Last quarter, we described the markets as looking past the political noise to the underlying moderate-but-unremarkable economic growth. Since then, the political deadlock has managed to worsen. While the House seemed to break gridlock with the passage of an Affordable Care Act repeal bill at the start of May, the Senate chose to start fresh rather than debating the House bill; with the vote postponed until after the Fourth of July recess, the Senate version looks increasingly likely to fail. Meanwhile, Trump's surprise decision to fire FBI Director James Comey in mid-May only briefly rattled the market and led to the appointment of a special counsel to oversee the Russian investigation, almost ensuring that this investigation will continue to absorb policy bandwidth in Washington for many months to come. This will likely sideline much of Trump's agenda and, in our reckoning, the odds of meaningful legislation passing before 2018 have dropped significantly since the start of the year.

Political malaise does not seem to have spread to the economy thus far. The first quarter GDP growth rate, initially weak at 0.9%, was subsequently revised up to 1.4%, while earnings growth of S&P 500 companies came in solidly ahead of consensus. The 75% earnings beat rate and 66% revenue beat rate in the most recent quarter both sit comfortably above recent rates. However, there is evidence that market participants worry this may not be the case down the road. The Treasury curve's flattening in the wake of the Fed's well-telegraphed increase of the Fed Funds Rate to 1-1.25% in June suggests uncertainty. While extenuating factors (such as the slide in the price of oil and an escalating mobile carrier price war) likely depressed inflation, they do not seem enough to fully explain the retracement in the 10Yr Treasury yield from 2.40% at the start of the quarter to 2.15% after the release of the Fed statement on June 14th.

While May's 4.3% unemployment rate marks the lowest reading in 16 years, the 138k jobs added were well below expectation, and, with April's downward revision, the three-month average is now an anemic 121k. Durable goods orders dropped, as well, sliding nearly double the expected decline of 0.6% to 1.1%. The reasonably solid May Consumer Confidence survey also shows forward-looking concern. While the overall index surprisingly increased to 118.9, beneath the headline number is a widening split between the current conditions' rise to 146.3 and the expectations' decline to 100.6, a reading only a decimal place removed from expectations for economic contraction. All in, companies seem to be deferring business investment due to political uncertainty. The market may not yet be influenced by the events in Washington, but there is growing evidence that it is starting to pay attention.

EQUITY REVIEW

Equities continued to advance throughout the second quarter of 2017, as investors were able to shrug off a number of concerns, including: a drop in the price of oil, questions surrounding the Fed's plans for rates and its balance sheet, and growing disdain for the situation in Washington DC. The drivers of performance in the second quarter were a continuation of the themes that carried markets in the first quarter; an improving global economic backdrop, a recovery in corporate profits, and the hope that the administration could execute on its growth agenda.

The first half of 2017 was unique with a level of volatility that trended at historical lows. So far this year, the S&P 500 has had only four trading days with a move of 1% or more in either direction; the first time that has happened since the first half of 1972. Furthermore, any dips in the market have been shallow, as investors consistently stepped in to buy any weakness. The largest drawdown in the S&P 500 this year has been a mere 2.8% from peak to trough. According to research from Bespoke Investment Group, there has been only one instance of a smaller drawdown over the first half of the year since 1928. It is important to remember during these tranquil stretches that the average intra-year drawdown for the S&P 500 going back to 1950 has been -13.5%. Double-digit drops occur in more than half of all years; they are the norm, not the exception. The team at Appleton believes that there are a number of factors driving the lack of volatility but two stand out in particular. First, is that the fundamental macroeconomic outlook appears stable. The outlook for the global economy seems to be improving and central banks around the world remain accommodative. Second, we have seen correlations among the sectors of the market drop, which lends to a smoother ride for the overall market. This divergence in underlying stock performance is exemplified by what we are seeing in growth stocks versus value stocks. After lagging for most of last year, growth stocks have vastly outperformed value stocks, with the Russell 1000 Growth Index outperforming the Russell 1000 Value index by roughly 10% year to date.

Looking forward to the second half, we remain cautiously optimistic. History tells us that when the first half of the year has few 1% moves and shallow drawdowns, the second half tends to follow suit. Oil, the flattening yield curve, geopolitical flare-ups, and policy implementation risk all remain threats of which the team at Appleton is mindful. We will be watching the coming earnings season for any signs of a change in sector leadership and, as always, will be monitoring how economic indicators come in versus expectations. Equally as important, we will have an eye on Washington to see how quickly Congress can pivot towards the two agenda items investors crave the most: tax reform and deregulation.

MUNICIPAL BOND REVIEW

Municipal performance year-to-date has exceeded our expectations and fundamentals continue to support the market. Demand for municipals over the quarter was strong and pervasive, and we anticipate this trend to continue through the summer. The hope that a consensus would build in the Republican Party ending the gridlock in Washington was short lived, and now lack of progress has led to political disorder and uncertainty; as a result, we believe the bond market remains a safe haven. Inflation remains below expectations, largely driven by prices of petroleum and other commodities, and we remain skeptical of the Fed's continuing focus on raising rates.

Broadly speaking, states continue to face challenges as constrained resources compete with rising costs, particularly for healthcare and pension benefits. While 2016 was the sixth consecutive year of growth for state tax revenues, that rate slowed, growing only 1.2% in fiscal year 2016. This is the weakest tax collection performance since 2010 and is significantly slower than the 4.7% growth in fiscal 2015. All major sources of tax revenues declined including personal income, sales, and corporate income taxes, and severance taxes in oil and mineral producing states. Collections continue to be mixed as preliminary data for the first quarter of 2017 indicate stronger growth in personal income taxes and sales taxes while corporate income tax collections declined. We continue to monitor the credit environment with an eye to any developments that could potentially impact our holdings and look for opportunities to add value where appropriate.

Expectations for the second half of 2017 and beyond are for the curve to continue to flatten, as the Fed is focused on a combination of higher Fed Funds rates and slowing reinvestment of maturities from their balance sheet. Both of these actions could cause rates to inch up further in the front end of the yield curve, while lower inflation expectations will likely keep the long end in check. Municipal fundamentals remain favorable through summer's end, although we could see the supply picture change in September and October. Hints of economic strength, albeit with little follow through, heighten our focus on maintaining strong underlying credits, and not extending too far on the yield curve. We are focusing on new issue supply, the net supply position, as well as mutual fund flows, and feel these three factors will dictate ratios and the shape of the yield curve. If we see a reversal of the net negative supply and positive fund flows, that could impact the constructive market fundamentals. We will maintain our duration target at 4.60-4.70 years, which remains in line with the benchmark.

TAXABLE BOND REVIEW

The second quarter was relatively quiet for Investment Grade Corporates, with spreads remaining in a very tight trading band of ±10 basis points. As measured by the Bloomberg Barclays Aggregate Corporate Index, the average Option Adjusted Spread (OAS) year-to-date high was 122 back in February, and slowly drifted to a low of 109 to close out the quarter. The last time spreads were this low was in September of 2014. Strong fund flows, low rates, and the continuous search for yield has been the main driver of this tightening. Additionally, Investment Grade issuance was disappointingly sporadic over the quarter, after the first quarter saw the highest issuance in three years. April brought only $105.2 billion in new debt, as earnings season blackouts weighed on issuance; however, banks came back to lift issuance out of the lower pace seen in the beginning of the month. There was a decent bounce back in May, with just over $154.0 billion issued, but it was not enough to satisfy investor demand. June was even quieter, with issuance falling to just under $89 billion. This brought total issuance for the quarter to $349 billion and to $886 billion year-to-date. We expect to see the continuation of that trend for at least the 3rd quarter, as uncertainty surrounding tax reform should keep issuers at bay.

US Treasuries experienced a tight trading range this quarter; this is especially true from 5Yrs on out to the 30Yr benchmark bond, with the 10Yr down 11bps to 2.27% and the 30Yr dipping lower by 18bps to 2.83%. The shorter end of the yield curve did the exact opposite, as maturities 2Yrs and in rose 20-25bps. The market expected this as the Fed took the Fed funds rate higher by 25 bps this quarter to 1.25%. It is worth noting that the spread between the 5Yr & 30Yr Treasury maturities as of quarter end was 97bps and the last time the difference between the two has been this low was November 2007. This bear flattener pattern is expected to continue through the summer with a combination of higher short term rates due to Fed speak of higher Fed Funds and a balance sheet wind down, as well as continued pressure on the long end of the curve as the hunt for yield continues.

Both stocks and bonds rallied throughout the first half of 2017 as equity investors were able to look past political headlines to focus on improving fundamentals, and bond yields tightened amidst scant signs of inflation. The team at Appleton believes that the key to the second half could be how investors react to a Fed that seems determined to tighten monetary policy in the face of little inflation. We will be monitoring that, and the situation in Washington, as we look for investment opportunities across asset classes.

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 also now active on Twitter: follow us on Twitter at @AppletonPtnrs.

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