

FLIPPIN, BRUCE & PORTER, INC.

INVESTMENT COUNSEL

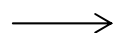
MARKET COMMENTARY

October 2009

The stock market continued to recover from the lows hit back in March by surging ahead more than 15% during this quarter. It was only the fifth time in more than 20 years that the market, as measured by the S&P 500, generated a quarterly return of more than 15%. One of the other times was the second quarter of this year, illustrating how strong the rally has been in a relatively short period of time. Given the severity of the market downturn last year a sharp recovery is not surprising, but the rally still leaves the market well below the highs of two years ago.

Many investors are now asking the question “has the market moved too high, too quickly?” Implied in the question are fears of a pullback and the possibility of another downturn for the economy. In our opinion, the recovery in stock prices is reflective of the reduction in fears that were widespread earlier this year and how depressed stocks had become. Yet there are legitimate reasons to be apprehensive about what lies ahead. Of primary concern is the deleveraging of the consumer, which could crimp consumer spending for years. Consumer confidence has edged up but remains well below its pre-recession levels. With unemployment rates near 10% and U.S. household net worth down almost \$11 trillion, confidence is likely to remain relatively low for some time. Banks are much healthier than last year, but still have work to do both in cleaning up troubled residential real estate and consumer loan portfolios and dealing with increasing losses on commercial real estate loans. In the short run, certain segments of the economy face challenges created by the unwinding of government stimulus programs such as the so-called cash for clunkers. The economy also faces longer-term inflationary pressures created by the huge increase in government debt and the massive amount of liquidity injected to reverse the recession.

On the other hand, there are many valid reasons to be optimistic about the future. Thanks in part to unprecedented global levels of stimuli, world economies appear to have stabilized and started to show signs of modest growth. The same can be said for the domestic housing market where low interest rates and attractive prices have spurred demand. Unemployment is elevated, but is not expected to rise much higher in the coming months. We also expect cyclical inventory rebuilding will add to economic growth measures in the coming quarters. There are positive factors working in the equity markets as well. Due to aggressive cost cutting during the recession, corporate profits have a chance to expand sharply even if revenue growth is modest. Currently, analysts estimate that earnings for the S&P 500 will be up more than 30% next year. Money market fund yields are near 0% and interest rates across the yield curve remain low indicating that competing investments to stocks are not offering much return potential. Many invested in these funds have missed a good part of the rally and are waiting in the wings for opportunities to reenter the market, which would help to drive equity prices higher. Additionally, merger and acquisition activity has picked up in recent weeks. On balance, we believe the equity markets are experiencing a typical post-recession rally. Historically, that means a sharp recovery followed by a leveling out of equity prices for a number of months. During this time, earnings typically expand and catch up with stock prices, ultimately fueling additional gains longer term.



Our relative performance was strong during the third quarter, as it has been in each of the quarters this year. The magnitude of the outperformance has been significant as well, with longer-term results showing marked improvement. Specifically this quarter, stock selection in the Energy, Industrials and Staples sectors was additive to performance. Health Care was a laggard for the quarter, not surprising given the current focus on healthcare reform. Where there is uncertainty there is often opportunity, and we believe the current healthcare debate is now creating some opportunities in this sector. For the year-to-date period, positive attribution has been split fairly evenly between stock selection and sector weighting, with Information Technology and Energy providing the bulk of our outperformance.

The fixed income markets have also staged an impressive recovery as credit markets began to thaw earlier this year. Yield spreads have contracted, allowing corporate bonds to show meaningful gains. We expect continued spread tightening over the coming quarters as economic conditions gradually improve and for interest rates to trend higher as investors keep a watch on how well the Fed maneuvers to withdraw the excess liquidity without stalling the economy. Given this expectation, shorter maturity corporate bonds should perform relatively well, which is where we have the major emphasis in our fixed income holdings.

Our goal is always to maintain a fully invested portfolio, but one that is valued at a substantial discount to our estimated values. With the third quarter's powerful advance, several stocks in the portfolio began to approach our target prices and we reduced our weightings or sold the position. Cash has risen modestly as a result. This increase in cash is simply a by-product of our investment process and is not a tactical move to reduce exposure to the market. We will redeploy the cash as new investment opportunities that trade at appropriate discounts to our target prices are identified. We thank you for our confidence and support.

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