

# FLIPPIN, BRUCE & PORTER, INC.

INVESTMENT COUNSEL

## MARKET COMMENTARY

July 2009

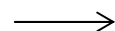
Equity markets rallied sharply in the second quarter with the S&P 500 up 15.9%, its best quarterly return in more than 10 years. It should be noted, however, that the index had fallen six quarters in a row prior to the rally, and that investors still feel the effect of the downturn. *Relief* rather than exuberance may be a better way to describe current sentiment. Is this simply a bear market rally or have we begun a lasting recovery in equity prices? As we stated in our last quarterly letter, while we expect there to be further bumps in the road, we are optimistic that the recovery has begun.

Currently however, the economic environment remains poor, with first quarter GDP revised to negative 5.5% and unemployment above 9%, a 25-year high. Exports dropped and manufacturing weakened as well. Bankruptcies by Chrysler and General Motors during the quarter offer additional proof that we are experiencing the deepest recession in decades. Economic problems aren't confined to the U.S., as weakness is also evident in Europe, Asia and across the globe. As a result, unprecedented stimulus has been brought to bear around the world. The actions have been broad and global and include \$621 billion loaned just last week to banks at 1% interest by the European Central Bank (ECB). The ECB hopes this money will be used to pass along attractive credit terms to consumers and businesses. During the quarter, the Federal Reserve also kept overnight lending rates at record low levels of near 0%. History suggests that economic stimulus takes time to work through the system, but it should bring about improved conditions going forward. The bursting of the real estate bubble was a major factor in triggering the recession, so improvement in housing will likely mean that economic improvement will follow. Some signs of stabilization in home prices began to emerge during the quarter. Government reports indicated that home prices dropped less than 1% during the first three months of the year, a pace that is considerably less than the prior rate of decline. Increased affordability due to lower home prices and relatively low mortgage rates helped stimulate activity.

In addition to housing, there are signs of improvement in some other leading indicators of future economic activity. Credit markets have stabilized and consumer sentiment surveys are improving. Perhaps most importantly, the stock market, historically a strong leading indicator, is higher. However, we expect this recovery to be less robust than it otherwise might have been given the enormous amount of monetary and fiscal stimulus actions that have occurred worldwide. Historically, these stimulus measures help drive a consumer-spending rebound, which cycles through to business spending, eventually bringing unemployment down. In this cycle, consumer spending is likely to be constrained by very high unemployment and the lack of access to home equity lines of credit because of lower real estate values. Corporations along with consumers are being cautious in their spending and both are rebuilding their balance sheets, which had become overleveraged during the past few years. Signs of the deleveraging process are emerging, evidenced by personal savings rates in the U.S. near 7% in May compared to a rate near 0% for the past few years. Long term this will be very beneficial, but it will constrain spending in the near term.

Inflation concerns are surfacing given the magnitude of economic stimulus around the world. We believe these concerns are premature, because excess industrial capacity and global weakness should keep inflation in check in the short run. Longer term, inflation is a concern that should be monitored. Additionally, U.S. government policies in the coming years are likely to lean toward higher taxes and regulation, creating potential headwinds for a rebound in corporate profits. Despite these issues our belief is that the economic recovery is underway, but it may be more subdued than past recoveries.

For the quarter, our portfolio outperformed both the Russell 1000 Value and the S&P 500. Our outperformance was driven by favorable stock selection in the Energy, Health Care and Industrials sectors



as well as positive sector selection in Information Technology. Financials were the best-performing sector this quarter, rebounding from extreme lows reached earlier this year. And while Financials were additive to the portfolio's results on an absolute basis, on a relative basis the sector held back returns. The year-to-date and one-year numbers also compare favorably to the benchmarks.

Fixed income markets also began to reflect a reduced level of fear during the quarter. Last year, U.S. Treasury bonds dramatically outperformed all other fixed income securities due to a classic flight-to-quality environment. With at least a semblance of appetite for risk returning to the market, corporate yield spreads narrowed from the record-high levels of last fall. For the quarter and year-to-date periods, corporate bond exposure led to better-than-benchmark performance for our fixed income portfolios. We also identified some additional opportunities in bonds and added them to the portfolio at what we believe are attractive levels.

Since equity markets tend to lead the economy, we consider the strong price movement in stocks since early March a positive signal that the worst is over for the economy. Initially the move in the market was fueled by the reduction of fear in the mind of investors. In other words, a *relief rally*—*relief* that major financial institutions didn't fail, *relief* that depression fears faded and *relief* that home prices have begun to stabilize. The rally was extended by some modestly positive economic signs. From these levels, we believe the rally will require more positive signs of economic progress and signs that a sustainable earnings recovery is underway. Markets seldom move straight up, so we can expect to experience continued volatility in the next few months. Given this outlook, it is important to maintain diversification across the portfolio including exposure to early cyclical, such as Consumer Discretionary and Industrials, as well as more defensive names in Consumer Staples and Health Care. Our Energy weights have been low on a relative basis, but we expect to increase these weights over time as opportunities present themselves.

We always strive to invest in stocks that are trading at significant discounts to our expected value. In this economic environment especially, we also want companies that possess strong balance sheets and are able to generate ample amounts of cash flow.

In the last six months we have identified a number of stocks that meet our investment criteria and we remain committed to our value-oriented investment philosophy. The recent market environment presented challenges unlike any we have seen before. As we move forward to what we believe will be a more rewarding environment, it is more important than ever to maintain and implement the same process and philosophy that has been our foundation over our 24-year history. We thank you for your confidence and support.

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