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SECOND QUARTER 2013- MARKET COMMENTARY

HIGHLIGHTS

- **Economic Environment**
- **A Year to Tread Carefully in the Bond and Stock Market**
- **The Positive Impact of High Interest Rates**
- **A Case Study in Profitability vs. Growth**

Economic Environment

It is our belief that the American stimulative monetary policy will be coming to an end. We are witnessing an active realignment of bond and stock prices. We will do our best to describe how this impacts the various parts of our portfolio and how this creates an opportunity for additional investments.

Four and half years of ultra-easy monetary policy looks like it is coming to an end. This should not be big news given the undeniable health of the US economy. However, the bond and stock markets seem to be treating it as a revelation, for the moment.

The US 10 year Treasury bond had a low yield of just 1.66% on April 26th of this year. The yield for that same bond hit 2.6% at the end of June. So while in absolute terms a 2.6% yield is still not that exciting as a total return, given persistent inflation, the percentage move is 55% higher.

As Canadian investors we will focus on US monetary policy because for now that is what moves Canadian policy. Also to be clear, the US Federal Reserve has only barely acknowledged that the US economy is doing well and that quantitative easing will be reduced sometime next year. Quantitative easing is the Federal Reserve's policy of creating money by buying bonds and mortgages in an effort to lower longer term interest rates. No mention has been made as to when the 0% interest rate on Treasury Bills will be increased.

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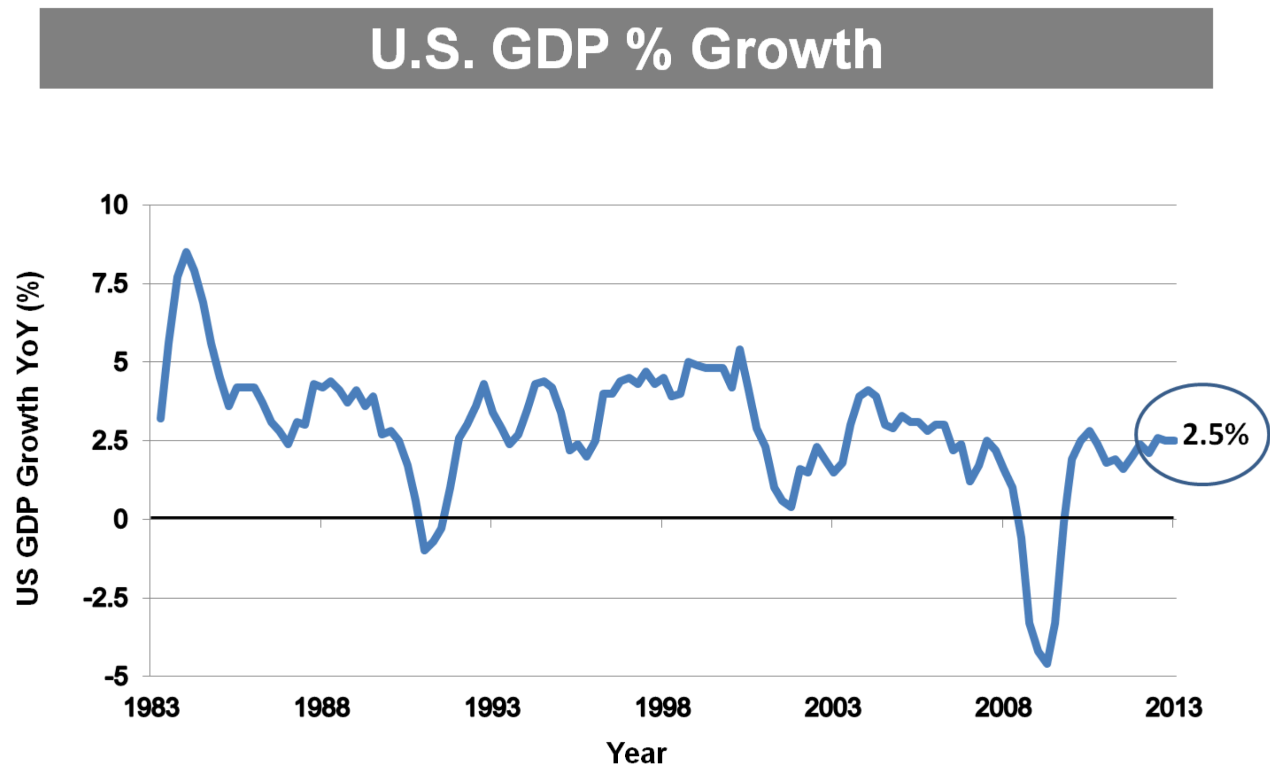
A Year to Tread Carefully in the Bond and Stock Market

At our Avenue Spring presentation in Toronto we summarized the main themes of our quarterly letters. We also added one new theme: we now needed to be careful in the bond and stock markets. While we think interest rates will stay lower longer, they still need to be higher than present levels. Ten year yields need to be 2.5% to 3.5% longer term but they should not stay at 1.8% as they have been for the last six months. Our warning came with an explanation that we had already adjusted our investments to allow for this increase in rates.

We argue that interest rates in a normal economic environment would end up much higher than 3.5%. But because the Government's debt is now so large, the social welfare state has to be rolled back which is having a real -1% drag on GDP. So the private economy is growing at 3.5% but the government is contracting at -1% with a net effect equal to GDP growing at 2.5%.



There is nothing that wrong with 2.5% GDP growth. The problem is that this amount of growth does not generate enough prosperity to pay off the accumulated Government debt load. The conclusion to this tidy argument is that monetary policy remains accommodative with low short term interest rates for years to come. To try and define low in more relatable terms, we would not be able to create a healthy retirement income by just investing in government bonds with a 2.5% yield.

So we know we have work to do finding higher consistent rates of return than offered by government bonds while still avoiding market disasters. We have been waiting for an increase in longer terms yields and now we are in the middle of that correction. However, the knock-on effect is dramatically different depending on which investments we are talking about.

A 55% increase in 10 government yields would confirm that there was a bubble in long maturity government bonds. A great deal of the excess money supply went into emerging markets as well. The effect of probable tighter money days in the near future has the Emerging Market Index down 22% in the last month.

First off we do our best to avoid investments where the return or the risk cannot be justified. Where our core strategy is impacted, we still have ways to reduce the risk.

The Positive Impact of High Interest Rates

The Avenue Bond Portfolio has not owned long maturity Government bonds since 2010. The average maturity has been lowered to a very conservative 4 years. While Government yields have gone up, the extra return we get from corporate bonds, called credit spread, has not been impacted. We are now in a position to buy longer dated bonds at higher rates and take advantage of the market turmoil.

The Avenue Total Return Equity Portfolio has groups of investments that will move differently to this change in interest rates. Higher rates are important but in the opposite way to our bond investments. The companies, in which we own shares, borrow money and now those companies have to pay higher interest so by definition corporate earnings will be lower.

Our utility and REIT investments would be the most directly impacted. Here we have felt that high valuation was already a concern so we have sold half our holdings over the last year. We are now in a good position to add to these sectors if the market was to decline.

The financial service industry is probably the most complicated industry to assess. Simply put, as interest rates go up, asset prices fall. However, higher interest rates are very healthy for the basic business of lending money. The Avenue portfolio is heavily weighted to commercial lending banks so we feel these higher rates will have a positive impact on earnings. Also, our investment in non-financial services, like Shoppers Drug Mart, was not impacted at all.

The portfolio's resource investments are still more impacted by China and the internal supply and demand dynamics of the North American energy market. We are already trading at what we feel are depressed valuation levels. Gold is the outlier and here we have been wrong so far. We sold half our position in Yamana Gold close to the top but bought it back too early. We will maintain 5-6% exposure to gold as intelligently as we can. Yamana Gold remains a very profitable company right down to a $1,000 per ounce gold price.

In summary, this significant rise in interest rates has given us an opportunity to make bond and stock investments at levels we have been patiently waiting for. But to be ready, we had to be positioning ourselves over the last six months. There even might be an opportunity to get fully

invested again but this would take an additional back up in higher yielding securities from today's levels.

A Case Study in Profitability vs. Growth

We are at a unique point in time that clearly demonstrates a universal investment fallacy where growth in Gross Domestic Product (GDP) will somehow translate to positive stock market returns. The performance of the Chinese stock market clearly exposes how simplistic this assumption is in reality.

Common folk lore, constantly regurgitated by the media, would have us believe that GDP growth is almost essential to stock market returns. We might never have a clearer example to clarify that the stock market does not measure growth in the economy by growth in profits.

The Chinese economy has grown 240% in the last 5 years, from $3.5 trillion dollars to $8.5 trillion dollars. There are few examples in human history to compare to this phenomenon of advancement. However, the stock market (here we use the Shanghai Composite Index) is down 68%.

We have to go back 14 years to 1999 before we can calculate a positive investment return. In that time frame the Chinese economy has increased in size 670%.

An explanation for this unique phenomenon is that the Chinese economy grew but profitability did not emerge as fast as anticipated by investors.

The core of our investment strategy at Avenue is focusing on the profitability of our investments. The reason we care so much about profits is because that is what drives stock prices. All our investments have to be profitable businesses or assets. We have to make sure we don't pay too much for them. But if the profits grow, that is even better.

Avenue Investment Management
Getting there together

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