"THE COMMITTEE EXPECTS INFLATION TO RISE GRADUALLY TOWARD 2 PERCENT AS THE LABOR MARKET IMPROVES FURTHER AND THE TRANSITORY EFFECTS OF LOWER ENERGY PRICES AND OTHER FACTORS DISSIPATE." -FOMC STATEMENT DECEMBER 17, 2014

2014 delivered a few surprises to the Markets, but the biggest surprise was the decline in rates and the tremendous flattening in the yield curve, despite the lack of Fed buying. The strength of the US economy was offset by weakness in Europe and Asia and a deflationary spiral that forced the hands of central banks. We move the range lower in 2015. Central Bank activism and market "jawboning" was front and center in 2014. By implementing non-traditional strategies, Central Banks around the globe have continued to prop up weak economies in Asia, weakening economies in Europe, and a US economy that is in recovery and strengthening. Our Fed is ahead of the curve, and they are in the mode of removing accommodation at this stage, not adding accommodation as almost all of their foreign counterparts are doing. While QE appears to have worked here, there are questions as to how well the same strategy might work in the EU, and both Japan and China have aggressively upped their buying in the hope of fighting the lack of inflation in Japan and the more sluggish growth in China. QE ended in the US in October with a Fed balance sheet that had grown to over $4.2 trillion (up from $900 billion at the close of 2007). The Fed continues to replace run-off, which in effect freezes the balance for now, and will continue to offer an additional level of accommodation. The timing differential between the US Fed Policy and other central bank policies has resulted in a US dollar that has strengthened considerably in 2014 against all major currencies. The Euro plummeted by almost 15% from the year high in May when it traded at 140, down to 120 by year-end.

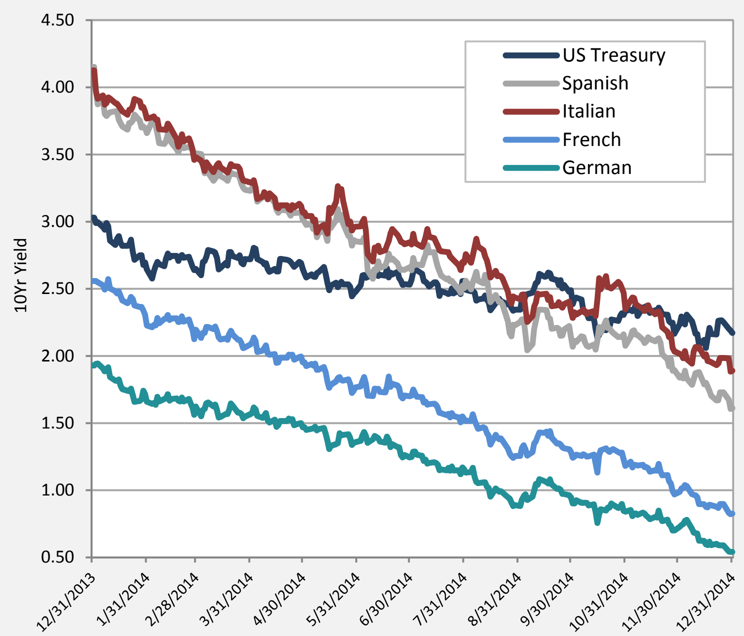
The Taper is behind us, but the Fed has work to do in 2015. The markets are focusing on the timing and the pace of rate hikes, but that is an action that will impact the *short end* of the yield curve. Inflation remains weak, well below the Fed's 2.0% target, despite job growth and tightening in the labor markets.

Why Longer Term Rates Can't Rise Significantly in 2015 …. The Fed and Central Bank Activity

The Fed's anticipated initiation of gradual rate hikes later in 2015 is well-advertised and built into market expectations. The Fed Funds Futures market is predicting a very limited move in 2015, with funds inching above .25% sometime during QIII. The futures markets predict a funds rate of .61% at year-end, well below the Fed's own forecast. The Fed has stated that they are *data dependent,* which gives them all the leeway in the world to adjust strategy in response to an unexpected series of economic data. But, we expect to see stronger trends in job growth, and we know that there is a subliminal desire on the part of the Committee to demonstrate that they can begin down the path to normalizing rates. It is our strong expectation that the initiation of rate hikes later this year will be followed by a slow and stagnant pace of additional hikes that will keep us lower than we might expect even today. The Fed's own forecast only finds the funds rate a 3.75% several years down the road.

The ECB will likely be forced into action in 2015 and will have to offer a creative solution to stem the tide of slow/recessionary growth and looming deflationary pressures. At this point, the markets have priced the debt of the strongest players to historically low levels in anticipation of a big move, meaning Draghi will be under pressure to deliver in 2015. These unusually low rates have created a ceiling on US debt, despite our relative economic strength. The spread between the 10Yr Bund in Germany and the 10Yr US Treasury has hit a record of about 150 bps – an all-time high.

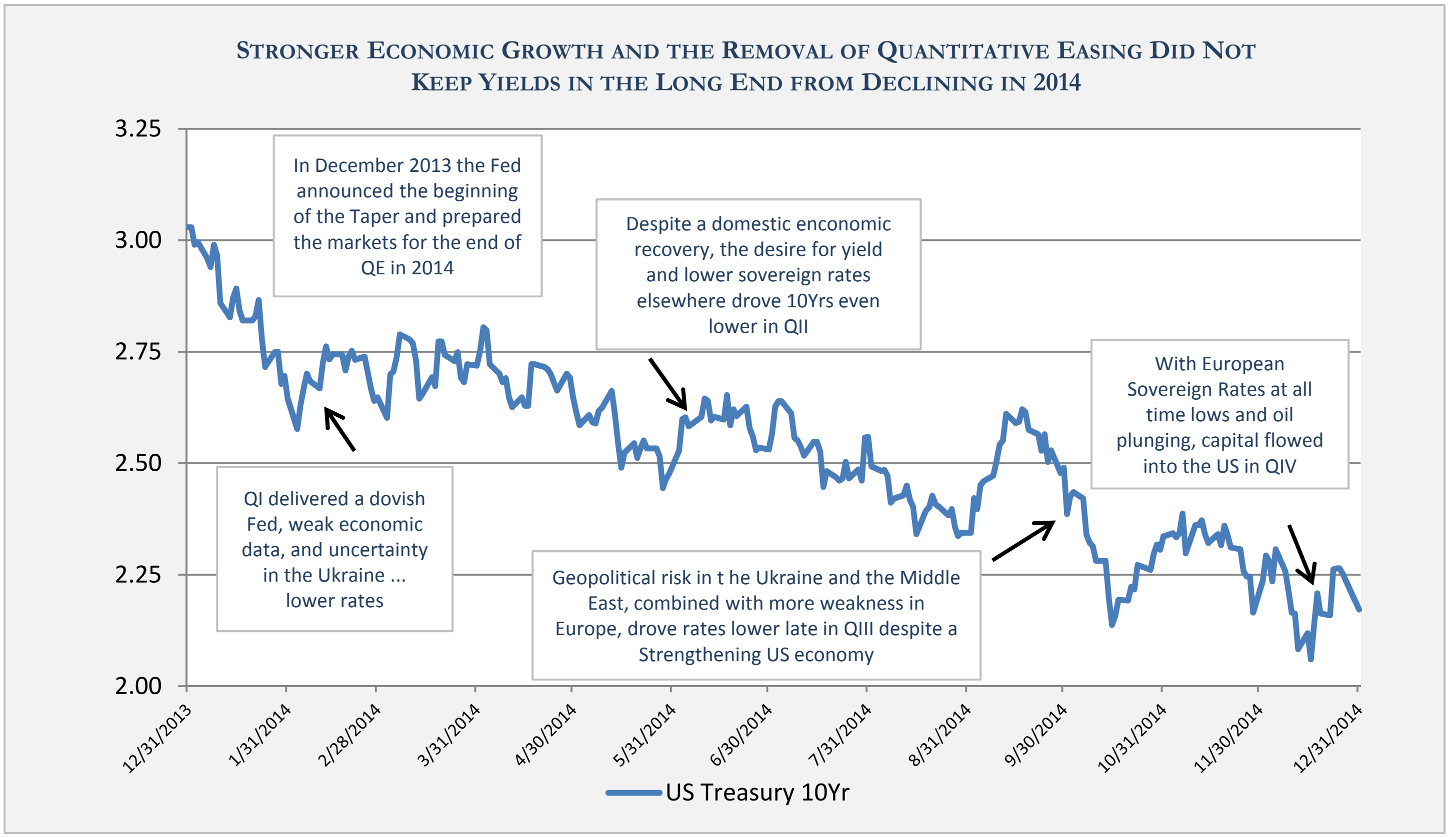
WHILE THE 10YR TREASURY DECLINED FROM 3.03% TO 2.17% IN 2014, OUR EUROPEAN COUNTERPARTS DECLINED EVEN MORESO, WITH SPAIN AND ITALY SURPRISINGLY ENDING THE YEAR AT YIELDS LOWER THAN THOSE IN THE US - FRANCE AND GERMANY HAVE WIDENED THE GAP AT YEAR-END



Source: Bloomberg

The Impact of Geopolitical Uncertainty and Event Risk

Geo-political uncertainty, emerging market weakness, and event-driven crises will periodically drive investors into the "risk-off" mode. The result has been, and will continue to be, a flight to quality benefiting US Treasuries, German Bunds, and other high quality alternatives. Anemic growth in Europe, political unrest in both the Middle East and Eastern Europe, and the impact of economic sanctions on already weakened states, may all create temporary market dislocations that can offer opportunities for investors. Much of the move in the US Treasury 10Yr in 2014, particularly in QIV, was driven by a capital flight to safe havens. The global instability that drove these moves will remain in place throughout 2015.



Source: Bloomberg

Corporate Bond Supply and Demand - Market Impact

Driven by low rates and high demand, Investment Grade (IG) Corporate bonds maintained their momentum through the 4th quarter as $260.5 billion of IG paper hit the market. By year's end, the total issuance of corporate debt reached a record $1.1148 trillion, beating last year's issuance of $1.0434 trillion by 6.8% or $71.5 billion. The largest deal of the year was Medtronic's 7-part $17 billion deal issued in December to fund its purchase of Covidien. Apple's 7 part $12billion deal in April marked the second largest, and the $10 billion Oracle deal in June was the third largest of the year. The Financial sector outpaced all other sectors this year, as it accounted for 46.9% of all issuance in 2014. From a rating perspective the single A bucket represented 32.2% of the issuance and BBB was not too far behind at 26.4%. Consistent with 2013, the issuance of bonds with maturities 10 years and in represented 76.7% of all issuance. Of this, maturities under 5 years represented 44.5% of total issuance. Looking forward, the estimates for 2015 issuance amount to approximately $1.05 trillion. Please note that all issuance data excludes CD's and bonds with a maturity less than 1Yr.

Balance Sheet Trends

A key concern we discussed throughout 2014 was "event risk," or unforeseen corporate actions that harm creditors, impacting our client portfolios. While historically leveraged buyout transactions have been a key source of event risk, spin-offs have come to the forefront as a leading source of such risk. Through September 2014, there were 57 spin-off transactions announced by nonfinancial corporations in the U.S. This was up substantially from 44 transactions in all of 2013 and just 33 in 2012. Spin-offs can often benefit shareholders at the expense of creditors by weakening the credit profile of either the parent, spun-off entity or both.

Appleton's latest experience with a spin-off event was when Hewlett-Packard announced in early October that it would separate into two new publicly traded companies: one comprised of HP's enterprise technology infrastructure, software and services businesses, to be called Hewlett-Packard Enterprise, and HP Inc., which will be comprised of personal systems and printer ops. With HP management making little disclosure about what the capital structure of either company will look like after the split, all three major rating agencies placed HP on negative watch. Our belief is that most of the existing debt will remain with the weaker legacy business.

Looking ahead to 2015, we continue to believe spin-offs and other corporate actions will remain at the top of our list of concerns. With activist shareholders continuing to gain popularity and their ability to raise additional capital, we believe management teams will continue to be pressured to find creative ways to generate "shareholder value." We continue to focus on avoiding management teams that take an aggressive approach to shareholder returns, and will also look to possibly take advantage of spin-offs that have been unfairly punished by the bond market.

Appleton Intermediate Taxable Performance Update

Q4 proved to be another strong quarter for high quality fixed income. Given the significant flattening over the quarter, our substantial underweight exposure to maturities inside three years was a strong contributor for our strategy during the final quarter of the year. While this was partially offset by relatively light exposure beyond seven years, on the whole our strategic positioning in the intermediate area of the curve was a net contributor during the 4th quarter. The flight to quality trade over the quarter favored Treasuries over high-quality corporates; however, we finished the quarter at 0.82%, down 19 bps against our strategy benchmark.

Our composite finished the year at 3.28%, a healthy 22 bps over the strategy benchmark's return of 3.06%. While the full year's flattening was slightly less pronounced than the move in the 4th quarter, rising yields inside of three years and falling yields beyond five remained broadly favorable to our strategic bell curve positioning concentrated between three and five years, although, the substantial flattening beyond seven years was a mild detractor.

From a sector standpoint, there were four main themes impacting performance this year:

- The continued value we found in investment grade credit, underweighting the substantial Sovereign benchmark allocation, was responsible for about 16 bps of excess return in 2014. This is a trade we continue to monitor closely;
- Our Banking exposure – this sector (please see our recent white paper on this sector) benefitted portfolios from a sector overweight perspective and a security selection perspective. Combined, we saw an additional 15bps from our exposure here;
- The Taxable Municipal sector continued to perform very strongly, and the positioning here added a further 15bps to excess return; and
- Our Insurance exposure was our biggest sector detractor in 2014. We remain comfortable with our holdings and believe they include strong names within the sector that should generate value in 2015.

As we begin 2015, we are monitoring sector opportunities in Agency MBS and the Treasury/TIPS markets. Market uncertainty and global risks will reward quality in 2015, and market liquidity will follow the strongest credits.

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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