The consensus in the Fixed Income market that rates will stay "low for longer" is hard to dispute given the transparency of the central banks and the pockets of global weakness that will persist for some time

From a market perspective, we are dealing with what might be called *"a moveable feast."* Just as one large economic bloc recovers and the removal of monetary accommodation is considered (the US), other global regions embark on strategies to combat economic weakness and disinflation (the EU and Asia). All debt trades are executed on a relative basis in the new global world order. So with European and Japanese debt yields trading in the negative to 1.00% territory, it becomes difficult for the higher quality US Treasury debt to trade above 1.00% to 2.00%. It is with this backdrop that we must understand how the central banks are orchestrating the direction and magnitude of rate moves, and why US rates, at least in the intermediate to long ends of the curve, may be locked up in a range for a considerable period.

FOMC Lowers Forecasts, Lowers the Dots, and Replaces "Patient" with Other "Patient-Like" Language

Following the removal of "patient" from Fed language, the markets were quick to realize that while the language had changed, Fed policy did not. The Fed views the strengthening labor market as needing further improvement, and the prospects for getting within the general vicinity of the 2.0% inflation target are slim at best in 2015. Bottom line: The Fed's own forecast came closer to the market consensus, particularly for the Fed Funds target, which was lowered dramatically. The year-end 2015 forecast was lowered from 1.125% to 0.625%, which is a meaningful change when one considers that the first quarter of the year is over.

FED FORECAST	DECEMBER 2014 MEETING	MARCH 2015 MEETING
Change in GDP	2.6% - 3.0%	2.3% - 2.7%
Unemployment Rate	5.2% - 5.3%	5.0% - 5.2%
PCE Inflation	1.0% - 1.6%	0.6% - 0.8%
Fed Funds Target	1.125%	0.625%

Source: FOMC Minutes, March 17-18

Appleton continues to believe that if a rate move were to occur in 2015, it would occur very late in the year, given that there are many signs, other than the poor winter weather, which indicate that economic growth is muted. Despite the futures market projecting a 2.00% funds rate in 2018, the Fed is still predicting a 3.75% funds rate. At some point, the Fed may also lower that forecast, and it is highly likely that the market reality will continue to lead the Fed lower. More importantly, the members of the FOMC in the Yellen era have been very vocal in stating that the pace of rate hikes, once they begin, could be very slow and very gradual, unlike many of the prior tightening cycles.

The ECB and Asian Central Banks Implement QE-Like Strategies to Ward Off Economic Weakness and Disinflation

While our Fed is about to wind down policy activism in response to an apparent domestic economic recovery, central banks in Europe, Japan, and China are aggressively adding to their balance sheets and embracing a low/negative rate policy as they fight deflationary pressures and slower growth. On March 9th, the ECB began its purchase program, targeting purchases of €1.1 Trillion between now and September 2016. The program achieved its stated goal in March by adding €60 Billion to the balance sheet. The market is now given the luxury of knowing that there is a large buyer of EU debt in the market (ECB) at least until September 2016, which will help to sustain the low rate environment for some time.

Potential Headwinds that Could Threaten the US Recovery in the First Half of 2015

The Fed will have to consider the potential effects of a number of factors that have impacted the economy since the start of the year:

- Historically bad weather in the Northeast and the Midwest;
- The "hangover effect" from a contentious port strike in CA that created an unprecedented cargo backlog;
- Dollar strength that negatively impacts exports and adds deflationary pressure to the economy; and
- Weakness in oil prices that hurts oil producing regions and has not yet translated into an increase in consumer spending.

While our Fed continues to monitor the economic pulse in Europe and Asia, the tentative nature of our own recovery will play a role as they determine the lift-off point for US rates. The term "data-dependent" gives the Fed leeway, based on just a few releases, to justify delaying their timing. The March employment data reported on April 3rd (payrolls increasing by 126,000 versus expectations of 245,000), is an important example of a data point that could support and justify such a delay.

The Disruption in the Price of Oil in 2014 will Most Likely Jolt the Energy Sector in 2015

While the plunge in oil prices was a 2014 story, the ongoing fallout for the energy sector is likely to be felt in 2015. Earnings for the energy sector could decline by more than 50% this year, according to some analyst estimates. This is particularly concerning given that energy companies have utilized the generous capital markets of the last several years for debt-fueled share buybacks and expansion projects. If the credit markets remain robust in 2015, there is a high likelihood that most energy companies will be able to finance their losses until energy prices stabilize. This was evident in the first quarter as the energy sector was the top performing sector in our benchmark. However, we would expect any disruption to the capital markets to result in substantial distress, particularly for smaller, high-yield credit quality issuers. Our preference is to larger, more globally diversified exploration and production companies that have operations which run the full range of the production process. Their scale gives us comfort these companies will be able to access the market and their diversity helps smooth earnings and cash flow during times of distress. For instance, while production operations may suffer from lower oil prices, refining operations could actually benefit. In addition to seeking out favorable "big fish" in the energy sector, we will also be on the lookout for event risk from consolidation activities, as companies may look to combine in order to weather the current oil price storm.

Strong Q1 Supply Driven By Mergers & Acquisitions Activity and Strong Investor Demand

At the turn of the year, the consensus estimate for 2015 issuance was approximately $1.05 trillion, and so far this year the pace to reach that has been strong with $446.64 billion issued through the end of the first quarter. This is roughly 7.3% higher than the $416.34 billion issued in Q1 2014. The surge in issuance has mostly been driven by an increase in mergers and acquisitions, which have been met with strong demand. So far, the largest deal of the year, and the second largest in history, behind Verizon's September 2014 deal, was the $21 billion deal brought by Actavis in the first week of March to fund its acquisition of Allergan. March proved to be the busiest month of the quarter, with $179.5 billion issued across 197 tranches. When looking at this quarter's issuance by maturity, there was $346.30 billion (77.5%) issued between three and ten years. Financials continue to outpace all other sectors with issuance of $164.05 billion (36.7%), and, from a rating perspective, bonds rated BBB represented $181.62 billion (40.7%) issued in the quarter. Looking ahead, consensus is that issuance will gradually slow in April, as corporate self-imposed blackout periods and earnings hurdles capture much of the headlines. As for the balance of Q2 2015, the combination of strong technicals, such as fund flows, the prospective bottoming of economic data, and the potential rise in rates from the Fed could preserve the Investment Grade market's run towards record issuance.

Credit and Duration Continue to Drive Performance

While there was a surprising amount of volatility in the yield curve during the first quarter, the long end continued its ongoing grind lower over the first quarter of 2015. The spread between the 10Yr and 2Yr Treasury, an often used measure for the steepness of the yield curve, modestly dropped 12 bps from 150bps at the close of 2014 to 138bps by the end of the quarter. This was significantly up from the intra-quarter low of 119bps, which represents the flattest curve we have seen since the Fed first began targeting a 0-0.25% Fed Funds Rate target in December 2008.

While credit spreads were essentially unchanged over the quarter, the higher prevailing yields for A-rated credits gave them a performance boost over AA and AAA names. This was a macro environment that continues to treat our strategy well, and our Intermediate Taxable composite returned 1.75%, outperforming our strategy benchmark by 34bps over the quarter.

Curve positioning was a positive contributor. We remained underweight to the front of the curve and overweight between 5-6 years, allowing us to benefit from the quarter's significant flattening. Meanwhile, both our overweight exposure to A-rated credit, including our selection of names within this credit range, contributed positively to excess return, as well. Turning to specific sectors, our overweight exposure and our outperformance within the Banking sector were positive factors to this quarter's performance, as was our overweight exposure and favorable selection within the Consumer Goods sector. Our underweight exposure to strong-performing 7-10 year bonds proved to be modest detractor, as was underperformance within the Healthcare and Taxable Municipal sectors.

Concluding Thoughts:

The Fed is positioning for a rate increase, causing short term rates to rise. Historical data from 1994, 1999, and 2004-06, shows that in similar rising rate environments, the curve flattened significantly as the rate cycle played out (Rate Cycles Driven by Rising Short Term Rates). In the years of 1994 and 1999, intermediate term investment grade portfolios had slightly negative returns, only to rebound significantly in 1995 and 2000. In the 2004-2006 periods, there was never a losing year for intermediate term high quality bond portfolios. The gradual moves by the Yellen Fed to normalize rates will force rates higher over time, but we do not believe they will mimic the extreme moves of prior cycles. The definition of "normalized" is changing in 2015 and 2016, it is our job to continue to seek value in both sector selection and security selection and to capitalize on supply and demand imbalances when they briefly offer opportunities.

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