APPLETON PARTNERS, INC.

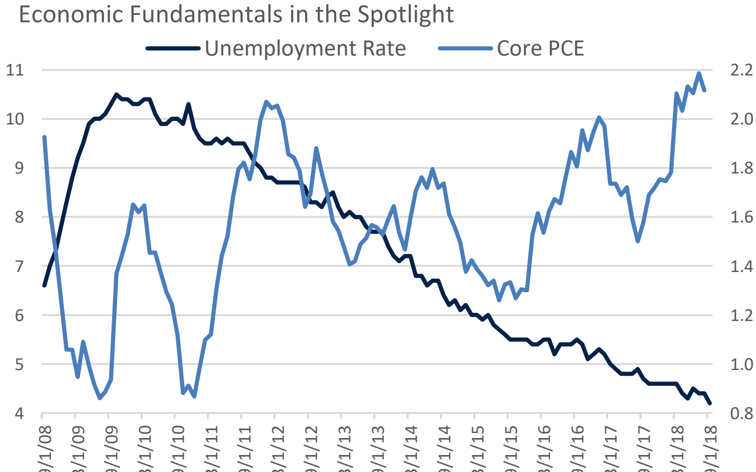
A Long Winning Season Forges Ahead

"Hall of Fame catcher and noted baseball sage Yogi Berra famously quipped, 'It ain't over till it's over.' His aphorism is usually taken as a never-say-die rallying cry for underdogs and longshots, but it's also good advice when you're riding the highs of a winning streak."

Baseball is an autumn tradition here in Boston. This city's storied affair with the sport hasn't always been a pretty one, most famously for an 86-year-long World Series dry spell we finally broke in 2004. The past decade and a half has been a little kinder to us, however, and this year may be no exception. Despite a rocky September, the 2018 Red Sox led the major leagues with a franchise-record 108 wins. While most of the city has been focused on this record, we at Appleton have been concentrating on a slightly different one. On August 22nd, the S&P 500 broke the previous record for the longest stock market rally in history, rising without a 20% correction from its lows of March 9th, 2009. Over the nine and a half years following that low, the stock market has risen nearly 430%. This recovery hasn't always been pretty either, but a scan of the economy today shows plenty of evidence of strength, though not without cause for concern.

For much of this bull market the recovery saw stock gains outpacing economic fundamentals. Notably, inflation remained stubbornly weak despite unprecedented Federal Reserve stimulus, while wages for American households stagnated. In the past year, however, both have shown signs of improvement. In August, average hourly earnings growth jumped to a robust annualized 2.9%, a rate not seen since June of 2009. Unemployment is now testing generational lows; September's rate of 3.7% represents the lowest reading since 1969. The surge we are seeing in labor demand is also reflected in survey-based measures of consumer and business sentiment, which are generally at or near cyclical highs. Meanwhile, GDP growth surged in the second quarter to the highest reading since 2014.

Economic Fundamentals in the Spotlight



Source: Federal Reserve Bank of St. Louis

Finally, while in 2017 the stock market's rise was largely driven by the so-called FANG stocks (Facebook, Apple, Netflix, and Google), this year's strong performance has shown much greater market breadth. We also think it's symbolically fitting that this bull market broke the previous bull market record the same quarter that the Federal Reserve hiked its overnight rate to a level above the inflation rate. This brings the so-called "real" interest rate, adjusted to account for inflation, to positive territory for the first time since the Fed slashed rates to zero during the Great Recession. The current recovery may have started a little slowly, but it seems to have finally found its legs.

However, just as the best major league sluggers are more likely to end a plate appearance called out as safely on base, even a robust, growing economy will also show pockets of weakness. As we suspected at the time of our last letter, simmering trade tensions did indeed dominate headlines for the past several months. Today, only the most optimistic market commentators would deny that we're in a full-blown trade war. While the market was able to shrug it off, at least through early October, its effects are visible in the economy; part of the surge in last quarter's GDP was US firms rushing to get ahead of retaliatory tariffs. With those now in place, the trade deficit widened in August and September to near-record levels as demand for US goods slowed. A successful resolution of the NAFTA trade talks did take a major trade risk off the table, however, as the 25-year-old trade agreement was renamed the USMCA but otherwise left largely unchanged.

Domestically, while inflation remains right at the Fed's target when measured year-over-year, there has been a slowdown in month-over-month readings, which if continued should soon begin to pull the yearly readings down as well. Survey-based measures of economic sentiment are fairly consistently near cyclical highs; they are also fairly consistently just off those highs. Emerging market economies continue to rumble as the dollar strengthens, echoing the 1997 Asian crisis. And, of course, it's been a rocky year in the bond markets; while spreads have hung in well and generally have tightened since December, interest rates spiked at the start of the year and then ground up slowly all third quarter, before spiking again in early October. While yields are currently at the top of a trading range we believe will hold, the speed at which they moved spooked equity markets.

Still, as Hall of Fame catcher and noted baseball sage Yogi Berra famously quipped, "It ain't over till it's over." His aphorism is usually taken as a never-say-die rallying cry for underdogs and longshots, but it's also good advice when you're riding the highs of a winning streak. While Bostonians certainly know a thing or two about snatching defeat from the jaws of victory – just mention the name Bill Buckner to anyone who grew up here – it's wrong to expect any particular winning streak to end just because it's gone on for a long time. Yes, there are things we are concerned about in today's economy and markets, but it's a rare quarter where that *hasn't* been the case, and it's hard to ignore the economy's demonstrated strength and resilience. Periods of strong performance and low volatility can lead to complacency, and now more than ever it's important to remain disciplined and stick to an investment plan. But, these can also be the periods where it's the most fruitful to be an investor. We're still in a record breaking bull market. One day, it'll end, as all rallies do. But there's no sure way to know when that is, so until that day comes, well, it ain't over till it's over.

MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals	• Yields slowly ground higher over the quarter, with the market pricing in the recently enacted Fed rate hike. The 2Yr AAA muni yield rose 33 bps, with the 5Yr up 21 bps, whereas the 10Yr only increased 12 bps. This asymmetrical uptick in Q3 yields led the curve to flatten, with 2-10s down to 61 bps from last quarter's 82 bps. • Carry associated with the 10Yr portion of the Municipal curve, coupled with change in curve structure, led the 10Yr segment of the Barclays Municipal Bond Index to be the best Q3 performer. The Barclays Municipal Managed Money 1 – 10Yr. Index was down 0.21% (YTD -0.45%). We are emphasizing 6 to 9-year maturities and maintaining Intermediate duration at 4.60-4.70 years, in line with the Index. • 10Yr AAA Muni/Treasury Ratio ended Q3 at 84.6%, more attractive than 2Yr and 5Yr ratios. • Market technicals remain favorable. Municipal bond mutual funds added a net $3.8B during Q3 (YTD +$10.9B). Intermediate and Long-Term funds led the way, with High Yield attracting considerable demand. Net issuance remains negative, with JP Morgan reporting -$51 billion for Q3 and projecting -$118 billion for all of 2018.
Investment Grade Corporates & Treasuries	• Economic strength reinforced by recent ISM and jobs reports, coupled with Fed Chairman Powell's comments after the September meeting, fueled a recent sharp increase in the 10Yr Treasury to 3.15%[1], the highest yield since 2011. This may be close to the high end of the near-term range, as global economies may be peaking, and inflation remains constrained. • Long rates also spiked, with the 30Yr Treasury reaching 3.33%[1], a level not seen since 2014. The longer end of the curve has also been impacted by waning pension fund demand following elimination of the ability to deduct pension plan contributions. • Outstanding marketable US Treasury debt climbed to a record $15.785 trillion as of August 31st, nearly $1 trillion greater than the end of 2017. This should continue to put pressure on shorter rates, although auctions have remained well received. • A surge in M&A deals has fueled otherwise lukewarm IG Corporate supply, with offerings from CVS, Cigna, Walmart, Bayer, and Vodafone adding $102.5 billion of new issuance. Rising rates are also increasing the cost of financing at a time when corporate leverage is close to all-time highs, a trend that warrants credit scrutiny. • Increased lower grade spread helped BBB lead Q3 IG bond performance, while AAA's performed worst. While we are selectively finding BBB value, our IG Corporate focus remains with larger, high quality, liquid names. 1. As of October 15, 2018
Equities	• Notwithstanding a 3.3% drop in the S&P 500 on October 10th in the face of rising rates, trade tensions with China, and the impact both will have on upcoming earnings reports, Q3 produced the strongest equity returns in almost 5 years. The S&P 500 was up 7.5% and has now been positive for 6 consecutive quarters. • Ironically given what has been a very turbulent start to Q4, the prior quarter saw a return to tranquility, featuring no trading days with a +/- 1% move. In our view, this reflects the strength and stability of corporate fundamentals, although such smooth sailing is highly atypical. Where we go from here is on everyone's mind. Fed policy and the bond market's behavior will exert significant influence on equities, as the speed of the spike in rates has prompted recent bearish sentiment. • Our outlook remains cautiously optimistic, despite GDP growth likely slowing down from a 3 – 3.50% pace. Although this year's earnings growth hurdles are unlikely to be matched by upcoming comparisons, Q4 earnings are still projected to advance by roughly 17%. Should these expectations be met, steady 2 – 2.50% GDP growth in 2019 would offer a favorable environment for equities.