

# FLIPPIN, BRUCE & PORTER, INC.

INVESTMENT COUNSEL

## MARKET COMMENTARY

October 2011

The third quarter of 2011 was painful for equity investors as the market endured its worst quarter in three years and its third worst since 2002. The S&P 500 slid 13.8% and the Russell 1000 Value index dropped 16.2%. Investors pulled approximately \$70 billion from stock mutual funds during the quarter according to the Investment Company Institute. The period was marked by increased volatility that spiked in early August and continued through quarter end. During August the average daily percentage move up or down for the market was 2.5%, while that same measure had been .8% the previous month. To put that in perspective, the Dow Jones Industrials had an average intraday swing of more than 330 points during August, approaching levels last seen in the bear market of 2008-09.

Several factors have contributed to the market weakness including:

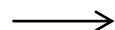
- a general lack of confidence in America's political leadership
- difficult Congressional negotiations concerning the U.S. debt ceiling
- S&P's downgrade of U.S. government debt
- ongoing government debt crisis in Europe
- the end of Fed stimulus known as QE2
- continuing decline in U.S. home prices
- the apparent slowing of Asian economies

These items have a common theme in that they all contributed to a decline in confidence, potentially leading to additional economic weakness. To be sure, we believe the odds of a recession have increased meaningfully, primarily due to the realization that Europe is probably entering one. The question is, will that spill over to the United States?

Economic data has been mixed all year with most indicators suggesting very slow growth or potential recession. The Federal Reserve announced a new stimulus effort, commonly called Operation Twist, to help address the concerns. It is a plan by which the Fed will sell short-term bonds and buy longer-term bonds in an effort to push long term interest rates down. President Obama also announced a jobs bill that includes additional stimulus efforts but also includes higher taxes, thus making passage difficult. European leaders are working to resolve their sovereign debt problems, but it is a challenging task. Housing affordability moved to new highs due to the combination of declining home prices and lower interest rates. Other recent economic reports, such as the Institute of Supply Managers index and construction spending, actually ticked higher last month and second quarter GDP was revised up slightly to 1.3%. Retail sales have also continued to track positive. Many economists are now calling for recession, but it is very difficult to forecast the economy with any certainty. We believe domestic GDP will continue to grow in the coming quarters, but that growth will likely remain slow and uneven.

How will the stock market react to that scenario? To a large extent it already has. Today's very low valuations on stocks appear to be discounting significant negative earnings revisions. Defensive sectors like Utilities, Telecommunications, Health Care and Consumer Staples have led the market while the more cyclical sectors such as Materials, Industrials and Information Technology have lagged. High quality, growth and dividend strategies have done well also. If GDP growth is better than currently expected, then the markets will not be as focused on defensive strategies and equities can recover nicely.

Our portfolio results have been disappointing, in large part due to an above average cyclical component and not enough defensive issues. The speed and depth of the correction have been rather



surprising, but we believe our portfolio is positioned for strong future returns. Whether measured on earnings or based on our estimates of company values, our portfolio is trading at a deep discount to its potential. When we have seen these discounted levels in the past, above average returns have followed. Thus, we are optimistic about our portfolio. We are also seeing additional opportunities to put cash to work in some high-quality companies that often trade at valuation levels too rich for our discipline. As we work through those various investment cases, we expect to add value to our portfolio.

We like to see “the pessimism so thick that you can cut it with a knife.” Today, there is no better example than Hewlett Packard (HPQ). Hewlett has been a disappointing investment, particularly since Mark Hurd was dismissed as CEO in 2010. The stock trades at less than 5 times earnings, demonstrating the pessimism. One Wall Street analyst reported that not a single large-cap technology stock has traded at that level in at least the last 25 years. We know that Hewlett has challenges, but we also see a company that has very strong market positions in its core businesses. The company has made management and board changes, and the new team certainly feels pressure to show improvement. HPQ is expected to generate approximately \$12.5 billion in net operating earnings this year. Its market cap is only \$49 billion. Philips Electronics, a European consumer electronics, lighting and health care company, also generates strong cash flow, forecasted to be \$2.2 billion this year. The company plans to return significant amounts of this cash to shareholders in the form of dividends, which provide a current yield of 5.3%, and stock repurchases that are expected to approach 15% of its market cap in the next 9 months. There are many other examples in our portfolio of high-quality companies selling at what we believe to be very attractive prices. Whirlpool, Lockheed Martin, Northrup Grumman, MetLife, Ingersoll-Rand and Sealed Air are among the stocks that are trading at the most significant discounts to our target prices. We believe the poor market environment has set the stage for strong portfolio performance in the coming quarters.

Almost universally, investment managers have expected higher inflation and interest rates from the massive stimulus programs in place. The markets have delivered just the opposite. The uncertain economic situation that drove stock prices down has brought about strong performance from fixed income securities. However, the positive performance has been concentrated in U.S. government bonds and high-quality corporates, which have benefited from a dramatic flight-to-quality. Yields on U.S. treasuries were already near 50-year lows, but the surge in prices has driven them down even further. The 10-year treasury yield hit 1.71%, a level not seen since the 1940s. We believe that the low yields available in government bonds are unattractive. Therefore, we continue to maintain a defensive portfolio structure for balanced accounts, emphasizing short-term corporate bonds that will better hold their value in a rising rate environment.

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