ASCENT INVESTMENT ADVISORS

Market Commentary Newsletter
October 2015

Performance Review:

Global REITs had their best month of the year in October, gaining 5.7% on a total return basis, with most developed markets popping back into positive territory for the year. Market volatility was lower during the month, perhaps because the focus was on the longer-term economic outlook and central bank policy. Investors watched and waited for monetary policy announcements from the European Central Bank (ECB), the U.S. Fed and the Bank of Japan (BoJ). While the major central banks actually made few changes, it was the change in language and signaling that really mattered for equity markets.

Eurozone property stocks rebounded in October as sentiment towards risk assets was helped by dovish central bank policy. Stock market gains accelerated after ECB President Mario Draghi declared that the ECB was prepared to expand its quantitative easing (QE) program and cut the deposit rate, perhaps as soon as December. Eurozone bond yields moved lower and Italy joined the growing list of countries that have been able to sell debt at a negative yield. Economic data from the Eurozone was generally encouraging. The composite PMI for the region rose to 54.0 in October from 53.6 in September, indicating a faster pace of economic expansion. The ECB's Bank Lending Survey showed a further broad improvement in credit conditions in the third quarter, particularly for corporates. Eurozone annual inflation improved to 0.0% in October, up from -0.1% in September, while the bloc's unemployment rate dipped to 10.8% in September. Meanwhile, the German Ifo business climate survey fell only slightly, to 108.2 from 108.5, suggesting that the Volkswagen emissions scandal has had a relatively limited impact on business confidence. On a country view, German equities were among the top performers.

UK REITs recovered strongly in line with global markets amid the return of risk appetite. However, lingering fears about the global growth outlook took some of the steam out of the recovery as the International Monetary Fund (IMF) cut its global growth outlook for 2015 and 2016. The Bank of England (BoE's) Monetary Policy Committee voted 8 to 1 to keep rates on hold at 0.5%, in line with expectations. What was more surprising were the BoE's new forecasts, which suggested that inflation could remain at or below the target level of 2% for the next 18 months, even on the assumption of no change in the policy rate before the end of 2016. This is markedly dovish in an environment in which the U.S. Fed and Fed Chair Janet Yellen have been raising market expectations for a December 2015 rate rise.

U.S. REITs performed well, responding to the start of another strong earnings season and the U.S. Fed's delay in raising interest rates. The FOMC's statement on October 28th raised the prospect of an interest rate 'lift-off' in December, but the market chose to focus primarily on the more reassuring assessment of the global economy. Property stocks performed strongly despite some disappointing macroeconomic data as industrial production, durable goods and trade numbers were all weak. The September non-farm payrolls data also raised questions about the consumer's ongoing buoyancy, as September's print of 142,000 was much less than expected (more than 200,000) and August's number was revised down to 136,000 from 176,000. The consumer displayed resilience amid evidence of continued strength on Main Street, as forward-looking consumer sentiment indicators remained strong and historical data on house prices and new home construction were robust. In terms of overall growth, the U.S. economy continued expanding through the third quarter, with 3Q15 GDP increasing 1.5% quarter-on-quarter.

After the sustained weakness in August and September, the Japanese equity market bounced sharply in October. The market was led upward by strong moves in both developers and landlords. Investor sentiment recovered somewhat in October, perhaps on the realization that a slowdown in global growth — especially in China — may not be as bad as previously feared. There was also a renewed focus on possible changes in monetary policy by the BoJ, especially following the decision by the U.S. Fed to leave interest rates unchanged. In fact, the BoJ decided not to loosen policy further, despite growing evidence that it seems virtually impossible to reach the BoJ's inflation target within its own timetable, which increased the expectations for additional easing measures over the coming months.

Across Asia ex-Japan, REITs bounced back from a challenging third quarter to post robust positive returns for October, spurred on by dovish comments from the U.S. Fed and signs of further easing by Chinese authorities. Chinese equities gained over the month on hopes of stimulus measures by the People's Bank of China (PBoC). Chinese leaders met in the last week of October and enacted several policy changes that we view as favorable to commercial real estate. The One Child Policy was abolished, and another interest rate cut was announced by the PBoC — the sixth such cut in a year. The Party will increase the emphasis on creating a “moderately prosperous society” by 2020, which likely means a renewed focus on fighting income inequality and improving social welfare — both good for residential real estate. However, data continued to be mixed. Third quarter GDP growth came in at 6.9% year-on-year, falling below 7% for the first time since 2009, although marginally beating expectations of a 6.8% expansion. The manufacturing PMI reading for September fell to a six-year low of 47.2. In Hong Kong, stocks rallied on policy support initiatives in China.

Market Outlook:

Looking ahead, we retain our broadly constructive outlook for global real estate fundamentals and listed REIT returns, but we also remain mindful of the risks. The emerging markets slowdown is constraining global growth, momentum in the U.S. and Europe is moderating and Japan faces stronger headwinds. The risks of policy missteps in China have manifested, raising the prospect of further volatility. The following themes guide our investment strategy through year-end:

- A combination of global macro risks, weak inflation and tighter financial conditions leaves monetary policy more dovish. The U.S. Fed may still raise rates this year, but the odds of a delay are growing.
- Inflation has so far proven fairly unresponsive to economic recovery, and even to massive stimulus, highlighting the limits of QE in the Eurozone and Japan and the implications for these economies.
- China’s recent actions related to its stock market and currency have contributed to policy uncertainty and global market volatility.

For the rest of the year, we are prepared for an increase in volatility as markets adjust to U.S. rates moving off of the zero lower bound for the first time in almost seven years, while simultaneously the ECB and BoJ might add more QE. European and Japanese property stocks look attractive given their undemanding valuations and supportive central banks. Divergent monetary policies and growth prospects for large economies will continue to make a selective approach to country allocation a key investment theme for the remainder of 2015 and into 2016.

The U.S. economy is caught in the cross-currents of domestic strength and global weakness. Fed Funds futures have a December rate hike as a toss-up, with risks increasingly skewed to later. Strengths include tightening in the labor market, improvements in the housing market and retail sales. Downside risks from tight financial conditions and weak global demand have increased, and capital expenditure faces headwinds from production cuts in the energy sector.

China's growth will remain at or below the 7% target, as China passes the turning point of its transition from an industry-led to a services-driven economy. Following recent volatility, we think policymakers will prioritize stability in the near-term. The services sector is strengthening but not yet offsetting the slowdown in investment and manufacturing. The property market's stabilization is encouraging. Looking ahead, we expect further targeted stimulus by the PBoC as financial conditions remain tight and recent interventions are just covering capital outflows.

Eurozone growth momentum has leveled out. The refugee crisis has replaced Greek exit risk as the dominant policy challenge. The ECB is likely to expand QE in early 2016, and we see European property stocks outperforming the U.S. Our eurozone growth outlook stands at 1.4% in 2015 and 1.2% next year.

Japan faces a possible relapse into recession, and we think the BoJ is likely to ease again in the next six months. We see Japan's growth at 0.5% this year and 1.1% in 2016. Consumption is still soft, and weak Asian demand is weighing on exports. Wage growth has been disappointing, and yen depreciation has stalled.

UK growth should pick up to 3% in 2016. We think the BoE may hike in early 2016 but is unlikely to move before the Fed.

While the timing of Fed lift-off remains uncertain, global REIT returns have been more dependable. Earnings momentum is supporting the rally: 76% of global REITs in the index beat consensus estimates for Q3 FFO, and year-on-year growth is averaging 6.2%.

With global central bankers still willing to provide support until job creation broadens and growth becomes self-sustaining, we believe the bull case for global REITs remains intact. We repeat our mantra that we continue to see commercial real estate, and by extension global REITs, as in the middle stages of a long-term bull market predicated on the "goldilocks scenario." Despite the length of the current bull market, we remain focused on the truism that bull markets don't die of old age, they die of excesses. For real estate, that means excess new supply from development, which continues to be muted and below the rate of demolition of old, obsolete space. Gains will be tougher to come by which means that selectivity and stock-picking have become increasingly important.

We also note that the only scenario wherein the Fed would begin to actually tighten is a scenario of sustainable economic growth — which is also inherently bullish for commercial real estate fundamentals, thus offsetting much of the negative impact of higher interest rates. We expect there will be occasional corrections as equities adjust to higher rates, but we intend to use those pullbacks to add to growth-oriented REITs, particularly in Europe and Asia-Pac.

DEFINITIONS

Federal Open Market Committee (FOMC): The branch of the Federal Reserve Board that determines the direction of monetary policy. The FOMC meets eight times per year to set key interest rates, such as the discount rate, and to decide whether to increase or decrease the money supply, which the Fed does by buying and selling government securities.

Funds From Operations (FFO): A figure used by real estate investment trusts (REITs) to define the cash flow from their operations. It is calculated by adding depreciation and amortization expenses to earnings, and sometimes quoted on a per share basis.

Gross Domestic Product (GDP): The monetary value of all the finished goods and services produced within a country's borders in a specific time period.

German Ifo: A key monthly survey that measures the business climate in Germany. It is widely followed as an early indicator of the state of the German economy.

International Monetary Fund (IMF): The IMF plays three major roles in the global monetary system. The Fund surveys and monitors economic and financial developments, lends funds to countries with balance-of-payment difficulties, and provides technical assistance and training for countries requesting it.

Purchasing Managers Index (PMI): An indicator of the economic health of the manufacturing sector. The PMI index is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

Quantitative Easing (QE): An unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase money supply.

About the Author, ANDREW J. DUFFY, CFA:

Andrew Duffy is the President of Ascent Investment Advisors, LLC and the Senior Portfolio Manager of the Global Real Estate Investments Fund (JAREX / JACRX / JARIX), a mutual fund that invests in publicly traded global REIT securities. Mr. Duffy has more than 20 years of global real estate securities investment experience.

Prior to joining Ascent Investment Advisors, Mr. Duffy was a Managing Director with Citigroup Principal Strategies, where he managed a long/short portfolio of global real estate securities. From February 2005 until January 2008 he was with Hunter Global Investors, L.P. where he was the Co-Portfolio Manager of the Hunter Global Real Estate Fund, LP. Before that he was a portfolio manager at TIAA-CREF for over six years, during which time he was directly responsible for managing over $3 billion in global real estate equity and debt securities. Between 1993 and 1999, Mr. Duffy was a Senior Research Analyst at Eagle Asset Management, where he launched and managed a dedicated real estate securities investment program.

Prior to his career in investments, Mr. Duffy served for five years as an officer in the United States Army, where his assignments included serving in the 7th Special Forces Group and the 82nd Airborne Division. Mr. Duffy received a B.S. from the United States Military Academy at West Point in 1979 as a Distinguished Graduate (top 5% of class) and an M.B.A. from Harvard Business School in 1986. He earned the Chartered Financial Analyst designation in 1996.

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As with any investment, there are multiple risks associated with REITs. Risks include declines from deteriorating economic conditions, changes in the value of the underlying property, and defaults by borrowers, to name a few. Please see the prospectus for a full disclosure of all risks and fees.

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2628-NLD-11/19/2015