companies have come under pressure recently due to heightened scrutiny over pricing practices. Given their strong performance over the first half of the year and a looming election cycle the overhang may persist. Should equity markets continue to climb higher, we will be looking for opportunities in the traditionally cyclical sectors, such as consumer discretionary and technology, where valuation relative to growth prospects is becoming increasingly attractive. For bonds, with global growth moderating and few to no signs of inflation, the Fed will likely err on the side of caution and push a rate hike into the New Year. With an accommodative Fed and elevated investor demand for high-quality municipal and corporate issues, fundamentals are likely to support the bond market as we move into 2016.

As always, we welcome your comments and questions. Please contact us if there are any changes to your financial situation or investment objectives. Appleton is also now active on Twitter: follow us on Twitter at @AppletonPtnrs.

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