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THIRD QUARTER 2018 - MARKET COMMENTARY

The last three months have seen the continuing trend of gradually rising interest rates in both Canada and the US. In this quarter's letter we will elaborate on Avenue's bond portfolio strategy where the majority of our investments are in shorter maturity Canadian corporate bonds. The shorter maturity helps us get through a period of rising interest rates. In Avenue's equity portfolio we have taken profits from some stocks that have done well and reinvested into stocks where we believe valuations have been depressed as a result of rising interest rates. In Avenue's equity portfolio we will also discuss why we have added to our energy holdings and we will comment on our one remaining gold investment.

Interests rates should move in a close relationship with inflation, over time. Inflation in Canada has been relatively stable for the last decade hovering around 2%. The perception was that while inflation was at 2%, the only likely direction was down to 1%. What has changed over the course of 2018 is that while current inflation is still 2%, the next level might be a rise to 3%. Therefore, bond yields are rising and bond prices are falling. Avenue's bond strategy is not to make a big short-term trading call on the direction of interest rates. We capture the higher return from investing mostly in Canadian corporate bonds. In today's environment where interest rates are rising, we keep our average maturing of the portfolio exposed to shorter term bonds. Currently the average maturity is roughly three years.

The purpose of Avenue's bond portfolio is not to hit a target rate of return. The money that is invested in Avenue's bond portfolio is money that needs to be there no matter what. For many clients this is the money they need to live on. We view it much more like a safe bank account but where you will get a better rate of return over time. To state this choice more clearly, you can either have this money in the bank or get a better rate of return from Avenue's Canadian corporate bond strategy. Consequently, it is not appropriate to use this money for investments in the stock market with its inherent risks.

There will be points of time when bank issued Guaranteed Investment Certificates (GICs) or bank savings accounts will have competitive rates. There are also times when short-term interest rates can be higher than long-term interest rates. That doesn't change our belief that if we stay with Avenue's strategy of investing in Canadian corporate bonds over the long term, we will get superior returns. The key investment decision we make is to keep the average maturity low when interest rates are rising and to have a longer average maturity in the portfolio when interest rates are falling.

In this month's Case Study we have put in a chart of Avenue's bond portfolio which shows each bond we own by issuer (who we are lending the money to), the term to maturity on the X axis and the current yield on the Y axis. If we did nothing more to this portfolio and we let all the bonds mature, we would get a 3.5% rate of return over the next five years or so. But in the short term we have to be patient.

We do have a view that there is a limit to the rising rates. In simple terms, if the interest rate for 10-year Government bonds in the US rises to 4%, this will trigger a consumer recession. Once we are clearly into a recession then interest rates will come down again. Therefore, with current US 10-year Government bond yields at 3.25%, we feel the majority of the move has already happened.

Avenue's equity portfolio strategy has a different way to take advantage of rising interest rates. We have reduced the size of some of our holdings that have done well and which are now a bit expensive, and we put that money into sectors like Real Estate and Utilities that have been depressed by rising interest rates. Yes, the news headlines read that the US market is at all-time highs and we are now almost 10 years into this bull market, which implies we should be cautious. However, that characterization is a bit simplistic. Most of the gains in the US are in just a handful of technology stocks.

There are other parts of the stock market where we find good consistent businesses, and the valuations are reasonable. We have bought WPT industrial real estate which owns warehouses across the United States and we have made a second attempt to invest in AltaGas. In January we sold AltaGas because interest rates had just started to rise and given their high level of debt. At today's stock price we think the stock market is already pricing in all the negative news, which has given us a good opportunity to buy shares.

Canadian energy stocks are another area where we believe we can invest in good companies and the valuations are reasonable. As with interest sensitive stocks, the headline news for the Western Canadian energy sector is alarmist. There is a fear that Canada will never get another pipeline built so the price for Canadian oil and natural gas will remain low for a long time. We believe enough pipeline capacity will get built in the next two to three years to help the Western Canadian oil price recover. Also, Shell's newly announced West Coast project to export liquified natural gas will improve the sentiment for natural gas pricing, again in the two to three-year time frame. We have added an investment in Arc Resources and added to our position in Vermillion.

A closing comment on our one gold investment in Roxgold which has not done well this year. We know the company well and we added more shares at $1.09 on the way down. The company has a uniquely profitable gold mine in West Africa. However, the company lacks a catalyst for what will happen next. We believe that either the profits will get returned to shareholders or the company will get bought in the near term. If either of these events don't materialize, or the corporate strategy changes, we will likely sell the position.