Covenant Asset Management, LLC

First Quarter 2017 Investment Perspectives

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Financial Markets Review & Outlook

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

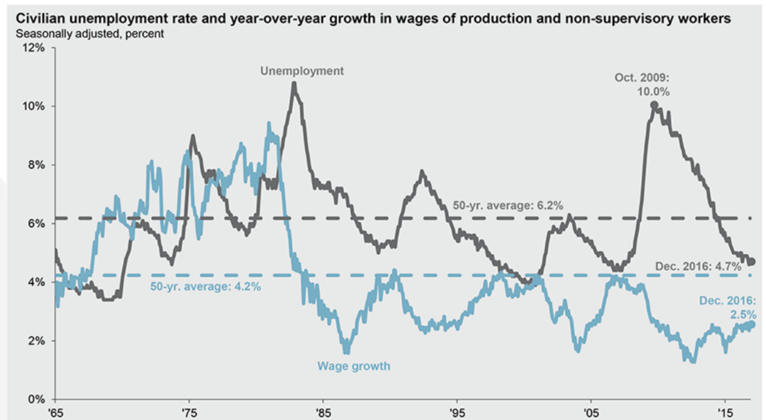
KEY THEMES

1. Election results portend fiscal policy changes ahead
2. As monetary stimulus ends, fiscal stimulus is coming
3. Economy now appears to be hitting on all cylinders
4. Market indicators point to rising interest rates and steady to rising stock prices near term, with caveats
5. Stock market rotation continues as expected new fiscal stimulus policies produce different winners and losers

The year 2016 was a period of heightened political anxiety which took investors on a rollercoaster ride filled with many ups and downs and twists and turns. The first six weeks of the year produced the sharpest decline to start the year in the history of the U.S. stock market. After the Fed blinked on their plan to steadily raise interest rates throughout 2016, stocks rallied until the Brexit-related sell-off in June. As cooler heads prevailed and investors began to realize that Brexit was much more of a political event than an economic one, stock prices quickly recovered. U.S. election turmoil caused renewed worries and stocks dipped again in September and October. The surprising election results produced expectations of fiscal stimulus and a more business-friendly approach to governing. Following the election, stocks rallied sharply through mid-December and have traded sideways in the ensuing four weeks. Fixed-income markets initially moved in the opposite direction as the potential for faster economic growth caused a harsh sell-off in bonds followed by a partial recovery in the past several weeks.

While fear and uncertainty dominated the news in the lead-up to the election, economic data released since November 8 suggest the U.S. economy has strengthened. Housing starts and existing-home sales have jumped to the highest levels in a decade, U.S. jobless claims dropped to a 43-year low and U.S. service-sector activity surged in November. Consumer and investor confidence have also surged since the election to levels unseen since 2007. U.S. Real GDP growth has not grown by more than 3% since 2005. After more than ten years of sluggish economic growth, the U.S. economy appears poised to re-accelerate. Consumers and investors are reacting to the hopes and expectations for fiscal stimulus in the form of corporate and individual tax cuts and for deregulation in economically important sectors.

Unemployment and wages GTM – U.S. | 26



Source: BLS, FactSet, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of December 31, 2016.

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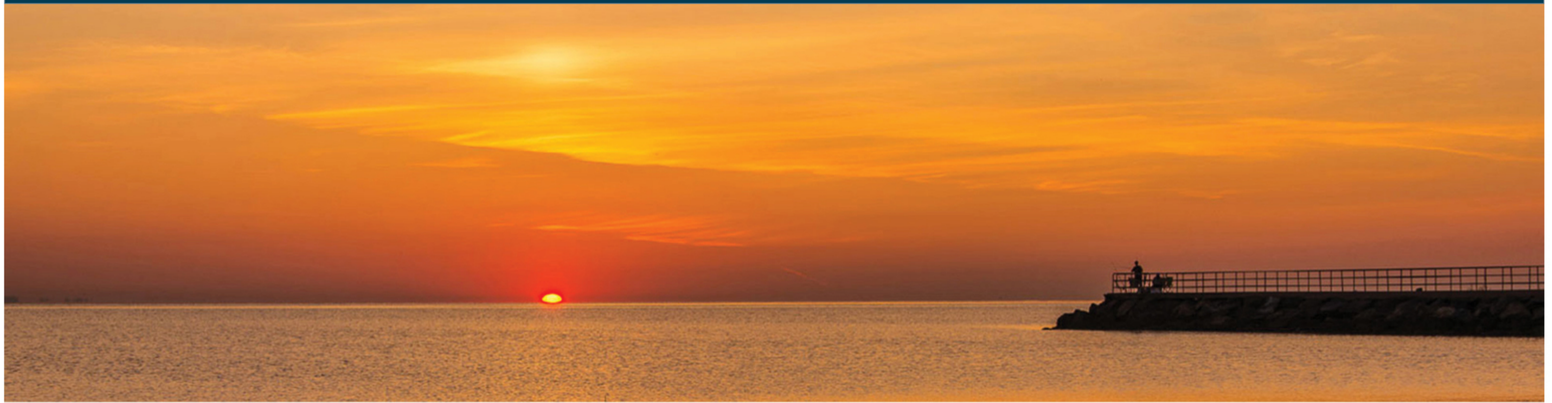
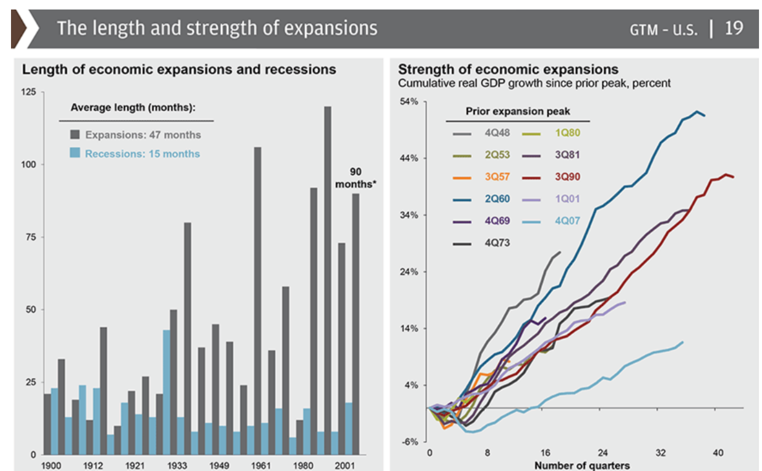
Economic and Financial Market Challenges



Expectations for stronger economic growth and rising interest rates have triggered a surge in the value of the U.S. dollar and generated a definitive sector rotation in stocks. Economically sensitive sectors and those that benefit from higher interest rates have surged higher while slow growth or stable growing sectors have lagged. Winning sectors include financial services, industrials, energy and materials. Healthcare, utilities and the consumer sectors are amongst the laggards with technology neutral. Financials are perceived to have amongst the most improved outlook as rising interest rates and a steeper yield curve should allow net interest margins to increase. In addition, deregulation and stronger loan growth in an improving economy should lead to faster earnings growth. Similarly, the industrials and materials sectors should benefit if a sizable infrastructure spending plan, as proposed by President-elect Trump, is passed by Congress. Alternatively, pressure on the healthcare sector may persist as debate over an overhaul the Affordable Care Act and potential for drug price negotiations or controls prolong investor concerns over future profitability and growth. Additionally, multi-national companies that generate a significant portion of their earnings outside the U.S. would be hurt by the rising value of the dollar.

For the past eight years, global economies and financial markets have been dominated by the fiscal and monetary policies that were pursued in the aftermath of the financial crisis in 2008 & 2009. Keynesian economic policies, prominent during the Great Depression in the 1930s, were rapidly enacted by many countries in an effort to divert the possibility of a global depression.

Major stimulus packages and highly expansionary monetary policies were put in place in 2008. In 2010, with unemployment levels in many countries still high, there was widespread acceptance amongst economic policy makers about the need for additional stimulus. But with public debt at



Source: BEA, NBER, J.P. Morgan Asset Management. *Chart assumes current expansion started in July 2009 and continued through December 2016, lasting 90 months so far. Data for length of economic expansions and recessions obtained from the National Bureau of Economic Research (NBER). These data can be found at www.nber.org/cycles/ and reflect information through December 2016.
Guide to the Markets – U.S. Data are as of December 31, 2016.

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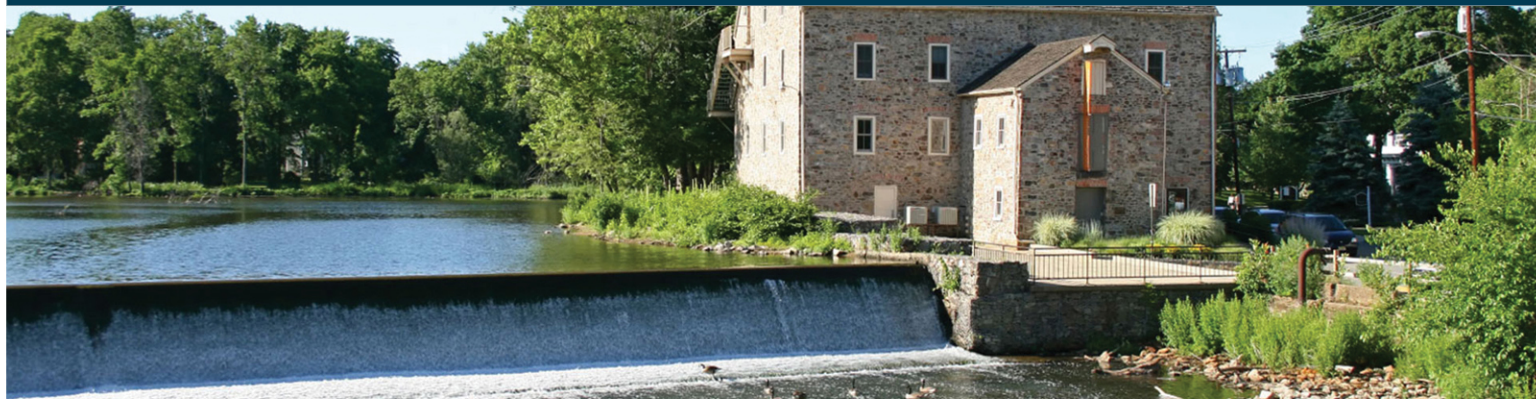
extremely high levels, additional fiscal stimulus, such as tax cuts, were decided against. Alternatively, the U.S., U.K., ECB, Japan, China and other countries embarked upon unconventional monetary stimulus. These policies generally consisted of some form of quantitative easing that involved massive central bank purchases of government bonds and, in some cases, other financial assets. This policy prescription had the effect of reducing interest rates to the historically low levels we have witnessed the past eight years.

Most economists believe that the pursuit of Keynesian economic policies in the immediate aftermath of the financial crisis likely helped avoid

Economic and Financial Market Challenges



a more devastating outcome. It is unclear however whether the decisions to rely exclusively on monetary policy was effective economic policy in the years since 2010. What is more clear is that monetary policy alone was insufficient to produce the rapid economic expansion that is typical after a recession. In addition, the very sluggish economic growth was one of the important contributing factors that led to the populist electoral uprising in the past couple of years.

We are now confronted with a Trump administration and Republican-controlled congress promising fiscal stimulus through infrastructure spending as well as corporate and personal tax cuts. Simultaneously, the Federal Reserve Bank is expected to stay on a course of normalizing interest rates by raising the Fed Funds rate 2-4 times this year to the tune of roughly 1 full percentage point. If all goes according to plan, similar fed funds rate increases are expected in 2018.

These expected economic policies are almost the complete opposite of the ones in place for the past eight years. As outlined earlier, these policy changes will very likely lead to a different set of winners and losers. Since the election, our investment research team has been studiously evaluating each asset class and resetting expectations for performance.

We have recently introduced updated fixed income, U.S. Equity Growth, U.S. Equity Dividend Appreciation and International Equity Models. In the days, weeks and months ahead, we will be executing changes to client portfolios. These trades are intended to re-position investment portfolios to achieve better results as new fiscal and monetary policies are put in place. Naturally we will attempt to implement these adjustments in as tax-efficient fashion as possible.

As we begin to reposition client portfolios for the economic and market environment we see ahead, it is important to communicate that timing investment changes in any environment is difficult. But these modifications are strategic in nature, intended to better position portfolios for the next several years and not necessarily the next several months. We are also cognizant of the long duration of the current economic expansion and bull market and aware that the recent gain of almost 2,000 DJIA points in less than two months is remarkable, if not somewhat concerning. The sideways action in stocks and partial recovery in bonds since mid-December has moderated the extreme over-extended price actions within these asset classes as of this writing. In addition, the weak expansion and absence of inflation over the last seven years may postpone any build-up in excesses in the economy that typically lead to aggressive monetary tightening, an environment that often triggers recession and a bear market in stocks.

For now, both macroeconomic and technical indicators for stocks remain healthy. But with expectations for fiscal and monetary policy changes high, investors could be disappointed if hopes for change get ahead of economic and political realty. An opposite concern is also warranted: should economic growth accelerate faster than expected and the Fed decide to raise interest rates more rapidly or aggressively than expected, both the stock and bond markets could suffer corrections.

Economic Charts

Additional risks include 1) the possibility of the incoming Trump administration moving towards trade protectionism, 2) political risk could re-emerge in Europe as Brexit negotiations begin and a number of important elections are held across the Euro zone and 3) a stronger dollar could cause new pressures on China and other emerging markets.

As we begin a new year, we feel obliged to emphasize to our clients that a well-diversified portfolio constructed to complement thoughtfully-defined investment objectives is the best strategy to achieve long-term results. Historical evidence also suggests that diversification is a far better approach to risk management than attempting to time the market. We are thankful for your business and our continuing relationship. Best wishes for a healthy, happy and prosperous 2017.

Bear markets and subsequent bull runs

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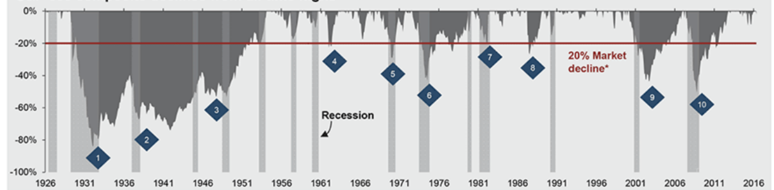
S&P 500 composite declines from all-time highs



Characteristics of bull and bear markets

	Market Corrections	Bear markets			Macro environment				Bull markets		
		Market peak	Bear return*	Duration (months)*	Recession	Commodity spike	Aggressive Fed	Extreme valuations	Bull begin date	Bull return	Duration (months)
1	Crash of 1929 - Excessive leverage, irrational exuberance	Sep 1929	-86%	33	◆			◆	Jul 1926	152%	38
2	1937 Fed Tightening - Premature policy tightening	Mar 1937	-60%	63	◆		◆		Mar 1935	129%	24
3	Post WWII Crash - Post-war demobilization, recession fears	May 1946	-30%	37	◆			◆	Apr 1942	158%	50
4	Flash Crash of 1962 - Flash crash, Cuban Missile Crisis	Dec 1961	-28%	7				◆	Oct 1960	39%	14
5	Tech Crash of 1970 - Economic overheating, civil unrest	Nov 1968	-36%	18	◆	◆	◆		Oct 1962	103%	74
6	Stagflation - OPEC oil embargo	Jan 1973	-48%	21	◆	◆			May 1970	74%	32
7	Volcker Tightening - Whip Inflation Now	Nov 1980	-27%	21	◆	◆	◆		Mar 1978	62%	33
8	1987 Crash - Program trading, overheating markets	Aug 1987	-34%	3				◆	Aug 1982	229%	61
9	Tech Bubble - Extreme valuations, .com boom/bust	Mar 2000	-49%	31	◆			◆	Oct 1990	417%	115
10	Global Financial Crisis - Leverage/housing, Lehman collapse	Oct 2007	-57%	17	◆	◆	◆		Oct 2002	101%	61
	Current Cycle								Mar 2009	231%	95
	Averages	-	**-45%**	**25**					-	**154%**	**54**

Source: FactSet, NBER, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.
*A bear market is defined as a 20% or more decline from the previous market high. The bear return is the peak to trough return over the cycle. Periods of "Recession" are defined using NBER business cycle dates. "Commodity spikes" are defined as significant rapid upward moves in oil prices. Periods of "Extreme valuations" are those where S&P 500 last 12 months' P/E levels were approximately two standard deviations above long-run averages, or time periods where equity market valuations appeared expensive given the broader macroeconomic environment. "Aggressive Fed Tightening" is defined as Federal Reserve monetary tightening that was unexpected and/or significant in magnitude.
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Diversification and the average investor

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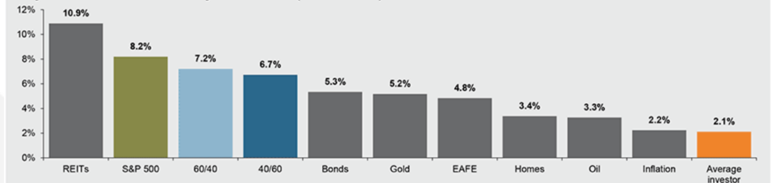
Portfolio returns: Equities vs. equity and fixed income blend

20-year annualized returns by asset class (1996 – 2015)



Source: J.P. Morgan Asset Management; (Top) Barclays, FactSet, Standard & Poor's; (Bottom) Dalbar Inc.
Indexes used are as follows: REITS: NAREIT Equity REIT Index, EAFE: MSCI EAFE, Oil: WTI Index, Bonds: Barclays U.S. Aggregate Index, Homes: median sale price of existing single-family homes, Gold: USD/troy oz, Inflation: CPI. 60/40: A balanced portfolio with 60% invested in S&P 500 Index and 40% invested in high quality U.S. fixed income, represented by the Barclays U.S. Aggregate Index. The portfolio is rebalanced annually. Average asset allocation investor return is based on an analysis by Dalbar Inc., which utilizes the net of aggregate mutual fund sales, redemptions and exchanges each month as a measure of investor behavior. Returns are annualized (and total return where applicable) and represent the 20-year period ending 12/31/15 to match Dalbar's most recent analysis.
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Stock Market Charts

Rather than write extensively about equity valuations, economic statistics and investing principles, we offer the following charts organized by topic and courtesy of J.P. Morgan Asset Management:

S&P 500 Index at inflection points

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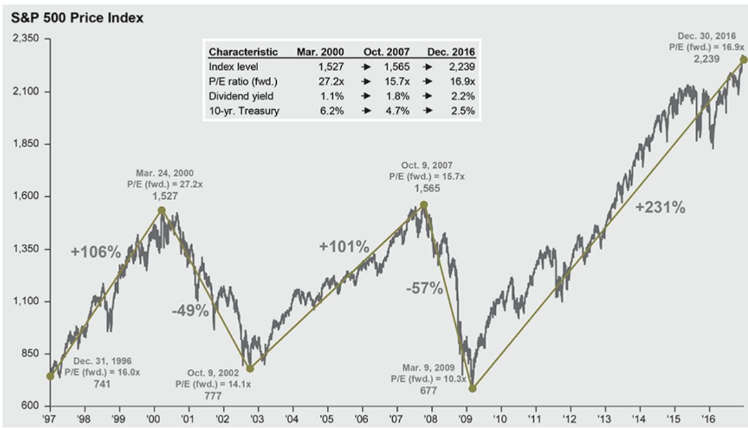

Characteristic	Mar. 2000		Oct. 2007		Dec. 2016
Index level	1,527	➔	1,565	➔	2,239
P/E ratio (fwd.)	27.2x	➔	15.7x	➔	16.9x
Dividend yield	1.1%	➔	1.8%	➔	2.2%
10-yr. Treasury	6.2%	➔	4.7%	➔	2.5%

Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent 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.
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Stock market since 1900

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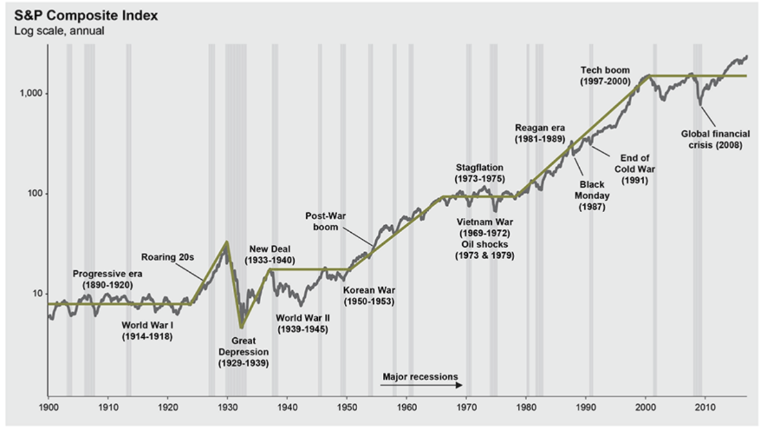

Source: FactSet, NBER, Robert Shiller, J.P. Morgan Asset Management.
Data shown in log scale to best illustrate long-term index patterns.
Past performance is not indicative of future returns. Chart is for illustrative purposes only.
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The Fed and interest rates

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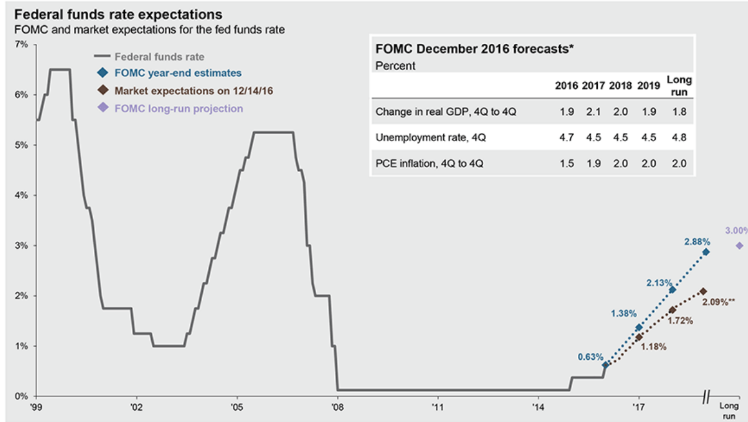

FOMC December 2016 forecasts*
Percent

	2016	2017	2018	2019	Long run
Change in real GDP, 4Q to 4Q	1.9	2.1	2.0	1.9	1.8
Unemployment rate, 4Q	4.7	4.5	4.5	4.5	4.8
PCE inflation, 4Q to 4Q	1.5	1.9	2.0	2.0	2.0

Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
Market expectations are the federal funds rates priced into the fed futures market as of the date of the December 2016 FOMC meeting. *Forecasts of 17 Federal Open Market Committee (FOMC) participants are median estimates. **Last futures market expectation is for November 2019 due to data availability.
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Interest rates and inflation

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	Average (1958-2016)	12/30/2016
Nominal yields	6.15%	2.45%
Real yields	2.41%	0.31%
Inflation	3.74%	2.14%

Source: BLS, Federal Reserve, J.P. Morgan Asset Management.
Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month except for December 2016, where real yields are calculated by subtracting out November 2016 year-over-year core inflation.
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*Any performance-related data listed in this report may represent un-audited results compiled by Covenant Asset Management or others. It could be intended to reflect results that are indicative of Covenant's individual client's equity performance who religiously invest according to our model portfolios. This performance data represents past performance and individual client results may vary materially. Past performance does not guarantee future results and current performance may be higher or lower than the performance data quoted.

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