APPLETON *PARTNERS,* INC.

QUARTERLY MARKET OVERVIEW – QI 2013

On the heels of strong returns in 2012, the stock market has been relentless in its rise to start the year, while fixed income markets have been range-bound. Despite the various geopolitical concerns that have arisen, the S&P 500 Index rose to all-time highs to finish the first quarter up 10.61%.

There were several reasons for the strong returns seen in the equity markets. Positive economic data further legitimized the recovery, and more importantly boosted investor confidence. Housing and manufacturing reports were viewed favorably, especially during the first two months of the quarter. The results from the latest round of US bank stress tests proved largely positive, clearing the path for more return of capital to shareholders by financial stocks. After a mildly disappointing third quarter earnings season that led to reeling in of expectations, investors applauded the return to a better than 60% earnings estimate beat rate from S&P 500 companies in the fourth quarter. Despite the lingering political overhang of fiscal budget uncertainty, resolution, even in the form of sequestration, was a welcome sight to executives, as it allowed for more predictable guidance. The most instrumental element driving equities higher, however, continues to be the Federal Reserve, as investors believe monetary policy actions will remain accommodative should the economy be threatened. This phenomenon was again made apparent as investors quickly shrugged off potentially threatening events in Europe, and a disappointing March jobs report, to rally to new highs.

European worries were reincarnated in the second half of the quarter as headlines out of Italy and Cyprus temporarily spooked investors. Similar to the Greek election issues of last summer, elections in Italy were closer than expected, with the party opposing austerity garnering a larger share of the vote. This shook investor confidence that the country wouldn't abide by their side of the deal. Sovereign yields spiked and the stock market took a small step back in turn. While the news out of Cyprus did not materially impact the stock market when it broke, the potential long term impacts could be more meaningful. The taxation of depositors in the small island nation's largest banks sent shockwaves around the financial world. The realization that money was in jeopardy in the bank was a dangerous precedent, and the fear that the political leaders of Europe could and would use it as a tool going forward hurt investor confidence.

Geopolitical tensions in other parts of the world also flared up this quarter as tough talk out of both Iran and North Korea forced everyone to sit up and take note. With nuclear capabilities in question, Iran is threatening the delicate balance of mid-Eastern politics and forcing the US into the fray. North Korea's saber rattling might be just that, but a young, radical leader looking for attention cannot be ignored. It is remarkable how fleeting investor concern has been over these issues, and while they haven't been significant factors thus far, they certainly bear watching per chance investor confidence slips.

For fixed income assets, US 10 Year Treasury rates rose modestly through the winter in reaction to improved investor confidence in the equity markets, and have traded in a band between 1.57 - 2.05% for the first quarter of 2013. The geopolitical events and data triggered dips in rates at times as investors rushed to safety. The taxable Merrill Lynch US Corporate & Government 1-10 Year Index returned 0.20% in the quarter, while the municipal Barclays Managed Money Short/Intermediate Index rose 0.34%. The dovish nature of the Federal Reserve should keep a lid on interest rates in the near term, and we expect the bond market will remain range-bound. The yield curve could potentially steepen later in the year if the economic expectations improve, further emphasizing the need for agile active bond management.

Much has been made over the past three months of the so called "Great Rotation". Many talking heads and market pundits have been calling for the end of the bond market bull run, claiming that rates cannot go any lower, and that we should see a large amount of resources reallocated from bonds into stocks. The numbers tell a different story according to a report by Strategic Insight, which provides mutual fund analysis and intelligence. For the first two months of the year, bond fund inflows have virtually matched last year's pace of $68 billion, while equity funds' inflows of $76 billion are more than five times the amount posted through February of last year. At its current pace, U.S. equity fund flows would be net positive for the first time since 2006. We are not choosing a side here, merely pointing out that the money pouring into equity funds is not coming out of bond funds, rather out of money market funds and cash equivalents.

According to Barclays, when the first two months of the year are positive for the S&P 500 Index, the average return for the full year is 19%, and the market hasn't finished down since 1951. While this would imply that the stock market rally will ride on, there are inconsistencies worthy of attention. One remarkable element to the strong equity performance we have witnessed in the first quarter is the rotation out of cyclicals into more defensive sectors. Staples, Healthcare, and Telecom stocks have been the strongest performers through the first three months of 2013 and this speaks to the skeptical nature of the rally. While money has flowed into equities, it is being put to work in the traditional "safe-haven" sectors. Investors need to see sustained economic growth before they cycle back into the more economically sensitive sectors. Furthermore, we believe that this rebalancing back into the cyclical sectors needs to take place for the stock market to continue its healthy march forward.

Labor reports have been inconsistent from January through March, however the positive February payrolls report set the tone for the market for much of the quarter. The reality of the jobs numbers are that many of these new jobs are part-time positions and given the amount of people dropping out of the labor force calculation, there is quite a bit of hiring still needed to foster a significant increase in wages and spending. The continuation of these labor data inconsistencies should steer more attention towards corporate earnings as well as Fed policy, given the FOMC's explicit targets for unemployment and inflation. With unemployment a full percentage point above the stated 6.5% goal, and inflation relatively scarce, the Fed will feel justified in continuing their accommodative approach. As for earnings, this coming report period will shed more light on expectations for the year and specifically how concerned companies are regarding the spending cuts and payroll tax headwinds. Guidance should bear significant influence over the duration of the current bull market.

We will continue to closely monitor economic and market signals. Though the path of least resistance remains upward for equities, uncertainty still remains and threats to confidence could lead to some corrections. Meanwhile easy money policies should continue to encourage equity investors, though focus on sector leadership rotation will be important. With fixed income markets likely range-bound, additional emphasis will be placed on our ability to manage our security selection and positioning along the yield curve.

As always, we welcome your comments and questions. Please contact us if there are any changes to your financial situation or investment objectives.

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