ASCENT INVESTMENT ADVISORS

Market Commentary Newsletter
March 2015

Performance Review:

Global REITs were essentially flat in March. Regional performance was mixed, with the U.S. and UK declining, while continental Europe and Japan rose. In the U.S., economic data generally remained soft, which combined with ongoing dollar strength contributed to concerns over the upcoming earnings reporting season. Views on the timing of the first U.S. interest rate rise fluctuated through the month with the strong labor market data bringing forward expectations for the first hike to June, while subsequent dovish commentary from the Fed pushed expectations back out again to September. This shift in expectations contributed to some volatility in U.S. equity markets in March.

In the UK, uncertainty ahead of the UK general election in May partly contributed to the weakness in UK equities. European economic data continued to improve during the month and contributed to the gains in European equities. With the ECB indicating that it would buy sovereign bonds down to negative yields, both bonds and equities rose further on the back of the expected continued reduction in European yields, which should be supportive of economic growth. Negotiations relating to the Greek bailout program continued, with Greece yet to sign up to a reform agenda which satisfies the demands of the European finance ministers. Ultimately, investors expect a compromise to be reached which could provide some small concessions to Greece, but not to the extent initially sought by the Greek government when elected in January.

Chinese data generally continued to disappoint, but was again distorted to some extent by the timing of Chinese New Year — with retail sales and industrial production weaker, although PMIs were slightly better. The HSBC composite PMI rose 0.8 to 51.8, manufacturing PMI fell -1.5 to 49.2 while services rose 0.2 to 52.0.

Japanese data also tended to be mixed with industrial production falling sharply after recent strong gains, while Q4 GDP was revised down to 1.5% annualized. However, many business sentiment surveys improved as did consumer confidence. The Bank of Japan (BoJ) left policy unchanged. While remaining upbeat on growth and indicating the economy had continued on its moderate recovery trend, the BoJ cut its inflation outlook, suggesting it could remain about zero for the time being. Despite the change in the short-term outlook for inflation, the BoJ continued to indicate that its longer-term inflation target of 2% is achievable. This suggests that the BoJ may wait and see how inflation trends develop in coming months — and an imminent increase in monetary stimulus in response to lower inflation readings could be delayed by a number of months but is probably still likely around mid-year.

In the U.S., the weak March jobs data was a disappointment. The question is, what is its significance? From a macro point of view, we would not place much emphasis on any one monthly data point. From a technical point of view, it may encourage a continued correction of the dollar's Q1 gains. The economic weakness in Q1 already prompted the U.S. Fed to lower its growth projections, though Fed Chair Janet Yellen noted that even with the downgrade, it expects above-trend growth for the year. The poor employment report is unlikely to change this assessment. Sectors like construction and leisure/hospitality, which are the most sensitive to weather, were particularly weak in March. Thus, we are reluctant to read too much into the weakness in Q1 economic activity. Over the last five years, there has been a clear pattern of weakness in the first part of the year. Consider that growth in Q1 has averaged 0.6% compared with almost 2.9% for all the other quarters. In three of the five years, growth in Q1 was the slowest for the year (2010, 2011, 2014) and in one year it was the second weakest (2013). Fed officials have argued that the headwinds in Q1 will prove transitory. This seems to be the most likely scenario. That said, the implications of the jobs report, especially the 0.1% fall in the average work week, suggests the quarter ended on a weak note.

Market Outlook:

Despite the mixed data, the global economy is still expected to grow just over 3% in 2015 with global PMI data suggesting a rebound in coming quarters and importantly, the U.S. economy is also expected to accelerate again over the remainder of the year following weakness related to the weather and port strikes on the West coast during the first quarter. The U.S. Fed's policy transition will almost certainly be met with increased volatility. We expect the U.S. economy to remain the principal engine of the global recovery, with growth moving above trend, while Japan rebounds from 2014 weakness. We expect the eurozone to accelerate modestly, albeit with growth still weak relative to potential. In such an environment, we believe that commercial real estate and listed REITs will continue to perform well. Nevertheless, uncertainty reinforces our bottom-up focus on property types with genuine pricing power and companies with robust business models — particularly specialty REITs with disequilibrium of demand over supply.

The cyclical recovery in the euro area will likely be confirmed by the March PMI reports, as the flash reports were at their highest level since the time series began three years ago. Of the large countries, France is the clear laggard. The decline in the euro, interest rates, and oil appears to be favoring Germany the most. Few appreciate how strong eurozone retail sales have been, considering that the three month average growth rate stands at 0.7% — the strongest since records began in early 2000. However, the shopping spree may have ended in March when retail sales are expected to have fallen by 0.2%. That said, barring a significant surprise, the eurozone is expected to have grown faster than the U.S. in Q1 '15. The decline in the euro, oil and interest rates continues to provide stimulus for the region. Money supply growth has accelerated; bank lending is improving and financial conditions more broadly are supportive as the European Central Bank (ECB) continues to purchase public and private securities.

Outside of the euro area, the UK economy appears to have expanded around 0.5-0.6% quarter-over-quarter in Q1. The economic data is expected to be broadly consistent with this estimate. The Bank of England (BoE) is on hold, as political considerations are overwhelming pure economic considerations in the run-up to next month's election.

Since the BoJ last met, investors have learned that inflation has slowed further to stand at zero when adjusted for last year's sales tax increase. The Tankan survey showed sentiment remains poor and businesses plan to cut capex this year. There appears to be growing pressure on the BoJ to ease policy further. BoJ Governor Kuroda wants to look beyond the recent weakness in inflation, which appears largely oil-related. Kuroda seems convinced that when last year's precipitous decline in oil prices drops out of the base effect, underlying inflation will be more evident. If the BoJ does choose to increase its asset purchases, we suspect it would include domestic REITs and REOCs.

In Australia, all eyes are on the Reserve Bank of Australia (RBA) and a potential rate cut. Futures suggest the market is pricing in a 25 bp rate cut at this week's RBA meeting. Even at 2%, the RBA's cash rate would be the highest among the major developed countries, despite its AAA rating. The continued collapse of iron ore prices suggests that the negative impact on net exports is an ongoing challenge.

In China, we're less sanguine about Beijing's ability to nudge economic growth to its target and keep it there. Much of the growth since the 2000s was based on a vast rise in debt owed by local governments and state-owned enterprises. With the labor force now shrinking, productivity growth slowing, considerable excess industrial capacity, the property market on the ropes and debt-financed expansion near its limit, economic growth will be hard-pressed to hit 7% again. A more likely target for 2015 is 6.5%, with trend growth to slow more in future years. Nevertheless, as a major oil importer, China will be a big beneficiary of the collapse in oil prices. Lower oil costs plus mild stimulus may allow growth to pick up a bit as 2015 progresses.

The framework agreement tentatively reached over Iran's nuclear program does not mean sanctions will be immediately lifted. The political opposition in Washington and Tehran could still torpedo the deal. Nevertheless, the prospect of more Iranian oil adding to the world's surplus output is negative for prices. The sharp drop in oil prices in the second half of last year has been the single biggest factor driving down measured inflation. As the year progresses, it will slowly drop out of year-over-year comparisons. Toward the end of the year and into next year, price pressures globally will intensify even if the price of oil does not increase much from here.

With 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.

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

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.

Real Estate Operating Company (REOC): A company that invests in real estate and whose shares trade on a public exchange. A real estate operating company (REOC) is similar to a real estate investment trust (REIT), except that an REOC will reinvest its earnings into the business, rather than distributing them to unit holders like REITs do.

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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 18 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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