APPLETON *PARTNERS*, INC.

THE TAXABLE FIXED INCOME MARKET – QIV 2012

While the Eurozone debacle drove market volatility throughout QIII, in QIV the market was fixated on Washington: the election outcome, the devastation of going over the fiscal cliff, and the potential revision of the tax code. As we move into 2013, the debate in Washington will be more intense, the Eurozone instability will come back into focus, and Central Banks, globally, will continue to accommodate the markets with traditional and non-traditional forms of liquidity. Despite the many uncertainties that remain, the power of our Federal Reserve, in conjunction with other Central Banks, to offer market accommodation will continue to place pressure on the markets to maintain a low rate environment across the yield curve that will ultimately spawn global growth.

The Fed Will Increase the Size of Its Balance Sheet Purchases as Operation Twist Ends at Year-End

Despite signs of recovery in the housing market and an apparent improvement in the labor markets, the Fed was firm in its resolve at the December meeting and added $45 billion/month in long Treasury purchases to the existing $40 billion/month in Agency MBS purchases. In addition to forecasting the Fed Funds rate out for two years, the Fed announced in QIV that they have assigned target levels for Unemployment and Inflation: "In particular, the Committee decided to keep the target range for the federal funds rate at 0 to 1/4 percent and currently anticipates that this exceptionally low range for the federal funds rate will be appropriate at least as long as the unemployment rate remains above 6-1/2 percent, inflation between one and two years ahead is projected to be no more than a half percentage point above the Committee's 2 percent longer-run goal..." There is a wide divergence of opinion, within the Committee and from external market players, on the efficacy of continuing a policy of aggressive central bank purchases. Despite the rhetoric and market concerns over the absolute level of rates, as QIV ended, pricing risk appeared to fall on the side of deflationary pressures – with little signs of impending inflation risk. The Treasury yield curve barely changed in QIV, with yields in the intermediate area of the curve slightly higher (5-10 basis points) and the short end of the curve virtually unchanged. It would appear that *Operation Twist* in its final phases combined with the monthly MBS purchases did little to further the cause of curve flattening in QIV. However, if the recovery in housing is sustained, the appeal of low mortgage rates encouraged by the Fed will be credited for some of that strength, even if those mortgages are broadly available to only the very highest quality borrowers.

The Fiscal Cliff and the American Taxpayer "Relief" Act of 2012 – Is the Glass Half Full or Half Empty?

The American Taxpayer Relief Act of 2012, which was passed on New Year's Day, addresses some of the goals on the revenue side of the balance sheet, but lacks concern for the magnitude of sequestration and debt ceiling issues that are bearing down on us with, yet again, another deadline…approximately March 1st. With the dysfunction in Washington continuing right to year-end, the fiscal cliff was somewhat averted with enactment of the American Taxpayer Relief Act of 2012. According to a statement released by the Office of Management and Budget (OMB), this new legislation will produce a total benefit of $737 billion, largely made up of $618 billion in higher taxes on the wealthy, and an additional $104 billion benefit from lower interest payments on federal debt. This is a long way from the deficit reduction target of $3.7 trillion which would keep our debt/GDP ratio from escalating from 73% today to 90% by 2022. We continue to see economic progress on the domestic front, but that progress is not even close to achieving the Federal Reserve's stated goals for employment growth in the context of price stability. Despite headline driven volatility, rates will stay in this low range, and any expense cutting as a result of the budget process will act as a drag on the economy, further pushing the pendulum to the side of economic weakness in 2013. Some key points in the bill:

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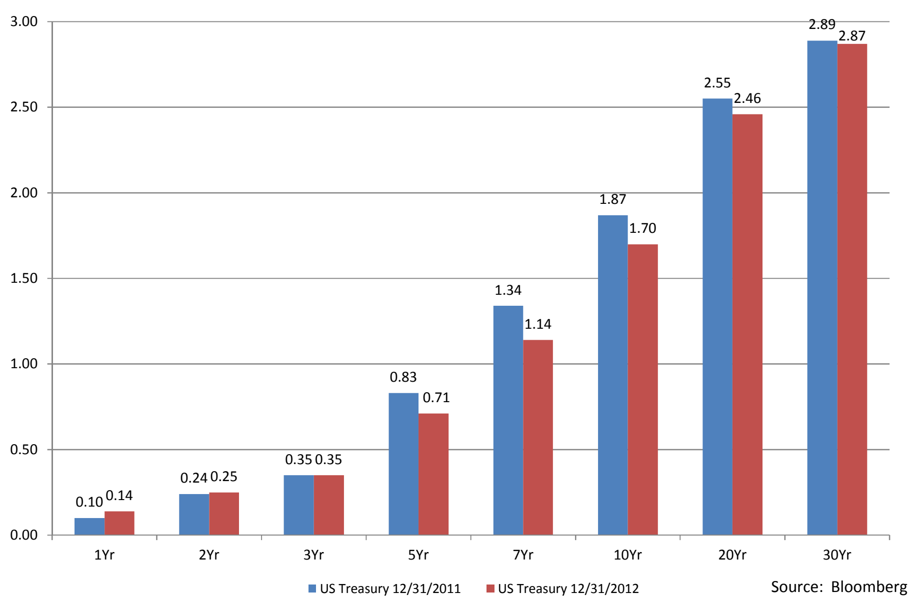
- The Bush era tax cuts have been extended for individual filers earning below $400,000 and for families earning less than $450,000. For filers above these thresholds, *marginal tax rates increase from 35% to 39.6%*.
- Tax rates on dividends and capital gains remain unchanged for filers with income below $400,000 for individuals and $450,000 for families, but the *rate for both capital gains and dividends increases to 20%* for filers above the threshold.
- The estate, gift, and generation skipping transfer tax will continue to have a cap of $5 million under the new legislation, but *the top tax rate increases to 40%.*
- As part of the Affordable Care Act passed in 2010, there is a mandatory 3.8% surtax on net investment income for filers with adjusted gross income of more than $200,000 for individuals and more than $250,000 for families. This will take capital gains and dividend rates to 23.8% for the highest earners and will affect most other forms of income as well.

2012 Returns Driven by the Intermediate to Long End of the Curve and Amazing Out-Performance of the Financials

While the long end of the yield curve struggled in December, resulting in a slight steepening (10Yr Treasury higher by 14 basis points with the short end virtually unchanged), full year performance came from intermediate to longer dated securities. While the entire yield curve was largely range-bound in 2012, there were opportunities to execute as we periodically moved from the low end to the high end of the range in response to headline news from Europe and conflicting messages from Washington. The graph below shows how little the Treasury curve changed in 2012.

In 2012, The 5Yr to 10Yr Part of the Yield Curve Captured the Benefit of Declining Rates Without Exposing Investors to the More Significant Risk in the Long End of the Curve



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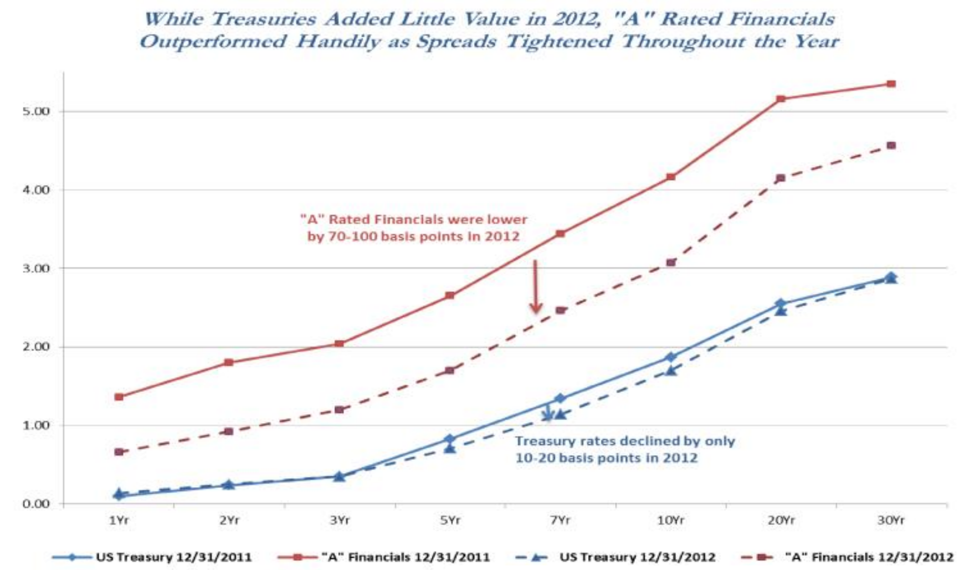
SPREAD COMPRESSION IN THE FINANCIALS WAS THE BIGGEST DRIVER OF INVESTMENT GRADE RETURNS IN 2012

The broad Finance sector, along with Life Insurance, offered the greatest returns in the investment grade space in 2012. According to Barclays report, *U.S. Banks & Brokers December 2012 Performance,* the U.S. Banking Index ended 2012 with an option-adjusted spread (OAS) of 145 basis points, 216 basis points tighter than the 361 basis point OAS at the end of December 2011. On a relative basis, the Banking sector tightened dramatically versus Industrials to a post-crisis low of 12 basis points. The spread between the two sectors stood at 127 basis points at the end of 2011.



Source: Bloomberg

APPLETON PARTNERS TAXABLE FIXED INCOME STRATEGY

We continue to subscribe to the belief that the Treasury market has little room to appreciate in a meaningful way from these levels. The Agency sector is shrinking from an issuance perspective and liquidity is not deep, particularly on callable issues. Our current sector mix is high quality Industrials, Financials, and Taxable Municipals. In Appleton's composite, all sectors in the corporate investment grade space realized spread tightening in 2012. Taxable Municipal issuance, which was up in the quarter, had a strong quarter as well. Because of our current lack of exposure to Treasuries, we are not aligned from a sector perspective with our benchmark. Extreme Treasury moves that do not flow into spread product will impact performance on a relative basis. Appleton's overweight to the Banking sector versus the Merrill Gov't/Credit 1-10Yr Index (19.3% API versus 7.2% Index), contributed greatly to out-performance for the year. We increased our exposure to Taxable Municipals in the fourth quarter, and now have a 9.3% exposure to that high quality sector.

Today, we are witnessing yields on lower quality, high yield securities trading exceptionally close to their very high quality counterparts. Spreads on Investment Grade debt tightened throughout the year, with year-end spreads averaging 139 basis points versus 237 basis points at year-end 2011. Spreads on High Yield debt hit all-time lows late in the year as investors saw signs of a nascent recovery and tired of the low rate environment. The Fed policy of maintaining low rates on a historical basis continues to influence investor preference and push strategies out the maturity curve or down in credit … or both. We see examples of this throughout the Fixed Income markets. Spain, Italy, and Greece are outperforming Germany, France, and the UK as investors chase yield and require a lower and lower risk premium. We continue to find value in the high quality Corporate and Taxable Municipal sectors. As prepays begin to slow, we will consider adding a small exposure to the Agency MBS sector. The back-up in Treasury yields early in 2013 is offering an opportunity to add value as we re-position within the established trading range.

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

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