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

Covenant Asset Management, LLC

Quarterly Letter to Investors
May 2012

Executive Summary

The strong market advance that began last October continued with little interruption in the first quarter of 2012. But barely a week after the S&P 500 posted its best 1st Quarter performance (+12.6%) in fourteen years, the major indexes declined for five consecutive days with cumulative losses totaling 4.3%. Corrections of this magnitude have been almost twice as frequent during the current bull market vs. normal historical experience. This is the reason the past three years have felt like an almost continuous roller coaster ride, even as stock indexes have more than doubled from their financial crisis lows in March 2009. In the past few weeks markets have stabilized and then rebounded to new four year highs on the back of better than expected corporate earnings reports.

The bond market has held relatively steady thus far this year as signs of improvement in economic data in the first quarter initially led to weakness in bond prices and a jump in yields. However, disappointing March and April jobs reports and a slower than forecast first quarter GDP report created the impetus for bonds to rally and yields to fall back to levels present at the beginning of the year. Commodities prices are relatively flat year-to-date but with a significant divergence amongst various components. While gold prices are up 4.4% and oil is up 2%, natural gas prices have plummeted 35% this year and agricultural commodities have declined by 6% on average. Real estate, as measured by the performance of REIT prices, has joined the equity markets with low double-digit gains to date.

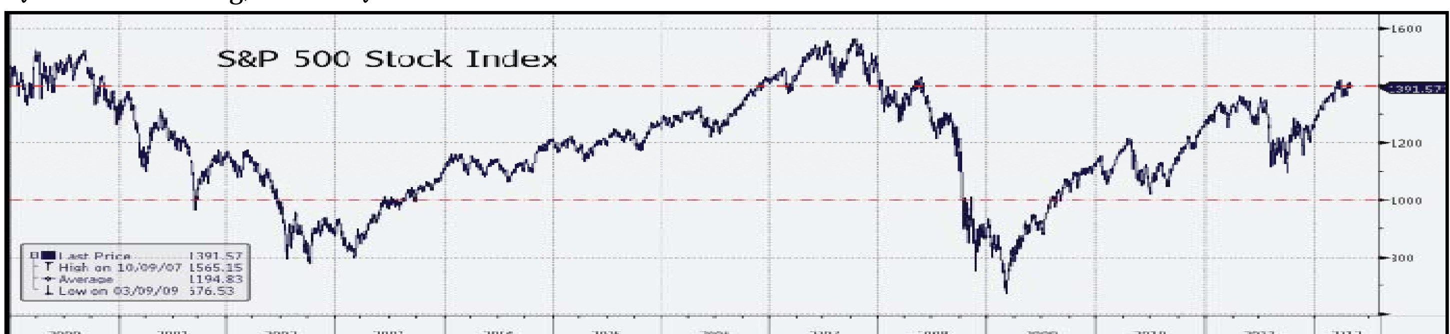
After providing some commentary on the current economic environment immediately below, we then offer a broad-based analytical view of where we believe we are in the current market cycle and which economic sectors are likely to perform best in the months ahead.

Global Economic Perspectives

In the first three quarters of 2011 the U.S. economy grew by less than 2% and then rebounded in the fourth quarter to 3%. Unfortunately, fourth quarter results proved to be unsustainable as the initial GDP reading for the first quarter of 2012 was 2.2%. On top of this, unseasonably warm weather may have improved the first quarter's performance which was seasonably adjusted to account for more typical cold weather and snow. Stronger employment statistics since last fall seem to have stalled as weaker-than-expected March and April payrolls confirm that at least part of the gains made earlier this year were weather related.

Globally, a sign of moderating growth was evidenced by China's first quarter GDP increase of 8.1%, down from 8.9% in the fourth quarter of last year. In addition, a number of countries in Europe have now officially sunk back into recession, including Spain, Portugal, Italy and Greece. The U.K. also slipped into recession after reporting a slight contraction in first quarter GDP. Europe's debt crisis, seemingly on hold for the last few months, appears to have returned to investors' list of concerns as Spanish 10-year bond yields approached 6%, the level at which debt problems in Greece, Ireland, and Portugal began to compound.

All of these concerns point to continued highly accommodative monetary policies and perhaps additional monetary easing. The weaker the economic data in the coming months, the more likely the Fed will respond with another round of Quantitative Easing, dubbed QE3.



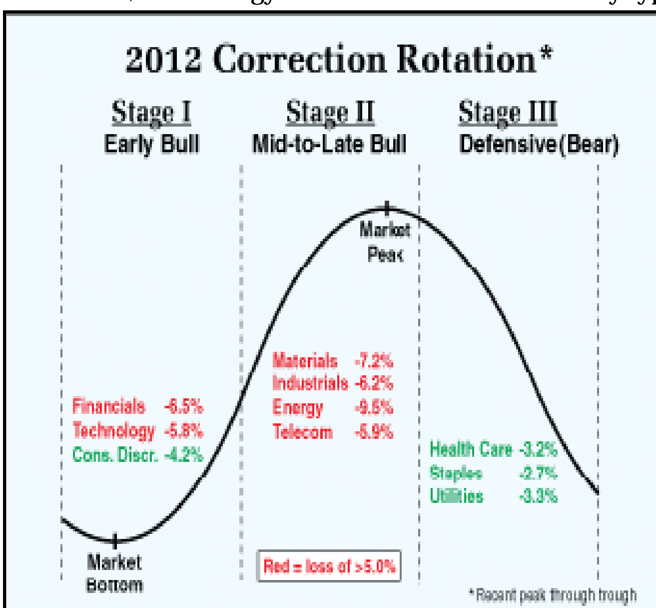
Market Cycle and Economic Sector Views

As we look back on the first four months of the year, it has been an exceptional, although somewhat unusual period where gains were concentrated in just three sectors. As displayed in the table to the right, all ten sectors have produced positive gains for the year to date. However, only three sectors - Technology, Financials and Consumer Discretionary - outperformed the S&P 500. These three sectors have produced nearly three-quarters of the overall gains in the index this year. Meanwhile, the more defensive sectors, which include Health Care, Telecom Services, Consumer Staples, Energy, and Utilities, significantly lagged the index.

S&P 500 Sector Performance Year to Date - 05/02/2012	
S&P 500 Sector	**Total Return**
Financials	19.45%
Information Technology	19.60%
Consumer Discretionary	18.74%
S&P 500	**12.20%**
Industrials	10.50%
Materials	10.16%
Health Care	8.90%
Consumer Staples	6.38%
Energy	2.79%
Telecom Services	8.19%
Utilities	0.20%

Sector leadership can change drastically as market and economic conditions change. The chart below, developed by InvesTech Research, is based upon their own research as well as studies by Ned Davis Research and Standard & Poor's. It shows the three stages of a stock market cycle, along with the sectors that have historically outperformed during each stage of the cycle.

Stage I covers the transition from late bear market to early bull market. This stage is when cyclical sectors such as Financials, Technology and Consumer Discretionary typically outperform the market. As a reminder, the stock market generally leads an economic recovery by as much as 6-9 months. As consumers and businesses begin to gain greater confidence in future economic conditions, they start spending more money in discretionary areas cut back on during the preceding downturn.



Stage II typically occurs during the expansion phase of the economic cycle. It is the mid-to-late bull market period when the economy has returned to and surpasses the previous economic peak and growth is more firmly established. Materials and Industrials tend to outperform during this stage, and are usually joined by Energy and Telecom stocks as the bull market matures.

Stage III is when as economic growth begins to wane, the bull market runs out of steam and nondiscretionary sectors – Health Care, Consumer Staples and Utilities – are usually the best performers. Companies in these sectors provide products and services that people need regardless of how bad they feel about the economy or the stock market.

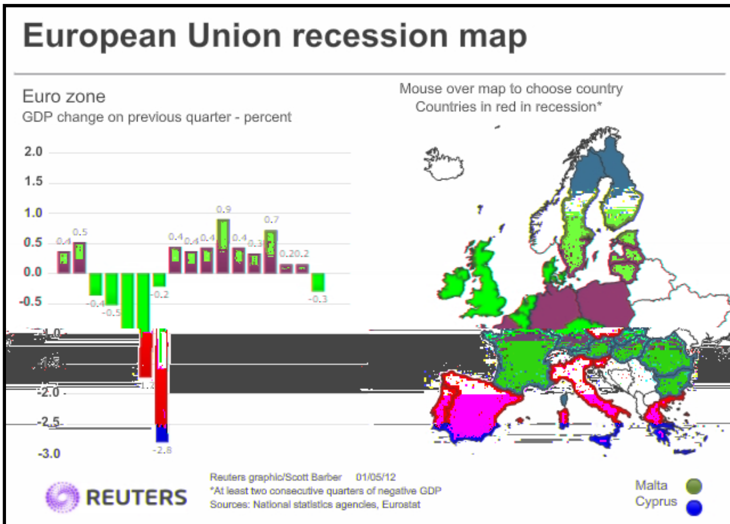
More than three years into the current bull market, we believe we are well into Stage II on the referenced chart and recent sector performance seems to support this view. The better relative performance of defensive sectors during the recent correction is instructive as to where we are in the current market cycle. It suggests that investors may already be rotating toward sectors that are likely to perform better in the next economic or market downturn. While we do not believe the economy is about to roll over into recession, nor the market fall into bear market territory, we do believe there are enough red flags causing investors to be highly sensitive to negative news.

Investment Strategy

With major U.S. stock indexes having rallied by more than 25% since their October 2011 lows, the recent bout of softer economic data has evoked a logically cautious response from investors. The key question investors will be pondering in the weeks ahead is whether the weakness in employment numbers, GDP growth and retail sales is temporary or the start of a new trend. Our view is that at least part of the better economic tone in the early months of the year can be attributed to warmer than normal weather in most of the country. This would mean that some business activities that would normally have occurred in the second quarter may have been pulled into the first quarter and suggests that the second quarter could experience some economic weakness as a consequence. There are also political realities to consider as we

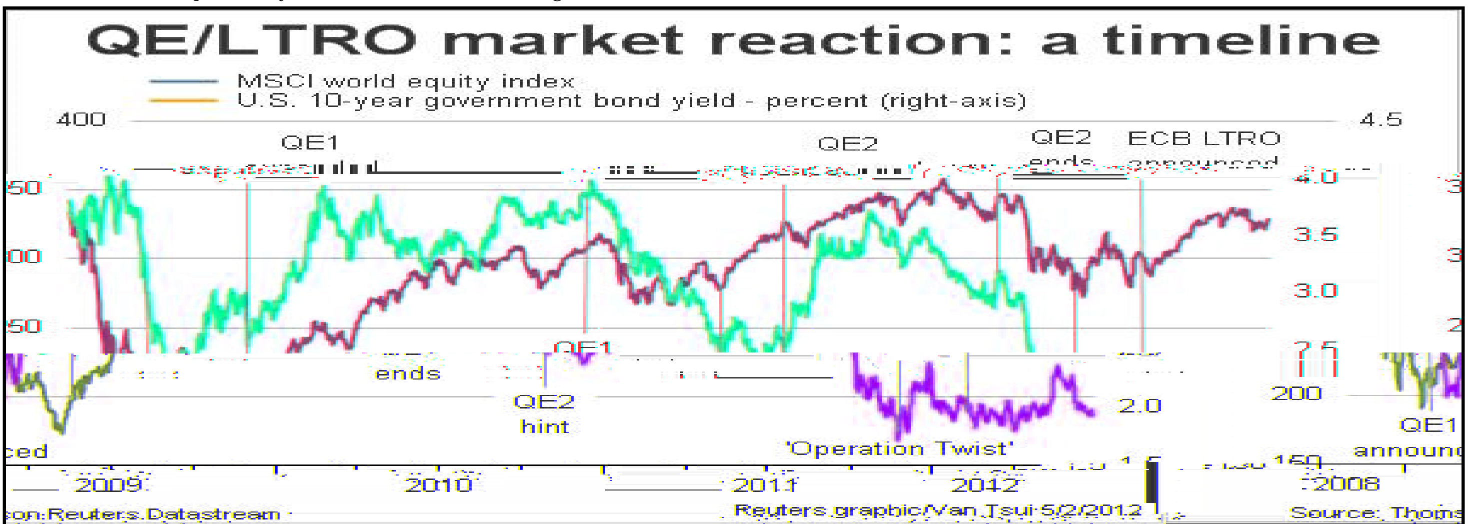
get closer to the November elections. In general election years, investors tend to remain cautious until the outcome becomes clear and policy implications can be determined. We therefore do not expect major market moves in either direction during the next two quarters. We will have more to say on this issue in coming months.

Our view on equity investing at this writing is that, more than at any time in recent memory, stock selection is critical to generating strong investment results. The first 2 ½ years of the bull market which began in March 2009 witnessed above-average correlation amongst stocks. In the past six months, investors have focused to a much greater extent on individual company fundamentals as opposed to macroeconomic trends and risks. As a result, equity investors who pick winners and avoid losers have been handsomely rewarded. We expect this renewed attention to individual security analysis to continue for the foreseeable future. With this in mind, we have redoubled our analytical efforts to identify attractive investment opportunities and add them to client portfolios in recent months. We expect these portfolio changes to enhance performance and encourage you to contact us with any questions or comments concerning any holdings with which you are unfamiliar. With respect to fixed-income investments and alternative asset classes, our strategy remains essentially unchanged. We expect interest rates to remain at or near current levels for the foreseeable future and continue to recommend other assets beyond high grade bonds for generating current income. Specifically, we are employing REITs, high yield bonds, preferred stocks, energy-related master limited partnerships and high yielding common stocks.



Once again, events in the eurozone affected the mood and risk appetite of investors worldwide. Spain joined the U.K. and other European Union nations who are once again formally in recession. That has led to a backlash against austerity programs that during the recent crisis have been advanced by Germany - the strong man of the eurozone - as the only logical way to resolve the fiscal crises from Greece to Ireland. Even in France - not in the grip of a recession - the tide is turning against austerity, as Nicolas Sarkozy faces a daunting challenge from the political left as he battles to hold onto the French presidency in runoff elections this coming weekend.

The improving job market seems to have buoyed stock market performance in the United States so far in 2012. As this chart shows, there has been a strong inverse relationship between the rate at which American workers have filed initial jobless claims and the S&P 500's gains. Now that those jobless claims have shown signs of rising once more in recent weeks, the question becomes whether this foreshadows another mid-year slump in stock market performance of the same kind investors endured in the summer of 2011.



Injections of liquidity by central banks in both Europe and the United States appear to have contributed to many of the stock market gains this year. The question now is what will happen if the Federal Reserve and the ECB pull back from further operations such as "QE2" and the LTRO in Europe.

The three charts and commentary above are courtesy of Thomson Reuters.