ASCENT INVESTMENT ADVISORS

Market Commentary Newsletter
August 2015

Performance Review:

Volatility dominated global equity markets in August as investors reacted to an array of global macro concerns, including the slowing Chinese economy, tumbling commodity prices and the uncertain timing of the Fed's first interest-rate hike since 2006.

A surprise devaluation of the Chinese yuan rattled markets in mid-August. Commodity prices and global stock markets fell sharply after the People's Bank of China (PBoC) undertook the biggest devaluation of its currency in almost two decades. Despite the weakness in resource prices, materials and energy stocks were among the strongest performers amid hopes for further stimulus from Beijing. The actions of the PBoC prompted speculation that the Federal Reserve may hold off from raising interest rates in September, as had been widely expected, given mounting global deflationary pressures. However, positive U.S. economic data releases at the end of the month were viewed as putting a September move back on the table.

In the U.S., factory production rose more than forecast as car assembly jumped to its highest level since 1978. Total industrial production also climbed as oil drilling rose for the first time since September 2014. U.S. retail sales rose 0.6% amid higher demand in almost all categories. The revised second quarter GDP report was solid and showed broad-based improvements. Real GDP was revised from 2.3% to 3.7% and nearly all segments of the economy showed improvements, with capital expenditures demonstrating particular strength.

Europe was hit hard by China's unexpected currency devaluation, as investors assessed the impact on the eurozone's fragile export-driven recovery. A cheaper yuan makes European goods more expensive for Chinese consumers and reduces the value of Chinese sales when they are converted back into euros. On fears that the move will reduce Chinese commodity demand, oil prices were down sharply, with crude falling to $42 per barrel — its lowest level since 2009. The disappointing data was reflected in a slowdown in eurozone economic growth in the second quarter, as GDP grew by 1.25% — down from the 1.5% growth achieved in the first three months of the year. German growth remained robust at 1.8%, but the French economy slowed to a standstill. In the U.K., the latest labor market report was seen as reducing the pressure on the Bank of England to raise interest rates.

The European Central Bank (ECB) sent a strong signal to investors that it was ready to respond to any further deterioration in the outlook for inflation in the eurozone. In his press conference, ECB President Mario Draghi noted that prices were rising at a lower rate than expected and pointing to renewed downside risks to growth. The ECB revised down its growth forecasts to 1.4% for 2015, 1.7% for 2016 and 1.8% for 2017. He went on to emphasize the option of adjusting "the size, composition and duration" of the ongoing quantitative easing (QE) program. Financial markets took Draghi's comments as a sign that an expansion in the ECB's QE program is indeed likely. The main take-away for investors is that Europe's central bank stands ready to respond if downside risks to the outlook for growth and inflation increase. Despite the significant improvement we have seen in Europe's economy since the start of the year, the core economies remain fairly dependent on the rest of the world for their growth. This leaves the region vulnerable if the global growth outlook deteriorates more than current consensus expectations. That said, this show of commitment from Mario Draghi should be positive for European REITs in the short-term, especially companies that are oriented towards domestic tenants.

Market Outlook:

The markets have been in turmoil since the Chinese currency devaluation a few weeks ago, which fueled concerns over the strength of the global economic recovery. A further slide in oil prices compounded these fears. Investors remain uneasy and prone to pessimism. We expect market volatility to remain elevated, even as data suggest the U.S. and global economies are continuing to expand. Concerns over slowing growth in China are unlikely to go away, but we also believe that most observers are overly focused on the downside. The pullback in energy prices, for example, should provide more positives than negatives for the global economy.

We believe the sharp sell-off in equities is a healthy and necessary correction, and a response to the fits and starts in the transition of the Chinese economy to a more consumer-focused model. The Chinese government still has many policy tools in its arsenal to help smooth the process over time. We have already seen the PBoC cut interest rates and lower reserve requirements for banks, two steps that should stimulate economic activity.

Moreover, the slowdown in China should boost U.S. economic growth. In particular, with the decline in crude, U.S. gasoline prices are down 25 cents per gallon over the month. Lower energy prices should boost consumer spending. Similarly, general economic weakness has kept mortgage rates low. This should prompt increased spending on housing, which should also help the broader economy.

Investor sentiment has clearly taken a hit and will take time to recover. Our view is that we have probably seen the worst of the current corrective action, and we do not believe we are at the onset of a new bear market. Volatility is likely to remain high, and there could be further downturns in the near-term, but we continue to believe it makes sense for investors to hold overweight positions in global REITs, seeing today's short-term volatility as an opportunity to buy rather than a reason to sell.

Last week's market lows may be tested further. The history of market corrections suggests that "V bottoms" are rare following the type of technical damage done in late August. We would not be surprised to see an additional pullback in the coming days or weeks, but we also may have already seen the lows for this correction.

Longer-term macro fundamentals are still trending in a positive direction, particularly in the U.S. and Europe. In the U.S., strong jobs numbers, better housing data and lower gas prices are supportive of stock prices in the long run. In addition, consumer confidence — typically a harbinger of increased consumer spending — has surged to its second-highest level since the end of the Great Recession. In Europe, the ECB's QE program remains in full force, and history has shown that QE tends to benefit stock markets.

The generally favorable long-term fundamentals in the U.S. and Europe, combined with valuations that, after the YTD pullback we consider fair (U.S.) or relatively inexpensive (Europe), have created pockets of buying opportunities. On balance, we still think Europe offers the best values. Property-level cash flows there are depressed but should recover along with the economy, which in turn should help asset values and share prices recover as well.

There are three things that will command investors' attention in the weeks and months ahead. The first, and most important, is whether the global capital markets will continue to move toward stability after the gyrations over the past several weeks. Our assessment of the technical condition of the market is that the panic is over, some capitulation was seen, and equities have taken a big step toward returning to stability. While the precipitous drop of the magnitude we experienced was alarming, the system showed a comforting resilience, both operationally and psychologically.

August's non-farm payrolls (NFP) release will be in strong focus ahead of the Federal Open Market Committee (FOMC) rate decision on September 17th. The consensus is for a slight increase on the previous figure at 218K with unemployment expected to fall 0.1pp to 5.2%. A strong NFP reading alongside the lower unemployment figure is likely to raise expectations of rate-lift off this month. However, a miss on expectations could see investors push back rate-hike expectations to either October or December. The market is currently pricing in a 30% probability of a rate hike in September.

We suspect that the outcome of September's FOMC meeting does not rest on one high-frequency report. The underlying trends in the U.S. economy have been persistent. Growth on a year-over-year basis has been largely stable. It may not be an impressive pace, but it has been sufficient to gradually close the output gap and absorb slack in the labor market. At the risk of oversimplifying, the domestic U.S. situation makes a rate hike very likely, but the Chinese international developments and the latent panic in the financial markets are of concern. The situation is fluid, and a decision will not be made until it has to (on September 17th).

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.

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.

V Bottom: a situation in which a security steeply declines in price, and then steeply recovers.

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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 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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