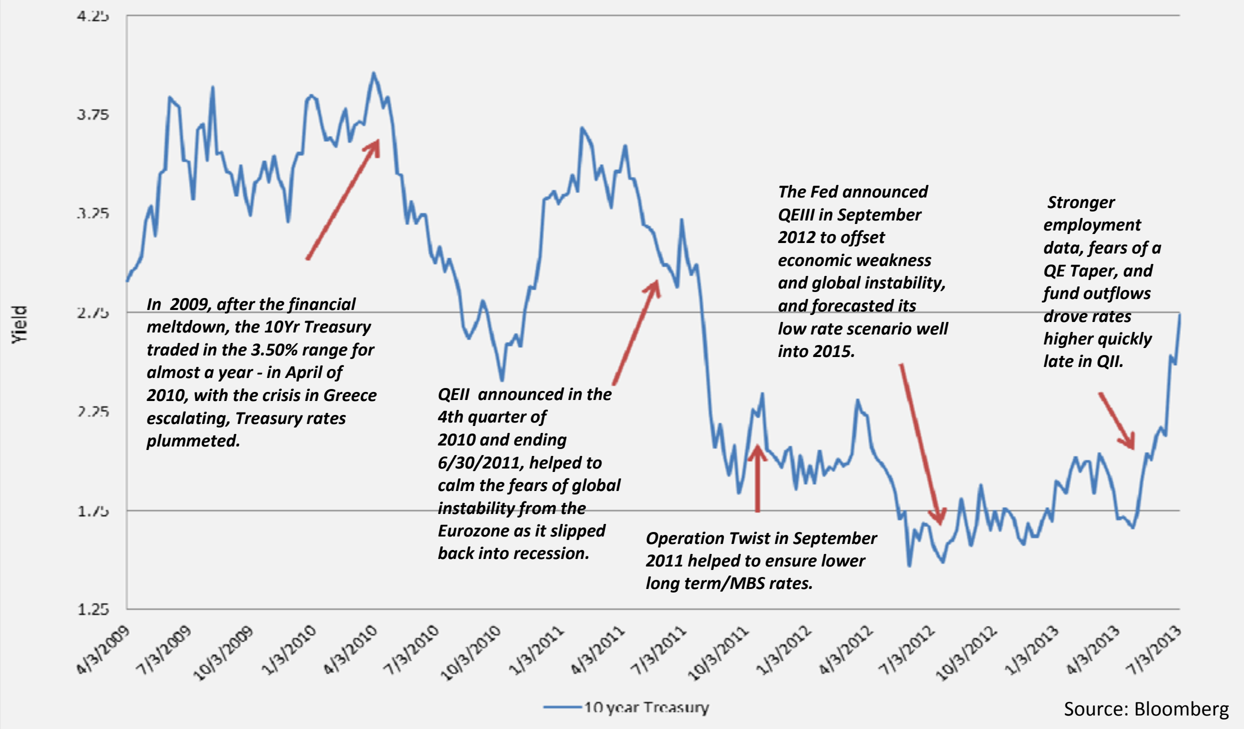
QUARTERLY TAXABLE REVIEW – QII 2013

HAVE THE FED'S ASSET PURCHASE STRATEGIES ACHIEVED THE DESIRED RESULT? THE JURY IS STILL OUT …

In one sense, the economy and the markets have moved beyond the financial meltdown of 2007-2009 and in a large part we can thank the Fed as we maneuver through a gradual recovery period. In the process, however, the Fed has used some non-traditional methods to achieve their dual mandate of price stability and full employment. As we look back on over 4 years of Fed policy evolution, we have witnessed a balance sheet that has grown from less than $1.0 trillion in December 2007 to almost $4.0 trillion by the end of 2013. The Unemployment rate has moved significantly since the quantitative easings have been in place – from 5.0% in early 2008 to 10.0% in late 2009, and finally to 7.6% today. Despite current monetary policy, Core PCE (year over year), one measure of inflationary pressures, has gone from 2.4% in early 2008 to barely 1.0% today, well below the Fed's longer term goal of 2.0-2.5%. The markets, and more recently the Fed, are divided on the efficacy of this strategy, but they do appear to be united on one point – the balance sheet purchases may no longer be necessary as we approach 2015.

THE FED HAS BEEN CONSTANTLY MANIPULATING RATES LOWER IN THE HOPE OF FUELING THE RECOVERY: THE FEAR OF THE TAPER IN QIII AND A LESS AGGRESSIVE FED GOING FORWARD PUSHED RATES HIGHER IN MAY/JUNE AS FEAR OVERCAME THE MARKETS



Source: Bloomberg

Throughout QII, the fixed income markets were obsessed with the policy making decisions of the Federal Open Markets Committee (FOMC), and in particular the longevity, or lack thereof, of the asset purchase programs. From 7/3/2012 to 5/3/2013 the average yield on the 10Yr Treasury was 1.74%, reflecting a range of 1.39% to 2.06%. In that same period, the 2Yr Treasury averaged .25% and traded in a range of .20%-.31%. With the Fed's hand constantly at the till since the financial meltdown in 2008, lowering short term rates and targeting specific asset purchases to manipulate longer rates lower, has left little room for rates to wander. We have been told that Fed actions will be increasingly "data dependent." Going forward the markets will not just be interpreting the data, but will now be interpreting how *the Fed will interpret the data*, not an easy task when the data is mixed. Weak QI GDP growth, weak ISM manufacturing data in May, and benign inflation reports are being offset by improvements on the labor front and strength in the housing sector. The recovery feels more like a tug of war than a slow and steady move forward. While the past year has been a calming period of low rates, tighter spreads, and somewhat predictable performance on the fixed income front, the future should hold more volatility. While this may have a negative near term impact, in many ways testing the range will be a positive move forward for the fixed income markets as we adjust over time to rates moving higher.

As we look at the next 12-24 months, there will be several ways the Fed could adjust policy:

1. The initial phase will be a tapering of asset purchases. The markets have concurred through fedspeak and economic data that the announcement of the reduction in asset purchases will be made at the September meeting (9/17-9/18). The execution could be straightforward – likely a reduction in Treasury purchases from $45 billion/month to $20-25 billion/month. Monthly MBS purchases should initially continue at $40 billion/month as a means of indirectly supporting the housing sector. Current forecasts call for the Unemployment rate to fall below 7.0% by mid-2014, at which point the purchases would end.
2. 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 will remove some accommodation without a major market impact.
3. Raising the Fed Funds rate will be a 2015 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 November 2015.
4. Lastly, the Fed could execute sales in 2016-2017 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 – and currently, the Fed seems to embrace the path of least resistance.

We are in unchartered waters here as it pertains to achieving full employment and price stability. By creating forecasted trigger points and by using asset purchases to such a large degree to revive the economy, the Fed will be in the unwind period. Additionally, the increased transparency has forced the Fed to respond to the markets' interpretations of their (the Fed's) potential actions. This is the *Transparency Conundrum* that they have created, and the markets will expect the Fed to respond by tempering any extreme market moves … a responsibility that goes way beyond full employment and price stability. One of the major determinants of success will be the clarity and consistency of the messaging. Ongoing communication has become another tool in the Fed's toolbox, but there is an added responsibility ensuring that the Fed's message is managed appropriately.

Supply and Demand

The technicals in the Corporate sector were positive in the quarter. While YTD issuance is almost breakeven versus 2012, $506 billion in 2012 and $522 billion in 2013 (Source: Barclays), mutual fund flows were positive in the quarter. Through July 3rd, Taxable mutual funds had net inflows of $88.2 billion. For this same period in 2012, fund inflows totaled over $152 billion. Due to the increase in rates, many high quality issuers already flush with cash, backed away from the market in June. The month saw only $37 billion in issuance, less than half the average monthly issuance in the past year.

Curve Steepening and Spread Widening in the Quarter

The Treasury move in the quarter was significant based upon the Fed's slight adjustment to its language and its message. From the lows in early May, 10Yrs traded 100 bps higher by late June, while 2Yrs were higher by 23 bps… a significant steepening. As the markets responded to the rate volatility, fund outflows and thin trading volumes, and the reduction in new issue supply resulted in temporary price dislocations. We expect to see a correction from the highs as the market regains stability, and expect to see the 10Yr area gravitate toward the 2.50% range. As we ended the quarter, the 10Yr US Treasury was trading 100 bps higher than the German Bund (a 7Yr wide), and significantly wider than the Japanese Government Bond. Crossover buying and a re-implementation of the carry trade should support the Treasury in its current range. The Financial sector had the steepest spread widening in the investment grade corporate space. 5Yr AA Financials had the worst performance, with spreads ending the quarter 21 bps wider. Where we lowered exposure to the Banking sector in QI, we will review the sector in light of Basel III implementation and may consider adjusting exposure in QIII.

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 for the foreseeable future. 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 and look to uncover value whenever there is opportunity. While we are still significantly underweight Treasuries, we are beginning to re-introduce the sector in temporary market back-ups. With prepays beginning to slow, we are reviewing the Agency MBS sector to add yield and diversification to our strategy. As we approach the second half of the year, we will continue to be tactical in our approach to both sector exposures and yield curve positioning.

Coupon structure makes a significant contribution during periods of rising rates, and will add 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 2.63% and the Barclays Intermediate GC at 2.69%.

Based on our outlook, we will look to maintain our Intermediate Duration target at 3.9-4.1 years and take advantage of that steepness picking up a substantial amount of yield in the 5-7Yr part of the curve. Additionally, we will continue to exploit other credit spread opportunities that arise and uncover value while the dust begins to settle as we begin the third quarter.

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