Covenant
Asset Management, LLC

Third Quarter 2015
Investment Perspectives

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Financial Markets Review And Outlook

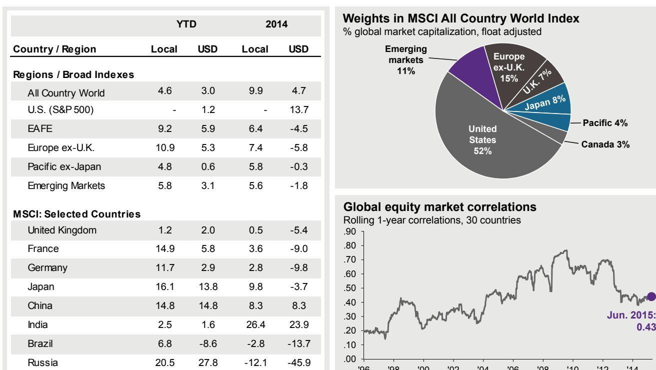
Covenant Asset Management is please to offer
our latest investment perspectives.
In this publication we review second quarter results
and highlight key economic and financial themes which
we expect will drive markets and investment
performance in the coming months.

KEY THEMES

1. U.S. equity markets first half trading range is the narrowest in history
2. Economic expansion and bull market in late stages
3. Slow labor force and productivity growth have negative implications for U.S. economic growth

Just a few weeks ago, stock investors were on track for respectable first-half gains. Greece's debt standoff and ultimate default caused global financial markets to whipsaw during the final week of June and had investors contemplating the implications for the eurozone and the global economy. Regardless of these events, the first half of the year for the S&P 500 was the narrowest trading range in history. If history is any guide, the rest of the year could break to the upside at some point as the top-ten previous narrowest first-half starts to the year all resulted in a positive return for the balance of the year, averaging 7%.

Global equity markets GTM – U.S. | 42



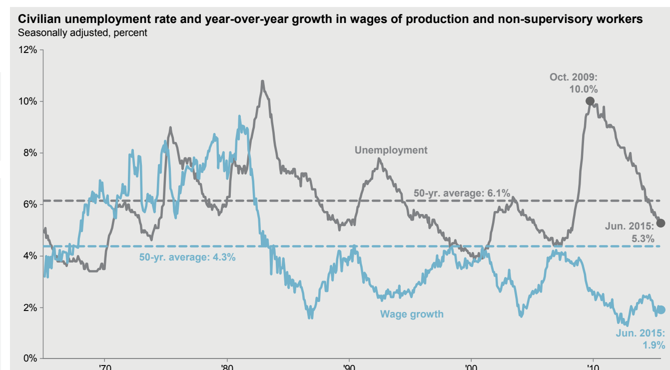
Country / Region	YTD Local	YTD USD	2014 Local	2014 USD
Regions / Broad Indexes				
All Country World	4.6	3.0	9.9	4.7
U.S. (S&P 500)	-	1.2	-	13.7
EAFE	9.2	5.9	6.4	-4.5
Europe ex-U.K.	10.9	5.3	7.4	-5.8
Pacific ex-Japan	4.8	0.6	5.8	-0.3
Emerging Markets	5.8	3.1	5.6	-1.8
MSCI: Selected Countries				
United Kingdom	1.2	2.0	0.5	-5.4
France	14.9	5.8	3.6	-9.0
Germany	11.7	2.9	2.8	-9.8
Japan	16.1	13.8	9.8	-3.7
China	14.8	14.8	8.3	8.3
India	2.5	1.6	26.4	23.9
Brazil	6.8	-8.6	-2.8	-13.7
Russia	20.5	27.8	-12.1	-45.9

Source: FactSet, MSCI, Standard & Poor's, 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 are as of June 30, 2015.

Major U.S. stock market benchmarks declined modestly during the second quarter with the S&P 500 losing 0.2% and the Dow Jones Industrials dropping 0.9%. Bond prices tumbled as the yield on the 10-year U.S. Treasury Note rose to 2.34% from 1.93% at the beginning of the quarter. The rise in yields had a global basis as reflected by the rise in German 10-year government bond yields to 0.74%, up from 0.18% at the end of the first quarter. Some investors have been reducing their exposure to bonds in preparation for the Fed's first interest rate hike since 2006, widely expected in the fall of this year.

The U.S. economy appears to be following a similar, though less pronounced, pattern as 2014 with a first quarter contraction due partially to weather and other non-recurring factors followed by a rebound in the second quarter. Consumer spending in the U.S., after a long drought, may be showing signs of improving. Retail sales have jumped in two of the past three months after nearly a year of weak results. And there is hope for continued improvement as energy prices are substantially lower than they were last year, unemployment is down, interest rates remain low, and wages are starting to rise – all important supports for consumer spending.

Unemployment and wages GTM – U.S. | 24

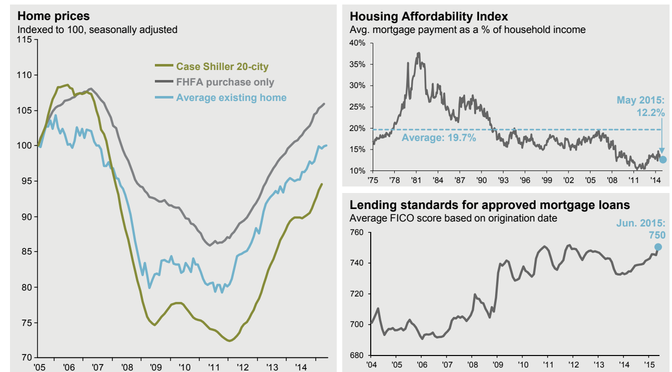


Source: BLS, FactSet, J.P. Morgan Asset Management. .
Guide to the Markets – U.S. Data are as of June 30, 2015.

Financial Markets Review And Outlook

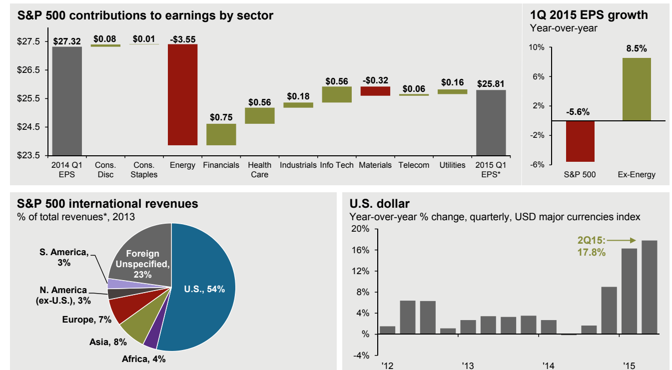
The recovery in housing is also showing signs of picking up steam with many gauges of new construction and home prices on the upswing. Manufacturing does appear to be the lagging sector of the economy, most likely related to the sharp increase in the dollar in the past year. Another concern for investors is the lack of growth in corporate profits. Much of the stagnation in profit growth is related to the stronger dollar hurting multi-national company profits and the drag on profits from energy companies having to do with the tumble in oil prices. With both the dollar index and energy prices having stabilized recently, investors are likely to look through the present weakness in profits and treat it like a non-recurring event.

Residential real estate GTM – U.S. | 21



Sources: (Left) National Association of Realtors, Standard & Poor's, FHFA, FactSet, J.P. Morgan Asset Management. (Top right) Census Bureau, J.P. Morgan Asset Management. Monthly mortgage payment assumes the prevailing 30-year fixed-rate mortgage rates and average new home prices excluding a 20% down payment. (Bottom Right) McDash, J.P. Morgan Securitized Product Research, J.P. Morgan Asset Management.
Guide to the Markets – U.S. Data are as of June 30, 2015.

Sources of S&P 500 earnings GTM – U.S. | 8



Source: Compustat, Federal Reserve, S&P 500 individual company 10K filings, S&P Index Alert, Standard & Poor's, J.P. Morgan Asset Management.
*International revenue numbers are subject to individual company management interpretation and reporting. S&P analysis was done on a company by company basis through 10K filings and is subject to variability based on accounting principles. Data is from a Standard & Poor's report *S&P 500 Foreign Sales 2013* by Howard Silverblatt. Currencies in the Trade Weighted U.S. Dollar Major Currencies Index are: British Pound, Euro, Swedish Kroner, Australian Dollar, Canadian Dollar, Japanese Yen, and Swiss Franc.
Guide to the Markets – U.S. Data are as of June 30, 2015

CURRENT STATE OF ECONOMIC & STOCK MARKET CYCLE

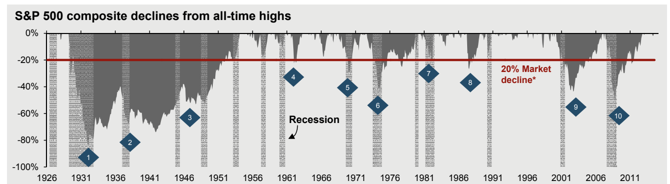
While we continue to believe the U.S. economic expansion and bull market in stocks are in the latter third of their cycles, we do not see any evidence that a recession or bear market is likely to begin within the next year. Bull markets typically end in one of three ways: (1) Either investors become euphoric and dismissive of risks which drive expectations to levels that reality fails to meet, or (2) economic growth and inflation begin to rise rapidly causing the Fed to begin a series of interest rate hikes intended to cool things down, or (3) a huge negative surprise hits the economy destroying trillions of dollars of economic activity. For example, we witnessed a climatic end to the late 1990s bull market when valuation levels reached unsustainable levels, and between March 2000 and October 2002 Nasdaq lost nearly 80% of its value.

It took over twelve years and a massive change in the composition of the index for Nasdaq to recover from the October 2002 bear market low. We note, however, that valuation levels today are only slightly above their long-term averages as indicated by the chart on the previous page. Similarly, we view the probability as remote that the Fed will raise interest rates in any aggressive or concerted fashion in the next twelve months. With U.S. and global economic activity still sluggish, mounting national debt in both the U.S. and most developed countries and plenty of unused capacity around the world, the Fed has been very clear it will raise rates only in a cautious manner.

Lastly, and by definition, negative surprises are hard to predict, otherwise they wouldn't be surprises. We don't see any significant excesses in the economy or financial markets today, such as existed prior to the 2008/2009 financial crisis, that could wipe out trillions of dollars in economic activity. Fortunately, consumer and corporate debt levels have improved dramatically since 2008 and balance sheets are in better shape than they've been in many decades. The only sector of the economy that is worse off today than in 2008 is the government sector. Both national governments and central banks around the world have piled on debts and supplied massive amounts of liquidity and capital in an attempt to counter financial risk and stimulate economic growth. Nevertheless, governments are better equipped to deal with sizeable debt levels for extended periods of time, given their taxing powers and ability to print money.

Bear markets

GTM – U.S. | 16



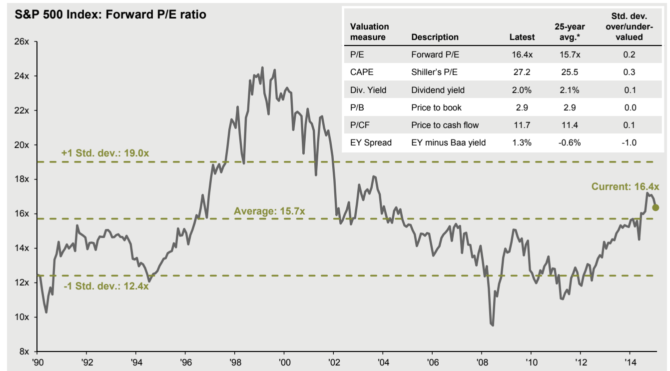
Characteristics of past bear markets

◆	Market Corrections	Cycle Peak	Bull Market Duration (Months)	Decline from All-time High	Recession	Commodity Spike	Aggressive Fed Tightening	Extreme Valuations	Commentary
1	Crash of 1929	Aug 1929	37	-84%	◆			◆	Excessive leverage, irrational exuberance
2	1937 Fed Tightening	Feb 1937	22	-74%	◆		◆		Premature monetary tightening
3	Post WWII Crash	May 1946	48	-54%	◆			◆	Post-war demobilization, recession fears
4	Flash Crash of 1962	Dec 1961	14	-22%				◆	Flash crash, Cuban Missile Crisis
5	Tech Crash of 1970	Dec 1968	73	-29%	◆	◆	◆		Economic overheating, civil unrest
6	Stagflation	Dec 1972	29	-43%	◆	◆			OPEC oil embargo
7	Volcker Tightening	Nov 1980	31	-19%	◆	◆	◆		Extremely high rates to rein in inflation
8	1987 Crash	Aug 1987	59	-27%					Program trading, overheated market
9	Tech Bubble	Aug 2000	118	-42%	◆			◆	Extreme valuations, mostly in tech stocks
10	Global Financial Crisis	Oct 2007	55	-51%	◆	◆	◆		Leverage, housing, Lehman collapse

Source: FactSet, NBER, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management.
*A bear market represents a 20% or more decline from the previous market high using a monthly frequency.
Periods of "Recession" are defined using NBER business cycle dates. "Commodity Spikes" are defined as significant rapid upward moves in oil prices. Periods of "Extreme Valuations" are those where S&P 500 last twelve months P/E levels were approximately two standard deviations above long run averages. "Aggressive Fed Tightening" is defined as Federal Reserve monetary tightening that was unexpected and significant in magnitude.
Guide to the Markets – U.S. Data are as of June 30, 2015.

S&P 500 valuation measures

GTM – U.S. | 5

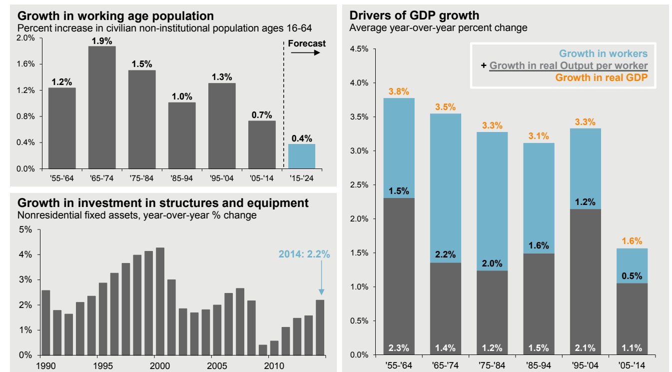


Valuation measure	Description	Latest	25-year avg.*	Std. dev. over/under-valued
P/E	Forward P/E	16.4x	15.7x	0.2
CAPE	Shiller's P/E	27.2	25.5	0.3
Div. Yield	Dividend yield	2.0%	2.1%	0.1
P/B	Price to book	2.9	2.9	0.0
P/CF	Price to cash flow	11.7	11.4	0.1
EY Spread	EY minus Baa yield	1.3%	-0.6%	-1.0

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, 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 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/undervalued is calculated using the average and standard deviation over 25-years for each measure. *P/CF is a 20-year avg. due to cash flow data availability.
Guide to the Markets – U.S. Data are as of June 30, 2015.

IMPLICATIONS OF SLOW GROWTH

Earlier this year, investors and policymakers were concerned about a slowdown in the U.S. economy, given the contraction in first quarter real GDP. While these fears were unwarranted as the weak results were related to bad weather conditions, a dockworker strike and faulty seasonal economic adjustments, a more serious problem facing the U.S. is slow labor force and productivity growth. The charts to the right reveal the drivers of long-term economic growth. The upper left chart shows the growth in the U.S. working-age civilian population over the previous six decades along with projections for the next decade. Since 1995, the number of available workers has been on the decline, which is only projected to get worse in the next ten years. The bottom left chart shows the growth in investment spending in structures and equipment each year which has been an important indicator of productivity growth. Collectively, these two measures, growth in workers and growth in real output per worker (productivity) equals real GDP growth. Slower real GDP growth in the past ten years is a direct result of the slower pace of growth in these two important gauges of the labor force.



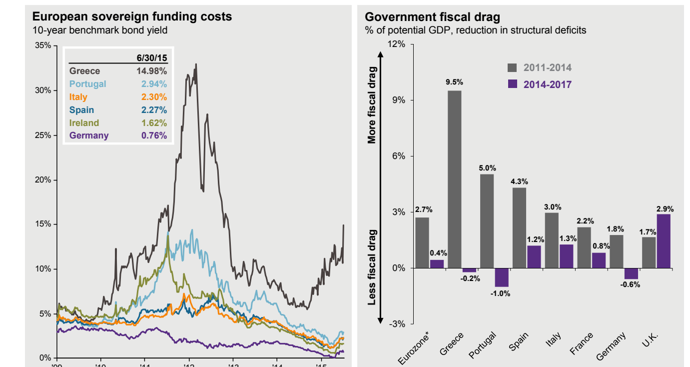
Source: BEA, BLS, Census Bureau, DOD, DOJ, J.P. Morgan Asset Management.
GDP drivers are calculated are the average annualized growth between Q4 of the first and last year. Future working age population is calculated as the total estimated number of Americans from the Census Bureau, controlled for military enrollment, growth in institutionalized population, and demographic trends.
Guide to the Markets – U.S. Data are as of June 30, 2015.

Sluggish economic growth for the U.S. in the decade ahead due to a limited supply of new workers and lower productivity increases has serious investment implications. In the short term, even a modest rebound in economic growth will continue to translate into a reduction in the unemployment rate which may convince the Fed to begin raising interest rates (cautiously). In the long run, the lack of strong economic growth may cause investors to look elsewhere for growth. This could come in the way of greater portfolio allocations to faster growing emerging economies or to faster growing sectors of the U.S. economy. We will have more to say about our response to these implications in the Investment Strategy section below.

RISKS

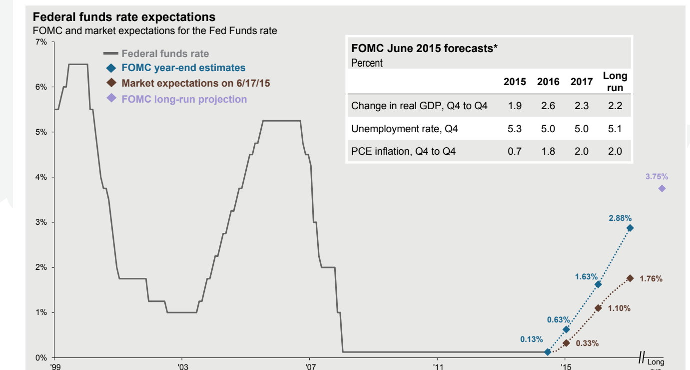
Financial news reports seem fixated on two perceived risks that could hurt investment portfolios, namely Greece and the Fed. While these two issues are newsworthy and potentially market moving, particularly in the short term, we continue to believe the greatest danger to investors is economic prosperity. If economic activity were to become surprisingly stronger and inflation concerns rise, the Fed would be forced to start raising interest rates steadily and rapidly to stave off inflation, likely resulting in a recession and a bear market correction. Given the slow growth rationale illustrated above, we believe the probability of an overheated economic environment in the foreseeable future is pretty low.

In terms of other issues, Greece has stolen the front page headlines from the Fed recently, as the new government battles euro authorities and the International Monetary Fund (IMF) over bailout loans and austerity requirements. Notwithstanding the Greek vote on July 5 to decline the international creditors' conditions for further bailout aid, all parties involved are motivated to compromise and kick the can down the road as they have in the past. We view the events of the past few weeks as political posturing which could lead to another loan agreement. However, unlike 2011 or 2012, there is no strong evidence that Greece threatens global markets. Peripheral 10-year government bond yields from Italy, Ireland, Spain and Portugal all fell below U.S. and U.K. yields as the Greek saga unfolded, indicating no fear of economic contagion. Our view is the real threat to Europe is political contagion. Should European authorities cave in to Greece's demands it might empower left-leaning political parties in Spain, Italy and Portugal to seek similar austerity relief. Absent contagion, Greece is far too small to threaten the global economy. With annual GDP around $190 billion, Greece is smaller than the Detroit metropolitan area's economic output in 2013, the year Detroit filed for bankruptcy. As a reminder, U.S. stock benchmarks rose by 30% or more in 2013. While markets are a bit jittery in response to recent Greece-related news, overall they have been rationally calm.



Source: FactSet, IMF, Tullett Prebon, J.P. Morgan Asset Management.
Data are based on the April 2015 World Economic Outlook. Government deficits are calculated by the IMF as the general government structural balance. The structural balance excludes the normal impact of the business cycle, providing a clearer measure of the independent impact of changes in government spending and taxation on demand in the economy. *Eurozone includes a J.P. Morgan Asset Management estimate for the 2017 structural deficit as a % of GDP.
Guide to the Markets – U.S. Data are as of June 30, 2015.

The other event investors are focused on is the course of monetary policy in the second half of 2015. Consensus forecasts call for the Fed to initiate the first increase in the Fed Funds rate since 2006 in September of this year. With expectations of a rate hike so widespread, the likelihood of a serious negative market reaction in response is small. Also, initial rate increases usually lack the material impact to deter financial markets. The level of short-term interest rates alone is not as important as the yield curve, which influences lending and economic activity. With short rates at 0-0.25% and the 10-year U.S. Treasury yield at 2.30%, it will be quite some time before short rates approach longer-term rates and threaten to invert the yield curve, one of the best indicators that monetary policy is becoming too restrictive and a recession and/or bear market is ahead. Fed Chair Janet Yellen has repeatedly suggested that the Fed would be data dependent on the question of rate hikes and deliberate and gradual in raising interest rates, erring on the side of caution. Many economists have described this Fed as one of the most dovish in U.S. history, which suggests we should take Janet Yellen at her word when it comes to how the Fed will conduct policy in the months ahead.



FOMC June 2015 forecasts*
Percent

	2015	2016	2017	Long run
Change in real GDP, Q4 to Q4	1.9	2.6	2.3	2.2
Unemployment rate, Q4	5.3	5.0	5.0	5.1
PCE inflation, Q4 to Q4	0.7	1.8	2.0	2.0

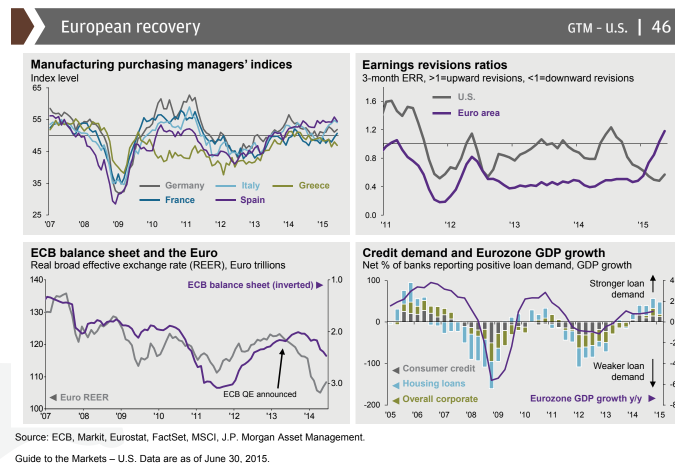
Source: FactSet, Federal Reserve, J.P. Morgan Asset Management.
Market expectations are the federal funds rates priced into the fed futures market as of the date of the June 2015 FOMC meeting. *Forecasts of 17 Federal Open Market Committee (FOMC) participants, midpoints of central tendency except for federal funds rate which is a median estimate.
Guide to the Markets – U.S. Data are as of June 30, 2015.

INVESTMENT STRATEGY

Earlier we made the case that U.S. economic growth would remain below long-term averages for the foreseeable future. If our assessment is correct, there are certain investment strategy implications we wish to communicate. The next interest rate cycle is likely to drive interest rates to levels perhaps half as high as during more normal cycles. This would suggest that short-term rates may only rise to 2-2.5%, instead of 4-5%, and intermediate-term rates such as the 10-year U.S. Treasury yield may peak at 3-3.5%, instead of 5-6% during prior peaks. From a strategy standpoint, should interest rates rise to these levels in the next few years, our inclination would be to sell some or all of the bond ETFs and bond mutual funds held in client portfolios and substitute them for a portfolio of individual high-grade bonds. Other high-yield alternatives such as REITs and energy MLPs would still be useful as a complement to fixed-income assets and provide additional yield enhancement and diversification.

With regard to equity investments in a slow growth environment, investors are likely to pursue growth where it might be found. This will likely include certain emerging market countries where the rule of law is strong and capital markets are relatively free, well-established and transparent. Developed international markets can still be an attractive place to diversify assets when valuation levels are low or accommodative monetary policies exist, conditions which are largely present in Europe and Japan today.

For U.S. stocks, a slow growth environment favors our investing style. As can be demonstrated by the performance of Covenant's equity growth model since the bull market began in 2009, a portfolio comprised of well-managed, innovative companies with brisk historic and prospective growth rates can deliver superior investment results, especially when GDP and overall corporate earnings growth is sluggish. We continue to find attractive innovators that meet these growth characteristics in the biotech, information technology and certain consumer-related sectors. In addition, within the other sectors of the economy, we look for companies with differentiated products, processes or distribution methods that provide them with a sustainable competitive advantage. We are confident that our investment philosophy and discipline will continue to deliver solid long-term investment performance for our clients.



Source: ECB, Markit, Eurostat, FactSet, MSCI, J.P. Morgan Asset Management.

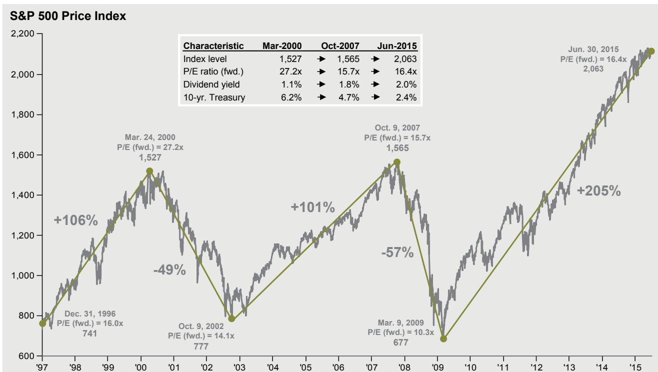
Guide to the Markets – U.S. Data are as of June 30, 2015.

We look forward to discussing our views and expectations with you on an individual basis and always appreciate your feedback, comments or questions.

Covenant Asset Management

S&P 500 index at inflection points

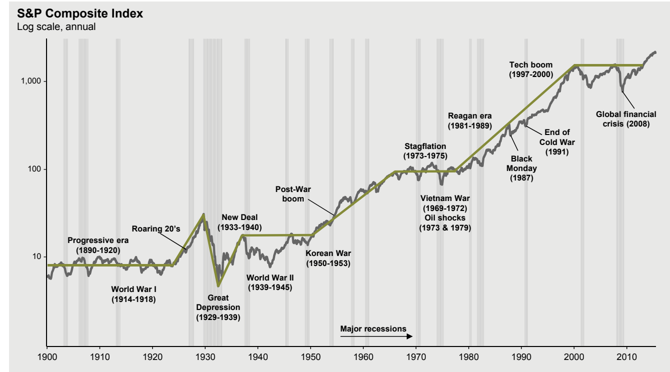
GTM – U.S. | 4



Source: Compustat, FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Dividend yield is calculated as the annualized dividend rate divided by price, as provided by Compustat. Forward Price to Earnings Ratio is a bottom-up calculation based on the most recent S&P 500 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 S&P 500 Index price movement only, and do not include the reinvestment of dividends. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of June 30, 2015.

Stock market since 1900

GTM – U.S. | 17



Source: FactSet, NBER, Robert Shiller, J.P. Morgan Asset Management.
Data shown in log scale to best illustrate long-term index patterns.
Past performance is not indicative of future returns. Chart is for illustrative purposes only.
Guide to the Markets – U.S. Data are as of June 30, 2015.

Global equity markets

GTM – U.S. | 42

	YTD		2014	
Country / Region	**Local**	**USD**	**Local**	**USD**
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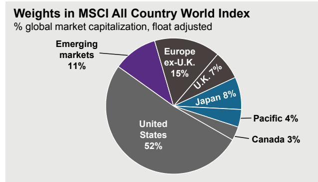
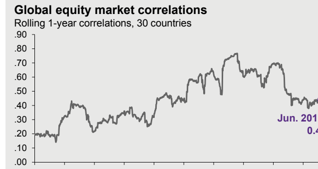


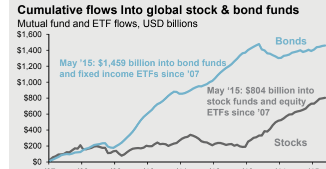


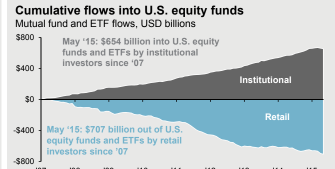
Source: FactSet, MSCI, Standard & Poor's, J.P. Morgan Asset Management.
All return values are MSCI Gross Index (official) data. Chart is for illustrative purposes only. Past performance is not indicative of future results.
Please see disclosure page for index definitions. Countries included in global 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 are as of June 30, 2015.

Fund flows

GTM – U.S. | 58

USD billions	AUM	Mutual fund flows YTD 2015	2014	2013	2012	2011	2010	2009	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999
Domestic Equity	6,460	(37)	(60)	18	(159)	(133)	(81)	(28)	(149)	(68)	(3)	17	100	120	(25)	57	258	176
World Equity	2,296	58	85	141	7	4	57	26	(80)	142	151	107	72	24	(4)	(23)	58	11
Taxable Bond	2,969	37	16	(13)	256	129	221	301	22	100	44	21	0	40	125	76	(36)	7
Tax-exempt Bond	575	8	28	(58)	50	(12)	12	70	8	11	15	5	(15)	(7)	17	12	(14)	(12)
Hybrid	1,401	11	27	71	45	40	35	20	(26)	40	20	43	53	39	8	7	(37)	(13)
Money Market	2,603	(125)	6	32	4	(85)	(455)	(444)	624	570	220	41	(175)	(273)	(62)	354	133	183





Source: Investment Company Institute, J.P. Morgan Asset Management.
TOP: Data includes flows through May 2015 and excludes ETFs. BOTTOM: Data includes flows through May 2015 and includes ETFs. ICI data are subject to periodic revisions. World equity flows are inclusive of emerging market, global equity and regional equity flows. Hybrid flows include asset allocation, balanced fund, flexible portfolio and mixed income flows.
Guide to the Markets – U.S. Data are as of June 30, 2015.

If you would like more information about how your clients can build a partnership with Covenant Asset Management, please call

908-879-4090

or visit

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