Third Quarter 2014
Investment Perspectives

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

Key Themes

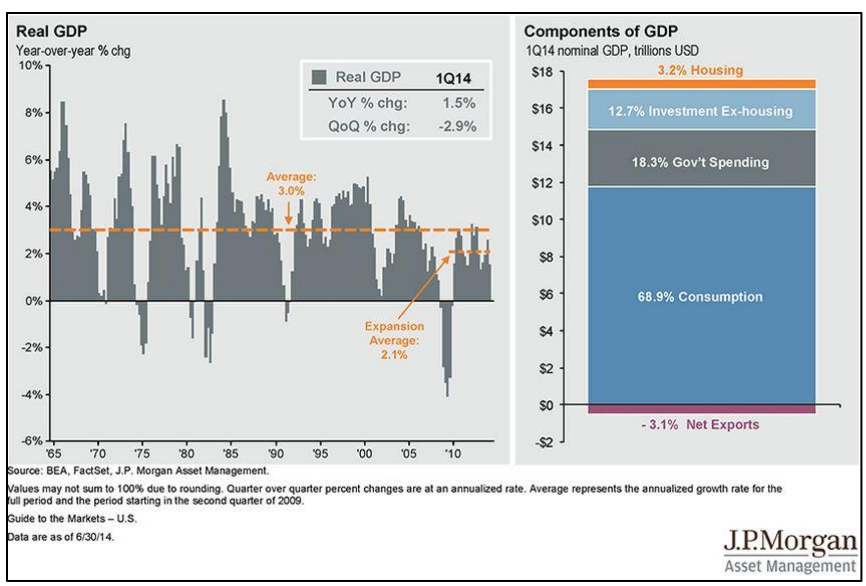
1. **Economic stagnation**
2. **Divergent central bank policies**
3. **U.S. equities: A repeat of 2013?**
4. **Other asset classes – slow but steady rebound**

ECONOMIC OVERVIEW

- Economic contraction in the first quarter should reverse with U.S. GDP growth near 3% the rest of the year.
- Severe winter weather has created pent-up demand in various sectors of the economy helping drive rebound in growth. Jobs growth has accelerated helping consumers and business.
- European economic growth remains disappointing but China and Japan have improved.

Economic Stagnation

First quarter weakness but growth expected to resume in Q2.
U.S. economic growth stumbled in the first quarter, contracting by 2.9%. A good portion of this weakness can be attributed to harsh weather conditions throughout much of the country during January and February. During the five-year economic expansion that began in March 2009, real GDP growth has averaged 2.1% annually, compared to the historical average of 3.0%. This sluggish growth has been due to low investment spending by corporations, reduced government spending and cautious consumer behavior. However, each of these trends appear poised to turn more positive which should help economic growth during the rest of this year. In 2013, decreased government spending reduced GDP by about 0.5% per quarter. Without the drama of another fiscal cliff or government shutdown and with no

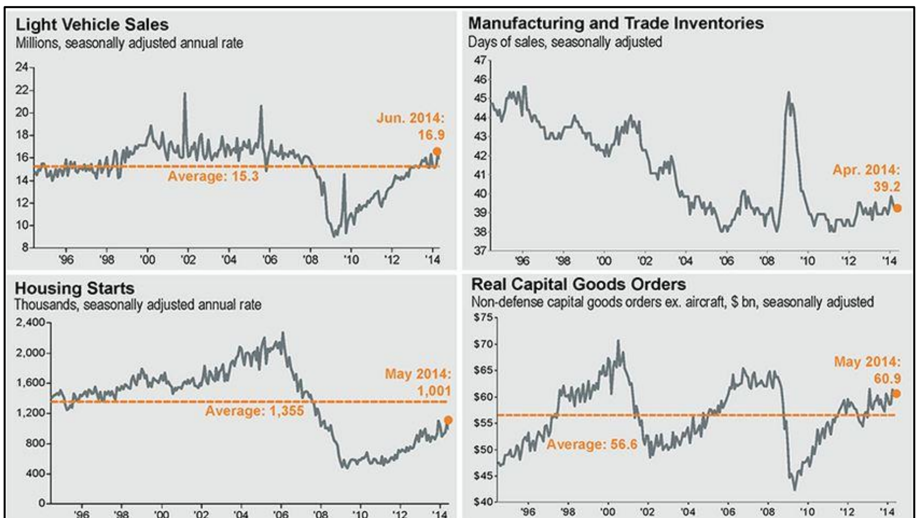


new tax increases on the horizon, economic drag from the federal government is lower in 2014 than in recent years. As the expansion progresses, corporations are reaching higher levels of capacity utilization which has historically led to increased capital spending. Additionally, merger & acquisition activity has risen significantly during the last eighteen months. The labor market has continued to improve in 2014, with monthly net new jobs averaging above 200,000. Household net worth has reached new heights as real estate prices continue to recover and stock indices have appreciated to record levels. Also, with a boom in domestic energy production, the U.S. trade deficit has shrunk to its lowest level in decades, reducing the economic drag from excessive imports.

INVESTMENT CONSEQUENCES

- U.S. economic growth should pick up after the first quarter contraction with improvement in many components of GDP and driven by pent-up demand.

- Despite the end of QE, low interest rates should continue and stocks are likely to perform well as economic activity accelerates.



Source: (Top left) BEA, FactSet, J.P. Morgan Asset Management. (Top right) Census Bureau, FactSet, J.P. Morgan Asset Management. (Bottom left) Census Bureau, FactSet, J.P. Morgan Asset Management. (Bottom right) Census Bureau, FactSet, J.P. Morgan Asset Management.
Capital goods orders deflated using the producer price index for capital goods with a base year of 2004.
Guide to the Markets – U.S.
Data are as of 6/30/14.
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The improving economic trends cited above, along with benefits from pent-up demand created when consumers and corporations delayed purchases from the first quarter due to the harsh winter weather, are expected to propel economic growth for the rest of the year. In fact, GDP growth is now expected to average approximately 3% for the rest of this year. Car sales have recovered to levels not seen since 2006, new housing starts are back above one million units at an annualized rate and manufacturing and trade inventories have begun to pick up as corporations plan for improved demand. Capital goods orders are also trending higher, another signal that corporate investment spending is accelerating.

Monetary Policy

The Federal Reserve Bank continues to unwind its nearly two-year-old bond buying program, better known as quantitative easing (QE), and has communicated its intent to end the program this October. Nevertheless, monetary policy remains highly accommodative in the U.S. as the Fed has also expressed its intent to maintain its near-zero fed funds rate policy for an extended time. In Europe, the European Central Bank (ECB), in response to continued concerns over slow growth and deflation, made the unprecedented move of lowering the deposit rate it pays banks to negative 10 basis points. In addition, Japan's massive QE program has continued unabated as it attempts to jumpstart its economy on the back of a devalued currency. So, while monetary policy remains easy in the U.S., it is extremely easy in the other two major developed regions of the world. Given these extraordinary policy maneuvers, it is more understandable why interest rates around the world have declined during the first half of 2014.

During the second quarter, the 10-year U.S. Treasury note yield fell to 2.53% from 2.73% at the beginning of the quarter. However, the yield on the 2-year U.S. Treasury note rose to 0.47% from 0.44% during the same timeframe. It is typical for short- and long-term yields to move in the same direction. Nevertheless, if economic data does begin to show the acceleration forecasted by the Fed and many economists, a continuation of this divergence between short- and long-term interest rates may persist. While no one expects an increase in the fed funds rate to be imminent, Fed chief Janet Yellen highlighted that the path of interest rates is expected to be dependent on economic data. Better data readings will likely lead to faster than expected rate increases, while continued economic sluggishness will lead to further postponements of rate hikes.

MONETARY POLICY OVERVIEW

- The Fed continues to wind down QE with October targeted as an end date.
- The ECB made monetary policy history by lowering the deposit rate it pays banks to negative 10 bps
- The U.S., Europe and Japan all maintain highly accomodative monetary policies.
- In the second quarter, short-term interest rates rose modestly while longer-term rates declined.

INVESTMENT CONSEQUENCES

- Rising short-term interest rates are likely to continue especially if economic data improves. Investors should be aware of this trend and be positioned in short-to-intermediate bonds.
- Alternatives to bonds such as REITS, MLPs, and high yield stocks and bonds may offer better returns than bonds until interest rates normalize.

U.S. Equities

As the year began, there were widespread expectations for U.S. equity markets to generate more moderate performance than last year, with greater volatility and the potential for a healthy correction. Part of the forecast has proven true, with returns on the major U.S. equity benchmarks producing mid-single digit returns. However, no significant correction has occurred and volatility has remained subdued. Current forecasts call for a continuation of these trends in the second half as investors grapple with the ending of QE and monitor both valuation levels and corporate earnings growth. As the following charts make clear, valuation levels, while no longer cheap, can't be considered overly expensive either. If interest rates and inflation expectations remain low, a case can be made that, given the lack of other attractive investment alternatives, equity valuations could rise further before warning signs are triggered. Corporate profits have continued to hit record levels over the past two years, and profit growth has averaged in the mid-single digits. With profit margins already at record levels and interest rates still low, it is possible that companies may begin to take on additional leverage in order to enhance earnings growth. It is for these reasons that we continue to believe the major equity indices will produce double-digit returns again in 2014.

U.S. Equity: Valuation Measures

Valuation Measure	Description	Latest	Historical Averages: 1-year ago	5-year avg.	10-year avg.	25-year avg.*
P/E	Price to Earnings	15.6x	13.8x	13.4x	13.8x	15.6x
CAPE	Shiller's P/E	25.6	24.4	21.7	22.9	25.1
Div. Yield	Dividend Yield	1.9%	2.0%	2.0%	2.0%	2.1%
PEG	Price/Earnings to Growth	1.5	0.8	1.1	1.7	1.4
P/B	Price to Book	2.8	2.6	2.2	2.4	2.9
P/CF	Price to Cash Flow	11.0	10.3	8.9	9.5	10.6
EY Spread	EY Minus Baa Yield	1.7%	1.5%	2.0%	1.2%	-0.7%

Source: Standard & Poor's, FactSet, Robert Shiller Data, 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. Price/Earnings to Growth Ratio is calculated as NTM P/E divided by NTM earnings growth. 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.
Latest reflects data as of 6/30/14.
Guide to the Markets – U.S. Data are as of 6/30/14.

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U.S. EQUITY OVERVIEW

- U.S. Equities performed well in the first half, especially coming off last year's high returns as stock prices kept pace with earnings gains.

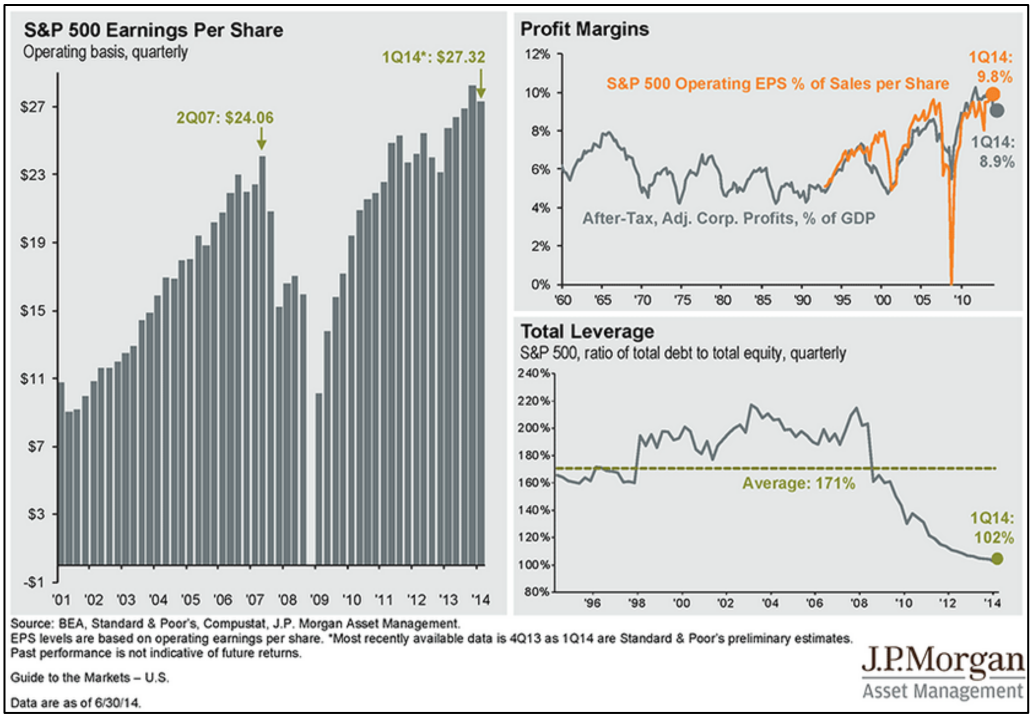
- Valuation levels for U.S. stocks, while no longer cheap, are in line with their longer-term averages.

- Corporate America is in good shape with strong balance sheets, lots of cash and wide profit margins.

INVESTMENT CONSEQUENCES

- Despite 18 months of strong gains for stocks, further gains are likely in the second half as earnings growth continues. Corporations are positioned to take on more leverage in order to accelerate profit growth and valuation levels could expand modestly.

- The fall can oftentimes bring with it a period of volatility. Investors are advised to use any serious weakness in the market as a buying opportunity as the fourth quarter could be rewarding.



Other Asset Classes

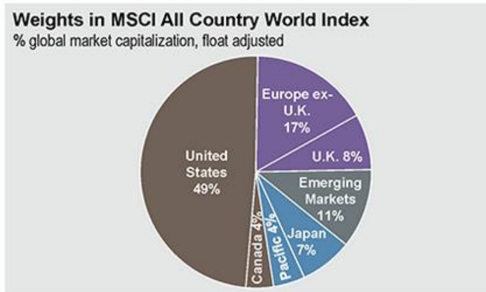
Foreign equity markets produced steady returns during the first half of 2014. The decline in interest rates reversed last year's fears that rising rates would hurt emerging market economies encouraging investors to return some of their risk assets to these same markets. The trading action within global equity markets suggests that some profit-taking occurred in certain of the most highly valued and best-performing sectors within the U.S. equity market and then reinvested in some of 2013's beaten down foreign markets. We continue to favor a market-neutral approach when investing in foreign equity markets with a disproportionate weight given to developed markets over emerging markets. We also prefer active management (mutual funds) to passive management (ETFs) at this point of the market cycle.

OTHER ASSETS OVERVIEW

- REITs, MLPS, Commodities and bonds all performed well during 2014's first half.

- The rebound in bonds and emerging market stocks can be partially attributed to a decline in interest rates and partially to asset rotation away from highly valued stock sectors.

Country / Region	2Q14 Local	2Q14 USD	YTD 2014 Local	YTD 2014 USD
Regions / Broad Indexes				
U.S. (S&P 500)	-	5.2	-	7.1
EAFE	3.7	4.3	3.5	5.1
Europe ex-U.K.	3.4	2.6	7.1	6.3
Pacific ex-Japan	3.0	4.4	3.6	7.5
Emerging Markets	5.2	6.7	4.8	6.3
MSCI: Selected Countries				
United Kingdom	3.4	6.1	1.9	5.2
France	3.1	2.4	6.1	5.4
Germany	2.9	2.3	2.6	2.0
Japan	4.9	6.7	-2.8	0.9
China	5.6	5.7	-0.5	-0.5
India	13.5	12.7	18.5	21.9
Brazil	5.2	7.7	3.5	10.7
Russia	8.1	10.8	-2.4	-5.2



Source: Standard & Poor's, MSCI, FactSet, J.P. Morgan Asset Management.
All return values are MSCI Gross Index (official) data. Chart is for illustrative purposes only. Past performance is not indicative of future results. Please see disclosure page for index definitions. Countries included in global correlations include Argentina, South Africa, Japan, UK, Canada, France, Germany, Italy, Australia, Austria, Brazil, China, Colombia, Denmark, Finland, Hong Kong, India, Malaysia, Mexico, Netherlands, New Zealand, Peru, Philippines, Portugal, Korea, Spain, Taiwan, Thailand, Turkey, United States. Guide to the Markets – U.S. Data as of 6/30/14.

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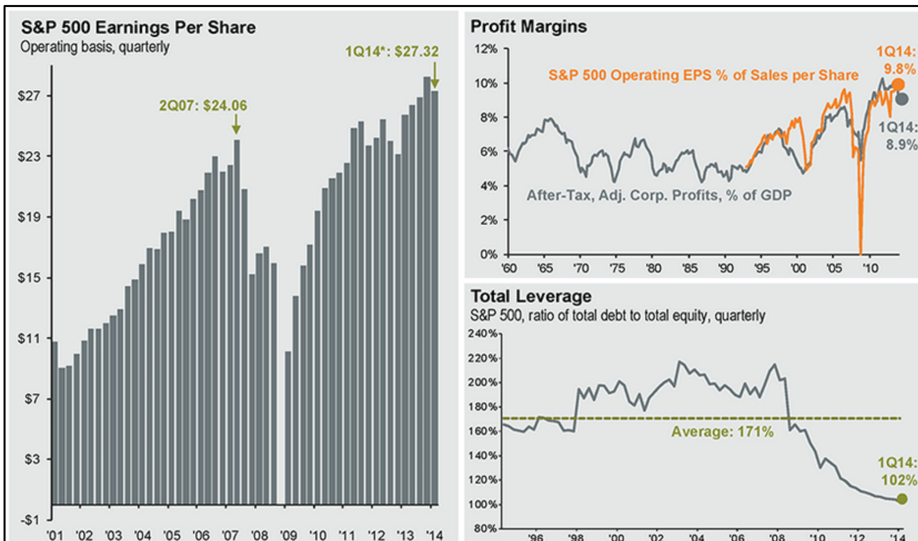
INVESTMENT CONSEQUENCES

- Investors are advised to keep fixed income investments in the short-to intermediate timeframe. Credit risk via lower grade bond funds is preferred over reaching for yields by extending maturities.

- A market neutral approach to foreign equity investing is recommended with a bias toward developed markets over emerging markets.

- REITs and MLPs continue to be favored as good altern-atives to bonds as they gen-erate high current income and appreciation potential.

The decline in interest rates has allowed fixed-income assets to recover from a difficult 2013. Emerging-market debt was the best-performing sector within the fixed-income class, generating an 8.7% return, while the Barclays Aggregate Bond Index produced 3.9% during the first half. We continue to recommend investing in fixed-income instruments with short average maturities and prefer to accept some credit risk through high yield funds, as opposed to reaching for yield by extending maturities. REITs have been the best-performing asset class thus far in 2014, producing an average return of 16.2%. Improved pricing in commercial real estate, coupled with modest declines in mortgage rates, provided the attractive backdrop necessary to trigger this year's gains. Interest rate declines and oversold conditions also allowed commodity prices to rebound from the drubbing they took in 2013. At mid-year the DJ/UBS Commodity Index



Source: BEA, Standard & Poor's, Compustat, J.P. Morgan Asset Management.
EPS levels are based on operating earnings per share. *Most recently available data is 4Q13 as 1Q14 are Standard & Poor's preliminary estimates.
Past performance is not indicative of future returns.

Guide to the Markets – U.S.

Data are as of 6/30/14.

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generated a 7.1% return, while gold prices rose by 10.3%. Master Limited Partnerships (MLPs) have also performed admirably during the first half of the year with returns upwards of 16%. We continue to believe that REITs and MLPs are attractive high yield alternatives as compared to bonds in the current environment.

Risks

With military action in Israel, civil war in Ukraine, Syria, and Iraq, and Iran getting closer to possessing nuclear weapons, it is clear that the world is full of geopolitical risks. In addition, while Europe appears to be heading in the right direction, economic growth there is not assured, as evidenced by the ECBs unprecedented monetary policies. As we look ahead to the fall, U.S. mid-term elections loom which could trigger a bout of political based volatility within the financial markets. Yet, we continue to believe that ultimately the greatest threat to financial markets may come from a rapid increase in interest rates premised upon rising inflation expectations or accelerating economic growth. We don't believe this scenario is likely to occur in 2014, but conditions which could bring it to pass need to be monitored.

We thank you for your support and extend our wishes for a safe, healthy and enjoyable summer.

INVESTMENT RISKS OVERVIEW

- Geopolitical risks, economic sluggishness in Europe, U.S. mid-term elections and the potential for rising interest rates are amongst the most serious risks to financial markets.

- Of the stated concerns, rising interest rates or inflation expectations could have the most deleterious effects on investment results.

INVESTMENT CONSEQUENCES

- Corporate earnings growth and the direction of interest rates continue to be the most important driver of invest-ment performance.

- Despite the various identified risks, we advise investors to stay the course with their investment plan and modify asset allocations based upon a change of objectives, as opposed to any financial market related reasons.