LEAVELL INVESTMENT MANAGEMENT

First Quarter 2018 Commentary

Dear Clients,

Please find enclosed your March 31, 2018 Investment Reports.

Volatility returned to the financial markets in the first quarter to a level unseen for quite a while. Stocks surged out of the gates in January, with larger-cap U.S. stocks up nearly 8% at the market high on January 26. This was followed by a short but sharp market correction, which dropped the market 10% over the next nine trading days. Stocks then rebounded into mid-March, clawing back much of their losses, before dipping again into quarter-end, buffeted by fears of a potential trade war with China and a Facebook data scandal. When the dust settled, large caps ended down 0.8% for the quarter.

Developed international stocks also got off to a strong start before suffering similar losses to U.S. stocks during the sharp correction in early February and they ended the quarter down 1.8%. Emerging-market stocks held true to their higher-volatility reputation, shooting up 11% to start the year, falling 12% during the mid-quarter correction, and then once again outgaining U.S. and international stocks to finish the quarter with a 1.5% return. Core bonds didn't play their typical "safe-haven" role in the first quarter. They posted losses during the sharp stock market correction in February and delivered a 1.5% loss for the quarter overall, as Treasury yields rose across the maturity curve.

The catalyst for the market disruption was an economic data point in early February showing higher-than-expected U.S. wage inflation. It unnerved investors to think that overall inflation may be rising more rapidly, thereby suggesting the Federal Reserve would tighten policy (raise interest rates) more aggressively than the consensus had been expecting. Selling then begat more selling, as short-term traders (the speculative herd) rushed to unwind their misplaced bets that the very low market volatility would continue.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	-0.8%	14.5%	13.4%
US Mid Cap Stocks	0.0%	12.4%	12.3%
US Small Cap Stocks	-0.2%	11.8%	11.7%
International Developed Stocks	-1.8%	15.5%	6.9%
Emerging Market Stocks	1.5%	22.0%	5.2%
US Bonds	-1.5%	1.2%	1.8%
Global Bonds	3.6%	11.7%	1.2%
US REITs	-8.4%	-5.6%	4.5%

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

Another observation about the market correction in February is that it was caused *not* by indications of an economic slowdown or recession, but by fears the economy may be getting a bit too *strong*, with a tight labor market finally causing rising wage growth and broader inflationary pressures. Fundamentally, even after the correction, the U.S. economy and global economy still look solid. Global growth may no longer be accelerating, but it remains at above-trend levels and the likelihood of a recession over the next year or so still appears low (absent a macro/geopolitical shock). The global economic and corporate earnings growth outlook

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has not materially changed from what it was earlier in the year. The near-term macro backdrop is still supportive for riskier assets even though the U.S. economic recovery is getting long in the tooth. If U.S. GDP growth continues another 15 months, this will be the longest U.S. expansion in post-war history and twice as long as the average upturn.

Consistent with this phase of the economic cycle, the Fed has been tightening monetary policy—raising the federal funds policy rate and unwinding its balance sheet by selling bonds it purchased during quantitative easing. They have done this in a gradual, deliberate, and well-telegraphed manner so far. But given that we are coming off a sustained period of unprecedented global central bank market intervention and monetary stimulus that have boosted asset prices, the risks of a policy mistake or market hiccup remain high.

The inflationary potential of the new fiscal stimulus further raises the risks. On the one hand, to prevent an inflationary spiral, the Fed might preemptively tighten more quickly than the market currently expects or than the economy can handle. Alternatively, the Fed could fall behind the inflationary curve by not tightening quickly enough and then have to take more aggressive measures later, causing a sharper eventual economic downturn. Obviously, neither outcome would be good for the stock market, which is still betting on a Goldilocks economic scenario (not too hot, not too cold). Core bonds would also get hit (rising yields mean falling prices) at the same time stocks are dropping. Investors got a taste of this during the February market correction.

There are, of course, myriad other risks besides central bank policy (there always are). The potential for a trade war between the United States and China attracted investor attention at the end of March, with threats and counter-threats. Stock markets tumbled on the news and remained jittery into quarter-end. No one knows how it will all play out, but rational observers agree that a full-blown trade war would be highly damaging to *all* economies involved. As such, the hope is the actors involved won't allow it to get to that point. One possible outcome is that some relatively minor, targeted tariffs and restrictions are imposed, which would impact individual industries and companies (perhaps meaningfully) but would not have a major impact on the overall U.S. and global economy.

Putting a trade war to the side for the moment, the market's expectation of a Goldilocks economic cycle implies that inflation will continue to move gradually higher without a sudden inflationary surge. If this scenario plays out, we would expect the Fed to continue its path of gradual rate hikes and quantitative tightening over the next couple of years. But as we've said before, not even the Fed itself knows exactly what it will do.

When it comes to the investment world, the human inclination to "do something" leads most investors to undisciplined performance-chasing, panicked selling and other detrimental portfolio moves. The best defense against market volatility is a sound, fundamentally grounded investment process that an investor has confidence in and is therefore able to stick with for the long term—through the ups and downs of market cycles, economic cycles, political cycles, and daily news cycles.

As always, we thank you for your continued confidence and trust.

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