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THIRD QUARTER 2014 - MARKET COMMENTARY

As we write this quarter's letter, the bond market and the stock market are going through a minor correction, after having a favorable return with very little volatility so far this year. Low interest rates and central bank policy continue to be investors' main points of interest. Both Avenue's Bond and Equity portfolios remain cautiously positioned with the hope that we will get the opportunity to make a few new investments at prices we like.

The stock market activity this summer was very informative in terms of investor sentiment. The summer is a time of year when many people go on holiday, trading volumes dry up and the market drifts down, usually for no other reason than no one is at their desks to drive it up. We in fact did get a pull back during the political events associated with Ukraine and Syria. However, the pull back was a matter of days not weeks.

The reality was that Ukraine had limited economic weight and put modest pressure on Russia, and even when combined with events in the Middle East, these crises did not create a ripple in global oil supply. So our continuing theme is that to capture dividend and income streams we have to stay invested with the majority of our portfolio regardless of how much some stocks may have gone up already. We continue to buy shares in good companies because that is our best option for growing capital.

When we look for things that can go wrong we find one of the starkest financial contrasts is in the global bond market. As North American investors, we may think the current US interest rates are very low by historical standards and are thus unattractive to long term investors. The US government 10 year Treasury bond yields 2.4%, and has come down over the course of this year from roughly 3%. However, this is actually quite a good yield when compared to 10 year German government bonds which now yield only 0.9%. As a reminder**,** when yields come down bond prices go up and Avenue's bond portfolio has returned a +3.8% year to date.

This difference in yields between the US and European interest rates is actually bad economic news for North America. As Europe remains on the edge of recession and potential price deflation, their interest rates are not likely to rise anytime soon. Therefore, global money flows to the US where interest rates are higher. This pushes up the US dollar exchange rate and has a marginal slowing effect on economic activity. The US dollar will then continue to strengthen

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due to the end of quantitative easing by the US Central Bank combined with the prospect of increasing short term interest rates at some point in the future.

Given this environment, we expect that the Canadian yield curve could flatten. This is the term used to describe the relationship where short term interest rates and long term interest rates trade closer to the same level. For example, coming out of the 2008 recession, Canadian short term interest rates were 0.5% and long term interest rates were 4% for a positive slope of 3.5%. If the yield curve flattens, short term interest rates could move up to 1.5% and long term interest rates could come down to 2% and the yield curve would still be a positive 0.5% but it would be flatter than the previous 3.5% slope. A flattening yield curve is significant because it often predicts a slowing economy.

In Avenue's bond portfolio we continue to invest mostly in Canadian corporate bonds with maturities between 3 to 7 years. The Canadian Bond index has done well this year because it has a large exposure to long maturity Government Bonds. We will at times use long government bonds as a way to increase returns, however, at this time we think the risk return is not in our favour. Investing in a 30 year government bond at this low interest rate is a lot riskier than it looks.

A slower global economy, and now a slower North American economy, is bad news for key parts of the stock market. Commodities prices are already significantly lower than earlier in the year. Oil and bulk commodities like iron ore and coal have been the big decliners. As well, as the economy stalls, growth in financial services and banking will level off. Banking, Energy and Mining are the three core components of the Canadian TSX Index.

This starts to sound like we are talking out of two sides of our mouth. Stay invested but be careful. But this is the best way of putting into words how we can be committed long term investors and cautious at the same time. We have done our best to reduce our exposure to some of our more expensive investments like Enbridge and CN Rail. We don't want to risk selling them outright because these are great businesses and are hard to replicate. We also have a constant stream of dividends coming into the portfolio and 8.6% cash and bonds which we can reinvest if given the opportunity.

In our existing portfolio many of our themes are still playing out. A slowing banking market is still not as important to our investments in US banks as the impact from the return to normal banking after five years of regulatory overhang**.** For example, next year will be the first clean year of results for the restructured Bank of America. Also our Canadian energy investments are more dependent on the price of Western Canadian heavy oil. In spite of the decline in the world price of oil, our Canadian heavy oil investments look good compared to last year.

More importantly, a stock market pullback from this level is a healthy reminder to investors that there is risk in the stock market. And lower stock prices means we might get a chance to invest in some of the companies we like. For example, we would like to increase our gold exposure in this weak gold market but we need Franco Nevada to be trading at a lower price than it is today.

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Getting there together