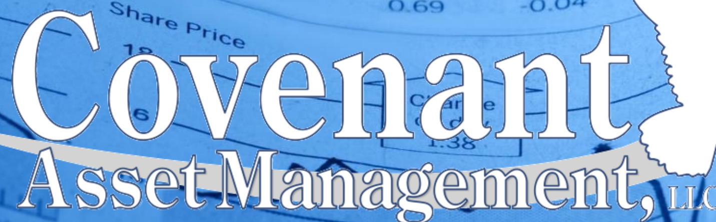
Second Quarter 2015 Investment Perspectives



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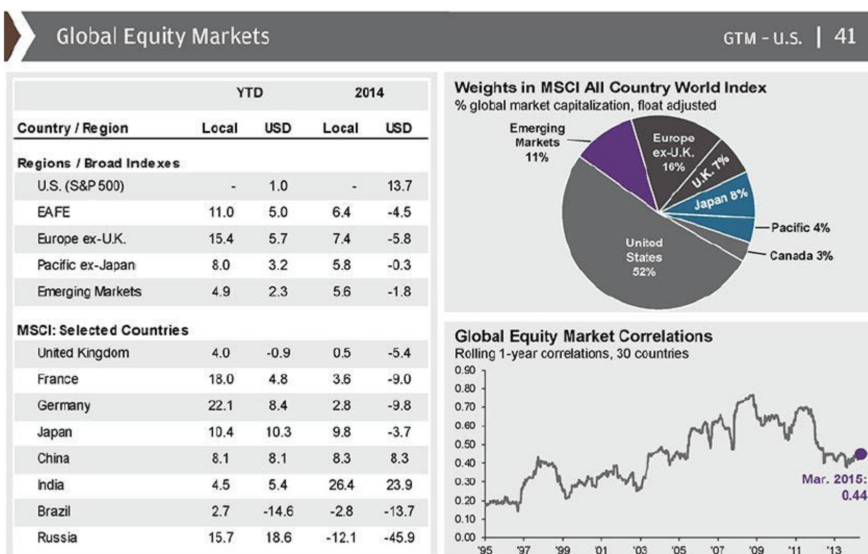
COVENANT ASSET MANAGEMENT IS PLEASED TO OFFER OUR LATEST INVESTMENT PERSPECTIVES. IN THIS PUBLICATION WE REVIEW FIRST QUARTER RESULTS AND HIGHLIGHT KEY ECONOMIC AND FINANCIAL THEMES WHICH WE EXPECT WILL DRIVE MARKETS AND INVESTMENT PERFORMANCE IN THE COMING MONTHS.

Key Themes

1. **U.S. equity markets virtually unchanged in Q1**
2. **Monetary policy divergence**
3. **Volatility rises, risks rise**

Financial Markets Review & Outlook

As the year began, few investors envisioned a first quarter where world financial markets would substantially outperform the U.S. Yet that is precisely what transpired as the MSCI All Country World Index ex-U.S. returned 6% vs. less than 1% for the S&P 500 index. Quantitative easing in Europe and Japan, coupled with the anticipation of the U.S. Federal Reserve Bank beginning to raise Fed Funds rates sometime this year, is the most widely cited reason for the divergent performance.

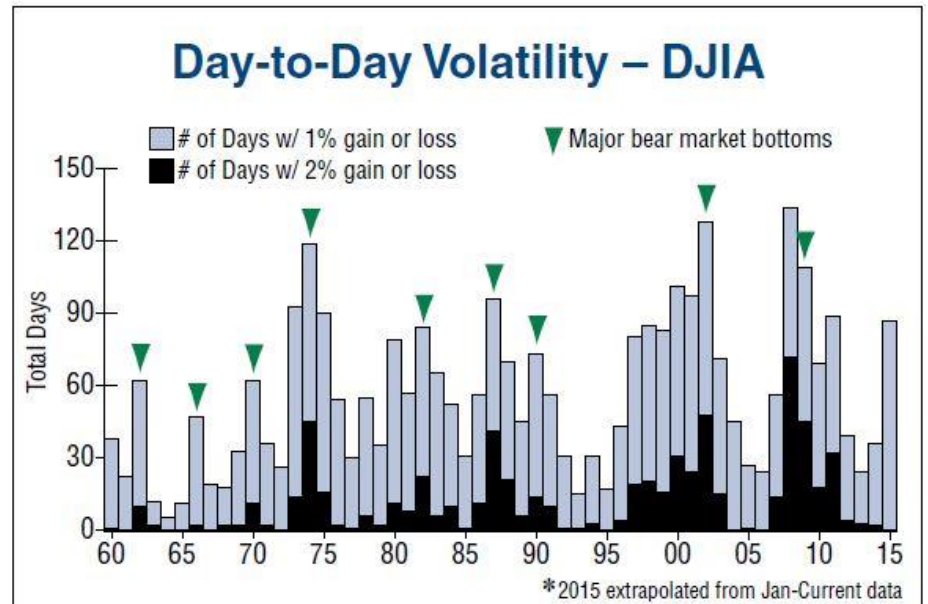


Country / Region	YTD Local	YTD USD	2014 Local	2014 USD
Regions / Broad Indexes				
U.S. (S&P 500)	-	1.0	-	13.7
EAFE	11.0	5.0	6.4	-4.5
Europe ex-U.K.	15.4	5.7	7.4	-5.8
Pacific ex-Japan	8.0	3.2	5.8	-0.3
Emerging Markets	4.9	2.3	5.6	-1.8
MSCI: Selected Countries				
United Kingdom	4.0	-0.9	0.5	-5.4
France	18.0	4.8	3.6	-9.0
Germany	22.1	8.4	2.8	-9.8
Japan	10.4	10.3	9.8	-3.7
China	8.1	8.1	8.3	8.3
India	4.5	5.4	26.4	23.9
Brazil	2.7	-14.6	-2.8	-13.7
Russia	15.7	18.6	-12.1	-45.9

This page looks at international equity markets and the opportunity set for global investing. The table on the left shows USD-denominated and local currency-denominated returns for various international indices. The top right pie chart highlights the share of global markets in each region while the bottom right shows the diversification benefit via lower correlations.

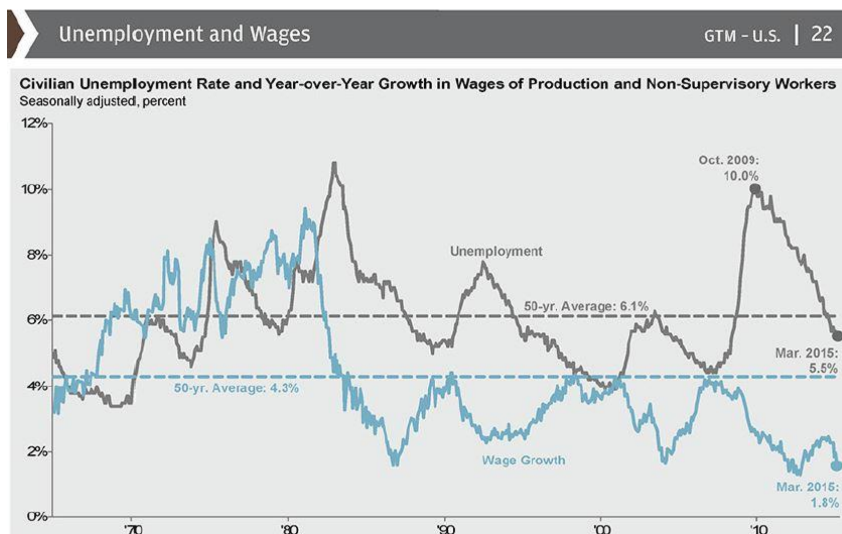
Fed policy uncertainty, dollar strength, recent weak economic data, oil price declines, and corporate profit growth concerns all contributed to increased volatility, but little advancement in U.S. stock indices. There were more 1% daily moves in the DJIA during the first quarter of 2015 than during the first three quarters of last

year. Additional worries persist that investors who had reallocated their investments toward more risk-based assets predicated on extremely accommodative Fed policy may now begin to shift assets toward more conservative investments.



First quarter earnings reports will provide some indication of the underlying strength of the U.S. economy. Overall first and second quarter earnings at S&P 500 companies are expected to decline by mid-single-digit rates due largely to the sharp drop in energy-related earnings. However, investors will be carefully analyzing reports from companies in other sectors and listening to guidance provided during post-earnings conference calls to assess future earnings trends.

While labor markets have improved in the past year, GDP growth remains sluggish. Fourth quarter 2014 GDP rose by 2.2% and first quarter GDP is expected to grow by around 1%. First quarter weakness is being blamed on bad weather (again) and the west coast port shutdown. The balance of the year is projected to show an uptick in growth to the 3% range, but there are plenty of concerns that 2015 will continue a pattern that has existed since the economic recovery began in 2009, where early year predictions of improved economic growth give way to disappointing growth as the year progresses. Should this trend continue, it could very well cause the Fed to postpone the initial Fed Funds rate increase



Source: BLS, FactSet, J.P. Morgan Asset Management.
Data are as of March 31, 2015.

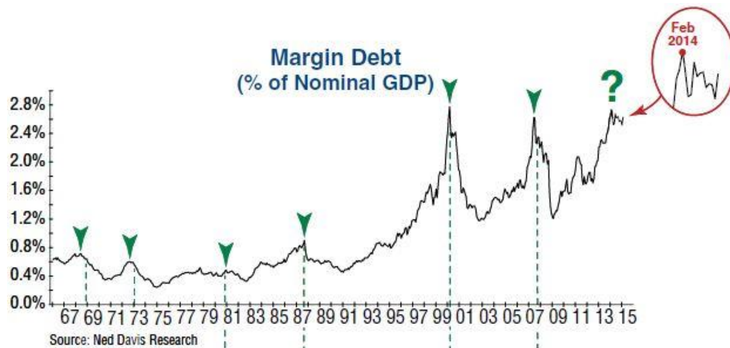
J.P.Morgan Asset Management

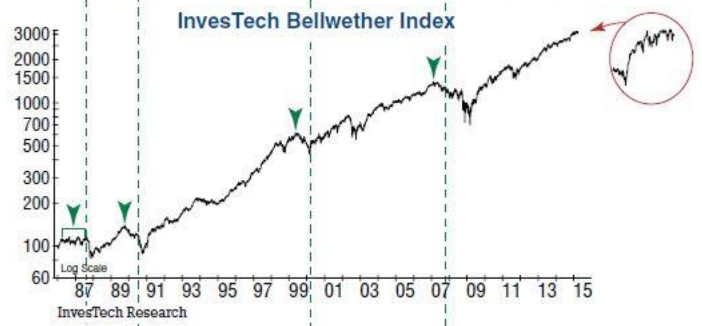
This page shows the unemployment rate and wage growth for production and nonsupervisory workers since the 1960s. The two measures have had a historically inverse relationship. As the unemployment rate continues its descent from a high of 10%, we expect wage growth to pick up.

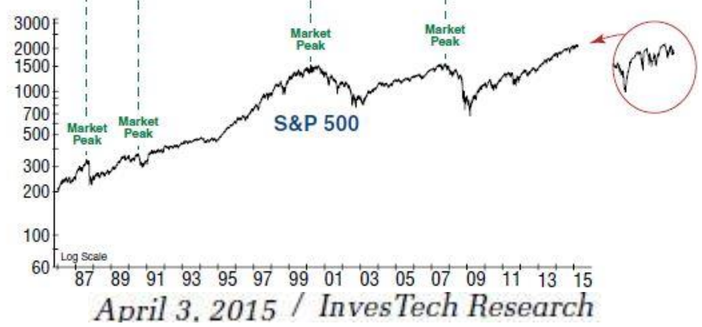
investors are anticipating and embark on a highly cautious and extended process of raising rates from the current near-zero level.

Updated Views on Stage of Economic & Stock Market Cycle

In our previous Investment Perspectives we highlighted a number of reasons we believe we are in the final third of the current bull market. The market recently entered the seventh year





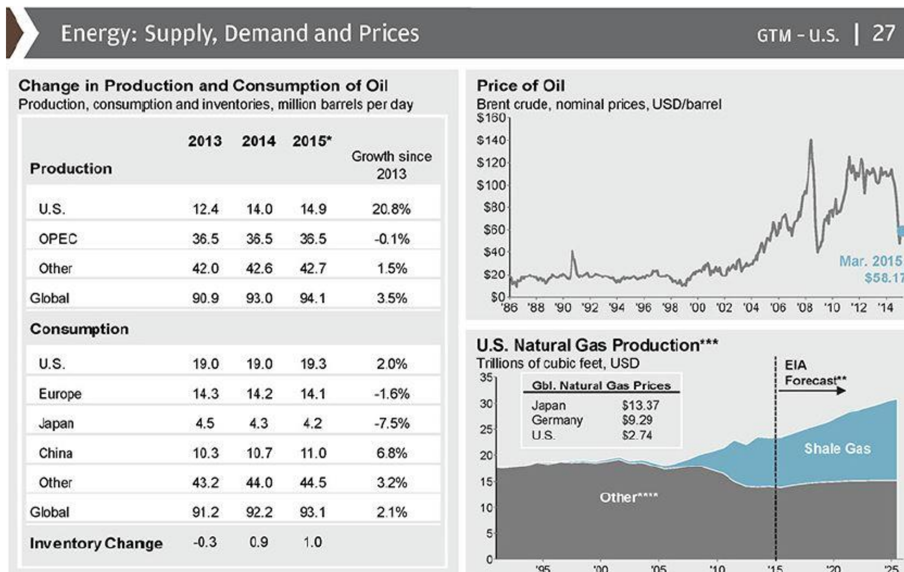


of expansion, a feat only matched 3 times previously since 1930. Earlier in the year we noted our concerns regarding the level of margin debt as well as overly bullish sentiment on the part of consumers and investors. We are pleased to report that while both of these indicators continue to bear watching, there have actually been some modest improvements in these trends, suggesting that we are likely to see further gains in U.S. stock prices before the cycle ends. And while there are few reasons to expect that a market peak is imminent, it is important to recognize the signs pointing to maturation in the cycle and the increased risks associated with an aging bull market.

Investment Strategy

Factors that influence U.S. equity markets aligned in the first quarter to allow good individual stock selection to produce out-sized relative gains. We were fortunate to have identified the right themes in the healthcare, technology and consumer sectors to produce strong gains so far this year, compared to the modest gains for U.S. equity benchmarks. In addition, as indicated previously, foreign markets have outperformed the U.S. this year and provided additional enhancements to portfolio performance, after being a drag on results the past three years.

In the months ahead, we expect volatility to continue and wouldn't be surprised to see additional sideways action for U.S. stocks as investors grapple with the implications of a change in monetary policy. We also expect upward momentum in the U.S. dollar to slow and downward pressure in energy prices to stabilize and begin to reverse as output and inventories shrink.



Energy: Supply, Demand and Prices

Change in Production and Consumption of Oil
Production, consumption and inventories, million barrels per day

	2013	2014	2015*	Growth since 2013
Production				
U.S.	12.4	14.0	14.9	20.8%
OPEC	36.5	36.5	36.5	-0.1%
Other	42.0	42.6	42.7	1.5%
Global	90.9	93.0	94.1	3.5%
Consumption				
U.S.	19.0	19.0	19.3	2.0%
Europe	14.3	14.2	14.1	-1.6%
Japan	4.5	4.3	4.2	-7.5%
China	10.3	10.7	11.0	6.8%
Other	43.2	44.0	44.5	3.2%
Global	91.2	92.2	93.1	2.1%
Inventory Change	-0.3	0.9	1.0	

Source: EIA, FactSet, J.P. Morgan Asset Management. *Forecasts are from the EIA Short-Term Energy Outook and start in 2015. **Forecasts are from EIA Annual Energy Outlook and start in 2014. ***Production numbers as of 2015. ****Other includes conventional on and offshore natural gas drilling, tight gas, and coalbed methane. Natural gas prices are $/mmbtu and are as of February 2015. Data are as of March 31, 2015.

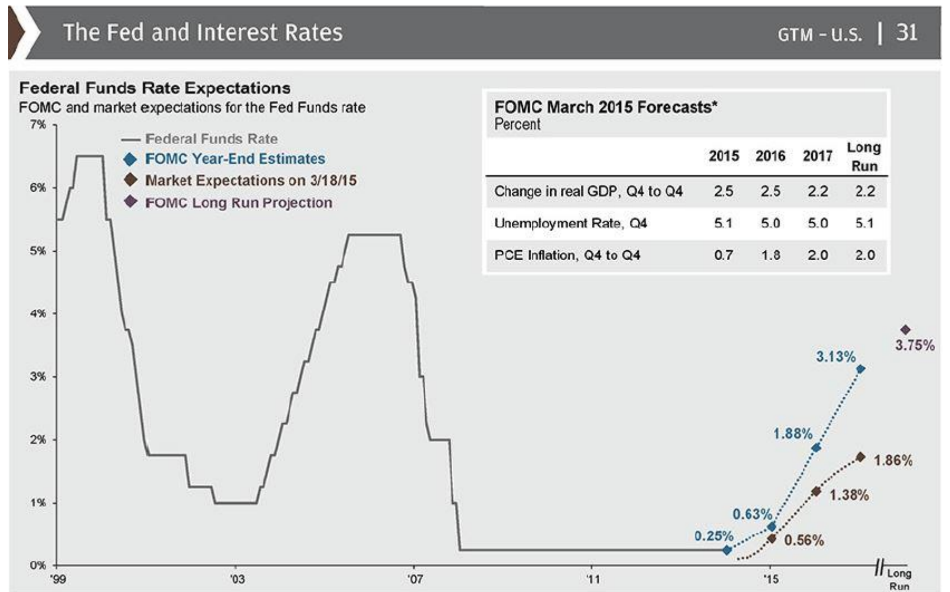
This slide looks at supply and demand dynamics for oil, the price of oil, and natural gas production. An imbalance in the growth of production and consumption trends for oil have contributed to the recent decline in oil prices. New technology has had an impact on the increasing oil and natural gas production in the United States.

We also expect the recent outperformance by many foreign markets to continue as Europe and Japan provide massive amounts of monetary stimulus through their quantitative easing programs. Whether or not these programs help their respective economies to rebound, history has proven that monetary programs of this fashion tend to increase asset prices proportionately to the size of the stimulus.

With regard to fixed-income strategies, there is no reason to believe the Fed is likely to begin raising interest rates in an aggressive fashion, given the mixed economic signals and fears

about the implications of further dollar strength. Expecting this scenario, we believe investing in a balanced portfolio of high-grade and lower-grade fixed-income securities with intermediate-term maturities should provide the best risk/reward opportunity.

We look forward to discussing our views and expectations with you on an individual basis and always appreciate your feedback, comments or questions.



	2015	2016	2017	Long Run
Change in real GDP, Q4 to Q4	2.5	2.5	2.2	2.2
Unemployment Rate, Q4	5.1	5.0	5.0	5.1
PCE Inflation, Q4 to Q4	0.7	1.8	2.0	2.0

This page shows the differences in rate expectations between the FOMC and market participants. Market participants expect the Fed Funds rate to be much lower than what is being projected by the FOMC, meaning large and unexpected rate hikes could disrupt the market. However, after the last meeting in March, the FOMC lowered their projections to end closer in line with the market.

S&P 500 Index at Inflection Points

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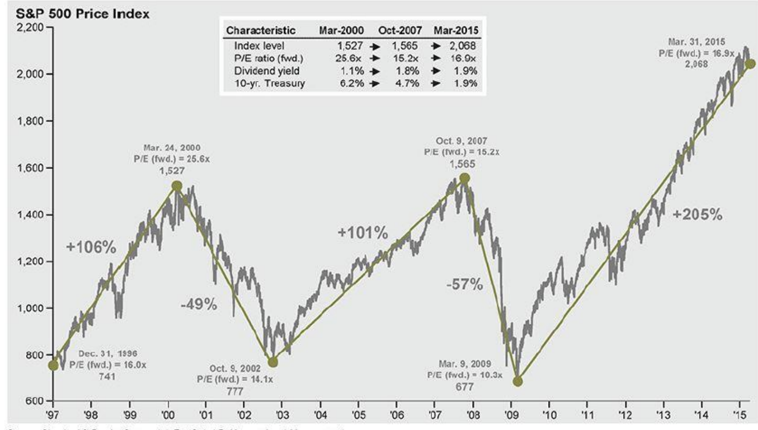

Source: Standard & Poor's, Compustat, FactSet, J.P. Morgan Asset Management.
Dividend yield is calculated as the annualized dividend rate divided by price, as provided by Compustat. Forward Price to Earnings Ratio is a bottom-up calculation based on the most recent S&P 500 Index price, divided by consensus 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.
Data are as of March 31, 2015.

This chart shows the past two market cycles in the S&P 500, highlighting peak and trough valuations, as well as inde levels, dividend yields and the 10-year U.S. Treasury yield.

Stock Market Since 1900

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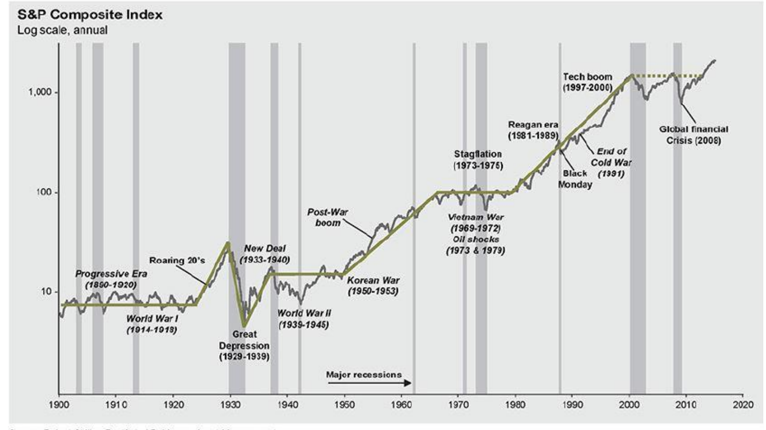

Source: Robert Shiller, FactSet, J.P. Morgan Asset Management.
Data shown in log scale to best illustrate long-term index patterns.
Past performance is not indicative of future returns. Chart is for illustrative purposes only.
Data are as of March 31, 2015.

This chart shows the S&P Composite Index, on a logarithmic scale, since 1900. The log scale helps illustrate long-term index patterns, namely the distinct periods of range and trend bound markets. Annotations help indicate what caused the movements in the market and average data helps put high recent annual returns in perspective.

Bear Markets

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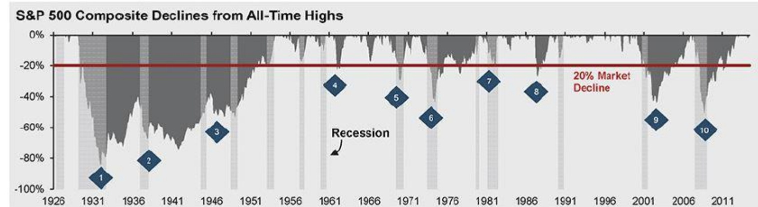

Characteristics of Past Bear Markets

◆	Market Corrections	Cycle Peak	Bull Market Duration (Months)	Decline from All-time High	Recession	Commodity Shock	Fed Tightening	Extreme Valuations	Commentary
1	Crash of 1929	Aug 1929	37	-84%	◆			◆	Excessive leverage, irrational exuberance
2	1937 Fed Tightening	Feb 1937	22	-74%	◆		◆		Premature monetary tightening
3	Post WWII Crash	May 1946	48	-54%	◆			◆	Post-war demobilization, recession fears
4	Flash Crash of 1962	Dec 1961	14	-22%				◆	Flash crash, Cuban Missile Crisis
5	Tech Crash of 1970	Dec 1968	73	-29%	◆	◆	◆		Economic overheating, civil unrest
6	Stagflation	Dec 1972	29	-43%	◆	◆			OPEC oil embargo
7	Volcker Tightening	Nov 1980	31	-19%	◆	◆	◆		Extremely high rates to reign in inflation
8	1987 Crash	Aug 1987	59	-27%					Program trading, overheated market
9	Tech Bubble	Aug 2000	118	-42%	◆			◆	Extreme valuations, mostly in tech stocks
10	Global Financial Crisis	Oct 2007	55	-51%	◆	◆	◆		Leverage, housing, Lehman collapse

Source: Standard & Poor's, NBER, FactSet, Robert Shiller, J.P. Morgan Asset Management.
*A bear market represents a 20% or more decline from the previous market high.
Data are as of March 31, 2015.

This chart shows historical bear markets (a 20% market decline from the previous all-time high), what caused them, and the magnitude of the drawdown. This is meant to illustrate that lofty valuations are not predictors of bear markets, but rather, bear markets are caused by external factors such as geopolitical conflict, monetary policy action and recessions.

Stock Valuation Measures: S&P 500 Index

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U.S. Equity: Valuation Measures

Valuation Measure	Description	Latest	1-year ago	5-year avg.	10-year avg.	25-year avg.*
			Historical Averages			
P/E	Price to Earnings	16.9x	15.5x	13.6x	13.8x	15.7x
CAPE	Shiller's P/E	27.8	25.9	22.7	22.9	25.4
Div. Yield	Dividend Yield	1.9%	1.9%	2.0%	2.0%	2.1%
REY	Real Earnings Yield	3.9%	4.2%	5.0%	4.5%	2.9%
P/B	Price to Book	2.8	2.7	2.3	2.4	2.9
P/CF	Price to Cash Flow	11.8	11.1	9.4	9.7	11.3
EY Spread	EY Minus Baa Yield	1.4%	1.7%	2.2%	1.3%	-0.6%

Source: Standard & Poor's, FactSet, Robert Shiller, FRB, J.P. Morgan Asset Management. Price to Earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months. Shiller's P/E uses trailing 10-years of inflation adjusted earnings as reported by companies. Dividend Yield is calculated as the trailing 12-month average dividend divided by price. Real Earnings Yield is defined as (trailing four quarters of reported earnings/price) - year over year core CPI inflation. Price to Book Ratio is the price divided by book value per share. Price to Cash Flow is price divided by NTM cash flow. EY Minus Baa Yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. *P/CF is a 20-year avg. due to cash flow data availability.
Data are as of March 31, 2015.

This slide shows a variety of valuation metrics for the U.S. equity market, as well as their long-term averages. The bottom right chart can be used to look at the relative valuation of stocks and bonds.

Historical Impacts of Rate Increases

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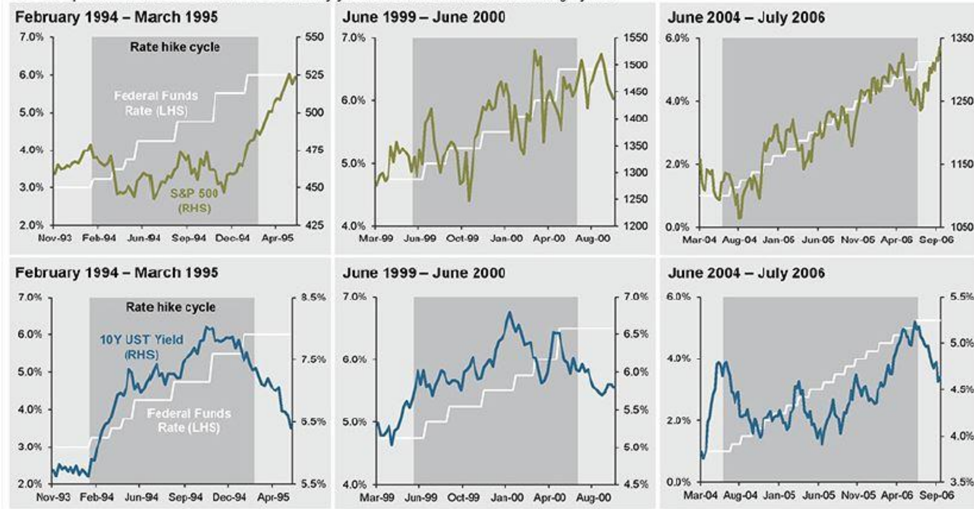
Returns and Yield Changes During Rate Hiking Cycles

S&P 500 price index and 10-Year U.S. Treasury yield over the last three rate hiking cycles



Source: Standard & Poor's, FactSet, J.P. Morgan Asset Management.
Data are as of March 31, 2015.

J.P.Morgan
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These charts illustrate how the S&P 500 and the fixed income market, as measured by the 10-Year U.S. Treasury yield, fared in the three previous Fed rate hike cycles. It shows that while both markets tend to have an adverse reaction to the initial rate hikes, they both rebound later on in the hike cycle. This allows investors to put the volatility they are most likely to experience leading up to the rate hike into perspective and to understand that markets typically react this way but ultimately recover by the end of the rate hike cycle.