QII 2014 Was Remarkable In the Fact That So Little Changed Subsequent TO QI

In looking back at both the second quarter and first half of the year, the bond markets are plagued by the adage "the more things change the more they stay the same." The dreaded trend to higher rates, or *normalized rates* as market pundits have coined the phrase, has not materialized and does not appear to be imminent. In fact, as we move into the second half of the year, many market participants are backing away from predictions of a 3.25% - 3.50% 10Yr Treasury at year-end, and are in fact lowering their estimates. According to the Bloomberg survey data, the forecasted yield on the 10Yr at year-end dropped from 3.25% in May to 3.07% in June. While the markets still believe that the Fed will begin to raise short term rates in June of 2015, the forward curve is telling us that the slower pace of the rate hikes will produce a more muted response in the longer end of the curve than previously thought. Lower volatility and a willingness to take on risk assets in exchange for some level of yield pick-up were the themes of the quarter as bonds continue to be locked up in a trading range.

Market News in QII Has Been a Net Positive For Bonds

We cited several reasons at the end of QI for why rates couldn't rise significantly in the near term and most of these factors are still in play at the end of QII. Geopolitical unrest and sectarian violence throughout much of the world first and foremost concerns us for humanitarian reasons, but secondarily could result in a flight to quality that would benefit US Treasury rates. While this scenario has yet to materialize in 2014, we are aware of the temporary market dislocations that can evolve.

Factors that continue to impact the bond markets as we move into the second half of the year:

A weak first quarter and a mixed read on the economy keeps yields in check:

- The final revision for first quarter GDP, a negative 2.9%, was driven partly by weather issues, but also by the health care component of personal consumption that was initially reported at 9.1% and then revised down to a decline of 1.4% in the final.
- The Labor market statistics are revealing steady growth in non-farm payrolls (averaging 270,000 per month in the second quarter), an unemployment rate of 6.1% (a level not seen since September 2008), but weaker wage growth, a low participation rate (62.8%), and a rise in part-time workers continue to over-shadow the employment picture. These are all metrics that the Fed follows closely.
- Consumer spending, beyond the QI weather meltdown, is sporadically recovering, but not exhibiting signs of staying power to date. Retail Sales has been mixed, but is expected to show a strong recovery in June, and Consumer Confidence as measured by the Conference Board is at its highest level in more than 6 years.

Low sovereign yields relative to US Treasuries creates a ceiling on rates – at least for now:

- While US Rates were markedly higher than our sovereign counterparts at the beginning of QII, they are even more exacerbated at the beginning of QIII. It is remarkable that the US Treasury 10Yr yield is 93 basis points (bps) higher than France and 137bps higher than Germany. But it is even more remarkable that the US Treasury currently trades only 5bps below Spain (where the Unemployment Rate is >25%) and 18bps below Italy.

Central Bank Accommodation remains firmly in place for the foreseeable future:

- The FOMC continues to reiterate the theme, *lower rates for a longer period of time,* as they wind down their asset purchases. In the June 17-18 meeting, the Fed revised its forecasts: Fed Funds at 2.50% at the end of 2016 and the long run equilibrium rate for funds at 3.75% (versus the previous estimate of 4.00%). However there were no meaningful or unexpected changes in policy. The focus on the "exit strategy" and timing of the rate hikes in 2015 will continue to dominate the markets as we approach year-end.

- On June 5th, the ECB took some bold steps: cutting its refinancing rate from .25% to .15%, lowering the deposit rate from 0.00% to -0.10%, and announcing that they will begin an asset-backed purchase program. Draghi continues to reiterate to the markets that the ECB is prepared to take any measures necessary to ensure growth and stability in the region.

While Eurozone inflation levels remain at near-term lows, US indicators are in an acceptable range, but beginning to reflect an upward bias:

- In the months of May and June, the ECB reported an annual inflation rate of .5%, a significant problem for the most indebted nations in the region. In the US, however, most indicators have been climbing consistently since February, with CPI reaching 2.1% in May (a 19-month high) and the PCE Core Deflator increasing from 1.1% in January and February to a 1.5% annual rate in May. At her press conference in June, Chairman Yellen referred to this increase as "partly noise," and while it is not an immediate concern, it is attracting some attention in the bond markets.

SUPPLY AND DEMAND

With demand for yield at record levels, investors have focused on the new issue market for supply. Issuance in the first half of 2014 has been robust, with $801.6 billion being priced. New IG issuance volume in the second quarter hit $385 billion as Oracle and Goldman Sachs tapped the markets for a combined $14 billion on the last day of June. Apple's $12 billion deal to begin the quarter and Oracle's $10 deal to end the quarter were the biggest deals since the mega Verizon deal of $49 billion last September. The steady demand, positive fund flows, and low rate environment continues to allow corporations to reduce the cost of debt. However, the amount of debt outstanding has grown at a steady clip. When breaking down issuance over the quarter, the leading Q1 sector position was reversed from Finance to Industrials and BBB credits continue to lead all ratings buckets. Positioning along the curve continues to be loaded in the 1-5Yr range. Supply is expected to slow over the summer months even though demand will continue to remain strong. This will most likely put pressure on the secondary markets and make a somewhat difficult trading environment even more challenging.

CURVE FLATTENING AND SPREAD COMPRESSION

The Treasury curve continued to flatten in the quarter, as 2Yrs pushed slightly higher to 0.46% and 10Yr yields declined by 19bps to 2.53%. With the Fed Taper coming to an end soon, the markets focused on the timing of the Fed Funds rate hikes. In the eyes of the market, a rate hike will occur in mid-2015, and as we march closer to that time period, the short end of the curve becomes more vulnerable. The longer end of the curve continues to be driven by technicals, with global institutional investors and pension funds buying yield. However, with the short end a year away from an expected Fed move and the long end locked in a trading range, there is little evidence that the curve will change dramatically in the short run.

GENERAL CREDIT TRENDS AND THE FINANCIAL SECTOR

We continue to observe multiple indications that credit risk is creeping into the fixed income markets. From corporations' ability to issue record amounts of bonds at increasingly extended maturities, to levels of covenant-lite loans not seen since before the financial crisis, or six-year lows for junk bond risk premiums- all signs point to increased risk appetite in the market. Under these circumstances, our credit research process becomes even more important. To that end, we are striving to avoid the proverbial "rob Peter (i.e. bondholders) to pay Paul (i.e. shareholders)" dynamic that is playing out across corporate credit. In the latest data we have, stock buybacks and cash dividends reached $241 billion during the first three months of the year, exceeding the previous record of $233 billion set in the fourth quarter of 2007, according to S&P Dow Jones. With this record in mind, we continue to focus on companies with management teams that fairly weigh the interests of equity and bondholders. Given the limited compensation investors are receiving for incremental risk in high yield and leveraged loan assets, we continue to believe that focusing on high quality, highly liquid bonds is the optimal positioning for our clients.

Recognizing we have a number of positions in large money center banks and global insurers, we recently published a thorough review of the investment grade financial sector. Our general takeaway is that the elimination of legal distractions, a rising interest rate environment, and a slowly improving global economic picture all support the long-term fundamental outlook for the group. Going forward, we will be monitoring the sector for a turn in the credit cycle and confirmation that net interest margins have troughed.

Appleton Partners Taxable Fixed Income Strategy

At the end of the first half of the year, our composite has returned 2.60%, outperforming our strategy benchmark by 58bps. During the quarter we saw both further flattening of the curve (where yields were relatively flat through three years and then falling 10 to 20 bps beyond that), as well as additional spread compression in the intermediate part of the curve. This was beneficial to our positioning, and we still continue to favor a bell shaped portfolio with a focus on the 3-6Yr maturity range. Within this range, however, we extended our maturity concentration somewhat, allowing our previous peak between 4 and 5 years to drift down a year and increasing exposure between 5 and 6 years to compensate. This ended up being one of our strongest contributors to return over the quarter, as a large active weight between 5 and 6 years coupled with strong outperformance relative to our benchmark captured approximately 15.7bps of excess return.   Our underweight of AAA-rated Corporates and Treasuries continues to be a strong driver of return in 2014, much as it was in 2013. We continue to benefit from higher overall yield and continuing spread compression in the lower investment grade ratings, and we remain confident in the quality of the names in which we invest. Our Banking exposure also continues to be a significant source of value for our strategy, where an additional 7.6bps of excess return brings us to about 14bps on the year. While our very low exposure to maturities longer than 7 years (5% of our portfolio, whereas a full 15% of our benchmark falls here) has led to mild underperformance in a number of economic sectors, our positioning here strikes a balance between capturing much of the roll-down the curve and protection against abrupt rate increases, and should provide support when the current period of prevailing low volatility invariably draws to an end. This is an exchange we are only too happy to make.

As we move into the second half of 2014, the markets will be looking for 2.50% - 3.00% growth, following on a much stronger second quarter (at ~3.5%). Inflation trends will be closely monitored, as investors try to decipher the Fed's initial timing on rate hikes. It is no secret that this Fed is more vigilant in the deflation fight than the inflation fight, and may be slower to raise rates in the face of economic strength. While credit spreads are tight historically, the higher quality investment grade space will continue to attract capital as a proxy for sovereign debt that is deemed too rich with little or no appreciation potential. We expect to see risk assets continue to be in favor unless geopolitical, EU uncertainty, or other event risk emerges. During these periods of uncertainty, the deep liquidity found with the larger, higher quality issuers will be invaluable.

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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