FLIPPIN, BRUCE & PORTER, INC.
INVESTMENT COUNSEL

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Equity markets tumbled, experiencing a sharp correction during the final quarter of 2018 that erased gains generated during the first nine months of the year. The selloff was especially acute in December, giving investors a holiday that only Scrooge could enjoy. The downturn was marked by wild trading, some days experiencing 1,000-point intraday swings for the Dow Jones Industrial Average. Ending the year with a poor quarter and heightened volatility no doubt alarmed many investors. If we step back and look at the big picture, however, we can get a better perspective on the negative return for calendar year 2018. It was the first down year for the S&P 500 since the bear market of 2008 and only the second negative year since 2002. We have been saying for some time that a market correction would not surprise us, would be healthy and could pave the way for better returns as we enter 2019.

As we see it, several factors were at work bringing about the sharp change in investor sentiment. The most likely spark that lit the flame of worry was Fed Chairman Jerome Powell's comments in October in which he implied that the Fed was "a long way" from normalizing interest rates to neutral levels. The idea that we could get much higher rates in a shorter amount of time clearly spooked investors. In December, despite public criticism from President Trump, the FOMC made good on its telegraphed plan to raise interest rates one more time in 2018, taking the fed funds rate to near 2.5%. With the ten-year Treasury yielding 2.7%, the yield curve is very flat but is not yet inverted. An inverted yield curve, where short-term interest rates are higher than long-term rates, has been one of the most reliable leading indicators of recession. Trade fears also came back into focus with news that the U.S. and China were at odds over tariffs. Oil prices tanked. Commodity investors seemed to realize all at once that with loosened sanctions on Iranian crude and global economic growth slumping, there could be a glut of supply on the market. The mid-term election, impeachment rumors, Brexit and the government shutdown were all factors that worked to pressure consumer confidence and equity markets. The big question now is, will these pressures push the economy into recession, and drag markets down with it?

While the risk of recession feels higher now than it has in some time, it is unlikely in the short-term. The U.S. economy is slowing but still appears solid. We expect 2018 GDP to approach 3% and the upcoming year around 2.5%. Contrary to some who claim we are experiencing a tax-fueled "sugar high" that is about to roll over, we believe there are lasting economic benefits from tax and regulatory reform. These benefits are significant for corporations, giving them additional resources to hire and invest in their businesses. Perhaps more importantly, since consumers drive the U.S. economy, lower taxes give households more discretionary dollars at their disposal. More discretionary dollars will also come from lower energy costs (gasoline and home heating) and increased wages. A resolution on the China trade issue, which both countries seem to desire, would remove a huge economic uncertainty and would be a significant long-term positive for trade, consumer spending and U.S. competitiveness. Given these factors, we see a slowing of the growth rate for the economy, but not a recession.

What does this economic outlook imply for the equity markets? The short answer is better returns in 2019. Corporate earnings are projected to grow another 7% in the next twelve months, following double-digit growth last year. Couple higher earnings with lower stock prices, and you have much more attractive valuations and the potential for better market performance. In January

2018, the projected earnings per share for the next twelve months for the S&P 500 was $150.68. At year end, the forecast was $170.58, evidence of continued earnings growth. Furthermore, the price of the S&P is lower now than it was last January resulting in a price/earnings ratio at 14.4 times, down appreciably from 19.1 times at the beginning of 2018. Additionally, our portfolio is trading at approximately 11 times earnings, a nice discount to the market.

In this challenging market environment, our Equity & Dividend Plus portfolio performed well compared to the S&P 500 and the Russell 1000 Value benchmarks for the quarter and for the full year. While we take no pleasure in down markets, the portfolio in general held up better than many other strategies. Longer-term results are also very competitive compared to the benchmarks. Cash flow is a primary objective of the portfolio, derived from dividends and from selling covered call options. The dividend yield at year end was approximately 4%. It can be a challenge to find opportunities to sell covered calls in a down market, yet we were pleased to generate just under 1.5% premium cash flow for the year. During the quarter, we added Carnival Cruise Lines to the portfolio. We also increased our weightings in a number of other stocks given the market weakness.

We made several adjustments in our Large-Cap Value portfolio during the quarter, establishing new positions in Broadcom and Carnival Cruise Lines, among others. We also swapped Schlumberger for Halliburton and increased the weightings in several other stocks in the portfolio. Our cash levels going into the quarter were generally a bit higher than normal, so we took advantage of market weakness to spend some of that cash in the portfolio. We try to adhere to the well-known philosophy of Warren Buffett to “be fearful when others are greedy, and greedy when others are fearful.”

In summary, we believe economic growth will continue and corporate profits will advance. Valuations are more attractive than they have been in several years, and consequently, we are more constructive for equity returns in the upcoming year.

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.