For the Bond Markets, QI Produced the Transition to a New Fed Chair and Reinforced the Sense that Rates Will Stay Low and Rangebound in 2014

Rates Remain Rangebound and Investors' Appetite for Credit Risk is on the Rise

As we look back on the factors that impacted the bond markets in the first quarter of 2014, the focus on rate risk was front and center. Credit concerns faded into the background as spreads continued to tighten, particularly on "BBB" and lower, and impatient investors willingly traded quality for yield. While we know that time is marching us closer to the end of Quantitative Easing in 2014 and the rise in short-term rates in mid-2015, there are many factors in play today that are contributing to a ceiling on rates.

Rising Rates are Constrained

While severe weather is being blamed for the renewed softness in the economic data released in the first quarter, there were other headwinds in place that may have impacted consumer behavior as well. The expiration of emergency jobless benefits, the confusion in the implementation of the Affordable Care Act, and a higher 2013 tax liability for many investors may have driven behavior domestically. A sales tax increase in Japan and more anemic growth in China created additional concerns from a global perspective.

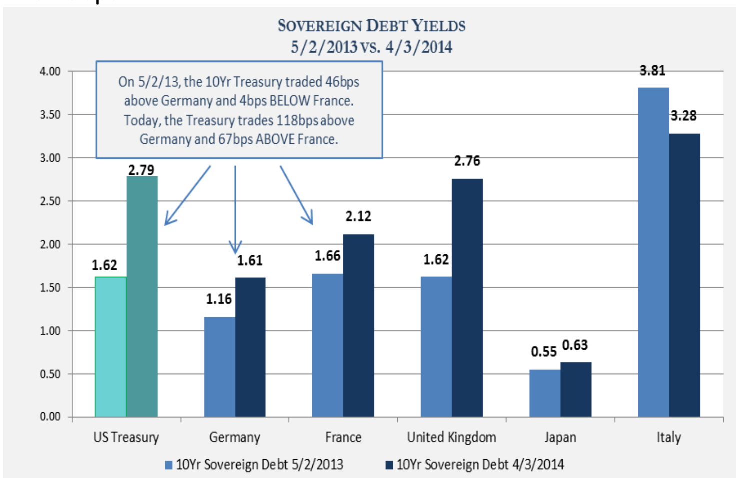
A Mixed Read on the Economy

Interpreting the data continues to pose a challenge to the markets. While home prices have held steady, new and existing home sales, and starts, all reached near term peaks in the third and fourth quarters of last year as rates trended higher and the cost of financing increased. Weekly initial jobless claims have been trending lower, the jobless rate is holding steady at 6.7%, and job creation as reflected in the non-farm payroll data registered a monthly average of 178,000 in the first quarter – all reasonably good signs. However, other factors that are tracked by the Fed, like underemployment, labor market participation, and wage growth are struggling to improve and are not reverting to pre-crisis levels.

US Rates Cannot Rise Substantially While Other Sovereign Yields are Still Declining

As global capital seeks yield and perceived "value," they have been attracted to the debt of many of our sovereign partners. Today, US Treasury debt represents real value basis versus the debt of other developed countries. Historically, our rates are somewhat higher than Germany, much higher than Japan, and lower than most of our other Euro counterparts. Today, US debt is trading at much higher yield levels than Germany, and very close to the levels of other countries like the UK and France. On a relative basis, our rates cannot rise substantially while the rates of other developed sovereign nations are still declining. The 10Yr Treasury has not been this cheap versus the German Bund since 2006.

Over the past 5 years, the average spread between these two sovereigns has been a give-up of 37bps to go into the Bund. Today that give-up out of Treasuries and into Bunds is 18bps.



Source: Bloomberg

Very Low Levels of global Inflation

Personal Consumption Expenditures (YOY), a favorite metric tracked by the Fed to gauge inflation, has been hovering at 1.1% for the past six months and shows no signs of accelerating. The Fed has indicated that they would tolerate an inflation level that was .5% above their 2.0% target, sending the message that we are far from realizing a monetary tightening as a result of inflationary pressures. While our Fed has been diligently fighting a potential deflationary spiral as a result of the 2007-2008

APPLETON PARTNERS, INC ONE POST OFFICE SQ, BOSTON, MA 02109 TEL. 617.338.0700 WWW.APPLETONPARTNERS.COM

meltdown, the EU is lagging behind us. Eurozone inflation is at its lowest level since 2009. In late March, annual inflation for the region was estimated at 0.5% causing Draghi to declare that the ECB would employ extreme QE type measures to stimulate the region if necessary. It is not likely that rates will rise soon under this scenario.

The Yellen Fed is Dialing Back on Adherence to Hard Targets and Looking at a Broader Range of Data to Set Policy

While the FOMC continues to reduce monthly purchases (currently at $55 billion versus the 2013 level of $85 billion), the issue of the pace and timing related to rising short-term rates is less clear. Yellen's comments after the March 19th meeting indicated that a 6 month lag between the end of the taper and the rise in the Fed Funds rate might be appropriate. Her comments related to the labor markets, also indicated that the 6.5% threshold unemployment rate might not trigger any action by the Fed as they are assessing a broader range of data. Lack of consensus within the Fed itself will become apparent when the minutes are released on April 9th.

More supply in QI Was Met with Increasing Demand as Rates Trended Lower

While new supply grew faster than the first quarter of 2013, ($343.3MM versus $307.7MM Source: Barclays) the deals were well received and in most cases oversubscribed. The largest corporate offering of the quarter was from Cisco Systems Inc. (CSCO A1/AA-AA+) who came with 7 part $8 billion deal on 02/24/14. This was the largest deal to come to market since Verizon's $49 billion issuance in September of last year. The issue spread on the 10Yr maturity was +87 to the 10Yr Treasury and ended the quarter tighter by 10 bps to +77. Other notable deals in the quarter were Bank of America's (BAC Baa2/A-/A) 4 part $7.6 billion deal in late March, Exxon Mobil Corp (XOM Aaa/AAA/AAA) with a 5 part $5.5 billion deal in March, and JP Morgan Chase (JPM A3/A/A+) with a 5 part $5.25 billion deal in early January. Issuance in the month of January alone was $157.9 billion and on March 10 there was $23.6 billion issued, which is one of the largest single days on record. To add to the demand, all Taxable Fixed Income funds had net inflows in the quarter of $35.5 billion, now exceeding total inflows for 2013. This influx of capital was at least partially a result of almost $78 billion in outflows from Taxable Money Market Funds as investors capitulated in the *low/no* money market rate environment.

Recipe for Lower *UST Rates in QI:*
January *- Mass Exodus out of Emerging Markets*
February *- Ukraine Crisis*
March – *Yellen Declares the Economy Still Very Fragile*

CURVE FLATTENING, SPREAD COMPRESSION, AND CREDIT TRENDS IN THE QUARTER

The Treasury curve defied many pundits' expectations in the first quarter of 2014, with media fears of a rising Treasury curve proving overblown. Instead, we saw a bull flattening, with the 10Yr yield coming in 31bps from 3.02% at year end to 2.72% at the end of the quarter, while the 3Yr rose 10bps from 0.77% to 0.87%, during the same period. However, the quarter itself brought slightly more volatility, as the first two months of the quarter saw a steady decline in yields across the entire curve, while March saw a sharp jump in the middle of the curve in the wake of Janet Yellen's first testimony as Chairperson of the Fed. The 3Yr curve spiked 20bps (0.67% to 0.87%) and the 5Yr jumped 22 (1.50% to 1.72%) on fears of a sooner and more aggressive than anticipated increase of the Fed Funds rate, erasing the rate moves (and then some, in the case of the 3Yr) of the first two months of the year. This move was partially cushioned by spread tightening, however; after holding fairly steady through January and February, spreads compressed in March, with the A-rated 3Yr Financials spread coming in 14bps between December and March, with the 5Yr coming in 7bps.

Focus on targeting "bond-friendly" issuers is key

The spread compression that occurred in the U.S. corporate bond market throughout most of 2013 has carried over into the first quarter of 2014. In fact, the first quarter marked the first time in three years that global corporate bonds outperformed global equities. Meanwhile, management teams continue to reward shareholders at the expense of bondholders. In the fourth quarter of 2013, share buybacks amounted to $126 billion, representing 28.5% year-over-year growth. Moreover, the fourth quarter represented the seventeenth consecutive quarter of growth in which the ratio of share repurchases to free cash flow increased. Looking forward to the remainder or 2014, our goal is to find portfolio holdings that adequately compensate our clients for increasing credit risk. As we survey the investment grade universe, we are increasingly finding the best risk/reward scenarios in the lower tier of the high grade market- an arena we are comfortable with given our dedicated credit research team. We continue to target high investment grade issuers with low leverage, conservative shareholder return policies, stable free cash flow, and ample liquidity.

Partnering Research with Portfolio Management Supports the Value Approach of This Strategy

APPLETON PARTNERS TAXABLE FIXED INCOME STRATEGY

These macroeconomic conditions were, although mixed, favorable to Appleton's strategy in the first quarter of 2014. We continue to target a bell-shaped maturity distribution peaking at the five year part of the curve, while our strategy benchmark is front-loaded toward the lower end of the yield curve and declines fairly linearly from there. Relative to our benchmark, our interest rate sensitivity is therefore higher to changes in the intermediate section of the curve (in particular, between 3 and 7 years), and significantly lower to interest rate moves in the short-end of the curve, inside three years, and the long-end of the curve, beyond seven years. With the largest increase at the three year, essentially flat at the five, and then decreases becoming more pronounced beyond seven years, the impact of the yield curve movement was essentially flat on the quarter. We saw positive contributions from our underweight positioning in the short-end of the curve almost exactly offsetting our underweight exposure at the longer-end of the curve. This left spread tightening as the main driver of our relative performance on the quarter, where our underweight exposure to Treasuries and AAA rated corporates and our overweight exposure to AA-rated, A-rated, and BBB-rated corporates all contributed positively to our excess return.

From a sector perspective, the single biggest story was our taxable municipal exposure, which after being a detractor for the past few quarters sprang back in a big way as the single strongest returning sector in both our composite and our benchmark (this sector's longer duration was a major factor here). Our underweight exposure to Treasuries continues to be a strong contributor to excess return, while both overweight exposure and in-sector outperformance in the Banking sector was another significant contributor. While the Insurance sector was a net detractor this quarter due to in-sector security selection, we continue to be very comfortable with the names we hold here and after a strong 4Q13 we do not find a pull-back here concerning. We *continue to manage to a* 3.9-4.1 year duration, find value in the 5-7 year area of the curve at this time due to its steepness, and continue to look for additional credit spread opportunities that may arise as the year unfolds.

Contributions to this piece were made by:
Bonnie Tracy, SVP
Jason Audette, AVP
Jason Cook, Research Analyst
Drew Peterson, CFA
Jill Timlin, Marketing Assoc.

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