Trusted Investment Solutions Since 1979

Third Quarter 2009

LEAVELL INVESTMENT MANAGEMENT

Investment Commentary

Stocks continued to climb in September, bringing the total return for the S&P 500 in the third-quarter to 15.6%. For the year to date, that benchmark is now up 19.3%. In terms of market capitalization, the small-cap Russell 2000 gained 19.3% in the quarter, and is now up 22.4% for the first nine months of 2009. Mid-caps outperformed both larger- and smaller-caps, gaining almost 21% for the quarter and more than 32% for the year to date. Foreign stocks continued to outpace their large cap U.S. counterparts, with the MSCI EAFE Index gaining 18.7% in the third quarter and 25.5% for the year to date. Emerging-markets equities (based on Vanguard Emerging Market Stock Index Fund) continued their sharp rally, with a near double-digit gain in September bringing their third-quarter return above 21% and their year-to-date return just north of 62%.

Turning to fixed income, the credit markets also extended their recovery in the third quarter. Bond prices were higher across the board, with high yield debt showing the largest gains. In contrast to late 2008, when credit markets were frozen amid the worst financial crisis in decades, the appetite for fixed income securities surged in the quarter. Domestic demand, coupled with continued strong overseas purchases, helped support bond prices and kept yields at the lowest levels in many years. The yield on the 10 year Treasury note ended the quarter at 3.31%. Low short term rates and paltry money market yields have left many investors in a quandary as to where to keep cash invested.

We are always assessing opportunities and risks...

Current Outlook

While we will see more bank failures, as real estate-related loan losses (residential and commercial) continue, we are confident that the government has taken the financial-system meltdown risk off the table. The economy is probably already growing again. But there remains the important question of how strong the recovery will be, and whether it will be sustained or whether there will be another leg down for the economy and the markets (which is commonly described as a W-shaped recession).

With drops in household net worth erasing years of gains; debt levels far too high; access to credit more limited than it has been in years; and labor markets feeble, the consumer is in a weakened state. We continue to believe it is highly probable that households will want and need to rebuild their balance sheets, especially the 78 million baby boomers depending on their net worth to help fund retirement. The end of the home equity ATM, and generally less available credit as financial institutions repair their balance sheets, will reinforce this trend. The consumer is 70% of the economy, so clearly consumption growth is of critical importance to economic growth. It is the expectation of slow consumer spending growth coupled with increasing regulation and likely reduced risk taking on the part of businesses and investors (relative to much of the past 20 years) that suggests to us that any near-term burst of economic activity may be difficult to sustain at robust levels for an extended period.

Opportunities and Risks

We are always assessing opportunities and risks. Valuations have certainly been affected by the recovery in financial asset prices we have witnessed and participated in this year.

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Stocks are less undervalued following their performance in recent months. The critical debate among today's investors is focused on the recovery and pace of corporate earnings growth. We know that no one has a crystal ball and there are experienced and very savvy investors on both sides of the argument as to how vigorous the recovery will be. Nevertheless, our best view is that the weight of the evidence continues to be skewed towards modest economic and earnings growth as compared to previous recoveries. Optimistically, it should be noted that companies have been vigilant in cutting costs in the last twelve months and that any revenue growth that is realized will magnify profits and lead to favorable quarterly comparisons.

Finally, the last year has clearly illustrated the importance of the asset allocation decision for all investors. It is critical to make that decision with a multi-year investment horizon and it should be reviewed annually or as circumstances dictate.

As always, we are engaged in the management of your portfolios with determination, enthusiasm, and focus on making the best decisions possible on behalf of our clients.

Best regards,

Timothy S. Healey

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