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Covenant Asset Management, LLC

Quarterly Letter to Investors
July 2012

Executive Summary

In the midst of great uncertainty and unsettled economic issues, financial markets posted very respectable results for the first half of 2012 with the Dow Jones Industrial Average up 5.4% and the S&P 500 stock index rising 8.3%. The ongoing debt crisis in Europe and more signs of a slowdown in China triggered investors to seek safe havens in U.S. Treasury obligations, pushing the U.S. dollar up and yields on U.S. Treasuries to record low levels. With signs of global economic slowing, many commodity prices retreated, particularly energy and metals, which are most sensitive to economic activity. Meanwhile, gold prices managed to rise by 2.3% and the housing market displayed some pockets of strength for the first time since the bubble burst in 2007.

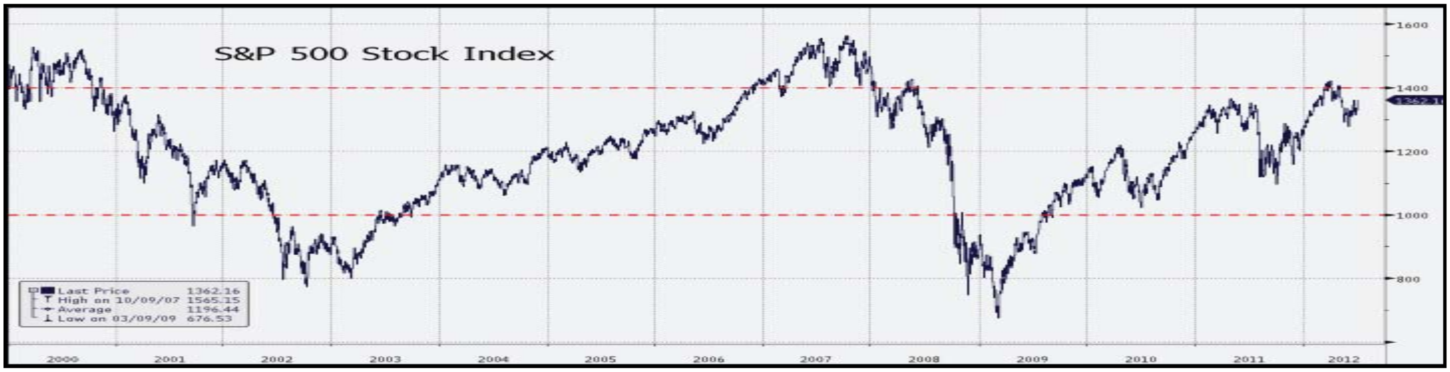
The latest batch of U.S. economic reports confirmed our belief that the better tone in the first quarter was more weather-related as opposed to a real improvement in economic activity. Weak employment numbers coupled with a contraction in manufacturing for the first time in three years suggests economic risks are rising.

We remain cautious in our outlook for the economy and stock prices in the months ahead, believing the best potential for improvement from current levels may occur in the fourth quarter and possibly not until after the November elections.

Global Economic Perspectives

With Europe in recession, China's economic growth slowing and now the U.S. showing signs its economy is losing steam, it is clear global financial risks are rising. U.S. GDP growth in the first quarter was 1.9% and expectations for the second quarter hover around the same level. With the economy growing so slowly, we must be alert to issues that could negatively influence consumer confidence and cause the economy to slip into recession. These issues could arise from another blow-up in the European debt crisis, a sharper-than-expected slowdown in China's economic growth or any number of geopolitical factors. It's also possible that another bout of political brinksmanship in the U.S., as candidates posture for the upcoming election, could create a negative psychological impact on consumers and investors.

All of these concerns point to continued highly accommodative monetary policies and perhaps additional monetary easing. Another weak employment report for July and/or further signs of contraction in manufacturing in the U.S. could cause the Fed to respond with another round of Quantitative Easing, dubbed QE3, as early as the next FOMC meeting in August.



November U.S. General Election Implications

With the November election just four months away, many clients have inquired about the likely impact on financial markets. Historically speaking, election years are generally stable or profitable for the stock market, in spite of the political barbs and tensions that lead up to Election Day. The accompanying table reveals that in 23 of the past 28 Presidential Election Years (over 80% of the time), the stock market in the September to November timeframe was either at a high for the year, or within 4% of the high.

Where is the Stock Market at "Election Time"?

Election Year	DJIA Level (by Sept.-Nov.)	Yearly High in 4th Quarter	Yearly Low in 4th Quarter
1900	At new high for year	✓	
1904	At new high for year	✓	
1908	At new high for year	✓	
1912	At new high for year		
1916	At new high for year	✓	
1920	18.1% below high		✓
1924	At new high for year	✓	
1928	At new high for year	✓	
1932	10.0% below high		
1936	At new high for year	✓	
1940	9.6% below high		
1944	1.0% below high	✓	
1948	1.5% below high		
1952	At new high for year	✓	
1956	2.2% below high		
1960	8.7% below high		✓
1964	At new high for year	✓	
1968	At new high for year	✓	
1972	At new high for year	✓	
1976	At new high for year		
1980	At new high for year	✓	
1984	3.3% below high		
1988	At new high for year	✓	
1992	1.1% below high		✓
1996	At new high for year	✓	
2000	3.5% below high		
2004	1.5% below high	✓	✓
2008	11.7% below high		✓
2012	?		

With regard to the likely outcome, it is still too early to predict a winner for the Presidency or control of Congress. Polling results are generally not reliable indicators until after party conventions when more of the public begins to tune in to the candidates and their positions on the leading issues. In years when an incumbent President is running for re-election, the election tends to be a referendum on the perceived performance of the incumbent during the previous four years. With a weak economy and stubbornly high unemployment rates, President Obama will be challenged to retain his position. However, he has proven to be an outstanding campaigner and is personally likeable, all of which means that at this time the election is still considered a toss-up. Most political analysts believe Republicans will retain control of the House of Representatives and may gain enough seats for narrow control of the Senate.

Regardless of the election outcome, there are enormous challenges confronting Congress post-election day. The so-called "fiscal cliff" that everyone is worried about is a legitimate concern. Essentially, as a result of last year's Congressional budget fiasco, $1.2 trillion in automatic federal spending cuts are due to take effect starting January 1, 2013. Simultaneously, the end of the Bush era tax cuts, along with the new Medicare surtax on investment income, increases in the estate tax and reductions in business expense deductions are due to occur. Unless Congress intervenes, the top income tax rate will increase from 35% to 43.4%, the capital gains tax rate will move from 15% to 23.8%, and the tax rate on dividends will rise from 15% to 43.4%. These spending cuts and tax increases are projected to result in a contraction of about 4% of GDP. Since the U.S. economy is expanding at a rate of approximately 2%, such a fiscal cliff would mean almost certain recession in 2013.

While both political parties have reasons to want to avoid such an outcome, it is unlikely that any compromise could be reached before the election, which raises the stakes and the risks in the lame-duck session of Congress between Election Day and Inauguration Day. Forecasters currently expect policymakers to either extend current policy for another year in order to give a new Congress the opportunity for spending and tax reform, or to agree to a compromise which reduces the fiscal contraction to about 1% of GDP, thereby reducing the likelihood of recession. The shape of any compromise or reform will have implications for the economy and investors. If Congress delays long-term structural reforms for another year or more and they allow large deficits to continue in the present, the economic outlook and investment climate will remain uncertain. The likely result would be individuals, businesses and investors continuing to be less confident about the future and unwilling to take economic risks.

Investment Strategy

As we indicated in our previous communication in May, stock sector leadership has shifted decidedly to more defensive economic sectors. In fact, the only sectors with positive returns during the second quarter were those that are less economically sensitive, specifically Telecom (+14.1%), Utilities (+6.6%), Consumer Staples (+2.9%) and Healthcare (+1.6%). Additionally, as investors sensed the slowdown occurring in Europe and China, companies less dependent on foreign operations for growth performed relatively better. Many of the changes we made to our domestic equity portfolios in recent months were intended to take advantage of these trends. Uncertainty surrounding the European debt crisis, China's economic slowdown and worries about the U.S. "fiscal cliff" are unlikely to abate anytime soon. As if these concerns weren't enough for investors to digest, corporate earnings growth in the second quarter is expected to slow to low-single-digit levels, the slowest growth since the recovery began three years ago.

2012 Changing Sector Leadership
S&P 500

Q1 - 2012		Q2 - 2012	
Sector	**Gain / Loss**	**Sector**	**Gain / Loss**
Financials	22.1%	Telecom	14.1%
Technology	21.5%	Utilities	6.6%
Cons. Discretionary	16.0%	Cons. Staples	2.9%
S&P 500	12.6%	Health Care	1.6%
Industrials	11.3%	Cons. Discretionary	-2.6%
Materials	11.2%	S&P 500	-3.3%
Health Care	9.1%	Industrials	-3.6%
Cons. Staples	5.5%	Materials	-4.2%
Energy	3.9%	Energy	-6.0%
Telecom	2.1%	Technology	-6.7%
Utilities	-1.6%	Financials	-6.8%

All is not doom and gloom however as valuation levels are reasonable, profitability is high, the housing market is improving and interest rates stand at record low levels. In addition, any further signs of weakness in U.S. economic data will likely elicit additional monetary stimulus via another round of money-printing by the Fed, officially called quantitative easing or QE3. Relying on policymakers to produce economic stimulus and create a positive backdrop for financial markets is hardly an ideal scenario. There will come a day when all the stars align and another long bull market in stocks will be spawned. Unfortunately, we don't believe that day is anytime soon and we remain cautious in our outlook for stocks and more concerned that, with economic growth slowing, the risk of outright contraction is rising, which could lead to further downside for stock prices. On the plus side, if a stock market correction were to occur from current levels, it would probably be less violent than the last couple, given the substantially lower valuation levels today compared to valuation levels prior to the last corrections in 2000 and 2008.

Rather than placing all of our eggs in one basket, our preference is to diversify most investment portfolios amongst a variety of asset classes, including U.S. and international stocks, fixed-income assets, commodities and commercial real estate. With the exception of U.S. equities, we generally recommend Exchange-Traded Funds (ETFs) to gain exposure to other asset classes. As has been our policy for the several years in which interest rates have been far below normal levels, we selectively recommend alternative vehicles rather than a traditional laddered bond portfolio to produce current income for clients. These include REITs, high yield bonds, preferred stocks, energy master limited partnerships and high yielding common stocks.

We extend our best wishes for a safe and enjoyable summer and encourage your feedback, comments or questions.