EUBEL BRADY & SUTTMAN
ASSET MANAGEMENT

MARKET REPORT
SECOND QUARTER 2018

Key Takeaways

- U.S. stock markets turned positive for the year, even as trade conflicts added to market uncertainty. We are positioned to capitalize on opportunities if markets become skittish.

- The private equity space has become crowded, expensive and debt-laden. While some investors remain enamored with the private equity market, we are more skeptical regarding its value.

Economic Overview

During the second quarter, U.S. stock markets, the global economy, and corporate profits rose. The unemployment rate remained low, inflation increased and the Federal Reserve increased the federal funds target range to 1.75% to 2.00%.

Geopolitical issues, including the introduction of tariffs and potential for more major trade conflicts, seemingly contributed to market volatility. It is difficult to predict with precision the outcome of the trade disputes on the increasingly connected global economy; there will be winners, losers, and unintended consequences. Who and what those are remain an uncertainty. We continue to be optimistic that the worst-case trade scenarios are unlikely to occur – where economic growth, corporate profits, and standards of living are significantly harmed. If more negative trade scenarios do develop, we believe we can take advantage of investment opportunities as we are currently defensively positioned in portfolios.

Total Return as of June 30, 2018						
			Annualized			
	QTD	**YTD**	**1 Yr.**	**3 Yr.**	**5 Yr.**	**10 Yr.**
S&P 500	3.4%	2.7%	14.4%	11.9%	13.4%	10.2%
NASDAQ	6.6%	9.4%	23.6%	16.0%	18.6%	14.0%
Russell 3000						
Index	3.9%	3.2%	14.8%	11.6%	13.3%	10.2%
Value	1.7%	-1.2%	7.3%	8.5%	10.4%	8.6%
Growth	5.9%	7.4%	22.5%	14.6%	16.1%	11.8%
Russell Mid Cap						
Index	2.8%	2.4%	12.3%	9.6%	12.2%	10.2%
Value	2.4%	-0.2%	7.6%	8.8%	11.3%	10.1%
Growth	3.2%	5.4%	18.5%	10.7%	13.4%	10.5%
Russell 2000 (Small Cap)						
Index	7.8%	7.7%	17.6%	11.0%	12.5%	10.6%
Value	8.3%	5.4%	13.1%	11.2%	11.2%	9.9%
Growth	7.2%	9.7%	21.9%	10.6%	13.7%	11.2%

Equities

The S&P 500 appreciated 3.4% for the quarter (including dividends), and is up 2.7% for the first half of 2018. As is always the case when viewing the S&P, it is important to understand sector-specific performance. The energy sector outperformed due to the increase in oil prices (more on oil prices below). On the other hand, the financial sector underperformed. This may be the result of investors fearing repercussions of a relatively flat yield curve, a scenario where the interest payment from a long-term bond is not appreciably higher than a short-term bond. Because financial firms tend to borrow at shorter-term interest rates and lend at longer-term interest rates, their profitability could be negatively impacted by a flatter yield curve. The industrial sector also gave up some ground during the quarter as trade disputes could adversely affect multinational industrial businesses.

Small cap stocks outperformed large cap stocks during both the quarter and first half of the year, and statistically inexpensive stocks underperformed their expensive counterparts during both time periods.

Fixed Income
Corporate bonds, as measured by the BofAML 1-to-10 Year Index, decreased 0.2% during the quarter and returned -1.6% for the first half of the year. U.S. Treasuries and Agencies, as measured by a similar index, edged up 0.1% for the quarter, but declined 0.6% for the first half of the year. The 10-Year Treasury bond's yield increased to 2.9% from 2.7% at the end of the first quarter and 2.4% at the end of 2017. As touched on in previous quarterly letters, we continue to position fixed income portfolios in this low interest rate environment such that we can benefit if interest rates rise.

Commodities
Commodities, as measured by the Bloomberg Commodity Index, increased 0.4% during the quarter and were unchanged for the first half of the year. However, the price of West Texas Intermediate crude oil rose 14.2% from $64.94 to $74.15 during the quarter and is up 22.7% for the first half of the year. Even though some of the largest oil-producing countries agreed to increase output, the higher prices may be reflective of both actual and potential oil supply issues related to events in Venezuela, Libya, Canada, and Iran.

Trade disputes provided additional uncertainty for an agricultural economy that has had difficulties for years. China, the world's largest soybean buyer, was set to introduce tariffs after quarter end on products including soybeans imported from the U.S. We believe this contributed to the 18.0% decrease in 2Q soybean prices, as measured by a Bloomberg Subindex.

Private Equity – An Introduction and Update
First, a simplistic definition is in order: Private equity involves companies <u>trying</u> to buy other companies at low valuations with money that typically includes large amounts of debt (therefore you may not be surprised to hear private equity deals called "leveraged buyouts"). When the private equity transaction is completed, the purchased company is privately held (not publicly traded like common stocks). The acquiring company hopes to make improvements to the purchased company and resell the company in several years at a higher valuation to another company or to public investors (think initial public offerings).

In previous letters, we have shared various valuation metrics that support our view that stock valuations are not cheap. As common stocks and bonds have become pricier, investors have sought attractive returns in the private equity markets. Perhaps as a result of this investment migration, we believe the private equity market has become more crowded, more expensive, and more debt-laden:

More crowded – Management consulting firm Boston Consulting Group reported the following: "As of January 2018, a record 2,296 private equity funds were active in the market, seeking to raise an aggregate $744 billion in capital—a 25% increase compared with January 2017. At the same time, the amount of dry powder among buyout firms remains at record levels: $628 billion as of the end of 2017." These figures indicate that money is pouring into the private equity markets, and yet there are already significant dollars already on the sidelines. Based on the traditional supply-and-demand equation, this is not a scenario that plays favorably for investors.

More expensive – In 2017, U.S. private equity deal valuations rose to 12.5x EBITDA, higher than the deal valuations in 2016 of 9.5x EBITDA and the previous all-time highs reached before the 2008 financial crisis. As a reminder, EBITDA is *earnings before interest taxes depreciation and amortization,* a term that can be thought of as an adjusted version of a company's earnings used for valuation purposes in the private equity industry.

More debt-laden – One way that investment professionals assess a company's financial risk is by looking at one of its leverage ratios, for example, debt to EBITDA ratio. According to a recent *Wall Street Journal* article, the average debt/EBITDA ratio is 6.36x, the highest since 2007 when it was 6.49x. A higher ratio can spur returns when things are good, but significantly impede a company if things sour.

As a result of the current private equity landscape and characteristics described above, this market is less attractive to us than it may be to others.