LEAVELL INVESTMENT MANAGEMENT

Second Quarter 2017 Commentary

Dear Clients,

Please find enclosed your June 30, 2017 Investment Reports.

The second quarter proved to be another very strong period for global stock markets. Larger-cap U.S. stocks gained 3.3%, developed international stocks rose 6.2% and emerging-market stocks rose by 4.1%. In a reversal of May's sector trends, U.S. financial stocks rallied in June on strong results from the Federal Reserve's "stress tests" of major banks plus more positive sentiment concerning rising interest rates. On the other hand, technology shares declined due to profit taking. Commodities prices and energy stocks remain a weak spot amid a global rally in risky assets. Oil prices fell 14% during the quarter and nearly 20% for the first half of 2017 on fears that production will continue to outstrip demand. Core bonds also delivered solid returns for the quarter with higher bond prices corresponding to lower bond yields.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	3.3%	18.4%	14.6%
US Mid Cap Stocks	2.8%	17.3%	14.8%
US Small Cap Stocks	1.9%	19.1%	14.3%
International Developed Stocks	6.2%	21.0%	8.9%
Emerging Market Stocks	4.1%	20.6%	4.3%
US Bonds	1.4%	-0.3%	2.2%
Global Bonds	3.5%	-3.8%	-0.4%
US REITs	1.3%	-3.1%	8.0%

Data source: Morningstar Direct. Past performance does not guarantee future results. It is not possible to invest directly in an index. Last five years data is annualized. Market indexes include:

US Large Cap Stocks: CRSP US Mega Cap TR USD
US Mid Cap Stocks: CRSP US Mid Cap TR USD
US Small Cap Stocks: CRSP US Small Cap TR USD
Emerging Market Stocks: FTSE Emerging TR USD
International Developed Stocks: FTSE Developed Ex US TR USD
US Bonds: Barclays US Aggregate Bond TR USD
Global Bonds: Barclays Global Aggregate Ex USD TR USD
US REITs: MSCI US REIT NR USD

The calm in the markets, as manifested in low measures of volatility across global markets, was briefly interrupted during the last few days of June. Global stock and bond investors were rattled by comments from the heads of the European Central Bank and the Bank of England suggesting they may be considering the potential end to bond buying policies designed to stimulate markets and a move to raise interest rates, respectively. They were further jolted by Fed Chair Janet Yellen's statement that "by standard metrics, some asset valuations look high." In response, bond yields quickly spiked higher, while currency markets saw large swings. Nevertheless, at quarter-end, the S&P 500 was only about 1% below its all-time high.

We continue to view exogenous risks—from central banks and geopolitics—as posing the most likely near-term threats to markets. The widely followed VIX index—an indicator of the S&P 500's expected 30-day volatility, fell to a 23-year low in early May. It remained at its lowest ever recorded level as the second quarter drew to a close. The U.S. stock market's calm seems to fly in the face of ongoing political uncertainty and geopolitical tumult, including tensions with North Korea, the ongoing crisis in

Syria, terrorist attacks in Europe, cyberattacks in the United States, and widening investigations of President Trump as well as members of his administration and election campaign staff. Each day seems to bring a new headline concerning something else to worry about.

That said, maintaining a degree of equanimity is a valuable attribute of successful long-term investors. Global risks *always* exist and unexpected events inevitably happen, causing markets to fall no matter their valuation. The world and financial markets have faced numerous negative shocks over the decades, but the broad economic impacts have ultimately proved transitory. Over the long term, financial assets are priced and valued based on their underlying economic fundamentals—yields, earnings, growth—not on unpredictable macro events or who occupies the White House. Therefore, we believe it is beneficial for investors not to react to every domestic political development or geopolitical event with the urge to sell their stocks nor get overly excited and jump into the market on some piece of news they view positively. We don't think refraining from such short-term trades is complacency—*if* the choice is supported by a sound decision-making framework. Having a disciplined investment process and a focus on the long term are essential to best achieve your financial objectives.

Treasury bond prices typically rise when people are worried about the economy or other macro risks and put their money into safe-haven assets. While there are plenty of things to worry about in the world, that doesn't seem to be what is driving core bond prices this year, given the accompanying low volatility and strength of riskier asset classes. Rather than fears of an impending macro shock, it seems the bond market is responding largely to the recent declines in inflation and inflation expectations. For example, the core Consumer Price Index (CPI) dropped to a year-over-year rate of 1.7% in May, down from 2.3% in January. Inflation is the enemy of bondholders. So in that regard, the drop in bond yields and rising bond prices makes sense. The equity market, on the other hand, likes neither too little inflation nor too much inflation. So stock investors have had plenty of reasons to propel prices higher: inflation is lower but still in the ballpark of the Fed's 2% target. The global economic recovery is ongoing and S&P 500 company earnings are rebounding.

There will inevitably be market volatility in response to day-to-day news flow and unexpected events whether negative or positive. Central bank policy, as usual, could trigger volatility. In the United States, the Fed is signaling it intends to continue gradually hiking rates—once more this year and three times next year. That contrasts with market expectations, as reflected in the federal funds futures market, for just one or two more rate hikes over that period. In past years, the Fed's actions have repeatedly converged to meet market expectations, with a less aggressive rate hiking path than it originally forecast for itself. The Fed is likely more hawkish at this point in the economic cycle with unemployment down to 4.3% coupled with its expectation that wage, and ultimately, inflationary pressures will emerge.

As always, we appreciate your continued confidence and trust.

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