LEAVELL INVESTMENT MANAGEMENT

First Quarter 2021 Commentary

Dear Clients,

Please find enclosed your March 31, 2021 Investment Reports.

Global stock markets celebrated the one-year anniversary of the pandemic-induced bear market low (March 23, 2020) with another strong quarter of returns. US large cap stocks gained 5.3%, developed international stocks rose 4.1% and emerging-market stocks gained 2.8%. From the low on March 23, 2020 to March 31, 2021, the S&P 500 Index was up an astonishing 80.6%. In fact, the S&P 500's one-year return from the low was its best since 1936. Clearly, it paid not to panic and get out of the markets last spring, despite the natural fear, anxiety, and uncertainty everyone was feeling at the time.

The first quarter also saw a continuation of the "reflation rotation" trend that has been happening beneath the market surface over the past several months. Specifically, smaller-company stocks have outperformed large caps and value stocks have done better than growth stocks. Looking at it from another perspective, cyclical (meaning more economically sensitive) stocks were the strongest performers. Energy and financials were the top-performing sectors in the S&P 500, gaining 30.9% and 16.0%, respectively. In contrast, utilities, consumer staples, and health care—considered "defensive" sectors—were among the worst, registering just slightly positive returns. The technology sector was also one of the worst performers for the quarter.

The reflationary trend moved through the fixed-income markets as well. The benchmark 10-year Treasury yield jumped nearly 75 basis points from year-end to close the quarter at 1.74%, a 14-month high. Correspondingly, the core bond index lost 3.4% for the quarter (Barclays US Aggregate Bond Index). This is its worst quarterly performance since 1981 and the fourth - worst return in the index's history

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	5.3	56.5	17.1
US Mid Cap Stocks	7.2	70.7	14.6
US Small Cap Stocks	10.2	87.7	15.6
Developed International Stocks	4.1	49.2	9.9
Emerging Market Stocks	2.8	56.7	12.0
US Bonds	-3.4	0.7	3.1
Global Bonds	-5.3	7.2	2.1
US REITs	8.5	36.1	4.0

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
Developed International 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

back to 1976. We continue to believe that core bonds serve an important role in more conservative/risk-averse portfolios as ballast and diversification against equity risk and volatility. As such, we do not own bonds for their long term return potential, but rather for their shorter-term risk-mitigating properties and generation of income.

There currently exists a positive outlook for a strong economic recovery in the United States (and globally to varying degrees) this year. Looking further out, absent a COVID-19 resurgence or a negative geopolitical shock, the recovery is likely to continue for some time, albeit at a much slower pace. Substantial progress on vaccines is reason for cautious optimism. Over the past two months, the United States has seen very sharp declines in daily new cases, current hospitalizations, and daily new deaths from COVID-19.

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Meanwhile, the rate of COVID-19 vaccinations has soared to 2.8 million per day and about one-third of the population have now received at least one dose, including more than 50 million who have been fully vaccinated. At the current pace, experts estimate the United States could achieve herd immunity by late summer, if not sooner. From an economic perspective, getting the pandemic under control will enable increased activity, employment, household income, consumer spending, economic growth, and corporate earnings.

After the Federal Open Market Committee (FOMC) meeting in March, Fed chair Jerome Powell summed up the Fed's current stance as follows: "The economy is a long way from our employment and inflation goals, and it is likely to take some time for substantial further progress to be achieved. We will continue to provide the economy the support that it needs for as long as it takes." Thus the Fed kept its policy interest rate (the federal funds rate) unchanged at near-zero percent and gave no indication it is planning a reduction (or tapering) any time soon in its $120 billion per month quantitative easing asset purchase program. Moreover, 11 out of 18 FOMC members still do not expect the Fed to even start raising rates until at least 2024. This is despite the Fed sharply increasing its median forecast for 2021 U.S. GDP growth to 6.5% —driven by the accelerating vaccine rollout, declining virus spread, and the passage of the $1.9 trillion American Rescue Plan (ARP) in March. In contrast, at the Fed's December FOMC meeting three months ago, its median 2021 GDP growth forecast was 4.2%. The Fed's latest forecast of the year-end unemployment rate dropped to 4.5%, compared to their prior forecast of 5.0%. The headline unemployment rate currently stands at 6.0%. Finally, the Fed increased its forecast of core inflation to 2.2% for 2021, from 1.8% previously. Core inflation is currently running at 1.4% year over year.

Moving to fiscal policy, the big news was the passage of the $1.9 trillion ARP, equivalent to roughly 9% of U.S. GDP. While most observers expected the Biden administration to enact a large fiscal package, many were surprised Congress passed the full $1.9 trillion initially proposed. Adding in the prior two pandemic-relief fiscal packages passed in March and December 2020, the total fiscal stimulus equates to more than 25% of GDP. This is a huge number and roughly five times the fiscal response during the 2008 Great Financial Crisis. It also contributed last year to the largest federal budget deficit since World War II, at 15% of GDP. The 2021 budget deficit is projected to be the second largest, at 10% of GDP.

There has been a recent sharp uptick in inflation fears as a result of the positive macro factors we discussed above: (1) the expected reopening of the economy as the pandemic is brought under control, (2) ongoing highly accommodative monetary policy, and (3) unprecedented fiscal stimulus/support and the prospect for more to come from the new administration and Congress. Inflation expectation*s* can be a key driver of actual inflation. If people act on their belief that future inflation will be higher, it can lead to a self-fulfilling cycle of actual higher inflation. Consumers tend to accelerate their spending to buy while prices are lower than they are expected to be in the future. Businesses do the same and may also raise prices to maintain profit margins while workers demand higher wages to compensate for higher inflation and businesses raise prices further to offset their higher input costs. Expert opinions diverge as to whether we are nearing the beginning of a sharp and sustained rise in inflation or just a temporary blip before it settles back to around 2% or lower, as the Fed has suggested. Investors and consumers alike will be keeping a close eye on this key economic indicator as the year progresses.

As always, we appreciate your continued confidence and trust.

Timothy S. Healey
Chief Investment Officer

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Chief Operating Officer

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