ASCENT INVESTMENT ADVISORS

Market Commentary Newsletter
June 2015

Performance Review:

Global equity markets were choppy during the month, as hopes for a resolution to the Greek debt crisis gave way to disappointment when negotiations stalled late in the month. Equity markets across the globe declined as Greek banks were closed and remained so until the weekend referendum. The initial equity market decline was followed by more muted action, suggesting that investors are still skeptical that Greece will actually exit the Eurozone, but the odds that it will do so have definitely increased. That said, it is important to note that the rest of the Eurozone is in a much stronger economic position than Greece. Last week, the Eurozone composite PMI came in at 54.1. This is a four-year high and clearly shows that the economy is picking up momentum. The upturn was broad-based, with strong gains in employment and new orders. France, a latecomer to the recovery, posted its best month since August 2011.

Economic growth in Europe should eventually translate into better corporate profits and help push equity markets higher. European equity markets already have experienced strong gains over the past six months in the face of the Greek uncertainty. Even after the month-end losses, the German DAX Index has risen 13% and the French CAC 40 Index is up 14% in local terms to date in 2015. Earnings estimates have been revised upward and valuations remain reasonable.

If Greece weren't enough for global investors to digest, China also grabbed headlines as the Shanghai Composite Index entered bear market territory — falling 21% since its high on June 12th. Chinese leading economic indicators have been declining while its equity markets have been rising. Despite the steep declines of the last two weeks of June, the Shanghai Composite Index is still up 25% for the year and 98% percent over the past twelve months.

China's recent equity-market decline has occurred in holdings that are mainly accessible to mainland China investors via the Shanghai Stock Exchange. The "A" share market trades in yuan and saw huge inflows of local investor money over the past year. Chinese officials have had a delicate balancing act of reining in excessive speculation in local markets without severely hampering the national economy. In June, the People's Bank of China (PBoC) cut rates for the fourth time in eight months in an effort to stimulate the economy. The combination of stimulus measures by the PBoC, meaningful reforms, and opening access to equity markets may attract more longer-term-focused investors. Until then, these markets seem to be driven more by momentum and money flows than by fundamentals.

U.S. and European equity markets finished the month with losses following news that Greek debt negotiations had broken down, and that Prime Minister Alexis Tsipras had scheduled a July 5th referendum for voters to approve or reject the terms of the creditors' last offer. The failed talks meant Greece did not receive a final €7.2 billion installment of bailout funds, thus assuring that it would not meet the June 30th deadline to repay a €1.6 billion debt to the International Monetary Fund (IMF). At mid-week, Tsipras made some conciliatory overtures to his negotiating counterparts, but his messaging was mixed, and a firm stand by Eurozone officials made it clear that no further talks would occur until after the referendum. European equities, which had fallen nearly 4% in the first two days of the week, began to recoup some of those losses as markets appeared to be betting on a "yes" vote.

Vying for the spotlight with Greece was Puerto Rico, which faced a July 1st deadline to make more than $1.4 billion in debt service payments. Puerto Rico has struggled economically for nearly a decade, and its government has borrowed heavily to cover shortfalls. Despite a warning from the Governor that the Commonwealth would need concessions from creditors in order to manage its heavy debt load, Puerto Rico avoided a default on July 1st, easing concerns among investors who feared broader repercussions in the municipal bond market.

In spite of a report showing that Japan's manufacturing sector contracted in June, the Nikkei 225 Index rose almost 2%, hitting a more than 18-year high along the way. Although the yen has weakened vs. the U.S. dollar this year, the Nikkei is up 15% year-to-date in dollar terms. Japan's advance has been supported by the government's continued push for corporate governance reform.

U.S. Treasuries benefited from a flight to safety. The yield on the 10-year Treasury note fell from 2.49% on June 26th to 2.33% on June 29th, then crept higher at month-end on solid economic releases and increased optimism about Greece.

The U.S. economy created 223,000 jobs in June, somewhat below forecasts. Meanwhile, payrolls for April and May were revised downward by a combined 60,000. While the headline unemployment rate fell to 5.3%, a seven-year low, the drop reflected another decrease in the labor force participation rate. Of greater concern was that wages were flat in June, while gains for the past two months were adjusted downward. Because the Fed will want evidence of employment growth along with several months of wage gains before raising interest rates, Fed Funds futures reacted to these reports by pricing in significantly reduced odds of a September move.

Our Market Outlook:

Overall, markets seem to be taking the Greek talks in stride, with fears of a "Grexit" giving way to headline fatigue as the initial knee-jerk reaction to the past week's unexpected developments has moderated. That said, even with the referendum vote resolved, the outcome of the Greek drama is still far from certain, so continued volatility is likely in the near term. Amid the uncertainty, there are a number of factors that may help mitigate potentially negative fallout in the coming days and weeks:

- Although Greece missed its June 30th repayment deadline, the IMF has yet to declare an official default, instead issuing a report on Greece's debt that appeared to side with the Greek government's position. This could provide a window for another round of negotiations post the referendum.
- The resounding "no" vote on the referendum does not automatically mean that Greece will exit the Eurozone, although it does increase the odds.
- Despite the "no" vote, Greek Finance Minister, Yanis Varoufakis abruptly announced that he will resign. This could lead to a positive change in the dynamics of the negotiations with the Troika.
- The Eurozone is in a stronger financial position than it was in 2012, with a recovering economy and a healthier banking sector that has eliminated most of its Greek debt exposure. Additionally, the European Central Bank (ECB) has expressed its determination to "use all the instruments available" to address any fallout from Greece, including expanded asset purchases (QE).

- However the Greek crisis unfolds, it should not have a major global economic impact. Greece's GDP makes up just 1.3% and 0.3% of EU and global GDP, respectively.

While the situation in Greece remains very fluid and the chances of a Greek exit from the Eurozone have increased, the odds remain in favor of a resolution. The primary risk is that the disruption in Greece may cause investors to become overly cautious, especially if the resolution is drawn out over months. However, we do believe that the risks are likely to be contained to Greece and the smaller, peripheral countries in the Eurozone. We also believe that the ECB's program to aggressively buy regional bonds should limit the extent of financial contagion and maintain the Eurozone's recovery. Moreover, a weaker euro also will improve the competitiveness of many exporters in the Eurozone. The benefits that a slightly weaker euro will bring to earnings and hence future market gains should outweigh the impact of U.S. dollar translation concerns.

How will the Greek crisis play out? The bank liquidity crisis is likely to turn into a solvency crisis once the ECB shuts down Emergency Liquidity Assistance (ELA), probably no later than July 20th (when a $4.2 billion payment to the ECB becomes due). Fiscal problems would become more acute and the government may be forced to issue IOUs, which effectively become a parallel currency to the euro. In short, the existing financial infrastructure would be broken and need to be rebuilt. Politically difficult fiscal and structural reforms would still be required to make the country more competitive, and promote economic growth.

U.S. stocks continue to be supported by a dovish Fed that has made it clear that the pace of rate increases will be gradual regardless of the lift-off date. This measured approach should help contain long-term yields, making real estate and global REITs relatively more attractive. On a cautionary note, past Fed tightening has introduced heightened market volatility. So while we maintain our constructive long-term stance, the advance will likely be uneven.

In the long run, global REITs should be driven by company fundamentals, interest rates, and the long-term growth of their underlying economies. In the near term, politics, momentum, and fear can all whipsaw equity markets. We do not believe that developments surrounding Greece portend that the economic recovery in the Eurozone is about to roll over. Further, we also believe that the huge rise and subsequent fall in local Chinese equity markets have more to do with money flows and investor access than with long-term growth and equity market prospects in China. We continue to believe that non-U.S. markets will offer better returns even on a risk-adjusted basis. We are mindful of the risk of contagion from the Greek crisis in Europe, but, as noted, we believe that it can be contained. With respect to China and other Asia-Pacific markets, we remain more cautious as we believe that China still needs to deal with poor underlying earnings growth and possible reform and policy mis-steps in coming quarters.

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.

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

Emergency Liquidity Assistance (ELA): Extended by a national central bank of the euro area to solvent lenders facing temporary liquidity problems, without such operation being part of the single monetary policy.

European Central Bank (ECB): The central bank of the euro and administers monetary policy of the Eurozone, which consists of 19 EU member states and is one of the largest currency areas in the world.

French CAC 40 Index: The French stock market index that tracks the 40 largest French stocks based on market capitalization on the Paris Bourse (stock exchange).

German DAX Index: A stock that represents 30 of the largest and most liquid German companies that trade on the Frankfurt Exchange. The prices used to calculate the DAX Index come through Xetra, an electronic trading system. A free-float methodology is used to calculate the index weightings along with a measure if average trading volume.

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.

Nikkei 225 Index: The leading and most-respected index of Japanese stocks. It is a price-weighted index comprised of Japan's top 225 blue-chip companies on the Tokyo Stock Exchange. The Nikkei is equivalent to the Dow Jones Industrial Average Index in the U.S. In fact, it was called the Nikkei Dow Jones Stock Average from 1975 to 1985.

People's Bank of China (PBoC): The central bank of the People's Republic of China with the power to control monetary policy and regulate financial institutions in mainland China. The PBoC has more financial assets than any single public institution, and is second only to the Federal Reserve System of the United States in terms of overall central bank assets.

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.

Shanghai Composite Index: A market composite made up of all the A-shares and B-shares that trade on the Shanghai Stock Exchange. The index is calculated by using a base period of 100; the first day of reporting was July 15, 1991.

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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