LEAVELL
INVESTMENT MANAGEMENT

Second Quarter 2021 Commentary

Dear Clients,

Please find enclosed your June 30, 2021 Investment Reports.

Global stock markets continued to surge in the second quarter. Developed markets led the way, with U.S. large cap stocks gaining 9.0% and developed international stocks gaining 5.7%. Emerging-market (EM) stocks rose 5.3%, held back by mixed news on the COVID-19 front and a tightening in China's financial conditions. Within the U.S. stock market, the rotation from growth to value stocks took a pause, with the Russell 1000 Growth Index gaining 11.9% versus a 5.1% rise for the Value index. Smaller-cap value stocks slightly outperformed their growth counterparts and remain the top-performing segment of the U.S. market this year. However, large-cap stocks handily beat small-cap stocks in the second quarter. In fixed-income markets, the 10-year Treasury yield dipped below 1.50% in June, ending the quarter at 1.45%, down from 1.75% at the end of March, despite higher inflation readings during the quarter. This contributed to a solid 1.8% return for U.S. bonds.

A global economic recovery is likely to continue, over the next 12 months at least, driven by expanding COVID-19 vaccinations and immunity, and still-accommodative global monetary and fiscal policy. While most asset class valuations are expensive, these macro conditions remain broadly supportive of corporate earnings and risk assets. Inflation risks have increased since three months ago but there is great uncertainty as to whether the recent price surge is transitory or an early indication that a sustained period of higher inflation lies ahead. Fed chairman Jay Powell has said there is significant uncertainty around the outlook for inflation as the economy recovers from the unprecedented pandemic-induced dislocations.

Benchmark Returns

	Last Quarter	Last Twelve Months	Last Five Years
US Large Cap Stocks	9.0	41.3	18.6
US Mid Cap Stocks	7.6	46.9	15.8
US Small Cap Stocks	5.6	56.5	15.9
Developed International Stocks	5.7	36.0	11.4
Emerging Market Stocks	5.3	39.2	12.8
US Bonds	1.8	-0.3	3.0
Global Bonds	0.9	4.6	1.6
US REITs	11.7	36.6	5.0

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

The Fed reflected the consensus growth view when it updated its economic forecasts at its June 16 Federal Open Market Committee (FOMC) meeting. The Fed now expects U.S. real GDP to grow 7.0% this year, up from its 6.5% growth forecast in March. The Fed left its 2022 GDP growth forecast at 3.3%. Most economists and the Fed estimate the U.S. economy's longer-term potential GDP growth rate, which is a function of labor force growth and productivity growth, is around 2.0%.

We believe the Fed and monetary policy are still likely to remain accommodative for some time. Before starting to raise the fed funds rate, the Fed will need to wind down its $120 billion per month quantitative easing (QE) asset purchasing program that

210 St. Joseph Street ■ Mobile, AL 36602
(251) 433-3709 Tel ■ (251) 433-3723 Fax

leavellinvestments.com

2712 18th Place South ■ Birmingham, AL 35209
(205) 879-1654 Tel ■ (205) 871-8708 Fax

it started last March. The consensus seems to be for the Fed to start QE "tapering" in early 2022 and end QE by the end of 2022. The Fed is afraid of upsetting the financial markets—it does not want another 2013 "taper tantrum"—and says it will give plenty of notice before beginning tapering. Then, after tapering is complete, it will allow some time before it starts signaling it is preparing to begin to increase the fed funds rate. Therefore, there exists a reasonable base case that we are still at least a couple of years from Fed rate hikes. But we acknowledge a wide band of uncertainty around any interest rate forecast. And we expect volatility as markets react to each and every Fed governor comment relative to policy.

The other policy pillar—fiscal policy—is also more uncertain as the American Rescue Plan and other emergency pandemic programs lapse later this year, including the $300/week enhanced unemployment benefits that expire nationally in September (and sooner in Republican-controlled states). While the Biden administration clearly wants trillions more in government spending for infrastructure and other programs, the politics of passing additional fiscal stimulus are proving challenging given the Democrats' slimmest of Senate majorities. Regardless of what happens with the infrastructure negotiations, the U.S. economy is about to shift from getting a large fiscal boost to facing a meaningful fiscal drag—a negative impact on GDP growth—in the latter half of 2021 into 2022 from the expiration of the pandemic programs.

Absent a severe resurgence in the pandemic, inflation is probably the key current market and macro risk. There is no question the recent CPI inflation numbers have been surprisingly high. However, research shows more than half of the monthly increases in core CPI in April and May are explained by (1) higher vehicle prices (which is largely due to semiconductor chip shortages constraining new auto production and causing spiking demand for used cars), plus (2) the sharp rebound in the prices of travel and leisure services most deeply hurt by the pandemic (airfares, hotels, and public events). To cite an extreme example, used car prices rose 10% in April and another 7% in May, contributing more than one-third of the total monthly CPI rate. It would seem that this type of price inflation is unsustainable. However, the monthly inflation rates do reflect the current supply/demand dislocations in the economic sectors recovering most sharply from the pandemic shock.

It is also possible that supply shortages and bottlenecks don't resolve as quickly as expected; or that wage increases accelerate despite the apparent labor market slack; or that the Biden administration pushes through another huge debt-financed and central bank QE-supported fiscal spending program; and that longer-term inflation expectations start to become unanchored from around 2%. Any of these occurrences would be inflationary and likely lead to asset price adjustments. Along these lines, absolute valuations for U.S. stocks are historically very high and reflect a lot of good news/high expectations for continued strong U.S. corporate earnings growth. This raises the potential for a typical market correction (a 10%-plus decline) should actual S&P 500 earnings growth fail to meet such lofty expectations.

Over longer-term investment horizons, stocks have generally been good at generating returns above the rate of inflation, although equity valuations and returns typically take an initial hit as the market adjusts to a higher inflation regime. It is still too early to say whether and to what extent the past two months' inflation reports are harbingers of a sustained period of meaningfully higher inflation. Or whether, as the Fed believes, most of the recent sharp price increases will prove transitory, as current supply shortages catch up to demand and increasing productive capacity comes online as the pandemic recedes.

As always, we thank you for your continued trust.

Timothy S. Healey
Chief Investment Officer

Janet R. Hayes
Chief Operating Officer