

We entered 2017 anticipating the inauguration of a new Republican president who, with party control of both the Senate and House, was presumed to have sufficient support for a pro-growth agenda. Reacting to the prospects for an aggressive fiscal policy and the need for tighter monetary policy, the Fed increased rates in December, signaling the economy was growing stronger. Stock markets traded higher on expectations for growth and tax reform, while the bond market was skeptical and continued to retrace the post-election sell off through the quarter. The first true test for the Trump administration came during the attempt to repeal and replace the Affordable Care Act (ACA), which failed when House Republicans were unable to garner enough support from within the party. Combined with setbacks on various other policy initiatives, this reinforced the narrative that President Trump has a tenuous hold on the Republican Party and called into question his Administration's ability to ultimately push forward with the rest of his agenda. This uncertainty has propped up the bond market, stopping the large exodus from mutual funds and driving a market that continues to exhibit exceptional demand. Without a strong consensus in Washington, expectations for tax reform and further fiscal measures have been tempered, which we believe will likely keep the bond markets in a trading range.

Despite the political turmoil, the markets remained remarkably calm all quarter. The stock market brushed off any uncertainty and steadily rose on the prospects of the stimulative effects of deregulation and tax reform, with the S&P 500 closing the quarter up 6.07%. Meanwhile, following the bond market's abrupt selloff in November, the 1st quarter was relatively stable. The 10Yr Treasury traded inside a tight 31bps range, ultimately ending the quarter 3bps lower at 2.42%. The 2Yr came in slightly further, dropping 11bps to 1.14%, as the curve steepened 8bps between 2Yr - 10Yr maturities. Market-based measures of inflation were essentially unchanged, hovering just below the Fed's 2% target.

Given a market disconnect this large, it is often useful to take a step back and scrutinize the economic fundamentals. While the 4th Quarter GDP growth rate of 2.1% is somewhat lackluster, it does represent a continuation of recent slow, but stable, growth. Despite a poor March number released in early April, jobs growth remained reasonably solid, with 216,000 and 219,000 jobs added in January and February, respectively. Unemployment sits at cyclical lows of 4.5%, the labor force participation rate ticked upwards by 0.3% over the quarter, and average hourly wages have seen continued increases. Combined, these trends indicate little remaining slack in the marketplace. Wages were up 2.7% year-over-year in March's jobs report, and remain close to post-recession highs. Housing numbers remain relatively strong, as well; new housing starts, while slightly off their 4th quarter peak, are currently at their second-highest reading since the Great Recession. Overall, the underlying health of the US economy

should provide some downside protections for equities, and the fall in rates after the Fed Funds hike on March 15th suggests that Janet Yellen currently has the market's trust to manage inflation. No one would call this a 'Goldilocks' economy, but the markets do seem to be rightfully tuning out the noise from Washington.

Municipal fundamentals were supportive of the marketplace, with fund flows turning positive by the third week of January. Weekly flows, as determined by Lipper, remained flat to slightly positive for the remainder of the quarter and finished with just a slight outflow of \$505 million combined. Interestingly, high-yield funds and long-term funds took in over \$2.65 billion and \$1.75 billion, respectively, for the quarter, while Intermediate funds saw assets decline by \$1.55 billion. Additionally, the market saw a large increase in global buyers, mainly banks and insurance companies. According to Barclays, this group purchased \$14 billion in the 4th Quarter, bringing their aggregate holdings above \$100 billion. Global holdings should continue to grow as municipal yields remain an attractive alternative relative to other international sovereign debt, and strong demand from the funds and the international buyers did not lead ratios lower. For the majority of the quarter, the 10Yr AAA municipal yield as a percent of the 10Yr Treasury remained in the mid-90s. These ratios remain elevated versus historical averages and likely will until tax reform, and more specifically the potential municipal exemption, is ultimately addressed. Looking ahead, there continues to be strong lobbying efforts on behalf of issuing municipalities which prefer the status quo.

With the first attempt at repealing and replacing the ACA floundering in the House, the growing uncertainty out of Washington has raised more questions. Changes to the ACA would have heightened investor concerns for the healthcare sector, due to an increase in the uninsured population negatively impacting hospital revenues and operating performance. The ACA repeal and replacement would have also put negative pressure on the state sector, where a cut in federal money flowing for Medicaid would have resulted in states having to assume increased health care costs for their populations, pressuring budgets and expenditures.

Also currently muddying the credit landscape is talk of the federal government withholding funding from those local governments that identify themselves as "sanctuary cities." Those municipalities that do not enforce federal immigration laws could be at risk of losing certain federal funding, though the magnitude of such potential cuts remains unknown. Despite the headlines, Citigroup has indicated this revenue stream is less than 1% of total Government Revenue; therefore, it is unlikely to have a meaningful impact on budgets at the state and local government levels.

Pension issues continue to be a large overhang for the market, with Dallas (A1/AA-) the latest name to have its rating cut a notch by both Moody's and S&P due to a \$7 billion shortfall in its police and fire pension plan. The news and subsequent rating actions raised anxiety over the funding and mechanisms imbedded in some local government pension plans. As always, we continue to monitor the credit landscape for developments that could potentially impact individual credits and sectors of the market, with added attention given to the ongoing surveillance of credits held in Appleton accounts.

Curve positioning had a significant impact on performance in the quarter, while lower grade sectors largely outperformed. The municipal curve steepened with yields lower in the front-end and were slightly higher 13 years on out. This move led the 7-year Bloomberg Barclays Index to be the best performing part of the curve, which was up 1.95% for the quarter, while the 5-year Index was up 1.90%. The 1-year index was the worst performing segment of the Bloomberg Barclays Indices, up just 0.69%. Higher yielding, lower rated bonds continue to entice buyers, driving lower grade sectors to outperform; specifically, the Housing and Industrial Development sectors best performed for the quarter. Credit spreads were essentially flat over the quarter, with both the 10Yr AAA-BBB credit spreads and the AAA-A spreads down 2 bps. The AAA-AA curve was flat over the quarter.

The bond sell off that accompanied President Trump's election and inauguration seemed overdone and was deemed an investment opportunity at the time. We continue to feel that without any inflationary pressures the curve should remain in a trading range, and possibly resume a flattening trade due to the uncertainty surrounding the timing of potential tax reform. Although we continue to be watchful of the growing pension burdens placed on various municipalities, we believe the overall credit picture remains solid. Appleton continues to actively manage its municipal strategies looking for opportunities to add value in the new issue and secondary markets; specifically, our Intermediate strategy continues to focus on a duration target at 4.60 - 4.70 years. It is our intention to remain well positioned by maintaining a high-quality, liquid, and broadly diversified portfolio. Our team knows that the political winds may have a significant impact on our markets, and we will be closely watching the story lines in Washington, while remaining focused on indications of underlying economic health.

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 @AppletonPtrns.