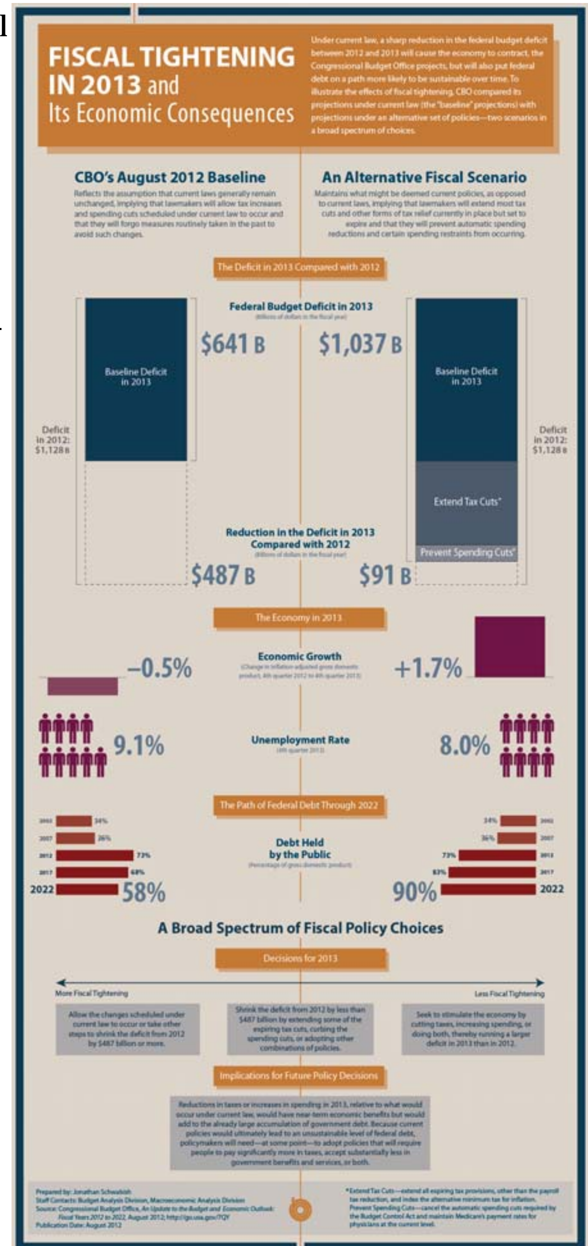
John Guarino, President
408 Main Street
Chester, NJ 07930
Phone: (908) 879-4090
www.covasset.com

Covenant Asset Management, LLC

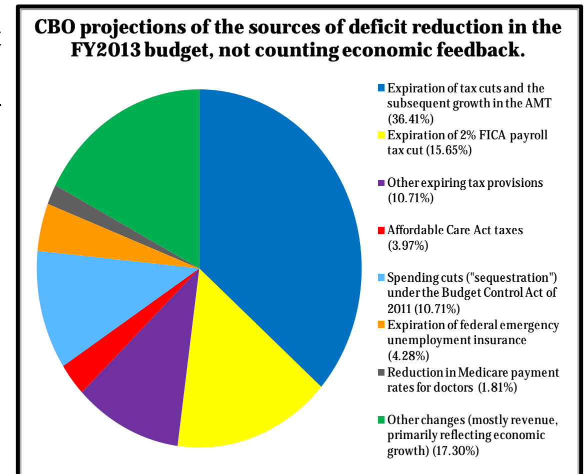
Quarterly Letter to Investors
November

Now that the election is behind us, the question of who will control government has been answered. With this uncertainty removed, markets have quickly turned their attention to the next major economic hurdle – what will be done about the fiscal cliff? We will know soon whether the President, the Democratic-controlled Senate and the Republican-controlled House of Representatives are more willing to compromise in order to prevent an economic nightmare or whether political gridlock will continue post the election. Democrats are certainly in a stronger position to dictate the terms of any agreement to avoid the damaging effects of allowing all of the Bush-era tax cuts to expire on the first day of 2013. They merely need to allow current law to expire at the end of the year and come back in the early part of next year rolling tax rates back to existing levels on those making less than $200,000 per year ($250,000 for married couples filing jointly) and defy the House Republicans to vote against cutting taxes on 97% of taxpayers. Ideally, as an incentive to gain Republican co-operation, a more comprehensive grand bargain could be negotiated using the framework of the Simpson-Bowles deficit reduction recommendations as a starting point and adding some sensible entitlement reform. In its simplest form, an agreement along these lines would include tax-rate reductions coupled with limits on deductions and spending cuts resulting in approximately $4 trillion of deficit reductions over the next ten years with three quarters coming from spending cuts and one quarter from additional tax revenues. This would cheer financial markets and could push businesses that have been reluctant to invest and hire off of the sidelines.



The good news is that it does appear economic activity has improved modestly and employment trends, although still sluggish, have also been showing signs of progress. Additionally, a surprising bright spot in the economy this year has been the apparent upturn in the housing market. It is also possible that with the election behind us, the most productive sectors of the economy will refocus on running their businesses as opposed to being distracted by the political campaigns and policy uncertainty.

CBO projections of the sources of deficit reduction in the FY2013 budget, not counting economic feedback.



On the downside, corporate profit growth has slowed to the lowest level since the economic recovery began in the summer of 2009, with third quarter results growing only 2% vs. a year ago. The recession in much of Europe and slowdown in China ha s finally caught up with U.S. corporations' ability to improve sales materially and profit margins seem to be hitting their upper limit. Manufacturing activity in the U.S. has also softened recently as a result of concerns over the fiscal issues confronting our federal government. One more issue certain to draw attention now that the election has ended is another battle over raising the federal debt ceiling. Having been chastened on this same matter in the summer of 2011, we believe politicians of either party are likely to avoid brinksmanship this time around. Instead, look for a demonstration of bi-partisanship on the debt ceiling as a good faith

effort by both parties as they prepare to battle over the larger issues of tax policy and federal deficits.

Until fiscal policy issues have been settled, it is unlikely that business confidence will improve or that economic growth will accelerate to a more normal level. As we've stated previously, if the fiscal cliff is not dealt with, it will mean almost certain recession in 2013. Financial market participants do not appear to be assigning a very high probability that these issues won't be addressed in some fashion, either by reaching an agreement in a lame duck session of congress, or by extending current policy on a short-term basis until the newly elected congress can be more deliberative in fashioning a long-term solution.

In the meanwhile, we expect much of the same economic and market trends that we've experienced since the financial crisis ended. These include sluggish economic growth and extremely easy Federal Reserve Bank policy intended to maintain interest rates near zero and provide as much liquidity as is necessary to prevent another crisis. It also suggests a persistent weak dollar policy as the Fed continues to print money at a record pace, resulting in sustained strength in prices of gold, oil, and other commodities. With interest rates held at artificially low levels, high grade bonds should hold their value, but offer low inflation-adjusted returns. Lower grade bonds and alternative fixed income assets offer higher yields and should continue to generate higher current income and better total returns. As far as the U.S. and foreign stock markets are concerned, after strong year-to-date performance, it is possible we may experience a correction due to the uncertainty surrounding the fiscal policy debate in the U.S., slower growth in China and chronic economic problems in Europe.

Until some of the issues we've addressed begin to clarify themselves, we recommend a more cautious investment strategy. Broad diversification across low-correlated asset classes and holding some cash reserves as opposed to being fully invested in stocks are the most common methods we employ during uncertain times.

We would be pleased to review investment strategy in light of current conditions and your own individual objectives and circumstances. In addition, in light of the election results, it may be particularly timely to review your estate plan to take advantage of existing estate tax laws before they expire at year-end. If you haven't done so already, we wish to offer our assistance as a starting point or sounding board to any of your estate planning considerations.

Chart courtesy of Bloomberg