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## AMG SUMMER 2011 COMMENTARY

After receiving some pretty encouraging economic data in the first quarter on the employment and manufacturing growth fronts, global financial markets struggled in Q2. The reasons for this souring of optimism are multivariate, but my view is that “knock-on” effects of the Japanese tragedy in March were the primary catalyst.

First off, the nuclear emergency at Sendai wrought a fear and loathing upon the entire global industry for nuclear power and boosted the prices of alternative energy sources, most notably oil. Crude oil remains the lifeblood of the global economy and its price was already elevated as a result of supply disruptions caused by civil uprisings throughout the Arab world. There is a well established inverse relationship between the price of crude and economic growth, and even a short price spike can have lasting effects. Although oil only topped \$115 per barrel for a short period in April, that was all the braking force needed to derail consumer momentum through April, May, June, and into early July.

The second effect was the impact that offline Japanese manufacturing capacity had on the global supply chain. The extent to which Japanese industry is integrated into the global manufacturing economy was underestimated by corporate executives in the wake of the tsunami. As a result, alternative suppliers for many high tech components in other nations were not able to scale up quickly enough to replace lost Japanese capacity. This had a braking effect similar to that of an oil shock, but on the production (as opposed to consumption) side of things.

The consequence of these combined factors was a marked reduction of optimistic sentiment towards, and confidence in, the midterm economic outlook, by consumers, investors and corporations. They expressed this negative sentiment in many ways: lower spending on consumption; lower levels of fixed investment; fewer hires in the workforce; lower investor risk tolerance, and so forth. These are economically constricting behaviors that markets don't like to see and can usually result the sort of correction / consolidation in stock prices that were seen in May-June period. Were not of the mindset that recession is back upon us however.

Adding to the market headwinds this quarter was a continuing spell of horrible weather for some major agricultural areas around the globe. While much of the Canadian wheat and US Corn acreage remained flooded well into June this year due to torrential rains, the crops in Australia and China have barely seen a drop since last October. Expecting this to translate into higher agricultural commodity prices, we have been playing this thesis through the Dow Jones Grain Index (JJG). In spite of the aforementioned supply stresses, we're down about 10% on the position although market forces seem certain to push prices higher eventually.

And finally, no discussion about financial market performance this month can escape a mention of the politicking and brinkmanship presently being displayed on each side on the Atlantic. It's almost as if leaders in America and the Eurozone are playing a game of ineptitude one-upmanship. Clearly the inability to design and implement solutions to their respective debt problems at the legislative level are amplifying market volatility, and beginning to draw the ire of trading partners, ratings agencies, bond vigilantes, the IMF, you name it. Without taking any particular political side in the matter, the current situation of apparent impasse reminds me of a line from a May 1977 article that Warren Buffet wrote for Fortune magazine: “*When very human*



*politicians choose between the next election and the next generation, it's clear what usually happens."*

Of course, it's not all negative. Monetary policy remains extremely accommodative with short term rates anchored near or below zero in real terms. Liquidity continues to flow freely from the spigot and its effects, although not tangibly visible, are much appreciated by global markets. Policy makers remain adamant that the recent inflationary spikes in energy and other commodities are transitory and consumer price levels are appearing to turn down from their highs earlier in the quarter. Lower inflation gives central banks more policy freedom to enact further stimulative measures, and many have stated that they stand prepared to do so should events warrant.

The low rate environment means also that investors, especially income-focused ones, have to adjust to generate target returns and this is increasingly forcing them to add to equities, emerging markets, and hedge funds. As I've said before, there really isn't a stand out investment alternative to equities (or equity-replacement strategies like hedge funds) right now for long term investors. In addition, equities are generally cheap given our outlook for earnings over the coming year and we expect companies to post excellent results in the coming reporting period. Early bellwether reporters in a variety of industries – Finance, Technology, Consumer and Resource – have all done just that. Because of these factors, we've largely maintained our equity and hedge fund allocations in client accounts through the recent volatility. I believe that upon resolution of some of the macro headwinds out there, we will see a sharp upward movement in stocks as the risk premium erodes, perhaps similar to what occurred at the end of June when stocks rose 7% in 7 days. These moves can be tough to spot in real time and even tougher to catch if we're out of the market and want to get back in, so we'll rely on the below-average beta of our client portfolios to manage downside equity market risk for the time being.

Another effect of negative real interest rates in much of the developed world is that confidence in paper currencies remains on the decline. At the end of June we are long Gold bullion and Gold miners in a substantial way as an alternative equity exposure. These have been rewarding positions to hold, with Gold recently spiking to new highs (in all major currencies save the Swiss Franc) just under US \$1,600 per oz. In terms of straight long equities, we continue to hold large exposures to energy companies and yield-producing entities such as REITs and Pipelines, many of which are at or near 52-week highs. We've also added a couple new US biotech names recently, Immunogen (IMGN) and Seattle Genetics (SGEN). Both of these companies are active in a field called antibody drug conjugates, and are working on cancer therapies that are both (a) more potent, and (b) less toxic than existing treatments. The sector is seeing major interest from big pharma companies like Pfizer, Amgen, Novartis and Roche.

Hedge funds in general have been performance challenged so far this year, and many of the industry's heaviest hitters are materially underwater at the midway point. Our managers, Vertex, Picton Mahoney and Man AHL have been middle of the pack performers relative to their peers, but still each of the 3 trail their respective benchmarks by a small amount as at June 30<sup>th</sup>. We're looking at making some change ups to the external manager roster in the coming months and as such our due diligence is ongoing.

Looking forward strategically, I think that the investment activities of large global hedge funds will be a major driver of how markets behave in the second half, for



several reasons. First, these funds collectively control over a trillion dollars of actively managed capital that needs to be invested; Second, many of these funds are materially underwater for the year to date period, a position they find extremely uncomfortable; And third, they represent “hot” money, meaning that if they fail to generate positive returns many fund managers could see substantial redemptions. As a result, it’s expected that they’ll aggressively pick up risk in an attempt to generate performance over the next 6 months.

Many of the most disappointing performers this year represent the “global macro” category, meaning they have “go anywhere, do anything” mandates. Over the last few years, the universe has offered up two extremely successful trades for these fund managers, and it’s likely that we’ll see them revert back to what’s worked in the past, given the opportunity. The first is attacking the balance sheets of fiscally weak sovereign nations, and the second is front-running the US Federal Reserve. This will probably result in continued high levels of two-way volatility, and we could see some winning long strategies and winning short strategies really develop for these investors. An example of this would be to short Spanish government bonds and use the proceeds to go long Swiss Francs against the Euro, for instance.

One of the things that could put a crimp in crowded trades like this, and something that I believe we will see sooner or later, is an expanded support package in explicit terms from China for the Eurozone. This support will probably come on attractive terms and may seem like it’s for the benefit of the continent, but in fact will be self serving in nature. In the face of persistently high inflation China will need to keep its export growth strong, and it understands that just as a stronger Euro means a weaker trade-weighted Dollar, it also means a weaker trade-weighted Yuan, through CNY’s managed peg.

Finally I think that we’ll be seeing increased levels of consolidation in the North American energy space. There has already been a lot of acquisition activity over the past year, particularly in the shale gas space, as majors such as Exxon, Chevron and Shell seek to add onshore resources to reserves. With the recovery in capex spending by the North American E&Ps, it looks poised to be an active drilling season. Companies that are successful in delivering meaningful growth from the drill bit in hot formations will become attractive bolt on acquisition targets.

As always, our deepest thanks for your continued support and trust. Here’s hoping that you’re able to capture the most out of this summer whether it be centered around family, friends, time outdoors, or time overseas.

As always,



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