ASCENT INVESTMENT ADVISORS

Market Commentary Newsletter
May 2015

Performance Review:

Global REITs moved lower in May. The month began with a European bond market correction, which bled into U.S. Treasuries and set the tone for a volatile month for bonds. Choppy bond markets tempered equity market gains, but the conclusion of earnings season boosted both confidence and index levels in Europe and the U.S. Amid these choppy markets, several developed market economies posted first quarter GDP growth. Euro area GDP surprised us on the upside at 1.6% annualized growth, trumping U.K. and U.S. growth for the same period. Oil prices remained steady, moving less than $1.50 per barrel for the month of May.

Europe, which had already posted returns of 14.6% year-to-date at the end of April, gained another 1.1% in May. This likely reflects a combination of optimism about an eventual solution in Greece and the power of the European Central Bank's (ECB) bond purchases, though it does raise the risk of more negative moves down the road if the Greek situation unravels. Earnings results for the first quarter revealed that European companies are starting to see the benefits of a lower euro and lower oil prices — tailwinds that boosted revenues for exporters and non-oil related companies. Euro-area first quarter GDP was mixed. Germany and the Netherlands disappointed, while Spain, Italy and France surprised to the upside. Purchasing Manager Indices (PMIs) for manufacturing echoed the same dynamic.

In the U.S., the first quarter earnings season was marked by somewhat disappointing earnings growth, extending a slowdown that began at the end of 2014. These declines were not due to a general deceleration in the U.S. economy. Rather, they were the result of two broad macroeconomic headwinds — lower oil prices and the strengthening U.S. dollar.

Japanese equities were strong this month, boosted by the Government Pension Investment Fund's mandate to invest further in equities, particularly in higher-yielding sectors including Japanese real estate investment trusts (J-REITs).

In the U.K., the Conservatives defied pre-election polling data and won a majority in Parliament. David Cameron and his party have committed to an in/out referendum to determine the U.K.'s place in the EU by the end of 2017. U.K. equities and gilts rallied on the news, as the result was generally thought of as the most market-friendly resolution.

Greece managed to make its $750 million euro payment to the International Monetary Fund (IMF) in mid-May, but still faces even larger payments with approaching due dates. Summer payments loom ahead and, in what has become a common theme, just a week before another large payment to the IMF in early June, Greece negotiated its way out of a textbook default — Athens will be allowed to postpone its early June payments to later in the month.

The market also reacted to the surprising results of the Spanish regional elections. Four parties will have to form a coalition at the national level if the general election results are similar to the regional election outcome. Spain has experienced a successful export-led and reform-focused recovery, and posted the best euro-area GDP growth of 2.7% annualized (compared to 1.6% for the entire Eurozone), so political discord has the potential to derail the economic progress. Indeed, Spanish stocks dropped 2% on the first trading day after the results.

May confirmed that 2015 continues to be the year of political events affecting markets, but longer-term implications of many of these elections and negotiations will affect the real economy even more.

Our Market Outlook:

In a still-soft global growth environment, hopes for greater government stimulus are having an outsized effect on financial markets. Following massive quantitative easing (QE) programs in the U.S., Europe and Japan, market speculation of an even-larger Chinese program has sparked a rally in both mainland and Hong Kong-listed shares. Global bond yields, on the other hand, mostly traded in a tight range until German bunds (bonds) sold off in late April. The market expects large ECB purchases to keep European yields at low levels for the next several quarters.

In the United States, tepid GDP growth along with other soft economic indicators increases the chances of the Fed holding off its first rate hike until later in the year. While many would prefer to see the Fed depart from its zero interest rate policy (ZIRP) stance sooner rather than later, Fed funds futures now point to a hike post-September and suggest a single increase for the year. That said, while the U.S. growth outlook has dimmed, the recent slowdown is probably a temporary setback, with the U.S. economy re-accelerating in the second half. On balance, we remain confident in the ongoing U.S. economic recovery, encouraged by robust job creation as well as early signals of wage growth. We think that will eventually translate into stronger consumption down the road, bolstering a strong year for the U.S. economy, but it may struggle to hit the 3% growth rate that investors had expected at the beginning of the year amid signs suggesting that the bounce may not be as strong as expected. Economic statistics this year have been missing expectations by the largest margin since 2009, and the strong dollar is hurting U.S. companies dependent on exports. A weaker-than-expected second quarter would have several implications for investors. First, we would likely only see a single Fed rate hike in 2015. Second, softer U.S. growth could cause at least a temporary stall in the dollar rally, giving U.S. exporters some relief. Third, softer growth calls into question whether earnings estimates remain too high. With U.S. REITs relatively expensive, we tend to look overseas for more attractive investment opportunities. We continue to favor specialty property types with an excess of demand over supply, and less expensive, defensive property types in the U.S.

We remain constructive on the Eurozone. Although upside surprises to economic releases are not yet widespread, the data points to a broadening expansion in Europe. While Greece's bailout negotiations have been tense as they enter the eleventh hour, European and Greek leaders have begun to exhibit signs of some modest flexibility. Against this backdrop of ultra-loose monetary policy, better economic data, improved earnings and decent valuations, we think Eurozone REITs offer additional upside potential.

We remain constructive on Japan. Although the economy is running at a lackluster pace, Japanese companies are growing earnings faster than almost anywhere else in the world. This bodes well for Japanese real estate companies and their share prices. Valuations are still cheap despite the strong outperformance so far this year. Furthermore, the Bank of Japan (BOJ) seems ready to boost its QE measures if the economy were to miss the bank's inflation goals. Such a move would be an obvious boon to Japanese equities.

We remain neutral on the United Kingdom. A clear mandate from the U.K. election precluded the near-term uncertainty of forming a coalition government, but the results created a set of longer-term political challenges, including the call for a referendum on Eurozone membership next year. We also note the country's outsized exposure to the energy sector, which could come under pressure should the recent increase in crude oil prices turn out to be short-lived.

We remain cautiously optimistic on China, but restrict our investment exposure to Hong Kong-listed H-shares. China cut interest rates for the third time since last November and remains committed to pushing ahead financial market liberalization, which should ultimately support financial assets and REITs. However, politically sensitive reforms, such as privatization of state-owned enterprises (SOEs), are proving more difficult. This creates risks, since SOE reform is a critical ingredient to boosting economic efficiency, and delays will only further weigh on the economy.

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-Pacific.

DEFINITIONS

H-Shares: A share of a company incorporated in the Chinese mainland that is listed on the Hong Kong Stock Exchange or other foreign exchange. H-shares are still regulated by Chinese law, but they are denominated in Hong Kong dollars and trade the same as other equities on the Hong Kong exchange.

Gilts: Bonds that are issued by the British government and generally considered low risk. Gilts are the U.K. equivalent to U.S. Treasury securities.

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.

Zero Interest Rate Policy (ZIRP): The lowest percentage of owed principal that a central bank can set. In monetary policy, the use of a zero percent nominal interest rate means that the bank can no longer reduce the interest rate to encourage economic growth. As the interest rate approaches zero, the effectiveness of monetary policy is reduced as a macroeconomic tool.

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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