Now that it's over, we can thank 2013 for providing us a new interest rate environment, although one marked by increased volatility. With the US economy showing hints of emerging from the stresses of the *Great Recession,* we were first hit by Taper talk in the spring, which drove yields higher over the course of the year. A combination of increasing yields from the Taper discussion and a few high profile municipalities garnering alarming headlines, namely Puerto Rico and Detroit, was more than enough to fuel the record outflows experienced by municipal bond mutual funds over the year. As if these stresses were not enough, when you throw in the political risks coming out of Washington due to partisan fighting, we find ourselves thankful to have 2013 behind us.

Although economic reports in 2013 were beginning to show signs of life, we remain watchful as recent reports have been mixed. While October and November's jobs reports were better than expected with sizable new job creation causing the unemployment rate to drop to 7.0%, the December report released in January reflected job creation well below expectations, and a drop in the labor participation rate to 35 year lows was responsible for the unemployment rate falling to 6.7%. Consumer confidence has flattened, but remains reasonably strong, while the ISM number (a gauge of economic activities) has been steadily improving to the current 57, from a low for the year of 49 in May. Concerns of inflation remain benign, and given the need for global accommodation, the risks of deflation are now being discussed. Commodity prices have continued to decline, with gold notably hitting multi-year lows, agricultural prices down, and energy prices sliding to a lesser extent. Home prices, new construction, and sales have leveled off and rising interest rates have been largely to blame as many of the transactions have been investment driven decisions. This less than stellar economic outlook is contributing to our benign rate forecast for 2014.

With the perception that economic data was strengthening as 2013 drew to a close, the market was focused on the timing and magnitude of a Fed response (Taper) contributing to another sell-off in municipal and Treasury rates the last 2 months of the year. After rising 20-30 basis points in anticipation of a Taper announcement, rates finished 2013 within a couple of basis points of levels when the $10B taper announcement was made in mid-December. We expect the Fed will continue to taper its purchases if job gains stay on track, while additional weak economic reports, like the December jobs report, may cause the Fed to "Taper the Taper!" The interest rate increases and evolving economic forecast contribute to our thinking that yields in the intermediate to longer-end of the yield curve may increase in the near term. With this new information, we are adjusting our trading range for the 10-Year Treasury from 2.50%-3.20% to a 2.80%-3.50% range. We anticipate these higher rates and the steeper curve in the first half of the year will present an opportunity to reposition portfolios in the new rate environment.

The other major theme this year was the weekly outflows experienced by municipal mutual funds, with issuance simultaneously dropping considerably compared to 2012. We ended 2013 with 32 consecutive weeks of outflows, bringing total outflows for the year to $62.7 billion. The outflows influenced selling across the curve, although long-term funds suffered the largest, with 79% of the total. In a normal year of municipal bond issuance, the magnitude of outflows would have made it difficult for dealers to place new issues. However, with overall issuance down $50 billion in 2013, or 13% of the prior year, the new issue market was well received by investors. Dealers remain capital constrained and buyers are value-oriented, a combination which led to a primary market that was well priced (cheap) and often met with many more buyers than bonds. This 'over-subscription' was typical in the 1-10 year part of the curve on new deals with strong credits. The value opportunities we found in the new issue market drove our participation in that segment of the market.

Navigating a market plagued by increased interest rate volatility, mutual fund selling, and strong demand in the 1-10 Year part of the curve stresses the importance for Appleton to focus on the bond structures that we buy. Our bias towards premium coupon bonds and strong call protection helped us avoid the whipsaw on duration that many lower coupon, short call structures experienced in the summer sell-off. As rates increased in 2013, lower coupon bonds issued over the last 3-5 years are now trading at a discount to par and some of these bonds have prices that are trading close to their market discount cut off price. We continue to buy premium coupon bonds in order to cushion our portfolios from the adverse impacts of bond extension and pricing closer to the market discount cutoff price. In addition to this benefit, higher coupon bonds offer a higher level of cash flow and also reduce the interest rate sensitivity versus similar lower coupon bonds.

After a big flattening of the AAA municipal yield curve in the end of the 3rd Quarter, the market experienced weakness in the 10-Year part of the curve and longer during November and December. With short bonds anchored in the 1-2 Year range, weakness in longer bonds caused the curve to steepen again. Thus longer duration bonds underperformed and the short end,

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held its own. For Q4, the 3-5 Year segments of the yield curve were the best performers, with the Barclay's 5-year municipal index returning 0.84%, while the Barclay's 10-year was the worst part of the yield curve for the quarter, returning -0.10%. Over the year, long duration hurt, with the Barclay's Long Bond Index down more than 6%.

There was very little change in credit spreads as a whole over the quarter, yet specific credit events did influence trading in individual names throughout 2013. After Illinois signed pension reform into law, spreads on the State's bonds tightened, leading it to be one of the best performing states over the 4th quarter. Meanwhile Puerto Rico continued to feel selling pressure leading it to be the worst performing state/sovereign in the 4th quarter, and the year for that matter. Appleton has no exposure to Puerto Rico paper after exiting our position in the sales tax-backed bonds in October. With the Commonwealth remaining under scrutiny and the largest buyers of the name currently being Hedge Funds, we remain comfortable in our decision to sell our position. This is especially true after Moody's and Fitch put the Commonwealth's GO credit on negative outlook, feeding right into our thesis that further deterioration of the GO credit would impact the Puerto Rico Sales Tax bonds.

THEMES FROM 2013 THAT WILL CARRY OVER TO 2014:

STEEPER YIELD CURVE – The Fed Funds rate is anchored at 0% - 0.25% and until we see a meaningful economic turnaround or growing inflationary pressures, the Fed will keep the yield curve very steep, into 2015. We do anticipate some initial selling in the 1st quarter causing the intermediate to longer-end of the yield curve to come under pressure, which we will look to trade into when the time comes. Currently the AAA 2Yr - 10Yr spread is 244 bps, after starting 2013 at 141 bps.

NEGATIVE HEADLINES PERSIST – While Detroit proceeds through its bankruptcy process and Puerto Rico's economy and fiscal position remain under a microscope, there will be plenty of headlines that will garner investors' attention. Although the credit deterioration experienced by these names is an issue, these credit events are isolated and there remains a large component of the market that is experiencing credit improvement.

OVERALL CREDIT IMPROVEMENT – Growing revenues, continued cost restraint and limited debt issuance led to improving credit quality at the State Level. Largely driven by increasing personal income tax receipts, state coffers are expanding and Moody's indicated that State's average reserves have increased to the 10-Year median of 4.5%. The resulting stronger state budgets, moderate economic growth, and an improving housing market have contributed to credit improvements for Local GOs. Default levels continue to decline.

NEGOTIATING THE MUNICIPAL ISSUANCE/MUTUAL FUND OUTFLOW SEESAW – At this point we do not anticipate the direction of municipal bond fund flows to reverse. The decline in issuance helps to dampen the effect that these outflows could show. When the flows do abate, we anticipate improved liquidity in the market place. We expect total municipal issuance to drop from 2013 levels as refundings remain under pressure due to the higher rates, and new money issuance will increase but not enough to offset the drop in refundings. Traditional tax exempt issuance as a percent of total issuance has been dropping. This decline in issuance coupled with the large amount of maturities in 2014 will likely lead to another year of net negative issuance.

WASHINGTON DC REMAINS A WILDCARD – A lack of consensus in DC gave us a government shutdown last year and will likely cause headlines as Legislators address the debt ceiling, budget deficit issues, and more importantly a mid-term election in November. The latter will likely leave any discussion of tax overhaul on the sidelines, which should limit discussion on changing the tax exemption of municipal bonds. The markets will also get used to the new Yellen-led Fed, although expectation is for a continuing dovish stance.

Our feeling is that volatility is here to stay and will be part of the investment process going forward. It is our goal to manage the increased volatility and incorporate it into the portfolio management process. Benign inflation expectations and lackluster economic output drive our expectations for interest rates to remain in a trading range for the foreseeable future. The curve will remain steep and could potentially get steeper, with pressure on the longer end of the yield curve. With this in mind, we continue to find value in the 5-9 Year part of the curve and will continue to manage to our duration target of 4.7 years. Diligence from a credit standpoint remains important and we will follow the case studies being played out in Detroit and Puerto Rico closely.

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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