LEAVELL INVESTMENT MANAGEMENT

Fourth Quarter 2018 Commentary

Dear Clients,

Please find enclosed your December 31, 2018 Investment Reports.

U.S. and global stocks dropped sharply in the last quarter, capping a year marked by turbulence and losses across most asset classes. Volatility spiked in the fourth quarter as the S&P 500 posted a daily close of up or down more than 1% on 28 days and on 12 days the price change was up or down more than 2%. Among investors' worries are signs of a global economic slowdown, exacerbated by ongoing Federal Reserve monetary tightening, U.S.-China trade tensions, and political uncertainties in Europe (Brexit, Italy) and the United States.

After tumbling 7% in October and then stabilizing in November, U.S. stocks fell again in December as investors reacted negatively to the Fed's language surrounding its 25-basis-point federal funds rate hike. While the Fed's updated forecast implied one fewer rate hike in 2019 than previously communicated (two instead of three), Fed chair Jerome Powell gave no indication that a pause in rate hikes was imminent (although he didn't rule it out). As one commentator summed it up: "This was a more dovish Fed, but not dovish enough for the markets."

Larger-cap U.S. stocks dropped 9% in December and fell 13.1% for the quarter (the worst quarter in seven years). For the year, large U.S. stocks were down a more modest 3.4%. The negative year broke the S&P 500's remarkable nine-year run of positive returns. Smaller-cap U.S. stocks fell more sharply, losing 20% in the fourth quarter and 11% for the year (iShares Russell 2000 ETF). Foreign stocks struggled as well, with developed international markets off 14.1% and emerging markets down 13% (Vanguard FTSE Developed Markets ETF and Vanguard FTSE Emerging Markets ETF). However, their underperformance versus U.S. stocks came earlier in the year. In the fourth quarter, emerging-market stocks beat U.S. stocks by seven percentage points, while developed international stocks matched the U.S. market's return.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	-13.1%	-3.4%	8.8%
US Mid Cap Stocks	-15.5%	-9.2%	6.2%
US Small Cap Stocks	-18.3%	-9.3%	5.2%
International Developed Stocks	-12.8%	-14.1%	1.1%
Emerging Market Stocks	-6.1%	-13.0%	2.4%
US Bonds	1.6%	0.0%	2.5%
Global Bonds	0.9%	-2.1%	0.0%
US REITs	-7.1%	-5.8%	6.4%

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

In addition to the equity market declines, what stands out about 2018 is the *breadth* of negative returns across almost every type of asset class and financial market, whether bonds, equities, or commodities. A study done by Deutsche Bank in mid-November noted that 90% of the 70 different asset classes they track were posting negative returns for the year. This was the highest percentage of losers in the study's 100-year history.

Core bonds, which typically perform well when stocks do poorly, had losses through November (Vanguard Total Bond Market Index). But a strong rally in Treasury bonds in December resulted in a flat return for the year. Only the U.S. dollar index and U.S. Treasury Bills (T-Bills) had a return above 1%. And after adjusting for inflation, T-Bills' real return was negative as well. Simply put, it was extremely difficult to make money in the financial markets last year.

The contrast with 2017's strong market results is striking—and serves as a useful reminder of the unpredictability of markets. It may feel like ancient history, but it was only a year ago that we were reporting 25% to 30%-plus returns for international and emerging market stocks. U.S. stocks were tallying 20%-plus gains, market volatility was at a historical low, daily market price swings were exceptionally muted, and losses were few. Most investment strategists expected 2018 would bring a continuation of the synchronized global economic recovery. The sharp market pullbacks this year only reinforce our view that no one can consistently predict short-term market moves with any accuracy.

The risk of an ongoing escalating trade war with China is a reason for near-term caution. If protectionism really takes hold, it would mean slower global growth and less open markets—both of which are negative for stocks. On the other hand, the potential exists for a positive surprise on the trade policy front; if so, emerging market stocks would likely respond strongly. More broadly, should global growth stabilize and reaccelerate next year stocks are likely to be a primary beneficiary.

We have frequently emphasized the importance of having a long-term perspective in becoming a successful investor. In fact, the terms "long term" and "investor" are inseparable in our mind. With a long-term perspective comes the necessity of discipline (sticking to your investment process and executing it consistently over time) and patience. It is important to maintain the temperament to allow your investment objectives to be realized over time and not be overly sensitive to shorter-term price volatility and portfolio swings that can trigger actions detrimental to achieving your investment goals.

No one knows what the next year will bring. We may see some continuation of recent market trends or a stabilization or reversal in some of them. The market consensus will likely be surprised again. We remain confident in our analysis and process which will enable us to achieve long-term success and avoid the pitfalls of performance chasing and emotionally driven investing. Successful investing is a process of consistently making sound, well-reasoned decisions over time, and across market and economic cycles. We believe our diversified, fundamental, valuation-based investment approach meets this definition. As long as we continue to execute our approach with discipline and remain patient we should continue to achieve successful and rewarding long-term results for our clients.

As always, we appreciate your confidence and trust and we wish everyone a happy and healthy New Year.

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Please advise us if you would like copies of our annual Securities & Exchange Commission Disclosure Brochure (Form ADV), a Prospectus for The Government Street Funds or a record of how your proxy statements were voted.