Covenant Asset Management, LLC

Third Quarter 2022

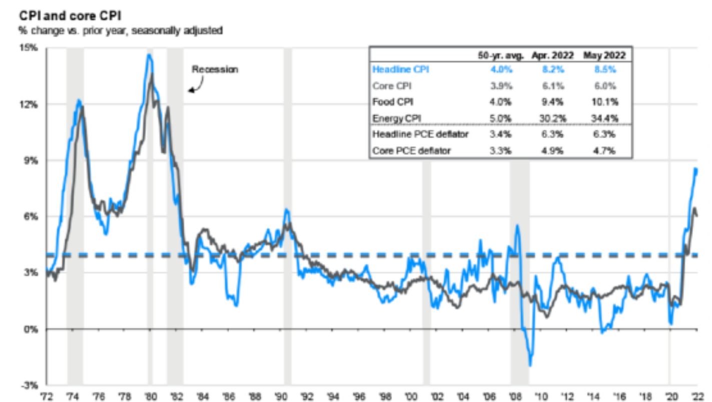
Investment Perspectives

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.

Key Themes

1. The U.S. economy continues to struggle with the highest inflation in four decades.
2. To combat inflation, the U.S. Federal Reserve Bank has embarked on an aggressive plan to raise interest rates and drain cash reserves.
3. Economic data has begun to weaken in response to rising inflation and interest rates.
4. Financial markets suffered one of the worst first halves in U.S. history as investors discount the increasing odds of recession in the near future.



	50-yr. avg.	Apr. 2022	May 2022
Headline CPI	4.0%	8.2%	8.5%
Core CPI	3.9%	6.1%	6.0%
Food CPI	4.0%	9.4%	10.1%
Energy CPI	5.0%	30.2%	34.4%
Headline PCE deflator	3.4%	6.3%	6.3%
Core PCE deflator	3.3%	4.9%	4.7%

The U.S. economy is in the throes of the worst bout of inflation since the 1970s. A combination of supply constraints, largely related to the global pandemic, the war in Ukraine, and policy mistakes by the federal government and federal reserve bank are to blame. By now, most economists admit that the federal government pushed too much money to consumers to counteract the effects of pandemic shutdowns. In the same vein, the Fed buoyed asset prices by cutting the fed funds rate to zero and purchasing nearly $5 trillion of bonds since March 2020. It has become increasingly apparent that the federal government is either unable or unwilling to help ease the supply constraints, leaving the full burden to rein in inflation to the federal reserve bank. In the first half of 2021, many economists warned the Fed that they needed to wind down their bond buying and begin to raise interest rates or inflation would rise. We now know that the Fed ignored these warnings and waited too long. After a series of monthly inflation numbers posted well above expectations, the Fed abruptly announced a reversal of its monetary policies. By the second quarter of this year, the Fed began raising the fed funds rate and shrinking its balance sheet in an effort to slow economic growth and reduce demand for goods and services. The fed funds rate now stands at 1.50%-1.75% with expectations of a continued increase to a range of 3.0%-3.5% by year-end.

Consumer Sentiment Sours

Inflation data has yet to show material signs of subsiding, but the Fed's actions are already contributing to slowing demand. Recent economic reports have revealed a slowdown in consumer spending and home buying. It is important to remember that rising prices also reduce demand, as consumers can no longer afford certain items or are unwilling to pay for them. Additionally, there is the effect of declining asset prices. As portfolio values decline, consumers feel the negative wealth effect and cut back on spending. Consumers, investors and voters are all in a sour mood as indicated by sentiment indicators. Consumer sentiment and confidence surveys, oftentimes indicators of consumer spending, have dropped to historic low levels in recent months. Similarly, investor sentiment and business leaders' confidence levels have dropped precipitously this year. Voters are also displeased according to right

track/wrong track polls, showing the lowest positive results in generations. The public seems to have lost confidence in the decision-making and judgement of leaders across nearly all facets of society.

Inflation can be controlled with the right political will

The current economic, political and cultural environments share a distinct resemblance to the 1970s. Just like then, inflation can be brought back under control with the right fiscal, monetary and economic reforms. Inflation targets were adopted in the early 1990s in New Zealand, Israel, Canada and Sweden and through the implementation of proper reforms, long-lasting success was achieved. However, it is unlikely the current administration and congress will embrace the tax and regulatory reforms necessary to contend with the root causes of the current inflationary cycle. In fact, the current policy proposals are just the opposite. The Biden Administration continues to pursue tighter regulations and higher taxes to fund new entitlement programs and climate initiatives. More regulations and higher taxes will result in less corporate investment, harming future supply capabilities. Additional spending on entitlement programs and climate infrastructure would stimulate demand instead of cooling it, making it more difficult to reign in inflation.

Market Overview

Massive fiscal and monetary stimulus propelled financial markets to all-time highs with cumulative returns of 100% for the S&P 500 and 142% for Nasdaq from 2019-2021. To a certain extent, what we are experiencing this year is the exact opposite of the environment of the previous three years. The withdrawal of fiscal stimulus and the advent of monetary tightening is the main reason financial markets have been hit so hard. The S&P 500 experienced its worst first half of any year since 1970, down 20%. Nasdaq dropped 29.2%, its worst first half ever. The Dow Jones Industrial Average declined 14.4%. With the exception of oil and agricultural commodities, virtually every asset class has had negative performance this year, including bonds evidenced by the Bloomberg Aggregate Bond Index falling 10.4%. To put in context the level of the rise in interest rates, the 2-year U.S. Treasury Note yield rose from 0.56% on December 31 to 2.90% at mid-year. The 10-year Treasury Note yield rose

Characteristic	3/24/2000	10/9/2007	2/19/2020	1/3/2022	6/30/2022
Index Level	1,527	1,565	3,386	4,797	3,785
P/E Ratio (fwd.)	25.2x	15.1x	19.2x	21.4x	15.9x
Dividend Yield	1.4%	1.9%	1.9%	1.3%	1.8%
10-yr. Treasury	6.2%	4.7%	1.6%	1.6%	3.0%

from 1.50% to 3.00% and 30-year-fixed rate mortgages began the year at 3.30% and rose to 5.80% recently. The effect of these interest rate increases is felt broadly throughout the economy, but foremost in the most interest rate sensitive

sectors. In the real world, that means housing and autos. Mortgage applications and new housing starts have already fallen sharply, and there is evidence that home prices have peaked in most parts of the country. Auto sales for both new and used cars have also weakened in recent months. In the investment world, the riskiest and most highly valued assets have been hardest hit. Growth stocks have outperformed their value brethren by a significant margin for most of the past fifteen years during a low interest rate regime. As interest rates have risen, the reversal in fortunes of growth vs. value has been stark with value stocks outperforming growth by nearly 20 percentage points year-to-date.

Odds of Recession Increase

For most of this year, stock prices have been revalued as a result of rising interest rates. Future earnings are worth less when discounted at a

Interest rates and inflation GTM | U.S. | 35

Source: BLS, FactSet, Federal Reserve, J.P. Morgan Asset Management.
Real 10-year Treasury yields are calculated as the daily Treasury yield less year-over-year core CPI inflation for that month. For the current month, we use the prior month's core CPI figures until the latest data is available.
Guide to the Markets – U.S. Data are as of June 30, 2022.

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higher rate, which explains why companies with faster expected earnings growth, that typically carry higher valuation levels, are harder hit when interest rates rise. The character of the market changed in June, as investors began to price in a greater likelihood of recession. The decline in stock prices broadened beyond just growth stocks and extended to more economically sensitive value sectors, including industrials, materials and energy stocks. Investors now believe that, with the Fed becoming more aggressive in raising short-term interest rates, there is a strong chance they will overshoot and tip the economy into recession. Recent economic data supports the notion that the economy is indeed slowing. Consumer spending, a vital part of the economy, has slowed quite a bit in the past few months, as higher prices and higher interest rates begin to affect spending. Industrial production has also slowed and manufacturing activity is edging close to contraction. Unemployment rates are still low by historical standards and many accounts suggest the labor

Residential real estate GTM | U.S. | 22

Average interest rate on a U.S. mortgage
30-year fixed-rate mortgage

Housing inventories
Inventory of new and existing single family homes for sale, thous, NSA

Home prices
y/y % change in Case-Shiller Home Price Index

Mortgage originations by credit score*
Billions of USD

Source: J.P. Morgan Asset Management; (Top and bottom left, top right) FactSet; (Top left) Freddie Mac; (Top right) Census Bureau, National Association of Realtors; (Bottom left) S&P/Case-Shiller; (Bottom right) New York Fed Consumer Credit Panel/Equifax. Monthly mortgage payment assumes the prevailing 30-year fixed-rate mortgage rates and average new home prices excluding a 20% down payment. *Credit score is Equifax Riskscore 3.0.
Guide to the Markets – U.S. Data are as of June 30, 2022.

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market is still tight with more available jobs than people seeking them. It is important to remember however that employment readings are very much lagging economic indicators. Typically, unemployment rises quickly only after the economy is in recession. With first quarter real GDP posting -1.6%, and second quarter GDP estimates declining toward zero, we could be in recession sooner than many economists predict. Consensus expectations for recession within the next twelve months are rising, but still stand at less than 50%. Though not a perfect indicator, recent action within both the bond market and stock market seems to imply much higher odds for recession.

If recession brings about enough demand

destruction and restores balance to the demand/ supply of goods and services, bringing inflation back near the Fed's goal of 2%, the short-term pain associated with declining asset prices and short supply of goods, services and labor would be worthwhile. However, the possibility of stagflation, which is slow or negative real GDP growth coupled with high inflation, cannot be dismissed. If the Fed ends its monetary tightening policy prematurely, inflation may remain too high once the recession ends and could rise again once economic activity and demand head higher. Additionally, if the federal government attempts another round of fiscal stimulus, always popular with politicians during recessions, it may push demand above supply and once again cause prices to rise.

Good News/ Bad News

The good news is that, left alone, the U.S. economy has many self-correcting elements. With the narrowest of majorities in the House of Representatives and a 50/50 Senate, the ability of Congress to pass economic legislation that would interfere with market adjustments presently underway is limited. And with Republicans expected to take control of at least one house of Congress in November, it is even less likely that any major fiscal legislation will pass in a divided government. Another positive is that neither consumers nor businesses are overly leveraged. Debt levels are much more reasonable than in prior recessions suggesting the potential for severe financial stress in the economy is not high. The bad news is that economic reforms needed to help lower inflation to long-term targets are equally unlikely as President Biden will probably not agree to tax cuts or regulatory relief that could help ease supply constraints. Unlike consumers and businesses, the federal government is conspicuous for its high level of debt and deficits. With interest rates on the rise and capital gains tax revenue likely to plummet this year, the federal deficit could rise by over $1 trillion from these two factors alone. Both political parties share the blame for this poor financial stewardship, but this is more of a longer term problem that shouldn't pose serious risk in the next few years.

Short Term Challenges, Long Term Opportunities

In a typical bear market associated with recession, the S&P 500 falls in excess of 30% on average. This suggests that if recession is in our future, stock prices may have further to fall. But with the S&P already down 20% and Nasdaq nearly 30%, it is treacherous to attempt to time the market too precisely. Markets are volatile in the short-term and tend to move very sharply and quickly once a bottom is reached. Predicting the bottom is virtually impossible with a myriad of economic and market variables that need to align to offer investors short-and long-term appreciation potential. After suffering through a serious correction in the first half, we believe the short term could remain challenging for investors. For those with an intermediate to long-term timeframe, plenty of opportunities are now available. Many large-cap technology and communications stocks have declined by more than 50% from their peaks in November 2021 and now represent attractive values. Should major stock market averages fall by another 10 percentage points, we suggest investors become more aggressive and maximize their exposure to stocks consistent with their long-term target allocation. For the first time in more than a decade, investors can actually earn a return on short-term cash reserves. Additionally, as bond yields have risen, we have begun to consider investing in individual high grade bonds. With the downward adjustment of most asset classes this year, it is a good time to rebalance asset allocations to optimal levels to meet long-term financial objectives. Your Covenant advisor is available to discuss any recommended changes to your asset mix, strategy or to answer any questions you may have. We wish you a safe, healthy and enjoyable summer.

Economic and Financial Markets Charts

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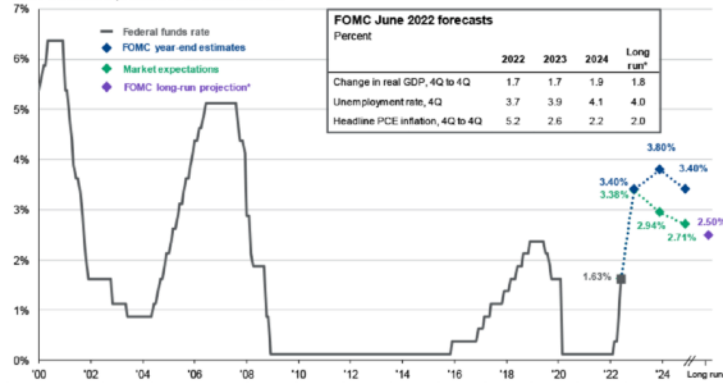
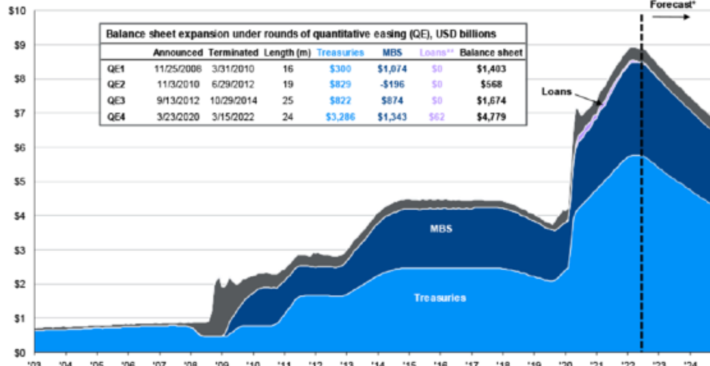
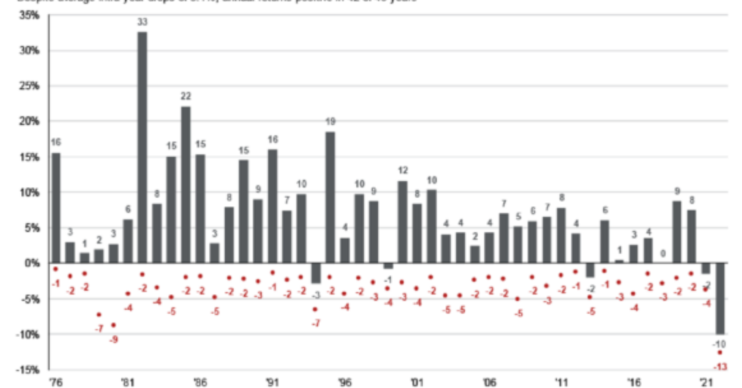


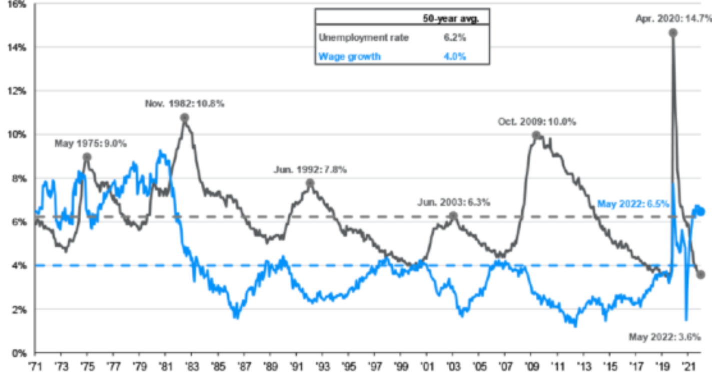




Economic and Financial Markets Charts

Unemployment and wages

GTM | U.S. | 27



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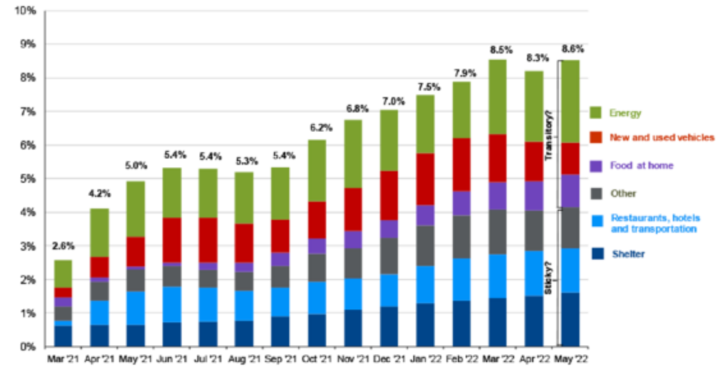
Inflation components

GTM | U.S. | 29



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Asset class returns

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2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	YTD	2007 - 2021 Ann.	2007 - 2021 Vol.
EM Equity 39.8%	Fixed Income 5.2%	EM Equity 79.0%	REITs 27.9%	REITs 8.3%	REITs 19.7%	Small Cap 38.8%	REITs 28.0%	REITs 2.8%	Small Cap 21.3%	EM Equity 37.8%	Cash 1.8%	Large Cap 31.5%	Small Cap 20.0%	REITs 41.3%	Comdty. 18.4%	Large Cap 10.6%	REITs 23.2%
Comdty. 16.2%	Cash 1.8%	High Yield 59.4%	Small Cap 26.9%	Fixed Income 7.8%	High Yield 19.6%	Large Cap 32.4%	Large Cap 13.7%	Large Cap 1.4%	High Yield 14.3%	DM Equity 25.6%	Fixed Income 0.0%	REITs 28.7%	EM Equity 18.7%	Large Cap 28.7%	Cash 0.2%	Small Cap 8.7%	EM Equity 22.9%
DM Equity 11.6%	Asset Alloc. -25.4%	DM Equity 32.5%	EM Equity 19.2%	High Yield 3.1%	EM Equity 18.6%	DM Equity 23.3%	Fixed Income 6.0%	Fixed Income 0.5%	Large Cap 12.0%	Large Cap 21.8%	REITs -4.0%	Small Cap 25.5%	Large Cap 18.4%	Comdty. 27.1%	Fixed Income -10.3%	REITs 7.5%	Small Cap 22.5%
Asset Alloc. 7.1%	High Yield -26.9%	REITs 28.0%	Comdty. 16.8%	Large Cap 2.1%	DM Equity 17.9%	Asset Alloc. 14.9%	Asset Alloc. 5.2%	Cash 0.0%	Comdty. 11.8%	Small Cap 14.6%	High Yield -4.1%	DM Equity 22.7%	Asset Alloc. 10.6%	Small Cap 14.8%	Asset Alloc. -14.6%	High Yield 6.6%	Comdty. 19.1%
Fixed Income 7.0%	Small Cap -33.8%	Small Cap 27.2%	Large Cap 15.1%	Cash 0.1%	Small Cap 16.3%	High Yield 7.3%	Small Cap 4.9%	DM Equity -0.4%	EM Equity 11.6%	Asset Alloc. 14.6%	Large Cap -4.4%	Asset Alloc. 19.5%	DM Equity 8.3%	Asset Alloc. 13.5%	High Yield -16.9%	Asset Alloc. 6.1%	DM Equity 18.9%
Large Cap 5.5%	Comdty. -35.6%	Large Cap 26.5%	High Yield 14.8%	Asset Alloc. -0.7%	Large Cap 16.0%	REITs 2.9%	Cash 0.0%	Asset Alloc. -2.0%	REITs 8.6%	High Yield 10.4%	Asset Alloc. -5.8%	EM Equity 18.9%	Fixed Income 7.5%	DM Equity 11.8%	EM Equity -17.5%	EM Equity 4.8%	Large Cap 16.9%
Cash 4.8%	Large Cap -37.0%	Asset Alloc. 25.0%	Asset Alloc. 13.3%	Small Cap -4.2%	Asset Alloc. 12.2%	Cash 0.0%	High Yield 0.0%	High Yield -2.7%	Asset Alloc. 8.3%	REITs 8.7%	Small Cap -11.0%	High Yield 12.6%	High Yield 7.0%	High Yield 1.0%	REITs -19.2%	DM Equity 4.1%	High Yield 12.2%
High Yield 3.2%	REITs -37.7%	Comdty. 18.9%	DM Equity 8.2%	DM Equity -11.7%	Fixed Income 4.2%	Fixed Income -2.0%	EM Equity -1.8%	Small Cap -4.4%	Fixed Income 2.6%	Fixed Income 3.5%	Comdty. -11.2%	Fixed Income 8.7%	Cash 0.5%	Cash 0.0%	DM Equity -19.3%	Fixed Income 4.1%	Asset Alloc. 11.7%
Small Cap -1.6%	DM Equity -43.1%	Fixed Income 5.9%	Fixed Income 6.5%	Comdty. -13.3%	Cash 0.1%	EM Equity -2.3%	DM Equity -4.5%	EM Equity -14.6%	DM Equity 1.5%	Comdty. 1.7%	DM Equity -13.4%	Comdty. 7.7%	Comdty. -3.1%	Fixed Income -1.5%	Large Cap -20.0%	Cash 0.8%	Fixed Income 3.3%
REITs -15.7%	EM Equity -53.2%	Cash 0.1%	Cash 0.1%	EM Equity -18.2%	Comdty. -1.1%	Comdty. -9.5%	Comdty. -17.0%	Comdty. -24.7%	Cash 0.3%	Cash 0.8%	EM Equity -14.2%	Cash 2.2%	REITs -5.1%	EM Equity -2.2%	Small Cap -23.4%	Comdty. -2.6%	Cash 0.7%

Source: Bloomberg, FactSet, MSCI, NAREIT, Russell, Standard & Poor's, J.P. Morgan Asset Management.
Large cap: S&P 500, Small cap: Russell 2000, EM Equity: MSCI EME, DM Equity: MSCI EAFE, Comdty: Bloomberg Commodity Index, High Yield: Bloomberg Global HY Index, Fixed Income: Bloomberg US Aggregate, REITs: NAREIT Equity REIT Index, Cash: Bloomberg 1-3m Treasury. The "Asset Allocation" portfolio assumes the following weights: 25% in the S&P 500, 10% in the Russell 2000, 15% in the MSCI EAFE, 5% in the MSCI EME, 25% in the Bloomberg US Aggregate, 5% in the Bloomberg 1-3m Treasury, 5% in the Bloomberg Global High Yield Index, 5% in the Bloomberg Commodity Index and 5% in the NAREIT Equity REIT Index. Balanced portfolio assumes annual rebalancing. Annualized (Ann.) return and volatility (Vol.) represents period from 12/31/2006 to 12/31/2021. Please see disclosure page at end for index definitions. All data represents total return for stated period. The "Asset Allocation" portfolio is for illustrative purposes only. Past performance is not indicative of future returns.
Guide to the Markets – U.S. Data are as of June 30, 2022.

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