FLIPPIN, BRUCE & PORTER, INC.

INVESTMENT COUNSEL

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The surprising outcome of the "remain or leave" referendum in the United Kingdom, i.e. Brexit, certainly added excitement and volatility to global financial markets as the second quarter came to a close. Few analysts had given the "leave" side much of a chance in the months leading up to the vote, although pre-vote polling within the last few weeks showed the election would likely be close. While markets reacted sharply, the long-term impacts remain uncertain. Some pundits are saying Brexit will be a non-event with very limited lasting effects, while others speculate major disruptions to the European Union and global economies will be forthcoming. As is often the case, reality likely lies somewhere between these extremes.

The U.S. equity market sell-off in the immediate aftermath of the June 23 referendum was broad and steep. The Dow Jones Industrials lost almost 1,000 points in the two trading days following the vote. After that, however, domestic stock markets quickly recovered with the Dow closing out the quarter within 100 points of where it was prior to the vote. Internationally, emerging markets equity funds quickly fell 7%; like the U.S. market, they have recovered most of that drop. Understandably, the most pain was felt in Europe where the EAFE index of developed markets dropped 11% in the days after the vote. The recovery there has been muted with the index still down 7% from its level on June 23. Other financial markets also reacted sharply to the rising uncertainty of the economic situation in Europe. The U.S. government bond market is considered one of the safe-havens of the financial world, and it rallied in the aftermath of the vote with bond prices surging and interest rates falling. The 10-year U.S. Treasury bond yield is now at all-time low levels under 1.40%. Gold, another asset considered "safe," spiked as well. Currency markets were disrupted, with the British pound sterling collapsing to levels against the U.S. dollar not seen in more than 30 years.

While the specifics of how Brexit will work, or even if it will actually happen since the referendum is non-binding, are unknown, there are several conclusions that we can reasonably assume. First, recessionary odds for the U.K, for Europe, and for the U.S., are higher now. It is virtually certain that the policy makers at the U.S. Federal Reserve will halt any additional interest rate increases until effects from Brexit are better understood. That means lower interest rates for longer than we previously expected. And low rates are not limited to the U.S. Remarkably, 10-year government bond yields are actually negative in Germany and Japan. We also know that while the wheels have been put in motion for a British exit, it will be a long process. In the meantime, the free movement of goods and people in the E.U. will continue. Also, since U.K. trade represents less than 5% of our imports and exports, very little direct financial impact will be felt here. Politically, the Brexit vote demonstrated how important the immigration issue is in that country. We expect the issue will be a major factor in the U.S. presidential election in November as well.

Somewhat overshadowed by the Brexit vote, the U.S. economy continued to exhibit steady, if unspectacular, growth. First quarter GDP was revised upward a second time from an initially reported 0.5% rate to 1.1%. Consumer confidence moved higher in June, as reported by the Conference Board, and the Institute of Supply Management's Manufacturing Index also advanced by 1.9 points for the month. The manufacturing index is at its highest level since February 2015. Retail sales numbers were mixed, with building-supply and wholesale clubs showing strength, while general merchandise department store sales lagged. If the positive economic momentum continues, we could see 2.5% or even 3% real GDP growth for the second half of 2016.

Despite the increased market volatility during the second quarter, our Equity & Dividend Plus and Large-Cap Value portfolios delivered total returns in line with or just below the broad market indices. So far in 2016, defensive sectors such as Utilities, Telecommunications and Consumer Staples have benefited from falling interest rates and the flight to less "risky" assets noted above. In the EDP strategy, we eliminated holdings in HSBC following the surprise Brexit vote due to our concerns regarding future economic conditions in Europe and the potential impact on the company's earnings prospects. While HSBC is among the stronger banks in Europe, the safety of the dividend became more questionable given increased European economic uncertainty. At June 30, the dividend yield of the stocks within the EDP portfolio was 3.7%, comparing favorably to the 2.2% yield of the S&P 500. The Price/Earnings ratio of our portfolio was 13.7 times forward earnings versus 16.7 times for the S&P, indicating attractive valuation as well.

Our Large Cap Value portfolio also offers attractive valuation characteristics with a yield of 3.1% and a forward P/E of 13.2. Earnings for the broad market have been relatively flat, and the average price/earnings multiple has been between 15 and 17 times forward earnings estimates. Since the end of 2015, the stock market has traded in a fairly narrow range, reflecting both risk-on and risk-off periods. Earnings growth, not lower interest rates, is needed to move stocks substantially higher. Strengthening oil and gas prices, along with higher prices for many other commodities, combined with better second half GDP growth should lead to improving earnings in the last six months of the year. This sets the stage for better earnings expectations next year.

In closing, if we are correct about the economic backdrop, we would expect to see a shift in market leadership with cyclically-oriented stocks leading the way; a significant change from the defensive-led market we have experienced so far in 2016. Both portfolios are positioned to benefit as economic growth and earnings-per-share move higher.

For additional firm wide information please visit our website at www.fbpinc.com or call us at 1-800-851-3804. As always we appreciate your continued interest in our firm.

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