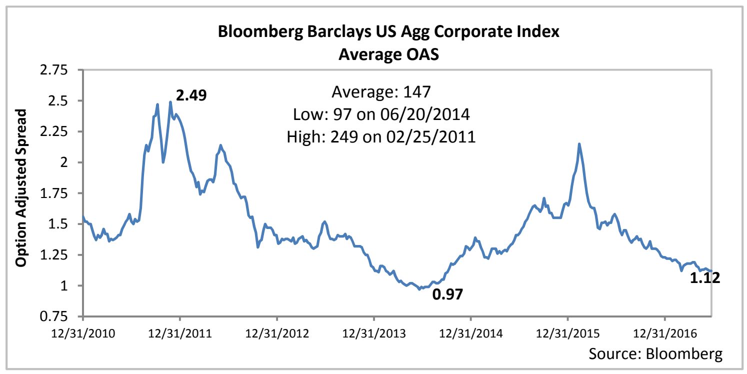
Last quarter, we described the market as looking past the political noise to the underlying moderate-but-unremarkable economic growth. Since then, the political deadlock has managed to worsen. While the House seemed to break gridlock with the passage of an Affordable Care Act repeal bill at the start of May, the Senate chose to start fresh rather than debating the House bill; with the vote now 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 legislative agenda; tax reform remains a possibility, but 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 Q1 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 the 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 increased to 118.9 (rather than falling to 116.0, as expected), 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.

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 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. Taking out the roughly $172 billion in sovereign debt issued over the quarter brings the total issuance of corporate debt down 5% year over year. 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 25bps 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.

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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