EUBEL BRADY & SUTTMAN
ASSET MANAGEMENT

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October 2008

Special Market Commentary: Five Influences

In light of the current environment and the abundant amount of news flow, we are sharing our views on five drivers of current and future stock market activity.

An overview:

- Investor Sentiment—In a depressed-like state, similar to extremes at bear market lows
- Volatility—Extremely high, consistent with past market bottoms
- Valuations—Very compelling
- Commodities—Significantly cheaper than 90 days ago (more $ in consumers' pockets)
- Government Intervention—Actions to restore confidence in the financial system and prime our economy occur almost daily. The list of actions is long, but investor patience is short. Patience is warranted.

<u>Investor Sentiment</u>

Investor sentiment is in the gutter – hitting an all time low – and logically so. Equity markets are down and the economy has weakened. Since recent experience heavily influences future expectations, investors tend to extrapolate current trends beyond reason. This extrapolation breeds fear thereby pushing markets to extremes which is where we believe markets are today. The media fuels the fire with its sensationalism. Ultimately, it can be helpful on the investing front, causing share prices to diverge from business values—greatly—thus creating opportunities for rotation within portfolios or for deploying new capital. Market history supports our conviction: opportunities abound when fear and panic have gripped investors.

<u>Volatility</u>

Recent daily market moves have been colossal. At this point in history, we are experiencing the highest levels of 30-day volatility in the S&P 500*. As of October 28th, the 30-day volatility for the S&P 500 was approximately **5.1%**. A more normal reading would be **2%** or less. At a minimum, volatility is **2.5 times** greater than is typical. This reflects indecisiveness and forced selling in equity markets. In such periods, shares typically migrate from speculators to investors (like you and us).

* Definition: Standard deviation of the daily percent price change over the trailing 30 days. Data was reviewed from 1940 to present.

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Valuations

From where we sit, great companies are on sale. As of October 28th our portfolios, in general, had an average price-to-earnings ratio of 11 and an average price-to-book ratio of 1.3. This is cheap on an absolute basis and relative to the S&P 500 which is itself arguably undervalued. In an analysis of the S&P 500, the Leuthold Group (an independent research group) found that from its current undervalued levels, the S&P 500 has historically produced annual returns of 15.7% compounded over three years and 15.1% compounded over ten years. Their analysis was conducted over a span of fifty years (1957 to October 10th, 2008) and evaluated the normalized price-to-earnings over a rolling five year period. Quality opportunities are numerous, as you may have surmised from the elevated level of portfolio activity. Much of 2009's anticipated bad economic news appears to be priced into stocks. As a side note, 41% of the S&P 500 companies have reported quarterly results, 62% have topped estimates. Not great, but not too bad.

Commodities

Most commodity prices have fallen significantly since July. Since July 2, 2008 examples include: crude oil -53%, natural gas -44%, copper -55%, aluminum -38%, steel -54%, lumber -28%, and wheat -52%. This is a huge shot in America's economic arm. A recent Barron's article estimates the "energy dividend" could be $170 billion in six months if oil holds at $80. Whatever the economic benefit turns out to be, rest assured it will be substantial and it seems to be presently underestimated in the equity markets. As a side note, it is amazing how much press time the media gave oil at its peak, but today when oil is significantly cheaper (a plus for our economy), the media is treating it as a nonevent, relatively speaking.

Government Intervention

The number of U.S. and global government interventions is too long to list. What should you take away from their efforts? Governments around the globe are pulling out all the stops and it is unlikely that a coordinated effort on such a large scale will fail. A little patience is needed because our economy is a behemoth and much like an ocean liner, takes a while to turn. A likely outcome is restored confidence in our domestic and global financial system and eventually confidence that U.S. and world economies will survive. The US Treasury announced plans to guarantee balances in most money market accounts as of September 19th, 2008. Further and more expansive government actions to support money market accounts announced on October 21st have been welcomed. Overnight LIBOR, a key global interest rate, shot up to an all-time high of 6.88% on September 30th. In the wake of many of the government actions, this rate has since fallen to 1.14% (as of October 29th). This is a small piece of evidence that credit tensions are easing; a critical step toward stability and recovery. Yes, economic data may worsen, but with regulators and Treasury finally doling out "TARP" (the $700 billion rescue) funds, we believe that more stability and confidence is coming.

<u>Gist of it All</u>

As we measure fear and volatility in the marketplace we notice that both are at extremes today. This is historically consistent with turning points in the stock market. Combine the extreme emotion (fear), the extreme volatility, the cheap valuations, and the financial underpinnings to foster long-term economic growth and you have a recipe that ought to yield a good outcome for stocks. Lower commodity prices, in concurrence with governments' determined efforts to re-liquefy credit markets, should pave the way for better times.

Fast-paced indiscriminant selling, some of which is forced selling, has impacted the share prices of financially weak and strong companies alike creating opportunities in high quality companies across small-, mid-, and large-cap securities. Expect continued portfolio activity as we work to capitalize on new opportunities.

We judge share prices to be depressed well below where they should be when considering America's longer-term earnings power, despite the current economic contraction. Using history as a guide, the market generally bottoms when the economic picture is gloomy and uncertain and rises sharply before enthusiasm and clarity resurface. With the stock market damage seemingly and largely behind us, in our opinion, we anchor investment decisions on fundamental valuations with long-term optimism.

We continue to believe that the best opportunity to achieve investment success is to focus first on the process, not the outcome. If we stay true to our disciplined process – a process we believe to be sound and proven successful – the desired outcome of investment success will follow.

Thank you for the continued opportunity to serve your investing needs. We welcome any questions that you may have—and look forward to more rational market behavior.

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Market and economic data has been provided by third party sources. This data, while believed to be reliable, has not been independently verified by EBS.