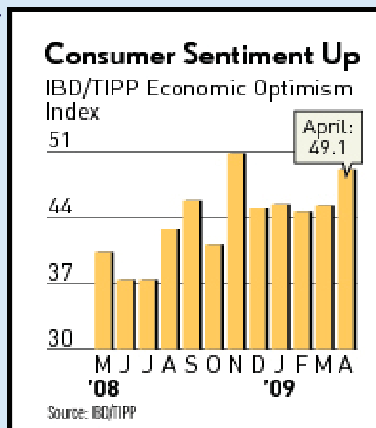
Covenant Asset Management, LLC

Quarterly Letter to Investors: *March 2009*

First Quarter Review

The first quarter began with an optimistic tone. After enduring a dramatic plunge in stock prices from September to November, relative stability had set in from December through early January. Barrack Obama was about to be inaugurated as President and the historical nature of his election combined with hope that he would govern in a centrist fashion had calmed the financial markets. It didn't take long for investors to conclude the opposite after the enormous $787 billion economic stimulus package sped through Congress and was signed into law before most lawmakers were able to read the contents. Disappointment related to the lack of any near term stimulus along with the staggering debt burden required to fund the bill. When newly confirmed Treasury Secretary Tim Geithner failed to deliver specifics on a promised plan to rid banks of toxic assets, markets proceeded to head lower. President Obama's budget proposal and his campaign to work simultaneously on economic recovery, health care reform, energy reform and financial market regulatory reform worried investors as taking on too much too soon. The final straw for stock market investors surrounded the whole concept of too much government intervention in private corporate affairs, i.e., the firing of General Motors CEO Rick Wagoner and the attempt by Congress to retroactively tax AIG executive bonus compensation.

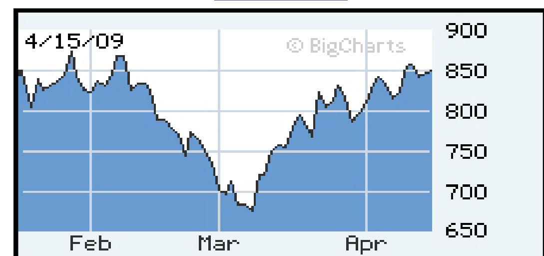
Concurrent with the dissatisfaction coming from Washington, economic indicators behaved just as terribly as was feared during the December through February timeframe. Real GDP contracted at an annual rate of 6.3% in the fourth quarter of 2008, the unemployment rate rose to 8.5%, manufacturing orders plunged and the housing and auto sectors remained at near depression levels. However, just as a spring thaw inevitably follows even the harshest of winters, March economic indicators have begun to exhibit some glimmers of economic thawing. After more than a year of sub-par retail sales and plummeting consumer confidence, recent results offer some glimmers of hope that the worst of the economic downturn might be over. The slide in manufacturing also appears to be subsiding as the latest figures have shown a slowdown in the rate of deterioration. And just at the pinnacle of fear in the financial markets, talk of important regulatory relief in areas such as mark-to-market accounting and short-selling rules finally began to be discussed seriously and with some urgency. And finally, a well-received Treasury plan to remove troubled assets from bank balance sheets was announced in mid-March.



Economic and Market Analysis

During the past six months, the Federal Reserve has shown its willingness to do whatever it takes to restore order to the economy and rekindle credit market activity to avert a long economic contraction. After reducing the fed funds rate to near zero, the Fed stepped up its policy actions once again by announcing the purchase billions of dollars in U.S. Treasury obligations in the open market. This is another step towards dramatically expanding the Fed's balance sheet in order to reduce market interest rates and reflate economic activity via extraodinarily stimulative monetary policy actions.

S&P 500

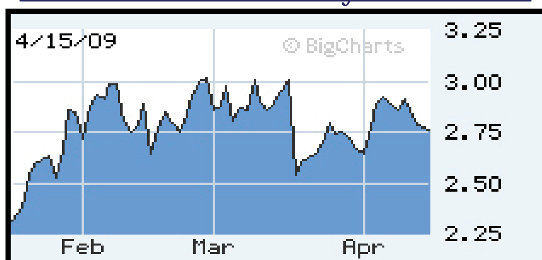


This stimulus along with a steeply positive yield curve has already produced positive results. With sharply reduced borrowing costs, banks are realizing their widest net interest margins in many years, enabling them to begin to re-liquefy their balance sheets and internally generate new capital they haven't been able to raise externally via private funding or the sale of securitized loans. Wells Fargo's announcement that first quarter earnings would far exceed expectations is the best example of how the current monetary environment is helping repair banks distressed financial conditions. Many banks have gone as far as to indicate their desire to repay the Treasury TARP funds soon, meaning within weeks in some cases and months in other cases. Of course, much of the reason for the banks haste in returning this capital to the government has as much to do with restrictive compensation limits placed upon companies who have received and still possess taxpayer money.

The Treasury's Public-Private Investment Plan,

although widely embraced when it was announced, may suffer from lack of participation as banks realize the benefits of the recently modified mark-to-market accounting rules. Even if the program is successful, banks may not increase lending for some time. After providing too much credit in the last cycle, many banks are likely to reduce their loan portfolios to more reasonable levels, especially in light of the ongoing weakness in the economy. Having been frightened by the sudden economic contraction, still rising unemployment rate and loss of net worth in their stock portfolios and home equity, consumers are apt to continue to boost savings and rebuild their own balance sheets rather than go on a new spending binge anytime soon. Current low mortgage rates and substantially reduced housing prices have made homes more affordable than any time since the early 1970s. Many experts believe a new housing cycle should begin within the next year. When it does begin, the upturn could be very sharp from desperately low levels as potential buyers who have been waiting for prices to bottom witness increased activity and start to jump in before mortgage rates or home prices begin to rise. Pent up demand in the auto sector could also create what may feel like a mini-boom from present dreadful levels. With major restructuring efforts well underway at most corporations, any increase in demand will quickly fall to the bottom line in the form of higher profits.

10 Year U.S. Treasury Note Yield



Big Picture Issues

The U.S. economy is expected to show positive growth by the end of this year, but there will be persistent doubts about the strength of the recovery. The current recession will probably end up as the deepest and longest since the 1930s. Deep recessions are generally followed by sharp and robust recoveries. However, even though housing and autos may rebound from deeply depressed levels, the prospects for a vigorous recovery are less certain. Lingering credit restraint combined with expected tax increases and increased corporate regulations will provide serious headwinds over the next several years.

The worst financial crisis in a generation has caused policymakers worldwide to take unprecedented and extreme steps to avoid another depression. The mind-numbing scale of monetary and fiscal stimulus, measured in trillions of dollars is understandable given the threat of a complete worldwide financial meltdown. However, history has taught us that massive policy interventions often create major unintended consequences. Too loose monetary policy intended to reflate the economy after the burst internet bubble of the late 1990s is often cited as a cause of the housing boom earlier this decade and subsequent tragic collapse. While the Fed engineered a short and shallow recession in the aftermath of the Tech bubble, the unintended consequence of a boom/bust cycle in housing and ensuing worldwide debt deleveraging is proving to be extraordinarily costly.

Every sector of the economy is immersed in the process of reducing debt, save the federal government. With enormous deficits projected for the forseeable future, it is possible we are sowing the seeds of a future financial crisis via current stimulus programs. With plenty of slack in the U.S. economy, headline inflation is currently close to zero, and core inflation is running at about 1.8%. Against this backdrop, it is premature to worry about the consequences of debt levels exploding at the federal level. However, in future years, the U.S. will have a significant policy decision to make - how and when to pay down the debt. Political pressures are likely to mount against leaving all these obligations for future generations to deal with, especially with major entitlement liabilities looming within a couple of decades. Throughout world history, every country confronted with the level of indebtness projected for the U.S. federal government has had three options at their disposal to repay their liabilities 1) cut federal spending 2) raise taxes and use the excess revenues to pay off debt or 3) print more money and pay off the debt in cheaper currency. It should come as no surprise that every country when faced with these choices has chosen option number 3. It has been the only politically feasible choice throughout history and we expect U.S. policymakers to default to this alternative again. In any event, fiscal stimulus is nearly impossible to withdraw, especially in a timely fashion. And while it is possible the Fed could move quickly to unwind its balance sheet expansion or tighten monetary policy when the economy and financial system is stronger, it is more likely it will overstay its welcome on the side of ease, setting the stage for a period of higher inflation in the future.

Investment Strategy

We are becoming cautiously optimistic that the pace of decline in U.S. economic activity has begun to slow. The recently concluded first quarter is likely to register a negative real GDP decline in line with the -6.3% recorded in last year's fourth quarter. The second quarter should show marked improvement owing to the need to rebuild inventories after significant draw downs in the last two quarters. Nevertheless, the recession is unlikely to end until sometime in the second half of the year.

World stock markets have staged a significant rally after having fallen to new lows in early March. While it is hard to know whether these lows will prove to be the trough in this cycle, it is typical that stocks tend to bottom approximately five months before the end of an economic downturn. Investors willingness to assume risk finally appears to be returning to financial markets after more than six months of hiding out in safe haven investments. NASDAQ has been outperforming the other major indices since early December, the financial sector has nearly doubled in the past month and the VIX index, a widely followed measure of market volatility has declined to its lowest level since the financial crisis began last September.

We believe the current market rally will run a bit further in the weeks ahead, after which investors are likely to pause to determine whether economic indicators are in fact showing the improvement that stock prices are indicating. From an investment strategy point of view, we suggest similar caution is in order when deploying funds. Given our view that inflation remains a long term threat, we have been limiting fixed income to short-term maturities or securities with some inherent inflation protection. With regard to our equity strategy, we have begun to pivot toward those sectors and geographies which will perform best during a period of economic reflation and the subsequent policy inspired inflation we see coming further down the road. It is important to recognize that we are at the very early stages of any economic stabilization and therefore our initial actions should merely be viewed as planting seeds of inflation hedges and not an agressive change in strategy at this stage. We envision a gradual buildup in those investment vehicles which have traditionally offered the best protection against the effects of inflation. These would include gold, U.S. Treasury Inflation Protected Securities (TIPS), energy related investments, commodities, natural resources and real estate. In addition, investments in countries which are rich in natural resources such as Canada, Brazil and Australia should perform well as global economies begin to recover.

While the past six months have proven to be historic in the pace and magnitude of decline in world economic activity and many global financial markets, we sense that the numerous and, in some cases, unprecedented monetary policy initiatives are beginning to work. Credit markets have stabilized; the initial public offering (IPOs) market is beginning to come back slowly and for the first time in a year, a large financial institution, namely Goldman Sachs, was able to raise money in the private market. Although we have witnessed significant global wealth destruction during the past few quarters, great op portunities lie ahead as economies begin the recovery process. The process may be long and there may be some bumps along the way, but the momentum and market psychology appears to be shifting toward the positive.

We appreciate the confidence you have displayed in our efforts during this difficult time and we look forward to working with you to rebuild the lost ground during the period ahead. As always, if you have any questions or comments, please do not hesitate to contact us.

John Guarino, President
Covenant Asset Management, LLC
408 Main Street
Chester, NJ 07930
Phone: (908) 879-4090
Fax: (908) 879-6468
www.covasset.com