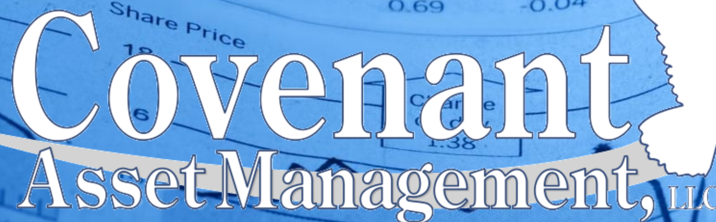
First Quarter 2014 Investment Outlook



John Guarino, President
408 Main Street
Chester, NJ 07930
(908) 879-4090
www.covasset.com

Executive Summary

When signals emerged from the Federal Reserve Bank in May 2013 that a change in policy was likely in the ensuing months, global investors embarked on asset re-allocation strategies that involved reducing bond holdings, commodities and emerging market equities and increasing U.S. and developed market equities. Consequently in 2013 U.S. equity markets experienced their best annual gains since 1998 as investors bid up prices despite sluggish economic and corporate earnings growth and rising interest rates. With the U.S. economy showing signs of accelerating, Europe emerging from recession, and China stabilizing, equity returns are expected to be positive again in 2014. However, valuations are no longer cheap and stocks enter the New Year with sentiment high and technical indicators suggesting the market is ripe for a correction. With interest rates expected to rise further, some near-term headwinds need to be overcome before equity markets are positioned to rise further. Bonds and commodities may continue to struggle in the year ahead if improved economic conditions hold true. Real estate prices should continue to improve, but at a slower pace than in 2013. International equity markets could play some catch-up to the U.S., given cheaper valuations and improving fundamentals.

Key Considerations

- U.S. equity markets enjoyed a great year in 2013 leaving investors to wonder if that will inhibit performance in 2014. With valuation levels no longer cheap and interest rates rising, many strategists are calling for a correction in the first half of this year. Historical experience suggests a correction at this time would prove to be a great buying opportunity.

- After nearly five years of sub-par growth, the U.S. economy appears to be gaining some momentum with consensus expectations of approximately 3% GDP growth in 2014. Employment gains, while still sluggish, have been improving and should continue to do so.

- In December, the Fed took the first step toward normalizing monetary policy by announcing a reduction in bond purchases from $85 billion to $75 billion monthly. While this action suggests the economic backdrop is healthier, expectations are for winding down this latest round of quantitative easing over the next 3 to 4 quarters.

- Fiscal policy should cause far less drama this year now that a budget deal has been passed and Congress is preparing for mid-term elections in November.

S&P 500 Index: Valuation Measures

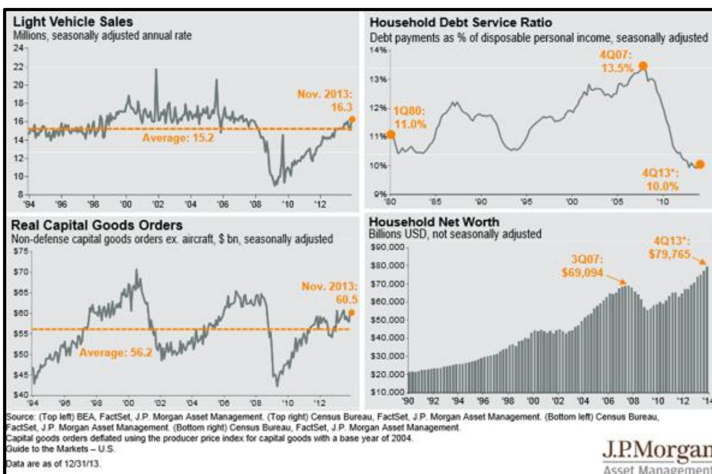
Valuation Measure	Description	Latest*	1-year ago	Historical Averages: 3-year avg.	5-year avg.	10-year avg.	15-year avg.
P/E	Price to Earnings	15.4x	12.6x	13.0x	13.1x	13.9x	16.2x
P/B	Price to Book	2.7	2.1	2.2	2.2	2.5	2.9
P/CF	Price to Cash Flow	10.6	8.7	8.9	8.6	9.5	10.8
P/S	Price to Sales	1.6	1.2	1.3	1.2	1.3	1.5
PEG	Price/Earnings to Growth	1.5	1.3	1.2	2.1	1.7	1.6
Div. Yield	Dividend Yield	2.1%	2.4%	2.2%	2.2%	2.1%	1.9%

Source: (Top) Standard & Poor's, FactSet, Robert Shiller Data, J.P. Morgan Asset Management.
Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months.

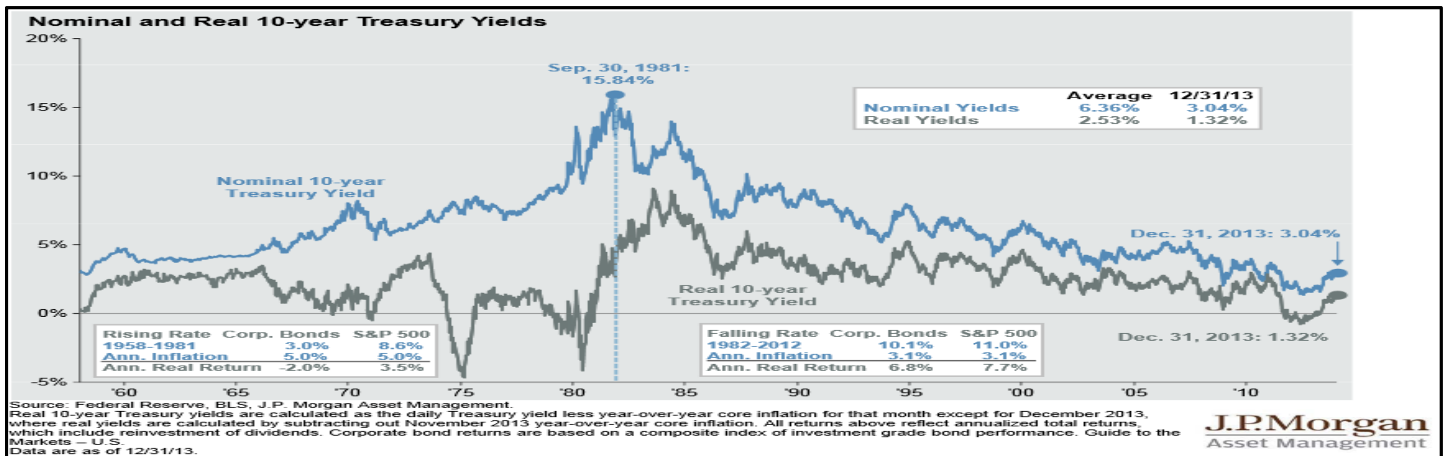
Besides the near-term technical indicators suggesting equity markets are due for a correction, there are good reasons to believe stocks should enjoy another positive year in 2014. According to several market studies, there have been eleven years since 1950 when the S&P 500 gained 25% or more. Other than 1981 and 1990, two recession years, the S&P posted positive results the following year, with average gains of better than 16%. According to Ned Davis Research, an excellent source of historical market data, since 1929 during a 4 year Presidential cycle, the second quarter of the second year of the cycle (which is 2014) shows a high occurrence of corrections. In the past, those corrections have been great buying opportunities.

Ever since the financial crisis hit in 2008, the main trends driving the economy and markets have been deleveraging by consumers and businesses and declining government bond yields. In 2013, these trends began to change in a number of important ways. Last May, during a speech to the U.S. Congress, Federal Reserve Chairman Ben Bernanke suggested the Fed was considering “recalibrating” its pace of bond and mortgage-backed securities purchases. These comments sparked a rapid rise in government bond yields and appear to have ended their three-decades-long downward trend. This adjustment caused a sharp correction in many emerging market stock indices, especially those with dual fiscal and current account deficits. Along with China’s difficulties in controlling credit growth while sustaining economic growth at high levels, this situation exposed the need for structural reforms in many of the larger emerging market economies. Implementing the necessary reforms will likely lead to a slower rate of growth than the world has been accustomed to for over two decades.

In the U.S., a rebound in asset prices, more certain federal tax policy, and a signed budget deal have created the backdrop for an improvement in business sentiment. In addition, better manufacturing activity and historically high levels of corporate cash suggest a rebound in capital spending may finally happen this year. The benefits of the boom in domestic energy production have begun to be felt in many sectors of the economy. U.S. manufacturers and petroleum-based materials producers are experiencing a competitive pricing advantage due to especially low domestic natural gas prices versus their global counterparts. And consumers, comprising nearly 70% of the U.S. economy, benefit enormously from lower energy prices as a greater portion of spending can be allocated for other uses. The housing recovery continued in 2013 and is poised for more gains. Consumer balance sheets are healthy and since mortgage rates remain low and housing prices haven’t fully recovered to pre-financial crisis levels, homes are still affordable. Consumer disposable income and spending should pick up in 2014 with improving labor market conditions, low inflation and the lapsing of last year’s federal tax hikes. Federal spending will also be somewhat less austere in 2014, given the modest adjustments made to sequester-related discretionary spending. These conditions and trends are expected to lead to a modest acceleration in U.S. economic growth in 2014 with GDP averaging closer to 3%.



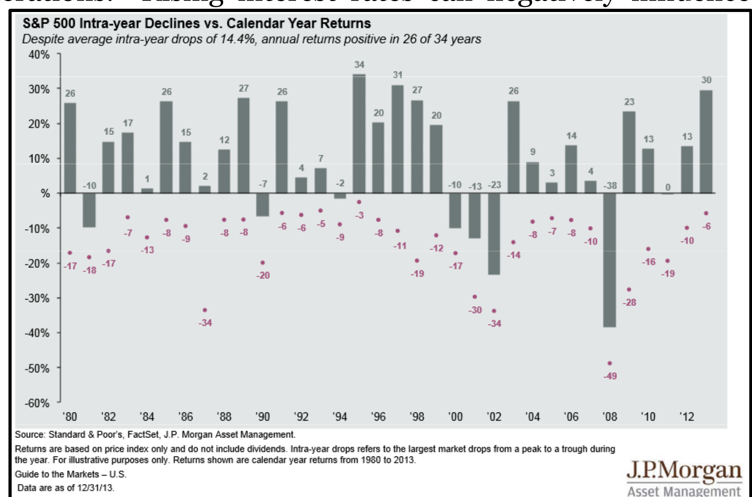
In December, the Federal Reserve Bank announced it would begin tapering its monthly bond purchases from $85 billion to $75 billion beginning in January 2014 with further reductions likely, but dependent on economic data. Consensus expectations are for steady declines over the next few quarters and a complete end to the program before the end of the year. The Fed seems to be hoping that it can contain interest rates at extremely low levels by promising to keep the fed funds rate (the only rate they control) at current extraordinarily low levels for a very long time. Economists interpret this fed-speak as meaning the fed funds rate will remain near zero into 2015 and perhaps into 2016 if the job market hasn't improved sufficiently and inflation remains below 2%. Expectations are for the benchmark ten-year U.S. Treasury Note yield to rise from the current level of just below 3% to around 3.50-3.75% as the year progresses.



The global economy is also expected to improve modestly in 2014, with an uptick in U.S. growth combined with stabilization in China, better growth in Japan, and Europe emerging from recession. Emerging market economic trends are disparate as the resource heavy economies may stay under pressure along with commodities prices, but other countries more dependent on recovery in developed market economies are likely to show improvement.

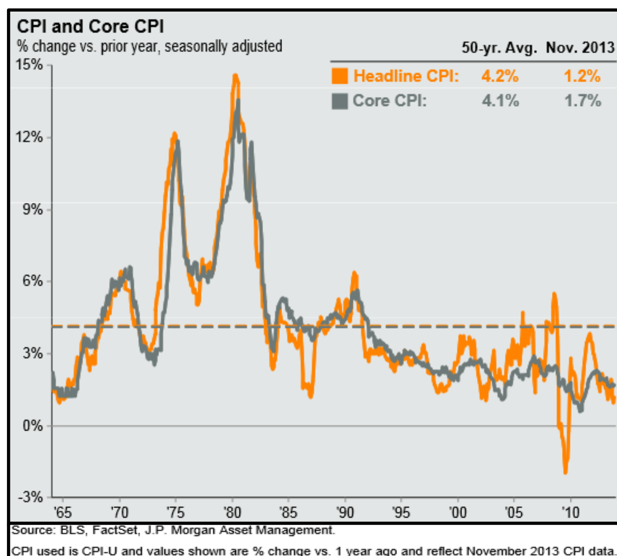
Asset Class Forecasts & Strategies

U.S. equity markets have risen by nearly 50% in the last two years without experiencing any serious correction. Corporate earnings on the other hand have only increased by about 10% during this period, meaning that valuation levels have risen and stocks can no longer be considered undervalued. At this junction, there are a number of crosscurrents affecting valuation considerations. Rising interest rates can negatively influence price/earnings ratios, but historically not until the ten-year U.S. Treasury yield is at or above 5%. Accelerating GDP and corporate earnings growth have also correlated with declining P/E ratios in the past as investors begin to worry about inflationary pressures. But with so much slack in global capacity utilization, abundant supplies of cheap labor pools around the world, and near ubiquitous consumer internet access allowing price comparisons to occur close to instantaneously, it is hard to make a case for a meaningful rise in consumer inflation anytime in the near future. Some concerns have been raised about the long-term impact on inflation due to all of the currency created by central banks around the world during the past five years. In order

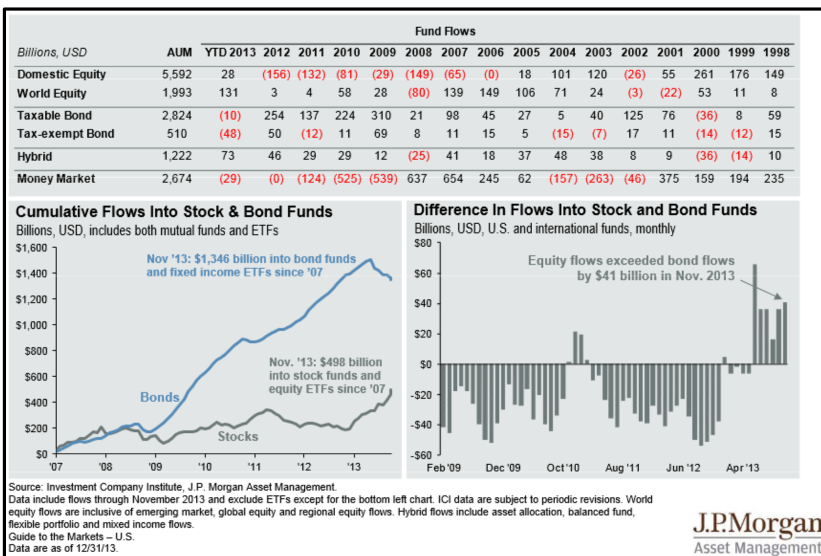


to frame this issue, it is important to realize that much of this newly created money is still sitting on bank's balance sheets in order to help restore their capital requirements. And the demand for that capital, the so-called velocity of money, has remained at very low levels throughout the entire recovery from the 2008/2009 financial crisis. We are therefore not concerned about problematic levels of inflation anytime soon.

Other issues that tend to affect valuation levels are investors' appetite for risk and fund flows amongst asset classes. In 2014, both of these factors should favor a somewhat greater willingness to bid up P/E ratios. Low interest rates continue to persuade investors to seek higher returns beyond fixed-income instruments and there is still plenty of cash in investment accounts waiting to be invested. Individual investors in particular, having been burned twice in the stock market during the last decade, have been very slow to return to the market and too many have missed the serious gains achieved during the past several years. Past experience suggests these investors will likely be buyers before the bull market peaks.



Source: BLS, FactSet, J.P. Morgan Asset Management.
CPI used is CPI-U and values shown are % change vs. 1 year ago and reflect November 2013 CPI data.



Fund Flows

Billions, USD	AUM	YTD 2013	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998
Domestic Equity	5,592	28	(156)	(132)	(81)	(29)	(149)	(65)	(0)	18	101	120	(26)	55	261	176	149
World Equity	1,993	131	3	4	58	28	(80)	139	149	106	71	24	(3)	(22)	53	11	8
Taxable Bond	2,824	(10)	254	137	224	310	21	98	45	27	5	40	125	76	(36)	8	59
Tax-exempt Bond	510	(48)	50	(12)	11	69	8	11	15	5	(15)	(7)	17	11	(14)	(12)	15
Hybrid	1,222	73	46	29	29	12	(25)	41	18	37	48	38	8	9	(36)	(14)	10
Money Market	2,674	(29)	(0)	(124)	(525)	(539)	637	654	245	62	(157)	(263)	(46)	375	159	194	235

Source: Investment Company Institute, J.P. Morgan Asset Management.
Data include flows through November 2013 and exclude ETFs except for the bottom left chart. ICI data are subject to periodic revisions. World equity flows are inclusive of emerging market, global equity and regional equity flows. Hybrid flows include asset allocation, balanced fund, flexible portfolio and mixed income flows.
Guide to the Markets – U.S.
Data are as of 12/31/13.

Our outlook for 2014 is for any correction in U.S. stock prices to be short-lived and not damaging to the bull-market trend. A pullback of up to 10% in the first half of the year would be within our realm of expectations, barring any unpredictable events. The probability of modest improvements in corporate earnings growth combined with somewhat higher P/E ratios leads us to believe any such correction would likely offer an attractive buying opportunity. Our view is that double-digit full-year total returns are probable for U.S. equity markets for the third year in a row.

Foreign stock market returns generally lagged the U.S. market in 2013, with emerging markets noticeable losers. The expectation for and eventual change in U.S. monetary policy produced a reversal of the trends that had favored rising commodity prices and emerging market stocks and bonds since early in the last decade. With last year's dramatic underperformance, emerging market equity valuation levels are cheap compared to those in the U.S., which may lead to some relative improvement in performance in 2014. However, the trend reversals of last year are likely to continue on a secular basis and we would use any relative improvement in performance from emerging markets to continue re-allocating foreign equity positions to a more dominant developed market weight. During this transition, we believe it makes sense to favor some active management (mutual funds) rather than passive management (ETFs) as active managers are more likely to exploit dislocations in prices or valuation levels.

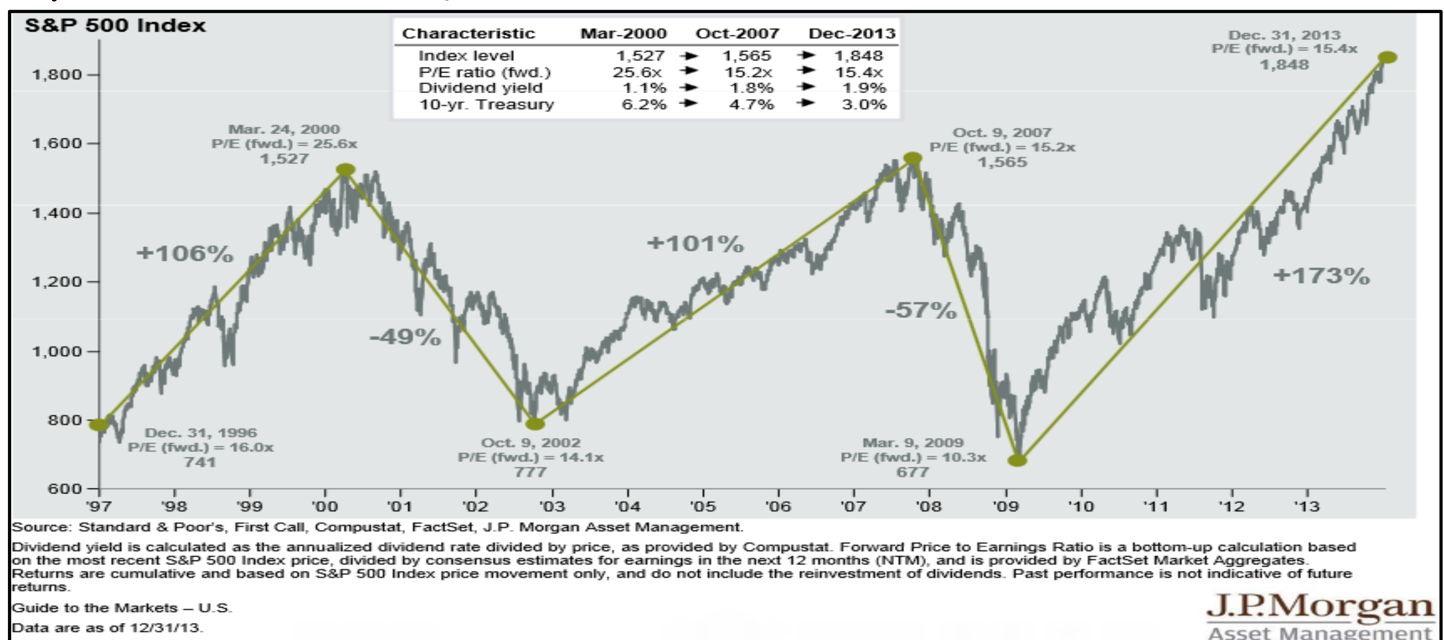
Within the fixed-income arena, we believe intermediate to long-term interest rates are likely to rise modestly throughout the year, with the benchmark ten-year U.S. Treasury yield rising to 3.50-3.75% by year-end. Over the past several months, we've continued to shorten the average duration of our bond holdings and have increased the mix of lower-grade bonds (using mutual funds or ETFs) and reduced the allocation of high-grade bonds. We believe taking some credit risk is preferable to interest rate risk in a rising rate environment. We also suggest using bond substitutes such as high-yield common stocks, master-limited partnerships and REITs for some portion of the fixed income allocation until interest rates normalize. This normalization process may still take several years.

The economic and investment outlook we've portrayed suggests that commodity prices are likely to return to their more cyclically normal pattern compared to the long uptrend they experienced for much of the period from 2000 until 2012. For this reason, we have been de-emphasizing their role within client portfolios and expect to do so for the foreseeable future.

Risks

We are mindful that, along with the opportunities that exist within financial markets, there are a number of risks that could sidetrack an otherwise favorable economic and market scenario. We're not entirely out of the woods concerning U.S. government dysfunction, as the federal debt ceiling needs to be raised again in the February/March timeframe (although it is hard to believe that Republicans will fall into the same trap they fell into last October, especially with mid-term elections looming in November). There are also the threats of a Chinese credit crunch, a reappearance of the eurozone debt crisis, and the possibility that Japan's resurgent growth peters out. Perhaps the greatest risk is U.S. economic prosperity. If the American economy continues to gain momentum and growth forecasts increase above current expectations, interest rates could rise much quicker or further than expected which could cause a more serious stock market correction. Finally, we're all counting on the Fed and its new chairman, Janet Yellen, to navigate monetary policy decisions smoothly. Any policy error, likely meaning a too-fast withdrawal of the quantitative easing (QE) program, could cause serious economic troubles.

We don't assign a high probability to any of the dangers outlined above, but we believe it is important to recognize and monitor the potential areas of concern. We thank you for your continued support and wish you all the best for your health and wealth in 2014.



Source: Standard & Poor's, First Call, Compustat, FactSet, J.P. Morgan Asset Management.

Dividend yield is calculated as the annualized dividend rate divided by price, as provided by Compustat. Forward Price to Earnings Ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.

Guide to the Markets – U.S.

Data are as of 12/31/13.

2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	4Q13	Cum.	Ann.
REITs 31.6%	MSCI EME 34.5%	REITs 35.1%	MSCI EME 39.8%	Barclays Agg 5.2%	MSCI EME 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Russell 2000 38.8%	S&P 500 10.5%	MSCI EME 197.7%	MSCI EME 11.5%
MSCI EME 26.0%	DJ UBS Cmdty 21.4%	MSCI EME 32.6%	DJ UBS Cmdty 16.2%	Cash 1.8%	MSCI EAFE 32.5%	Russell 2000 26.9%	Barclays Agg 7.8%	MSCI EME 18.6%	S&P 500 32.4%	Russell 2000 8.7%	Russell 2000 138.3%	Russell 2000 9.1%
MSCI EAFE 20.7%	MSCI EAFE 14.0%	MSCI EAFE 26.9%	MSCI EAFE 11.6%	Market Neutral 1.1%	REITs 28.0%	MSCI EME 19.2%	Market Neutral 4.5%	MSCI EAFE 17.9%	MSCI EAFE 23.3%	MSCI EAFE 5.7%	REITs 128.5%	REITs 8.6%
Russell 2000 18.3%	REITs 12.2%	Russell 2000 18.4%	Market Neutral 9.3%	Asset Alloc. -24.0%	Russell 2000 27.2%	DJ UBS Cmdty 16.8%	S&P 500 2.1%	Russell 2000 16.3%	Asset Alloc. 14.9%	Asset Alloc. 4.6%	S&P 500 104.3%	S&P 500 7.4%
Asset Alloc. 12.5%	Asset Alloc. 8.3%	S&P 500 15.8%	Asset Alloc. 7.4%	Russell 2000 -33.8%	S&P 500 26.5%	S&P 500 15.1%	Cash 0.1%	S&P 500 16.0%	Market Neutral 7.9%	Market Neutral 3.8%	MSCI EAFE 104.1%	MSCI EAFE 7.4%
S&P 500 10.9%	Market Neutral 6.1%	Asset Alloc. 15.2%	Barclays Agg 7.0%	DJ UBS Cmdty -35.6%	Asset Alloc. 22.2%	Asset Alloc. 12.5%	Asset Alloc. -0.6%	Asset Alloc. 11.3%	REITs 2.9%	MSCI EME 1.9%	Asset Alloc. 100.1%	Asset Alloc. 7.2%
DJ UBS Cmdty 9.1%	S&P 500 4.9%	Market Neutral 11.2%	S&P 500 5.5%	S&P 500 -37.0%	DJ UBS Cmdty 18.9%	MSCI EAFE 8.2%	Russell 2000 -4.2%	Barclays Agg 4.2%	Cash 0.0%	Cash 0.0%	Market Neutral 62.7%	Market Neutral 5.0%
Market Neutral 6.5%	Russell 2000 4.6%	Cash 4.8%	Cash 4.8%	REITs -37.7%	Barclays Agg 5.9%	Barclays Agg 6.5%	MSCI EAFE -11.7%	Market Neutral 0.9%	Barclays Agg -2.0%	Barclays Agg -0.1%	Barclays Agg 56.0%	Barclays Agg 4.5%
Barclays Agg 4.3%	Cash 3.0%	Barclays Agg 4.3%	Russell 2000 -1.6%	MSCI EAFE -43.1%	Market Neutral 4.1%	Cash 0.1%	DJ UBS Cmdty -13.3%	Cash 0.1%	MSCI EME -2.3%	REITs -0.2%	Cash 17.1%	Cash 1.6%
Cash 1.2%	Barclays Agg 2.4%	DJ UBS Cmdty 2.1%	REITs -15.7%	MSCI EME -53.2%	Cash 0.1%	Market Neutral -0.8%	MSCI EME -18.2%	DJ UBS Cmdty -1.1%	DJ UBS Cmdty -9.5%	DJ UBS Cmdty -1.1%	DJ UBS Cmdty 9.0%	DJ UBS Cmdty 0.9%

Source: Russell, MSCI, Dow Jones, Standard & Poor's, Credit Suisse, Barclays Capital, NAREIT, FactSet, J.P. Morgan Asset Management.
The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EMI, 25% in the Barclays Capital Aggregate, 5% in the Barclays 1-3m Treasury, 5% in the CS/Tremont Equity Market Neutral Index, 5% in the DJ UBS Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. All data represents total return for stated period. Past performance is not indicative of future returns. Data are as of 12/31/13, except for the CS/Tremont Equity Market Neutral Index, which reflects data through 11/30/13. "10-yrs" returns represent period of 1/1/04 – 12/31/13 showing both cumulative (Cum.) and annualized (Ann.) over the period. Please see disclosure page at end for index definitions. *Market Neutral returns include estimates found in disclosures.
Guide to the Markets – U.S. Data are as of 12/31/13.