EUBEL BRADY & SUTTMAN
ASSET MANAGEMENT

MARKET REPORT
FOURTH QUARTER 2017

Stock markets finished the year strong as corporate earnings and economies continued moving in the right direction during the quarter and a tax bill perceived to be pro-business was passed into law. Sentiment among individual investors appeared optimistic and the Federal Reserve raised federal funds rates for the third time in 2017.

During 2017, stock markets shrugged off potential risks and marched straight upward: The total return for the S&P 500 index (including dividends) was 6.6% for the quarter and 21.8% for the year, and 2017 was the first year on record that the S&P 500 generated positive returns in every single month. Additionally, the Dow Jones Industrial Average rose for nine consecutive months, the longest streak of monthly gains since 1959.

At the same time, the stock market exhibited little downside volatility: Despite the S&P 500 experiencing average intra-year declines of 13.8% going back to 1980, the S&P 500's largest intra-year decline in 2017 was only 2.8%. This did not allow us to take advantage of significant downturns that have typically been more frequent, even in years with satisfactory stock returns.

Total Return as of December 31, 2017						
				Annualized		
	QTD	**YTD**	**1 Yr**	**3 Yr**	**5 Yr**	**10 Yr**
S&P 500	6.6%	21.8%	21.8%	11.4%	15.8%	8.5%
NASDAQ	6.6%	29.7%	29.7%	14.8%	19.5%	11.4%
Russell 3000						
Index	6.3%	21.1%	21.1%	11.1%	15.6%	8.6%
Value	5.1%	13.2%	13.2%	8.7%	14.0%	7.2%
Growth	7.6%	29.6%	29.6%	13.5%	17.2%	9.9%
Russell Mid Cap						
Index	6.1%	18.5%	18.5%	9.6%	15.0%	9.1%
Value	5.5%	13.3%	13.3%	9.0%	14.7%	9.1%
Growth	6.8%	25.3%	25.3%	10.3%	15.3%	9.1%
Russell 2000 (Small Cap)						
Index	3.3%	14.7%	14.7%	10.0%	14.1%	8.7%
Value	2.1%	7.8%	7.8%	9.6%	13.0%	8.2%
Growth	4.6%	22.2%	22.2%	10.3%	15.2%	9.2%

A closer look at the data can help explain our relative performance a bit more: There is a large number of stocks that makes up the Russell 3000 Index, which can be divided into a statistically cheap group (called "Value" stocks by various indexes and market participants) and more expensive stocks (called "Growth" stocks by various indexes and market participants). We typically hunt for stocks in the "Value" space because it has outperformed the "Growth" space over long periods of time and is likely to have stocks that are underfollowed, misunderstood, and mispriced. Well, "Value" stocks performed admirably in absolute terms during 2017 but took it on the chin compared to "Growth" stocks (see table below). However, below you can also see Value stocks performed much better than Growth stocks in 2016, thus dramatically reducing the difference in performance between the groups in the last two years.

	Return for 2017	Return for 2016	Combined Return for 2016 and 2017
Russell 3000 Growth	29.6%	7.4%	39.1%
Russell 3000 Value	13.2%	18.3%	33.9%

Source: Bloomberg

In addition to the underperformance of our primary hunting grounds for investment opportunities, we also have reduced our equity allocations relative to where we may have normally been at times in the past. As we discussed in the previous quarterly letter, even the statistically cheap "Value" stocks are more expensive than they have historically been. And yet they've continued to go up. So where does that leave us?

We continue the defensive positioning and investment philosophy that we believe has served us and our clients well over the long term as sentiment seems to have changed in the few years after the last financial crises from plenty of fear to a fear of missing out.

While the current environment is not exactly like the market conditions that led to stock market meltdowns in 2000 and 2008-2009, it has similarities:

- Valuations are not cheap, similar to the start of the previous referenced downturn periods (a point we have made in recent letters).
- 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 aforementioned "fear of missing out" on potential upside.
- 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).
- 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).
- Central banks are viewed by many as creditworthy institutions that know what they are doing.
- 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).

Equities

Consumer Discretionary led sectors for the quarter as consumers may have become more willing to spend as consumer sentiment stayed healthy, and no sector generated negative returns for the quarter. Utilities was the worst performing sector for the quarter, generating a 0.2% return... higher interest rates and more of a "risk on" market environment may have negatively impacted the share prices of these stocks that some have viewed as bond alternatives.

The Technology sector was the best performer for the year due to good earnings growth and positive investor sentiment (in our view). The Telecom and Energy sectors generated positive returns during the quarter, but were the only sectors with negative returns for the year.

For the quarter and year, growth stocks outperformed value stocks as previously discussed, and large-caps outperformed small-caps. Large-caps have outperformed small-caps in recent years, and we have benefitted as we allocated more of our equity holdings toward large-caps than small-caps where the style of management permitted.

Fixed Income & Commodities

Corporate bonds, as measured by the BofA ML 1-10 year index, edged up 0.2% during the quarter, increasing returns for the year to 4.1%. U.S. Treasuries and Agencies, as measured by a similar index, decreased 0.4% for the quarter but finished up 1.1% for the year. The 10-Year Treasury bond's yield of 2.4% was slightly higher than the previous quarter-end of 2.3% but down slightly from 2.5% at the beginning of the year.

In this low interest rate environment, we continue minimizing interest rate risk in favor of taking selective credit risk where our fundamental analysis leads us to conclude it is worth doing so. We hope to capitalize on market dislocations that may occur in the future (e.g., as the Federal Reserve raises short term interest rates and the Federal Reserve and other central banks look at unwinding accommodative monetary measures to a greater extent; unforeseen events related to economies, industries, or specific companies) and feel we are positioned to do so.

Commodities (as measured by the Bloomberg Commodity Index) increased 4.7% during the quarter, which resulted in a gain of 1.7% for the year. West Texas Intermediate oil prices increased to $60.42 as U.S. crude stockpiles have fallen, a group of major oil supplying countries extended their agreement to limit oil production through 2018, and global demand has increased. Interestingly, Palladium, a precious metal used in the reduction of harmful emissions from gasoline-powered vehicles, rose more than 50% as increased demand and supply shortages worked in its favor.

Summary

- Stock markets had both a strong quarter and year as benefits (e.g, positive economic growth, a general increase in corporate earnings, and a tax plan thought by many to improve the economics of many U.S businesses) seemed to outweigh potential risks. Many bonds generated lackluster quarterly results but positive returns for the year as the Federal Reserve increased short term interest rates…but a low interest rate environment persisted. Commodities finished the year strong to push returns for the Bloomberg Commodity Index into positive territory for the year.
- In general, we continue to find valuations across asset classes lacking the margins-of-safety and risk-to-reward combinations that we typically find compelling. So while we have participated in the positive returns that various asset classes have generated throughout the year, we maintain a defensive posture in our portfolios. At the same time, we feel we have the resources to act when opportunities present themselves (we are also busy at work digging them up).