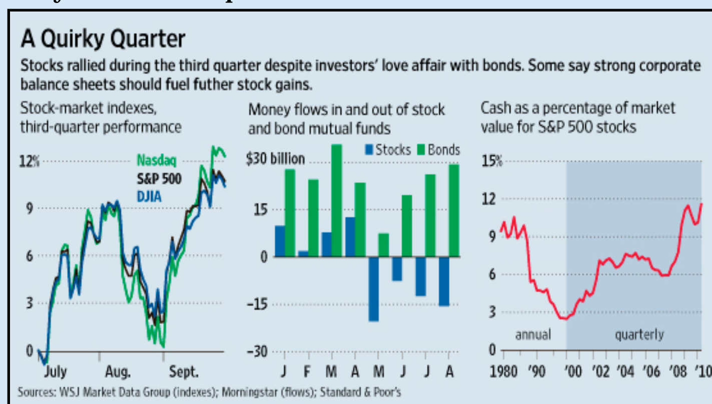
Covenant Asset Management, LLC

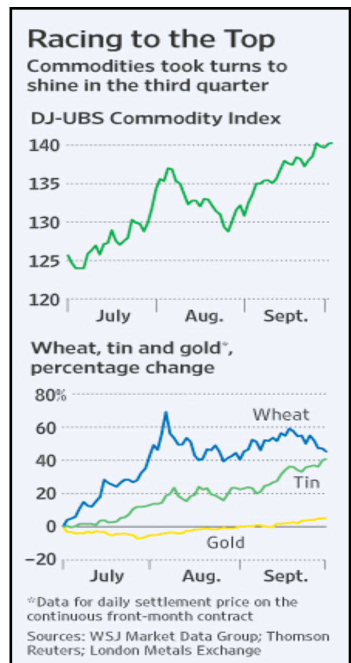
# Quarterly Letter to Investors: *October*

## Third Quarter Review

Economic and political uncertainty dominated trading in the financial markets in the third quarter. U.S. Stocks rallied in July, sold off in August and surged in September, ultimately producing double digit gains in the major U.S. stock market indices for the quarter, with the benchmark S&P 500 stock index returning 10.7%. While the gains were encouraging, they merely offset losses incurred in the second quarter leaving stock market returns for the year in the low single digits. Global stocks performed even better as developed markets, as measured by the EAFE index rose, by 18% and emerging markets increased by 20% during the third quarter. All of this uncertainty and volatility has fueled a continued exodus of individual investors out of stocks and into perceived safe havens - bonds and gold. During the third quarter, bond mutual funds took in an estimated $87 billion, bringing the total inflow since January 2009 to $620 billion. This compares to outflows of $43 billion from stock mutual funds over the past three months and $100 billion since January 2009. Nonetheless, bond returns lagged behind the sharp gains in stocks during the quarter as investment-grade bonds returned 4.9% and Treasury securities produced a 2.7% return.




The U.S dollar slumped against most major currencies during the third-quarter amid renewed weakness in the housing market and sluggish employment growth. Worries about the lethargic pace of economic activity drove the Federal Reserve to signal their willingness to take additional action to boost economic growth. More on this later. This pronouncement by the Fed caused an already weakening dollar to slump further. Conversely, many commodities prices surged, as is often the case during periods of dollar weakness. Factors ranging from damaged crops in Russia to strong demand from China, in addition to fears of further monetary easing by the Fed, led to the strength in commodities. Toward the end of the quarter, gold prices jumped to new highs as it became clear that many of the developed world's central banks would continue to promote monetary policies which would devalue their currencies in an attempt to enhance domestic economic growth. Energy prices lagged many other assets during the quarter, led by a 16% decline in natural gas prices due to weak demand and an increase in supplies. Oil prices traded in a narrow range as strong demand in emerging markets offset weaker demand and over-supplied conditions within the U.S market. At quarter-end, oil was trading at $79.97 per barrel, up 5.7% for the quarter.



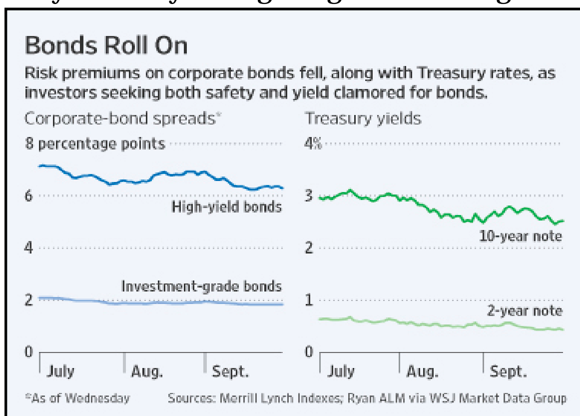

## Current Economic Outlook

The economy grew at a 1.7 percent annual rate in the second quarter, according to the government's latest estimate. That's a sharp slowdown from the 3.7 percent growth rate in the first quarter. Most economists expect growth to be similarly weak in the third and fourth quarters, with estimates ranging between 1.5 percent and 2 percent per quarter.

Consumer spending, accounting for about 70 percent of economic activity, is likely to remain soft as consumer confidence is weak, incomes are rising slowly and debt burdens continue to be reduced. After signs of life appeared in the spring, the housing market has softened once again. Home prices, after declining for four years, seem to have stabilized for the time being, but housing starts remain near record lows. Employment growth has been anemic, averaging 96,000 so far this year, below the level needed to absorb new entrants into the labor force as a result of a growing population. This has kept the unemployment rate, currently at 9.6%, above 9.5% for fourteen consecutive months.

This slow pace of economic growth, combined with the inability or unwillingness of Congress to agree on additional fiscal stimulus, has caused the Federal Reserve Bank to conclude that additional monetary stimulus may be required to revive the economy. It is now widely expected that the Fed will announce another round of "quantitative easing," commonly referred to as QE2, sometime after the November

3-4 meeting. The Fed employed a first round of quantitative easing beginning in March 2009. After creating $1.7 trillion in new money and purchasing U.S. Treasury and federal mortgage backed securities, the program ended a year later. Quantitative easing is a central bank policy occasionally used when interest rates have already been lowered to near 0% levels in an effort to promote increased lending and liquidity. The central bank simply creates new money, in a process typically referred to as “printing money.” In effect, at the stroke of a computer key, money is created by crediting the central bank’s own bank account. It can then use this money to buy assets, usually government bonds or mortgage-backed securities. With the central bank buying, the prices of these assets should rise and the yields, or interest rates, on those assets would fall. The theory behind this action is, with cheaper borrowing costs available, companies and consumers who are able to borrow or re-finance existing debt, will have more money to spend, putting additional demand into the economy thereby energizing economic growth.

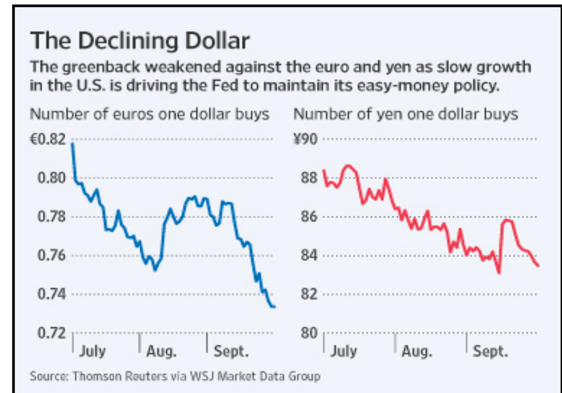



There are a number of risks to the Fed’s strategy, the most worrisome of which is the potential inflationary impact. The U.S. dollar has lost 10% of its value in the past month merely on expectations the Fed would embark on another round of quantitative easing. A decline in currency value is, in itself, inflationary. Another concern is that QE2 will be ineffective. Simply engineering lower interest rates provides no guarantee that consumption will improve.

## Financial Market Outlook

Underlying the rebound in stock prices was evidence that, while U.S. economic activity has slowed down, it is still growing and unlikely to slip back into recession. Corporate balance sheets are in the best shape they’ve been in decades with low debt levels and an abundance of cash. In addition, optimism is building that likely Republican gains in the November 2 mid-term elections will result in a more business friendly political environment and resolve uncertainties about tax policy and government regulation. Based upon recent strength in the stock market, it is clear that many investors are betting that this could be the catalyst for corporations to start putting their cash to work via stock repurchases, dividend increases, mergers and acquisitions, or increased hiring and investing. Strong third quarter earnings reports are expected, which should also provide a positive backdrop to equities markets.

Given the sharp decline in bond yields over the past several months, we have become less constructive about the prospects for the bond market. While we don’t envision an environment of rising interest rates in the next few quarters, rates are unlikely to drop much further from the present levels.




With U.S. dollar weakness expected to continue, commodities, precious metals and energy prices are likely to remain in uptrends. Similarly, the outperformance of foreign stocks relative to U.S stocks should persist.

## Investment Strategy

Volatility has returned to all asset classes since the European debt crisis, the May 6 “flash crash,” and disappointing employment data this spring. Volatility and fear can sometimes cause investors to deviate from their investment plan or question their financial objectives in order to follow the latest trends. Despite this uncertainty, we advise clients to stay disciplined and focused on long-term goals.

With regard to individual asset classes, it is becoming increasingly apparent that bonds are becoming less and less attractive by the day. Bonds can play an important role in diversifying an investment portfolio and reducing risk. However, a thirty-year bull market in bonds is likely nearing its end. With the Fed determined to drive interest rates lower to strengthen the pace of economic activity, yields should soon bottom out. Eventually, when growth begins to accelerate, yields will begin to rise and bond prices will fall. At current levels, bonds are unlikely to offer an attractive real return for intermediate to longer-term investors. Rather than abandon bonds completely, an even riskier strategy, we believe it is appropriate to diversify holdings among tax-exempt, government, corporate, high-yield, convertible and other fixed income securities. For investors seeking income, consideration should be given to other sources such as REITs, master-limited partnerships and high-yielding common stocks.

Stocks may offer additional upside from current levels although we still do not believe conditions are ripe for a new long-term bull market to begin. We continue to believe a trading range for stocks is more likely with a short-term target of about 11,600 for the DJIA

and between 12,500-13,000 over the next few years. Many emerging foreign markets appear more attractive than the U.S. due to their better overall growth characteristics and healthier financial conditions. Asia and Latin America seem to offer especially good growth potential.

The appropriate mix of assets tailored to your objectives is always the best approach to investing. Together with you, we look forward to reviewing your individual circumstances in conjunction with market trends to affirm or modify investment strategy. We also welcome your questions, observations, comments and feedback.

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