When everything was said and done, 2015 ended much the way it began. The big news of the fourth quarter was the Federal Reserve finally raised the overnight Federal Funds Rate from a range of 0-0.25% to 0.25-0.50%. While the Fed's move had been widely anticipated, the market's reaction was mixed. Short-term rates increased dramatically in the quarter, with the 2-year Treasury climbing 43 basis points to 1.10%, while longer bonds increased more modestly, with the 10-year Treasury increasing 24 basis points to 2.34% and the 30-year increasing 14 basis points to 3.04%. This curve flattening reduced the spread between 2-year and 10-year Treasuries from the start of the year at 149 basis points to a year-end 124 basis points, mere basis points off the 2015 low of 119bps, reached in February.

### *Market Review: Persistently Low Inflation and Commodity Prices Dampen Bright Spots in Economy*

While the Federal Reserve had been grabbing headlines all year with 'will they or won't they' speculation, the real story for Fixed Income investors has been the general lack of inflation. The most recent year-over-year reading of 0.5% hardly provides a strong reason to raise short-term rates. Much of the Consumer Price Index's (CPI) lack of growth can be attributed to the decline of commodities, most notably oil. Historically, falling oil and gas prices have provided a lift to the economy, as consumers have spent savings at the gas pump elsewhere. Unfortunately, it appears that consumers are using the savings to pay down debts or to save for a rainy day, as there has been no meaningful increase in economic activity. A rare exception was auto sales, where we saw sales of over 17 million units this past year. Encouragingly, even with last year's impressive sales, the average age of a car on the road is still close to 12 years old, suggesting there may be room for further growth.

### *2015 Was a Record Year for Investment Grade Issuance*

Last quarter we mentioned that volatility in the stock and bond markets had steadily increased. That trend continued through the fourth quarter as global economics, commodity prices, and central bank activity acted as catalysts for moments of short-term unpredictability. That did not stop or curtail corporations from issuing debt. In fact, Investment Grade issuance was a record setting $1.51 trillion in 2005, up 8% over 2014. Share buyback funding, a substantial increase M&A activity, and the re-leveraging of corporate balance sheets at still low interest rates were major drivers. In 2015 there were 15 deals over $10 billion, compared to only three deals the year prior. Of the 15, eight were due to M&A activity. Actavis took the prize for the largest deal at $21 billion to fund its purchase of Allergan in March. We believe issuance in 2016 will continue to be robust but not nearly as active as 2015. Generally speaking, IG spreads were wider over the course of the year and the credit curve steepened. Continued global economic headwinds and pressures on commodity prices will keep spreads wide and volatility elevated as we enter the first quarter of 2016.

### *Bearish Sentiment for Financials Overlooking Credit Fundamentals*

One of the notable observations we made during the second half of 2015 was the increasingly bearish tone towards the financials and particularly the global banks. With this in mind, we thought it was a good time to review Appleton's credit outlook for the sector. In mid-2014, we published a paper outlining our positive outlook for the large banks, underpinned by a few key observations:

Tapering and eventual rate hikes should result in stabilization of net interest margins (positive)

A modestly improving economy will lead to accelerating lending activity (positive)

Continued employment gains and improving household balance sheets will lead to more mortgage origination (positive)

The credit cycle is likely reaching an inflection point; lack of volatility and trading volume will likely impact trading revenue (negative)

As we look back, our expectations noted above were mostly met: banks reported widespread loan growth, stable capital ratios, and stable asset quality. Heading into 2016, we are mindful of the flattening in the yield curve and a slight uptick in nonperforming loans; but, we remain constructive on the large cap banks. Our view is that a misconception of recent rating agency actions for certain "systematically important" banks, not credit fundamentals, has generated the recent bearishness. In December, S&P lowered the ratings of *non-operating holding companies* of all eight U.S. systematically important financial institutions ("SIFIs") by one notch. The downgrade was enacted based on the assumption that the U.S. government would not extend the same level of support to the SIFIs as we saw in the most recent financial crisis. We want to point out that these holding companies are not where the assets and business operations of the large banks reside; rather they are primarily intended to hold capital that would bail out operating subsidiaries in the event of a crisis. In fact, to the contrary, S&P actually raised the outlook for the operating subsidiaries of Bank of America, Citigroup, Goldman Sachs and Morgan Stanley earlier in 2015.

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### *Performance Recap*

Despite Taxable bond market weakness in the final quarter of 2015, Appleton's Taxable Fixed Income strategy held up well, returning -0.16% versus our strategy benchmark's -0.66%. While curve positioning was mildly detrimental, our credit-heavy bias was a very strong contributor to outperformance. Spreads tightened materially, with Factset estimating A rated Financials

coming in 32bps at the 7-year point of the curve, largely offsetting a rising Treasury curve. Our overweight allocation to this rating was responsible for approximately 35bps of our quarterly outperformance. We also saw strong contributions from our overweight allocations to Banking, Consumer Goods, Retail, and Taxable Municipals, and our underweight exposure to Treasuries continued to be a significant driver of performance.

Overall, curve positioning remained positive on the year, despite Q4's mild detraction. The strongest contributions came from our underweight exposure to the 1-2 year part of the curve, and overweight exposure to the 5-6 year area. Credit allocation impacted performance positively, but successful security selection within the A-rated universe was an even larger factor. The Banking sector was the single strongest sector for our strategy in 2015, where our overweight allocation and intra-sector outperformance were both favorable, contributing 18bps to our excess return. We outperformed in a broad range of sectors over the year, however, and despite some spread volatility in the middle of the year our decision to maintain our underweight to Treasuries in favor of credit continued to offer value. On the whole, we closed 2015 with an annual return of 2.06%, well ahead of the 1.35% return of our strategy benchmark.

### *Commodities & Stagnant Global Economies Puts Pressure on Future Fed Hikes in 2016*

Looking to 2016, commodity prices, and especially oil are expected to remain low due to global oversupply and weak industrial demand, and many experts predict that it may be a number of years before oil reaches $50 a barrel again. In spite of all this doom and gloom, the US economy remains the shining star of global economies, admittedly one brightened by the comparison to a dark global backdrop. The Federal Reserve will once again have to balance its twin mandates of inflation stabilization and full employment; as a result, they will be walking a fine line with regard to further rate increases. We continue to believe four rate hikes in 2016 to be a very optimistic objective if the Fed does not see further progress towards meeting the price stability side of its mandate.

Despite significant flattening in the 4th quarter, we believe the Treasury yield curve has room to flatten further in 2016. The front-end will remain pressured by potential Fed Fund rate increases, while the long-end remains stable with minimal threats of inflation and upward pressure on the US dollar, and the potential for further stagnant global economic pressures. Therefore, we are maintaining our intermediate duration target of 3.9 years. Potential risks to our expectations will be driven by unforeseen inflationary pressures, and, as we discussed, we strive to remain focused on individual credit selection and look to take advantage of value opportunities as the economic recovery persists.

***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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