

# FLIPPIN, BRUCE & PORTER, INC.

INVESTMENT COUNSEL

## MARKET COMMENTARY

**April 2010**

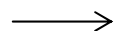
The stock market enjoyed its best first quarter in eleven years with the S&P 500 up 5.4% and the Russell 1000 Value up 6.8%. The market has now experienced four straight quarters of positive returns, which is certainly welcomed by investors in the aftermath of the bear market of 2008-09. The one-year return for the S&P 500 ending March 31 is an eye-popping 50%, not surprising given that the market bottom was reached in March of last year. Our portfolios generally performed better than the indexes for the quarter and the year.

The positive start to 2010 was due in part to a better-than-expected earnings season. Most companies did a good job of reducing costs during the recession and the modest improvement in the economic environment produced surprisingly strong bottom line numbers for stocks. The National Bureau of Economic Research, the official arbiter of U.S. business cycles, has not officially declared the recession of 2007-2009 over, but we expect that body will ultimately judge mid-2009 as the end of the cycle and the beginning of the expansion. While we cannot rule out the slim possibility of a double dip recession, it appears less likely as the Federal Reserve continues to target a fed funds rate near zero.

We expect domestic GDP growth to be in the 3.5-4.5% range for the year, a decent economic environment. Unemployment remains high at 9.7%, but is down from its seasonally adjusted peak last year of 10.1%. We expect the unemployment rate, which is traditionally a lagging indicator, to improve gradually as the economy continues to gain traction. Some evidence of this improvement is already appearing, with unemployment claims recently making an 18-month low. Understandably, consumer spending remains subdued, and consumers are continuing to deleverage their balance sheets. Expectations for spending are very low, so even minor upticks in retail sales numbers are being favorably received by investors. We believe a pickup in corporate spending will be a key driver of the economic recovery. During the uncertainty of the recession, companies became reluctant to spend and began hoarding cash. As a result, companies had on average 11.4% of their assets in cash at the end of last year. As managements see continued economic stability, we expect them to loosen their purse strings and invest in capital projects, technology, and payrolls. The credit markets have normalized, but there are signs that bank lending hasn't returned to normal levels yet. As bank balance sheets continue to improve over time, lending should pick up, providing additional fuel for the economy.

Our portfolios continued to generate relatively strong performance results against both the S&P 500 and the Russell 1000 Value. The Consumer Discretionary, Industrials and Financials sectors were the best performing groups for the quarter. The rising market moved several stocks in these sectors to prices near our target values and we subsequently reduced our weightings in these names. We added to our holdings in the Energy sector as several opportunities presented themselves. We continue to focus on stocks with strong cash flow generation and high financial flexibility, and are managing the portfolio with a keen eye towards keeping the holdings at an appropriate discount to our calculated values.

Nearly 18 months after President Obama was elected, a sharply divided Congress made good on his campaign promise to pass health care legislation. Many of the specific details have yet to be worked out, but the broad framework of reform is in place. A few aspects of the plan are scheduled to begin this year, but the most significant changes, including tax increases, will be phased into effect over the next four years. The health insurance stocks generally performed well once it became clear that the bill would not include a national plan and would mandate individual coverage. As a result, we reduced our exposure



to that industry during the quarter. We will continue to monitor the impact of this legislation on the other healthcare stocks in the portfolio as the regulations are rolled out in the coming quarters.

With interest rates at historically low levels, equity valuation levels reasonable and a decade of very low returns behind us, we are quite optimistic about the potential for stocks to perform well over the long term. In fact, we believe it is possible for stocks to exceed their long-term average annual return of 9% over the next ten years. The short-term story for stocks is less compelling, however. The 50% return over the past year has moved stocks from undervalued levels closer to more normal valuations. Additionally, the market will likely be forced to reckon with higher interest rates in the coming quarters, as the Fed will gradually need to remove economic stimuli to keep inflation at bay. However, the huge cash balances at corporations can provide some lift to stock prices in the short-to-intermediate term as merger and acquisition activity will likely pick up and shareholder-friendly actions such as dividend increases and share repurchase programs become more prevalent.

The investment outlook for bonds is much different than for stocks. Currently, the bond market is ending a multiyear period of relatively strong performance, just as one would expect with interest rates moving to record low levels. As the economy improves, the potential for interest rates to rise is quite likely, thus offering an unattractive return profile for bonds, whose prices move inversely to interest rates. Our strategy is to maintain short maturities to protect principal value and to accept some credit risk to generate higher income for the portfolio.

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