The disconnect between heightened political gridlock and the remarkably calm markets has been the dominant theme for much of 2017. Additional stresses in the third quarter were caused by building tensions between the US and North Korea, as well as a devastating storm season that battered the Caribbean islands and Gulf Coast states. These factors led to a flight to quality that brought Treasuries lower over the first two months of the quarter; though, yields did subsequently turn higher when Fed Governors began opining about the need for an additional rate move.

However, outside of the brief flight-to-quality trade mentioned above, the 10Yr Treasury stayed roughly within a 20bps range all quarter, closing the quarter virtually unchanged at 2.33%. The Fed's decision in October to begin a slow and measured balance sheet normalization was widely telegraphed, as was their decision to maintain the Fed Funds Rate at 1.0-1.25% and the accompanying slightly lower forward guidance. The latter was predicated on an unexpected slowdown in inflation (Core PCE fell to 1.29% in August, below the Fed's inflation target of 2%), which Chairperson Yellen strongly believes is transitory in nature.

Heading into the fourth quarter, we believe there are three key themes that will set the stage for the rest of the year and into 2018: (1) a labor market approaching full employment and the Fed's inclination to raise rates, despite stubbornly low inflation; (2) the steady escalation of rhetoric between the US and North Korea and the possibility of open military engagement; and (3) the Republican tax plan. In the wake of the Republican health-care plan collapse, the market remained reassured by the belief that this would allow the party to move forward to tax reform. While a plan was introduced, details need to materialize, and further delay may begin to jeopardize any type of agreement. As new events continue to unfold, seemingly daily, additional themes may also emerge.

Overall, we see an economy little changed from the start of the year, with low unemployment, low inflation, and decent underlying growth. Even though the pillars of the Trump tax plan have been announced, the specifics remain unknown, which casts uncertainty on ultimate costs and potential impact on the markets. Increased discussions surrounding the potential elimination of the state and local tax deduction could also influence investment decisions.

EQUITY REVIEW

Stock markets around the world rallied throughout the third quarter with the major U.S. averages hitting all-time highs heading into the end of September. Typically a seasonally weak month for stocks, it was the best September for the S&P 500 since 2013. The fundamental narrative that carried stocks to record territory remains largely intact, with tailwinds including a synchronized upswing in global economic growth, a strong corporate earnings environment, and still supportive global monetary policy.

Washington D.C. dominated the headlines for much of the quarter. After a drawn-out attempt to repeal and replace the Affordable Care Act, investors were becoming increasingly doubtful that the administration would be able to follow through on its growth agenda. In September, some hope of fiscal stimulus returned as the GOP released its tax reform blueprint, and President Trump reached a surprise deal with Democrats to avert a government shutdown and debt ceiling breach. This renewed optimism not only helped stocks advance, but boosted the president's approval rating which interestingly has been positively correlated with the 10-year Treasury yield.

This anticipated fiscal stimulus, coupled with economic improvement and the Fed's continued focus on transitory inflation headwinds, has helped fuel a meaningful increase in the odds of a December rate hike. As a result, we witnessed a backup in yields and a shift in leadership in the stock market towards the end of the quarter. Interest rate sensitive sectors (e.g., Consumer Staples, Utilities, & Real Estate) underperformed while Financials, which typically rally as rates rise, gained. Energy stocks also moved higher as the price of oil jumped 12% from oversold levels following supply disruptions from a pair of hurricanes. In a year where growth stocks have outperformed their value counterparts, the shift towards value at the end of the quarter is worth noting and watching. We would view the fact that the overall market was able to advance despite a change in sector leadership as a positive.

It is often said that in order to move higher, the market needs a "wall of worry" to climb, and this market is certainly not void of concerns. Geopolitical tensions ran high during the quarter as North Korea made a number of verbal threats, fired two missiles over Japan, and successfully detonated what was believed to be a hydrogen bomb during a test in early September. At home, President Trump was again amid controversy, following riots in Charlottesville and the subsequent disbanding of the manufacturing and strategic policy advisory panels. While we anticipate that the Fed will remain largely accommodative, it is unclear what the ultimate impact of monetary policy shifts will have as the Fed unwinds its massive balance sheet and charts a course for further rate hikes. Given the continued lack of volatility, which we highlighted in our last letter, even investor complacency is being treated as a risk. For the time being, investors are likely to discount these risks as long as the fundamental narrative remains intact and the prospect of tax reform lives on. Remaining cautiously optimistic on stocks, the team at Appleton will be mindful of these risks and their potential impact to the portfolios as we move into the fourth quarter.

MUNICIPAL BOND REVIEW

Demand for municipals remains strong largely driven by the positive fundamentals in the marketplace. Municipal bond mutual fund cash inflows added just under $8 billion in the third quarter, bringing total inflows for the year to $13.1 billion. Cash additions have mainly been split between Intermediate and Long Term Funds, with High Yield also gathering a portion of the inflows. After nearly a 20% drop in issuance during the first two months of the quarter, September issuance fell further, declining 34% from 2016 and bringing year-to-date totals through September 30th down 17%. The drop off in new issuance from last year further magnifies the potency of strong fund flows in to the market. We continue to anticipate lower issuance in the fourth quarter and into 2018; however, one wild card for 2018 issuance could be infrastructure stimulus. At this juncture, though, it is hard to imagine a broad infrastructure plan materializing. Historically, September and October have delivered positive issuance; however, net issuance finished flat for September and does not appear to be picking up in October, thereby contributing to buyers facing a supply-demand imbalance in the market.

The credit picture remains stable at the state and local level, although there are a handful of issuers that are grabbing headlines. Two states, Pennsylvania and Connecticut, remain without a full budget in place, four months into their fiscal year. Additionally, three powerful hurricanes, Harvey, Irma, and Maria, struck the US within a short period of time, causing destruction across the southeast coast of Texas and Puerto Rico, as well as parts of Louisiana, Florida, and the U.S. Virgin Islands. The storms have led to widespread humanitarian challenges, and recovery and rebuilding efforts for these regions will take time. The full extent of damages currently remains unknown; however, there is historical precedent that the municipal bond market experiences minimal credit deterioration or payment defaults due to natural disasters. Short term challenges could materialize for state and local governments in the affected areas, but we anticipate that local, state and federal dollars, as well as insurance proceeds and charitable contributions, should provide the necessary support. In fact, as these affected areas move forward, rebuilding efforts often provide a boost to local and regional economies.

TAXABLE BOND REVIEW

Investment grade corporate credit markets saw a busy first half of the third quarter for corporate issuance. July started off with a bang, as several major U.S. corporations, including JP Morgan, Wells Fargo, Citigroup, and Bank of America, emerged from earnings blackouts to issue a total of $31 billion in new debt. There was also a decent amount of merger and acquisition activity during the month, with AT&T issuing $22.5 billion worth of debt to fund the Time Warner acquisition. This gluttony of supply continued in early September, which put pressure on spreads during a time credit markets were already feeling soft from risk off sentiment spurred from tenuous US/North Korea relations. Over $90 billion was issued in the first two weeks of the month, notably, another $5 billion from Apple and $6.3 billion from Discovery Communications. September tends to be robust and, in this case, there seemed to be some urgency with political uncertainty and the prospects of a Fed hike looming. However, supply seemed to fade going into the last week of the quarter, and total new issuance over the quarter came in at $169.92 billion. Year-to-date volume hit $1.31 trillion, down 2% over the same period in 2016. With the decrease in supply and a rebound in investor confidence, credit spreads reversed the widening trend seen during the middle of the quarter.

The much-anticipated Trump tax plan announced at the end of September has the potential to put its mark on the taxable bond market, but not enough is known about the broader details to make concrete assessments on its effects. Despite the lack of clarity, demand for Investment Grade bonds should remain strong. We believe this should be especially true for higher rated and less volatile names and sectors. We have already seen that the initial response from the market has been positive, but there seems to be some concern due to the lack of any detail and the continuing political gridlock in Washington. One of the larger components of the tax plan is the potential for repatriation of the estimated $3 trillion in corporate cash that is overseas, which could bring in enough funds to help offset a corporate tax reduction. This repatriation could put pressure on Investment Grade corporate supply to the downside, although it is not clear that companies will buy back debt.

As we look ahead, we remain focused on the current economic and political environment and continue to assess investment opportunities as they arise.

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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