After the sedate close to 2017, a combination of embedded market expectations and newfound policy and political risk brought volatility roaring back in the first quarter of 2018. Expectations of a potential devaluation of the US dollar pushed the stock market higher in January, but caused the bond market to trade off sharply, with the 10Yr Treasury climbing 32bps over the course of the month. Next came a stronger-than-expected 2.9% increase in January average hourly earnings. The stock market, already uneasy about the possibility of December's tax cuts fueling inflation, plummeted on the news, with the Dow dropping an all-time intraday record of 1,600 points. These inflation concerns temporarily pushed bond yields higher, with the 10Yr treasury peaking at 2.94% on February 21st, 54bps above its December close.

Volatility remained elevated as March arrived, with President Trump igniting a fresh sell-off by announcing an intention to implement a series of trade tariffs on imported steel and aluminum, as well as a range of Chinese imports. Nonetheless, strong macroeconomic fundamentals provide a basis for optimism. While January's average hourly earnings spiked, they were offset by a decline in the aggregate work week, muting the impact to aggregate earnings. While the final revision to the third quarter GDP was higher than expected, it also saw inventory increases outpacing consumer spending. Consumer confidence remains high, in part driven by low unemployment, while workforce participation is rising, and companies continue to hire. The irony of the first quarter's volatility may be that it happened despite a strong economic foundation.

While, we do not currently see significant inflation, we remain vigilant to the risk of it picking up later in the year, as that would likely force the Fed to hike short term rates faster expected before year-end. At present, we see an economy that appears to be stronger than it has been in some time, and one that could continue to grow for a prolonged period, absent external shocks.

EQUITY REVIEW

After a prolonged period of calm dating back to the election of 2016, equity markets experienced a stretch of unrest over the final two months of the first quarter. The S&P 500 experienced its first correction in nearly two years and had its first negative quarter since the third quarter of 2015. As we noted in our final letter of 2017, last year's market calm was highly unusual and unlikely to persist. This tranquility was best illustrated by the historically low number of trading days with at least 1% market moves and the shallowness of drawdowns from market highs. In the first quarter of 2018, the S&P dropped ~10% from its all-time high and experienced twenty-three 1% or greater moves, and six 2% or greater moves. Since 1980, the average drawdown in a given year is roughly 14% with fifty 1% or greater days and ten 2% or greater days. During these turbulent times, it is important to remember that what we have experienced this year is much closer to "normal" than 2017.

More often than experts care to admit, the stock market is driven by human emotion, and fear was the primary motivator in the first quarter. A large contributor to January's 5.7% gain, the best since 1987, was a "fear of missing out" as investor optimism drove stocks to new all-time highs. That confidence quickly dissipated in early February as the S&P dropped 10% in just nine days. It started as fears of inflation and rising interest rates and these concerns morphed into fears of a trade war. We believe that the proposed tariffs are being used as a negotiating tactic, and that a true trade war should be avoided. Amid the trade war fears, several widely-held technology stocks sold off due to uncertainty over the mishandling of user data and the potential for increased scrutiny and regulations. Investor sentiment has clearly shifted from overwhelmingly optimistic to comparatively bearish. During these sharp swings in sentiment, the team at Appleton believes it is wiser to take a longer-term view with a focus on the underlying fundamentals.

Along those lines, we see equities supported by the same positive backdrop that drove them higher in 2017. Despite some flattening, the yield curve has yet to invert. Domestic GDP growth is expected to be in the 2.0-2.5% range, far from recessionary levels. Valuation, which was a concern last year, has been reset to more palatable levels with the S&P 500 trading at 16.4x expected 2018 earnings, in-line with its 5-year average. Lastly, corporate profits are expected to grow by approximately 17% in the coming quarter, with tax reform likely to be a strong tailwind. With all the uncertainties swirling towards the end of March, the team at Appleton is looking forward to the upcoming earnings season to catalyze some market stability. We are mindful that analysts' earnings expectations are elevated which could lead to some disappointment, but believe that investors will be able to find some solace in the results of companies. We also believe the fact that "growth" stocks continue to outperform "value" stocks suggests the market has confidence in the outlook for an acceleration in earnings. We will be closely monitoring these results, and the myriad news out of Washington, as we look for stocks to find their footing in the second quarter.

MUNICIPAL REVIEW

After a near record year, a decrease in municipal issuance was anticipated coming into 2018. Issuers moved nearly $35 billion of issuance into the fourth quarter of 2017 in anticipation of the tax reform bill and the impact it would potentially have on advanced refundings and Private Activity Bonds. Not surprisingly, issuance in the first quarter of 2018 totaled $62.8 billion, down 32% over the same period a year ago. Without a subsequent pick up in issuance, the market may have a hard time reaching the expected $330 billion for 2018, let alone breaking $300 billion. Analysts estimate that there will be nearly $120 billion more in bond maturities, calls, and coupon payments than this lowered expected issuance. This net negative issuance environment should provide strong fundamental support for municipals going forward. Municipal bond fund inflows, which surpassed $6 billion in the first quarter, should add to the favorable demand fundamentals.

Despite the positive fundamental supply/demand backdrop, the municipal-Treasury ratio traded higher during the first quarter. The 10Yr AAA Municipal as a percent of the 10Yr Treasury started the year at 81.4% and finished the quarter at 88.3%. The tax reform bill, which lowered the corporate tax rate by 40%, decreases the benefit of municipal bonds relative to corporate bonds for corporate buyers. These buyers represent over 25% of the municipal market thus, the decrease of corporate buying and concerns brought on by the market volatility led municipals to underperform relative to Treasuries. The team at Appleton believes there is relative value in municipals given the current ratio level, and would look for the ratio to return to the low 80% range, particularly with primary issuance languishing where it is.

The credit landscape for municipals continues to exhibit broad stability. State and local tax revenues are growing, albeit at a slower pace, while balance sheets have been rebuilt in many instances. Sustained growth in the national economy should support ongoing stability of revenues that secure the debt of state and local governments, as well as essential service revenue bonds. This credit environment, strong municipal market inflows, and reduced issuance provide a backstop for a stable environment in the municipal market.

TAXABLE FIXED INCOME REVIEW

Treasury yields rose during the quarter on fears of a misstep from the new Fed regime as they continue to normalize rates, inflation, and an increase in Treasury bond issuance due to rising Federal deficits. In the face of a steady rise in Treasury yields, the steepness of the curve initially increased in January, as the spread between the 2Yr and 10Yr rose from 51 to 67 basis points. However, the Treasury's decision to upsize February's shorter maturity auctions, citing a larger-than-expected funding gap after the passage of the December tax bill, put pressure on the short end of the curve. This flattening continued for the rest of the quarter. By quarter end, the 2-10Yr spread decreased to 47 basis points. These are issues we will closely monitor given the potential impact to the bond market.

Similar to what we witnessed in the municipal market, investment grade (IG) issuance in the first quarter was negatively impacted by the tax bill signed into law in December of 2017. The team at Appleton believes two factors led to the 20% decline in IG issuance from the year-ago period. First, corporations pulled numerous deals into 2017 amid uncertainties over the new tax bill. Second, the new US tax code allowed corporations to repatriate cash held overseas at a much lower rate (15.5% vs. prior 35%), lowering the need for new debt. This lack of issuance supported the IG market to start the year, but credit spreads spiked to 2018 wide levels as the month of February ended. The selloff was in response to a broad rise in volatility across asset classes fueled in large part by tariff and associated trade fears, uncertain future Fed monetary policy, and speculation concerning the path of short-term rate increases. IG spreads, while still tight relative to historical averages, ended the quarter 16 basis points wider than at the end of 2017. That is not a huge move, but softening was apparent as volatility seeped into the credit markets. Once again, we fall back on strong underlying corporate fundamentals, and while an investment grade credit dislocation event is not evident, global trade conflict presents a risk that cannot be ignored.

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