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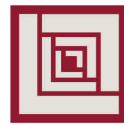
Fourth Quarter 2010



LEAVELL INVESTMENT MANAGEMENT

Investment Commentary

A strong fourth quarter rally, punctuated by a December sprint, turned an okay year for stocks into a very good one. The large-cap Vanguard 500 Index gained nearly 11% for the quarter, and ended 2010 up 15%. The small-cap iShares Russell 2000 and iShares Russell Midcap both returned in the mid teens in the fourth quarter, and gained 25% and 27% for the year, respectively. Looking abroad, the story was similarly positive for emerging markets, with the Vanguard Emerging Stock Index climbing 7.5% in the quarter and 19% for the year. Developed-market foreign stocks also had a good year, but returns for the benchmark Vanguard Total International Stock Index were restrained by concerns over Greece's fiscal problems earlier in the year and Ireland's later in the year, which drove the euro (and therefore returns to U.S. investors) lower. The Vanguard Total International Stock Index nevertheless gained a healthy 7% in the fourth quarter and 11% for the year.

Turning to fixed income, the Vanguard Total Bond Market Index Fund, a proxy for high-quality intermediate-term bonds, saw most of its 1.4% fourth-quarter loss come in December. Still, its strong performance earlier in the year left it with a full-year gain of just over 6%. Plagued by abundant supply and credit concerns, the municipal bond market weakened late in the year and yields climbed to their highest levels in almost two years. Foreign bonds and emerging market debt also struggled through the fourth quarter but saw strong returns in the mid-teens for the year.

Macro Thoughts

We are encouraged that the economic environment has continued to improve and that markets have reflected that. Things are slowly getting better on many fronts. Corporations have large cash reserves thanks to strong earnings and, where possible, are taking advantage of cheap credit. Capital investment is already beginning to strengthen and companies are well positioned to hire and invest more when confidence improves. Retail sales recently hit their highest level since before the recession began and a payroll tax cut could provide further stimulus to consumer spending in the New Year. Jobless claims for unemployment insurance are declining, which strongly suggests that layoffs have peaked. There are multiple indicators that suggest the job market should strengthen in 2011, though at this time job growth remains subdued. Emerging markets are growing nicely thanks to strong exports and improving domestic consumption. They are flush with foreign currency reserves and lack the debt problems almost all the developed world faces.

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The recent tax bill will offset the scheduled decline in government stimulus, providing more support with extended unemployment insurance and reduced payroll taxes. Though it adds to deficit concerns, this will buy more time for the economy to gain momentum and will probably result in a healthier level of growth in 2011. We've seen estimates of a GDP growth boost of as much as 1%, which would be material. Finally, we continue to believe that inflation is unlikely to spike dangerously higher in the near term in the developed world given excess labor and manufacturing capacity and weak demand. As the economy strengthens, inflation risk will increase but we don't believe a quick spike to harmful inflation levels is likely. This suggests that interest rates will stay in a relatively low range for a while (rates have spiked higher

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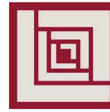

lately but in a longer-term context remain extremely low) though that range could top out above current levels.

There is ongoing debate about whether bonds are in a bubble. We don't view them as a bubble from the standpoint of having the downside risk that equity asset classes do when they are in bubble territory. Moreover, it is too simplistic to generalize about the bond market. Some sectors of the bond market still offer reasonable value. In addition to traditional investment-grade bond funds, it will be important to remain more flexible in the willingness to invest globally, across bond sectors, and to manage the duration of portfolios going forward.

Tax-Exempt Bonds

Muni bonds have been in the headlines perhaps more than any other investment category. With stretched state and local budgets there is growing fear that defaults could become a major problem for the tax-exempt market. Prices declined across the board late in the year. Part of this was due to a general rise in intermediate and long-term interest rates across all investment-grade bond markets. But muni yields rose more (and prices dropped more) due to credit fears, rising new issue supply, and also because of two technical factors. One was the tax bill, which kept tax rates from rising for another two years (making tax-exempt interest less attractive than it would have been). The second factor was the ending of the Build America Bond (BAB) program. This program allowed some tax-exempt borrowers to benefit from a federal interest-rate subsidy so they could issue taxable bonds. This issuance effectively replaced a portion of the supply of new tax-exempt bond issues, which positively impacted the supply/demand dynamics in the tax-exempt market boosting bond prices. The end of this program at year end will impact the supply of tax-exempt bonds—particularly long-term bonds (most BABs had 15-year maturities or longer).

Unless we see a material increase in defaults in the tax-exempt bond universe, investors in well-managed tax-exempt bond portfolios should continue to see acceptable rates of return over time. Though we believe defaults may be more likely than in past cycles, we don't expect them to be so widespread that well-managed muni bond accounts will be hit with meaningful performance impact from defaults. There are many solid revenue and general obligation bonds to build a portfolio around. In many cases debt servicing is not onerous for issuers but selectivity will be paramount in evaluating bonds for purchase. Given the weak condition of many state and local budgets we expect temporary headline risk to remain and volatility to be higher than in past cycles.

As we look ahead to 2011, though the range of possible outcomes is wide, there are many positives to consider. Europe should muddle through, China will likely be able to manage its inflation problem, the U.S. economy could accelerate while inflation stays low, and the Fed should stay accommodative. With close to $3 trillion in money market funds earning very little, investors may take on more risk and drive stocks higher around the world. So 2011 could be a good year. Of course, we are not confident that we can precisely predict what next year will bring and with that understanding our portfolios are typically positioned with a longer term perspective in mind.

We wish for you and your families a healthy and prosperous year!

Timothy S. Healey
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