Covenant Asset Management, LLC

First Quarter 2016 Investment Perspectives

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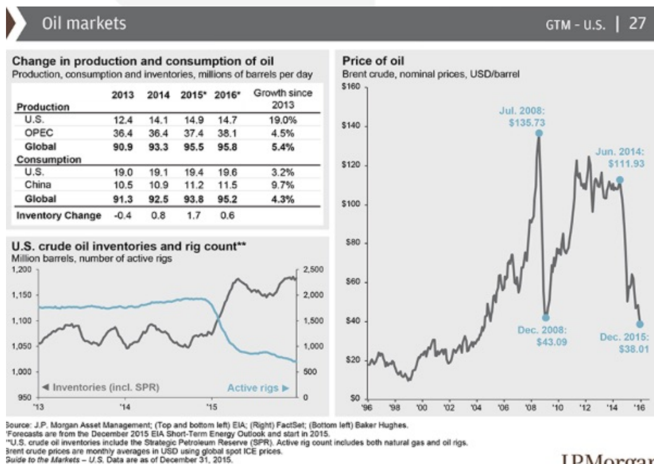
Financial Markets Review And Outlook

Covenant Asset Management is pleased to offer our latest investment perspectives. In this publication we review fourth quarter results and highlight key economic and financial themes which we expect will drive markets and investment performance in the coming months.

KEY THEMES

1. Implications of the unprecedented decline in stock prices to start the new year
2. Oil prices, China growth, geopolitics & the Fed
3. Health of the U.S. Economy

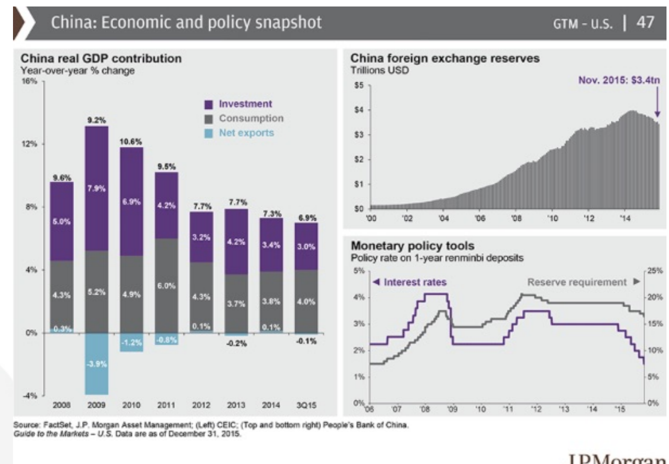
Ordinarily, the first several paragraphs of Investment Perspectives are devoted to a review of the previous quarter's economic and investment results. However, given the unprecedented declines in global equity markets in the first three weeks of the new year, 2015 seems like an eternity ago. While 2015 was volatile, the year ended virtually unchanged for many broad-based U.S. equity and fixed-income indexes. Why then did investors wait until the first trading day of 2016 to begin a barrage of selling that has continued steadily through the first half of January? The most cited catalysts for the selling - China growth fears,



	2013	2014	2015*	2016*	Growth since 2013
Production					
U.S.	12.4	14.1	14.9	14.7	19.0%
OPEC	36.4	36.4	37.4	38.1	4.5%
Global	**90.9**	**93.3**	**95.5**	**95.8**	**5.4%**
Consumption					
U.S.	19.0	19.1	19.4	19.6	3.2%
China	10.5	10.9	11.2	11.5	9.7%
Global	**91.3**	**92.5**	**93.8**	**95.2**	**4.3%**
Inventory Change	-0.4	0.8	1.7	0.6	

declining oil prices and geopolitical events - have most certainly played a role in this year's rough start. This year's decline clearly has roots in 2015. The S&P 500 Index closed down 0.7% in 2015, but many stocks and sectors lost a lot more. The overall market was held up by an increasingly narrow group of large momentum growth stocks such as Amazon, Netflix, Google and Facebook. This phenomenon, known as narrowing market breadth, is often a troublesome sign for stocks. A new calendar year and tax year allowed investors to begin taking profits in previous year's winners.

Weak China manufacturing data on the first day of 2016 caused anxious investors to drive down oil prices and spread fears of a global economic downturn at a time when the U.S. Federal Reserve had begun reversing its seven year long zero interest rate policy. In addition, while China, the world's second largest economy and the driver of global growth since the financial crisis



ended, has been slowing for some time, the sentiment is that China's leaders have lost their ability to guide the county's economic slowdown to a soft landing. China's stock market is plunging, the yuan is sinking, and capital outflows are soaring, as China's monetary authorities attempt to prevent the yuan from

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collapsing. A significant and disorderly China currency devaluation would have global repercussions, especially in already reeling, commodity-exporting, emerging market countries.

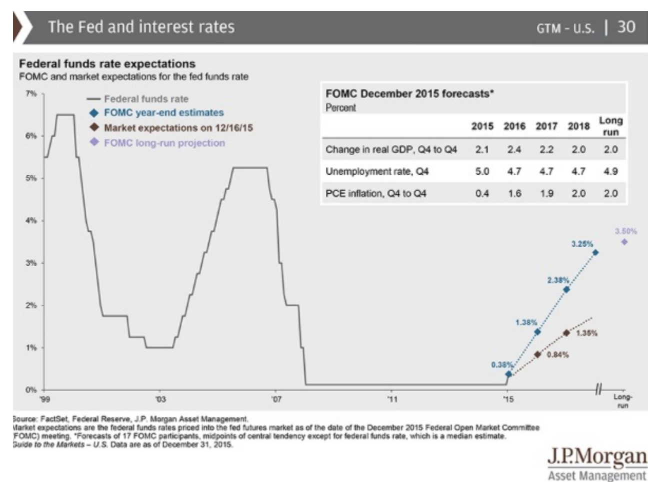
Additional challenges facing the global economy and markets in early 2016 include 1) the unwinding of unprecedented monetary policy 2) deflationary pressures 3) a manufacturing recession 4) U.S. dollar strength and 5) increasing geopolitical risks. We will discuss each of these along with their implications for financial markets in the pages that follow.

In December 2008, in the midst of the worst financial crisis since the Great Depression, the Fed lowered the fed funds rate (the overnight rate at which banks lend to one another) to zero. In an effort to further stimulate the economy, the Fed embarked on three rounds of quantitative easing (QE), the last of which ended in October 2014. During this monetary easing, the Fed injected over $4 trillion into the financial system which pushed asset prices higher and postponed negative consequences of the financial crisis.

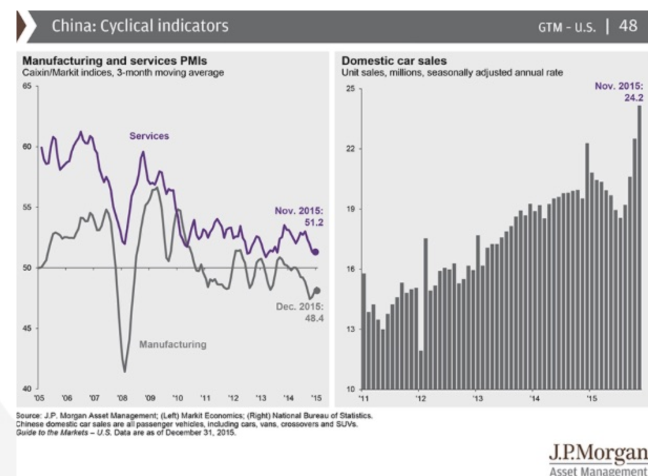
Ever since former Fed Chairman Ben Bernanke, in May 2014, first floated the possibility of slowly reversing these policies, financial markets have been on edge. As we have seen in the high yield bond market and commodities markets, key beneficiaries of QE, the reversal of monetary accommodation by the Fed has increased uncertainty and volatility and has ultimately pressured global equity markets.

In addition, with Europe, China and Japan all continuing to provide significant monetary stimulus to their economies, the U.S. Fed's decision to remove stimulus has caused capital to flow out of these regions and into the U.S., lifting the dollar and harming oil and commodities prices. The strong dollar has hurt U.S. multinational corporate profits, as profits earned in weak currencies are worth less when translated to dollars. In addition, U.S. businesses, in order to stay competitive on global markets, often need to cut prices which hurts their profit margins.

Since 2012, China's economy has been slowing from the double-digit rates it had consistently grown at during the previous two decades. Recently, there has been concern that China's economy has slowed to levels much below their official economic reports. Private



	2015	2016	2017	2018	Long run
Change in real GDP, Q4 to Q4	2.1	2.4	2.2	2.0	2.0
Unemployment rate, Q4	5.0	4.7	4.7	4.7	4.9
PCE inflation, Q4 to Q4	0.4	1.6	1.9	2.0	2.0



economic surveys as well as demand indicators such as electricity usage confirm these worries may be true. It is no secret that China is attempting to transition from a predominantly export-based economy to a more consumption-based one. However, consumer spending in China today represents approximately 40% of GDP compared with 70% in the U.S.. Until the consumer represents upwards of fifty percent of China's economy, the best way to stabilize and ultimately accelerate economic growth is to stimulate exports. To do this quickly, the Chinese currency, the renminbi (also known as the yuan) must be devalued.

After a decade of pegging the renminbi's value to the U.S. dollar, China finally lifted the peg in July 2005. For three years China allowed its currency to strengthen, only to re-peg the yuan to the dollar as the financial crisis intensified in July 2008. In June 2010, China once again lifted the peg, allowing the yuan to strengthen until late 2014. As the slowdown in China's economy became more noticeable in 2015, China moved again to re-peg the currency in August 2015. To put in perspective what has happened to the yuan/dollar relationship over the past ten years, from 2005 to 2014, the yuan appreciated approximately 25% versus the dollar. Since December 2014, the yuan has been devalued by nearly 10%. The relevance of this is that China's devaluation has effectively been exporting deflation throughout the world through lower commodity prices and pressuring emerging market countries that export commodities (i.e., Brazil, Chile, South Africa, Indonesia).

At essentially the same time (November 2014), Saudi Arabia decided they would no longer give up market share in order to support oil prices. The price of Brent crude oil had already dropped by 30% from $114/barrel in June 2014 to $79 by the end of November 2014, after Ben Bernanke had signaled the Fed's zero fed funds rate policy might come to an end. After the Saudi's policy change announcement, oil prices dropped by another 40% over the next two months to a low of $45/barrel. A rally then ensued driving the price/barrel back to nearly $70 by early May 2015. However, signs of China's accelerating economic slowdown, coupled with stubbornly high production and excess oil supply, has resulted in a steady decline to today's level below $30/barrel, representing an almost 60% drop since last

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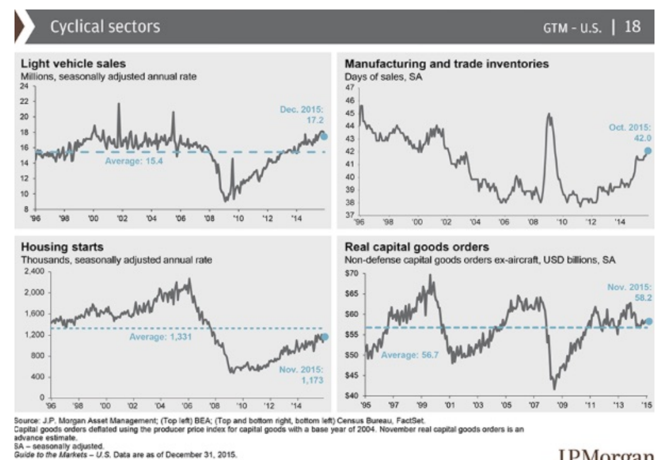
May. In fact, oil has dropped roughly 25% since the beginning of the new year.

While oil and many commodity prices are oversold, until supply and demand come back into balance, prices may not have bottomed. OPEC oil output will likely remain elevated in 2016 as the Saudis continue their production levels, while Iran ramps up production upon the recent lifting of sanctions. U.S. domestic oil production will likely decline only modestly as technology improvements allow producers to extract oil at lower prices. Eventually, a number of small, financially distressed U.S. energy companies are likely to fail, eliminating a certain level of supply from the market. Demand is expected to rise in 2016, which should begin to bring the supply/demand picture closer to balance by the end of the year. As the excess supply gap begins to close, oil prices should bottom for this cycle.

As of December 2015, it became clear that a global manufacturing recession had already taken hold. The PMI manufacturing index, an economic indicator used to measure manufacturing activity, indicated U.S. manufacturing has been contracting for the past two months. China's manufacturing activity has registered contractionary levels for the past nine months. Slowing demand, coupled with current high inventory levels, could cause conditions to weaken further.

Geopolitical risks have been on the rise, with increasing tensions between Saudi Arabia and Iran and heightened tensions throughout the Mideast. Deteriorating economic conditions in emerging markets and China could cause civil unrest. Increasing terrorist attacks and strains over Mideast migrants in Europe and immigration in the U.S. are also creating concerns. Finally, with election results still ten months away, it may be a bit premature to venture a guess on the outcome of the U.S. elections. However, the lead up to primary voting has been the most unusual in our lifetimes and could be cause for concern, as primary results become known over the next few months. We will have much more to say about the election and how it may impact financial markets in next quarter's Investment Perspectives.



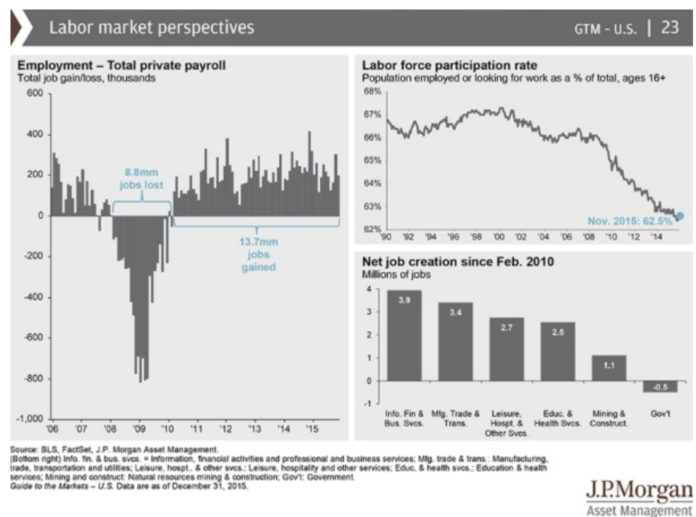
Economic and Financial Market Outlook

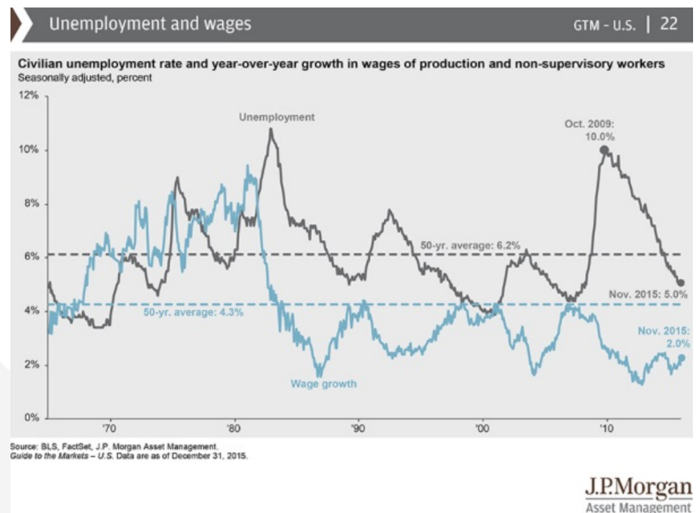
With all of the challenges outlined above, combined with the harsh sell-off in stocks to start the year, an obvious question is whether financial markets are projecting a recession and/or a bear market. Major U.S. stock market indices are approaching declines of 15%, still shy of the 20% required to attain a technical bear market designation. However, many stocks and sectors of the market are already in bear market territory. The Russell 2000, a small cap index, is down nearly 23% from its 52-week high and former leadership groups such as semiconductors and biotechs are down more than 30% from levels reached last summer. Most energy, metals, and mining stocks are down greater than 50% in the last year. Nasdaq, 2015s big winner, is down more than 12% since the Fed meeting on December 16 of last year.

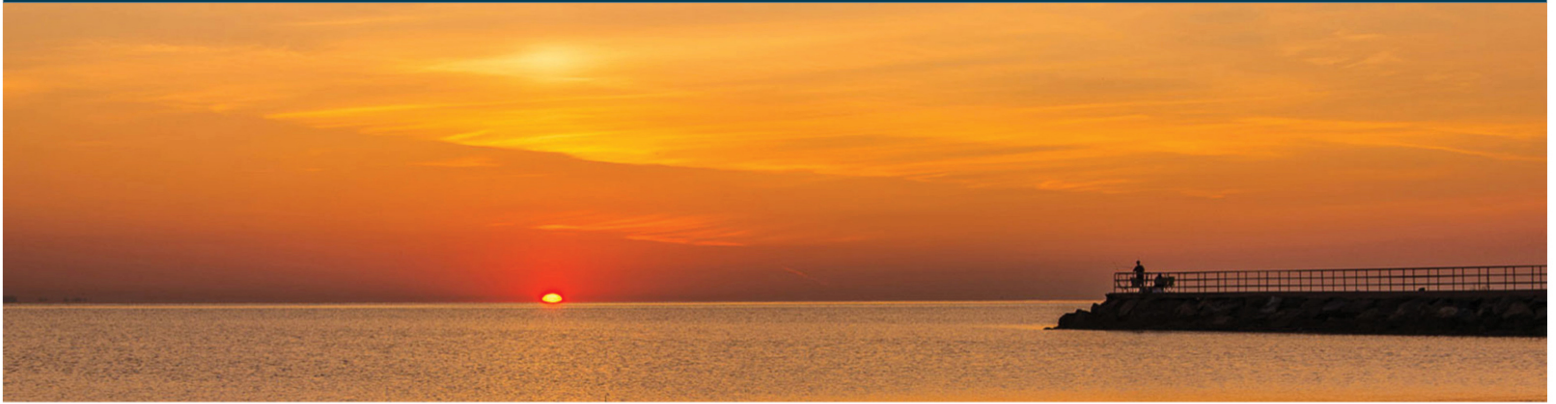
Is this a coincidence? Or are investors showing their dismay that Fed officials seem oblivious to the trends in the economic data and indicators they claim to rely upon in their policy decision-making? It is true that economic data is mixed, with some data such as manufacturing and retail sales showing weakness, while other data such as jobs and wages point to a strengthening economy. Despite the recent turmoil in financial markets and decidedly mixed economic data, several Fed officials are on record within the past several weeks of reiterating what Fed Chair Janet Yellen stated in her remarks on December 16, after the Fed had raised rates by a quarter point, that the FOMC believed economic conditions were likely to warrant another full percentage point increase in Fed Funds rates in each of the next three years.

Markets are currently rejecting that viewpoint and futures are now projecting merely a single one-quarter point rate increase in September of this year. In light of recent market action, we would expect the Fed to begin to moderate their expectations for rate hikes in the future. Let’s recall that the Fed has been overly optimistic about economic growth in each of the past five years, so, if their track record continues, they will need to ratchet back their economic growth projections and their Fed Funds rate targets.

The depth of the market decline of the past few weeks is alarming and reminiscent of the way markets behaved during the financial crisis in 2008 and early 2009. We, however, believe the economy and markets are in a very different place than the environment just prior to the







financial crisis. Importantly, in both the household and corporate sectors, debt ratios are far lower than in 2008. Household debt levels today are 103% of income compared with 130% just prior to the financial crisis. In addition, debt payments represent 15.3% of household income versus 18.1% in 2007. Within the financial sector, banks have been recapitalized in a major way, placing them in a far better position to absorb losses during the next economic downturn. The amount of capital held by banks as well as the level of their common equity capital ratio are both nearly 150% higher than in 2007. It is true that government debt has risen substantially since the financial crisis, from 63% of GDP in 2007 to just over 100% today. Nevertheless, governments are better able to handle higher debt levels given their ability to borrow, tax and inflate their way out of trouble.

Given the behavior of financial markets so far this year, it appears that investors have succumbed to the uncertainties outlined previously and have decided to reduce their risk exposure. At this juncture it is hard to predict whether the selling will abate prior to a broadly defined bear market or whether there is additional sizable market declines ahead.

Stabilization of oil prices or some constructive central bank policy response to recent market volatility could help calm markets. In addition, valuation levels have suddenly gotten cheaper than they were just a few weeks ago. We will be listening carefully to corporate earnings forecasts in the weeks ahead, when more companies report fourth quarter earnings and provide guidance.

From a strategy viewpoint, we are inclined to wait until markets settle down before putting idle cash to work or taking on additional risk. However, we do not believe markets are in for a repeat of the cataclysmic declines during the financial crisis or the dot-com bust in 2001-2003. With this in mind, we will be looking to improve the composition of equity portfolios, as market corrections inevitably create buying opportunities.

Within fixed income, the trajectory, pace and projected level of interest rates throughout the yield curve are what dictates our strategy. With continued sluggish U.S. and global growth, coupled with the lack of inflation, there is a strong likelihood that the pace and trajectory of additional interest rate increases will be moderated from the Fed's original plan.

Recent action reminds us that in the short term, markets can be unpredictable and that the myriad of risks portend additional periods of volatility throughout the year. The financial crisis in 2008/2009 reminded us how important it is to maintain a long-term view and portfolio asset allocation focused on your financial objectives. After dropping nearly 40% in 2008, U.S. stock market indices gained more than 220% from the March 2009 low to highs reached in 2015. We believe now is a good time to review portfolio asset allocation and confirm that it matches your investment objectives. We look forward to discussing our views and expectations with you on an individual basis and always appreciate your feedback, comments or questions.

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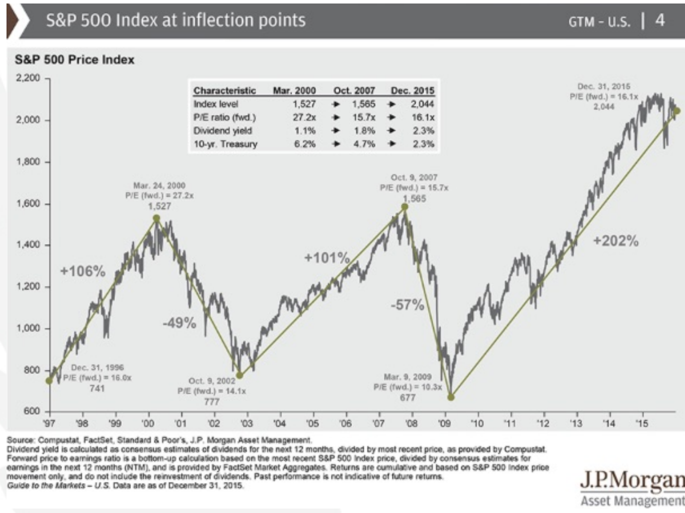
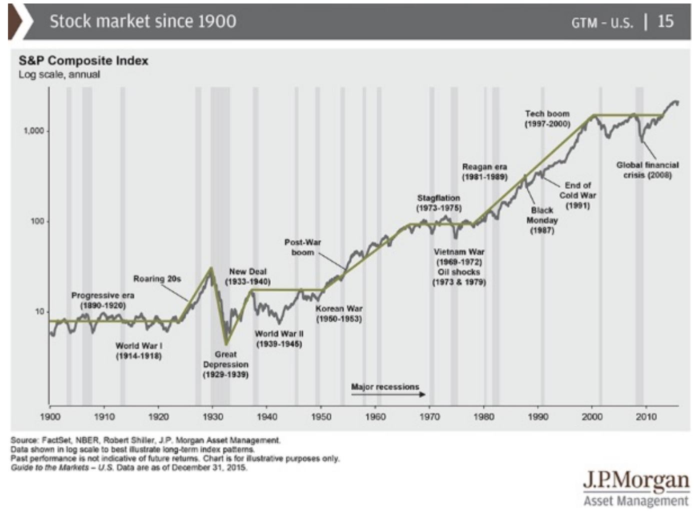
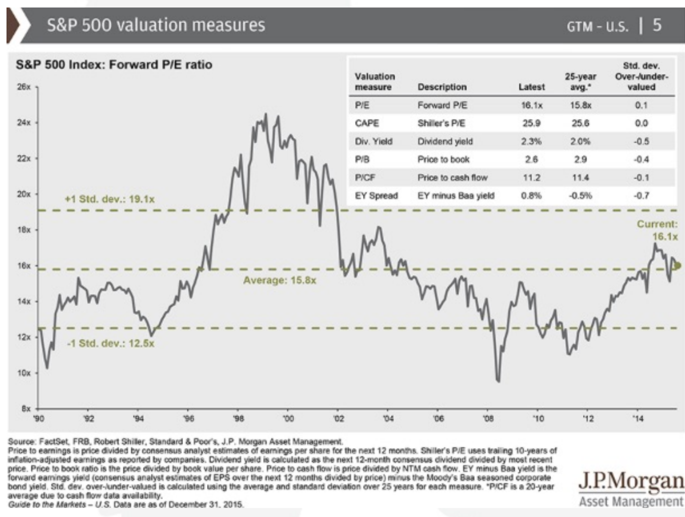
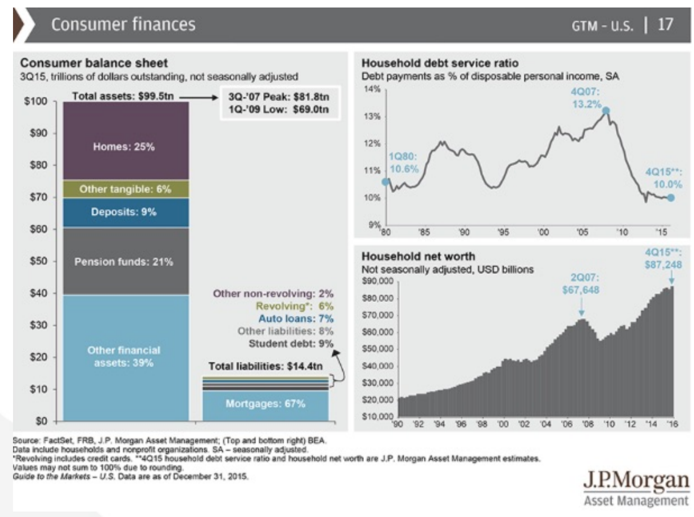


Characteristic	Mar. 2000		Oct. 2007		Dec. 2015
Index level	1,527	→	1,565	→	2,044
P/E ratio (fwd.)	27.2x	→	15.7x	→	16.1x
Dividend yield	1.1%	→	1.8%	→	2.3%
10-yr. Treasury	6.2%	→	4.7%	→	2.3%





Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-valued
P/E	Forward P/E	16.1x	15.8x	0.1
CAPE	Shiller's P/E	25.9	25.6	0.0
Div. Yield	Dividend yield	2.3%	2.0%	-0.5
P/B	Price to book	2.6	2.9	-0.4
P/CF	Price to cash flow	11.2	11.4	-0.1
EY Spread	EY minus Baa yield	0.8%	-0.5%	-0.7



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