Covenant
Asset Management, LLC

Second Quarter 2018 Investment Perspectives

John Guarino, President | www.covasset.com
125 Maple Avenue Chester, NJ 07930 | (908) 879-4090

Economic and Financial Markets Review & 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.

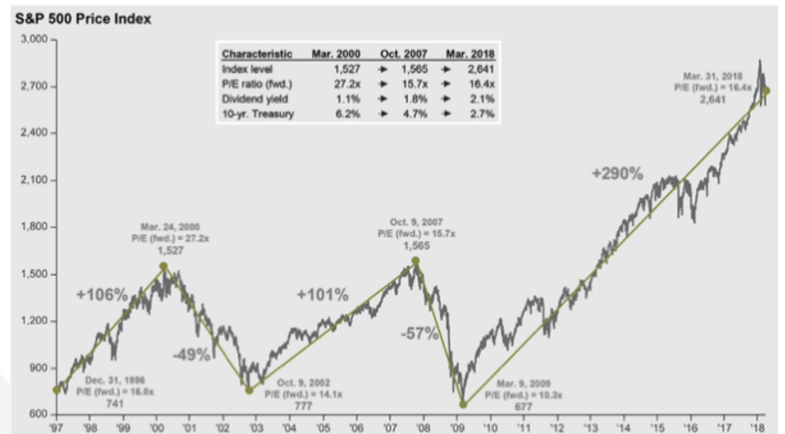
An historic period of low volatility came to an abrupt end in 2018's first quarter. Strong gains in January couldn't hold as a rapid rise in interest rates led to a spike in volatility measures and a sudden plunge in stock prices in early February. By the end of the month, most of the losses had been recouped, but stocks sold off again in mid-March after the Trump Administration announced broad-based steel tariffs and imposed tariffs on $50 billion of Chinese imports. The market-leading tech sector has been hard hit in the past few weeks on concerns that social media giant Facebook allowed third parties to improperly use customer data. These concerns spilled over to other FANG stocks (Facebook, Amazon, Netflix and Google), and President Trump's recent tweet storm berating Amazon for not paying taxes and taking advantage of cheap delivery costs at the U.S. Post Office perpetuated the declines.

U.S. stock indices ended the first quarter of 2018 with declines for the DJIA and the S&P 500. Nasdaq managed a small gain which disappeared on the first day of trading in the second quarter. These negative results ended an historic nine quarter stretch of gains dating back to the third quarter of 2015. During this period, major indices gained more than 40% and investor sentiment reached euphoric levels.

With markets officially in correction territory, more than 10% below their January highs, investor behavior in the next several weeks will likely determine whether new leadership will emerge and markets stabilize or another leg down materializes. Our view is that strength in economic indicators and first quarter earnings are likely to steady markets for a period of time. However, significant technical damage has been inflicted in the past two months, which typically takes time to repair. Nine years

KEY THEMES

1. Stocks have experienced renewed volatility the past few months and the first correction in over two years. Increased volatility doesn't mean the end of the bull market, but the environment has become more challenging.
2. The U.S. economy has shown improved growth in the past year, but risks to growth are emerging as trade issues arise and the Fed continues its rate-hiking campaign.
3. Strong economic and corporate earnings reports in coming weeks could help steady markets, but it is late in the economic and market cycle and defensive measures may be warranted at some point this year.



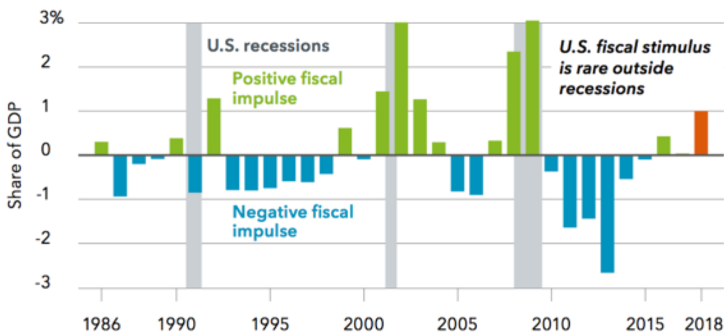
Economic and Financial Markets Review

into an economic expansion and a bull market in stocks, investors should begin to prepare for the end of the expansion.

With the passage of tax reform last year and an increase in spending authorized in the recent federal budget plan, the U.S. economy is getting its first big fiscal stimulus since the financial crisis ended. This increased stimulus has lifted expectations for economic growth and corporate earnings momentum. After hitting an 18-year high in February, U.S. consumer sentiment retreated slightly in March, perhaps reflecting consumers' reaction to

Hello, big stimulus

U.S. fiscal impulse, 1986–2018



Sources: BlackRock Investment Institute, with data from the Organization for Economic Cooperation and Development (OECD), March 2018. Notes: The fiscal impulse gauges the annual impact of fiscal policy on GDP growth, measured by the change in the primary U.S. fiscal deficit (excluding net interest costs) as a share of GDP. OECD figures are cyclically adjusted. The orange bar is a full-year 2018 BlackRock estimate of tax cuts (+0.4 percentage point) and spending increases (+0.6 percentage point), both based on a multiplier below one because late-cycle stimulus typically has reduced knock-on effects.

February's stock market volatility. The labor market appears to be strong and tightening as weekly jobless claims recently dropped to the lowest level since 1973 and over three-hundred thousand net new jobs were added in February. Inflation expectations have been on the rise of late, although they are still below the 2% Federal Reserve Bank target. This should allow the Fed to continue to go slow in their campaign to raise short-term interest rates. The environment for stocks remains positive, but with more muted returns and higher volatility expected than in recent years. However, rising U.S. protectionism is the clearest threat to the

Changing environment

Source: Charles Schwab, Macrobond, Standard & Poor's, Chicago Board Options Exchange (CBOE) as of 3/27/2018

near-term global economic outlook. Proposed U.S. trade actions against China and other countries are likely to trigger bouts of volatility, but in their present form they are unlikely to derail the economic and market expansion. Any escalation into a trade war would likely harm investor sentiment and could change the market outlook. Fortunately, there are good reasons to believe a trade war is improbable. Since the last trade war during the Great Depression 90 years ago, a number of important lessons have been learned and global trade advancements implemented. The most important lesson was taken from the experience during the Great Depression when global trade shrank by over 50%. Since that time, globalization has increased dramatically as free trade agreements were implemented between many countries. In addition, globalization has led to longer supply chains as companies have outsourced parts of their manufacturing operations to low-cost

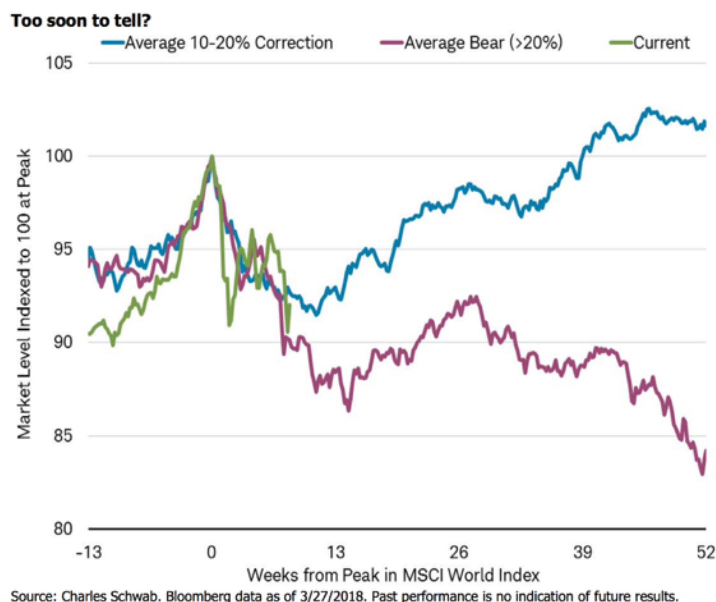
Economic and Financial Markets Challenges

regions of the world. Finally, the World Trade Organization, founded in 1995, has a dispute resolution process intended to prevent escalating trade tensions. In recent decades, tariff changes have been mostly modest, narrowly-focused, and short-lived. There is also good reason to believe that President Trump is using tariffs as a threat to renegotiate better terms on what he believes were poorly conceived trade deals enacted during previous administrations. Considering these factors, we believe the current trade disputes are unlikely to develop into something serious. However, U.S.-China trade discussions and NAFTA renegotiations and announcements in coming weeks may cause bouts of market volatility.

Recent equity market turmoil has resulted in investors cashing out of stocks and piling into safe haven assets such as U.S. Treasury securities. U.S. 10-year Treasury rates touched a 7-week low last week at 2.70%, down from a high of 2.95% at the end of February. With the Fed having raised short-term rates again in March, the yield curve has flattened to under 50 basis points. This has some investors concerned that the Fed is becoming too aggressive in their pursuit of monetary policy normalization. The strong economic backdrop described previously suggests a recession is not likely this year, but, if the Fed continues to raise short rates without a commensurate rise in longer-term yields, a continued flattening of the yield curve could foretell an economic slowdown on the horizon.

Recent market behavior reinforces the idea that markets are in the later stages of a long bull market. At this point, odds favor a stabilization of markets in the coming weeks and an attempt to rally toward the highs reached in January.

However, the ride is likely to be bumpier than in recent years and the possibility exists that the bull market already peaked earlier this year. To highlight possibilities, we display below a chart courtesy of Charles Schwab displaying the historical average performance of stocks since 1979 once they enter correction territory (10% decline).

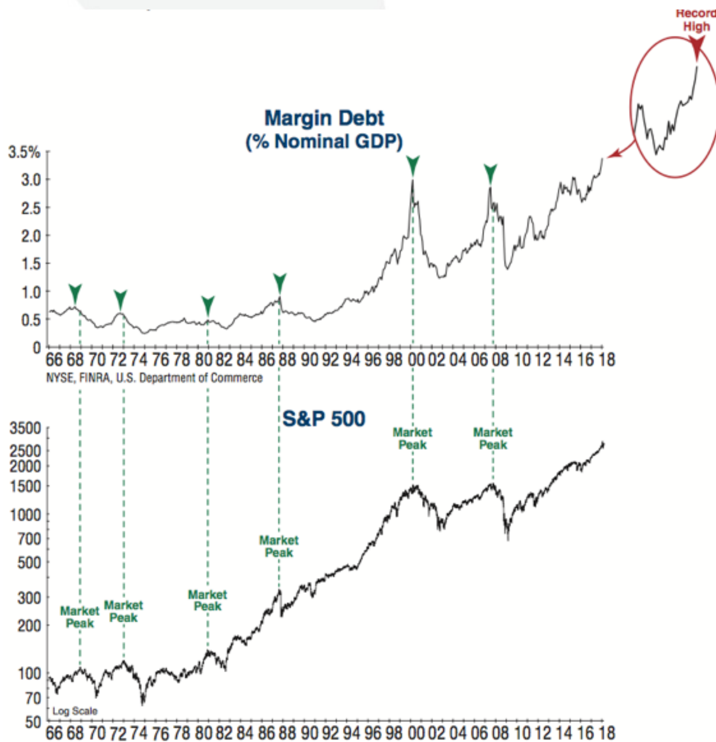


Source: Charles Schwab. Bloomberg data as of 3/27/2018. Past performance is no indication of future results.

From an historical perspective, it is highly likely that increasing inflationary pressures, the dollar, and Federal Reserve policy decisions will play a decisive role in determining how and when the bull market ends. As mentioned earlier, markets have experienced significant technical damage during the past two months. At a minimum, it will probably take months before markets steady themselves and reestablish an upward trend. In a worse-case scenario, markets are unable to establish new leadership after the breakdown of tech stocks and continue to decline into bear market territory.

Investment Strategy

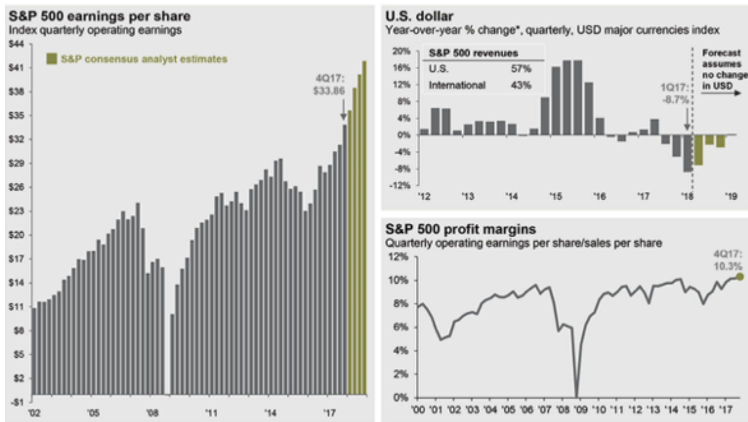
Even though markets are well off their highs from earlier this year, most portfolios are not far from the year-end 2017 values achieved after a multi-year stretch of robust returns. From a strategy and asset allocation standpoint, recent market action would suggest prudence and a reassessment of the appropriate level of risk, given an investor's time horizon and risk tolerance. There are a few options to consider, in order to protect asset values in case we do experience additional downside in financial markets this year. In the past 50 years, every market peak has coincided with a peak in margin debt as can be seen in the chart below:

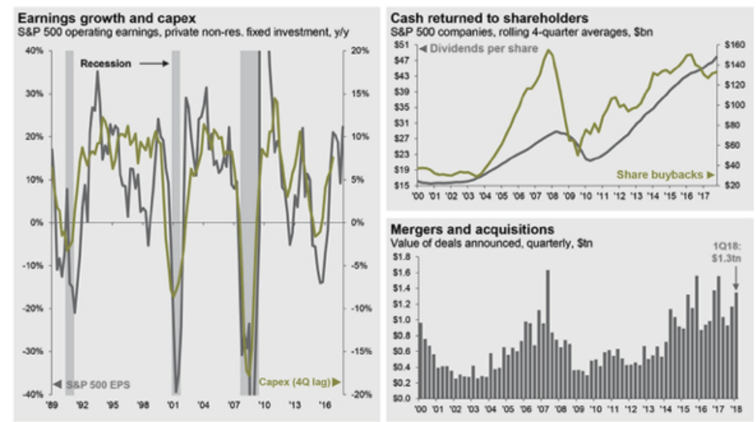


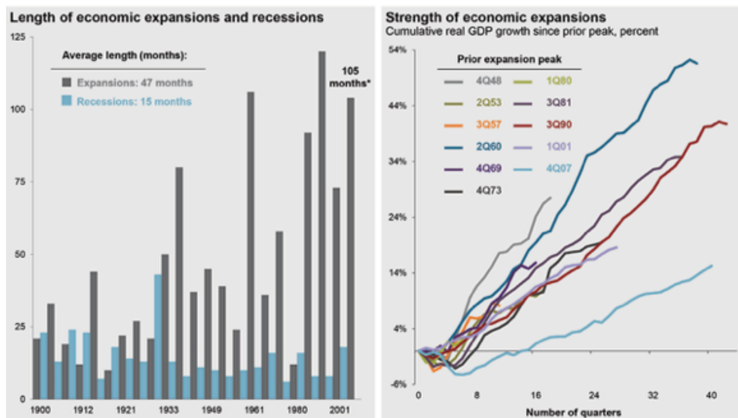
To the extent possible, we suggest investors eliminate or reduce to a minimum any margin debt they may currently maintain. Leverage is helpful in improving returns during upwardly trending markets, but can exacerbate negative returns during corrections. In addition, with short-term rates on the rise, margin rates have become more costly. Furthermore, rebalancing asset allocations back to more defensive levels may be appropriate depending on an investor's ability and willingness to ride through periods of correction or even a bear market. Keep in mind, most corrections and bear markets last less than a year and markets typically recover within a couple of years or less. However, from a psychological standpoint, investors have a tendency to act against their long-term interests during periods of severe volatility. To make the short-term pain more tolerable, having some cash available can help and provides a source of funds to take advantage of particularly attractive market opportunities. We have already begun the process of reducing exposure to the more economically sensitive sectors of the market by exiting many basic materials sector stocks and semiconductor companies. Additional moves that could reduce portfolio volatility may also be warranted in the months ahead. It is important to mention that none of the risk reduction maneuvers that may be reasonably implemented can eliminate all portfolio downside - they may just soften the blow. In addition, investors must consider the tax consequences of any risk-reduction moves. For taxable investors, capital gains taxes could cost anywhere from 15% to 30%, when state and federal taxes are reflected. Please be assured your Covenant financial advisor will always be working in your best interests.

Equities 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:







Fixed Income Charts

Unemployment and wages

GTM – U.S. | 25

Civilian unemployment rate and year-over-year wage growth for private production and non-supervisory workers
Seasonally adjusted, percent

Source: BLS, FactSet, J.P. Morgan Asset Management. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of March 31, 2018.

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Interest rates and inflation

GTM – U.S. | 34

Nominal and real 10-year Treasury yields

	Average (1958-YTD 2018)	3/31/2018
Nominal yields	6.09%	2.74%
Real yields	2.38%	0.88%
Inflation	3.70%	1.86%*

Source: BLS, FactSet, 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 March 2018, where real yields are calculated by subtracting out February 2018 year-over-year core inflation. *Inflation is as of February 2018.
Guide to the Markets – U.S. Data are as of March 31, 2018.

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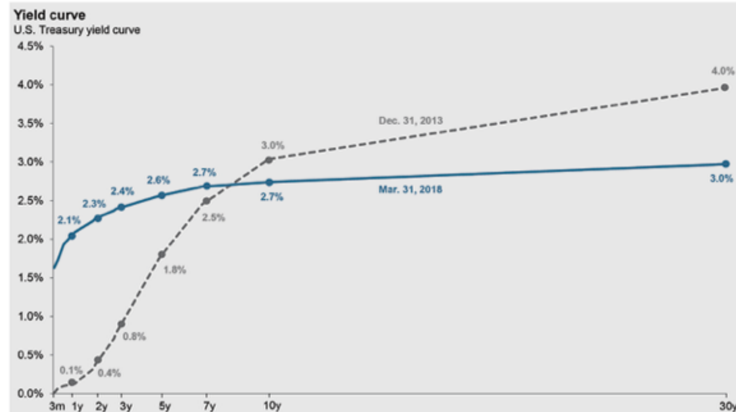
Yield curve

GTM – U.S. | 35



Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
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Economic Charts

*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.

125 Maple Avenue,
Chester, NJ 07930

www.covasset.com

Main: (908) 879-4090
fax: (908) 879-6468