EUBEL BRADY & SUTTMAN
ASSET MANAGEMENT

MARKET REPORT
FOURTH QUARTER 2019

Key Takeaways

- The Fed had a pivotal role in 2019.
- The investment world was arguably turned on its head during the year.
- "This time" is unlikely different.
- Keep reading for The Good Stuff.
- Equity markets aren't pricing in any missteps, in our view.

Total Return as of December 31, 2019						
			Annualized			
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	9.1%	31.5%	31.5%	15.3%	11.7%	13.6%
NASDAQ	12.5%	36.7%	36.7%	19.9%	15.0%	16.1%
Russell 3000						
Index	9.1%	31.0%	31.0%	14.6%	11.2%	13.4%
Value	7.5%	26.3%	26.3%	9.3%	8.2%	11.7%
Growth	10.7%	35.9%	35.9%	19.9%	14.2%	15.1%
Russell Mid Cap						
Index	7.1%	30.5%	30.5%	12.1%	9.3%	13.2%
Value	6.4%	27.1%	27.1%	8.1%	7.6%	12.4%
Growth	8.2%	35.5%	35.5%	17.4%	11.6%	14.2%
Russell 2000 (Small Cap)						
Index	9.9%	25.5%	25.5%	8.6%	8.2%	11.8%
Value	8.5%	22.4%	22.4%	4.8%	7.0%	10.6%
Growth	11.4%	28.5%	28.5%	12.5%	9.3%	13.0%

The Year in Review

After a brief dose of welcomed market turbulence in the final weeks of December 2018, U.S. equity markets stabilized in January and began marching higher – led once again by technology stocks. This change in sentiment concurred with Federal Reserve Chairman Powell's (the "Fed") remarks that future interest rate increases would be data dependent, as opposed to a foregone conclusion, and the Fed's bond reduction program wasn't really on "autopilot" as previously implied. This change in perspective coupled with indications of preliminary progress on trade negotiations between the U.S. and China spurred market participants into action. The market's proverbial glass was again half-full.

Modest downside volatility returned during the second and third quarters as concerns about slowing economic growth, U.S. – China trade tensions, Brexit and civil unrest in Hong Kong mounted. The Fed, desiring to extend the longest economic expansion in U.S. history, reduced short-term interest rates by 0.25% in August, September and October. Additionally, it injected billions of dollars into the system after overnight interest rates spiked to around 10% intra-day on September 17. This loosening of monetary conditions was embraced. Stocks sprinted higher through year-end, while bond yields declined and credit spreads contracted – lifting bond prices. When comparing average stock valuations for year-end 2019 to 2018, multiple expansion largely drove stock returns. In other words, stocks generally became more expensive as the year progressed.

One could argue the investment world was turned on its head during 2019. Who would have thought investors would buy stocks for income and bonds for capital appreciation? Based on the valuation at which many dividend paying stocks trade, they are undoubtedly coveted. Speculation in long bonds has run rampant in recent years as yields have declined, lifting their prices markedly. This scenario is a byproduct of negative yielding debt, globally. We devoted ink to the topic during the third quarter, so will spare you here. Negative yielding debt remains bizarre and misunderstood, in our view. There is a chance for normalcy. The world's oldest central bank, Sweden's Riksbank, was the first of the European central banks to abandon its negative interest rate policy on December 19. Other central banks are watching for clues as to how this policy change is being received.

Taking into consideration the risks not taken in our various strategies, we are pleased with our absolute results. Although we are unlikely to keep pace with momentum and growth strategies during frothy markets, we believe the persistent application of our value-oriented investment process will lead to favorable compounded returns over time with less indigestion.

U.S. Equities

Ten of 11 economic sectors supported the S&P 500's 9.1% quarterly increase, including dividends. Technology (+14.4) and Health Care (+14.4) tied for first place, followed by Financials (10.5%) and Communication Services (+9.0). Only Real Estate (-0.5%) was a detractor.

Growth, as categorized by Russell (table, page one), outpaced value for the quarter. The degree to which it has done so over the last one and three years is unusual and arguably unsustainable. You may note that the disparity increases as you go from the bottom to the top (small-cap, to mid-cap to broad based index). A few, in some cases very expensive, large cap technology companies drove cap-weighted indexes. Unsurprisingly, the "this time is different" gremlins have started to come out. In investing, "this time" is rarely different. Fear gives way to greed. Greed causes prices to be bid up, eventually to unsustainable levels. Then, almost instantaneously, market participants decide profitability and valuations are important. This cycle has repeated itself countless times throughout history. Unless human psychology has changed, this time won't be any different. As the late, legendary investor Philip Fisher once said, "The stock market is filled with individuals who know the price of everything and the value of nothing."

A recent Wall Street Journal article, *Tech Backers Fed Up with Freebies*, made us smile: "The discounts and freebies many tech startups have used to lure customers – free lunch delivery, $3 beauty products and bargain taxi rides – have fallen out of favor with investors who are losing patience with the failure of these companies to turn a profit. The proliferation of subsidized products and services from venture-capital-backed startups over the past decade reflected a rush by investors to fund the next behemoth consumer tech company." Abundant and cheap capital can cause investors to do dumb things, in our view. Eventually, profits and an adequate return on the capital invested must accompany growth to drive shareholder returns.

Fixed Income & Commodities

Corporate bonds' total returns, as measured by the BofAML 1-to-10 Year Index, increased 1.1% during the quarter. U.S. Treasuries and Agencies, as measured by a similar index, were flat 0.0% for the quarter. Beyond the two-year mark, Treasury yields increased along the yield curve. Corporate bond yields generally declined during the quarter and credit spreads contracted, lifting bond prices. In light of full equity valuations, the number of convertible security opportunities remains limited.

Commodities, as measured by the Bloomberg Commodity Index, increased 4.4% during the quarter. Oil (WTI) finished the quarter up 12.9% and 34.4% for the year, yet energy related shares haven't felt the positive impact of higher prices. Institutional investors continue to pressure exploration and production companies to live within their cash flows and likely remain frustrated by the lack of adequate returns. Low prices are often the solution to low prices in the commodity space. In other words, reduced capital spending on exploration and production usually leads to reduced supply, which often leads to higher prices.

The Good Stuff

From our perspective, knowing what you own, why you own it and what it's worth is important – a business-like approach to investing. To give you a sense of how goofy we perceive things have once again gotten in corners of the technology space, we offer the following excerpts from a global investment firm's recent research report we reviewed relating to internet related issues:

> *"Loss-making IPOs have brought the valuation debate around consumer Internet to the forefront, calling into question the usefulness of 'traditional' valuation frameworks." And "Why this Framework is Relevant: Before revenue multiples became the norm to value high-growth companies, varying forms of discounted cash flow methodologies were the primary method. However, many early-stage growth companies trading in public markets today have a long way to reach profitability and free cash flow generation. Consequently, new valuation constructs may be needed … for valuing these high-growth companies."*

This reminds us of the '99 – '00 era when investment banks and analysts were touting an array of new valuation methodologies for freshly minted tech IPOs, because that was the only way share pricing could be justified. In case you are concerned about us being dazzled by such sorcery, let us put your mind at ease: We pledge not to stray from our time-tested value-oriented investment process

The folks over at value investing shop Tweedy Browne recently surfaced an old Barton Biggs quote from early 2000 when he was admonishing investors. Barton was an esteemed equity strategist at Morgan Stanley and shared the following words of wisdom:

> *"Don't despair on value, and for goodness sake don't fire value managers now and hire growth firms. In fact, the rational brave fiduciary with a contrarian bent should be doing just the opposite." He reportedly "wrote these words just two weeks before the technology bubble burst in late March 2000, heralding in a period of significant outperformance for the beleaguered value strategy."*

Looking Ahead

From our vantage point, equity markets are not pricing in any missteps, yet there are plenty of things to be mindful of: slower than expected economic growth in the coming year, lower than expected corporate profitability, higher than expected unemployment, increasing credit default rates, a flare up with Iran or North Korea, unreconcilable trade differences with China and higher interest rates to name a few.

The combination of stock and bond prices being a bit pricey, in our view, and the aforementioned concerns cause us to keep our guard up. Of course, we are prepared to act swiftly should investments meeting our criteria become available for purchase.

We believe patience, discipline and judgement are key: the patience to wait for the right opportunity; the discipline to say no to all the bad ones; and the judgement to know when to place the order.