

Investment Commentary

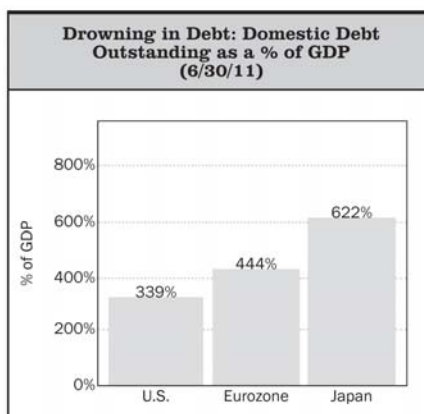
After tremendous volatility throughout the year, the S&P 500 index ended 2011 where it started, with its 2% return coming from dividends. Small and mid-cap stocks closed the year down 4.2% and 1.7%, respectively, despite posting double-digit fourth-quarter gains. Fear over Europe and slowing growth in China dragged foreign stocks down 11.8%, with China concerns and an aversion for risk hitting emerging-markets stocks even harder; they fell 18.8%. High-quality bonds were on the other side of the volatility, with sharp flight-to-safety rallies that helped net the Vanguard Total Bond Market Index a 7.6% full-year gain.

As most of the developed world struggles to dig out from under a mountain of debt, all options towards a resolution involve some level of economic pain that is compounded by political uncertainty. Having hit debt levels that are unsustainable, deleveraging (debt reduction relative to GDP) is necessary. Ideally this comes from economic growth—increasing the denominator in the debt/GDP ratio. But when debt is so high, it becomes a headwind to growth. Governments try to use fiscal stimulus to counterbalance the private sector's retrenchment, but this can only continue for so long, as increased government spending/stimulus adds to the growing burden of public debt. So, that leaves spending reductions and tax increases as solutions at the government level (austerity), or some degree of debt default. The action of default is of course the option of last resort. An alternative is to create inflation by "printing" money so that money is devalued. Both of these options lead to other problems.

Governments can also attempt to force "financial repression," where they use all possible tools to keep interest rates low. This serves several purposes including keeping their borrowing rates low so that the debt-service burden does not

December Benchmark Returns (Preliminary)			
Large-Cap Benchmarks	Dec	4Q	YTD
Vanguard 500 Index	1.0%	11.8%	2.0%
Russell 1000 (iShares)	0.8%	11.8%	1.4%
Russell 1000 Growth (iShares)	-0.3%	10.5%	2.5%
Russell 1000 Value (iShares)	2.0%	13.0%	0.2%
Mid-Cap Benchmarks			
Russell Midcap (iShares)	-0.1%	12.3%	-1.7%
Russell Midcap Growth (iShares)	-1.5%	11.2%	-1.8%
Russell Midcap Value (iShares)	1.2%	13.3%	-1.6%
Small-Cap Benchmarks			
Russell 2000 (iShares)	0.7%	15.4%	-4.2%
Russell 2000 Growth (iShares)	-0.2%	15.0%	-2.9%
Russell 2000 Value (iShares)	1.5%	15.9%	-5.6%
Other Benchmarks			
Vanguard Total Int'l Stock Index	-2.6%	4.2%	-14.6%
MSCI World ex USA Index	-1.1%	3.6%	-11.8%
Vanguard Emerging Mkt Stock Index	-3.3%	6.0%	-18.8%
Vanguard REIT Index	4.6%	15.2%	8.4%
Vanguard Total Bond Mkt Index	1.1%	0.9%	7.6%
Merrill U.S. High Yield Cash Pay	2.5%	6.2%	4.5%
Barclays 7 Yr Muni Bond Index	2.1%	2.8%	10.2%
S&P/LSTA Leverage Loan Index	0.5%	2.9%	1.5%
Citigroup World Govt. Bond Index	0.9%	-0.1%	6.3%
JPMorgan GBI-EM Global Div. Index	-1.5%	0.5%	-1.7%
DJ-UBSCI (Commodity Futures)	-3.7%	0.3%	-13.3%

explode to impossible levels. For investors, this means low returns from fixed-income investments.



Sources: U.S. Federal Reserve, Bank of Japan, and Eurostat.

There are many debt-related risks in the world today. Europe is the obvious big risk in the near term. What we're seeing in Europe is that investors are afraid that the region lacks the political unity and possibly even the financial capacity required to provide a sufficient financial backstop for the Eurozone. That increases the risk of weaker governments defaulting on their debt, which makes investors demand higher yields for taking on that risk. Those higher yields contribute to the potential for default because governments can't sustain interest payments above a certain level.

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Therefore only some type of unified policy action and intervention can allow governments to roll over all the debt that is coming due.

It is highly probable that we will find out during the next year whether governments and banks can keep the European Union together and get through the crisis with a mild recession. Most economists now view recession in Europe in 2012 as almost certain. European authorities have so far been ineffective in containing the crisis through incremental steps. However, the worsening of the crisis actually increases the likelihood that the European Central Bank will finally step in more decisively and provide major support for the sovereign debt market and the banking system, e.g., by buying Italian and Spanish government debt via “quantitative easing” (much as the Federal Reserve has done with Treasuries) to bring down interest rates and restore confidence. The costs of a European Union break-up are high so there should be strong motivation to avoid it, but the political and practical realities are highly complex.

In the U.S. our economy, though still weak, has performed somewhat better recently and appears to have moved back above stall speed. But, 2012 will be a year of fiscal contraction with the amount still uncertain as we write this. If a European meltdown can be avoided it is expected that the United States will continue its slow expansion. The political landscape will continue to evolve as we progress through the year and debt problems along with continued housing weakness make the United States susceptible to economic shocks and policy errors. Most economists are projecting a GDP growth rate of about 2% for 2012. This would be slightly above the 1.7% rate anticipated to be reported for 2011 which was boosted by the strong 3.5% growth rate in the fourth quarter.

So Where Are We? Our Portfolio Strategy

In the 33 years since Leavell Investment Management was founded, we have managed through numerous difficult investment environments, though probably none has been more challenging than the recent financial crisis and its aftermath. The weight of the evidence suggests to us that it is right to be cautious, but there are bullish arguments worth examining. By far the strongest bullish argument, in the short run,

is that authorities will do whatever it takes to avoid financial catastrophe, and therefore there will be much stronger steps taken in Europe. For example, if the European Central Bank undertakes major quantitative easing as discussed above, global stock markets could experience a significant rally. If this coincides with continued improvement in the U.S. economy, 2012 could turn out to be a very good year for the stock market. That could happen because a second bullish factor is that companies have piles of cash and are ready to spend it if uncertainty declines or demand increases. So, if policies are pushed forward that reduce some of the scariest risks, we could see companies loosening up their purse strings. This could be a positive double play for the economy and markets—as we’d have both policies that reduce uncertainty and a business sector that is poised to expand.

We continue to focus on maintaining the proper asset allocation for each client, consistent with their investment time horizon, risk tolerance, income needs and other relevant data. In such volatile markets like we have experienced of late, there is often a temptation to make short term “risk on – risk off” decisions of moving in and out of stock investments based on the macro headlines of the moment. It is during just such periods that it is important to remain resolute with the investment strategies that are consistent with your long term objectives. We will continue to make investment decisions that are in the best interest of our clients and that are designed to maximize the probability of achieving your individual investment objectives. We appreciate your continued confidence in our firm.

Timothy S. Healey
Chief Investment Officer
Leavell Investment Management, Inc.

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