After a dramatic close to the second quarter, volatility seemingly followed many traders for the remainder of the summer. Coming off the whipsaw moves of late June, the third quarter brought a staggering 43 consecutive trading days without a 1% move in the S&P 500. A brief bout of anxiety over the Fed's next policy move only momentarily shook this calm in early September, but the S&P quickly stabilized and closed the quarter with a 3.85% gain, bringing the year-to-date total return to 7.84%. Interest rates gradually drifted higher over the summer, as well. After touching an all-time low of 1.36% on July 5th, the 10-Year Treasury recovered and barring some volatility around Fed policy, traded in a remarkably tight range for the rest of the quarter, to close at 1.60%. Given this gradual rise in yields, the Barclays Managed Money Municipal Short/Intermediate Index fell -0.18% for the quarter, to bring the year-to-date total return down to 2.70%. Taxable bonds, as measured by the Merrill Lynch US Corp/Gov't 1-10Year A or better index gave back a modest -0.05% over the quarter, bringing the year-to-date total return down to 3.63%.

If we were to choose one word to characterize the stock market during the third quarter of 2016, it would have to be "rotation." Despite the index trading in a fairly tight range and touching an all-time high in August, there was a substantial shift under the surface. In our last letter, we highlighted that the first-half of the year's outperformance of the defensive, bond-proxy sectors such as Utilities, Telecoms, and Staples had left these sectors relatively overvalued. Over the third quarter, in general, we saw cyclical sectors, particularly the Technology, Financial, and Industrial sectors, outperform those defensive sectors. We believe that this change was due not only to the move up in bond yields, mentioned above, but to investors taking a more "risk-on" approach and rotating out of the overvalued low-volatility, high dividend stocks into more relatively attractive high beta stocks. This rotation may continue if the potential of higher interest rates hinders the performance of the bond proxies and we see positive earnings growth in the coming third quarter earnings season.

The team at Appleton remains cautiously optimistic on stocks over the coming months. Global central bankers may be approaching the limits of monetary policy, but remain extremely accommodative by historical standards which will keep liquidity ample. Based on survey data, cash and margin balances, and other anecdotal evidence, investors do not appear to be positioned for further upside in stocks. The lack of excessive optimism among investors historically is a bullish signal. As we approach earnings season, Wall Street analysts have been cutting their earnings forecasts, and now see a decline of -2.1% for the third quarter. However, over the past four years on average, actual earnings have exceeded estimated earnings by +4.3%, according to FactSet Research, giving us hope for a return to positive growth. The Energy sector remains the largest detractor from aggregate earnings. Should the price of oil continue to stabilize, in turn boosting the sector's profits, we believe that mid-single digit earnings growth for the index is achievable. With the Dow Industrial Average, S&P 500, and NASDAQ all reaching all-time highs this past quarter, one of the largest obstacles to further gains could be valuation levels.

The S&P 500 appears rich relative to its own history using a number of valuation metrics, but investors have been willing to pay up for stocks in the face of record low interest rates, volatile commodities and foreign stocks, and/or less liquid alternatives like hedge funds or private equity. This willingness on the part of investors will not last forever, so a return to earnings growth could prove necessary for the market to advance in the coming months.

While many market pundits anticipated election-driven volatility, the fixed income markets were essentially range-bound. With Treasuries range bound, investment grade spreads remained in a tight band as well. While investment grade credit was quiet during the quarter, the rally in high-yield or "junk" bonds continued its torrid pace. High-yield spreads have tightened over 4% since the lows we saw in February and currently stand at a 15-month low. The positive tone towards junk is likely being driven by (i) the recovery in the energy sector and (ii) likely interest in higher yielding assets from abroad. With oil recovering into the $50 per barrel range and signs OPEC may finally cooperate on production cuts, spreads in the energy sector recently hit a 22-month low; a nearly 14% recovery from all-time wides seen in February. Though investment grade didn't see the price action that junk did, we are still optimistic on our strategy of focusing on high quality credit. Given the gap between investment grade and junk spreads, the modest pace of economic expansion, record corporate margins and growth in balance sheet debt of U.S. corporations, we feel investment grade offers a much better risk-return profile.

As we have highlighted in prior letters, political uncertainty will be a risk to the fourth quarter outlook, as well. At home, the Presidential election remains undecided, though polls widened heading into the second debate. There is also unusual uncertainty over the types of policies the next president will pursue. There are rare areas of agreement; both major candidates appear interested in infrastructure spending (which we consider a positive for growth), though both share opposition to trade deals (which we consider a negative). What could prove to be more of an impact on the market are the House and

Senate races. The market has shown that it likes the certainty of no major legislative impacts, which are likely with a divided Congress and President. Should one party gain unified control of Washington, the status quo of political gridlock will be in jeopardy and could unnerve investors.

The fourth quarter is shaping up to be an eventful one. The team at Appleton will look to focus on elections, corporate earnings, geopolitical developments, and the potential for the Fed to raise interest rates. As always, we will be searching for opportunities in the markets as these events play out.

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.