LEAVELL
INVESTMENT MANAGEMENT

Third Quarter 2018 Commentary

Dear Clients,

Please find enclosed your September 30, 2018 Investment Reports.

The divergence in global stock market performance in the second quarter widened in the third quarter with US stocks gaining and emerging-market (EM) stocks falling. The US market was propelled by continued strong profit growth, thanks in large part to the Trump corporate tax cuts. S&P 500 operating earnings per share grew 27% year over year in the third quarter—compared to their 6% long-term annualized growth rate—and a record-high 80% of S&P 500 companies reported earnings that beat the consensus expectation. Record levels of share buybacks provided further support for the US market. Putting it all together, large-cap stocks hit a new high in late September and gained 8.2% for the quarter. Smaller-cap stocks gained 4.8%.

There are always multiple factors behind short-term market moves, but the intensifying trade conflict between the United States and China was an important one for foreign markets and EM stocks in particular in the third quarter. Another factor was the US dollar, which appreciated against other currencies during the quarter. This was a further drag on foreign stock market returns for dollar-based investors. For the quarter, EM stocks fell 0.6%. Developed international equities fared better, posting a slight gain of 1.4%.

In the fixed - income markets, the 10 - year Treasury yield rose to 3.05% at the end of the third quarter, flirting with a seven-year high. As such, the core bond index had a negative 0.5% return in September and was flat for the quarter. At the end of September, the Federal Reserve raised the federal funds rate 25 basis points (0.25%) as expected to a range of 2% to 2.25%. The futures market is now discounting a fourth rate hike this year in December but doesn't yet fully reflect the Fed's own forecast of three more hikes next year.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	8.2%	18.7%	14.2%
US Mid Cap Stocks	4.7%	13.4%	11.7%
US Small Cap Stocks	4.8%	16.7%	11.5%
International Developed Stocks	1.4%	3.4%	5.0%
Emerging Market Stocks	-0.6%	-0.9%	4.0%
US Bonds	0.0%	-1.2%	2.2%
Global Bonds	-1.7%	-1.5%	-0.3%
US REITs	0.8%	2.4%	7.8%

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

Given the negative headlines concerning emerging markets in recent months, there are several points worth highlighting. In 2017, EM stocks gained 31.5% and outperformed the S&P 500 by 10 percentage points. That has sharply re-

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versed this year, with US stocks beating EM by roughly 20 percentage points. This type of volatility and this level of divergence in relative performance is not unusual. It is common for US stocks or EM stocks to outperform the other by double digits over any 12-month period. In more than one-third (36%) of the rolling 12-month periods from January 1988 through August 2018, EM stocks beat US stocks by a margin of 10 percentage points or more. Conversely, US stocks beat EM stocks by a 10-percentage-point or more margin in another 36% of the rolling 12-month periods. So, over shorter-term periods it's actually pretty rare for both markets to perform similarly. However, over this entire 30-year period, the annualized returns for EM and US stocks were an *identical* 10.8%.

The prospect of an expanding trade war between the United States and China intensified in the third quarter and has caused investor sentiment to turn against emerging markets all year. Uncertainties remain, but our base case continues to be that a full-fledged trade war is unlikely since it's in neither country's interest. A positive resolution to the trade conflicts would likely encourage investors to re-examine their emerging market allocations. At the least, we may be living in a world with an overhang of trade tensions for a while.

The tight labor market has finally translated into modest wage increases. History and economic theory suggest wages may continue to rise. This could negatively impact corporate profit margins and earnings growth. It could also cause companies to raise prices, which would stoke further inflation and allow the Fed to continue the move to higher interest rates. The recent rise in the dollar is likely to be another headwind for US multinational corporate profits, as it was in 2015 when the dollar rose. The fiscal stimulus from the tax cuts has boosted corporate earnings growth this year, but those benefits will fade next year (barring further cuts).

By our way of thinking, being an "investor" is synonymous with having a *long time horizon*. In the financial markets, almost anything can happen in the short run because market prices are driven more by investor sentiment, unpredictable events, and human herd behavior. But as you extend your investment horizon, market returns are determined by economic and business fundamentals (earnings and dividends) and valuations (what you pay for those earnings and dividends).

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

Timothy S. Healey
Chief Investment Officer

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Chief Operating Officer

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