Covenant Asset Management, LLC

Quarterly Letter to Investors: *October 2009*

Third Quarter Review

Dow 10,000! Who amongst us would have assigned even the remotest possibility of reading those headlines seven months ago when panic stricken investors feared the widely followed index would plummet to 5,000? Since those dark days, the Dow Jones Industrial Average is up 55%, the S&P 500 has gained 64% and Nasdaq has rebounded 71%. In the third quarter alone, the S&P 500 increased by 15%, the best third quarter performance since 1970.

S&P 500

GDP contracted at a 5.4% annual rate during the fourth quarter of 2008 and another 6.4% in the first quarter of this year before starting to stabilize during the second quarter. But now, having just passed the second anniversary of the onset of the credit crisis and one year after the financial panic of September 2008, it has become increasingly evident that the deepest economic recession since the 1930s has likely ended. Retail sales posted a small year over year gain in September, the first in 13 months and are now up at a 3.9% annual rate so far this year. The service and manufacturing sectors have expanded for two consecutive months, weekly jobless claims have recently fallen to an 8 month low and the pace of monthly job losses has been trending lower. In addition, home sales have been improving for six months and housing prices have actually risen for three consecutive months. Commodity prices are up significantly and GDP is expected to expand by 3-4% in the third and fourth quarters.

U.S. Dollar Weakness

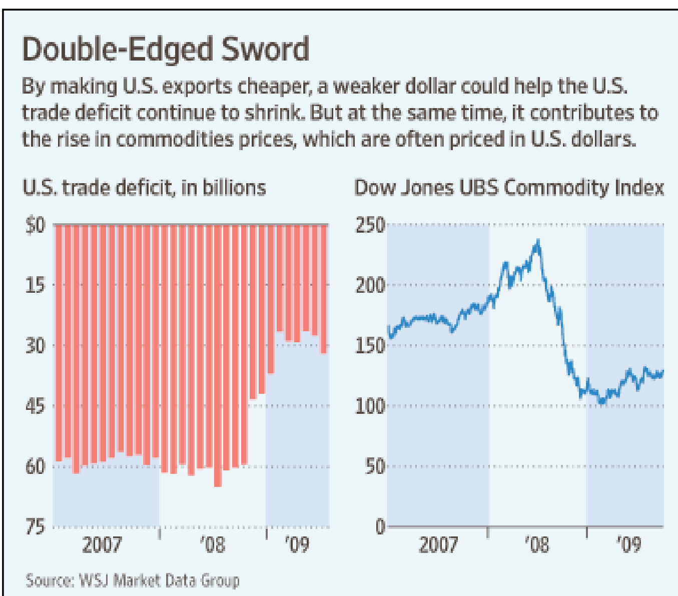
Perhaps the most significant story in the world economy is the continuing fall of the U.S. dollar. As with any currency, the value is ultimately determined by the supply and demand for that currency. The U.S. Federal Reserve Bank's massive expansion of the money supply in order to avoid a serious deflationary spiral has created an environment in which there is a much greater supply of dollars than there is global demand for them. During the height of the financial panic, the dollar benefited as global investors sought the relative safety of U.S. Treasury securities. But as global aversion to risk has abated, investors have been dumping their safe havens, including U.S. Treasury securities, in pursuit of higher returns elsewhere.

The dollar exodus accelerated recently when the Reserve Bank of Australia became the first G-20 central bank to raise interest rates since the global financial crisis began. This is in stark contrast to U.S. Fed policymakers who have reiterated their determination to keep rates exceptionally low for a long period, a strategy they credit for helping to revive U.S. banks and steady credit markets. Investors throughout the world have also observed overall U.S. economic policy which they interpret as becoming less appealing for those seeking a return on their capital. They fear that prospects for higher taxes on income and capital gains, health care and energy reform that may require trillions of dollars in new federal debt, a stricter regulatory environment and increasing trade barriers all point to the prospects for slower than normal U.S. growth. Unease relating to the federal government's exit strategy from unprecedented policies has begun to mount. If fiscal and monetary stimulus is taken away too soon, there is a chance of relapsing into recession and deflation. If it is taken away too late, inflation pressures may rise or stagflation - slow growth or recession coupled with inflation, may result.

Relevant Economic and Investor Issues

Aside from the devaluation of the dollar, U.S. investors have plenty of concerns to consider. Though the economy appears to be in recovery, it is important to emphasize that any expansion is unlikely to be robust. Typically, the first few quarters of economic recovery produces GDP growth of 4%-8% on an annualized basis. Most economists expect growth at half the normal pace in the early phase of

this recovery as credit markets remain somewhat impaired, tax rates are expected to rise and business regulations are likely to increase. Also, the commercial real estate market has yet to bottom, and while housing appears to be in recovery, foreclosures remain high and many homeowners still have mortgage balances that exceed the current values of their homes. The labor market probably won't experience improvement any time soon as the unemployment rate is expected to exceed 10% before finally peaking in the next few months. Even as the broader economy continues to pick up momentum, many employers will remain reluctant to hire as job growth typically lags the overall economic recovery by anywhere from five months to a year. In fact, the unemployment rate won't fall until monthly job growth exceeds approximately 130,000 net new hires. That's still a long way from where we are today as recent months have witnessed job losses exceeding 200,000 on average. It will likely take many years of strong growth to return our economy to full employment and probably much lower if GDP growth is more moderate, as anticipated. Given the likelihood of tepid growth and stubbornly high unemployment, consumer spending is not expected to return to sustainable normal growth anytime soon.



The dramatic increase in government spending, massive new government debt issuance and record low interest rates have sparked inflation fears amongst some investors. It remains our belief however that in the current deleveraging environment and with manufacturing capacity utilization at low levels, consumer price inflation pressures will remain latent for some time. A day of reckoning is inevitable given the enormous monetary stimulus applied during this downturn, but that day is probably a couple of years away. Asset price inflation, particularly when measured in U.S. dollars, may have already begun as many commodity prices have surged since financial markets bottomed in March. We are convinced that the federal government will quietly allow a period of above average inflation, as well as continued dollar devaluation, as more politically appealing ways to partially work out from under its massive debt burden, since both policies redistribute wealth from creditors to debtors.

Asset Allocation and Investment Strategy

Having survived the often difficult stretch from Labor Day to the end of October without a major stock market correction or any new disasters, we now expect the rally to continue as lean corporations exceed earnings expectations and tremendous cash on the sidelines migrates back into stocks, especially with short-term investments yielding near zero. At this stage of the economic recovery, we maintain over-weighted positions in the technology, energy, basic materials and the industrial sectors, equal weights in healthcare, financial service and retail, and are underweighted in defensive sectors such as consumer staples, utilities and telecom.

On the fixed income front, we have been avoiding investments with maturities beyond 2 or 3 years in the current record low interest rate environment, choosing instead to patiently wait for higher yields before extending maturities. In our view, the Fed may wait another six to nine months to be certain the U.S. economy is in full recovery before beginning to raise interest rates.

Given our outlook for a tepid U.S. economic recovery and continued dollar weakness, we have been increasing our allocation to non-dollar denominated assets, including foreign currency Exchange Traded Funds (ETFs), and foreign equity index ETFs primarily in Asia (ex-Japan) and Latin America. We also advocate even broader diversification across additional asset classes such as commodities and commercial real estate as the best way to reduce risk over the course of most business cycles.

We are pleased to report this approach has paid handsomely for clients as the value of many portfolios are nearing or have exceeded their pre-crisis levels. We appreciate the confidence and support you have displayed during this chaotic period and always welcome your insights, questions or comments.

John Guarino, President
Covenant Asset Management, LLC
408 Main Street
Chester, NJ 07930
Phone: (908) 879-4090
Fax: (908) 879-6468
www.covasset.com