LEAVELL
INVESTMENT MANAGEMENT

Fourth Quarter 2017 Commentary

Dear Clients,

Please find enclosed your December 31, 2017 Investment Reports.

The fourth quarter capped yet another stellar year for U.S. stocks. Large-cap U.S. stocks gained 6.8% for the quarter and ended the year with a 22.6% total return. This was the ninth consecutive year of positive returns for the index—tying the historic 1990s bull market and capping a truly remarkable run from the depths of the 2008 financial crisis. The broad driver of the market's rise for the year was rebounding corporate earnings growth, supported by solid economic data, synchronized global growth, still modest inflation, and accommodative monetary policy. U.S. stocks got an additional catalyst in the fourth quarter with the passage of the Republican tax plan, presumably reflecting investors' optimism about its potential to further boost corporate after-tax profits, at least over the shorter term.

Benchmark Returns - As of 12/31/2017

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	6.8%	22.6%	15.9%
US Mid Cap Stocks	5.6%	19.3%	15.1%
US Small Cap Stocks	5.1%	16.2%	14.5%
International Developed Stocks	4.9%	26.3%	8.2%
Emerging Market Stocks	7.0%	32.5%	4.6%
US Bonds	0.4%	3.5%	2.1%
Global Bonds	1.6%	10.5%	-0.2%
US REITs	1.0%	3.7%	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 U.S. stock market's recent performance run has been unprecedented based on several different measures. The market's 1.1% gain in December crowned 2017 as the first year *ever* that stocks rose in each and every month. By year-end, the S&P 500 Index had rallied for more than 400 days without registering as little as a 3% decline. This is the longest such streak in *90 years* of market history, according to Ned Davis Research. Foreign stock returns for the year were even stronger, with developed international markets gaining 26.3% and emerging markets up 32.5% for the year.

Moving on to bonds, the core U.S. bond index gained 3.5% in 2017. This return was close to the index's yield at the start of the year, as intermediate-term interest rates changed little with the benchmark 10-year Treasury yield ending the year at 2.4%. Although the Federal Reserve raised short-term rates three times (75 basis points total), yields at the long end of the Treasury curve declined and the yield curve flattened, a result of subdued inflationary expectations. Corporate and municipal bonds across all credit qualities and maturities had positive returns.

Politically, it was an eventful year for Europe. The uncertainties stemming from the 2016 surprise Brexit vote flowed into 2017. Markets then heaved a sigh of relief after French elections suggested that populist forces might be receding. Political uncertainties notwithstanding, Europe continues its economic recovery within what appears to be a benign fiscal and monetary environment. Europe is matching the United States in terms of economic growth and, according to Capital Economics, is on track to generate its strongest growth since 2007. In terms of the near-term macro outlook, the consensus view is that there is little risk of a U.S. or global economic recession in 2018. The market expects the in-sync global growth that we saw in

2017 to continue. Without a recession, a bear market in stocks is unlikely—although a run-of-the-mill 5% to 10% "correction" can happen at any time (the recent tranquil market notwithstanding) and an unexpected macro/geopolitical shock could cause a larger drop. The simplest answer is that we have little confidence in our (or anyone's) ability to forecast the timing/onset of recessions.

This market cycle has the added "feature" of an unwinding of unprecedented monetary policies put in place after the financial crisis: trillions in central bank asset purchases and negative interest rates that have yet to be normalized. Given the boost to asset prices from these policies, it is reasonable to expect some negative impact as they stop and then reverse course (i.e., "quantitative tightening"). The Fed's gradualist and well-telegraphed steps have, so far, not been disruptive. There will also be a new Fed chair and several new voting FOMC members in 2018, creating more potential for a market surprise. At the very least, it raises the potential for increased market volatility.

The year 2017 was a very good one for most financial markets and particularly global stocks. But there was one small corner of the investment world that did a bit better than stocks: bitcoin gained 1,518%. We don't own bitcoin (or any other crypto currency) in our portfolios. It doesn't fit within our investment discipline or circle of competence. It's a speculative game we *simply don't need to play* to achieve our clients' investment objectives. However, the exponential rise of bitcoin and the questions, emotions, and behaviors it triggers in many investors offers us an opportunity to restate some of the core principles and practices that underlie our investment approach. First, the path to long-term investment success is simple to describe but not easy to achieve. Successful long-term investors are disciplined and patient. They are honest with themselves about what they know, what they don't know, and what they can't know (the unknowable). Successful investors have the humility to know that not every decision will turn out to be right and that simply having conviction about something doesn't mean it will actually happen. Their investment process is well defined and repeatable. It requires having a sound basis for each decision, so that if investors consistently implement the process over time they should be right more than wrong.

Successful investors are willing to challenge their own ideas and admit when they are wrong—whether due to new information and changing circumstances, or an error in their original thesis. They keep their eyes on their long-term financial objectives and on the underlying fundamentals that ultimately drive investment returns. They don't get emotionally caught up in the day-to-day noise of the financial news channels or the zigs and zags of the markets. If the market isn't presenting them with compelling investment opportunities, they are content to hold their current positions; in other words, they don't confuse activity with progress. Successful investors are self-aware about their own risk tolerance and investment temperament. As such, they are invested in a portfolio consistent with those personal attributes, managed by an investment manager aligned with them as well. This enables them to remain disciplined and patient—during the good times as well as the inevitable challenging periods—on the road to achieving their long-term success.

Thank you for your continued confidence and trust. All of us at Leavell Investment Management wish you and yours a very happy, healthy, peaceful, and prosperous New Year.

Timothy S. Healey
Chief Investment Officer

Janet R. Hayes
Chief Operating Officer

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