Market Outlook

1st Quarter 2018

Midland States Bank®

Happy New Year! 2017…We will miss you!

We hated to see 2017 end because it was a great year for the markets. Even with headline news stories of problems in Washington and heightened geopolitical concerns, U.S. economic growth continued to expand at a slightly faster pace than the previous years. At 4.1%, U.S. unemployment is at a 20 year low, and global economies are experiencing synchronized growth, with Europe doing particularly well. Even though growth has been improving, inflation has remained tame enough to allow most global central banks to keep monetary policy accommodative even as the Federal Reserve Bank (Fed) has gradually raised short-term rates.

For investors, 2017 was nearly perfect. U.S. equity markets performed very well with positive contributions coming from increased economic growth, rising corporate earnings, lower unemployment, improved business and consumer confidence, low inflation, reduced regulations, and relatively easy monetary policy. Even with the stellar returns coming from U.S. equities, international and emerging markets did even better as a 10% decline in the dollar contributed even more to these overseas returns. The aggregate U.S. bond market also produced positive gains even in the shadow of a stronger economy and superior equity returns.

For 2018, optimism is excessive, perhaps too excessive, as the U.S. and global economic expansions are expected to continue. We feel the general international financial picture is good, but politics (geopolitics included) may be more of a concern moving forward.

As fundamentalists, we monitor both fiscal and monetary policy as the first step in determining investment strategy. This year, the U.S. economy will realize new fiscal stimulus from the just passed tax reform bill. Conversely, the Fed is taking away its monetary stimulus by gradually raising short-term interest rates. Nonetheless, U.S. companies are projecting improved bottom lines and increased corporate earnings from the recently signed tax legislation. Some corporations will put part of their new found tax savings into capital investments, while others may reward shareholders with increased dividends. With economic growth expected to increase during 2018, the U.S. unemployment rate is expected to fall even though many economists believe we are already at full unemployment. What could go wrong?

Accelerating inflation would be a nasty, negative headwind this year. Rising inflation is typically indicative of a maturing U.S. business cycle. Many economists predict 2018 inflation will exceed 2017's pace of 2.1%. Hourly wages are growing at 2.5% but are considered tame. The relatively mild gain in pay contradicts the standard notion of full employment, in which businesses give in to workers' demands for raises in a tight labor market. Companies seem to be doing their best to keep wages in check for now. Several factors seem to be responsible for

Economic Forecasts

Year Ahead Forecast	Economic Indicator
↑	**GDP** Anticipate moderate growth for 2018 to range between 2.50 – 3.00%
●	**Unemployment** 2018 to *average* between 3.80-4.30%
●	**Interest Rates** Expect slowly rising interest rates with a generally flat yield curve
↑	**Fed Funds Rate** Fed leaning towards gradual rate increases in 2018
●	**Inflation** Should move above 2.00% during 2018
↑	**Retail Sales** Continued modest growth as wages increase in 2018 driven by e-commerce
↑	**Housing Prices** Low inventory levels will continue to push home prices higher
●	**Oil Prices** Volatility likely to continue - anticipate 2018 prices in the $50 - $75 per barrel range

● Neutral Outlook
↑ Upward Outlook
↓ Downward Outlook

the lagging wage growth. First, many workers who lost their jobs around the 2009 recession have since returned to work at a lower wage. A second factor is the development of a global labor market that puts U.S. workers in competition with peers in China and Europe. Thirdly, younger workers are replacing baby boomers who typically retire at their peak career salaries, which has dampened the rise in employee earnings. Finally, technology advancements in specific industries are replacing workers, increasing productivity and reducing labor costs and benefits. The headline unemployment rate of 4.1% may not adequately reflect the degree of slack in the labor force because some Americans were too discouraged to look for work, and others settled for lower-paying, part-time jobs. We are not confident that the benign wage growth will continue. In urban areas facing worker shortages, companies have little choice but to raise wages to attract skilled workers. Several Federal Reserve Districts are reporting wages growing more than 4% in several major cities. We believe inflation will rise throughout the year.

For 2018, we are monitoring two other sources of inflationary concerns - oil prices and the U.S. dollar. OPEC's oil production cutbacks sparked a rebound in energy prices back to levels last seen in mid-2015. During the fourth quarter of 2017, crude oil prices jumped 15%. While we do not expect significant price gains during 2018, we do believe energy prices will help fuel some inflationary pressures. Also, the U.S. dollar bears watching this year after falling roughly 10% during 2017. A decline in the dollar increases the pricing attractiveness of our goods in the competitive, overseas market, which is a benefit to our economy. However, the cost of imported goods would increase and could add to overall inflation. As the primary world currency, the dollar's value this year is predicated on U.S. interest rates, the strength of the U.S. economy, and its safe haven qualities. The current worry for dollar traders is inflation, which could upset the markets if it accelerates too quickly. For fixed income markets, inflation could step up the pace of Fed interest rate hikes and may support the dollar. For businesses, increased interest costs would squeeze profit margins, reduce earnings growth for multi-national companies, and call into question current equity valuation levels.

Economic cycles come and go. Bull markets do not die of old age. We see the reasons to believe inflation will rise through next year. Problems always arise to disrupt the markets. Nonetheless, we believe that success in the markets is not made from the timing of the market but from your time in the market.

Fed Policy & Fixed Income Markets

During the final quarter of 2017, U.S. fixed income returns were mostly positive. Longer-term fixed income securities performed better than their short-term counterparts. For the year, the best gains came from the same longer-term securities and the riskier high yield bonds. Credit spreads for high-yield and investment-grade corporate bonds remain near record lows as demand for income by investors remains high. Tightening U.S. monetary policy has held back the returns on shorter-term fixed income securities.

During the fourth quarter, the Fed continued "normalizing" its accommodative monetary policy. This process is the Fed's way of gradually bringing what were once ultra-low short-term interest rates back up to levels that can be a starting point for the next accommodative monetary cycle. The Fed raised the Fed Funds level by 25 basis points in mid-December. The Fed raised short-term rates three times in 2017, for a total of 75 basis points. The result of these actions flattened the Treasury yield curve. Short-term rates rose while longer-term rates did not increase as much. The longer-term rate movement is attributed to the market's belief that the Fed is

overreacting by hiking rates in the low inflation environment, which could slow the economic recovery. That yield curve configuration has often, but not always, signaled a coming recession.

Most international central banks are continuing their easy monetary policies that have been beneficial for global equity markets over the past nine years. However, they are beginning to signal an end to the practice. Our Fed is committed to reducing the extremely loose monetary conditions it put in place after the last financial crisis without crushing the current economic expansion. The Fed wants short-term interest rates to return to a more normal level for this stage of the economic cycle. Also, the Fed worries about the potential for increased inflation and systemic problems from possible asset bubbles.

Statements from the Fed suggest another three rate hikes during 2018. Its target for the Fed Funds rate is 2.50% in 2019, up from the current 1.25% to 1.50% level today. Last October, the Fed began shrinking the size of its asset balance sheet by slowly reducing its reinvestment from maturing securities. This action will continue through 2019 and is expected to reduce the Fed's balance sheet by $2.5 billion, which has the potential to increase longer-term interest rates. The Fed keeps reminding the market that it is trying its best to normalize monetary policy to regain the tools it needs to fight the next recession. We are concerned it will normalize too quickly, effectively putting the brakes on the economy. Fortunately, other global banks will not be in such a hurry to scale back their security purchases for a few more years. Global central banks' balance sheets are still growing by 8%, year over year, even with the Fed discontinuing its asset purchases. The Fed would prefer to manage the shape of the yield curve by allowing long-term interest rates to rise to match the increase in short-term yields. If the Fed cannot pull this off, it will risk inverting the yield curve (short-term rates exceeding longer-term rates) and potentially throw the economy into a recession.

Simple economics suggest the supply and demand for fixed income securities affects prices and yields. We are concerned that further Fed rate increases, rising inflation, and increasing budget deficits may cause a hiccup in the fixed income markets. Investors have not seen a sustained fixed income bear market in years and may react irrationally. Fortunately, the demand side should remain strong. U.S. fixed income securities offer better yields than comparable term global securities. This yield advantage is critical. Also, boomers can support the bond market as they rebalance their portfolios from higher-risk equities to lower risk bonds. An aging population means more investors will want to reduce their risk profile and add to their fixed income allocations. Retail investors seem more willing to stick with bonds than professionals as yields rise. These retail investors see a pragmatic appreciation for bonds, steady income, and relative price stability. It remains to be seen if retail investors will hang on to their fixed income securities if yields start to skyrocket. During the 2013 "taper tantrum," bond mutual funds suffered net outflows for eight consecutive months. We should expect some market indigestion this year. However, one must remember, history has shown us that a really bad year in bonds is a lot better than a bad year in stocks.

A great year for stocks, who would have thought!

I think it is safe to say that the global equity markets pretty much surpassed most investors' expectations in 2017. Over the past 12 months, global equity markets have made strong advances, driven by continued, broad-based economic growth.

More importantly, the equity markets were led by a synchronized global expansion with economic

fundamentals surprising on the positive side throughout 2017. As this expansion gained momentum, it became evident that the U.S. government was set to take some of the load off of the Fed. Although Congress failed to provide much in the way of fiscal policy stimulus, the economy did benefit from significant government de-regulation. Continued de-regulation, accompanied by the recently passed "tax reform bill," should provide a favorable environment for stocks in 2018.

Having underperformed the U.S. equity markets for the last several years, international stocks finally benefitted from a weaker U.S. dollar and were the clear winners throughout 2017. Emerging market equities fired on all cylinders, generating a 37% return followed closely by the larger, developed international markets, which returned 26%. Not to be outdone, the S&P 500 came in with a very respectable 21% gain that was driven by a 14% growth in corporate earnings. All of this was accomplished without the benefit of a corporate tax cut too.

As we enter 2018, we intend to maintain our over-weighted position to international and emerging market equities as lower P/E multiples, accelerating earnings growth, and improving global GDP should provide a solid foundation for global equities. We continue to believe that since the foreign economies lagged the U.S. going into the last recession, they should have further to go within this global economic expansion. This situation is evident when analyzing the forward P/E multiples for the S&P 500 at 19x, developed international at 15x, and emerging markets at 12x.

Although we believe the secular bull market is well intact and should continue in 2018, we do see a few speed bumps in the road. Our two primary concerns are (1) an overzealous Fed raising interest rates too far and too fast and (2) a substantial deceleration in corporate earnings. Interestingly, the recently passed "tax reform bill" could have a significant impact on both of our concerns; one positively and one negatively. The irony is the corporate tax cut could alleviate the risk of slowing earnings growth; however, stronger earnings accompanied by accelerating GDP growth could lead to higher interest rates. With this increasing uncertainty, we would expect more significant volatility in 2018.

What happened to volatility?

Global equities experienced a year of exceptionally low volatility and along with it, positive returns in every month of 2017. In fact, 2017 saw only one day with a return higher than +1% and just two days with a return less than -1%. The MSCI All Country World Index has never gone so long without a 5% correction in its 30 years of history, while the S&P 500 Index hasn't rallied as long without even a 3% correction during its 90-year history.

There have been, and will likely continue to be, downturns throughout this extended bull market. Since 2010, there have been 18 downturns in the market, 14 of which were between 5% and 10% and four of which were between 10% and 20%. The market has bounced back following each pullback and then has moved higher. The likelihood of a 5-10% correction in 2018 has increased significantly, as has our expectation for that correction. However, a correction is not necessarily the end of the bull market. In fact, it has historically created buying opportunities.

Equity markets in the U.S. have been rising for almost nine years. Overall, investment fundamentals are strong. Corporate earnings are growing at a healthy rate, and companies are generating excess cash flow. Cash continues to build on corporate balance sheets, with $5.2 trillion in cash and short-term investments among the S&P 500 Index companies. A corporate tax cut, repatriation of foreign earnings, and continued efforts toward regulatory relief

should provide support for equities. Currently, a synchronized global recovery and solid fundamentals outweigh our valuation and interest rate fears; hence our continued bullish outlook.

Tactical Asset Allocation Strategy

With volatility at record low levels and solid earnings growth, it should come as no surprise that there were no tactical changes to our portfolios during the 4th quarter. We will enter 2018 with a slight overweight to stocks, particularly favoring international and emerging market equities. The weak U.S. dollar should continue to benefit emerging markets, as well as large-cap U.S. multi-nationals. The wild-card in 2018 could be small-cap stocks. We have been underweight small-cap stocks throughout 2017 due to high valuations and lackluster earnings growth, which is not out of the ordinary late in an economic cycle. However, the corporate tax cut should favor smaller, domestic-oriented companies as they will see the most significant tax cuts. A reversal in the strength of the U.S. dollar would be a key variable for changing our current outlook. A weak dollar should continue to benefit emerging markets and U.S. large-cap, multinationals, while a stronger dollar would benefit the smaller, more domestic-oriented companies.

Our fixed income portfolios held up very well and outperformed their taxable benchmarks for 2017. Lower quality credits continued to outperform investment-grade bonds since the risk of defaults remained historically low as the economy picked up momentum. The 10-year Treasury note nearly ended the year where it started, even with three rate increases by the Fed.

Higher short-term yields and a flatter yield curve limited the returns of shorter-term maturities, but bonds were generally positive across the curve. We are becoming much more cautious on the fixed income markets as all eyes will be focused on the Fed and its ability to navigate the economy through a tightening of monetary policy.

We continue to favor stocks over bonds. However, the historically low levels of volatility and lack of any meaningful stock market correction have us a little on edge. By all accounts, we are well overdue for a correction. If the correction occurs, we will use it as another buying opportunity.

Tactical Asset Allocation

	Underweight	Target	Overweight
Fixed Income	●		
Short Term Bonds			●
Intermediate Term Bonds		●	
Long Term Bonds	●		
High Yield Bonds	●		
Intl Developed Bonds	●		
Bank Loans			●
Emerging Market Fixed	●		
TIPs	●		
Equity		■ →	●
U.S. Large Cap Equity		●	
U.S. Mid Cap Equity		●	
U.S. Small Cap Equity	●		
Intl Developed Equity			●
Emerging Market Equity			●
Real Estate	●		
Alternatives	●		
Commodities	●		
Absolute Return		●	
Cash		●	

● ● ● Indicates current position

■ ■ ■ Indicates position as of last report if position has changed

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