FLIPPIN, BRUCE & PORTER, INC.
INVESTMENT COUNSEL

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Increasing fears of slowing economic growth spread through financial markets during the third quarter. Stock market volatility spiked, and bond yields fell sharply. The S&P 500 managed to eke out a total return of about 1% for the quarter. Despite the lackluster returns for the three- month period, year-to-date returns for the index are very strong. In fact, 2019 has given us the strongest three-quarter return to start a year since 1997.

U.S. GDP growth slowed to around 2% over the summer. Ongoing trade tensions, particularly with China, appear to be at least partially responsible for the slowdown. While 2% growth may seem lackluster, economic growth domestically is among the highest in the developed world. The EU continues to suffer from very slow growth, and some analysts are now forecasting growth of less than 1% for this year. With continuing Brexit delays and uncertainty, the economic backdrop in both the U.K. and Europe will likely remain subdued for several more quarters. In light of slowing growth, central banks around the world have stepped up efforts to stimulate their economies. Negative interest rates are now commonplace across Europe and in Japan. After three years and several rate hikes, the U.S. Federal Reserve joined the accommodation ranks and lowered the fed funds rate twice during the third quarter. While some may accuse the Fed of succumbing to public pressure and criticism from President Trump to lower rates, the committee appears to be simply responding to the reality that growth has slowed and acknowledging that it may have overdone the rate increases late last year. In other words, it decided a mid-course correction was in order for interest rates.

The shape of the U.S. Treasury yield curve has been a major discussion point recently. As has been widely reported, yield curve inversions, in which 2-year bond yields are higher than 10-year yields, have been a fairly accurate leading indicator of a recession. A modest inversion did occur earlier this year, but it proved to be temporary. Early this month, the U.S. ISM Manufacturing Purchasing Managers Index came in at 47.8%, the lowest level in ten years. Numbers below 50% indicate contraction, giving further evidence of slowing economic conditions. Given that the U.S. economy is more service oriented today and much less reliant on manufacturing than in the past, the ISM report is perhaps not as concerning as it might have been years ago. As is usually the case, not every economic indicator is flashing caution. The unemployment rate near 3.5% is at a level not seen in more than 50 years, and wage growth remains strong. Corporate bond yield spreads continue to fall within the average range, indicating that bond investors are not overly concerned about credit risk. We believe the most likely outcome for the economy is not recession, but a temporary slowdown marked by weakness in some cyclical industries. The U.S. economy experienced something very similar to that in 2015. The China trade dispute certainly creates headwinds for the economy and for stock market sentiment; that issue needs to be resolved before more robust growth can resume.

On and off since 2015, U.S. stock market performance has been led by the so-called FAANG stocks, fast-growing, technology-oriented companies. Late last year, more defensive sectors including Consumer Staples, REITs (Real Estate Investment Trusts) and Utilities joined FAANG in leading the market. This narrow leadership made benchmark comparisons challenging, especially for diversified portfolios with more economic exposure. In early September, there was a significant change, with investors rotating funds into value-oriented stocks and industries. More attractively valued sectors such as Energy, Consumer Discretionary, Financials and Industrials performed markedly better during that stretch. Certainly, it is too soon to call the FAANG trade dead, but the rotation was a welcome sight for value investors. Our portfolio continues to trade at a sizeable discount to the overall market on price to earnings and provides a premium dividend yield.

There was significant portfolio activity in our Equity & Dividend Plus account for the quarter. A number of stocks were called away (sold) after strong price performance. Procter & Gamble, Coca-Cola, Hershey and Apple were all eliminated from the portfolio at elevated valuations through call option exercises and stock sales. We also sold Nordstrom following a disappointing earnings report. We lost confidence in the management team following the death of the prior CEO. We also established new positions in Nokia, Philip Morris International and Simon Property Group. In addition to an attractive yield, Nokia will benefit from the global rollout of 5G in telecommunications as service providers upgrade their networks. Philip Morris International offers an attractive dividend yield, low valuation and an improving growth profile. Simon Property Group is a well-managed REIT with a 5.5% dividend yield and the potential to grow its dividend over time. We believe each of these new additions to our portfolio offer attractive total return opportunity.

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.