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THIRD QUARTER 2023 – LETTER

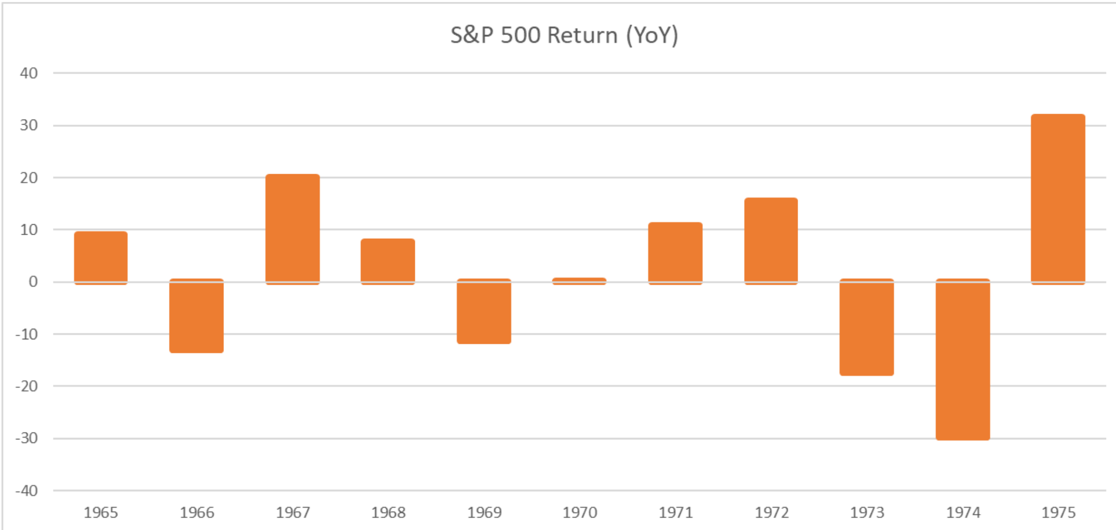
“The way I see it, if you want the rainbow, you have to put up with the rain.”
- Dolly Parton

Dolly’s mindset is exactly what is needed to successfully invest in financial markets. While we have confidence that over time our investments in high quality businesses will appreciate in price, there are also going to be periods when prices are weak. And it is in weak markets where we find opportunities and build the portfolio for future returns.

Avenue’s equity portfolio’s value stayed about the same over the year. While our hard asset stocks in real estate and infrastructure, where we are underweight, have gone down, these have been offset by positive returns in our investments in industrial and consumer businesses. **Going forward, we believe that investors are less likely to expect a consistent smooth annual return from the stock market each year.** We still believe we can compound returns at a reasonable rate over a five-to-ten-year period, but the short-term swings will revert to what has historically been higher volatility, or rather bigger annual swings in prices.

Most investors’ mindset becomes anchored by their recent experience. For the last 15 years, stock market returns have been positive most of the time and only occasionally has there been a bad year, like last year. There have only been two significant down years since 2008. We argue that this is abnormal, and we are more likely to return to the mid-1960s to mid-1970s stock market period where a portfolio could be up 20% one year and down 15% the next, then up 30%.

Stock market returns – 1965 to 1975

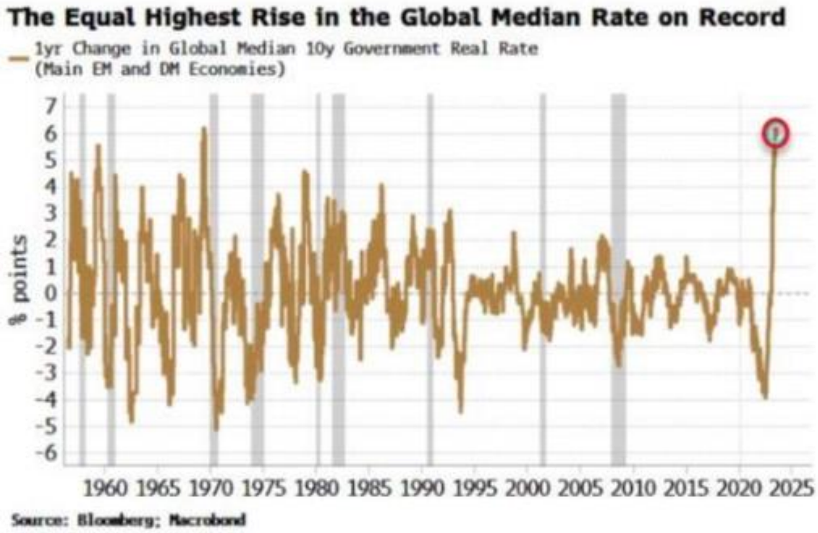


Market Timing is a trading strategy where an investor goes in and out of the market. This strategy is tempting but it would expose us to very risky decision making where we might be in or out of the market at exactly the wrong time. We might risk either taking a big loss or missing out on a big gain, in additional to the tax consequences of recognizing capital gains. Avenue's equity strategy can reduce this type of timing risk by using an approach where we underweight stocks and sectors that become expensive and overweight stock and sectors where we find value. Our goal, as always, is to try and find the best return for the least amount of risk.

The volatility of returns is already back.

One of our stated goals for Avenue's equity strategy is to reduce these swings from individual stocks, as well as the concentrated swings caused by investing in just one sector like technology or healthcare. For example, the big technology stocks represented by the NASDAQ index are up just over 30% this year. This number sounds great except that the NASDAQ index was down 30% last year. Remember, in percentage math problems something that is down 30% then up 30% is not back to the same price. For example, a loss of 30% followed by a rise of 30% would result in $100 dollars becoming $91.

So far, the big volatility swings have been in the bond prices. You can see from the rate of change chart of US 10yr government bond yields, that we have not experienced this kind of rapid price change since the late 1960s. However, we know that we need to invest to protect our savings from inflation. We also have to acknowledge and accept that big price swings can happen. Therefore, we should incorporate this challenge into our investment strategy.

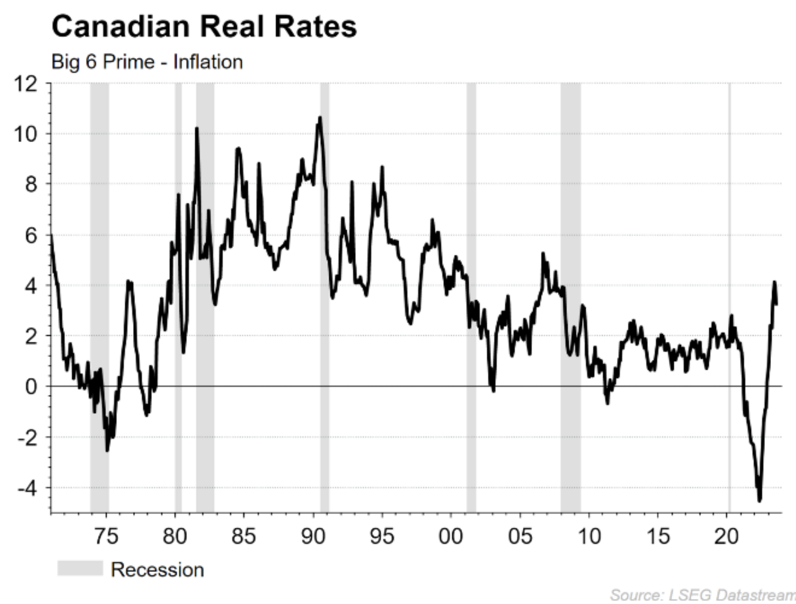


Slow motion rolling recession.

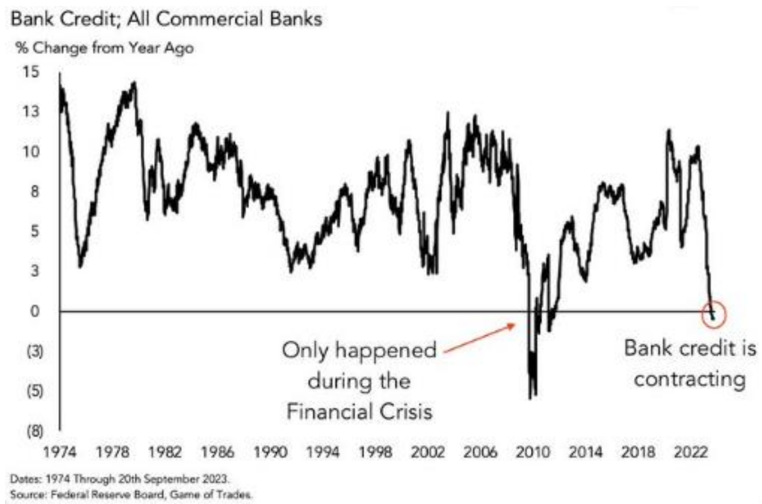
We have been writing now for two years about being defensive and protecting the portfolio from the shock of rising interest rates. The difference from a year ago is that we can now earn a 5% yield on short-term cash. While it feels like a long time to sit tight, we can now see a few economic and financial data points indicating that we might finally get an opportunity to reinvest.

It looks like higher interest rates are finally having an impact on inflation and the economy. The real interest rate, which is a simple calculation of taking the short-term interest rate and subtracting the rate of inflation, is finally positive. This will have the effect of slowing and even reversing asset price inflation.

Real interest rates highest in 15 years

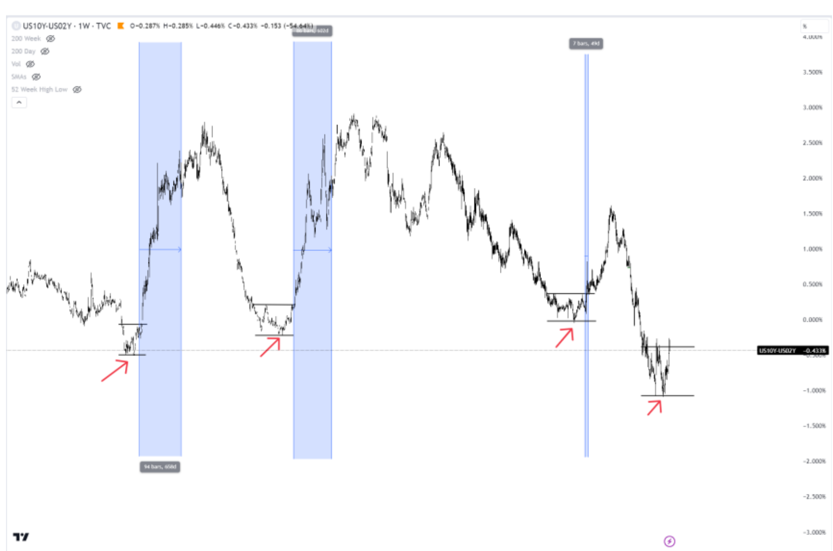


Higher interest rates are reducing bank lending. Subsequently, economic indicators for the economy show that we are finally headed for a recession. Why this is a good thing for investors is one of the quirks of stock market investing. We needed to get defensively positioned before the bad news. But now that we have bad news and a recession can be confirmed in parts of the economy, this will be reflected in lower stock prices and we can start to look to invest our cash over the coming months. When investing feels good we need to be cautious, but when investing feels bad we can look for the best prices.



At the risk of making this too financially detailed, we wanted to show a chart of this important relationship. The financial indicator that we have been patiently watching and waiting to turn positive, is the relationship between the 2year bond yield when compared to 10year bond yield. Just because short term interest rates go up, that does not immediately trigger a recession. Rather a recession occurs at the inflection point where short rates stop going up and may actually fall when compared to the 10year bond yield. Previous recessions are marked by the blue bars.

US 2yr bond minus US 10yr Bond Spread



Are we missing out on not owning the big tech stocks?

Why we don't own any of the big technology stocks is a question we get asked quite often. Our answer is that we did own Apple and Microsoft until a few years ago, then they were sold as we felt they became too expensive. Both these stocks have continued to do well as Apple and Microsoft are both up an oddly identical +32% this year. Whereas these businesses now trade at 40 times earnings, Avenue's US investments trade at 15 times earnings and are not household names, yet. EMCOR is up +45%, Atkore +35%, Constellation Software 28%, Murphy USA 28% and even Canadian Natural Resources is up 20% this year (all owned in the equity portfolio).

Last year we tried to own Meta (Facebook) as its price fell and the underlying business remained resilient. However, our risk management was triggered at a 20% loss. The stock continued to fall 50% before being up 200% this year. Our conclusion is that this type of stock is very hard for us to own given the wild swings in the stock price.

While we sometimes miss out on big wins, it is also the big losses we are trying to avoid with our strategy. Enbridge was sold last year given its interest rate sensitivity and the stock is down -30% this year. Another error made by many investors, but not at Avenue, was forgetting to sell long-term bonds which were bought in the low interest rate environment. An investor in the 'safe' US long bond is now down -50% in a year and half.

Why is there no recession, yet…

As we have stated previously, many sectors of the economy are already in recession. This is not showing up in the official GDP numbers because we have very low unemployment and government stimulus is still so high. In this letter we will again highlight just how big an impact government spending is having on the economy as persistent deficits have now become a mainstream theme for investors.

We will use the US federal debt and deficit to illustrate not just its impact on our North American economy but also global money flows. The total US federal debt outstanding is now $33 trillion and growing. This is in the context of a global debt market of $307 trillion bonds outstanding. So, the government of a country with only 4% of the world's population has borrowed 11% of the money. That number does not include personal or business debt, just the government debt.

The US Federal government expects to spend $6.2 trillion dollars this year but will only take in $4 trillion in taxes. The $2.2 trillion deficit is 9% of the US economy which we measure at $23 trillion. The combined spending on the government itself, defense, healthcare, and education is close to 30% of the economy. So even with higher interest rates, these parts of the economy are not affected.

Higher inflation is incorporated into higher pension costs as many are indexed to inflation. Baby boomers, with savings, are now getting returns on their bond investments and bank accounts whereas a year ago the return was negligible.

Higher interest rates are impacting loans and the financial sectors. However, at this time there is still lots of healthy government stimulus and consumer spending in other areas of the economy.

We have to differentiate between government supported businesses and the financial sector. However, we still have to anticipate how this will change over time.

Why is the Canadian Dollar so weak?

Our final comment is about the US dollar's relationship to the Canadian dollar. Shouldn't the Canadian dollar be higher given the recent run up in the price of oil? Avenue's take on our currency is that we are still in a weak period for the financial system globally. Canada is often, unfortunately, an afterthought in a world which needs US dollars. While this persists, we would like to have more exposure to US businesses, when we can find ones that fit our investment parameters.

Currently, direct US exposure in Avenue's equity portfolio is just over 30%. And when we incorporate our Canadian businesses that own businesses in the US, we measure the total US cash flow coming into our portfolio at over 55%. We can further include an additional 10% where our commodity related businesses produce their resources, like oil, in Canada at lower cost than the US but sell their product at the US dollar price. When we look at our portfolio in this way, two thirds of our income is derived from outside the Canadian dollar.

A Case Study in Quality Stock Picking vs Momentum

There are many strategies for investing in financial markets but at the core most revolve around two basic principles. The first group we can generally describe as “do what everyone else is doing”, which is called momentum investing. The second, which we believe to be a more thoughtful approach, is to constantly seek out businesses where value is not being recognized by the stock market. This is broadly referred to as stock picking.

The problem with momentum investing is that a trend eventually exhausts itself, at which point you really do have to get completely off the train and wait on the sidelines. But nobody is there to tell you how long the trend will last and then when to get off.

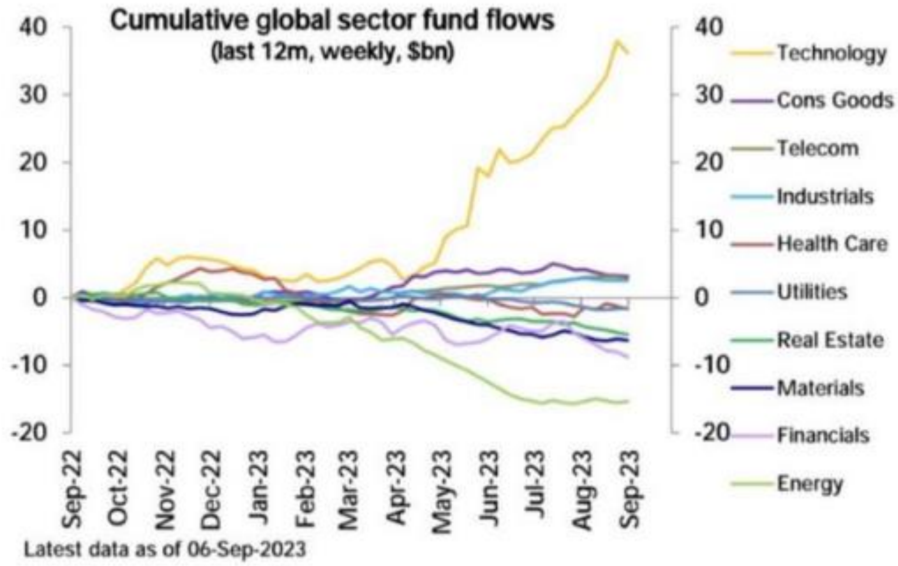
Stock picking strategies vary from targeting distressed businesses that might turn around, to focusing on acquisition targets, to discovering businesses that have lots of cash that is unrecognized by the market. Avenue prefers the stock picking strategy of looking for a diversified group of quality businesses that share the common theme of generating free cash flow and where their stocks trade at a reasonable valuation. We should be able to stay invested to capture the long-term compounding of our stocks and not have to jump in and out in the same way as momentum investing.

The reason we are addressing this now is to highlight the momentum strategy and its effects on a handful of stocks that have taken over investor psychology once again. The chart below shows the S&P500 index which represents the largest stocks in the US compared against the index of all the biggest stocks in the world but without the US stocks. The chart shows 12 years of returns in percentage returns.

What is so striking about the relative performance is the understanding that over the past decade only the US has gone up. You can understand that the resulting investor behaviour is now to get your money into the US large technology stocks at the expense of everything else.

We know an asset bubble when we see one, we just don't know when it is going to end. We believe we are closer to the end point where the technology trend is exhausted because everyone who can buy it now owns it.

The following chart illustrates the exhaustion of this trend. The chart shows that new money flowing into the stock market over the last six months has gone almost exclusively to technology stocks. Yes, we have a potential renaissance in artificial intelligence but profits from AI are a long way off and it is not entirely clear which AI companies will be the winners and which will be the losers.



Source : EPFR, Haver, Deutsche Bank Asset Allocation