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FIRST QUARTER 2018 - MARKET COMMENTARY

In the first quarter, Avenue's Equity Portfolio experienced its first decline since January of 2016. The Avenue bond portfolio's performance also had a small decline. Both portfolios were affected by the market's reaction to rising inflation expectations as interest rates rose and the added new risk of a global trade war reduced the outlook for corporate profits. We were conservatively positioned ahead of this market move and we argue that a significant amount of the correction has already taken place. In Avenue's equity portfolio, we have already taken advantage of a few compelling valuations and we have trimmed some investments where the company's debt level may be perceived as a problem in a higher interest rate environment.

Avenue's bond portfolio strategy is not about trading bonds. For most of the bond investments, we buy the bonds then hold them to maturity. We still have to make one fundamental forecast as to the level of interest rates in the medium term. The bond investments will have shorter maturities if the outlook is for higher interest rates or longer maturities if the outlook is for lower interest rates.

Currently, much of the discussion around the level of interest rates is centered on the US 10-year government bond yield. Currently the yield is 2.8% and the fear is that interest rates will continue to increase to 3.5% and maybe even 4% level. Interest rates are rising to offset the strength in the North American economy. The North American economy may finally have some inflation, given the economy is close to full employment.

A further interest rate rise of this magnitude is possible but will not likely be that disruptive to the bond market. It is true that a 10-year US government bond yield rising to the level of 5% to 6% would dramatically affect all markets. This is the level where large sums of money would switch from stocks to bonds. However, we don't believe this is likely because if interest rates rise above 4%, it would trigger a consumer recession. Avenue's position is that interest rates can move slightly higher but most of the move and psychological impact has already happened. Avenue's bond portfolio will mark time as interest rates increase in the short term, but returns will resume as soon as interest rates stabilize.

This quarter's Case Study includes a relevant and descriptive picture titled: "Ten-year US Treasuries: the end of the long decline in yields?"

This interest rate change is playing out in the stock market as well. As we have written many times, Avenue's equity portfolio looks to invest in consistent, profitable businesses. These types of businesses usually borrow some money so an increase in interest rates will decrease their profitability over time as bonds are re-issued. So as interest rates have increased, the stock prices of some of our investments have declined.

In last year's Avenue cocktail party presentation, we showed a slide of the two pullbacks in Avenue's equity portfolio over the last 10 years. The first one in 2012 was of 5.6% and one at the beginning of 2016 was 7.9%. So far Avenue's portfolio is down roughly 6% from the November 2017 high. We believe most of the pullback has already taken place for our type of investments and our core long-term holdings are trading at much better valuations.

Given the volatility in February and March, we have much higher activity than normal. We pared back, selling partial amounts in areas where we felt there could be higher risk of a pronounced correction and added to existing investments where we felt the valuations were already compelling. All the trades where the security is completely new or where the security has been totally sold are listed with a description in the trading section of this quarter's letter.

Of course, we ask ourselves if there are further risks out there. Two risks are that higher interest rates might tip the economy into recession and a trade war would slow the entire global economy. To protect ourselves, Avenue's equity portfolio is still conservatively weighted with an 8% cash position. Also, many of our investments are more insulated from the economy as they are what are called consumer staples as opposed to consumer cyclicals. Plus, as new money from dividends continues to flow into the portfolio, we actively look for new opportunities to invest.