QUARTERLY MUNICIPAL REVIEW – QII 2013

The recent 2nd Quarter sell-off in bonds seems to have provided temporary vindication to those "Bond Bears" who have been looking for higher rates for the past 4-5 years. A quick snap back though in the final week of the quarter took some of the wind out of the Bears' sails. The magnitude seemed well overdone coming into the first week of the summer and the onslaught of selling provided ample opportunities for buyers to find municipal bonds at levels not seen in years. The market has calmed and we are back to discussing whether the hints of economic strength have staying power. The pent-up concerns about the market will likely translate into a time of increased volatility, and while sellers currently outweigh buyers, the volatility will likely remain for some time to come. This selling has been most acute for Municipal Bond Mutual Funds, especially longer duration funds and their high yield counterparts.

Internally, we often measure ourselves in comparison to more retail-oriented offerings like mutual funds or the increasingly popular ETFs, which are sold primarily on yield. Over the past quarter our intermediate benchmark, the Barclay's Managed Money Short/Intermediate Index, was down -2.23%, and year-to date it has declined -1.90%. It is important to put these figures into context versus a Fund or an ETF in order to give a proper perspective of how a well-positioned intermediate Separately Managed Account (SMA) can offer protection to investors. When we look at the performance of the bell weather Vanguard Intermediate Fund or relative newcomer iShare's Municipal Bond ETF ("MUB"), the story changes. Since flows out of municipals have picked up, the Funds and ETFs have been hit hardest and given their retail focus and active secondary market it is not a surprise that these portfolios have been underperforming. The Vanguard Fund was down 2.91% in the quarter and is down -2.53% year-to-date, while "MUB" was down -4.97% year-to-date, and at one point during the height of the sell-off was down a full -8.3%. Tracking error of ETFs and funds to their indices has long been an issue and this becomes quite evident during volatile markets. As other shareholders redeem shares, a Fund must raise cash through forced sales. These can often present opportunities for Appleton and other active managers as bonds trade at market clearing levels that tend to be very cheap. Since we feel there has been minimal material change to the economic outlook, we have been aggressively investing cash and maintaining our duration in the Intermediate strategy.

In fact, we feel that this recent sell-off has provided further evidence for the value of our disciplined approach. We are often asked what we will do when rates rise and how we will position the portfolios. Even though we do not feel a large rate increase is imminent, we feel it is important to always be thinking about the dramatic turns that can happen on a dime in the municipal market. These times emphasize the importance of buying liquid and marketable securities for our clients, and supports our focus on buying large issuers, above market coupons, solid call protection (2-3 years between the call and maturity), and high grade credits. These four facets have always been at the core of our strategy, have helped us weather the recent volatility, and are critical in times of decreased market liquidity.

While the yield curve was relatively unchanged in the 1st quarter, cash flows into municipal mutual funds had helped absorb the slight up-tick in new issuance. The tide changed in the 2nd quarter, as all but two weeks experienced outflows from Municipal Funds. Over the quarter, $12.7 billion came out of funds, leaving the year-to-date fund flows at negative $5.8 billion. 2nd Quarter issuance was well off expectations, as refundings dropped and higher rates in the latter half of the quarter led to a number of deals getting pushed off. For the quarter, total Municipal issuance came in at $89.5 billion, 23% lower than in 2012. New money issuance had been strong in the 1st Quarter, but slowed in the 2nd Quarter, resulting in an overall decline for the first half. Of interest is the increasing amount of taxable Municipal issuance, with $24 billion in the 1st half, up 89%, versus net tax-exempt issuance, which is down 19%. In light of the decreased tax-exempt issuance and rate moves experienced in the 2nd Quarter, expectations for issuance in the 2nd half of 2013 are being scaled back. Merrill and Citi dropped their 2013 issuance to $330 and $350 billion, respectively, $50 billion off their January projections. The drop in issuance could provide an underpinning of strength for the municipal market, especially as we are entering a period of sustained net negative issuance.

We entered the quarter with Municipals fairly cheap versus Treasuries, with the AAA Municipal/Treasury ratios above 100% for 2, 5, & 10 Yrs. These valuations helped municipals outperform their taxable counterparts in the 1st half of the quarter, when the 10Yr AAA Muni/Treasury ratio rallied to 93.3% from 102.1% by mid-May. As the outflows increased and munis were pressured further, the ratio temporarily reached 110% and finished the quarter at 101.6%. Readings above 100% are typically beneficial entry points into the muni market and, in fact, when the recent selling pressure brought the ratios as high as 110%, cross-over (taxable) buyers started actively buying municipals. A combination of the valuations and decreased issuance should help support our market during the increased volatility.

The economic back drop continues to send mixed signals. The employment picture has been trending higher with May's report coming in at 175k but the unemployment rate increased to 7.6%. The widely known levels of 225-250k needed to spark some growth on the job front have not happened. Very low labor participation rate levels last seen in the 1970s are artificially keeping the stated unemployment rate low at 7.6%, but the underemployment rate is unofficially at 13.8%, and until this figure drops, we do not foresee sustainable economic growth. 1st Quarter GDP was revised lower to 1.8% and expectations are for the sequester cuts to continue to pressure GDP growth, with expectations for the 2nd half of the year at 2%. Home prices, new construction, and sales are all continuing to improve. However, the recent rise in interest rates pushed mortgage rates above 4%, initially slowing refinancings. These mixed signals are accompanied by benign inflation, which is helping to keep rates low. The Fed's trigger of 6.5% unemployment and 2.0% inflation are not in danger of being met and will contribute to the Fed's need to keep rates low until 2015. We believe this will not derail the overall housing recovery as home prices are positively contributing to sentiment through the wealth effect. Given that this segment is a significant positive for the economy, it bears watching closely for any sort of weakening.

The credit picture remains mixed as states are improving with revenues continuing to increase year-over-year, but local credits remain challenged. Preliminary 1st Quarter state revenues were up 9.3% over Q1 2012, led by personal income tax receipts, which were up 17.6% according to the Rockefeller Institute. Defaults continue to be a diminishing concern, with only $2.2 billion in 1st time defaults year-to-date, according to Merrill Lynch, which represents 0.059% of total munis outstanding. Detroit was among the defaults this year, which caught the attention of the Municipal community. It has been a distressed credit for some time and the recent announcement that the city was going to cut payments to unsecured creditors was a surprise for the market. The city defaulted on Certificate of Participation debt in June and has hinted that it could possibly default on GO debt. This would be unprecedented and a bondholder fight would ensue to challenge the city, who is trying define GO backed debt as an unsecured obligation. While Appleton Partners' clients do not own Detroit debt, we will be watching this case closely.

With yields increasing across the curve throughout the 2nd quarter, longer duration bonds hurt performance and volatility also pressured credit spreads, thus lower-grade credits underperformed higher-grades in the quarter. The Barclay's Long Bond Index was the worst performing segment of the market, down 4.35% for the quarter and 4.07% year-to-date. Meanwhile, the 1 Yr index was the best performer in the quarter, at 0.03% and 0.31% for the first half. High grades outperformed lower investment grade over the quarter, with the AAA index off 2.49% and the BBB index off 3.56%. In light of this, our longer intermediate exposure, especially recent purchases, hurt our performance in the quarter. In addition, our exposure to A rated bonds detracted from performance as volatility led to wider credit spreads.

We anticipate that the remainder of 2013 will be filled with volatile trading based upon economic head fakes and budget news out of Washington, while in the end, the Fed has been very clear that it remains on hold through 2015. Threats of tapering bond purchases is obviously driving the markets right now and with this in mind, we expect the front end of the yield curve to be anchored. After such a significant steepening trade in the 2nd quarter, we anticipate that the market will settle into these new rate levels and will continue to be data dependent. It is possible we could see some pressure on longer term bonds, which will result in further curve steepening. Managing our yield curve exposure in the 2nd half of 2013 will once again be a large component of success throughout the remainder of the year.

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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