Covenant Asset Management, LLC

Fourth Quarter 2018 Investment Perspectives

John Guarino, President | www.covasset.com
125 Maple Avenue Chester, NJ 07930 | (908) 879-4090

Economic and Financial Markets Review & Outlook

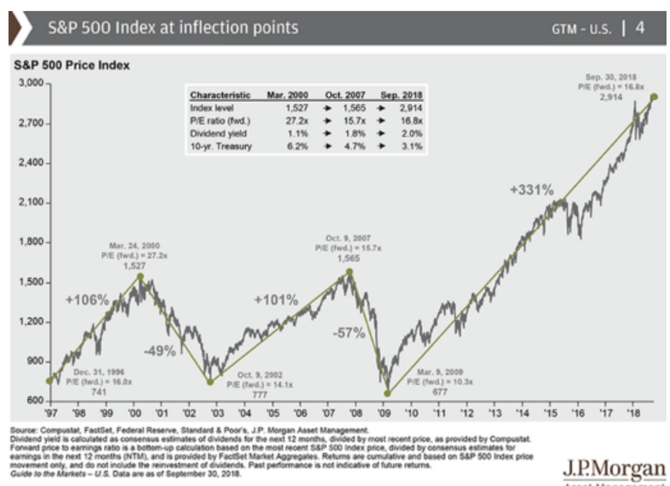
Covenant Asset Management is pleased to offer our latest investment perspectives. In this publication we review third quarter results and highlight key economic, financial and political themes which we expect will drive markets and investment performance in the coming months.

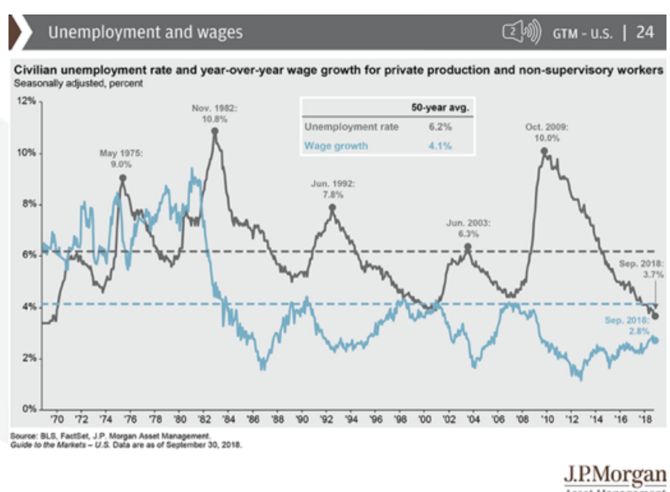
By all accounts the U.S. economy is booming. Second quarter real GDP rose by 4.2%, consumer confidence and small business optimism are near record highs and unemployment, at 3.7%, is at the lowest level since 1969. With this backdrop, it is no surprise that stock market indexes have surged to all time highs. The S&P 500 rose by 7.2% in the third quarter and has produced a 10.6% total return year-to-date through the end of September. Economic strength has allowed the Federal Reserve Bank to continue to gradually raise short-term interest rates. At the end of September, the Fed raised the Fed Funds rate for the 8th time since the end of 2015. The Fed Funds rate at a range of 2.00%-2.25% still remains low by historical standards, but more rate increases are expected in the next year. On the heels of strong economic data the ten-year U.S. Treasury Note yield recently climbed to 3.23%, the highest level in seven years, and oil prices have risen to their highest levels in nearly four years.

A consequence of rising interest rates has been weaker housing and auto demand. As mortgage and auto loan rates rise, affordability becomes more of an issue. However, economic stimulus from personal and corporate tax cuts has buoyed consumer spending and industrial production. As a result, corporate earnings are poised to surge to record levels this year.

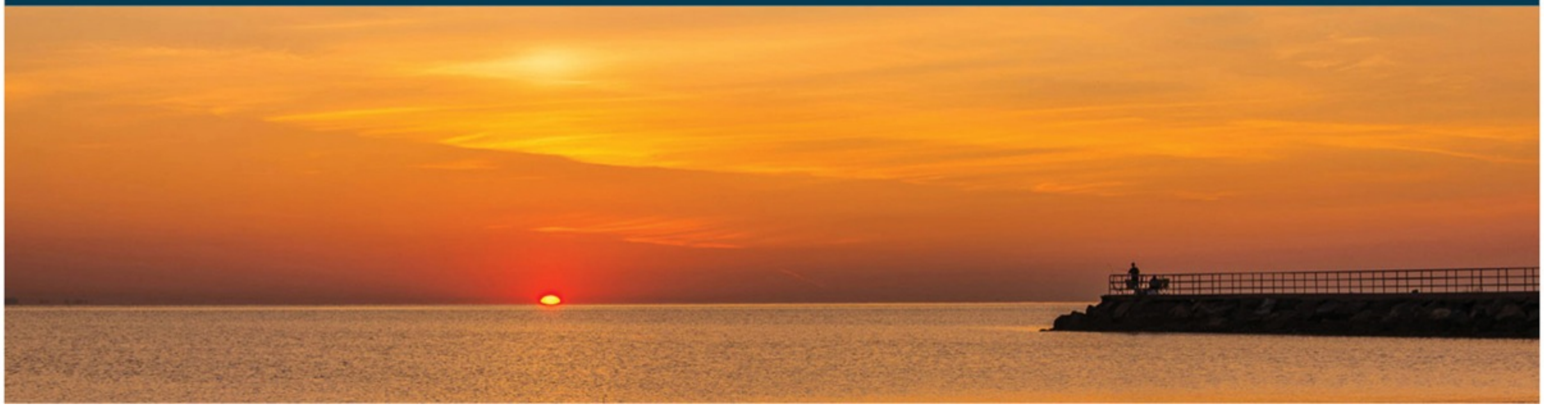
KEY THEMES

1. The U.S. economy is booming with unemployment at a 49 year low of 3.7%, but warning signs are beginning to appear.
2. U.S. stock indexes continued to hit record highs but markets have become wobbly as we enter the fourth quarter.
3. Rising interest rates and oil prices are becoming worrisome to investors.





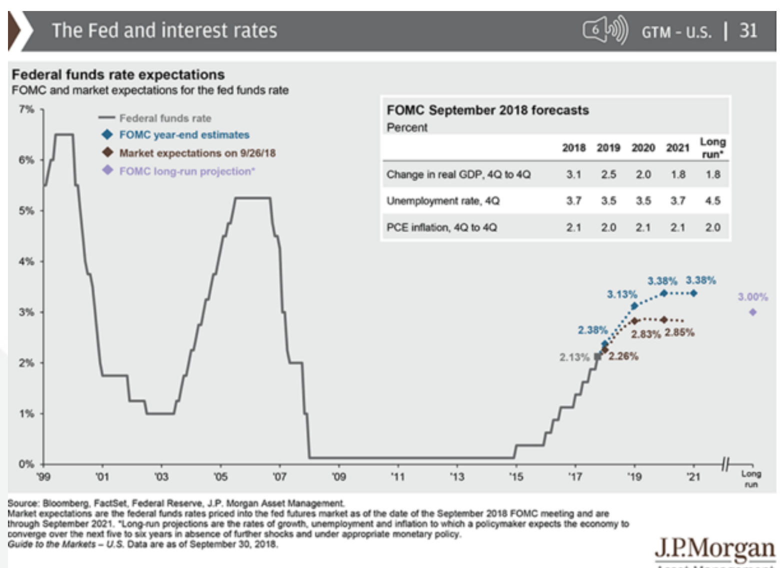
Economic and Financial Markets Review



One of the issues we have discussed previously that has worried investors for much of this year has been trade tensions. President Trump has embraced the policy of raising tariffs on our trading partners in an effort to negotiate better trade terms. The Trump administration's trade representatives have cited unfair trading practices and terms of existing agreements. In the third quarter, European trade officials displayed a willingness to renegotiate certain trade terms and the U.S., Mexico and Canada agreed on a new free trade agreement to replace NAFTA. Trade disputes don't appear to be having a noticeable impact on the U.S. economy at this point, although the expansion of tariffs on Chinese goods has just occurred and are not yet reflected in economic data. China is now the second largest economy in the world. Therefore, further escalation of trade tensions with China must be monitored. To date, China has resisted any pressure to resolve unfair trade and intellectual property piracy disputes. Pressure on China is rising, however, as their economy has weakened and their stock market is down more than 20% so far this year.

Since the financial crisis in 2008, the Fed has kept interest rates at abnormally low levels and remained committed to a gradual path of normalization. After raising rates again in September, the Federal Open Market Committee (FOMC) released a statement removing the reference to monetary policy remaining "accommodative." The real (inflation adjusted) federal funds rate is now positive for the first time since the financial crisis. Coupled with the ongoing shrinkage of the Fed's balance sheet, monetary policy has moved from loose to tighter over the past year. While there is no indication that the Fed wishes to harm the economy or stock prices with these actions, the risks of a policy mistake are rising.

Rising bond yields, however, could become a headwind for stocks in the not-too-distant future, should trends continue. Higher yields beyond current levels begin to bring valuation of stocks into greater focus. They also have the potential to make fixed-income securities relatively more attractive. A long-awaited shift out of high yield alternatives such as high yield stocks and bonds, REITS and MLPs could be on the horizon.



Another issue that has garnered a fair degree of attention is the effect of mid-term elections on financial markets. At this writing, odds favor Democrats taking control of the House of Representatives and Republicans retaining control of the Senate.

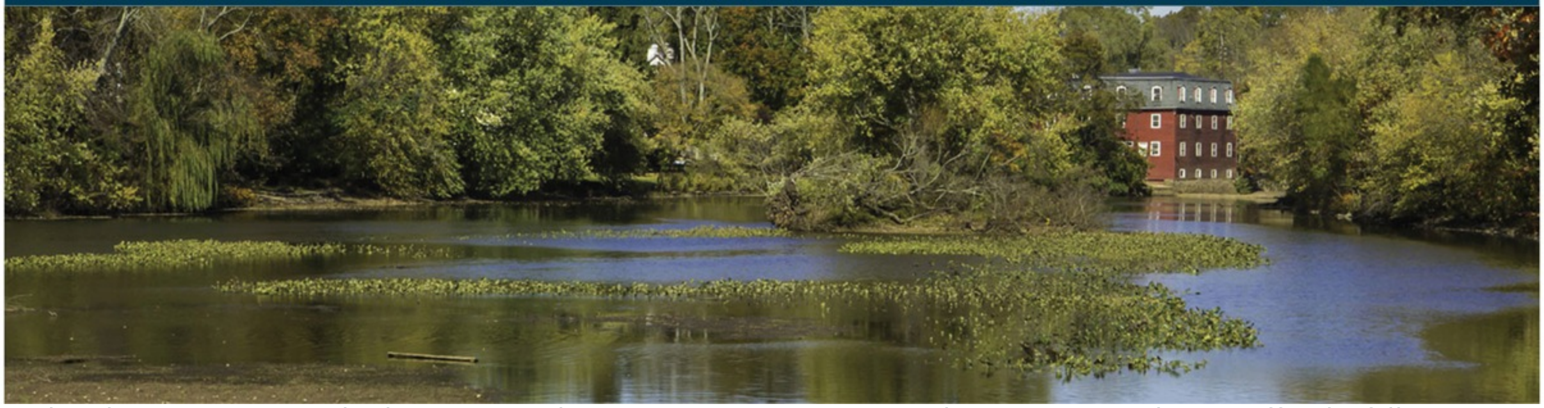
Economic and Financial Markets Challenges

It is worth remembering that the stock market discounts future events, and markets react to unanticipated events. It is therefore fair to conclude that at current levels, the market is anticipating a split Congress after the mid-terms. If this happens, and once the uncertainty lifts, it is likely the stock market could rally into year-end. Alternatively, if mid-term election results differ from current expectations, the market will likely react positively if Republicans retain control of both houses of Congress or negatively if Democrats gain control of both the House and Senate.

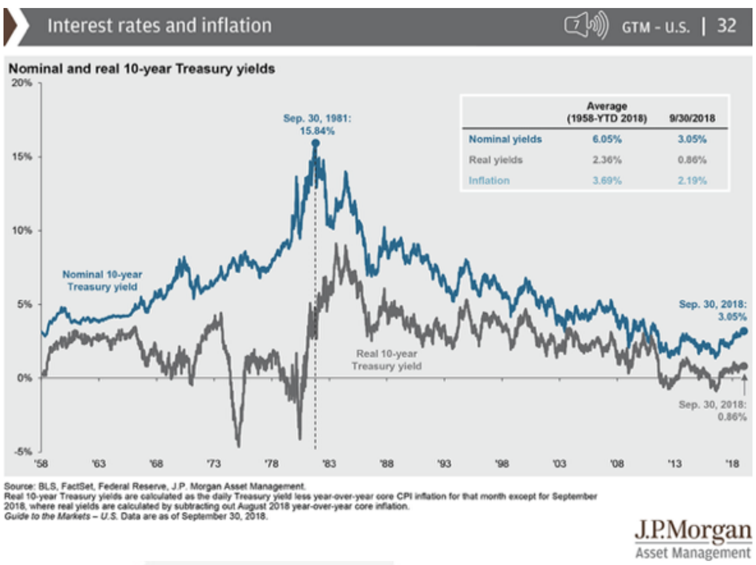
It would be easy to look at equity indexes hitting record highs and accelerating economic data and conclude that the economy and financial markets have smooth sailing ahead. However, ebullient markets and overly optimistic sentiment warrants a degree of caution. For some time now, we have been concerned that the next notable correction in stock prices would occur when economic conditions improved enough for the Fed to normalize interest rates more quickly than anticipated. Although the Fed has continued on a gradual approach to raising the Fed Funds rate, the persistence of its actions and outlook for more rate hikes ahead may finally be having an impact on investor sentiment. The strong September employment report, coupled with a rapid jump in Treasury yields, has resulted in a predictable and sudden shift in trading patterns. When stock traders believe the economy is strong and interest rates are likely to rise, they typically sell growth stocks in favor of economically sensitive companies such as industrials and energy companies. What has been unusual about this year is that economic strength and rising short-term rates have been evident for several quarters, yet growth stocks led the market higher for the first three quarters of the year. Last week's strong economic data and jump in rates may have triggered a shift in investor sentiment that, at a minimum, could cause traders to shift away from growth stocks and into value stocks or could potentially be the start of a deeper correction ahead.

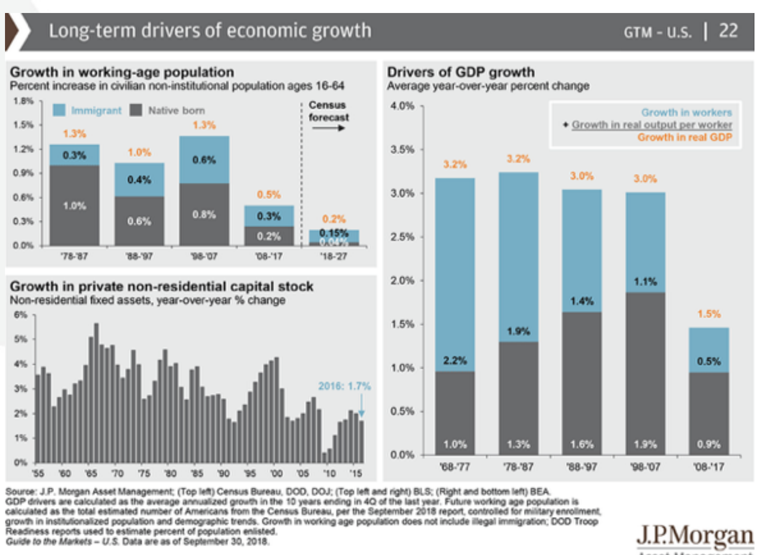
We have been optimistic about the prospects for the stock market this year, believing that there is likely to be further gains ahead after last year's robust gains. However, we have also been careful to warn that we are late in the economic and market cycle and investors should begin preparing for the end of these cycles. Reducing or eliminating margin and other debt and rebalancing portfolios to ensure they match investor objectives are important steps in this process. Raising cash to protect against potential losses and creating a source for future purchases at lower levels is another step. Given the length and strength of this bull market, however, most taxable investors have significant unrealized capital gains which could inhibit the benefit of raising cash. Prices on long term holdings would need to drop substantially to offset the cost of federal and state capital gains taxes resulting from the sale of highly appreciated securities. Short-term holdings would need an even bigger drop. Be assured that your Covenant financial advisor is well aware of your individual needs and circumstances and is prepared to act in your best interests. We welcome any questions or concerns and look forward to continuing to serve you.

Economic Charts

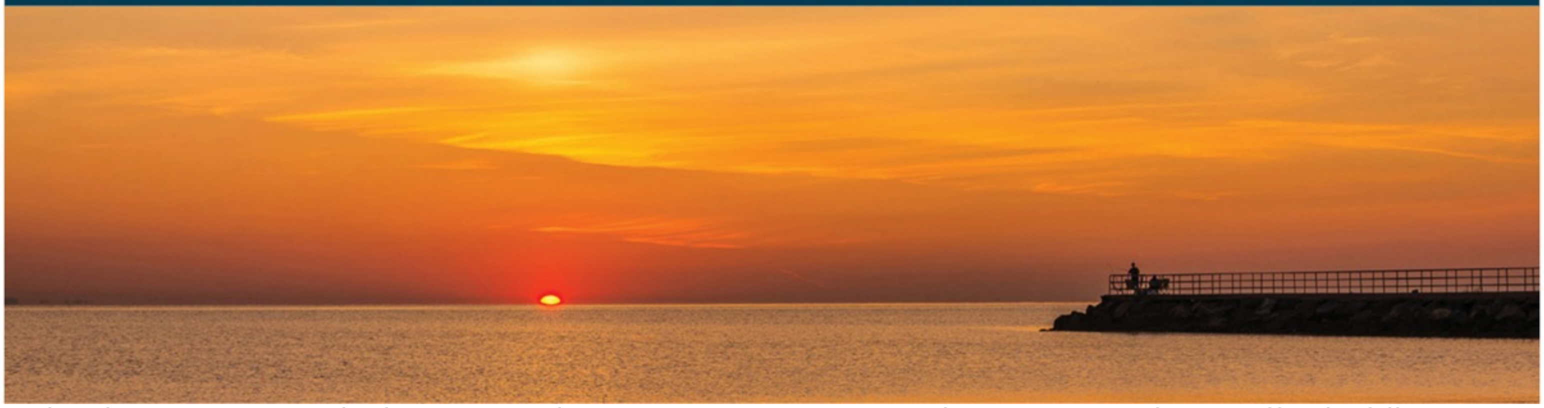


Rather than write extensively about equity valuations, economic statistics and investing principles, we offer the following charts organized by topic and courtesy of J.P. Morgan Asset Management:

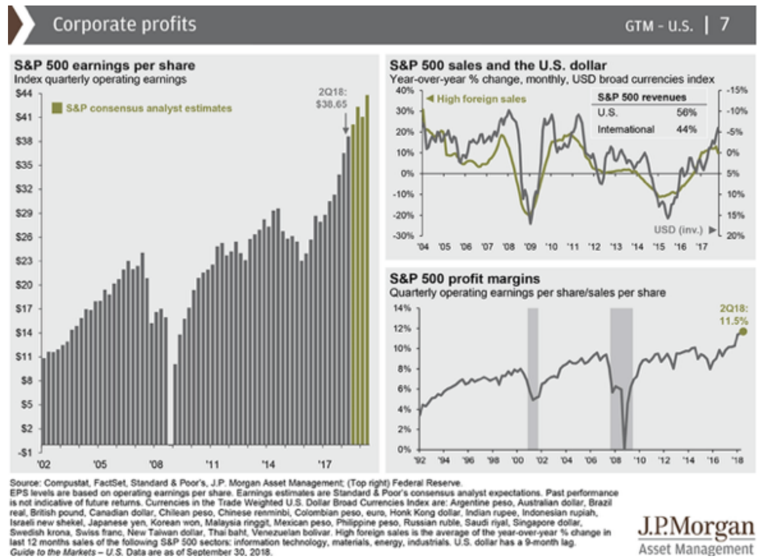


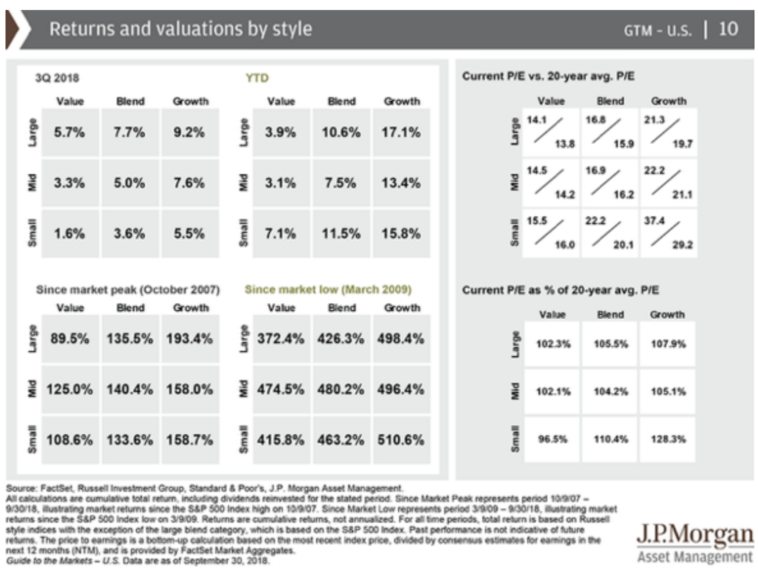


Financial Markets Charts



Rather than write extensively about equity valuations, economic statistics and investing principles, we offer the following charts organized by topic and courtesy of J.P. Morgan Asset Management:





Returns and valuations by style

GTM – U.S. | 10

3Q 2018

	Value	Blend	Growth
Large	5.7%	7.7%	9.2%
Mid	3.3%	5.0%	7.6%
Small	1.6%	3.6%	5.5%

YTD

	Value	Blend	Growth
Large	3.9%	10.6%	17.1%
Mid	3.1%	7.5%	13.4%
Small	7.1%	11.5%	15.8%

Since market peak (October 2007)

	Value	Blend	Growth
Large	89.5%	135.5%	193.4%
Mid	125.0%	140.4%	158.0%
Small	108.6%	133.6%	158.7%

Since market low (March 2009)

	Value	Blend	Growth
Large	372.4%	426.3%	498.4%
Mid	474.5%	480.2%	496.4%
Small	415.8%	463.2%	510.6%

Current P/E vs. 20-year avg. P/E

	Value	Blend	Growth
Large	14.1 / 13.8	16.8 / 15.9	21.3 / 19.7
Mid	14.5 / 14.2	16.9 / 16.2	22.2 / 21.1
Small	15.5 / 16.0	22.2 / 20.1	37.4 / 29.2

Current P/E as % of 20-year avg. P/E

	Value	Blend	Growth
Large	102.3%	105.5%	107.9%
Mid	102.1%	104.2%	105.1%
Small	96.5%	110.4%	128.3%

Source: FactSet, Russell Investment Group, Standard & Poor's, J.P. Morgan Asset Management.
All calculations are cumulative total return, including dividends reinvested for the stated period. Since Market Peak represents period 10/9/07 – 9/30/18, illustrating market returns since the S&P 500 Index high on 10/9/07. Since Market Low represents period 3/9/09 – 9/30/18, illustrating market returns since the S&P 500 Index low on 3/9/09. Returns are cumulative returns, not annualized. For all time periods, total return is based on Russell style indices with the exception of the large blend category, which is based on the S&P 500 Index. Past performance is not indicative of future returns. The price to earnings is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates.
Guide to the Markets – U.S. Data are as of September 30, 2018.

J.P.Morgan Asset Management

Financial Markets Charts

Rather than write extensively about equity valuations, economic statistics and investing principles, we offer the following charts organized by topic and courtesy of J.P. Morgan Asset Management:

S&P 500 valuation measures

GTM – U.S. | 5

Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	16.8x	16.1x	0.2
CAPE	Shiller's P/E	33.2	26.7	1.0
Div. Yield	Dividend yield	2.0%	2.0%	0.0
P/B	Price to book	3.2	2.9	0.4
P/CF	Price to cash flow	12.5	10.7	0.9
EY Spread	EY minus Baa yield	1.1%	-0.1%	-0.6

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1989, and FactSet for September 30, 2018. Average P/E and standard deviations are calculated using 25 years of FactSet history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. 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. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
*P/CF is a 20-year average due to cash flow data availability.
Guide to the Markets – U.S. Data are as of September 30, 2018.

J.P.Morgan
Asset Management

Global equity markets

GTM – U.S. | 41

Returns	2018 YTD		2017		15-years	
	Local	USD	Local	USD	Ann.	Beta
Regions						
U.S. (S&P 500)	-	10.6	-	21.8	9.9	0.85
AC World ex-U.S.	0.7	-2.7	18.8	27.8	9.2	1.12
EAFE	1.8	-1.0	15.8	25.6	8.6	1.08
Europe ex-UK	1.4	-1.6	14.5	27.8	9.4	1.24
Emerging markets	-2.6	-7.4	31.0	37.8	12.7	1.29
Selected Countries						
United Kingdom	1.0	-2.6	11.8	22.4	7.1	1.03
France	7.1	3.6	14.1	29.9	8.8	1.26
Germany	-4.2	-7.3	12.9	28.5	11.5	1.39
Japan	2.7	1.9	20.1	24.4	7.2	0.74
China	-8.8	-9.0	55.3	54.3	16.2	1.25
India	2.7	-9.6	30.5	38.8	14.9	1.38
Brazil	5.9	-12.1	26.9	24.5	15.8	1.61
Russia	22.8	9.8	1.2	6.1	8.8	1.57

Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
All return values are MSCI Gross Index (official) data. 15-year history based on U.S. dollar returns. 15-year return and beta figures are calculated for the time period 12/31/02-12/31/17. Beta is for monthly returns relative to the MSCI AC World Index. Chart is for illustrative purposes only. Please see disclosure page for index definitions. Countries included in global correlations include Argentina, Australia, Austria, Brazil, Canada, China, Colombia, Denmark, Finland, France, Germany, Hong Kong, India, Italy, Japan, Korea, Malaysia, Mexico, Netherlands, New Zealand, Peru, Philippines, Portugal, Spain, South Africa, Taiwan, Thailand, Turkey, UK and the U.S. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of September 30, 2018.

J.P.Morgan
Asset Management

U.S. and international equities at inflection points

GTM – U.S. | 44

	P/E	20-yr. avg.	Div. Yield	20-yr. avg.
S&P 500	16.8x	15.9x	2.0%	2.0%
ACWI ex-U.S.	12.9x	14.3x	3.4%	3.0%
As % of U.S.	*77%*	*90%*	*173%*	*149%*

Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
Forward price to earnings ratio is a bottom-up calculation based on the most recent index price, divided by consensus estimates for earnings in the next 12 months (NTM), and is provided by FactSet Market Aggregates. Returns are cumulative and based on price movement only, and do not include the reinvestment of dividends. Dividend yield is calculated as consensus estimates of dividends for the next 12 months, divided by most recent price, as provided by FactSet Market Aggregates. Past performance is not a reliable indicator of current and future results.
Guide to the Markets – U.S. Data are as of September 30, 2018.

J.P.Morgan
Asset Management

*Any performance-related data listed in this report may represent un-audited results compiled by Covenant Asset Management or others. It could be intended to reflect results that are indicative of Covenant's individual client's equity performance who religiously invest according to our model portfolios. This performance data represents past performance and individual client results may vary materially. Past performance does not guarantee future results and current performance may be higher or lower than the performance data quoted.

Covenant Asset Management, LLC

125 Maple Avenue,
Chester, NJ 07930

www.covasset.com

Main: (908) 879-4090
fax: (908) 879-6468