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FIRST QUARTER 2013 - MARKET COMMENTARY

HIGHLIGHTS

- **Recovery Continues**
- **Spending Cuts Equal Job Cuts**
- **Low Interest Rates For The Long Haul**
- **Conservative Risk Management**
- **Gold Update**
- **Case Study: Safety (Owning Good Assets In Good Places)**

Recovery Continues

The recent US federal budget cuts of $85 billion confirm our belief that interest rates will remain low for some time. Stock market investors continue to buy consistency and sustainability where they can find it. However, both Avenue's Bond Portfolio and Avenue's Total Return Equity Portfolio have slightly increased weightings in cash given the higher prices and unsustainably high positive sentiment.

We are officially in the next phase of this low interest rate and overleveraged cycle. The US federal reserve chairman, Ben Bernanke, has acknowledged that there is healing in the property market and a recovery in the private sector. He agrees that in a normal cycle short term interest rates should gradually increase. However, he concludes that since the US Federal Government has been hit with automatic spending cuts of $85 billion, interest rates will not be going up any time soon.

Spending Cuts Equal Job Cuts

The way the $85 billion in spending cuts works is that it directly hits the operating budget of the US federal government. Health care and pensions are unaffected, so the only way to reduce spending is

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to cut jobs. Herein lies the core of the conflict. Ben Bernanke has stated that interest rates will not be going up until unemployment falls to 6.5%, down from today's 7.7% level. This is a difference of about 1.9 million new jobs.

The US private sector is growing at roughly 2%, but the public sector is now contracting. Although we cannot yet calculate how many government jobs will be cut, it will now take several more years to get to 6.5% unemployment due to this new burden of constant government job losses.

The perception is that consumer demand in the US economy will remain slack and therefore interest rates should stay accommodative. Without addressing pension and healthcare reform, there is no way to overcome the economic drag created by reducing the public sector. Effectively, one major piece of the economy is deflationary and holding down what would normally be much higher interest rates.

Low Interest Rates For The Long Haul

This view of low interest rates for a longer period of time underpins our investment strategy for the Avenue Bond Portfolio. We will remain conservatively positioned for the foreseeable future by holding more cash and waiting for security-specific opportunities. Even at these incredibly low yields, we still believe we can get a 4% rate of return by having the majority of the portfolio invested in shorter maturity Canadian corporate bonds.

In terms of the stock market, getting the level of interest rates and wage inflation correct is very important because they are two of the major factors in determining corporate profitability. We have written in past letters that the strong stock market run in non-commodity businesses has been underpinned by the current record level of profitability. Corporate profitability is unlikely to grow dramatically from here, but it is not likely to collapse given that borrowing will remain inexpensive and excess labour will mitigate wage gains.

Stock market investors have caught on to this trend and money continues to flow into conservative equity and dividend funds which then buy the handful of profitable and sustainable publicly listed businesses. Shares of slow growth utility companies would be a good example. However, we believe that most of this good news is already in the share prices. The valuations are now expensive and broad measures of sentiment are now high.

Conservative Risk Management

Our risk management for the Avenue Total Return Equity Portfolio is to build some conservatism into the portfolio in two ways. The first is, raise more cash and wait for better opportunities in the future. The second is to incrementally sell shares in our more expensive utility and real-estate stocks and buy shares in companies with better valuations. Many of Canada's commodity businesses are inexpensive for the first time in a long while.

The Canadian dollar is also caught up in the same investment theme. As the Canadian price of oil has deteriorated and the relative health of the US economy has improved, the Canadian dollar has decreased in value compared to the US dollar. We looked for investments outside of Canada when we had a strong dollar. Now we are focused on inexpensive investment opportunities at home.

Gold Update

We would like to finish with a gold update. The metal is now trading lower at about $1,600 but the stocks of the gold producing companies have fallen dramatically. This industry has all sorts of problems with profitability, growth and political risk but we believe we can own one or two of the better companies in the sector and accomplish our investment return objectives. We have taken advantage of the recent weakness and added to our investments in Yamana and RoxGold.

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Case Study: Safety (Owning Good Assets In Good Places)

We would like to share a couple of recent developments which confirm our belief that investing Safely in today's world is best served by owning a hard asset or business in a sound legal jurisdiction.

This month's economic event of interest is the unwinding of the tax haven of Cypress. The two-state island exists inside the umbrella of the European Union but there are many complicating issues. The overleveraged banking crisis has now hit the island in such a way that a traditional bailout is not possible. At this time it looks like basic bank deposits will take a hit.

When you put money in a bank and the bank lends the money and loses it, in this case by lending it to Greece, the bank shareholders lose first, then the bank bond holders and finally the bank depositors. Usually the government comes in to save deposits because a run on a bank is bad for everyone. However, in the case of Cypress where the majority of depositors are wealthy Russians, it seems to only be bad for tax evaders. The bank is going to fail and foreigners are going to have to find another place to put the remainder of their money.

What is important about the events in Greece and Cypress is that the traditional view that cash and government bonds are the safest assets no longer holds true. We believe that owning a good business is the safest way to maintain and compound your wealth. We also believe a few more Cypress savers and investors now share our view.

The second argument is that you have to own the business in a sold legal jurisdiction. China now has many inter-listed public companies in Canada and the US. However, we would not recommend owning them given the lack of accountability.

Recently uncovered fraud in inter-listed Chinese public companies has prompted the US Securities Exchange Commission (SEC) to demand domestic audit documents for these companies. The Chinese auditors have refused to cooperate because they fear that releasing Chinese audit documents might accidentally pass on "state secrets", which of course is illegal. Amusingly, the answer to the SEC's request for records is that they will not be getting any and nor will shareholders.

Our conclusion here is that in this age of global investing, the importance of where your business is located and if it is supported by a high quality legal structure is under appreciated. We certainly prefer to invest in Canada first and we have observed that more and more individual Chinese citizens share our conviction as their personal money is landing on our shores every day.

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