APPLETON PARTNERS, INC.

QUARTERLY MARKET OVERVIEW
QI 2016

Domestic financial markets ended this first quarter with modest gains, with the road to those gains bumpy and filled with potholes. A litany of fears gripped stock investors over the first six weeks of the year, sending the S&P 500 down over 10% before rallying off the February 11th low to finish the quarter with a 1.35% total return. According to the WSJ, this quarter marks the first time since 1933 that the benchmark fell over 10% yet rallied to finish positive. Amid the volatility in stocks, bonds benefited from a flight to safety as the yield on the 10-Year U.S. Treasury Bond dropped nearly 50 basis points to close the quarter at 1.78%. Municipal fixed income as measured by the Barclays Managed Money Municipal Short/Intermediate Index finished the quarter with a total return of 1.34%. Taxable bonds, as measured by the Merrill Lynch US Corp/Gov't 1-10 Year A or Better Index returned 2.32%.

Fear and extremely negative sentiment drove stocks substantially lower and credit spreads wider in January and February. In our estimation, markets were trading on macro anxieties including a recession in the U.S., a hard landing in China, a continued slide in oil prices, and a persistently strong dollar. We believed that there was a disconnect between those fears and what the underlying fundamentals were signaling, and resisted the urge to capitulate. We would note that stock market corrections, a decline of 10% or more from the high, are normal. The S&P 500 has experienced a drawdown of 10% or more in 64% of all years since 1928. In 57% of those years with a double digit decline, the index went on to finish the year positive. Despite the rebound in the general market, the underlying sector performance was disparate. The drop in bond yields and overall volatility enticed investors into the traditionally defensive, value-oriented sectors such as Telecom, Utilities, and Consumer Staples. The rally in stocks off the February 11th low has been largely driven by Energy, Materials, and Industrials which all are largely tied to the rebound in oil. All of these sectors have low/negative growth profiles, so were driven by short-term trading dynamics rather than long term fundamentals. Meanwhile, the higher growth oriented Healthcare, Technology, and Consumer Discretionary sectors underperformed due to rotation. By the end of March, fears over China's imminent collapse had subsided, oil prices had rebounded off lows, and the dollar stabilized at a weaker level- all developments that lowered both volatility and spreads in the investment-grade credit market. The supply demand imbalance for high quality credits has led to stronger bond pricing.

Looking ahead, we anticipate volatility to persist as investors will have to deal with a number of concerns. Chief among them is political uncertainty, as candidate rhetoric is sure to increase heading into summer. Fears of whether the United Kingdom will remain in the European Union, (Brexit") are likely to linger until the referendum on the matter in June. Specific to equities, investors are likely to struggle to get comfortable with elevated valuation metrics. The market rebound heading into the end of the quarter has left the S&P 500 trading at nearly 17 times the next 12-months' earnings as compared to a 5-year average of 14.4 times earnings.

After hitting a new record high in 2015, global mergers and acquisitions fell 14% in the first quarter. In the U.S., activity was actually much weaker, down nearly 25%, but was masked by a Chinese buying binge and stronger EU activity. Clearly the volatility, particularly in the capital markets, in the quarter had a dampening effect on M&A. We also believe that the U.S. Treasury's hard line stance on tax "inversion" transactions will exacerbate the situation. We view a more moderate pace of M&A activity as a modest negative for stocks but a credit positive for the fixed income investment-grade space. As the second quarter progresses, it appears that the Federal Reserve has taken its aggressive rate increase timeline off the table. There was no increase in March and expectations for an April increase are minimal. The Fed's dovish shift should help to provide a productive backdrop for both the equity and fixed income markets.

Despite the challenges, we remain constructive on equities over the coming months. Largely owed to historically low commodity costs, inflation remains stubbornly low. Low inflation, combined with soft global growth expectations, is likely to keep worldwide monetary policy accommodative. Easy monetary policy should keep credit readily available and the cost of long-term financing low. In that environment, we anticipate that the U.S. should be able to avoid a recession and maintain positive, albeit low, economic growth. For corporate America, the earnings picture is anything but rosy as we head into April's first quarter reporting period. Wall Street analysts have continued to cut their estimates for the quarter, recently predicting a decline of -9.1% which is significantly lower than previous expectations for +0.2% as of December 31st. At Appleton, we expect to see upside to these lowered expectations principally due to the recent stabilization in both the price of oil and the U.S. dollar. Those two factors have pressured corporate profits over the past year and a half and we anticipate that those headwinds are likely to abate somewhat as we move forward. In that scenario, we would anticipate aggregate earnings returning to positive growth in the latter half of the year, which could provide a lift for stocks.

In our last letter, we called for modest stock market gains in 2016, but with increased volatility. However, we did not anticipate a decline and subsequent snapback to the extent that we experienced in such a short period of time. The team at Appleton remains focused on the long term and will continue to favor companies in sectors which show positive earnings growth at sensible valuations. For fixed income, we continue to focus on credit fundamentals and will focus on companies that can sustain cash flow generation healthy enough to support their balance sheets.

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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