Avenue
Investment Management

47 Colborne Street, Suite 300
Toronto, Ontario, Canada M5E 1P8
T 416.482.2004 • 888.482.2007 F 416.482.0007
www.avenueinvestment.com

FOURTH QUARTER 2014 - MARKET COMMENTARY

2014 Returns

Avenue Composites 2014

Avenue Bond Portfolio	**4.4%**
Avenue Equity Portfolio	**9.8%**

Indices 2014

Canadian Consumer Price Index	**1.9%**
DEX Canadian Bond Index	**8.8%**
S&P/TSX Composite Index	**7.4%**
S&P 500 Composite Index (CAD$)	**21.9%**

Note: 2014 percentage change returns, pre-audited, net of fees. Individual performance may differ due to size and timing of investment.

We continue to believe that there are few better substitutes for our investable savings than owning quality stocks for growth and certain selective bonds for income and safety. Again, we witnessed two rapid recoveries in the stock market following volatility in October and December. Moreover, corporate share buybacks and acquisitions reinforced the dynamics of the equity bull market. However, potential big risks to North American equity investors are a potential rise in wage inflation and increased geopolitical unrest. These constantly changing dynamics give us opportunities to make adjustments within the portfolio to take advantage of a lower Canadian dollar, a much lower oil price, and insulate ourselves from a rising interest rate environment.

In our Q3 2014 letter, we raised a concern that the stock market could continue to fall due to repercussions from a stronger US dollar, since all world markets in bonds, stocks and commodities would likely adjust. Avenue's Equity Portfolio is built with the intention of being more stable than the overall stock market, so we are very interested in how our equity portfolio holds up in the periods where there are rapid declines in the stock market. The TSX Index fell 13% between the September high and the October low, whereas Avenue's Equity Portfolio declined 7% through this period. Because of greater diversification and a focus on higher quality investments, or lower relative valuations, Avenue's Equity Portfolio continues to perform with less volatility than the TSX Index.

Since last summer's stock selloff was followed by a rapid recovery, we were not surprised to experience two more rapid recoveries in the price of high quality cash-flowing stocks from both the October and December stock market corrections. Avenue has been quite repetitive about

Paul Harris, CFA
Partner
pharris@avenueinvestment.com

Paul Gardner, CFA
Partner
pgardner@avenueinvestment.com

Bill Harris, CFA
Partner
bharris@avenueinvestment.com

pointing out that given the present low interest rates, investors are forced to look to stock dividends as an income substitute. As a reminder, at the start of 2014 the Canadian 10-year Government Bond yield was 3% and today those same bonds yield 1.8%. Compare this to Royal Bank's dividend of 3.8%.

Stock market values have also risen because companies are buying back their own shares. Last year in the US, total share buybacks were worth roughly $450 billion which is the equivalent of a 3% dividend yield. However, the actual dividend yield was 2%, so the dividend added to the stock buyback combined for a total cash return to investors of 5%.
In past newsletters we have discussed that when companies continue to make money, but don't have a need to reinvest it in their own business, a merger and acquisition cycle can develop. In the fourth quarter of 2014 the US public equity market was back to the same level of takeover activity last seen in the frenzied days of 2007. Takeovers have the effect of pulling assets out of the stock market with the result that there is more cash to invest in fewer listed companies.

When we assess risk to corporate profitability, a key variable is the cost of production and the largest component of costs is wages. So far, the pace and nature of the economic recovery after the 2008 financial crisis has not resulted in increased labour costs in North America. We have referred to our current economic period as being a golden age of corporate profitability where taxes have come down, interest costs are low and wages are stable. However, wage pressure might start to appear as US unemployment has now come down to 5.6% and the US economy is estimated to grow at 3% for 2015**.** Not all wages will go up, but many businesses are starting to notice a skilled labour shortage. We don't expect rapid wage inflation, but rather we are watching closely for incremental change.

The list of geopolitical risks is getting longer: countries that run a real risk of default include Russia, Greece**,** Venezuela and Nigeria; there is limited economic growth in Europe and slowing economic growth in China; and the conflict in Syria and Iraq continues unabated. World events will likely have a short term shock effect on the bond and stock markets, but hiding our money under the mattress will not help us either. Avenue aims to be invested in stable, profitable businesses and the North American economy continues to make slow but steady progress in spite of all these problems.

Avenue's Bond Portfolio remains more weighted to Canadian corporate bonds with shorter term maturities. At this time we wish to be defensive to protect against a potential increase in interest rates or a surprise credit event that would weaken the corporate bond market. The primary function is safety and providing an income for Avenue's clients where this level of risk is appropriate.

Avenue's Equity Portfolio has made some minor adjustments due to the changes in interest rates, the currency, and the price of oil. With interest rates this low we will continue to underweight hard asset classes like Real Estate and Infrastructure. We don't see any imminent reversal to dramatically higher interest rates. Rather, we feel the move will be gradual to a more normal level over the next 3 to 5 years, given inflation of 1.5% to 2%.

The Canadian dollar has now reached the $0.85 level in US dollar terms, which encourages us to look at Canadian opportunities first when making new investments. Remember, we are now benefiting from those international investments we made when the Canadian dollar was at par or

higher with the US dollar. Lastly, we see the collapse in the price of oil as an opportunity to increase our exposure, having been significantly underweight in the energy sector going into this fall's correction. We believe today's oil price of $50 may not be the absolute low needed to clear the oversupply, but with a 12 to 18 month time horizon, the oil price should get back to the $75 to $80 per barrel level.

Avenue Investment Management
Getting there together

DISCLAIMER
This report is provided by Avenue Investment Management Inc. (Avenue) for customers of Avenue. It is for information purposes only and may not be appropriate for other purposes. The report does not provide material information about the business and affairs of Avenue. Charts, diagrams and other information contained in this report have been drawn from sources believed to be reliable, but are not guaranteed to be accurate or complete. The report contains economic analysis and views, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. Avenue Investment Management Inc. is not liable for any errors or omissions in the information, analysis or views contained in this report, or for any loss or damage suffered.