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

THIRD QUARTER 2019 - LETTER

There are three distinct themes emerging that separate the world of investing and define our times. The first is the phenomenon of low interest rates and their impact on what can most easily be described as the slow growth, pre-digital, old economy. The second is the rapid change brought about by the digital revolution and the amount of money directed towards it. And finally, the emergence of environmental and social issues against which companies will be judged. When investing we must clearly separate these complex themes to understand which of these are risks and which are opportunities for our portfolios.

As an example, the current headline-grabbing topic is: Are we heading into recession in 2020? At Avenue, we feel this is too broad a question and all investments need to be broken down into the three themes mentioned above. We are asking ourselves, what does a recession look like when money is almost free because we are already in a global ‘industrial’ recession and these types of industrial stocks are already inexpensive? Will there be a contraction in the digital revolution? This is unlikely due to the pressure of all businesses to evolve and compete but perhaps there will be a pullback in valuation and the price of technology stocks will decline. Has Canadian productivity stalled as a result of self-imposed environmental and social policy? Here we must make sure our investments are aligned with positive social impact so that projects can get built, on time and on budget.

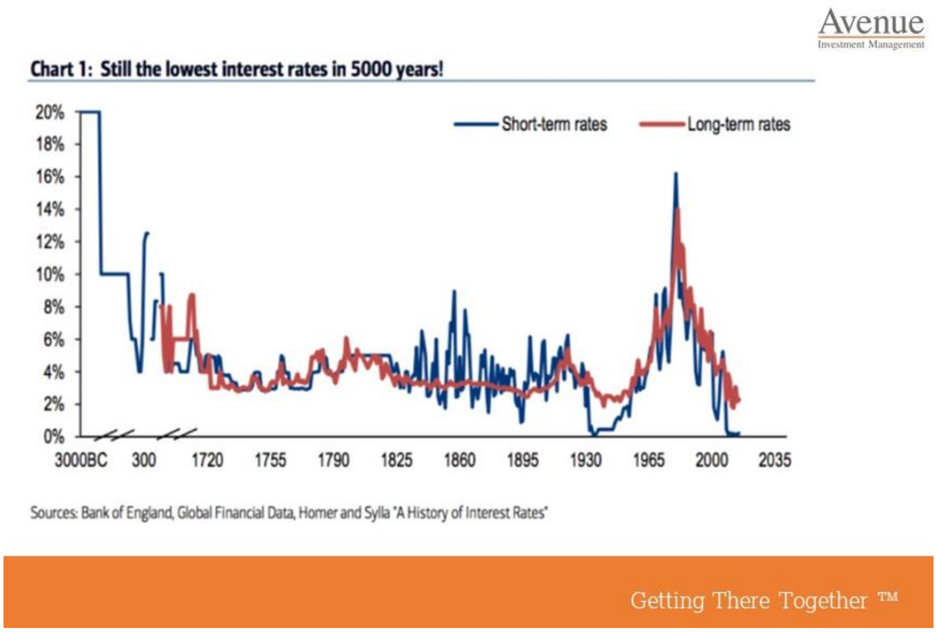
The Old Economy

While a recession has an important influence on stock market prices, it is also by definition temporary. The bigger issue for us as investors is the very low level of interest rates and how that affects the valuation of bonds and stocks. In last quarter’s letter, we described how an estimated $12 trillion of global government bonds were trading with negative interest rates. Now, just three months later, that number has grown to $17 trillion, which is almost half the global bond market. The US has the highest 10 year interest rates in the world at 1.65% and Canada is second highest at 1.40%.

Country	10 Year Rate	30 Year Rate
United States	1.65%	2.16%
Canada	1.40%	1.59%
Japan	-0.21%	0.36%
Germany	-0.47%	0.02%

To better describe what a negative interest rate is, if you put $100 in the bank, next year the bank will give you $99 back. For 5,000 years, humans have produced written records of people lending money to each other in an organized contractual fashion for profit. Negative interest rates are not supposed to happen. In no economic textbook is there a formal theory where money is lent to get less in return. For the last decade Japan was the only country with such abnormally low interest rates, but the belief was that Japan would normalize at some point. But what has happened is that the rest of the world is slowly becoming Japan and being pulled towards the blackhole of negative rates.

5000 years of interest rates



There was a great quote this summer from past US Federal Reserve Chairman, Alan Greenspan.

> *"I wouldn't be surprised if yields on U.S. bonds turned negative and if they do, it wouldn't be that big a deal."* – **Alan Greenspan, CNBC Interview, September 2019**

Mr. Greenspan's comments reflect a central bankers concern with inflation and funding government debt. What is ignored is that the banking system, which is effectively our financial plumbing, would stagnate with negative yields. And most importantly, the retirement funding for an entire generation of baby boomers gets a whole lot riskier.

Our conclusion at Avenue is that there is now a real risk that, over time, financial assets will be monetized. Monetization of debt is an obscure economics term which can be explained more clearly by saying, big borrowers like the US Government will have no way to pay back their lenders. Government debt is increasingly likely to be paid back with printed money and outright monetization.

Having a defined investment strategy is more important than ever. At Avenue, we believe that if income is needed from a portfolio, then a certain amount of bonds is still appropriate. But we must temper our return expectations. The absolute level of interest rates is just so low.

Investment savings that can be allocated to longer time horizons need to be invested in businesses that have hard asset value and predictable income streams. You have heard us say this many times before. What is different this time is that hard asset investing must be a core strategy to maintain wealth in a world where paper or financial wealth may slowly resemble the analogy of the frog in the pot of water that comes to a slow boil.

The New Economy

Talking about technology stocks is a completely different conversation from what we have been discussing so far. The digital revolution has created the ability to turn the internet and internet connectivity into a useful tool for everyday life. Most of these technology companies don't borrow money from banks. Most of these companies are venture capital funded until they are mature businesses and have large valuations even before they become public companies. Really what we are saying is that you can't throw out a line like "the stock market is expensive" or "a recession is going to impact the market in 2020" unless you clearly define which market you are talking about.

Every corner of the economy from media to transportation to banking is being disrupted. Avenue's problem with investing in technology disruptors, that are purely internet based, is that by definition their businesses and underlying incomes are not consistent. Given the level of competition, it is nearly impossible to create a useful earnings model for these companies that looks ahead five years from now. Where we can observe industry leadership with barriers to entry, for example cloud computing, we find the stocks are very expensive. **(See the Case Study for a more detailed story of WeWork.)**

What Avenue does look for is establish businesses that use these digital tools to improve their existing business. Like Boardwalk REIT making it easy to get renters into apartment units in Alberta. Canadian Natural Resources using driverless trucks in the oil sands. BCE creating the network for 5G in Canada. Enbridge using drones to monitor pipeline integrity.

Environmental Sustainability

The mention of pipelines above, leads us right into the importance of environmental and social issues. The level of environmental scrutiny of all public companies is only going to increase. So far, the biggest effect on Canadian companies is that the building of infrastructure, be it pipelines or ports, has completely stalled. What we have witnessed is that companies we have already mentioned, like Enbridge, are making their new investments in the US. Also, we see foreign investors standing back from making any investments in Canada, for now. The net result is that perfectly solid and profitable Canadian businesses are being neglected because of this overall negativity and we can make new investments at very attractive valuations.

To finish off this quarters letter, here is an example of how valuing a business like the oil sands has changed over the last 20 years. To value an oil sands project, you initially estimate the amount of money needed to build the mine and then determine how much that money will cost to borrow. Then once built, you estimate how much cash can be generated to repay the original money borrowed, plus the accumulated interest. The excess profits determine the rate of return of the investment. For example, 20 years ago $3 billion for pipeline construction was borrowed at 6%. Here 6% is the cost of borrowing money. If when built, the project makes $500 million of operating profit the original money borrowed plus the accumulated interest can be paid off in 7 or 8 years, and the excess profits will deliver the rate of return that shareholders receive. Borrowed money plus interest to build and operate the pipeline were the inputs and up until now, air and water were considered free.

In one generation, the inputs have completely reversed where borrowing money is effectively free at these low interest rates, however air and water have become priceless because of environmental and social concerns. It is very difficult to use traditional valuation tools as all businesses have some amount of carbon footprint. We must be very mindful of what we own and how we profit from our investments.