

Second Quarter  
2008



LEAVELL  
INVESTMENT MANAGEMENT

## Investment Commentary

The first half of 2008 dramatically reinforced the idea that over the short term the stock market is *predictably unpredictable*. A sharply negative first quarter was followed by two months of positive returns, but the stock market selloff resumed in June. The S&P 500 is down 12% as of June 30<sup>th</sup> and is about 18% below its October 2007 high. The Dow Jones Industrial average fell 6.9% in the second quarter to end at a level of 11,350. The Dow posted a loss of 13.4% for the year. The market offered few places to hide. Mid- and smaller-cap stocks fared better than large cap but all sectors suffered mightily in June. Vanguard's Total International Stock Index Fund was also weaker, losing 9% in June and 2.2% in the second quarter. REITs were hit hard, dropping almost 11% in June and falling into negative territory for the year. Positive returns were hard to come by, though investment-grade bonds were up 1.1% for the year.



Though not a good return on an absolute basis, bonds nevertheless provided balanced investors with a margin of protection, which is part of their role.

The Federal Reserve Board cut the Fed Funds rate by 225 basis points in the first half of the year to its current level of 2.00%. At the end of the second quarter, the yield on the 10-year Treasury was slightly below where it stood at year end. There is great debate as to the timing and direction of the Fed's next move. Certainly, the inflationary outlook places pressure on the Fed to raise rates going forward. On the other hand, continued uncertainty in the credit markets and the faltering economy provide little room for interest rate hikes. It is unlikely that the Fed would raise rates in the near term given the pressures in the financial sector.

As always happens in an environment of fear, there are a lot of questions: What is going on?

How bad could it get? What should be done in investment portfolios? This particular environment is in many ways unique and presents its own set of challenges, but we want to reiterate that we've successfully navigated through a number of financial crises in our almost three decades of managing portfolios. While each of these periods presented its own particular challenges, things that were common to them all were a sense of accelerating bad news, escalating risk, and fear.

Looking back a few months, the Federal Reserve's unprecedented actions to shore up credit markets and create liquidity led many to hope that we were past the worst of the financial crisis and that the stock market had hit bottom. Today it seems that while the Fed's actions may have significantly reduced the risk of a financial meltdown, the losses from bad loans are continuing to be worse than expected. Meanwhile, the positive feedback loop of soaring home prices and easy credit is now gone, and with it has gone a major source of consumer spending – an important driver of the economy. Add in the impacts of higher levels of household debt, higher gas and food prices, a weakening labor market and it would seem that consumer spending will remain under pressure. As always, there are positives as well. Outside the financial sector, corporate balance sheets remain generally healthy and earnings have been decent. One source of strength has been exports, which so far have managed to offset much of the impact of the housing decline on U.S. economic growth.

Though we have seen a number of market crises over the years, we also recognize that history never repeats itself exactly, and almost anything can happen from here. In the current environment, in which bad news is prevalent and market psychology is decidedly negative, a sense of perspective and a reliance on our investment discipline help us avoid becoming

P.O. Box 1307 ■ Mobile, AL 36633  
(251) 433-3709 Tel ■ (251) 433-3723 Fax

[leavellinvestments.com](http://leavellinvestments.com)

800 Shades Creek Pkwy., Suite 585 ■ Birmingham, AL 35209  
(205) 879-1654 Tel ■ (205) 871-8708 Fax



panicked by short-term concerns and paralyzed by longer-term uncertainty. Like it or not, we are always faced with making decisions in an uncertain world and this is rarely more evident than the present.

Our experience in past market cycles, and our analysis of the current market environment, lead us to two important conclusions. First, it is easy to put too much weight on negative scenarios when bad news dominates the daily headlines and it is important to maintain an asset allocation commensurate with your investment horizon, income needs and risk tolerance. Second, big market downturns

*Our experience in past market cycles...*

invariably present opportunities. Bubbles lead investors to make errors in judgment and misprice assets on the way up. On the way down, riskier assets often fall to bargain prices when investors are gripped by fear. Valuations become more reasonable and opportunities inevitably present themselves to prudent, disciplined investors. Although we believe we can identify certain investments which are attractive from a long term perspective, we are equally confident that it is impossible to pick the absolute bottom of market declines like the one we are currently experiencing.

We suspect this will continue, at least for a while, to be one of the most challenging investment environments we've faced. We are not, however, among those who expect a disastrous outcome for the economy and the markets. The reality is that the U.S. and the global economies are experiencing growth, although domestic growth is at a very modest rate. Two critical elements that would provide a reversal of the recent market trend would be a sustained drop in oil prices and some sign of strength in the housing market. Caution remains the order of the day, though there will be opportunities to buy shares of high-quality companies at attractive prices. Consequently, even though the overall market does not look compelling to us from a top-down valuation perspective, the current economic and market turmoil appears to be creating significant opportunities for bottom-up individual stock selection.

Indeed, it is often when the overall trend is negative that disciplined investors can build a portfolio for long-term outperformance by carefully taking advantage of the opportunities created by these dislocations. This requires patience as well as the ability to favor long-term analysis over short-term fear, which is what distinguishes successful investors.

Please feel free to contact me if you have any questions. We appreciate your continued trust and confidence.

Best Regards,

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