ASCENT INVESTMENT ADVISORS

Market Commentary Newsletter
April 2015

JAMES ALPHA MANAGEMENT

Performance Review:

Global REITs moved lower in April, with non-U.S. markets outperforming the United States. At the end of the month, volatility picked up, with investors appearing to unwind certain widely-held positions. For the month as a whole, credit spreads tightened a bit, bond yields edged higher and the dollar retreated about 4%. This configuration of outcomes occurred without much support from economic data, which generally disappointed. Indeed, the most striking market development in April — a China-led surge in emerging market equities — appeared to reflect policy stimulus and local investor position shifts, and came in the face of weak economic news.

U.S. macro data remained soft given the seemingly strong backdrop for growth. The run of soft data culminated in a surprisingly weak real GDP figure for the first quarter — just 0.2% quarter-on-quarter, far below the consensus expectation. The run-up in the dollar and the repercussions of the earlier oil-price plunge appear to be making themselves felt in some areas. For example, export growth has slowed (although the West Coast dock strike has complicated interpretation of the trade data), and cutbacks in the energy sector are leaning against business capital spending. These drags will likely persist but in themselves should prove insufficient to derail the expansion. The continued downward movement of U.S. bond yields has been somewhat unexpected, given the U.S. Fed is setting the stage for higher interest rates later this year.

In China, equity market gains reflected domestic sentiment shifts more than economic fundamentals. Chinese data released during April disappointed, with first-quarter GDP growth cooling to its slowest pace since the global recession and the March round of indicators pointing to continued deceleration. Moreover, April PMIs suggested no relief.

In Europe, the saga of Greece's negotiations with its European partners dragged on during April, without much by way of new developments. With the country unable to agree with its creditors on a plan to handle upcoming debt maturities, the possibility of some sort of stalemate remains fairly high. Even an outright default would not necessarily lead to Greece's expulsion from the EU, as most likely the authorities would impose capital controls first (as happened in Cyprus, which has remained within the eurozone). It might, though, generate ripple effects elsewhere in the region. Thus far, markets outside of Greece have taken this uncertainty in stride. The euro appreciated more than 4% against the dollar, and spreads of Spanish and Italian bonds over German bonds barely moved. This stability likely reflects a combination of optimism about an eventual solution in Greece and the power of the European Central Bank's bond purchases, though it does raise the risk of more negative moves down the road if the Greek situation unravels.

Our 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 (e.g., data centers, wireless towers, student housing and medical office buildings) with disequilibrium of demand over supply.

Long-term interest rates have never been this low for this long, and we expect them to rise modestly this year. Volatility remains below the long-term average, but it's on the rise in both the stock and currency markets, and the spike thus far in 2015 suggests a more volatile year to come.

In the U.S., improved data, including signs of a strengthening labor market, will likely prompt the Fed to raise short-term interest rates as early as September. The normalization of rates should further boost the dollar, hurting corporate profitability. As forward earnings estimates have come down with virtually no change in stock prices, forward earnings multiples have risen, making U.S. stocks look relatively expensive. We therefore expect to shift exposure to cheaper international markets like Europe and Japan, where valuations are more forgiving and monetary policy more accommodative. While U.S. stocks are some of the most expensive among global markets, valuations are still below the market peaks of the past 20 years. By most measures, there are few signs of an impending recession, and monetary conditions will probably stay accommodative for the foreseeable future.

In Europe, the improved tone in the eurozone economy, the ECB's asset purchases and a weaker euro are all helping to boost forward earnings estimates of European companies. Despite delivering meaningful outperformance in euro terms so far this year, European REITs still trade at a considerable discount to their U.S. counterparts. While slower economic growth, low inflation and geopolitical risks related to Greece and the Russia/Ukraine standoff may justify some of Europe's discount, current valuations for most of the region are still below the long-term average. We continue to search for compelling risk-adjusted return opportunities in Germany, the U.K. and the Scandinavian countries.

We are also constructive on Japanese REITs. Fundamentals in Japan remain mixed: although this spring's wage negotiations produced healthy gains for a second straight year, the economy is still stuck in the doldrums following last year's consumption tax hike. Consequently, the Bank of Japan is holding fast to its bond-buying program and efforts to force down interest rates, especially as more Japanese pension funds mimic the Government Pension Investment Fund's decision to reallocate away from bonds into stocks. Japanese equities remain inexpensive even after outpacing the U.S. market year-to-date, and we think more dividend hikes and share repurchases are likely.

In the U.K., despite relatively strong employment and economic growth, productivity has barely advanced since the global financial crisis and ranks second worst among G7 nations (ahead of only Japan). Meanwhile, upcoming May elections have the potential to amplify market volatility: a Conservative-led cabinet would pave the way for a 2017 referendum on the country's European Union membership, while a Labor-led coalition with key Scottish National Party backing could create a disunited kingdom.

While we are cautiously optimistic on Chinese property stocks, we continue to invest only in Hong Kong-listed H-shares. China's economy is still struggling under the weight of weak global demand, and policies aimed at rebalancing the economy away from investment toward consumption. Moreover, Chinese equities' recent gains have been driven primarily by multiple expansion, as investors bid up equities on hopes for further monetary and fiscal stimulus.

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.

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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