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SECOND QUARTER 2015 - MARKET COMMENTARY

The main financial event in the second quarter was the rise of short term interest rates. As a result, the price of bonds fell but this did not result in a stock market selloff. Therefore, not much has changed since we last wrote three months ago and the equity portfolio has been unusually stable. There are two popular concerns that we would like to address in this quarter's letter: the risk to corporate profit margins and the danger of illiquidity in some markets.

When short-term interest rates are this low, there has to be a reversal of some kind eventually. Some interest rates in Europe actually went negative for a few weeks. We have written in previous letters about how a 0% interest rate policy (ZIRP) by the central banks is not in the text books. We are all learning as we go. To state the obvious, until interest rates recently tipped up, one could give the German government $100 dollars and expect to receive back $99 dollars in a few years' time.

Our Avenue bond strategy remains the same. The majority of the portfolio is invested in short to medium-term Canadian corporate bonds. We are getting the extra return that a corporate bond gives us but not taking on the risk of buying long-term bonds, in spite of their extra yield. So as interest rates went up in the last few months, Avenue's bond portfolio did not go down in price as much as the Canadian bond index. We believe our portfolio should still be able to return 3% to 4% per year on average if, as we expect, inflation stays low and stable.

Even with this significant rise in interest rates, there was not a corresponding drop in the stock market. It has felt more like a holding pattern. In fact, the US stock market has now had over 1,350 consecutive trading sessions without a 10% correction. Many stock market watchers are now looking for reasons why stocks should go down, simply because the market has gone up for so long.

There is general concern that the current level of record profit margins cannot last. We have written in the past that as interest rates, which are the costs to borrow money for companies, have declined and wages stalled the result is record profit margins. We have even referred to our current investment climate as a golden age of corporate profitability. Conventional wisdom is anticipating that the cost of borrowing will soon be going up in the US and wages will finally

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have to increase as the labour market tightens. The conclusion is that profit margins will have to fall and the stock market will fall with them.

At Avenue we make a distinction between the impacts of different interest rates. We believe that short-term interest rates in the US should rise over the next two to three years. This will have an impact on parts of the economy that borrow short term, like housing. However, companies borrow for medium terms, like 10 years, and the stock market reacts more to these corporate medium term borrowing rates. Here we would expect that interest rates might go up by 1% but this is not enough to either destabilize markets or dramatically revalue asset classes like pipelines or commercial real estate.

Unemployment in the US has gradually fallen to the 6% level and the expectation is that wages will finally face some pressure to increase. So far we have seen this to be true in some specialty areas like high tech and health care. However, because we are in a debt heavy and slow growth economy, many companies still prefer cutbacks and efficiency compared to growth to maintain profits. The result is a constant supply of surplus labour. In Canada we have also had the shakeout in the Alberta energy sector which has shed workers and lowered wages for those who have kept their jobs.

The other hot topic of concern is a very technical argument about bond index funds and liquidity. We will expand this discussion in this month's case study. In summary, if everyone who owned a bond index fund felt that interest rates were going up and put in a simple order to sell the fund, the manager of the fund would then go and sell the actual bonds into the market. However, because of various factors, one being new bank capital regulations, what is called the depth of the bond market is not as deep as it used to be. In plain language, there is no buyer for the bond. The result is a bond market panic instead of an orderly selloff as interest rates rise.

At Avenue we are positioned to weather a bond panic and we plan to maintain our bond portfolio strategy. We always intend to mature our bonds. (Although sometimes we don't let the bonds mature for technical reasons). If a bond market collapse occurs, we have cash and constantly maturing bonds that we can then reinvest to take advantage of the higher rates. It is no more complicated than that. However, bond trading can become much more complicated and one can end up really losing money if one tries to time the market using a trading strategy in a volatile market.

We will also mention that there is always the risk of political shock. This is very topical since Greece teeters on the edge of default as we write this letter. Bond and stock markets could react negatively to this event given its deflationary impact. But we would argue that the bulk of this negative news is already reflected in the prices of bonds and stocks. Also, Greece is not such an important economy globally. So it is more important to look through a Greek collapse and imagine the world in a few months' time.

When we look at our existing investments, we ask if their underlying businesses can meet our target return of 8%. For the most part the actual business environment is good and quite stable. We would now argue that stock market multiple expansion is likely after this uncertainty with interest rates and Greece clears.

Interest rates can go up but not to a level where we would say we don't want to be invested in the stock market because we get a higher return from bonds. If stocks are still the only place to get

8% rates of return then we believe money will continue to flow into the stock market. Today's valuation is about 17 times earnings for consumer and industrial companies but we feel a price earning multiple close to 20 is possible. Earnings don't need to go up for the stock market to go higher. A higher multiple on existing earnings will be the next driver of higher stock prices. The one caution is that with higher valuations comes more volatility, which means bigger price swings in the months and years ahead.

We wrote about the oil cycle last quarter and we can talk this quarter about other mini cycles going on in other industries, like mining. We have had a bull market in stable companies but a collapse in mining over the last two years. We have watched and waited to buy Labrador Iron Ore Mines until it was finally down by 60% from its high. It is a debt free royalty stream from Canada's largest iron ore mine operated by Rio Tinto and it sells a high value product into the global specialty steel market. We feel we can get our 8% rate of return over the next few years with the possibility that the iron ore market recovers in the future. To buy it, we sold our diversified mining investment in BHP.

Our investment in John Deere is doing well and acting as we had hoped in a counter cyclical way. The corn price is terrible but the stock market has a way of looking through this. It is another example of having a very different return profile within the portfolio that offsets the impact of our previously discussed theme of higher interest rates. This leads to a final comment that higher interest rates are good for US banks. This is what we have been waiting for to propel our returns in Bank of America. Higher interest rates will have a negative effect on the valuations of tangible assets but there are a lot of diversified investments in Avenue's equity portfolio to smooth the return.

Avenue Investment Management
Getting there together

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