EUBEL BRADY & SUTTMAN
ASSET MANAGEMENT

MARKET REPORT
FOURTH QUARTER 2018

Key Takeaways

- Various asset prices fell throughout the world during the quarter and year due to a variety of factors. As a result, more opportunities are surfacing and we have the dry powder to capitalize on them.

- Economies and financial markets do not always move in lockstep: In any particular year, good corporate earnings growth and economic growth do not always translate to stocks or bonds performing well for investors.

- We believe the number of investors who trade based on non-fundamental factors has contributed to recent market volatility and may provide opportunities for fundamental investors like us in the future.

Total Return as of December 31, 2018						
				Annualized		
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	-13.5%	-4.4%	-4.4%	9.3%	8.5%	13.1%
NASDAQ	-17.3%	-2.8%	-2.8%	11.2%	11.1%	16.9%
Russell 3000						
Index	-14.3%	-5.2%	-5.2%	9.0%	7.9%	13.2%
Value	-12.2%	-8.6%	-8.6%	7.0%	5.8%	11.1%
Growth	-16.3%	-2.1%	-2.1%	10.9%	10.0%	15.2%
Russell Mid Cap						
Index	-15.4%	-9.1%	-9.1%	7.0%	6.3%	14.0%
Value	-15.0%	-12.3%	-12.3%	6.1%	5.4%	13.0%
Growth	-16.0%	-4.8%	-4.8%	8.6%	7.4%	15.1%
Russell 2000 (Small Cap)						
Index	-20.2%	-11.0%	-11.0%	7.4%	4.4%	12.0%
Value	-18.7%	-12.9%	-12.9%	7.4%	3.6%	10.4%
Growth	-21.7%	-9.3%	-9.3%	7.2%	5.1%	13.5%

Overview

During the quarter, the world economy and corporate profits continued to grow. However, a myriad of fears – including the potential for slower global economic growth and corporate profits, increases in various interest rates, trade conflicts, debt-related issues, and asset valuations lacking significant downside protections – weighed on various financial markets and contributed to significant downside in global stock markets for the year. During 2018, numerous stock markets around the world experienced bear markets (defined as drops of 20% or more) and others came close. And it may not be over...time will tell.

Here we compare aspects of the current market environment with some of the market characteristics discussed in the last quarterly letter for 2017:

What We Said at the End of 2017	What We are Saying Today
Valuations are not cheap, similar to the start of the previous referenced downturn periods.	Valuations in general are still not very cheap relative to fundamentals, but have become less expensive with the market offering up more opportunities to purchase investments with what we perceive to be satisfactory margins-of-safey.
We see little fear from market participants of market downturns, much like there was little fear before 2000 and 2008. Instead, the largest fear we see is the "fear of missing out" on potential upside.	This has changed as volatility has increased and more investors are running for the door. For example, the Wall Street Journal reports that in the largest monthly outflow since at least 1992, investors removed a net $75.5 billion from U.S. stock-based mutual funds and exchange-traded funds in December.
This is arguably the second longest bull market on record (the bull market ending in 2000 was arguably the longest), and related to the point above, retail investors have large allocations toward stocks (e.g., a recent survey from the American Association of Individual Investors showed their members' allocations toward stocks at 72%, the highest allocation since they reached 77% in 2000).	Per the American Association of Individual Investors, by December retail investor allocations towards stocks decreased to 62.4% as allocations towards cash rose to 21.8%, a nearly 6 year high.
A belief by Main Street and Wall Street in relatively new asset classes regardless of the assets' underlying fundamentals (e.g. dot-com stocks before 2000 downturn, investment derivatives and securitizations before 2008-2009 downturn, cryptocurrencies such as Bitcoin at the current time).	Bitcoin, the poster child for new cryptocurrencies, fell about 70% and lost approximately $160 billion in value as people became less interested in the currency and real world uses for the currency are seemingly lacking.
Central banks are viewed by many as creditworthy institutions that know what they are doing.	We believe by year end, more stakeholders are questioning the judgement of the U.S. Federal Reserve and whether it should be increasing short-term interest rates or not.
The potential for unforeseen events not being priced into markets (e.g., Attacks on September 11, 2001; Bear Stearns and Lehman Brothers failing as housing prices tumbled during 2008-2009 period; cyberwarfare, nuclear war, or significant trade wars today).	We think various trade conflicts fell in this category in 2018.

We believe investor psychology changed a fair amount during the year as investors became more risk averse. It is also worth reiterating something we have mentioned in past discussions with clients: Increases in earnings and economies do not mean asset markets will increase too. Recent examples are below:

- U.S. corporations are expected to have grown earnings over 20% in 2018 by the time all the data is reported in 2019 (a very impressive number), but U.S. stock markets generated negative returns in 2018.

- China's reported GDP is expected to be greater than 6% for 2018 (once again when all data is reported). While the reported GDP number is expected to be much better than the final reported U.S. GDP number for 2018, China's stock markets suffered worse than U.S. stock markets in 2018.

The good news is that valuations came down and opportunities to find investments with improved margins-of-safety increased. Having portfolios defensively positioned for quite some time, we feel we can not only unearth some of these opportunities, but have dry powder to capitalize on them. While many fret about the increased volatility and decreases in asset prices, we see them as giving us opportunities to plant the seeds (buy low) for potential success in the future (sell high)…Warren Buffett likens asset prices going down to providing him a chance to buy hamburgers on sale. Regardless of what analogy you use, these are improved hunting grounds for long-term, risk averse investors.

One area that we will touch on later has to do with the significant prevalence of trading occurring in U.S. stock markets without the consideration of companies' fundamentals. But first, we review stocks, bonds, and commodities.

U.S. Equities

The S&P 500 fell 13.5% for the quarter (including dividends), which wiped out all the gains through the first three quarters of 2018 and some of the 2017 returns, resulting in a decline of 4.4% for the year.

Utilities was the only sector with positive returns for the quarter (a slight 1.4%), as it is seen as a defensive area with higher-than-average dividend yields. In addition, utilities are generally U.S.-based businesses that are not as directly susceptible to trade conflicts when compared to more international companies prevalent in other sectors. Utilities and healthcare outperformed for the year. Healthcare companies gave up some of their annual gains during the quarter, but have been growing their earnings at a good clip. These businesses typically hold up better in more difficult economic environments than many other sectors.

Although most sectors generated negative returns for the quarter, technology, industrial and energy sectors led decliners. Industrials and technology seemingly suffered from slowing global demand, trade conflicts, the potential negative impacts of interest rates and cost inflation on their businesses, and higher valuations declining. Fears of too much supply in the face of too little demand was a familiar dynamic that contributed to the difficulty in energy and materials sectors, which were the biggest underperformers for the year.

Large caps outperformed small caps during the quarter and the year. Statistically, inexpensive stocks outperformed their expensive counterparts during the fourth quarter but trailed during the full year.

Fixed Income

Corporate bonds, as measured by the BofAML 1-to-10 Year Index, rose 0.6% during the quarter but declined 0.2% for the year. U.S. Treasuries and Agencies, as measured by a similar index, increased 2.2% for the quarter and rose 1.5% for the year. The 10-Year Treasury bond's yield decreased to 2.7% from 3.1% at the end of the third quarter but increased from 2.4% at the end of 2017. During market downturns, many investors move to government bonds because they are viewed as a safe haven. This increased demand during the market havoc of this quarter drove various government bond prices higher, making them even less attractive for the longer term in our view (they have skimpier yields now). At the same time, market fears have made investment grade and high yield bonds more interesting.

However, in general we continue to be wary of debt investments with fixed rates and long maturities. We are reluctant to take what we believe is significant interest rate or credit risks unless we are adequately compensated to do so.

Commodities

Commodities, as measured by the Bloomberg Commodity Index, declined 9.4% during the quarter and finished the year down 11.2%.

West Texas Intermediate oil was up 21.2% through three quarters of the year (from $60.42 at the end of 2017 to $73.25/barrel by the end of the third quarter), but finished down 24.8% for the year at $45.41/barrel. U.S. exemptions provided for numerous countries to purchase oil from Iran, coupled with market fears described earlier in this letter, contributed to the eye-opening decline in oil prices.

Investors Paying Less Attention to Business Fundamentals

As briefly mentioned earlier, an increasingly significant portion of market trades are taking place without assessing businesses and their economic prospects. Quantitative funds (investors that primarily use technology and non-humans to make trading decisions) now make up more than 28% of all trades. When combined with other market participants that may not assess company fundamentals (e.g. index fund investors, short-term traders), it is estimated that approximately 85% of trading volume occurs without much regard for how underlying businesses are doing and their value.

We believe this large share of trading volume by non-fundamental investors has contributed to the kind of recent volatility in the Dow Jones Industrial Average as described by the Wall Street Journal: “During a dizzying Christmas week, the worst-ever Christmas Eve selloff was followed by the biggest one-day point gain on record and an 871-point swing on Thursday. The Dow changed direction 19 times during Friday’s trading, ending the day down 0.3%.”

While the downside volatility may not feel good at any point in time, we believe the increasing prevalence of these market participants can provide opportunities for fundamental investors like us to take advantage of the volatility. For example:

- If quantitative funds sell stocks for non-fundamental reasons, they may push the stocks low enough that their prices become attractive relative to their business prospects.

- Investors could sell out of index funds as markets fall, thus potentially exacerbating market declines regardless of business fundamentals, and providing us opportunities to purchase assets at more attractive prices.