COVENANT
CAPITAL MANAGEMENT INC.

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Forecasting

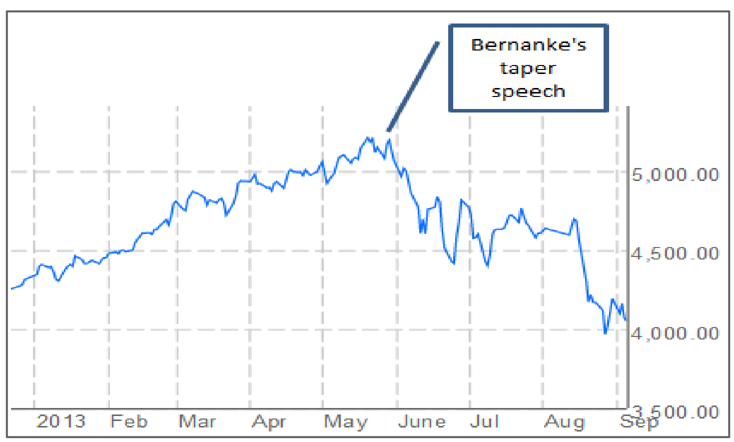
It was never quite clear whether we fell off, slid down, dodged or simply turned our backs on the 'fiscal cliff'. But with the media rife now with opinion on the implications of US government shut-downs, debt ceilings and healthcare reforms (none of which, apparently, are negotiable….) we now have bigger, or at least different fish to fry. In this edition we will try again to present our thoughts on some of the actions and reactions impacting financial markets. Some of the language is necessarily technical – for which we apologize. This is complicated stuff. But above all the noise and jargon, we are prepared to make one bold and unequivocal forecast: God is in control, and His plans will not be frustrated! The 'wisdom' of man may cause us to roll our eyes. Lifting them toward the architect of all, brings Peace.

The Markets

Wall Street's Addiction to Easy Money

Summer is usually a quiet time of year with kids out of school a many people away on holidays. Wall Street is also traditionally fairly quiet at this time of year with low trading volumes and a somewhat flat stock market. This quarter has proved to be anything but a quiet Summer in all respects. In August, Syria launched a chemical weapons attack in Damascus prompting threats of air strikes from the US. Syria eventually agreed to dismantle its chemical weapons arsenal after strong negotiations with the US and Russia. Shortly thereafter, the White House was in the spotlight once again, this time over a rejected spending bill regarding "Obamacare" that ended in a stalemate between Republicans and Democrats. We now look ahead to the debt ceiling debate, which will no doubt degenerate into another "dog and pony" show with no ultimate budgetary measures to tackle the issues. What has taken an even bigger toll this quarter with worldwide influence on the stock markets, however, has been the Federal Reserve System's (FED's) unexpected decision to continue with its aggressive quantitative easing (QE) agenda.

On September 18, 2013 at the latest FOMC meeting, the FED decided to not pull back on its US$ 85 billion per month bond buying program despite numerous hints at tapering, with the primary reason being that the economic data did not provide enough evidence of a prolonged economic recovery. This surprise decision was met with euphoria as stocks and bonds rallied.



Source: Bloomberg. An example of the global impact of FED policy: The Jakarta Composite Index recently gave up all their gains accumulated for more than a year, in a short span of time during FED's "tapering" talks from May to July 2013.

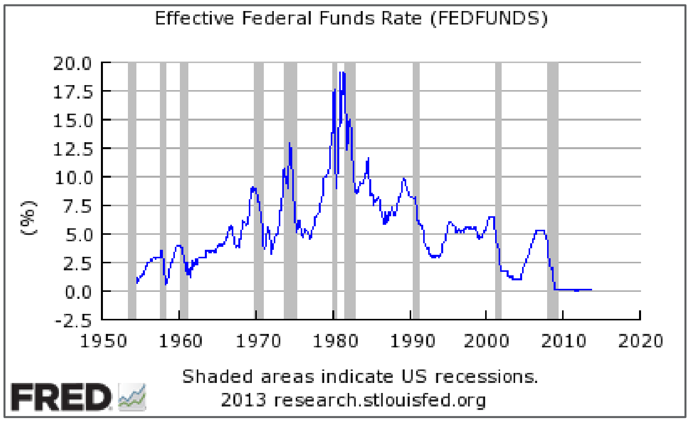
Emerging Markets, in general, have benefited from QE. The US' easy monetary policy juxtaposed with extremely low rates in the developed world (with 10 year Canadian Government Bonds yielding just over 2.5%) has increased the appetite for risk, causing fund managers and investors alike to flow billions of dollars into the emerging markets as they seek higher returns. Unfortunately, much of this growth has been fueled by short term capital inflows and these markets often do not have the capacity to withstand a sudden withdrawal of money from their systems, thus increasing their risk. As a result, we have seen increased volatility in this sector with overall negative returns for the year to date. As we are not in the business of venturing into higher risk for the sake of potentially higher returns, we are currently underweight in our emerging markets exposure with most clients' portfolios having 4% exposure or less.

Commodity prices have been hurt by lower demand and consumption by China. As the new China leadership embarks on restructuring their economy through less stimulus, more deleveraging and structural reforms, their GDP growth rate has dropped from the double digits down to about 7% recently. Additionally, the inflation outlook for many developed countries is below their long term trend. This higher interest rate differential between the US and other countries has continued to support a stronger US dollar, thus making the short term commodity prices further suppressed (the US dollar is inversely related to commodities.) Stronger global economic growth, a weaker US dollar and higher inflation expectations are necessary conditions for the commodity sector to outperform and although we see the easy money and low interest rate environment ultimately raising its long term prospects, commodity prices are likely to continue struggling in the short term. We are also currently underweight in our commodities exposure.

Portfolio Updates

Fixed Income

In September 2012, the FED announced that it is likely to keep the federal funds rate near zero until at least 2015 due to the continued weakness in the US economy with any rate rises potentially hurting the housing recovery. The expectation of low interest rates at the short end of the Treasury yield curve has not stopped the rise at the longer end of the curve as markets anticipate rising yields once the FED does start to pull back on its QE program. In the absence of tapering, the immediate pressure for rising bond yields, and therefore bond price decreases, has been removed for the time being. However, as we anticipate an eventual rise in interest rates, we continue to hold modest positions in floating rate notes, whose coupons are periodically reset based on a benchmark interest rate plus a spread. With generally increased volatility seen in the bond sector lately, we have tended towards diversifying our fixed income position to incorporate more of our mortgage pool which has been yielding approximately 8-9% in interest income on an annual basis.



Preferred Shares

It has been a tough year to date for our preferred shares. As tapering rumours were taking shape in the earlier part of the year, traders were selling off their bond positions and we felt losses on our interest rate sensitive preferred share holdings. Although many of these are now slowly coming back in price, we have since taken some extra measures to reduce the sensitivity to interest rate risk by shortening the overall duration on our preferred share holdings all the while placing a greater emphasis on high quality issuers on the financials side.

Stocks

QE has had its biggest impact on the US stock market with the S&P 500 having risen above its all-time highs, surpassing the previous highs of 2007. Unfortunately, when markets are rallying despite a lacklustre economy, one must face that not only is there a real disconnect between Wall Street and Main Street but that this dichotomy must somehow be re-aligned. This market irrationality can sometimes linger (recall the tech bubble of the 90's which lasted almost a decade before it crashed) but it cannot be sustained. Stock market levels have traditionally been determined by the health of corporations and consumer confidence. Instead, we have witnessed a huge distortion in the marketplace leaving traditional investing in its current

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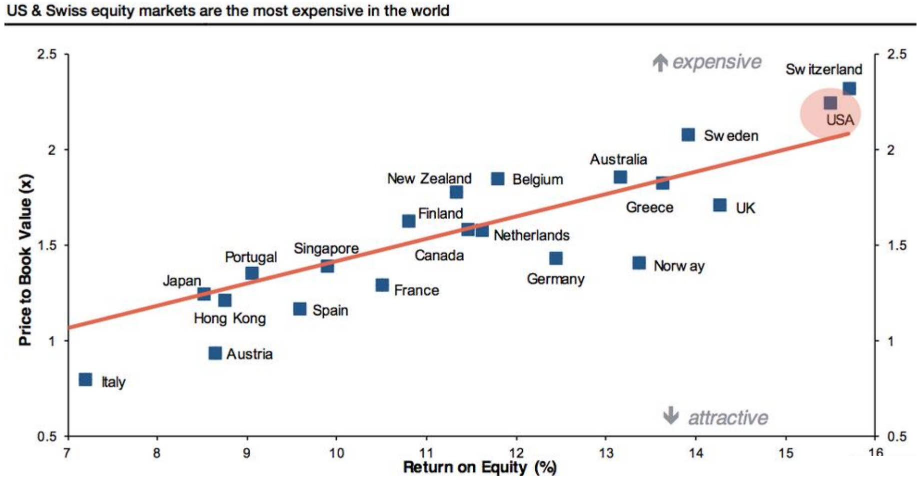
state a precarious one: an environment dependent on the FED's easy money made worse by a low interest rate environment encouraging more risk taking. We still hold tightly that fundamentals will reign and rather than chasing the markets, we patiently continue with our long term investment philosophy: looking for solid value with more attractive pricing than what we have been seeing.

US & Swiss equity markets are the most expensive in the world



Source: Datastream, SG Cross Asset Research/Global Asset Allocation

Summary

No one can say for certain when the FED will begin to pull back on its stimulus but we anticipate that this will likely temper the stock market with shockwaves spreading globally, of which we have already seen hints.

As we evaluate the prospects for financial markets, we recognize that the traditional world of investments is not as it once was with safe havens such as fixed income yields at their lowest levels ever and the stock market becoming a risky play with fear and greed taking over as key motivators. For precisely these reasons, we are starting to take a different approach to diversifying the risk in clients' portfolios. The mortgage pool was the first step towards more non-traditional asset classes and as you may have already heard, we are working hard to launch our second in-house pooled fund this Fall: a multi-strategy fixed income pool. As we see the need for more non-traditional investment solutions, we are looking to other high yielding income solutions including real assets such as real estate and infrastructure with the goal of improving our overall portfolio composition.

The Team

We are delighted to report that Maria gave birth to a healthy baby boy on August 18, 2013. Jacob Dawes weighed in at 8lbs 11oz. (a lightweight compared to his older brother Micaiah who weighed 10lbs 8oz at birth.) Maria and her family are doing well and she will be back in the office in the New Year.

We are also pleased to announce that Victor Whang, having recently passed the Level 3 of the Chartered Financial Analyst (CFA) examinations, has been designated as a CFA Charterholder. The awarding of this Charter involves passing three levels of intense examinations lasting 6 hours each in combination with four years of relevant work experience. This prestigious designation has fast become the gold standard in the investment industry and we are very proud of his accomplishment.

After the bustle of Summer, Fall often seems a little calmer, less hectic, peaceful perhaps. We pray that it will be so for you and that, most of all, it will be His peace that brings you comfort. Please let us know if you have any questions or concerns about your investments – we're here to help.

Your Covenant Capital Management Team.