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FIRST QUARTER 2016 - MARKET COMMENTARY

In the first three months of 2016 we experienced a dramatic stock market sell-off followed by a rapid recovery. At Avenue, we have argued that along with low interest rates, and higher stock market valuations, comes increased volatility. Just a small change in investor perception of the future can trigger a pronounced stock market move in either direction. An important part of Avenue's investment strategy is to be ready for the unexpected and to take advantage of it.

We would like to discuss the last few months to illustrate how volatility can be magnified as a consequence of very low interest rates. Most of January's stock market and corporate bond sell-off was caused by a heightened sensitivity to increasing short-term interest rates in the US. At the beginning of January expectation was for the US Federal Reserve bank to increase short-term interest rates to 0.75% later this year from where they stand today at 0.25%. Taking the US economy in isolation, an increase in interest rates of this mild a magnitude would not seem like it warranted a crisis. However, on a global scale it created the potential major interest rate imbalance.

At the root of this mild market shock is the reality that there are trillions of dollars of surplus global savings washing around the financial system looking for a safe short-term investment with a positive rate of return. Most places for people to invest their savings are viewed as poor choices this year. China's economy is slowing, most of the large emerging markets are in recession and parts of Europe, as well as Japan, have negative interest rates. A further increase in US interest rates would make a US short-term bond investment even more compelling compared to the alternatives.

This interest rate trend is a problem because higher interest rates restrict lending and a higher US dollar exchange rate stifles US exports. Also, imports become cheaper which is deflationary. The US dollar has already appreciated 25% against a majority of America's trading partners in the last year and a half and the domestic impact is only now being felt in lower corporate earnings. Continuing to raise interest rates would result in a higher US dollar exchange rate and put a further drag on the US domestic economy which is only expected to grow by 2% this year.

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All of this played out in a matter of weeks and the US Federal Reserve as of March 16th stated that given the impact of previous currency appreciation and the economic dampening effect, US short term interest rates will stay where they are at 0.25% for the foreseeable future. As a result, the US stock market bounced right back up again.

To summarize the first quarter of 2016, at the beginning of January interest rates were expected to go up 0.5% from 0.25% to 0.75%. The S&P 500 (US stock market index) fell a dramatic 13% in a few weeks in anticipation of higher interest rates and the potential of a stronger US dollar. Fearing the economic consequences, the US Federal Reserve announced a hold on future interest rate increases keeping short-term interest rates at 0.25%. Consequently the US stock market rebounded by 14%, which is back close to its all-time high. So in actuality US interest rates didn't move at all and the US dollar exchange rate didn't move by much. It was just the investors' perception that created the big moves in places like the stock market and the corporate bond market and this is what Avenue argues is the new norm of magnified perception-based volatility.

We have to incorporate this volatility into our investment strategy and be ready for it. This means vigilant risk management where we will sell investments that are not playing out as we would have hoped. Then, we need to not miss the opportunity to reinvest in businesses that offer a better risk reward.

In Avenue's equity portfolio we have held individual investments for an average of five years, which in industry jargon is a turnover of 20%. However, when there is a big stock market movement, we get the chance to increase the quality of our investment. Often, there are more Sells and Buys in that period.

In Avenue's equity portfolio in Q1 we sold our underperforming investments in Barclays, Regions Financial, Crescent Point Energy and PHX Energy. We were able to reinvest these funds in J.P. Morgan Chase, BMW, Allied Properties and Potash Corp.

In Avenue's Bond portfolio we had accumulated cash so were we able to make a new investment in Canadian Natural Resources bonds maturing in 2020.

Avenue Investment Management
Getting there together

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