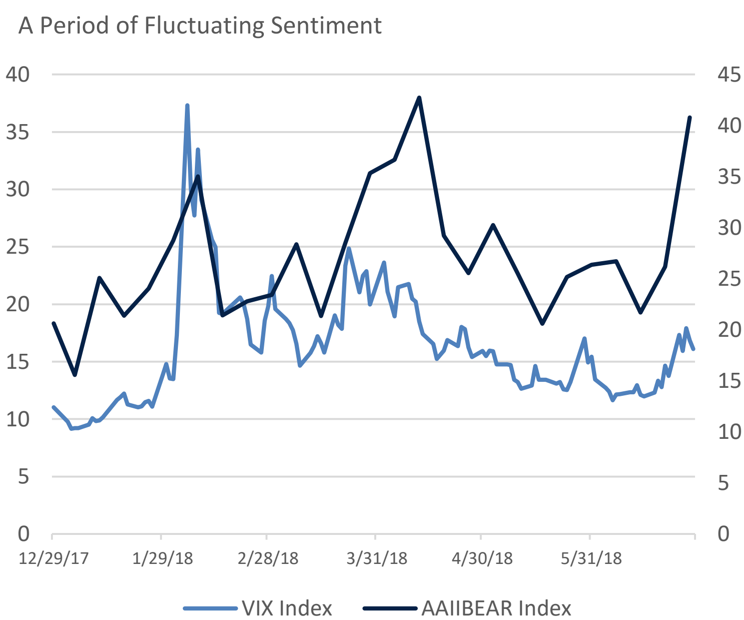
Reading Markets and Emotions

> "While investment markets, unlike novels, have no natural beginning or end, we feel clear parallels can be drawn, most notably the importance of focusing on the broader narrative rather than whatever short-term story is currently in vogue."

First published in 1979, Italo Calvino's novel "If On A Winter's Night A Traveler" is a whimsical tale told through alternating chapters of one's experience reading Calvino's novel, and the actual text of the novel itself. A series of printing errors, forgeries, lost manuscripts, and various other surprises conspire to interrupt the reader at critical points in the story, each time returning the reader to the start of an entirely new text. Over time, the story gradually becomes the reader's search for the novel, rather than the series of incomplete tales initially presented as the story. The experience is jarring, confusing, and disorienting, or in other words something an investor looking back at the first half of 2018 might find oddly familiar.



Source: Bloomberg, Chicago Board Options Exchange, and AAII

The Chicago Board Options Exchange Volatility Index (VIX) reflects a market estimate of future volatility, based on the weighted average of the implied volatilities for a wide range of option strike prices.

Reproduced with permission from the American Association of Individual Investors (AAII). The indices reflect the sentiment of individual investors towards the stock market over the next 6 months. AAII polls indicate the bullishness and bearishness of the stock market.

From January's fears of an intentional devaluation of the dollar, to February's inflation scare, to March's announcement of steel and aluminum tariffs, to a resurgence in inflation worries in April, followed by nervousness about a flattening yield curve and trade wars returning to the forefront in May and June, the market has struggled to hold onto a consistent theme for more than a few weeks. Meanwhile, although the 10Yr Treasury yield spiked at the start of the year, both interest rates and US stocks have since spent the first half of 2018 trading sideways, unable to find a clear direction. So, when the micro-narrative seems jarring, confusing, and disorienting, taking a step back and looking at the larger story can sometimes provide a clearer picture.

For the most part, a ten-thousand-foot view reveals a US economy that's in pretty good shape. There is evidence that GDP growth has slowed somewhat since the strong fourth quarter of 2017, although with manufacturing surveys showing strong business confidence, inventories unusually low, and hiring still strong, there are good reasons to expect very strong Q2 GDP growth and a solid Q3. Despite unemployment touching 40-year-lows, wage pressures remain contained, and aggregate inflation measures may have slowed over the past two months. US corporate earnings are still growing at a rapid clip, and increasingly the US economy is outpacing most of the world.

Nonetheless, the market's continually shifting narrative reveals skittish investor sentiment. We are now entering the ninth year of economic recovery, the third longest in modern history. The fact that the source of fear rarely stays the same for more than a few weeks matters less than that the market is not only constantly afraid, but appears to be desperately looking for something to be afraid of. This is probably healthy. An old industry saying is that the surest sign of an impending recession is when no one is worried about an impending recession. Any of the themes from the first half of the year certainly could manifest themselves in a sustained equity market correction. In particular, we suspect we will be discussing trade concerns in our upcoming monthly "Review and Outlook" commentaries (and if you do not currently receive these and would like to, please let us know and we would be happy to add you to our distribution). Investors have every right to be nervous.

At the same time, a period of consolidation after two years of strong equity market performance gives underlying earnings time to support valuations, while interest rates remaining in a trading range after an abrupt rise offers investors time to digest and reposition portfolios. Supply and demand imbalances remain a source of support in the Municipal market, and sustained balance sheet strength coupled with relatively weak issuance is backstopping Investment Grade Corporate credit. Investors should be skittish, but they should also allow themselves to remain cautiously optimistic.

In Calvino's novel, the reader eventually, with the assistance of a second reader met along the way, is successful in tracking down the manuscript of the novel, and the novel concludes as the reader finishes the original story. While investment markets, unlike novels, have no natural beginning or end, we feel clear parallels can be drawn, most notably the importance of focusing on the broader narrative rather than whatever short-term story is currently in vogue. While the market's attention and investor emotions will continue to be drawn to risk after risk in rapid succession, concerns to which the Appleton team will remain vigilant, in our opinion the broader story remains favorable. Despite the market's jagged nerves, there's a fair amount of cause to stay optimistic given the fundamental backdrop that supports today's equity and debt markets.

Market Observations & Implications	
Tax-Exempt Investment Grade Municipals	• YTD fund flows of $7.12 billion are supporting strong technicals, including negative net issuance. JP Morgan anticipates $75 billion in net negative issuance during 2018. • 10Yr AAA Muni/Treasury Ratio sat at an attractive 86.3% level as of June 30th, despite being 2% richer on a relative basis vs. the prior quarter end. • The municipal curve steepened a bit during Q2, with 2–10Yr AAA spreads of 82 bp, up 5 bp over the quarter. • We are targeting duration on the Intermediate curve at 4.50-4.75 years, in line with the Index. • Sustained economic and fiscal strength are bolstering state budgets, and reserve funds. Nonetheless, pension and other fixed cost obligations remain an acute concern for certain issuers, creating clear credit demarcation. • The Supreme Court's 5-4 ruling in Janus vs. AFSCME banned public unions from requiring non-union members to pay dues. This should facilitate pension reforms and moderate union wage pressures, although the impact will take time and be focused on heavily unionized states with sizable unfunded pensions.
Investment Grade Corporates & Treasuries	• $90 billion of new M&A-related investment grade corporate debt has hit the market YTD; the largest share was a $40 billion CVS deal to fund its acquisition of Aetna. According to HIS Markit, investment grade notional credit shorts of $55 billion now represent a post-crisis peak. • We feel investment grade risks are issuer specific and not reflective of a decline in overall credit conditions. In the face of rising borrowing costs and late cycle economic uncertainty, we are emphasizing quality and look for strong balance sheets, cash flow, and operational strength. • A 10Yr UST trading range of 2.50-3.00% remains intact. We expect to remain within these parameters for a sustained period given signs of global economic weakness and constrained inflation.
Equities	• The equity markets rebounded in Q2 following a negative Q1. Stock values are supported by US economic strength, earnings, reasonable valuations, and large cash returns to shareholders. Risks include growing trade war fears, tighter monetary policy, and peak cycle concerns. • In the long term, stock prices tend to track corporate earnings. With S&P 500 earnings growth of 20% expected for the balance of 2018 and roughly 10% in 2019, stocks should continue to find support. • Growth continued to outperform value in Q2. • Fed tightening is putting pressure on the short end of the curve and the equity markets are watching for further flattening. However, the yield curve has not inverted, and when it has historically done so there has been an average 18 month lag before stocks moved into sustained decline.

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