Closing out 2015, the Federal Reserve finally raised the overnight lending rate and announced to investors that four additional rate increases were expected during 2016. What the Fed did not account for with its "Dot plots" is the deepening interconnection between the US economy and economies of the rest of the world. As the Fed began its preparation for further rate increases, central bankers elsewhere were cutting rates and increasing quantitative easing activities. Japan went so far as to institute negative overnight rates. Though the US economy is currently on stronger footing than the rest of the world, no man is an island and the US cannot simply increase rates in a vacuum.

As a result of the Fed's action and subsequent back peddling, volatility came roaring back into the markets during the first half of the quarter. Treasury yields across the yield curve dropped between 40 and 65 basis points in January and into early February. At the same time, spreads between Treasury and investment grade corporate bonds widened between 15 and 35 basis points, depending on the credit and position on the yield curve. By the second week of February, the "risk off" trade started to settle down and unwind. Treasury rates started to rise once again and by mid-March retraced about 50% of their January decline. Volatility was not done there as interest rates declined once again and ended the quarter within 5 to 10 basis points of the January/early February low. While the Treasury market was going through its gyrations during the second half of the quarter, the corporate market caught a bid with most credits ending the quarter 5 to 10 basis points tighter than they began.

In our estimation, credit spreads were not moving on specific credit fundamentals but rather on macro concerns, including a hard landing in China, a continued slide in oil prices, and a persistently strong dollar. By the end of March, fears over China's imminent market 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.

Despite the macro noise, the team at Appleton remains focused on credit fundamentals. At present, consensus estimates are calling for a decline in earnings of approximately 8%, which would represent the third straight quarter of declines. We'll be closely watching the coming earnings season for signs that margins may be topping out, with a focus on companies that can sustain cash flow generation healthy enough to support their balance sheets. While still near historical highs, one risk that moderated over the quarter was M&A "event" activity, which carries the potential to drastically change credit profiles. After hitting a new record high in 2015, global mergers and acquisitions fell 14% in the first quarter. In the US, activity was actually much weaker, down nearly 25%, but was masked by a Chinese buying binge and stronger EU activity. The volatility in the quarter, particularly in the capital markets, had a dampening effect on M&A. We also believe that the US Treasury's hard line stance on tax "inversion" transactions has played a role. We view a more moderate pace of M&A activity as a modest credit positive for the investment grade space.

Investment Grade supply ended the first quarter of 2016 at $458.3 billion, up 2% over the first quarter of 2015. Although supply was robust, it was not without its own volatility. The last couple of weeks of January and into the beginning of February were very quiet due to earning season blackouts, a "risk off" sentiment, and rate volatility. However, in the last two weeks of February, there was an abrupt turnaround lasting through the end of the quarter when $241 billion of new debt was issued. The largest deals of the quarter were brought by Anheuser-Bush InBev (7 tranche $46 Billion on 01/13/16), Apple (9 tranche $12 billion on 02/16/16), and Exxon Mobil (8 Tranche $12 billion on 02/29/16). It is interesting to note that Exxon and Johnson and Johnson, 2 of only 3 AAA rated companies, issued debt during the week of February 26th, which totaled $51.4 billion. Proceeds from these issues are expected to flow into R&D, as well as potential M&A activities at both companies. Overall, most deals done over the quarter were well received and done without any disinclination. In fact, most deals priced nearly 20 basis points richer (on average) than initial price talk. Demand for credit is still strong and we expect that trend to continue through the balance of the year, especially with rate projections remaining quite low. Speaking of demand, the ECB announced that they will expand their quantitative easing program by beginning to buy non-banking European investment grade corporates. This was a positive surprise for the markets and is poised to affect US IG spreads in the near term, as many international corporations issue debt in USD as well as EUR.

Between the flattening US Treasury curve and credit spreads that ultimately tightened over the quarter, Appleton Partners' Taxable Fixed Income strategy exhibited strong performance in the first quarter of the year. Despite lagging on a relative basis in January, the strategy put up strong returns in all three months of the quarter, and spread tightening at the end of the quarter ultimately led the strategy to close up 2.85%, 53 basis points over our benchmark's 2.32%. Overall, longer bonds tended to outperform short, and our underweight exposure to maturities between 1-3Yrs was a large contributor to our excess return. While underweight exposure to "AAA" rated bonds was a relative detractor in the first part of the quarter, the quarter-ending credit rally led to strong contributions from our overweight "A" and "BBB" rated credits. Outperformance within the Telecommunications sector was also a positive, as was our overweight exposure to the Technology & Electronics, Consumer Goods, and Retail sectors. Detractors were relatively modest, with overweight exposure and underperformance in the Insurance sector, and underperformance in Basic Industry and Taxable Municipals all detracting somewhat.

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. Looking at Fed Funds Futures, increases are going to be sporadic at best, with the Futures contracts predicting we will not see a 1% overnight rate until late 2018. We continue to expect market participants to be focused on macro data on an international aggregate basis, as well as on how the Fed will balance continued pressure from forces within the boundaries of the US along with realities of the global economy.

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 on Twitter: follow us at @AppletonPtnrs.