QUARTERLY TAXABLE REVIEW – QI 2013

"To be, or not to be, that is the question: Whether 'tis Nobler in the mind to suffer the Slings and Arrows of outrageous Fortune or to take Arms against a Sea of troubles … and by opposing end them." Hamlet, Act III

This was the moral dilemma plaguing Chairman Bernanke, and the markets, early in 2013 – "To QE or Not to QE" – and it reflects a quandary that has evolved both inside and outside the Fed. The markets became obsessed in QI by the debate, as the minutes of the December FOMC meeting, released in January, reflected a broader discussion around the removal of accommodation and its impact on the markets. With the Fed's balance sheet approaching $3.3 trillion, and growing, two questions come into play:

- Are the balance sheet purchases achieving the stated dual mandate by contributing to an improvement in labor market conditions within the context of price stability?
- Is it possible that the longer term effects of asset purchases could undermine financial stability over time?

Just as the debate was intensifying at quarter-end, pockets of weakness in our domestic recovery, the growing intensity of the recession battle in Europe, and the decision by Japan to "QE" all converged to support Bernanke in his current policy stance. The March 20th FOMC meeting was followed by the following turn of events:

- A weak March employment report (Nonfarm Payrolls grew by only 88,000), weak PPI data (MOM -0.6%) accompanied by a significant sell-off in commodity prices (Gold closed the quarter at $1596, heading to a low of $1361 on 4/15), weak Industrial Production data, and an unexpected drop in Retail Sales (-0.4%).
- A three year bailout plan for Cyprus funded by: €1.0 billion from the IMF, €9.0 billion from the EU (in 15-20Yr loans), and a remaining €13.0 billion to be internally produced by Cyprus, at least in part funded by "bail-in" money generated by the banking system.
- A decision by the BOJ on April 4th to pursue a bold policy of monetary easing by doubling asset purchases and broadening the range of assets that qualify in an effort to achieve a 2% inflation goal.

The combined result of a domestic recovery that is still tentative and a global recovery that continues to struggle, once again has offered Bernanke the cover he needs to maintain monetary accommodation – in all forms – well into 2014 and beyond, and then the March minutes released in early April, confirmed this. After achieving a quarterly high of 2.06% on March 11th, these recent market developments pushed 10Yr Treasury yields back in early April to their mid-December low of 1.70%, where it does find some resistance. The impact of sequestration, tax increases, and further budget cuts will create additional headwinds to the economy as we move into the 2nd quarter, increasing the likelihood throughout 2013 that we will maintain the current trading range. As we enter QII, the IMF has lowered its 2013 global growth forecast from 3.5% to 3.3%, perhaps a harbinger of things to come.

WITH RATES AT HISTORIC LOWS, CORPORATIONS ARE BUILDING RESERVES AND STRENGTHENING BALANCE SHEETS

In a recent report issued by Moody's Investor Service, they noted that US non-financial companies rated by Moody's held $1.45 trillion in cash as of year-end 2012, up 10% from the record level of $1.32 trillion at the end of 2011. As we look at the strength of corporate balance sheets, while leverage generally has drifted lower, there has been a tendency for borrowers to hold cash. The uncertainty spurned by potential changes in our domestic tax structure, changes in the regulatory environment, the longer term impact of things like sequestration, and the scarcity of investment opportunities in certain industries, have all combined to encourage this strategic move. Much of the cash is held overseas for tax reasons, with estimates currently at $840 billion, or approximately 58% of total cash. While there were increases in Capital Expenditures and Dividend payouts and acquisition spending remained constant, there were slight decreases in share buybacks in 2012. Emblematic of this trend, Apple, the largest of the US cash-rich companies ended 2012 with approximately $137 billion in cash, more than twice that of number two Microsoft. Early in QII, Apple announced that they will issue debt to increase the dividend by 15% and to fund a share buyback program. Technology, Healthcare, Consumer Products, and Energy are building cash reserves at the fastest pace. It would seem that many of these companies have adequate cash on hand to cover debt for the next five years. It is not surprising that spreads have tightened, and will continue to tighten, versus a Treasury that has debt exploding on its balance sheet.

WITH LITTLE CHANGE ON THE RATE FRONT, QI 2013 API RETURNS WERE DRIVEN BY A CONCENTRATION IN FINANCIALS AND AN OUTPERFORMANCE IN THE TECHNOLOGY SECTOR

Despite Treasury rates edging slightly higher in the quarter, the combination of spread tightening and the rolldown effect on the positively sloped yield curve contributed to performance. While the crisis in Cyprus plagued the European Banks in QI, US Banks and Financial Services firms de-coupled and continued to tighten into mid-March. The late March widening ended nine straight months of positive or flat excess returns from June 2012 through February 2013 according to Barclays Capital. Appleton took advantage of the tightening and lowered Banking exposure slightly in QI from 19.3% to 15.6%. We believe discussion around the implementation of Dodd-Frank will periodically create opportunity in large high quality issuers in the sector.

Coupon structure makes a significant contribution during periods of little or no rate change, but the scarcity of these bonds in the secondary market creates an ongoing challenge. It is also important to note that the benchmark coupons are declining rapidly as this rate environment produces more and more new issues with 1.25%-2.50% coupons. Our composite coupon is currently 5.00% versus the Merrill GC 1-10Yr at 2.73% and the Barclays Intermediate GC at 2.69%.

APPLETON PARTNERS' TAXABLE FIXED INCOME STRATEGY

We continue to subscribe to the belief that the Treasury market has little room to appreciate in a meaningful way from these levels for the foreseeable future. The Agency sector is shrinking from an issuance perspective and liquidity is not deep, particularly on callable issues. Our current sector mix is high quality Industrials, Financials, and Taxable Municipals. While Taxable Municipal issuance was up in the quarter, the low coupon structures in the new issue market forced us to look to the secondary market, where supply was limited. We continue to leverage our expertise in this area and uncover value whenever there is opportunity. Because of our current lack of exposure to Treasuries, we are not aligned from a sector perspective with our benchmark and extreme Treasury moves that do not flow into spread product will impact performance on a relative basis. TIPS continue to struggle in the face of the current disinflationary environment. As we move through the rate cycle we will look to identify an appropriate re-entry point for that Treasury sector. With prepays beginning to slow, we are reviewing the Agency MBS sector as an additional means of diversifying our strategy. As we approach mid-year we will continue to be tactical in our approach to both sector exposures and yield curve positioning. We expect that Chairman Bernanke will continue to rise above the voices that question the Fed strategy.

"Tis the times' plague, when madmen lead the blind."
King Lear, Act IV

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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