

FLIPPIN, BRUCE & PORTER, INC.

INVESTMENT COUNSEL

January 2020

U.S. markets went out with a bang in 2019. Record high prices were notched across much of Wall Street in December, capping the best year for equity markets since 2013. In unusual fashion, stocks, bonds and commodities were all strong. The year began with high anxiety given that stocks were coming off a dismal fourth quarter in 2018. Fears of an inverted yield curve and trade wars dominated headlines and spooked recession worries almost daily. One might say that 2019 was proof positive that the classic mantra “markets climb a wall of worry” remains accurate today.

Digging deeper into what happened last year, it is fair to say that the two primary investor fears listed above, interest rates and trade, could have indeed been recessionary triggers had they played out differently. As it turned out, both issues were resolved positively, at least it appears that way today. The Fed Open Market Committee reversed course and lowered short-term interest rates three times in 2019. In effect, this resolved the yield curve inversion relatively quickly. The Fed also aggressively provided accommodation to improve liquidity in overnight lending markets by buying billions of short-term assets. Furthermore, it initiated a program to purchase longer-term bonds, resembling the quantitative easing employed in the past. Secondly, the Trump Administration announced late in the year the successful negotiation of phase one of a trade agreement with China. While this positive step is certainly not a comprehensive solution to the issue, investors were pleased that progress was made, and additional tariffs were avoided. U.S. officials say the deal will be signed January 15. The favorable trade news and stimulative Fed actions greatly reduced recession worries and helped bring about the market rally.

Economic conditions showed continued improvement during 2019. GDP growth could be described as strong, but not spectacular. Near record low unemployment, decent wage gains and positive consumer spending were the economic highlights, while business capital spending remained somewhat muted. Corporate earnings advanced modestly, but stock market gains of more than 20% handily outpaced earnings growth. Clearly, improving investor sentiment resulted in significant valuation expansion, which drove the market. The forward P/E for the S&P 500, which stood at 14.4 times earnings at the beginning of the year, is now 18.3 times, one of its highest levels in years. We would not expect to see that type of multiple expansion repeated in 2020. Given indications that the Fed intends to hold rates steady this year, it will be earnings growth, which is estimated to be in the mid-single digit range, that likely drives market returns in 2020.

It bears noting that stock markets hardly suffered a blip as the presidential impeachment vote passed the House of Representatives, only the third such vote in U.S. history. We surmise it was the clear lack of bipartisan sentiment, which made the outcome of the House vote and, presumably, the Senate trial, a virtual certainty, that kept investor fears tamped down. Politics will take center stage in 2020 as the presidential election cycle ramps up. We suspect markets might become jittery if candidates from either party espouse policies that may be considered anti-business. That risk is probably the most significant one facing investors as we begin the

year, since most economists and analysts expect continued economic expansion, corporate earnings growth and a stable Fed. Other risks include the possibility of rising inflation, ongoing trade and tariff negotiations with China and geopolitical upheaval in the Middle East or North Korea.

We are pleased with the progress of our portfolio in 2019. The dividend yield on the equities in our account at quarter end was almost double the 1.9% yield of the S&P 500. Cash flow generation from dividends and option premiums is a primary objective of the portfolio, and we were able to produce cash flow of approximately 5% last year. Projected dividends grew by about 10%, and total returns were in the 20% range. There was significant portfolio activity in the quarter, with positions in Microsoft, Williams Sonoma and Pepsico sold, primarily through exercised call options. We added positions in Lincoln National and J.M. Smucker Company to the portfolio. Lincoln is a highly rated financial services company with an emphasis on life insurance products. The stock is trading at a discounted valuation level and possesses attractive cash flow generation potential going forward. Smucker has strong exposure to pet foods (Rachel Ray's Nutrish, Milk-Bone, Meow Mix) and coffee (Folgers, Dunkin' Donuts, Café Bustelo), as well as its legacy consumer foods business (Jif, Smucker's, Crisco). The stock is attractively valued at around 12 times earnings with a dividend yield of 3.4%. As a result of portfolio actions for the quarter, cash levels are modestly elevated. We are comfortable holding higher cash reserves with the market at or near all-time highs.

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.

The information provided herein should not be construed as a recommendation to purchase or sell any particular security or an assurance that any particular security held in a portfolio will remain in the portfolio or that a previously held security will not be repurchased. Securities discussed herein do not represent a portfolio's entire holdings. It should not be assumed that any of the security transactions or holdings discussed herein have been or will prove to be profitable or that future investment decisions will be profitable or will equal or exceed the investment performance of the securities discussed. Past performance is no guarantee of future results. All recommendations/holdings within the preceding 12 months or applicable period are available upon request. S&P 500 is a market capitalization-weighted, total return index of widely held common stocks. Russell 1000 Value is a market capitalization-weighted, total return index of larger capitalization companies which exhibit traditional value characteristics. Indices are unmanaged and cannot accommodate direct investments. This information is intended solely to report on investment strategies as reported by FBP, the Investment Manager. Opinions and estimates offered constitute our judgment and are subject to change without notice, as are statements of financial market trends, which are based on current market conditions.