The second quarter headlines were dominated by discussion surrounding the Federal Reserve and Brexit. The Federal Reserve's Open Market Committee telegraphed that there was great potential to raise rates during the quarter, while in the United Kingdom the Brexit vote was seemingly considered a non-event. While a rocky first quarter made Janet Yellen's stated objective of four Fed Funds Rate hikes in 2016 unlikely, at the start of the quarter, the futures market was still pricing in the possibility of one to two increases before year end, with the odds of at least one occurring being better than 50-50 by December and June's meeting very much in play. As a result, US Treasury bonds traded in a tight range, with the 10 year benchmark UST trading between 1.57% and 1.92%. The 2 year was even more range bound, trading between .69% and .92%. We've long held the market was overly sanguine about the prospect for rate hikes. These beliefs were further supported by May's abysmal employment report, where nonfarm payrolls expanded by a mere 38,000 (later revised down to 11,000) versus projections of 162,000. The 10 year Treasury eventually broke through its earlier trading range and began drifting downwards, and the market's expectation for an impending Fed Funds hike rapidly cooled.

On June 23rd, however, the voters of the United Kingdom decided to shake up the narrative of the quarter, and surprised the markets by voting to leave the European Union. Since the Brexit vote was so unexpected, it resulted in a "flight to quality" response by the markets, sending the 2 year UST yield down 15 basis points and the 10 year UST down by 30 basis points in a single day. With that vote, a great deal of uncertainty was injected into the marketplace. The "flight to quality" not only impacted the US markets, but also all worldwide markets, resulting in negative government interest rates throughout Europe and Japan. Global risk asset markets responded to the Brexit vote by falling into a tailspin. The British pound plummeted to levels not seen since the early 80s, money fled risk assets into traditional safe havens, and sovereign yields came screaming in across the world. The 10 year US Treasury benchmark skirted all-time lows before closing the quarter at 1.46%, while the 10 year German bund fell sharply to end the quarter at -0.13%. In the quarter's final trading days, cooler heads prevailed and U.S. and European stock markets recovered much of their Brexit-related losses.

Amidst the turbulence near the close of the quarter, demand for Investment Grade remained robust. The nearly $440 billion in issuance that was priced by 269 issuers over the quarter was very well received. Although issuance decelerated 4% compared to the first quarter, the amount of issuance so far this year is still up 1% year to date vs. this time last year. The month of May in particular was the largest month of issuance since 2014. However, at the end of June, new issuance basically shut down as a result of the volatility stemming from the Brexit vote, with only $94 billion brought to market. As the fallout in the UK cools and rates remain low, issuers will most likely come back in to the debt market, satisfying the demand of investors seeking incremental yield.

In our Q1 letter, we touched upon the deceleration trends that we have seen within global M&A. That trend continued in the second quarter, with the value of announced transactions declining by a third from the same period last year. While this lowers the likelihood of an event-driven credit issue across the asset class, we are growing increasingly concerned about corporate profitability as we head into what is expected to be the fifth straight quarter of earnings declines for the S&P 500. Between 2013-2015, revenue for the S&P was essentially flat, while earnings before interest, taxes, depreciation and amortization ("EBITDA," a proxy for cash flow) increased by $72 billion (*i.e.* growth through margin expansion). For 2016, consensus expects revenue growth to come in at less than 2% but for EBITDA to grow more than 2%, despite the fact that EBITDA margins are now trending at a level that is more than 1% above the post financial crisis averages. With this scenario in mind, we continue to focus on the high quality balance sheets and defensible business models. We will continue to monitor companies to verify whether they can further tighten their costs to squeeze more cash flow out of their bottom line. Lastly, we would be remiss if we did not speak to the energy market: domestic West Texas Intermediate crude (WTI) oil rallied 17% in the quarter, bolstered by unexpected supply cuts in Canada (wildfires) and Nigeria (domestic terrorism). At Appleton, we continue to believe that energy prices will remain "low for long" and believe that the significant equity fundraising activity by E&P companies and the recent uptick in drill counts support this view.

Given the macro volatility, performance within our strategy continues to be driven by curve and credit positioning which has overshadowed the impact of individual security selection so far this year. The recent curve flattening and credit tightening in a macro environment has been very favorable to investment grade fixed income and our strategy outperformed its benchmark by 14pbs, returning 1.47% vs. 1.33%. As the yield curve flattened, our underweight position to 1-3 year maturities at the front of the curve was a strong contributor to excess return, although this was partially offset by modest underweights to 8-10 year maturities that benefited the most

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from the curve's flattening. Our underweight exposure to "AAA"-rated credit and overweight exposure to "A"-rated credits also contributed strongly to our return. The impact of security selection was more muted; our recent Treasury purchases outperformed the Treasury exposure in the benchmark, while Banking, Consumer Goods, and Taxable Municipals were modest detractors. This quarter brings us to 4.37% year-to-date, 69bps ahead of our benchmark's 3.68%.

At the quarter's close, we are in a market that no longer expects the Federal Reserve to raise rates before 2017. In fact, the possibility of a rate cut seems to be back on the table. Additionally, the market believes that the Fed is still a long way from achieving its 2% inflation mandate. If we believed market fundamentals showed a "lower for longer" interest rate environment at the start of the quarter, that picture is now even clearer today. With Q3 underway, we are optimistic that the Fed will make the necessary choices in response to the ever changing global landscape. With that said, we will look to continue focusing our efforts on maintaining our current strategy positioning, closely monitoring global economics, and remain deeply committed to our credit process.

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 on Twitter: follow us at @AppletonPtnrs.

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