



Market Outlook

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Welcome

Welcome to the first joint Market Outlook from Midland Wealth Management. There have been many things going on during the past few months with the integration of the two investments teams. While it may seem as though it may be an overwhelming task to integrate the two groups, it is amazing how similar the strategy, philosophy and processes were between the two groups. As a team, we have determined our strategy going forward and rest assured to our client base, you will see minimal change in the investment process and your portfolio. We are a stronger team united as one and look forward to continuing to provide stellar investment performance to you.

The Economic Cycle: When Will It End?

The current business cycle is now the second longest in history and may well surpass the longest one, which occurred in the 1990s. The duration of that cycle was 120 months. The current economic environment continues to show steady growth and there are no immediate signs of a recession in the near term. With each passing month, we are closer to exceeding the longest business cycle of all time.

Recessions are triggered by tightening monetary policy by the Federal Reserve to lower inflation and prevent overheating in the parts of our economy that are growing too swiftly. In the late 1990s the technology sector of the stock market grew at an unsustainable rate, leading to the recession in 2000. Approximately six or seven years later the housing market grew at a clip that was both irrational and unhealthy, causing the most recent and most painful recession. Since the growth rate of the current business cycle has been slower and more gradual than past ones, it is possible to realize a longer cycle of growth than in the past.

The average annual rate of growth has been around 2%, which is the long-term trend level of growth determined by the productivity rate and population growth. In 2018, the country is experiencing even more robust growth, largely as a result of the Tax Reform Act that was passed at the end of 2017. The 2018 growth projection is 3%, led by capital spending, consumer confidence bolstered by the strong labor market, and overall optimism about people's balance sheets. The most recent unemployment rate was reported at 4% and according to the Job Openings and Labor Turnover Survey (JOLTS), the number of job openings are greater than the number unemployed. The mismatch of skills as well as geographic availability may lead to wage pressure, which has been absent through most of this economic cycle. While we have not seen above trend inflation during most of this cycle, the tight labor market may lead to higher input costs, resulting in higher prices for consumer goods.

Some forecasters are calling for a recession in order to instill fear or make a name for themselves but the vast majority believe it won't occur until late 2019 or 2020 at the earliest. Business cycles always work this way as there is no way to have strong and sustainable growth indefinitely. If one digs into the economic numbers, the indicators that typically precede a recession are not apparent. The Leading Economic Indicators (LEI) are still improving and once the numbers roll over and begin to decline, it has usually taken 9 to 12 months before a recession begins. An inverted yield curve (10 year – 2 year Treasury) is another indicator of a pending recession, appearing 12 to 18 months beforehand. The yield curve has flattened but there is still some slope to it. Another component that typically occurs before a recession is the spread or difference in yield between high yield (non-investment grade) and AAA bonds (investment grade). As the economy strengthens, the spread tends to tighten while widening spreads indicate a slowing and possibly recessionary economy.

At this time, high yield spreads have been fairly flat and near historically tight levels. Looking at these indicators and other potential precursors to a recession, we continue to affirm our belief that there should not be a recession in the next 12 months.

Global economies continue to grow, albeit at a slower rate than experienced during the first quarter. The question that arises is whether the slowing global economic environment was caused by stronger currencies relative to the dollar in late 2017 and early 2018, creating a drag on growth. The dollar has strengthened during this past quarter, and will these conditions benefit global economies going forward? The other unknown is the global impact from tariffs and potential trade wars.

While we are uncertain if the tariff and trade talk coming out of the White House is simply leverage for negotiations or if we will end up in a trade war, the ultimate goal is fair trade but this may become a headwind for businesses across the globe. The fear of higher input costs as well as slower demand for products in a more inflationary environment may lead to less business investment spending, lower demand for new employees and slower growth in the economy. The tariffs alone will not lead to a recession but could impact the rate of growth. We will, of course, continue to monitor these developments but remain confident the next 12 months will be a continuation of the current business cycle growth, leading to the longest one in the history of our country.

Fed Policy & the Bond Market

While many investors would prefer to watch paint dry than discuss the bond market, we find this asset class worthy of a closer look. This year, however, the slow grind of rising U.S. interest rates is tiresome to even the most passionate fixed income professionals. Most of the major domestic and international fixed income sector benchmarks have negative returns for the year. Two sectors have bucked that trend, high yield and very short-term securities. Even though the credit spreads for high yield are near record lows, they are wide enough to protect their value from this year's gradual increase in interest rates. The yield spread for lower rated bonds of investment grade quality expanded to the widest levels in almost two years. High yield spreads have been relatively stable due to an increase in oil prices. Roughly 20% of the high yield benchmark hold energy companies, which are surely benefitting from rising oil prices. Rising yields have been beneficial for very short-term securities. After many years of earning little on overnight funds, cash has provided both downside protection and additional yield in the rising rate environment.

The movement in interest rates during the second quarter and for the past year reflects the Federal Reserve Bank's

(Fed) objective to normalize monetary policy. In other words, pushing short-term interest rates high enough to eliminate the effects of years of low interest rates and easy money in order to boost economic growth during the last recession. The Fed feels comfortable raising rates in light of the current economic growth rate, low unemployment and the slow increase in consumer inflation. Along with the rate normalization strategy, the Fed is also reducing the size of its security holdings in its nearly \$4.1 trillion plus balance sheet. These securities were originally purchased under various QE (quantitative easing) programs, which led to more liquidity to hasten the recovery. By not repurchasing all of the cash flow roll off from its balance sheet, the Fed is effectively reducing market liquidity. The capital market is needed to soak up the additional supply of Treasury securities because the U.S. still needs to borrow money.

The effects of the Fed's goal of normalizing interest rates are seen in the flattening shape of the Treasury yield curve. Short-term rates are rising faster than longer-term rates, leading to a flattening of the yield curve, which may be a precursor to a bigger problem where short-term rates overtake and exceed longer-term Treasury rates (an inverted yield curve). An overly aggressive Fed could tighten too quickly, creating an inversion and possibly cutting economic growth. While the difference between the two year Treasury and the ten year Treasury yields may be declining, it is only when the yield curve actually inverts that we begin to have concerns. An inverted yield curve has a pretty good track record of predicting a recession, usually about 17 months in advance. So the Fed has the dual goal of raising short-term interest rates to contain inflation while not choking off economic growth too dramatically. Unfortunately, the Fed has had a difficult time balancing the two, historically.

With the U.S. economy in the mature stage of the business cycle, we expect the Fed to further raise short-term rates to contain and cool economic activity, flattening the curve along the way. We do not see an inverted yield curve in the immediate future. The QE programs over the past years have effectively lowered longer-term rates by as much as 60 to 80 basis points. As the Fed unwinds QE purchases over the next few years, the additional supply in the markets should, in theory, increase the supply of securities and put upward pressure on longer-term rates to reduce the chances of an inverted curve. In addition, the U.S. is expected to have plenty more debt to sell because of the larger deficits stemming from the 2018 tax cuts and additional fiscal spending. With global central banks continuing their accommodative monetary policies, investors have the opportunity to soak up some of the additional supply of longer-term Treasury securities.

In our view, the U.S. economy is strong enough to handle additional rate hikes. We look for the Fed to raise rates

two more times in 2018 and two more times in 2019. By that point, the Fed's balance sheet should be smaller as it continues to unwind its QE programs. This will leave the central bank in a better position to address any potential crises that may come down the road.

We call for modestly higher rates over the next several quarters. Unless the U.S. dollar falls, we anticipate international investors' demand for longer-term Treasuries to keep yields relatively low on a historical basis. Still, we would not be surprised by geo-political events that could send rates sharply in either direction. In our economic projection, inflation continues to pick up as the unemployment rate drops, and the ballooning U.S. budget deficit causes the Treasury to issue more debt.

Finding value in the fixed income market is tricky. Even though domestic debt securities offer narrow credit spreads, we prefer credit over duration. With respect to duration, we favor the short- and intermediate-term as opposed to the long term. Proceeds from newly matured notes can be reinvested at higher rates, assuming our interest rate outlook is on target. Thus, corporate bonds are favored over treasuries, especially if investors find financially sound companies or mutual funds that hold them. Select short-term fixed income securities also offer relative safety from rising yields. International debt, both developed and emerging markets, remain at risk from a strong U.S. dollar.

Rising inflation and increasing budget deficits may yet cause a hiccup in the fixed income markets. Investors have not seen a sustained fixed income bear market in years and may react irrationally. As already mentioned, we see an adequate demand for the additional debt supply. U.S. fixed income securities have a critical advantage because they offer better yields than comparable international fixed income securities. Aging boomers, in time, should reduce their risk profile by adding to their fixed income allocations. As long as interest rates do not skyrocket, individual investors seem more willing to stick with bonds than professional money managers. As evidenced by the increase in yields over the past year, individual investors have a pragmatic appreciation for bonds, steady income, and relative price stability. However, we also remember the 2013 "taper tantrum" where bond mutual funds suffered net outflows for eight consecutive months. While the bond market may suffer some market indigestion this year, history has proven that a bad year in bonds is a lot better than a bad year in stocks.

With the current market environment, our fixed income portfolios will continue to have a shorter duration as compared to the benchmarks and focus on investments with additional yield over risk free securities.

Headwinds Remain Despite Strong Earnings Growth

The U.S. economy remains on solid footing as corporate profits grew by double digits in the 1st quarter of 2018, thanks largely to the corporate tax cuts. This should lead to higher stock prices. However several "headwinds" have developed leading to greater volatility and limiting the near-term upside for stocks.

The biggest headline for investors is the current trade tensions between the U.S. and China. Roughly two-thirds of North American and Asia-Pacific CFOs say U.S. trade policy will have a negative impact on their company over the next six months. The Dow Jones Industrial Average has experienced 35 moves of 1 percent or higher this year, 12 of which were entirely or substantially related to trade news. Of course a trade war with China would not bode well for the global market, however, the expected impact from tariffs is expected to only reach 0.40% of GDP. The fiscal stimulus from corporate tax cuts and consumer spending is expected to represent 1.40% of GDP, more than offsetting the tariff concerns. So far, investors believe that the tariffs implemented will be relatively small and unlikely to hamper near-term growth.

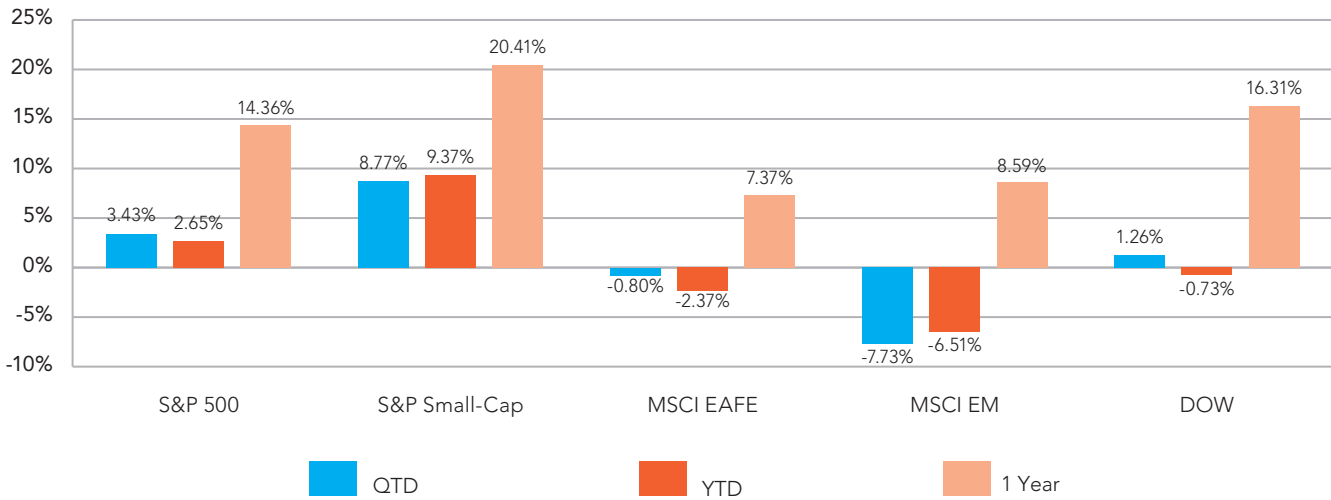
Another hurdle adding to the market volatility is the continued rate hikes and gradual removal of fiscal accommodation by a more hawkish Federal Reserve. Investors remain nervous that the Fed will increase rates too quickly, which may lead to slowing of the U.S. economy. The 10-year Treasury has reached 3% several times in 2018 only to be followed by a sell-off in the equity markets. History indicates that stock prices can continue to increase even in a rising rate environment, assuming the economy continues to grow above trend with contained inflation.

The market recovery has been fairly narrow in the 2nd quarter as only a few areas of the market have returned to all-time highs, including the NASDAQ Composite, information technology, and small-cap stocks. In fact, more than half of the S&P 500 companies are back in correction territory (down 10%) as of this writing. The technology sector has been the standout so far in 2018 growing earnings by 30% in the first quarter and now representing more than 25% of the S&P 500. Investors have also been gravitating toward small companies, which tend to operate largely in the U.S. and will likely be more sheltered from global trade tariffs.

U.S. earnings growth accelerated in the 1st quarter, with companies in the S&P 500 seeing a 26.4% year-over-year rise in earnings per share, with strength in energy, financials, industrials, technology and telecom. Earnings growth may be peaking, but growth remains strong as analysts are now expecting earnings to rise by 26.5% in 2018 and another 10.9% in 2019. As we enter the 9th year of economic

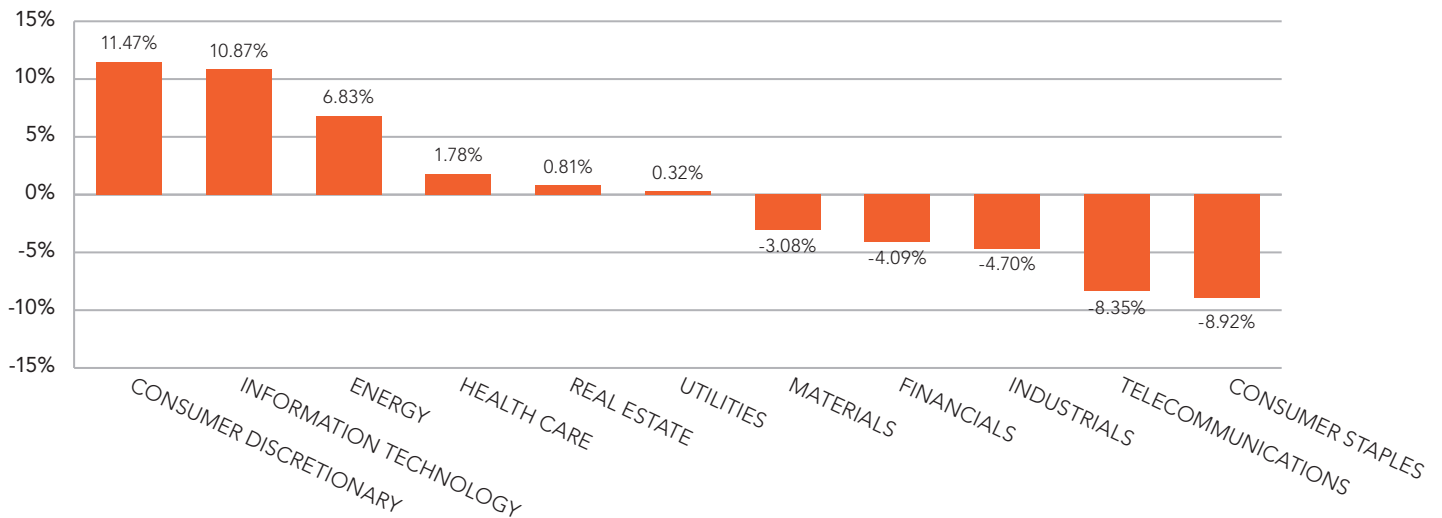
Stock Market Returns

6/29/2018



Sector Returns Year to Date

6/29/2018



expansion, valuations continue to appear reasonable with the S&P 500 forward P/E ratio between 16 and 17x next year's earnings. Within our current investment strategy we continue to have a slight overweight to equities versus fixed income and a continued emphasis on growth and international.

The combination of robust earnings and subdued prices leaves equity valuations more attractive than they appeared earlier this year. Stocks continue to remain our preferred asset class despite a more challenging landscape. As we move into the 2nd half of the year, we will be keeping a close eye on a tightening Fed, increased tariff talks, mid-term elections, and corporate profits.

As you may be aware, Midland States Bancorp, Inc. purchased Alpine Bancorporation, Inc., including its Trust and Investment division, earlier this year. The official transition of Alpine into Midland occurred on July 16th. The two Wealth Management groups will combine and will be known as Midland Wealth Management.

As we combine the two Wealth Management teams, you will have access to the strength, stability and expertise of more than 70 team members to help you achieve your financial goals. Midland Wealth Management will now have over \$3.2 billion in assets under administration.

Please know that there will not be any impacts to your current accounts, your Relationship Manager, your access to online systems or any statements you receive at this time.

While our team may be stronger and bigger, we will not lose the personal touch you have grown to expect.

We sincerely appreciate your trust and look forward to continuing to serve you and help you achieve all of your financial goals.

Should you have any questions feel free to contact your Relationship Manager.

Sincerely,



Eric Chojnicki
President
Midland Wealth Management



We believe a disciplined approach through prudent investing and diversification minimizes risk and enhances return to achieve clients' goals both financial and aspirational.

Midland Wealth Management Investment Team



Betsy Pierson
Chief Investment Officer



John Culhane
Director of Fixed Income
Senior Portfolio Manager



Tracey Garst
Senior Portfolio Manager



Michele Lind
Senior Portfolio Manager



Steven Lukasik
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Daniel Zeigler
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