LEAVELL INVESTMENT MANAGEMENT

First Quarter 2019 Commentary

Dear Clients,

Please find enclosed your March 31, 2019 Investment Reports.

The first quarter was an unusually strong period for equities. It also marked a striking reversal from the end of 2018. After posting the worst December since 1931, U.S. stocks surged to their best January since 1987, followed by further gains in February and March. Larger-cap U.S. stocks gained 13.2% for the quarter, placing it in the top decile of quarterly market returns since 1950. As a reminder, large cap stocks declined 14% in last year's fourth quarter. Once again, the markets surprised the consensus and demonstrated the folly of trying to predict short-term performance. Foreign stocks also rebounded sharply in the first quarter. Developed international markets gained 10.2% and European stocks were up 12.9%. Emerging-market stocks rose 10.4%, after holding up much better than U.S. stocks on the downside in the fourth quarter of 2018. Fixed-income markets were also strong. Investment-grade bonds rose 2.9% and the 10-year Treasury yield fell to 2.39% during March, its lowest level since December 2017.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	13.2%	10.2%	11.2%
US Mid Cap Stocks	16.8%	6.0%	8.9%
US Small Cap Stocks	16.2%	5.6%	7.9%
International Developed Stocks	10.2%	-3.6%	2.9%
Emerging Market Stocks	10.4%	-5.3%	4.5%
US Bonds	2.9%	4.5%	2.7%
Global Bonds	1.5%	-4.1%	-0.3%
US REITs	15.9%	19.2%	7.6%

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 key catalyst for the rebound in equity markets was a significant shift in the Federal Reserve's stance on monetary policy. In late December and throughout January, the Fed became much more accommodating (that is "dovish"). After hiking interest rates four times in 2018, including at their mid-December meeting, and indicating further tightening would occur in 2019, Fed officials suddenly reversed themselves. They emphasized they would be "patient" and pause any further rate increases. In early January, Fed chair Jerome Powell said the Fed could also slow down or stop shrinking its balance sheet of bonds purchased during quantitative easing. The U-turn in Fed policy was music to the ears of the financial markets, which had become concerned about ongoing policy tightening in the face of slowing economic growth in the United States and abroad. Powell also cited persistently low inflation/disinflation across the globe as "one of the major challenges of our time" for central bankers.

There were other positives for the markets as well: The federal government shutdown, which had started to weigh on sentiment, ended in late January. Signals from the U.S.-China trade talks turned more positive, although far from anything definitive. The likelihood of a "hard Brexit" also seemed to wane, but again, far from anything definitive. In sum, the market rebound was due more to improving investor sentiment and risk appetite—caused largely by the shift in Fed monetary policy—than any meaningful improvements in underlying economic or business fundamentals.

The U.S. economy is in better shape than most, but even here growth expectations have been coming down. At its Federal Open Market Committee (FOMC) meeting on March 20, the Fed downgraded its median GDP growth estimate to just 2.1% for 2019 and 1.9% for 2020, citing the effects of economic slowdowns in China and Europe, fading stimulus from the 2017 Trump tax cuts, and ongoing uncertainty around Brexit and trade policy.

It's also worth noting that two days after the Fed's dovish announcement, the 10-year Treasury yield fell to 2.44%, causing an inversion in the yield curve between the 10-year Treasury and the 3-month T-bill, which yielded 2.46%. A *persistently* inverted 10-year/3-month yield curve has been a consistent leading indicator of recession in past U.S. economic cycles, although the lead time has been variable and lengthy—anywhere from four to 16 months prior to the onset of recession.

Besides the indicators of a slowing economy, U.S. corporate earnings growth expectations have also continued to decline, albeit from unrealistically lofty levels last year. Even with the Fed now on hold, earnings growth will need to improve for stocks to appreciate meaningfully from current levels, given their sharp rebound in the first quarter and high valuations. Investors will continue to keep a close eye on China where the government is once again trying to boost their economy via fiscal and monetary policy. It is not yet clear if they will be successful, as these policy changes flow through to the economy with time lags and uncertain impacts. A revival in Chinese growth would have positive ripple effects across the global economy. It would benefit other emerging markets and Europe in particular, as China is a major importer of their goods.

It certainly feels better to see strongly positive portfolio performance this quarter compared to the losses in the fourth quarter of 2018. But just as we wouldn't extrapolate last year's losses when looking out over the coming years, it's equally important to temper our expectations on the upside after this quarter's strong rebound. This is particularly true for the U.S. stock market, which is back up to its levels of early October 2018.

As always, it is wise to be prepared (mentally, emotionally, and financially) for shorter-term downside and negative market surprises. No matter what the future brings, maintaining a healthy patience and perspective, and sticking to one's investment discipline, is necessary for long-term investment success.

All of us at Leavell Investment Management appreciate your trust and confidence.

Timothy S. Healey
Chief Investment Officer

Janet R. Hayes
Chief Operating Officer

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.