Uncertainty surrounding domestic monetary policy kept equities range bound and triggered volatility in fixed income trading throughout the second quarter of 2015. Stocks continued to grind higher throughout the first two months before succumbing to worries over the financial future of Greece in June. The S&P 500 finished the second quarter with a modest 0.28% gain to bring the year-to-date total return up to 1.23%. Mixed economic data, both in the U.S. and abroad, created volatility in fixed income markets as the 10-year U.S. Treasury yield (2.36%, up from 1.92%) followed European sovereign yields higher throughout the quarter. Municipal fixed income as measured by the Barclays Managed Money Municipal Short/Intermediate Index finished the quarter up 0.03% to bring its year-to-date return up to 0.50%. Taxable bonds, as measured by the Merrill Lynch US Corp/Gov't 1-10 Year A or Better Index, are up 0.88% on the year after falling 0.52% during the quarter.

With the Fed's self-proclaimed data dependent approach to interest rate policy, investors appropriately scrutinized each piece of macroeconomic data released throughout the quarter. U.S. GDP was notably weak with an initial reading of +0.2% for the first quarter before ultimately being revised down to -0.2%. The soft reading was shrugged off by many due to unseasonable weather and a west coast port slowdown, with the Fed labeling the weakness as "transitory." Many economists, including Fed members, are calling for a rebound in the second half of 2015 and some data suggests they may be right. Auto sales are showing strength, the housing recovery is ongoing, and the labor market continues to show signs of improvement. The Fed, however, will have to counterweigh these promising indicators of growth against signs of stubbornly low inflation. The strength in the jobs report is largely owed to service sector jobs, which tend to be more fickle and lower paying. Wage growth remains anemic and, as we have mentioned in prior letters, inflation will struggle to rise in the face of little to no wage increases. Also anchoring inflation expectations is the price action in commodities. From gold to copper to oil, commodities have been pressured by supply/demand constraints and the strength in the U.S. dollar. Although the U.S. dollar plateaued in the second quarter, should global monetary policy continue to diverge and Greece continues to roil the euro, we could see the dollar resume its move higher. For oil, the Fed labeled the softness as transitory and anticipates a rebound in price. As we have mentioned before though, the newfound overabundance of supply has ushered in an era of surplus. As oil drillers gain efficiencies, the breakeven price to extract oil from the ground drops so any rebound in the price is likely to be met with increased drilling activity. This added supply, in addition to any from Iran should sanctions be lifted following a nuclear deal, should essentially act as a ceiling on the price of oil. If inflation does continue to run below the Fed's target, they will be hard-pressed to meaningfully hike rates in the short term. During her last press conference, Chairwoman Yellen advised investors to focus on the trajectory of potential rate hikes rather than the timing of the initial raise. We would look for a "one-and-done" token raise later this year, allowing the Fed to break the ice.

The fundamentals that have driven the current bull market in equities remain largely intact. Healthy corporate balance sheets have led to continued strength in merger & acquisition activity and a steady return of capital to shareholders. Central bankers from around the world, most notably in the U.S., Europe, China, and Japan, remain accommodative in regards to monetary policy. The yield curve has steepened somewhat, which typically signals a firming economy, in turn supporting the stocks of cyclical industries. First quarter S&P 500 earnings were much better than feared, although the impact of the drop in oil and the strengthening U.S. dollar remained primary risks. Both of those concerns showed signs of stabilization throughout the second quarter, which could aid companies in beating lowered expectations once again in the coming earnings reporting period. While current valuation levels are above long-term norms, the current low interest rate and inflation environment suggest that further valuation multiple expansion is possible. Lastly, according to data from the American Association of Individual Investors, bullish sentiment, a typically contrarian indicator, has remained below its long term average for the entire quarter. Ultimately, we believe the stock market will continue to show resiliency in the face of any near term macro event concerns.

Most fixed income asset classes were generally weak during the second quarter as we saw significant volatility in global benchmark yields, despite aggressive easing measures in Japan, the EU and China. In contrast to the rest of the world, the Fed is prepping the domestic markets for a tightening cycle but continues to ratchet down expectations for a rate hike in 2015 given the recent spate of mixed economic data. When the Fed does begin to tighten, we are skeptical of a major liftoff in interest rates for several reasons: (i) the Fed has signaled their intention to target a gradual rate trajectory; (ii) U.S. long-term yields that remain relatively high and attractive for foreign investors; and (iii) the demand-supply dynamics given that the central banks in Japan and the EU plan to purchase the equivalent of 100% of the expected new government bond issuance of the world's four largest developed economies during 2015. Beyond the risk to the yield curve, corporate credit remains stable in our view. Earnings for the first quarter generally came in better than the rather somber consensus expectations. We view the largest near-term risk for corporate credit to be the elevated pace of M&A activity and other financial engineering.

As we look out into the third quarter and the remainder of 2015, we will continue to monitor multiple sources of "event risk" in the global financial markets. In Europe, the outlook for Greece's membership in the EU seems to change on a daily basis, but our focus is on how a "Grexit" might have a systematic impact on the global banking system. For years, the small European country has been at the center of a debate over austerity versus access to further financial aid to prop up the economy. Given Greece's minimal impact on the Eurozone's GDP (< 2%), the most concerning element is contagion risk. If Greece were to exit the Eurozone, it is impossible to foresee the numerous impacts and ripple effects both in the short term and long term. Puerto Rico is particularly relevant to the domestic bond market, as many municipal bond funds (and opportunistic hedge funds) own Puerto Rico bonds. Further deterioration of the Puerto Rico credit or a default by one of the public corporations would likely trigger fund redemptions. Should this technical selling temporarily increase yields/spreads in the broader municipal market, we would consider it to be a possible buying opportunity. At Appleton, we have no exposure to Puerto Rican credit, however, we do hold a limited position in pre-refunded Puerto Rico bonds, which are backed by U.S. Government securities. Turning to Asia, China's stock markets continue to experience a sharp correction, having fallen more than 30% off June highs. The Chinese government has taken steps to support the market ranging from interest rate cuts to a prohibition on IPOs, and a consortium of brokers has launched a market stabilization fund to try to provide further support. For the time being, however, Chinese market volatility is likely to remain high. The geopolitical concerns and uncertainty around the message from the Fed will most likely cause some volatility in the short term for domestic equities. Given the reasons discussed earlier, however, we believe any dips in the stock market will be shallow. We remain constructive and look for the upcoming earnings season to provide a tailwind as companies are able to surpass lowered analyst expectations.

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