COVENANT
CAPITAL MANAGEMENT INC.

INVESTORS' JOURNAL

October 2012

WWW.COVENANT.CA

20385 64TH AVENUE, LANGLEY BC V2Y 1N5 PHONE 604.546.1100 TOLL FREE 1.888.629.0044 FAX 604.546.1101 EMAIL info@covenant.ca

Back to School

For many, fall is characterized by the re-engagement of the mind. Students of all ages have returned from their vacations and summer jobs (and other less academic pursuits) to continue their studies. For families with students under 18, perhaps this is the season to consider how to plan financially for post-secondary education. For some families, education costs can leave a significant dent in financial resources. For others, the impact is less severe and funding Thurston's or Daphne's double PhD in ballroom dancing may not be a challenge. In either case, Registered Education Savings Plans offer two rare features; free money from the government (up to 20% of your contributions), and tax sheltered growth! These are benefits that should not be overlooked. Our investment committee recently re-evaluated how we allocate RESPs - we believe the steps we have taken will add significant value for clients that need, or wish, to be intentional about preparing for their children's education.

Our culture places significant value on post-secondary education. Certainly, understanding how our world and its systems function can be very beneficial – particularly if that knowledge is then applied to gainful and productive employment. But becoming fascinated by the world and its people can also lead to a dangerous consequence; we risk being tempted to worship the creature, or the creation, more than the creator.

Spanish "flu"

Spain has managed to grab a number of headlines in 2012. Certainly because of their success in becoming European Football Champions, but also, sadly, because of their continuing financial troubles. In March 2012, failures began erupting in their banking sector that required a $100 billion government bailout three months later. Thereafter, there has been a steady exodus of cash from Spain, driving up interest rates - and therefore government borrowing costs - to levels beyond the government's ability to service those debts. We are likely to see four key events unfold in Spain during October:

1. A presentation of the 2013 Parliamentary Budget. They may attempt to spend more or to cut their budget deficit. They may also ask the European Central Bank to intervene in their bond market in return for the promise of austerity measures.

2. Introduction of a fiscal and budget reform plan. Any fiscal or budget cuts would please lenders like the ECB and International Monetary Fund, but would make more Spaniards angry. Many already feel betrayed by their government's mismanagement and are suffering from the cost of the bailout. Increased social unrest in Spain seems likely.

3. Spain is in the final stage of their banking audit and the true cost of the bailout may soon be known. Market expectation is for another shortfall of EURO$60 billion or more.

4. Agencies such as Moody's will finalize their review of Spain and may further cut their debt rating.

The Bigger Picture

Taking a more global view, what Spain is going through is fundamentally no different to what many developed nations have faced, or are still facing, which is a process of massive deleveraging. This is inevitable when asset values have sharply declined, or disappeared, but the debts that accumulated while acquiring those assets during boom years remain. Deleveraging, in short, has to occur when debt can no longer be serviced.

In face of deleveraging, governments have some broad options to reduce debt:

Monetary Policy

1. Print money – attractive, because it is quick and easy.
2. Depreciate their currency, which is linked to, and often a consequence of printing money.

Fiscal Policy

1. Undertake austerity measures - cut back on spending, accepting the painful social costs and consequences to the economy.
2. Fiscal transfers in the form of debt write-downs. For example, transferring bad debts from the banking sector to the government balance sheet, debt forgiveness, or other forms of fiscal transfers to individuals.
3. Long term government fiscal support, often by spending on new or rebuilt infrastructure.

Large scale deleveraging took place in Japan over 20 years ago. Speculation bubbles in stock and real estate markets burst, ushering in a long period of declining asset values while debt remained high. Japan's government stepped in aggressively with fiscal spending and maintained a long-term, loose monetary policy. That gave individuals and the business sector time to repair their balance sheet (15 years or more) while government supported the public sector. Not surprisingly, Japan now has one of the highest debt to GDP (Gross Domestic Product) ratios in the developed world, but managed to sidestep depression with a slow average growth each year.

In 2007, Asian countries such as Thailand, Korea, Indonesia, Taiwan, Hong Kong and Singapore experienced similar debt deflation due to unsustainable current account deficits. Their stock and housing markets crashed, currency values plummeted and their economies tanked. Ironically, their lower currency exchange rates made these economies cost competitive, laying the foundation for their subsequent rapid recovery. They are now experiencing growth rates above those of more developed countries.

Similarly, the US and UK governments, since the shocks of 2008, have provided much fiscal stimulus and monetary support to their economies. In fact, the US Federal Reserve recently announced that it will embark on a further quantitative easing (QE) estimated at about US$1 trillion/year, with no time limit. This is analogous to the infinite printing of unlimited money. While less dramatic, the UK has been in a quantitative easing mode for a long time. The European Central Bank (ECB) has also announced that they will act on behalf of any EU members, to buy their bonds (a form of QE) upon request, in exchange for austerity measures. Recently, Japan also announced that they will buy bonds (QE) up to US$1 trillion to the end of 2013. China has chosen to counter their slowing growth with an infrastructure spending package of $157 billion.

Small economies sometimes have the opportunity to be more creative in their approach. Iceland's stock market plunged 90%, unemployment and inflation rose dramatically, and all their banks failed. They have actually implemented a debt-forgiveness to home owners that experienced negative equity in their homes. They have also depreciated their currency and since then have repaid their loans from International Monetary Fund and begun to experience economic growth of 2.5%.

Overall, actual economic recovery seems increasingly dependent on decisive and well-reasoned actions by governments. We see that countries have chosen to pursue different monetary and/or fiscal paths to deal with deleveraging, with various degrees of success. Longer term success will require an optimal balance between their short and long term fiscal policies and monetary measures that avoid significant social unrest.

Responding to Low Interest Rates

Successive rounds of quantitative easing have resulted in persistently low interest rates. **Our response has been to structure our first 'home grown' fixed income product, the Covenant Mortgage Pool.** Launched in April and having now completed two quarterly distributions, early indications are that we are on track for our targeted 8% annual return. With 8 development groups participating in the pool, we are delighted with the quality of mortgages written to date and as the pool grows, risk will be further diversified among a broader scope of projects.

Interest from other investments firms suggests we will be adding capital from their clients also. By diluting costs and adding further diversification, this will bring additional benefits to Covenant clients, and establish Covenant Capital Management as an institutional firm.

Covenant's CORE 50 Portfolio Update

September 28, 2012

DATE	S&P TSX	S&P500	MSCI	CORE 50
3 Year	2.70%	8.31%	-3.60%	6.7%
2 Year	-0.21%	10.54%	-3.59%	5.5%
1 Year	5.97%	20.23%	3.87%	7.7%
Year to Date	3.03%	10.70%	3.35%	4.5%

Notes:

1. *The number represented by the "Core" model denotes that model's maximum exposure to equities (e.g. Core 50 Model has up to 50% equity exposure).*
2. *Returns for the Core50 Models are composites of actual client portfolios. Returns for individual portfolios will have some variance from the composites due to the timing of cash flows and different acquisition dates of component securities.*
3. *Returns for the Core Models are after all management fees and transaction costs.*
4. *Returns for the stock indices assume no transaction or management costs; in practice, accessing these markets would incur costs of some type.*
5. *Our standard management fee is 1% per year, with discounts applied to portfolios over $3 million. Covenant's fees may be tax deductible, further enhancing effective returns.*