APPLETON *PARTNERS*, INC.

QUARTERLY MUNICIPAL REVIEW – QI 2013

We entered 2013 not only with the overhang of the Fiscal Cliff and the resulting American Tax Payer Relief Act, but also with a historic wave of cash entering the municipal marketplace. Accordingly, we saw a rally in mid-to-late January, which was subsequently supported by Euro-zone turmoil. Early year strength in the equity markets led some to reassess asset allocations and had market prognosticators calling for the end of the bond bull market. As we stated last quarter, we remain concerned about the pervasive weakness in the economy, which we believe will give the Fed cause to remain accommodative until at least late 2014. In the first Quarter, we opportunistically took advantage of higher rates, but we continue to believe the market will be range-bound, despite what you may hear in the media.

The economic picture remains mixed; while Q4 2012 GDP was eventually revised up from an initial -0.1% to 0.4%, this is still well below the level necessary for the American economy to realize full potential GDP output. The large decline in defense spending likely contributed to this disappointing reading and concerns for continued weak growth remain as the tax increases enacted in the American Taxpayer Relief Act are widely expected to be a drag on economic output. We have seen some estimates that the payroll tax increase and sequester spending cuts could have a 1-1.5% drag on GDP. On the other hand, home prices, new housing construction, and existing home sales are all improving, which is having a positive impact through the 'wealth effect.' We saw strong February employment numbers, which drove the unemployment rate to 7.7%, the lowest level since 2008. We were leery of this number at the time as the labor force participation rate continued to drop to levels not seen since the early 80's and the unexpectedly weak March jobs report only deepened our concerns. The Fed has maintained its dovish policy and has even gone as far as defining the duration of its accommodative stance as 'very long-term.' FOMC policy remains unchanged with the Fed Funds Rate at 0-0.25% and has indicated trigger points being an unemployment rate at 6.5% and inflation over 2.5%. Given the current economic climate, this seems to be a long way off, but we will continue to factor this into our yield curve positioning.

Despite the volatility in rates, issuance dynamics and valuations continue to support the asset class. Thus far, refundings are down 7% over last year, while new money issuance is up 20%; the combined impact being Q1 2013 issuance increasing 2%, coming in at $81.0 billion, which is below expectations. We had anticipated an increase in issuance coming into 2013 with refundings staying on track, if not increasing and new money issuance expected to pick up from last year. Looking ahead, pent-up need for investment in infrastructure after years of neglect and austerity, should lead municipalities across the country to increase borrowing for new projects.

At the start of the year, we considered Municipal-to-Treasury ratios comparatively fully valued, with 10Yr Municipals versus Treasuries at 93.3%. The strong demand for municipals stemming from mutual fund inflows drove ratios down to 86%, while the Treasury market sold off at hints of economic growth. Municipals eventually caught up with the Treasury sell off in mid-March just in time for a flight to quality rally in Treasuries at month-end. Most recently, sovereign concerns with North Korea and a weak jobs report for March have caused Treasuries to rally and have brought the 10Yr Municipal-to-Treasury ratio to 102%, which we view as attractive. Despite the recent outflows in municipal mutual funds, $6.9 billion has flowed into muni funds year-to-date and we would expect valuations to support continued investment in the asset class. There is a considerable amount of cash on the sidelines, as well; George Friedlander at Citicorp has noted more than $10 trillion in cash and near cash alternatives in the personal sector through his analysis of the Fed's Flow of Fund Data. Furthermore, even if rates were to rise, we would expect some of this cash to come off the sidelines in support of the asset class as those in cash would be attracted by increased yields in the tax-exempt sector.

Fortunately for the municipal market, the status of the municipal Tax Exemption was not addressed by the Fiscal Cliff resolution. That being said, we don't believe this issue is dead and will be closely watching events in Washington DC. There have been increased lobbying efforts by municipal issuers highlighting the expected impact a change to the Tax Exemption could pose to municipalities, and the expected borrowing cost increases from any change to this Tax

Exemption are beginning to resonate with the politicians. In fact, the House Committee on Ways and Means held a hearing on Tax Reform in March, during which the Tax Exemption was the focus. There was bipartisan support to maintain the status-quo, which is promising. We hope to continue to hear positive news on this topic and know that despite the bi-partisan effort, the issue will not be considered closed until after Washington votes. The cap on deductions at 28% remains the likely worst case scenario, but we remain hopeful that the longer the issue remains unresolved, the less likely there will be any change to the existing exemption.

Within the Municipal market, our comfort level with State GO credits continues to grow as we have seen the number of states facing deficit situations drop and fund balances grow. According to the Rockefeller Institute, states are on track to register their 12th consecutive quarterly gain in revenues through year-end 2012. The strength in revenue was driven largely by increasing personal income tax receipts in the 4th Quarter. We will be watching to see how much of the increase was due to the desire to recognize revenue in the 4th Quarter of 2012 in order to avoid any tax changes that were thought to be coming due to Fiscal Cliff negotiations.

On the other hand, we do remain more watchful of the Local GO sector, where credit parameters have not materially improved and there has been an increase in the number of "super-downgrades," or downgrades of three or more notches by one of the major rating agencies. After further scrutiny of these large downgrades, we believe they are more a reflection of the stale ratings by the agencies and the inappropriate rating re-calibration by Moody's back in 2010, rather than fundamentals of the credits. This was evident when some of the effected credits were reviewed and we noticed the rating move took them back to their pre-recalibration rating. The credit concerns in the Local GO sector support the continued diligence in our analysis and why, in our opinion, stale ratings raise red flags.

With upward pressure on rates in 7-10Yrs and beyond, performance was driven by yield curve management in addition to careful credit selection. Over the quarter, the 5Yr Barclays component of the municipal market was the best performing part of the yield curve, returning 0.85%, while the 15-20Yr part of the Barclays index was flat to slightly negative. The municipal curve steepened, with the 4Yr down 1 basis point, the 5Yr up 5 basis points (bps), and the 10Yr up 19 bps. We did see credit spreads tighten in the 1st quarter, especially for lower grade credits, with the spread between AAA rated bonds and A rated bonds tightening 12 bps to 60 bps in the 10Yr part of the curve, while AAA to BBB spreads tightened 14 bps to 137 bps. These are levels not seen since July of 2008. The spread tightening contributed to robust performance in lower grade sectors, like tobacco, industrial development, and resource recovery. Specifically for Appleton, our performance was driven by our state exposure, most notably over-weightings in California, Michigan, and New Jersey, while our Local GO and Airport exposure also added to our performance. Additionally, with credit spreads tightening in lower grades and remaining relatively unchanged for AA rated bonds, our A rated exposure was a positive for performance as well.

As the Treasury market continues to be driven by international events and lingering economic uncertainty, the municipal yield curve will take its cue from the Treasury curve. The economy remains fragile and recent tax changes could put further stress on disposable income. We continue to expect volatile trading based upon news out of Washington and the rest of the world. Economic challenges are high despite signs of hope in the housing market, and although the unemployment rate has been dropping as noted above, this has largely been attributed to drops in the labor force participation rate. We expect this uncertainty will keep Treasuries, as well as Municipals, in a trading range, which will place additional emphasis on our ability to manage both our security selection and yield curve exposure.

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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