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THIRD QUARTER 2015 - MARKET COMMENTARY

We have spent the last three quarterly letters saying that not much has changed. Now, almost every corporate bond, stock and asset is being repriced and the rate of change or volatility is up significantly. We believe this environment to be another symptom of low interest rate policies. However, this current sell-off improves our opportunities to invest in quality income-producing securities, which is Avenue's core investment strategy.

To solve the 2008 financial crisis, interest rates were lowered to encourage higher prices on hard assets like real estate and to promote more debt (or cause existing debt to be affordable). At present, monetary stimulus has run its course. The current trend is that few investors or companies want to borrow more than they already have. So the natural question is, if there is no more borrowing, where is the next buyer going to come from? And more important, is a buyer going to be there if we need to sell?

Last quarter's case study dealt with liquidity risk as it relates to bond exchange traded funds (ETFs). If everyone wants to sell a bond fund all at once and the fund owns illiquid bonds, then prices for those bonds will move dramatically lower until a clearing price can be found. Illiquidity and herd selling create their own self-fulfilling market mini crash. The hypothetical scenario we discussed in the Q2's Case Study became a reality across many markets in August.

In a market where many players have borrowed heavily, they are actually short-term speculators, not investors. A more tangible example is to compare selling a stock to selling a house. If you want to sell your house and similar houses on your street have sold for a million dollars, but you have only been offered $900,000, then you are likely to wait a few weeks to see if the current soft market, is just an aberration. You hope that someone will come along and offer a million dollars for your house as well.

The stock market doesn't work like this. If you have borrowed a lot of money to buy bank shares and then the immediate future becomes less certain, you simply sell at the current market price so that you don't have any debt and then stand on the sidelines. You might miss a rally but you absolutely get to keep what money you had. In fact, you might be happy to knock the stock down $2 dollars just so that you can sell all your stock by 9:35am, just minutes into the trading day. Debt creates instability. This is what we believe we saw the morning of August 24th when the Dow Jones stock market index opened down 1,000 points. In industry jargon this is referred to as a 'loss of risk appetite'.

By late August three negative factors appear to have converged to cause the market to drop. The first is the consensus that interest rates in the US will be going up. That means that borrowing

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costs will increase for all those leveraged stock speculators. So to lower debt levels, stocks need to be sold. Since the level of borrowing is at a record high when those speculators sell there are incrementally more sellers than buyers. Another result of higher US interest rates is that the US dollar continues to appreciate and earnings for America's global businesses will be reduced, from a US investor's point of view.

China is the second negative factor. The Shanghai index collapsed by 41% this summer. But the real trigger for the US stock market weakness was the devaluation of the Yuan versus the US dollar on August 13th. It was a direct Chinese government acknowledgment that their economy was weak. Again if you had borrowed money to speculate on stocks that will benefit from continued global economic health, you might be willing to wait on the sidelines for a bit to see the true state of China's economy unfold.

The third factor would be the Middle East. This would include a lower oil price shock and a civil war which has resulted in a massive destabilizing refugee crisis. One result is that the Saudi Arabian budget deficit has been reported to have prompted sales of $73 billion in securities in the month of August. The sales included everything from shares in Apple and Johnson & Johnson to German utilities. This is another example that there are more sellers than buyers and the selling has nothing to do with the health of the underlying investment. It is just that today, for the seller, it is more important to have cash in hand.

In our estimation, we are in a liquidity crisis. There is always potential for this type of event but what is new is the scale because of the ability to borrow large amounts of money at relatively little cost. Building up leverage is gradual but unwinding leverage can cause a sudden drop in prices. So we can predict with relative certainty there will be a liquidity crisis, the hard part is predicting when.

Avenue's strategy requires patience, we prefer to wait for a crisis to hit and then we can make investments in securities we have been waiting to buy. When the market is doing well, we try to maintain a cushion of cash that we hold in reserve to use when the market slumps. This eliminates the need to predict or time market events. For the most part, the purchase of stocks is done through valuation. An example is that we recently added to our investment in Inter Pipeline. The security now has a 6% dividend yield and the company should grow by 2-3% over time. This satisfies our 8% return target. Inter Pipeline owns and operates many of the interconnecting pipelines within the Alberta oil sands.

The portfolio has fallen slightly through September but we think the valuations of our core holdings look good. Another example is Royal Bank where the dividend yield is over 4% and its dividend payout is less than 50% of earnings. When one combines the dividend and the retained earnings, our investment will be compounding internally at over 8%. There is a fear that earnings will not hit analyst expectations for growth. But for now, analysts do not believe earnings are going to go lower, just not grow as quickly. So the Royal Bank is compounding at 8%. The returns are gradual and Avenue is thinking long term so this is exactly the type of investment that we look for. However, a return is not guaranteed enough for the leveraged investor who worries about the next few weeks. All the negative issues we have just discussed out weight the long term view. Avenue owns *un*leveraged positions and thinks about the long term value of the company not the value of its stock on a short term basis.

A further example of an investment we own but where the outlook is actually negative for their industry is MainStreet Equity. The company buys and renovates old apartment buildings in B.C and Alberta then rents out the refurbished spaces. Layoffs and wage reductions are very real in Alberta but we feel this is already reflected in MainStreet's stock price. The shares trade at a 40% discount to the breakup value of the underlying real estate. So far revenue has not declined and the company hopes to make opportunistic acquisitions of over $100m in this depressed market. Once again our assessment is that if we didn't already own it we would want to buy it at this price.

PHX Energy Service is the big percentage loser this year in our Equity Portfolio. We bought the shares believing this energy service company has the flexibility in their business plan to ride out impacts of the low oil price on the Western Canada industry. So far the company has done what it said it would do and we see positive cash flow this year and we expect to eke out a gain next year while most in the industry are losing money. What we didn't expect is that investors would completely walk away from this oil and gas service sector. We have doubled the position to lower our overall book cost. We will be closely monitoring the health of this investment and it is only 1.8% of the portfolio.

In terms of the Canadian dollar, our opinion remains the same that we will incrementally sell foreign securities and invest that money back in solid Canadian companies when given the right opportunity. We have already reduced our direct foreign holding to 24% where at one point it was well over 30%. But just a reminder, we still have plenty of *indirect* foreign exposure through investments like TD Bank's American operations and Canadian National Railway's US track. The addition of indirect exposure brings the foreign holding closer to 36% of the portfolio.

We don't want to leave this quarter without touching on Avenue's Bond Portfolio. Continuing with the theme of illiquidity, the lack of liquidity has resulted in a slight price decline in the corporate bond market this quarter. However Avenue's bond portfolio is still up 2% year to date. For the most part, our portfolio of shorter-maturity investment-grade bonds are not that affected. The real weakness in the market is in high yield bonds, what used to be called the junk bond market. We have spent time analyzing industrial and resource company debt but so far we have not made any investments as the risk return does not look to be in our favour.

Avenue Investment Management
Getting there together