Although the second quarter has come and gone, many of the themes which dominated the markets over the past few months continue to draw our attention. As we write this letter, the markets are preoccupied by financial turmoil in Greece, China, and Puerto Rico, and we are trying to discern the direction of the US economy, as well as that of Europe and Asia. Meanwhile, the Fed has to channel all of these inputs to time its first rate hike in many years without disrupting improvement in the domestic economy. As we have previously discussed, volatility has worked its way into the marketplace and will remain for the foreseeable future. Despite liquidity concerns in the global fixed income markets, demand for municipals remains very strong and new issue deals are repeatedly oversubscribed. We have entered a seasonal period that is supportive of municipals, and the prospect of continued global turmoil is likely to keep Treasuries attractive as a safe haven asset, and lessen the immediacy of the first Fed Funds Rate hike.

Fed May Lower Expectations

Markets remain focused not only on trying to anticipate the Fed's initial move, but also the pace at which they will enact further policy tightening. US GDP was notably weak for the first quarter, with an initial reading of +0.2% before ultimately being revised down to -0.2%. The soft reading was shrugged off by many due to unseasonable weather in the Northeast and a West Coast port slowdown, with the Fed ultimately 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 well be right: automotive sales are showing strength, the housing recovery is ongoing, and the labor market continues to show signs of improvement. However, the Fed will have to counterweigh these promising growth indicators against signs of stubbornly low inflation. The strength in the jobs report is largely owed to the service sector, which tends to be lower paying. Thus, 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. Much of the quarter's rate volatility was attributable to speculation about the timing of the first rate increase. While the unemployment rate fell to 5.3%, below the Fed's 6% target traditionally considered a "natural" level for the American economy, the lack of wage growth accompanying this drop suggests that, due to a combination of factors including a declining participation rate, the natural rate of unemployment has probably fallen and the domestic economy still has room for further stimulus.

During the second quarter, the consensus view for the rate hike jumped between June and September. With June now behind us, December has emerged as an option. While there is no consensus on the timing of the actual increase, there is consensus that the move to increase rates will likely be small and incremental. We believe the economy cannot yet handle a sharp increase, as economic growth remains fragile and inflation continues to be soft. Given the above, it is likely the Fed will have to ratchet down their Fed Funds expectations in the coming months. Fed Funds Futures have rates unchanged through year-end (0.28%), while the Fed is looking for an increase to 50bps by the close of the year. The Fed has decreased its rate outlook, and it is possible that they may have to change it again. Our view is that while there may be value in simply getting a hike out of the way to quell uncertainty, even a December increase would probably not be justified by economic fundamentals.

Global Factors Continue to Influence the Treasury Market

While the US debates policy normalization, the EU continues to be accommodative, despite an initial increase in inflation and the resulting bond yields. Mario Draghi has reiterated a commitment to continue the quantitative easing program initiated in March and, in doing so, increasing the ECB's balance sheet by more than €1 trillion. Deterioration of the Chinese stock market, along with Greece's payment "default" to the IMF and the large payment due to the ECB in late July, have dominated market discussions. Greece's "No" vote on the final day of the quarter added considerable uncertainty in the market place, and the July 20th debt payment to the ECB will likely seal Greece's fate within the EU unless an agreement can otherwise be reached.

While the Treasury Market trades in sympathy with these global influences, the dire fiscal position developing in Puerto Rico is more acute to the municipal market. Toward the end of the quarter, Governor Alejandro García Padilla of Puerto Rico publicly stated that a broad-based restructuring of the Commonwealth's $73 billion in debt is inevitable, as the cost to service the island's debt has become overly burdensome. Creditors should expect some form of a restructuring, including possible payment deferrals, reduced payments, or an extension of maturities, especially on Puerto Rico's enterprise debt. Governor Padilla's comments now also put the Commonwealth's General Obligation bonds and sales tax-backed bonds (COFINA) on the table for negotiations. Given that neither the central government nor its public corporations have access to pursue debt-restructuring through a Chapter 9 bankruptcy, options remain more limited.

Since Puerto Rico represents only about 2% of the overall municipal market and the fiscal issues facing the Commonwealth are specific to the small island's economy, we believe the developing situation in Puerto Rico does not reflect the fundamental credit strength of the broad municipal market. Puerto Rico's economy has been mired in recession for a number of years, and growing liabilities associated with pensions and debt have magnified weak economic and financial performance. The Puerto Rican trade is largely impacting High Yield Funds, Hedge

Fund investors, and some mutual funds. Outside of Puerto Rico, we would consider broad market increases in yields/spreads due to technical selling to be temporary, and a possible buying opportunity. At Appleton, we have no direct 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.

In contrast, states and local governments throughout the US have generally seen improving credit trends driven by recovering housing and labor markets, stable growth in tax revenues, and relative deleveraging. The mid-May downgrade of Chicago's GO debt by Moody's to Ba1, and the subsequent downgrades by S&P to A- and again to BBB+ in early July, was one specific credit activity that impacted the broader municipal market in the quarter. With pension costs driving the downgrades for Chicago, a ripple of spread widening worked its way through the municipal market in the states that are on the lower end of suitable pension funding (i.e., New Jersey, Connecticut, Pennsylvania, Kentucky, and Illinois). For example, 10-year credit spreads on Illinois paper widened 45bps to 185bps over the AAA scale during the quarter. Likewise over the AAA scale, New Jersey 10-year GO Spreads widened 42bps to 95bps and Pennsylvania 10-year paper widened 31bps to 62bps during the same period. States that are also prolific lease-backed debt issuers, like New Jersey and Kentucky, saw their respective lease-backed paper widen even further, as well. Fortunately, these issuers have sound underlying economies, and we saw stabilization and some spread tightening after the initial widening.

2015 Issuance Expectations Exceed $400 Billion

Issuance had been on a steady rise all year, driven largely by increased refundings due to low rates. However, in the month of June, issuance took a pause and registered the first year-over-year drop in 10 months. Even with this decrease, year-to-date debt financings are 42% ahead of the same period in 2014. Total municipal issuance for 2015 is expected to exceed $400 billion, a threshold not crossed since 2010 when issuance was $433 billion on the tail end of Build America Bonds. The decline in June and anticipated light issuance over the summer months will be met by a pickup in calls, maturities, and coupon payments. According to JPMorgan, this phenomenon will contribute to "Net Negative Issuance" of $38 billion in July and August and a total of $43 billion for the July through December period. This will have a positive impact on municipal demand, especially as we have begun to see municipal mutual fund outflows increase. Over the last two months of the quarter, funds have experienced outflows with the last week of the quarter having the largest outflow totaling $1.2 billion. However, year-to-date as of 7/8/15, flows still remain positive with $8.0 billion coming into the funds.

Performance Recap

A slow, gradual grind higher in yields throughout April and May drove the quarter's returns, as yields were flat to slightly lower in June. Overall for the quarter, 10Yr AAA municipal yields were up 32bps to finish at 2.28%, while 30Yr and 5Yr AAA municipal yields were up 48bps and 14bps over the quarter, respectively. This steepening of the yield curve is best reflected in the Barclay's Municipal Index performance, as the Barclay's Long Bond Index (22 years and out) was the worst performing index, returning -1.59% for the quarter. The 10- and 15-year indices were tied for a close second, with -1.14% returns each for the quarter. The Barclay's 1-year Index was the best performing segment of the larger Barclay's Index, returning 0.00% over the quarter. Within the 1-year Index, lower grade sectors detracted from performance, with Leasing, Industrial Development, and Hospitals being the three worst performing sectors. However, the 10Yr AAA-BBB credit spread widening from 93bps to 96bps, along with the AAA-A spread widening of 2bps, did not reflect the widening of specific names.

Even though current market conditions are supportive of the municipal market, we remain disciplined in our bond purchases and very aware of the potential for market liquidity to dry up. We have been buying bonds primarily in the new issue market, as the value has tended to exceed that seen in the secondary market. Broker dealers are pricing new issues at wider spreads to ensure they are not left with balances, a function of their capital constraints. Additionally, there are growing concerns across fixed income markets that with the Fed's eventual rate move, the dealer community's bids for bonds will worsen, disrupting the market. As a result, we remain focused on buying and holding strong credits from larger deals to enhance liquidity, and our breadth of over 90 broker dealers provides a vast network for us to transact. Our separately managed accounts have the benefit of not being forced to transact in times of illiquidity or disruption, unlike a mutual fund or ETF. We are maintaining our duration target in the 4.60 – 4.65 year range, and are poised to take advantage of the potential market disruptions as investment opportunities, rather than be penalized by them.

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