Covenant Asset Management, LLC

Second Quarter 2016 Investment Perspectives

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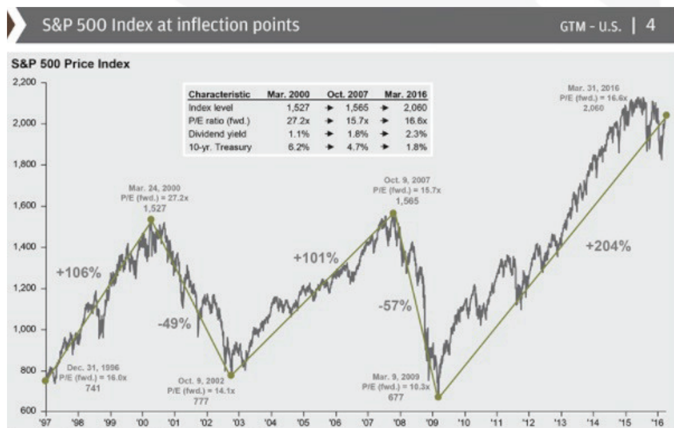
Financial Markets Review And Outlook

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

Stock markets around the globe went on a wild ride in the first quarter of 2016. After beginning the first six weeks of the year with the worst opening losses in Wall Street history, the rally that began in mid-February was the biggest since 1933. The reversal was ignited by a rebound in oil prices and subsequently fueled by the announcements of additional monetary stimulus programs by a number of central banking authorities. The rapid recovery in stock prices has allowed investors to reset their expectations for the remainder of the year. While some investors may be more optimistic, we believe a cautionary bias is appropriate at this point, given the fragility of global growth along with concerns related to the upcoming U.S. national elections.

Lethargic U.S. economic activity continues to be the norm with fourth quarter 2015 GDP growth reported at 1.4% and expectations of 0.7% for the first quarter of 2016.



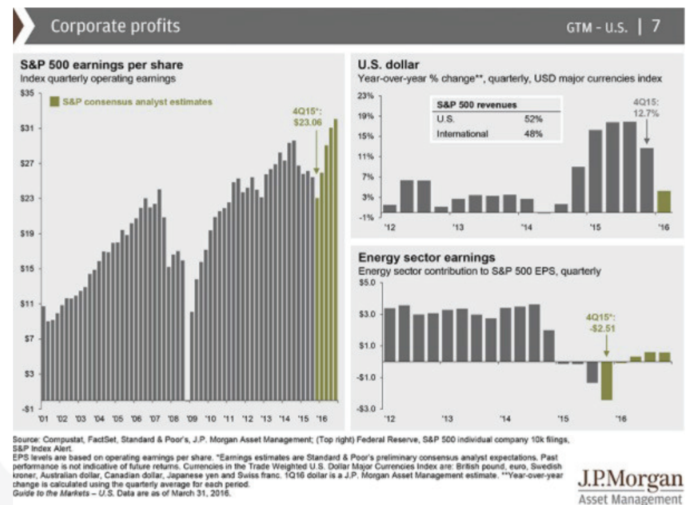
S&P 500 index at inflection points

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

KEY THEMES

1. Unprecedented quarterly stock market action
2. U.S. economy still sluggish but manufacturing rebounding
3. Federal Reserve Bank sending mixed signals
4. Recent government action and campaign rhetoric decidedly negative for business

According to the Institute of Supply Management's (ISM) Manufacturing Index, U.S. manufacturing appears to have emerged from a six-month contraction. Most encouraging is the new orders component which has shown a big jump recently, potentially setting the stage for further improvement. Since part of the downturn in manufacturing can be attributed to the collapse in oil



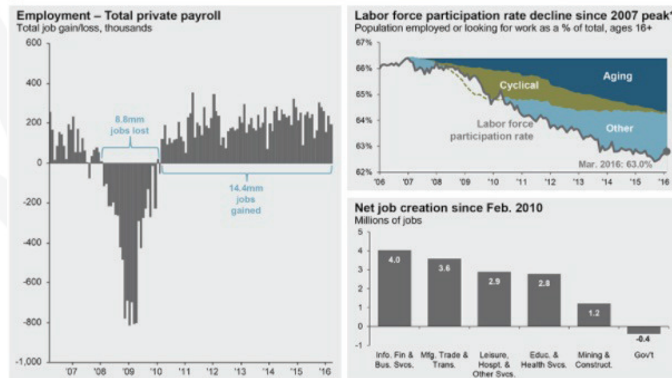
Corporate profits

This slide looks at corporate profits. The left chart shows operating earnings for the S&P 500 as well as consensus analyst expectations for earnings through the end of 2016. This is meant to illustrate that the pullback in earnings was due to transitory factors and we should see a rebound once these subside. The two charts on the right side show the two macro factors that have detracted from earnings thus far this year: The strength of the U.S. dollar and dismal energy sector earnings from low oil prices.

prices, the rebound in oil and commodities prices and recent weakness in the U.S. dollar provide some hope for an uptick in GDP growth to 2% or higher during the rest of the year. While the bounce in oil prices may be a bit stretched, the decline in the number of oil rigs in operation by more than 75% in the past year has probably run its course.

Financial Markets Review And Outlook

The labor market continues its steady progress with monthly job growth averaging above 200,000, unemployment at 5.0% and initial jobless claims trending near historic low levels. Another positive sign

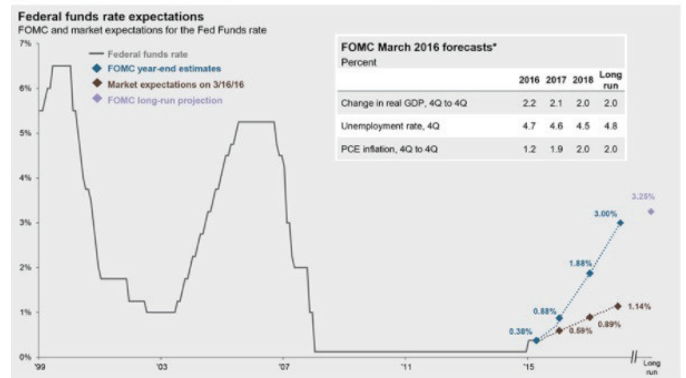


Labor market perspectives

This page examines the unemployment situation further. The left side of the page highlights the number of jobs created since the financial crisis, and the right side of the page shows an ever decreasing labor force participation rate since the 1990's, which will limit the number of workers available to take each new job created. The causes for this decline are explored in this chart as well. A large portion of the decline in participation comes from an aging workforce (retirees are counted as potential labor, but are not participating in the workforce). A cyclical decline in the participation rate was to be expected as the unemployment rate shot up, though the effect has diminished as the expansion has progressed. Other factors contributing to the decline in labor force participation may include the rise in the population with a criminal record, in workers claiming disability benefits, and the mismatch of workers' skills with job requirements. The bottom right chart shows which economic sectors have created the most jobs during this recovery.

is that the labor force participation rate has begun to rise for the first time since the financial crisis as discouraged workers finally begin to return to the job market. However, the U-6 unemployment rate, which includes discouraged workers and workers who are working part time that would like to be working full time, is 9.9%, which is down from 11.0%, but still high.

In the past few months it has become evident that the Fed is feeling the same frustrations as investors. Its unprecedented monetary measures have been less effective than expected and, after more than seven years of near-zero fed funds rates, some Fed members have become concerned that risks are building if rates are left at extremely low levels. Some members are advocating a quicker move to more normal fed funds rate levels. However, other members, including Janet Yellen, are more worried about raising rates too aggressively and causing a recession. In the past month, the Fed has ratcheted back its previous rate



FOMC March 2016 forecasts*
Percent

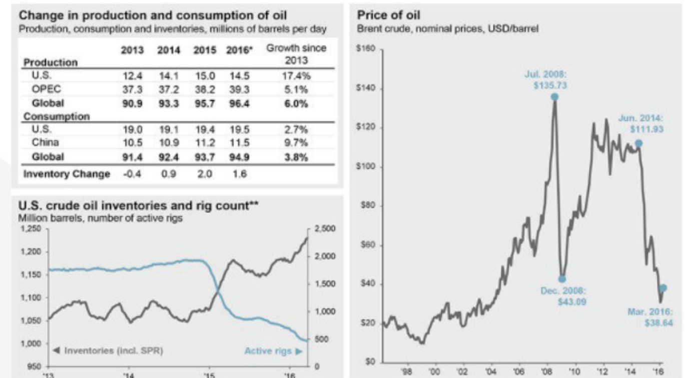
	2016	2017	2018	Long run
Change in real GDP, 4Q to 4Q	2.2	2.1	2.0	2.0
Unemployment rate, 4Q	4.7	4.6	4.5	4.8
PCE inflation, 4Q to 4Q	1.2	1.9	2.0	2.0

The Fed and interest rates

This page shows the differences in rate expectations between the FOMC and market participants. Market participants expect the federal funds rate to be much lower than what is being projected by the FOMC, meaning large and unexpected rate hikes could disrupt the market.

hike expectations from four to two in 2016. Market forecasts call for no more than one rate hike this year.

Another issue that has the potential to weigh on corporate sentiment and markets in the months ahead is the decidedly negative recent government actions.



Change in production and consumption of oil
Production, consumption and inventories, millions of barrels per day

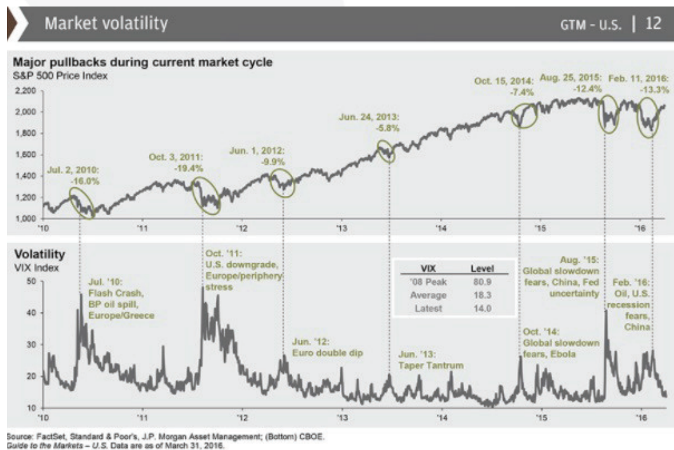
	2013	2014	2015	2016*	Growth since 2013
Production					
U.S.	12.4	14.1	15.0	14.5	17.4%
OPEC	37.3	37.2	38.2	39.3	5.1%
Global	**90.9**	**93.3**	**95.7**	**96.4**	**6.0%**
Consumption					
U.S.	19.0	19.1	19.4	19.5	2.7%
China	10.5	10.9	11.2	11.5	9.7%
Global	**91.4**	**92.4**	**93.7**	**94.9**	**3.8%**
Inventory Change	-0.4	0.9	2.0	1.6	

Oil markets

The table on the top left hand side shows the growth in supply and demand for petroleum over the past few years, which highlights that while demand has not increased much globally, supply has. The increase in supply has mainly come from the U.S., due to the shale oil revolution, shown by the steady increase in inventories on the bottom left chart, while the number of active rigs producing this supply has fallen with prices. This increase in supply is one of the drivers of the recent downturn in oil prices, which can be seen on the right side of the page.

Economic and Financial Market Challenges

When rules can be changed retroactively through executive or regulatory actions without going through the normal legislative process, corporate planning and capital expenditure decisions become more difficult. A recent example of this is when the Treasury Department issued new regulations to restrict tax inversions. These new rules were successful in killing the proposed Pfizer/Allergan merger, but may inhibit the ability for corporations to confidently engage in strategic planning. A better approach may have been to focus on corporate tax reform which would reduce the incentive for corporations to move their tax domicile to countries which offer lower corporate tax rates.



J.P.Morgan
Asset Management

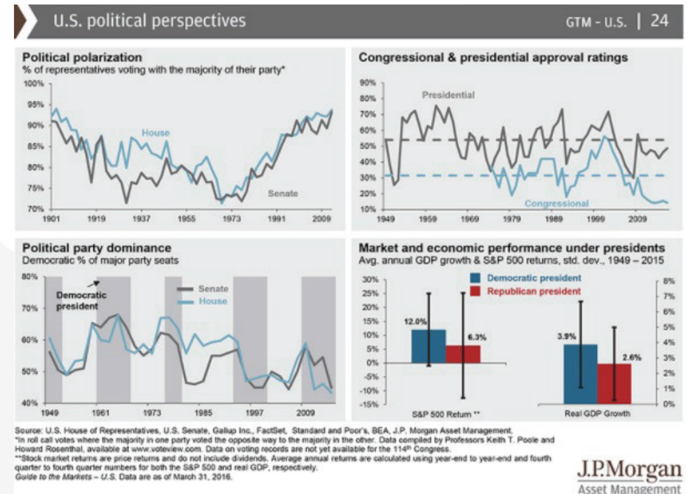
Market volatility

This slide looks at various measures of market volatility, with the top left chart showing the number of 5% pullbacks for each calendar year, and the bottom left chart showing the magnitude and date of pullbacks of greater than 5% over the course of this cycle. The top right chart shows the VIX and the bottom right chart shows equity correlations, which typically move in tandem with the VIX.

Adding to market uncertainty is the unfriendly business-related rhetoric being expressed on the primary election campaign trail. On the Democratic side, Hillary Clinton, in an effort to secure the nomination, has been moving further to the left in order to keep up with Bernie Sanders' (an avowed socialist) promises of punishing Wall Street and instituting higher taxes to fund such initiatives as free college tuition and expanded healthcare. In addition, Donald Trump, the Republican front-runner, has been promoting protectionist policies. He has blamed currency devaluations around the world for hurting the U.S. economy and costing American jobs and has called for a tougher stance on trade. He has floated the idea of slapping 45% tariffs on Chinese imports if they fail to negotiate in good faith. If Trump eventually secures the nomination, markets could be vulnerable to a correction based upon geopolitical global growth concerns.

Beyond the campaign rhetoric, it is not too early to begin considering the implications of various election result scenarios on financial markets. As an investor, it is important to remember that, as dysfunctional as our government can seem at times, our system was designed to be self-correcting. Party control of the Presidency and Congress tend to alternate and mid-term elections provide the electorate a mechanism to prevent either party from having too much control for very long.

As the chart nearby suggests, both the economy and financial markets have shown their ability to perform under both Democrat and Republican leadership. Markets do tend to perform best under divided government, given the lower probability of significant economic policy changes. And, while companies may not like certain policies, they have always proven adaptable in order to make money.

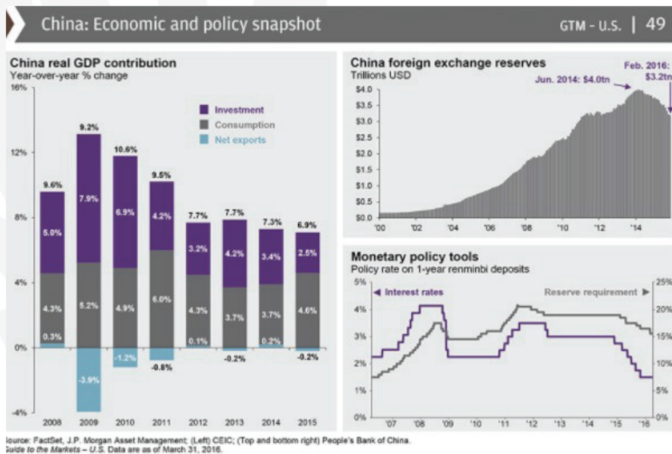


U.S. political perspectives

This page explores the political environment's impact on markets and the economy. One common refrain is that our political system is more polarized than ever, which the top left chart shows to be true. This may be one of the reasons no one seems to like current office holders very much; this page shows the current approval ratings for the President and for Congress in the top right corner. The bottom left chart shows that, for those disapproving of the job being done by the party in power, it will likely change. Our political system is designed to be mean reverting, and it works. The bottom right displays the average return in the equity market and average growth in real GDP with different parties in the White House. The black bars show one standard deviation on each side of the average, demonstrating how widely market and economic performances have varied under different administrations.

Investment Strategy

As the charts below related to China suggest, the economic stimulus measures instituted by the government over the past several quarters appear to have stabilized reported GDP growth. These measures are considered to have partially contributed to the rebound in oil and commodities prices over the last couple of months. They have most likely also influenced the rebound in manufacturing activity in China, as the April PMI report revealed a big jump to expansion mode which reversed the contraction in manufacturing seen in the last six months.



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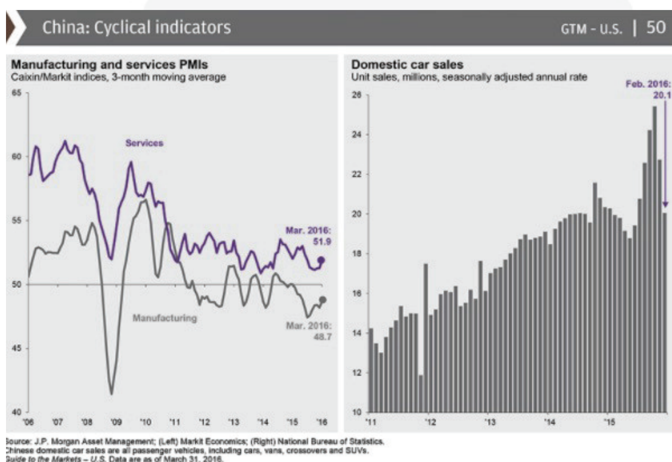
China: Economic and policy snapshot

Chinese growth overall has been slowing down over the past few years, as the government works to shift the composition of growth away from investment spending and towards domestic consumption (left graph). In order to make sure that this growth slowdown is orderly, the Chinese government can rely on policies to stabilize the exchange rate such as unwinding their massive foreign exchange reserves (top right graph) and stimulus, such as policy interest rate cuts and/or reserve requirement ratio cuts, like they have begun to do this year (bottom right graph).



J.P.Morgan

China: Cyclical indicators

This page examines some of the cyclical indicators influencing China's economic growth. The right side shows the dramatic rise in vehicle purchases in the last few years, as China has sifted toward a more consumption based economy. The left shows the PMI reading for the manufacturing and service sectors of the economy, which further illustrates the manufacturing slowdown. Though China's economy is slowing down overall, the manufacturing sector is slowing more.

A final note on Covenant's preferred style of equity investing. The following link to our website details our equity selection process: http://www.covasset.com/philosophy/equity-growth This process has served our clients very well over many years with our annual returns meeting or exceeding the S&P 500 Index price performance in six of the past eight years and cumulative returns nearly doubling that of the S&P 500 during that period. Notably, our style has been very much out of favor thus far this year and our year-to-date results have significantly lagged the S&P 500. While it is uncomfortable to go through a period of under-performance, we know that in the short-term equity styles move in and out of favor on a regular basis. From experience, it is vital that we do not attempt to change our style or philosophy. Rather, we need to stay disciplined in our approach and redouble our efforts to differentiate those companies which have suffered declines because the characteristics of their company is currently out of favor in the eyes of investors from those where the fundamentals of the company or industry have been negatively altered.

As your fiduciaries, we assure you that we will make every effort to work with you to know and understand your needs and objectives and diligently fashion a portfolio that is best suited to meet those objectives. The nature of markets makes it nearly impossible to achieve market-exceeding results over every time-frame. We are confident that the approach we have utilized in the past with a proven level of success will continue to produce strong results for you over the long term.

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

Economic and Financial Market Outlook

Returns and valuations by style GTM – U.S. | 8

1Q 2016

	Value	Blend	Growth
Large	1.6%	1.3%	0.7%
Mid	3.9%	2.2%	0.6%
Small	1.7%	-1.5%	-4.7%

2015

	Value	Blend	Growth
Large	-3.8%	1.4%	5.7%
Mid	-4.8%	-2.4%	-0.2%
Small	-7.5%	-4.4%	-1.4%

Since market peak (October 2007)

	Value	Blend	Growth
Large	38.9%	58.3%	81.0%
Mid	66.7%	69.6%	70.2%
Small	39.4%	48.3%	56.7%

Since market low (March 2009)

	Value	Blend	Growth
Large	246.4%	253.7%	269.3%
Mid	325.6%	309.3%	293.5%
Small	244.6%	257.7%	269.7%

Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	16.3 / 14.3	16.6 / 17.2	19.5 / 21.1
Mid	17.7 / 14.5	19.1 / 16.8	20.6 / 22.1
Small	17.3 / 14.7	18.8 / 17.5	20.5 / 21.6

Current P/E as % of 20-year avg. P/E

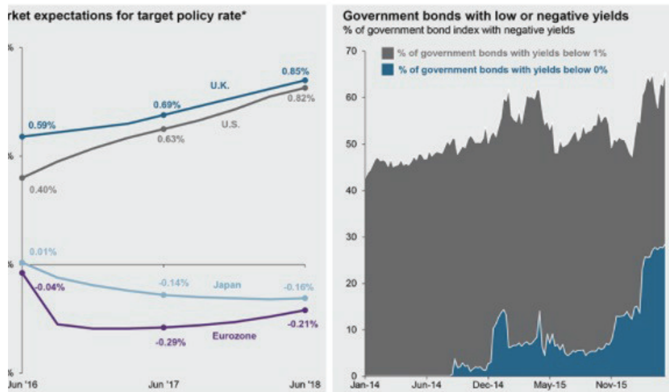
	Value	Blend	Growth
Large	113.9%	96.7%	92.1%
Mid	121.8%	113.6%	93.3%
Small	117.5%	107.3%	94.9%

Source: FactSet, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management.
All calculations are cumulative total return, including dividends reinvested for the stated period. Since Market Peak represents period 10/9/07 – 3/31/16, illustrating market returns since the S&P 500 Index high on 10/9/07. Since Market Low represents period 3/9/09 – 3/31/16, illustrating market returns since the S&P 500 Index low on 3/9/09. Returns are cumulative returns, not annualized. For all time periods, total return is based on Russell-style indexes with the exception of the large blend category, which is based on the S&P 500 Index. Past performance is not indicative of future returns. P/E ratios reflect latest available data. Earnings estimates are as of January for Russell Indexes and as of February for Standard & Poor's.
Guide to the Markets – U.S. Data are as of March 31, 2016.

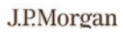
Returns and valuations by style

This page shows returns and valuations by investment style for the U.S. equity market, and leverages the "style box" framework pioneered by Morningstar. Return periods include the most recent quarter, year-to-date returns, returns since the 2007 peak and returns since the 2009 low. To the right, valuations depict which areas of the U.S. equity markets are trading at a deeper discount or premium, relative to their own 20-year average.

Global fixed income dynamics GTM – U.S. | 35



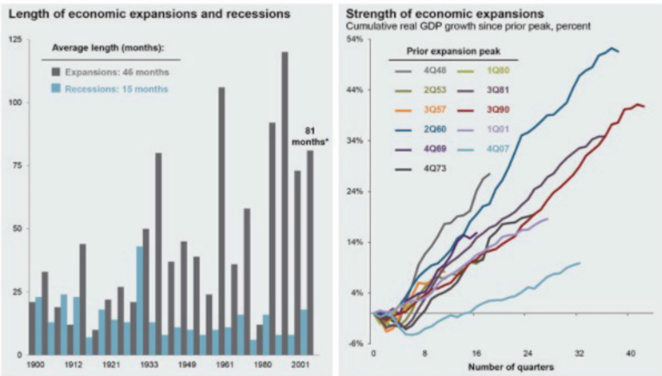
Bloomberg, J.P. Morgan Asset Management; (Right) BofA/Merrill Lynch.
policy rates for Japan are estimated using EuroYen 3m futures contracts less a risk premium of 6bps. Government bond index is the BofAML Government Bond Index.
o the Markets – U.S. Data are as of March 31, 2016.



Global fixed income dynamics

The chart on the left shows the expected direction of monetary policy in developed markets. While rates in the U.S. and the U.K. remain positive and are expected to increase, rates in Japan and Europe have moved below zero and are expected to be lowered further into negative territory. This negative interest rate policy has caused the universe of government bonds with low and negative yields to increase rapidly in recent years.

The length and strength of expansions GTM – U.S. | 17

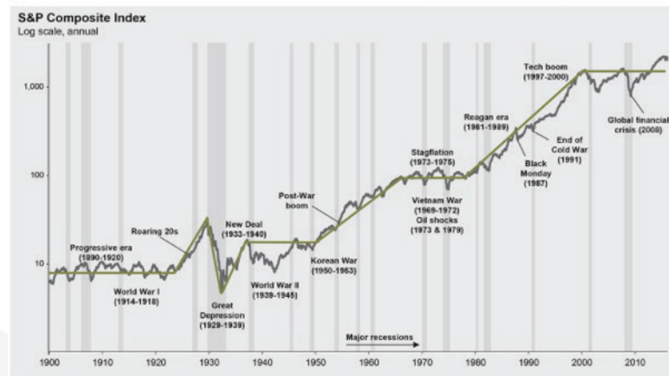


Source: BEA, NBER, J.P. Morgan Asset Management. *Chart assumes current expansion started in July 2009 and continued through March 2016, lasting 81 months so far. Data for length of economic expansions and recessions obtained from the National Bureau of Economic Research (NBER). These data can be found at www.nber.org/cycles/ and reflect information through March 2016.
Guide to the Markets – U.S. Data are as of March 31, 2016.

The length and strength of expansions

This page compares the current expansion to previous ones. The left side of the page shows that while recessions do happen every so often, they typically do not last long. Expansions, on the other hand, last much longer. This current expansion is no exception. However, despite lasting much longer than the average, this expansion is the weakest in terms of GDP growth in the post-World War II period. This is shown on the right side of the page.

Stock market since 1900 GTM – U.S. | 16



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.
Guide to the Markets – U.S. Data are as of March 31, 2016.

Stock market since 1900

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.

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