# FLIPPIN, BRUCE & PORTER, INC.

INVESTMENT COUNSEL

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Domestic equity markets advanced during the third quarter, with large-cap benchmarks posting returns of 3.5% to 4.0% even after experiencing a modest pullback in September. It was the fourth quarter in a row that stocks moved higher and the strongest quarter of 2016. The S&P 500 has generated a somewhat surprising total return of 7.8% year-to-date. FBP's results have been above the benchmarks for both time periods. While returns during 2016 have been solid for the first nine months, several key upcoming events in the fourth quarter will factor heavily in determining market performance for the year.

The presidential election is one of these events. With the vote next month, polls show that Hillary Clinton has the lead over Donald Trump in most of the key battleground states. Polling also indicates, however, that Democrats have little chance to gain control of both houses of Congress this November. Consequently, a continuation of the current contentious political environment in Washington is likely. We believe that investors are pricing that scenario into the market. This has been a very unusual election cycle; it is possible that the outcome could surprise the markets and result in short-term volatility. Ultimately, though, it is the economic and earnings environment that will drive stock returns over the long term.

Another key event coming up in the fourth quarter is the Federal Reserve Open Market Committee (FOMC) meeting in December. The FOMC also meets in November, but it is widely expected that no action will come out of that gathering. Committee minutes released earlier this year have given strong indications that the fed funds target rate will move higher at the December meeting. The Fed, led by Janet Yellen, has indicated that it will gradually increase rates as economic conditions slowly improve. A December rate increase will mean that the Fed made two moves in twelve months, indeed a very modest pace. Some might argue that Yellen's Fed has been too focused on short-term market conditions, but even critics would acknowledge that she has done a good job communicating future plans such that there have been no real surprises. Given that, financial markets have accepted higher rates with only limited increased volatility. It remains to be seen if that continues. Overall, economic growth is expected to remain around 2% for the year despite temporary softness in some economic indicators over the summer. The historically low unemployment rate and initial jobless claims, as well as decent consumer confidence numbers, lead us to conclude that "slow but steady" economic conditions will remain into 2017.

We have mentioned in prior letters that we believe earnings growth is the key factor needed to fuel future stock market gains. With price/earnings multiples in the high teens, stocks appear fairly valued. As we enter the fourth quarter, we will keep a close eye on third quarter earnings reports as well as the tone of corporate managements' comments about next year. Overall, earnings have been relatively flat in 2016. This has been due to the strong dollar and because certain market segments, namely energy and commodity-related stocks, have seen significant earnings declines. According to a recent report from Charles Schwab, analysts are expecting 10% earnings growth for the market in the fourth quarter and a sizable increase of 16%

for next year. Those numbers will likely prove overly optimistic, but with increased commodity prices this year, a modest improvement in earnings appears to be on the horizon for the coming quarters.

As noted above, 2016 has generally been a good year from both an absolute and relative return perspective for our managed accounts. Third quarter performance helped as our portfolios' results exceeded benchmark returns for the period. Recently, some market pundits have suggested that value/dividend strategies could suffer in a rising interest rate environment due in part to their heavy weightings in Utilities, REITs and Consumer Staples stocks. Those sectors have performed well but now sport valuation levels well above their historical averages. It should be noted, however, that our portfolios are well diversified and are underweighted in those areas. The portfolios are positioned to achieve growth and generate above-average dividends from exposure to in stocks that benefit from economic growth, not just low interest rates. Additionally, they are trading at valuation levels well below that of the S&P 500. We believe our portfolios are structured to provide upside potential even in a moderately rising interest rate environment. Key portfolio activity in our Equity & Dividend Plus portfolio included the purchase of Nordstrom and sales of Applied Materials, R.R. Donnelley and PepsiCo. In our Large-Cap Value portfolio, we added a new position in Nokia and eliminated EMC, which was acquired by Dell.

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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