APPLETON
PARTNERS, INC.

Rate Cycles Driven by Rising Short Term Rates
1993-95 2004-06 2014-16

Premise: The Prospect of Rising Short Term Rates Initiated by the FOMC Does Not Necessarily Negatively Impact the Intermediate and Longer Points on the Yield Curve

In 1905, philosopher George Santayana thought it was prudent to remind people about the important role that history can play in determining a present or future course of action. As we look back on the past 20 years and the Fed's manipulation of interest rates as a lever to re-direct economic growth and price stability, the market response to those historic actions can shed some light on the outlook for rates today. As we struggle to recover from a financial collapse of historic proportions, central banks are enacting policies to combat disinflation (teetering on deflation) and weakening economic conditions in many regions around the globe. While the US is ahead of the curve from a recovery perspective, the data measuring many areas of domestic growth are coming in mixed. If the US is the growth engine of the global economy, we cannot afford to falter. It is in this context that we review the current conditions impacting the world markets and the potential for future interest rate changes. While *"this time is different" thinking* might apply here, we can still learn something from recent market behavior in two prior cycles. For, as George Santayana noted, "Those who cannot learn from history are doomed to repeat it." As we address some instances where the Fed felt it was prudent to hike short term rates and remove accommodation, it becomes increasingly evident that the Fed's ability to control short term rates does not apply to the behavior of intermediate and longer term rates. With very short term rates still yielding close to zero, we feel that there is value in the intermediate areas of the yield curve that can be captured over time. We would make the case that over a one to two year horizon, this value is not necessarily in jeopardy.

Many Factors Impacting Today's Yield Curve Support Lower Intermediate and Longer Term Rates:

Activist Central Bank Intervention

- While our Fed seems to be winding 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.
- *Very low bond rates in the Eurozone and Japan have forced our rates lower despite the end of QEIII in 2014, a growing economy, and the prospect of rate hikes in the intermediate term. Yields on German Bunds from 1-7 years currently trade in negative territory as EU capital chases the safe haven.*
- *A Greek exit from the EU could benefit the flight to quality trade, at least temporarily, boosting demand for high quality US assets.*

Geopolitical Unrest and Event Risk

- The geopolitical landscape particularly in Ukraine, the Middle East, and Western Africa, is fraught with uncertainty, and, in many cases, is an added layer of risk to already weakened states.
- *When these events periodically escalate, the flight to high quality US assets will follow on, with global investors looking to lock in value in the intermediate to longer parts of the yield curve.*

Oil Prices Plummeting

- While there is a near term negative impact on oil producing nations and regions, there is a longer term positive impact for our domestic economy and others, as an increase in consumer spending fuels economic growth.
- *As prices declined recently, longer term rates declined as well, reflecting a perception that the move would fuel deflationary pressures. Given the supply glut in the market today, it is unlikely that the price of crude will climb significantly in the near term.*
- *Importantly, in the Fed's eyes, moves in energy prices are almost always considered "transitory."*

The Next Tool the Fed Will be Grabbing from the Toolbox – Hiking the Fed Funds Rate

The US economy is far from fixed, and the innately dovish FOMC, will be cautious when it comes to raising rates. While their goal for "full employment" may be close to a reality, their inflation target of 2.0% will probably not be achieved when the first rate hike occurs. This reinforces a forward outlook that calls for *gradual rate hikes*, and hikes that may not even reach a more normalized 4.00% funds rate by 2019, or the Fed's own forecast of 3.75% in 2018. If the Fed pursues a late 2015 or early 2016 date for the initial hike, where does that put the yield curve as they enact policy in the next 1 to 2 years?

What Forward Guidance Can We Derive from Prior Periods When the Fed Raised Short Term Rates?

Historically, as short term rates rose, intermediate to longer term rates initially followed and then flattened significantly as investors tried to lock in those longer term yields. In reviewing two prior periods when the Fed used the Fed Funds rate lever to tighten – 1993-95 and 2004-06 – there is evidence that the curve flattened between 2Yrs and 10Yrs by approximately 150 basis points over the first year in each of these cycles, representing a 90% flattening in 1995 and a 65% flattening in 2005. In the past year, we have flattened by 40%, down from 230 basis points to 130 basis points. As short rates rise, there should be room to flatten further.

Appleton Partners, Inc. One Post Office Sq. Boston, MA 02109 tel. 617.338.0700 www.AppletonPartners.com

APPLETON PARTNERS, INC.

1994-95

The Fed Raised the Funds Rate from 3.00% to 5.50% (250 bps) in 11 Months in 1994

Starting in early 1994, fears of inflation led the Fed to pre-emptively act and increase the Funds rate target seven times (by 25, 50 and on one occasion 75 bps). With the complacency of a Fed Funds rate at 3.00% for 18 months, the markets did not see the February 1994 rate hike coming. In the ensuing months, all rates rose, only to completely flatten out by year-end and initiate a decline in the long end by mid-1995.

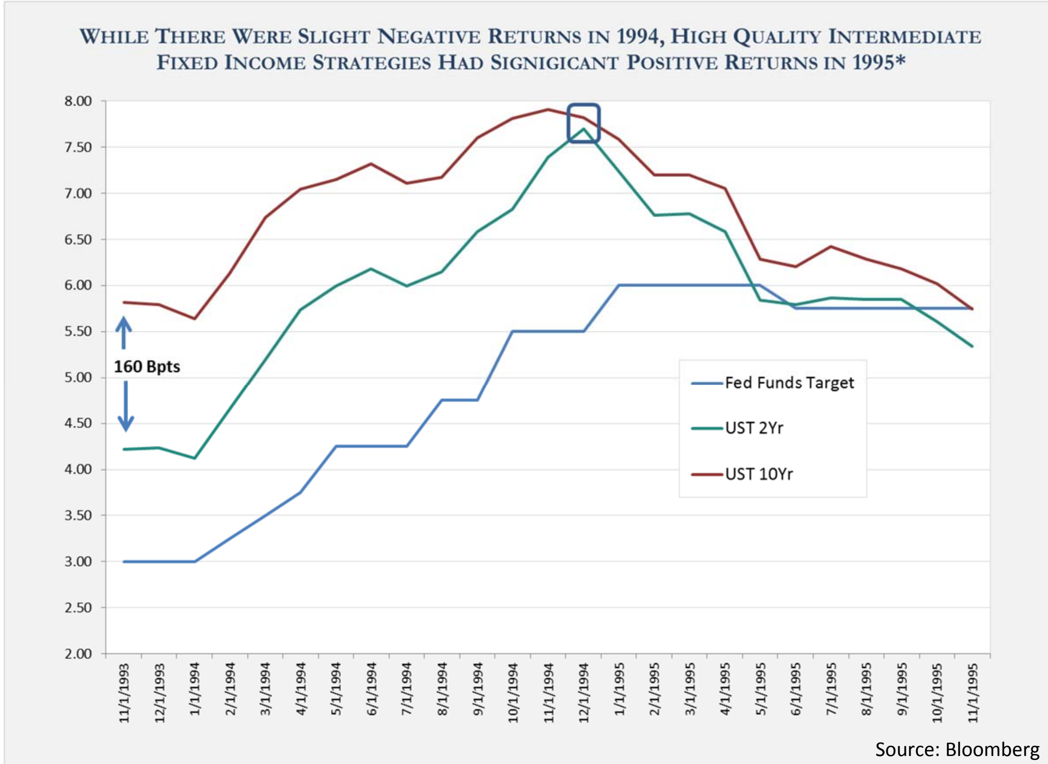
2004–2006

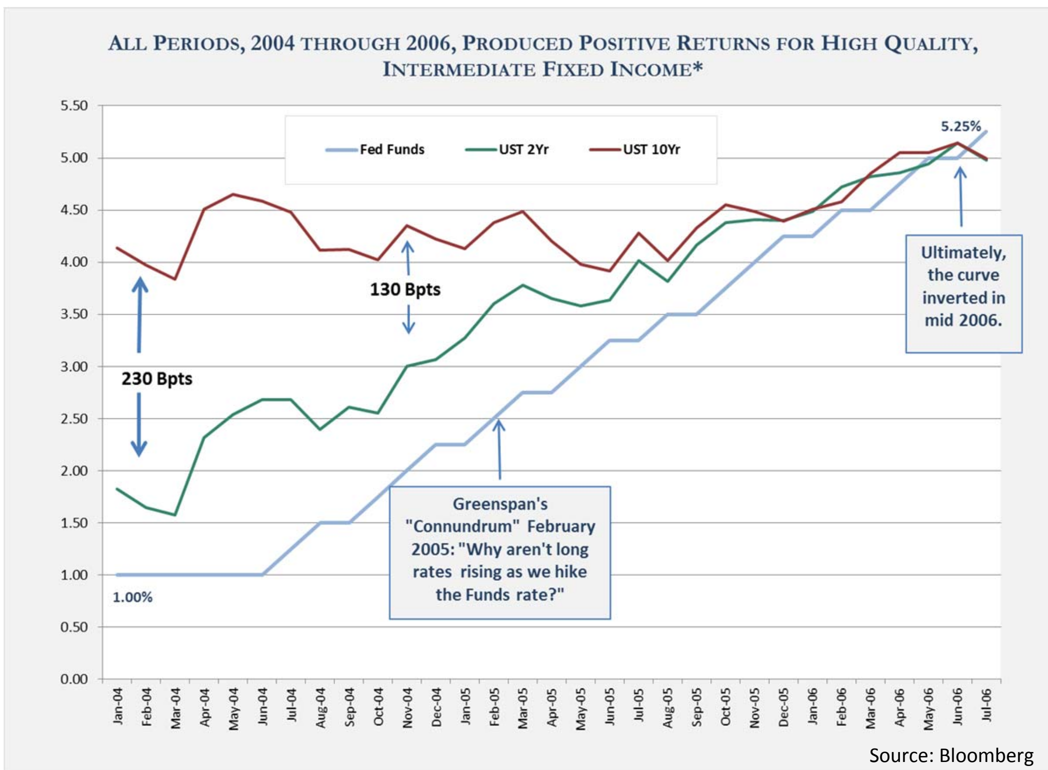
The Fed Raised the Funds Rate Over a 24 Month Period from 1.00% to 5.25% (425 bps)

At that time the FOMC was dealing with higher energy prices, considered to be "transitory," and an economic expansion. At the November 10, 2004 meeting where the FOMC raised the Funds rate by 25 bps to 2.00%, the statement read: "Output appears to be growing at a moderate pace despite the rise in energy prices, and labor market conditions have improved." As the Fed raised rates in 2004, 2005, and early in 2006, the 2Yr Treasury tracked the move, but the longer end of the curve remained range-bound as investors chose to lock in longer term rates.

	BC MMS/I	MLCG1-10
1994	-2.09%	-1.93%
1995	12.49%	15.33%
2005	1.38%	1.71%
2006	3.71%	3.99%

* Index (Barclays Managed Money Short/Intermediate and Merrill Lynch Corp Gov 1-10Yr) Returns for calendar years 1994, 1995, 2005, and 2006. Source: IDC

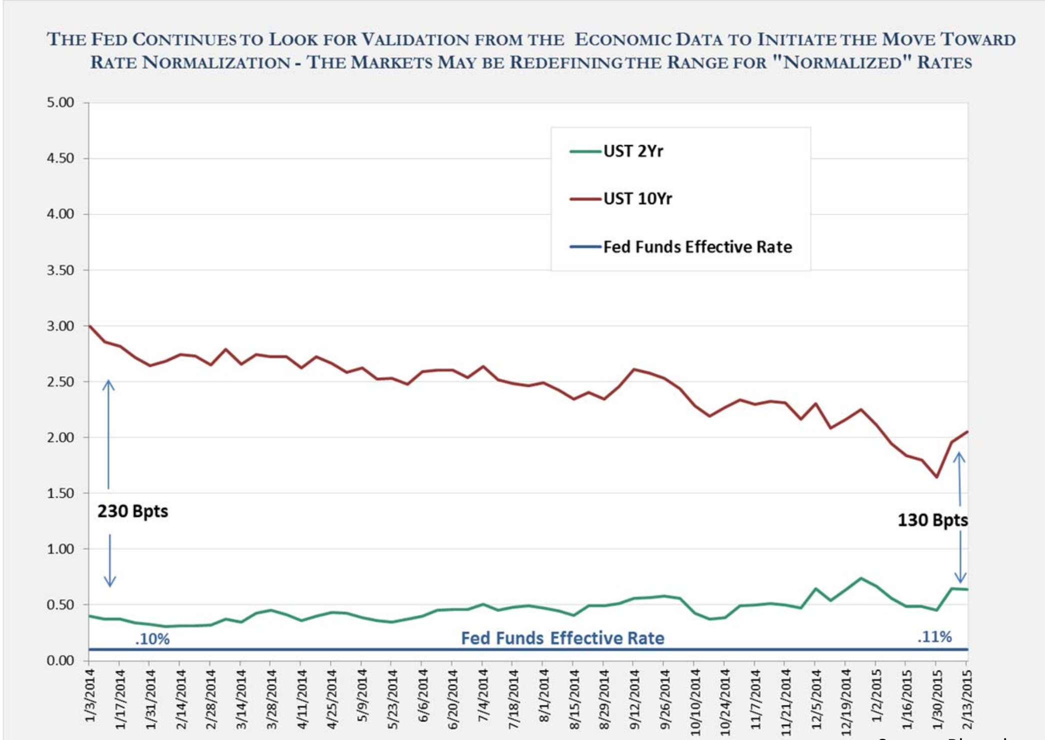




APPLETON PARTNERS, INC. ONE POST OFFICE SQ. BOSTON, MA 02109 TEL. 617.338.0700 WWW.APPLETONPARTNERS.COM

2014–2016
The Market is Already Adjusting to the Prospect of Rate Hikes
"The Committee expects inflation to rise gradually toward 2.00% as the labor market improves further and the transitory effects of lower energy prices and other factors dissipate."
FOMC Statement December 17, 2014

As the markets emerge from the financial meltdown of 2008 and 2009, and Fed Funds hover in the 10bp range, the anticipation of higher short term rates sometime in the next 12 months is already driving the curve flatter. Other factors, like ECB policy and very low global inflation, contribute to the demand.



Source: Bloomberg

Conclusion: History Teaches Us That Even in Cycles with Fed Funds Rising Significantly and Quickly, Investors with Intermediate Term Portfolios Can Experience Positive Results Over a 12 – 24 month Period

While higher short term rates will impact the shape of the yield curve, there is a likelihood that the short and intermediate areas of the curve will continue to converge, just as they did in 1995 and 2005. Today's futures market has built in an initial rate hike in late-2015, which may be too aggressive if dollar strength and global economic weakness persist. In any case, a gradual rise in rates in this cycle, unlike the extreme move in 1994 or the bigger move in the 2004-2006 period, will allow markets to adjust over time. Investor appetite for duration without significant rate risk should continue to benefit the intermediate area of the yield curve. Central Banks will have little reason to remove accommodation aggressively in an increasingly tentative global economy.