EUBEL BRADY & SUTTMAN
ASSET MANAGEMENT

MARKET REPORT
THIRD QUARTER 2017

Economic growth and stock markets were positive for the quarter and market volatility remained low, even in the face of numerous risks including: Geopolitical risks such as nuclear threats from North Korea; the unknown effects of unwinding hugely accommodative and experimental monetary policy that arguably helped propel asset prices higher since the Great Recession; government difficulties passing potentially pro-growth legislation; cybersecurity issues; and a nation more divided politically and socially than at any time in recent memory. Of course there are always risks when investing. However, with bond prices and stock market valuations elevated (pricing in a good amount of beneficial outcomes that may or may not manifest) and more than eight years into the current economic cycle (recessions have typically occurred at least once per 10 years), we continue a defensive stance throughout our portfolios.

Unless we make aggressive assumptions (more on these later), attractively priced securities with good margin-of-safety are few. Quite simply, we do not want to risk your hard-earned capital in more highly priced securities and chase markets when we believe the risk/reward is not compelling.

We will provide some additional information on valuations that shape our views as well as the aggressive assumptions mentioned above. First, we recap equities, fixed income and commodities below.

Total Return as of September 30, 2017						
				Annualized		
	QTD	**YTD**	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	4.5%	14.2%	18.6%	10.8%	14.2%	7.4%
NASDAQ	6.1%	21.7%	23.8%	14.5%	17.4%	10.5%
Russell 3000						
Index	4.6%	13.9%	18.7%	10.7%	14.2%	7.6%
Value	3.3%	7.7%	15.5%	8.8%	13.2%	6.0%
Growth	5.9%	20.4%	21.9%	12.7%	15.2%	9.0%
Russell Mid Cap						
Index	3.5%	11.7%	15.3%	9.5%	14.3%	8.1%
Value	2.1%	7.4%	13.4%	9.2%	14.3%	7.9%
Growth	5.3%	17.3%	17.8%	10.0%	14.2%	8.2%
Russell 2000 (Small Cap)						
Index	5.7%	10.9%	20.7%	12.2%	13.8%	7.9%
Value	5.1%	5.7%	20.6%	12.1%	13.3%	7.1%
Growth	6.2%	16.8%	21.0%	12.2%	14.3%	8.5%

Equities
The S&P 500 rose 4.5% during the quarter, bringing year-to-date returns to 14.2%. Technology was the strongest performing sector for the quarter and the year as investors appeared to highly value these companies' growth prospects and their increasing impact on business and society. The telecommunications and energy sectors rebounded during the quarter but are still negative performers for the year. Consumer staples was the only declining sector during the quarter as changing customer preferences and competition seemingly weighed on this area.

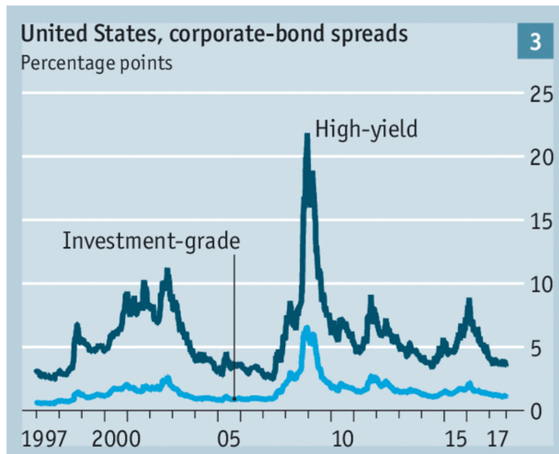
Small-cap stocks outperformed large-cap stocks for the quarter, but large-cap stocks still lead small-caps for the year. While statistically cheap stocks generally outperform statistically expensive stocks over the long-term, statistically expensive stocks outperformed cheaper ones for the quarter, adding to their significant outperformance so far this year.

Fixed Income & Commodities

Corporate bonds, as measured by the BofA ML 1-10 year index, appreciated 1.1% during the quarter, increasing returns for the year to 3.9%. U.S. Treasuries and Agencies, as measured by a similar index, increased 0.3% for the quarter and 1.5% year-to-date. The 10-Year Treasury bond's yield of 2.3% was basically unchanged from the previous quarter and down from 2.5% at the beginning of the year.

In general, bond yields remained low and corporate bond spreads (excess yield provided by corporate bonds over government bonds) stayed tight (see the chart nearby) as interest rates remained low and bonds were still in demand.

Commodities (as measured by the Bloomberg Commodity Index) rose 2.5% for the quarter, but have declined 2.9% year-to-date. Oil prices rose strongly as production cuts led by major oil supplying countries may be having their desired effect, and the International Energy Agency increased its forecast of oil demand growth for this year due to stronger than expected demand growth in Europe and the U.S.



The Economist

Interestingly, vanilla prices have been off to the races for the last several years and hit an intra-quarter high of more than $600/kilogram (in 2015 you used to be able to get one kilogram of vanilla beans for around $100). Increased demand from consumers for more natural ingredients in products, coupled with a cyclone hitting top vanilla producer Madagascar this year, have been contributing factors to the huge escalation in price. Hopefully, this does not increase ice cream prices too much!

Earnings-based Valuations for Stocks

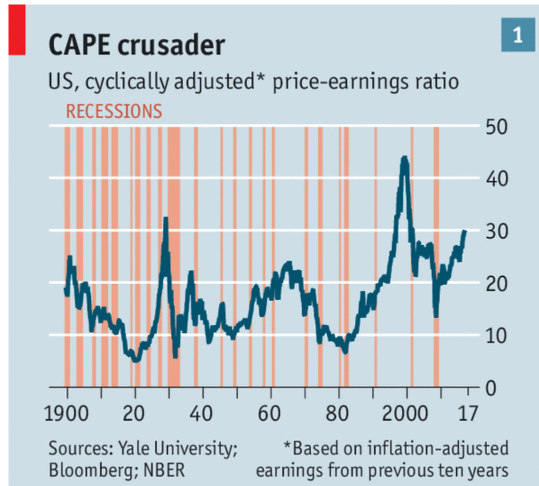
One way to assess the attractiveness of a stock is by looking at the stock's market price relative to its earnings: the price-to-earnings ratio (P/E). The numerator of this ratio is quite easy to determine: just plug in the stock's publicly quoted market price. The denominator, however, can be more difficult because there are different types of earnings to examine (e.g. earnings over different time periods, earnings that conform to rules such as generally accepted accounting principles versus earnings that may not be rules-based but reflect the company's economic reality better). Although we will avoid boring you with a more detailed discussion of these intricacies, we believe sharing how various P/E ratios are trading relative to historical norms will help frame the current environment.

One way to calculate the P/E is to simply divide a company's stock market price by its earnings for the last twelve months (this is sometimes called the trailing twelve month P/E or TTM P/E). As you can see in the calculations below, the TTM P/E at quarter-end for the S&P 500 is on the high side. This suggests stocks are loftier than their historical average.

- TTM P/E at Quarter End (using As Reported Earnings Per Share) for S&P 500 — Above 24x
- TTM P/E at Quarter End (using Operating Earnings Per Share) for S&P 500 — Above 21x
- Average TTM P/E since 1870's — Approx 16.7x

  Sources: S&P Down Jones Indices website, dshort/Advisor Perspectives

An alternative P/E is called the cyclically adjusted price-to-earnings ratio, aka the CAPE ratio. It is calculated by taking the market prices of companies and dividing them by an average of the last 10 years of their earnings, adjusted for inflation. It is a ratio with some predictive power for longer term returns; we have discussed it in the past but it's worth reviewing again. As you can see in the chart to the right, the CAPE ratio has only been higher in the late 1920s (think market crash of 1929) and the dot-com boom that ended in the early 2000s.



Economist.com

Yet another way of calculating a price-to-earnings ratio for a company is by dividing a company's market price by earnings that analysts forecast the company will earn in the upcoming 12 months. This is often called the *forward P/E*, but is labeled the *current P/E* in the table below. As you can see, whether big or small, statistically cheap (titled "Value") or statistically expensive (titled "Growth"), companies are expensive based on this measure relative to where they have traded on average over the past 15 years. During bull markets such as the dot-com boom, we were able to find stocks in the small-cap and mid-cap spaces that were inexpensive outside of the technology sector. In the current market environment, fewer areas of the stock market appear cheap.

Current P/E as % of 15-year avg. P/E*

	Value	Blend	Growth
Large	120.9%	122.5%	123.5%
Mid	116.3%	115.7%	116.7%
Small	116.0%	125.3%	138.3%

J.P. Morgan Asset Management. Guide to the Markets 4Q 2017.

The P/E ratios above are by no means an exhaustive list of the different valuation metrics we look at, but hopefully give you a better idea of the market environment we are in. In order to get comfortable with many current stock valuations – in what is already one of the longest (although not much loved) bull markets in history – investors have to make assumptions that we feel are aggressive. One may have to assume that interest rates remain close to historical lows, corporate earnings growth – which is currently quite good and could get a tailwind from pro-growth legislation if passed – remains good over many years, and that market participants may have to be willing to pay historically high P/E multiples in the future. But even if one gets comfortable enough with these assumptions to validate current stock prices, stocks with significant margins-of-safety (e.g., prices trading well below calculated intrinsic values) are limited when viewed through our lens.

As an aside, investors may be holding off selling investments with significant unrealized gains until more detail on tax legislation surfaces (which could impact taxes paid on capital gains in 2017 and 2018).

Summary

- In general, stocks and bonds did well in the quarter and added to year-to-date gains.
- P/E metrics suggest few areas of the stock market are cheap. Investors have to make what we feel are aggressive assumptions to validate many current stock prices. Currently, finding stocks with an adequate margin-of-safety is a tall order.
- In light of the current environment, we have a defensive bias while awaiting more attractive risk/reward opportunities.