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Politics and subsequent government policy normally affect the level of interest rates, the economy and the stock market gradually, over time. However, the election of Donald Trump as president of the United Sates is a rare exception where market perceptions dramatically changed overnight. In this quarter's letter, we will discuss what are the most likely US government policy changes and the potential positive impacts on our Avenue Fixed Income and Equity portfolios going into 2017.

First let's step back and review the economic 'big picture' at the beginning of last November. We will focus on the United States because of its oversized impact on financial markets compared to Canada. The US economy has become so predictable that most people have stopped paying attention to the big picture and simply nitpick at small details. For the last five years in a row the market expectation was 2% inflation and 2% economic growth. As predicted, for each of those five years inflation came in at slightly less than 2% and the economy actually grew at about 2%. Again, before the US election in November, the expectation for 2017 was 2% inflation and 2% economic growth.

As an investor, inflation is right in line with expectations. The economy could be better, but 2% growth is fine since Avenue has always said that we are looking for stability. However, in this golden age of predictable economics, anxiety is still prevalent due to the real-world experience caused by the debt overhang and the dislocation of the work force due to globalization. This brings us to Avenue's core investment argument since 2009 which has been, due to too much debt and the efficiencies of globalization, that interest rates will be low and stay low for a long time. We are eight years into this low interest rate world and the questions is, with the election of Donald Trump, have we hit an inflection point and will inflation, interest rates and economic growth materially change from here?

Since Donald Trump's election, the US 30-year bond price has fallen 8% and the stock market is up 15%. Markets are often good predictors of economic change. However, in this case the

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potential government policy changes have a far bigger impact on the price level of bonds and stocks than an actual change in the real economy. The three big proposed policy changes are lowering the corporate tax rate, allowing for the return of stranded foreign profits and reducing regulation.

Very simple math can determine the potential impact on the stock market of lowering the US corporate tax rate. The basic corporate tax rate is 35% but because there are so many loopholes the average tax paid is 25%. One scenario has Donald Trump proposing that the corporate tax rate be lowered to 15% for a practical reduction of 10%. So for example, the S&P500 index earning of $120 would instantly jump to $145 at that lower corporate tax rate. At today's 18 times price earnings multiple, this means the S&P500 can trade at 2,600 ($145 x 18) which is 15% higher than today's index price of 2,250.

The second boost to the US economy would be from encouraging repatriation of the corporate profits of US companies overseas subsidiaries. The overall number of stranded offshore profits is getting close to $1 trillion dollars which is 6% of the annual US economic output. For example, the technology firm Apple has over $200 billion in cash which they have not wanted to bring home to the US because of the punitive 35% corporate tax rate.

And thirdly, Donald Trump has challenged government to eliminate two regulations for every new regulation. It costs roughly $2 trillion dollars a year for US companies to comply with government regulations, and from our previous point in the above paragraph, we know $2 trillion is equal to 12% of the annual US economic output. In practice, it might not be so easy to reduce regulation but any progress in this direction can be a boost to economic activity.

In summary, due to proposed policy changes that may lower corporate tax rates, return stranded foreign profits and reduce regulations we have a potential boost to profits and cash on corporate balance sheets. However, we don't know if this money will be reinvested in a low growth economy because business leaders are worried about the other side of Donald Trump's agenda which is clearly isolationist and bad for growth.

Bond yields have quickly moved up in the anticipation of improved growth potential and the expectation of a shift to higher inflation. We argue that we have already had a large move in interest rates and that yields would better be described as normalizing. The low interest rates back in July of 2016 were the result of an almost universal panic that there might be no inflation. Now inflation is much more likely to be, you guessed it, around 2% with a normal interest rate spread between short maturity bonds and long maturity bonds.

Avenue's bond portfolio has been conservatively positioned for the last two years not because we anticipated an increase in yields but because we felt we were not getting paid enough to take on the risk of owning longer maturing bonds. Given our emphasis on owning corporate bonds, Avenue's bond portfolio was up 4.3% in 2016 despite the recent drop in bond prices and increase in yields. We are now looking for opportunities to gradually buy longer-maturity bonds.

So far, the stock market has moved up sharply to reflect that companies will get to keep more money due to lower taxes and less regulation. The implementation of these policies will take time and so measurable results could be a year or so away. We expect that economic growth in the US could increase from 2% to 3% for a period of time, given the cash washing around in the system. To expect growth beyond 3% would require too many unknowable events. In summary, we have a better outlook for growth in the economy, inflation and interest rates are within expectation and overall stock market valuation is reasonable. We believe we have to stay invested in our diversified portfolio of businesses.

Avenue's equity portfolio was up 16.2% in 2016 having clearly benefited from this rerating of our investments. The best example of who benefits immediately are US banks where we have holdings in Bank of America and JPMorgan. Higher interest rates mean banks can earn more in interest income. Banks make significant taxable income compared to many businesses so a drop in corporate taxes will result in a direct increase in earnings. And rolling back some of the more stifling parts of post 2008 banking regulation might be one of the easiest acts for the new legislators to enact.

We don't believe Avenue's equity portfolio needs many changes. We believe our investments in financial stocks are appropriate and our energy investments are playing out as expected. Utility stock prices are the most vulnerable to increases in interest rates but our infrastructure investments are more geared to the improving energy sector. Two new investments were made in areas that we feel are being overlooked. We invested in AutoCanada which owns 54 car dealerships across Canada and has been recently restructured. Also, we bought Western Forest Products which harvests and mills cedar and hemlock on Vancouver Island. We believe this company is out of favour given the unresolved softwood lumber agreement but the business should do well over the next few years.