



Market Outlook

Contents:

Headwind or Tailwind?	1
How Long Will the Fed Continue to Tighten?	2
What Tariffs? – U.S. Stocks Hit All Time Highs	3
Charitable Donations and Year End Tax Planning	4

Headwind or Tailwind?

While there are several economies facing growth challenges across the globe, the majority of global economies continue to demonstrate stable growth, with the United States being the strongest cog in the wheel. Purchasing Manager's Indices both in Europe and the U.S. remain above the key 50 level signaling continued growth. Lending has increased in both Europe and the U.S. demonstrating confidence in the business cycle. The domestic labor market remains tight with more job openings in the JOLT index than the number of unemployed in the monthly labor statistics. Consumer and business confidence are near all-time highs. We certainly believe this economic expansion will continue and will more than likely be the longest in post- World War II history.

While the economic growth cycle is still alive and well, potential headwinds continue to be a strong dollar, Federal Reserve (Fed) actions, trade wars and mid-term elections. Instead of worrying about these headwinds, perhaps we should think about what could positively impact the economy and markets.

- 1) The Fed has been very transparent on future actions regarding short-term interest rate movements. What would happen if the Fed slowed down and didn't increase rates as aggressively as market participants expected? Fear of the inverted yield curve and tightening monetary policy too quickly has raised red flags in the equity market. If the Fed slowed down or paused, market participants could see more value in the market resulting in potentially higher market values.
- 2) Since early May, the dollar has been in rally mode and has strengthened relative to most major currencies. What if the dollar remained range bound or even weakened relative to other currencies? Large U.S. based multinational companies could experience a revival from the slowdown experienced during the last quarter. Sales

may increase, which could result in higher earnings growth and ultimately lead to potentially higher share prices. In addition, the fear of weaker currencies relative to the dollar in emerging markets has been a drag on that market. Emerging market economies and markets could experience a sigh of relief due to a weaker or stable dollar. A stable or weaker dollar could provide stability and potential upward movement in emerging market equities.

- 3) Progress has been made in trade negotiations with Mexico and Europe, but advancements in negotiations with Canada are still lacking. The biggest elephant in the room is still China. Tariffs and trade wars have been an overhang on market participation and have increased the risk of higher inflation, less demand for U.S. products, and fear of the impact on global growth. What will happen if agreements are reached in the next couple of months? Depending on the agreed upon terms, this definitely could be a stimulant to the markets and the economic outlook.
- 4) Every two years we have elections, and this year is no different. The country has become more polarized on the political front, and swings in the house and senate control are a concern to the markets. Historically, the markets waiver in advance of elections and improve once the results are known. This cycle tends to happen whether there is a change in leadership or not.

With the domestic equity indices near all-time highs, you wonder how much additional upward opportunity exists. These four items could be headwinds, or they could be tailwinds. No one knows for sure, but staying invested for the long-term in an appropriate allocation allows investors to benefit from resolutions to uncertainties in the market place. If three of these four items become tailwinds, international and emerging markets as well as domestic markets should benefit.

Current interest rates remain low relative to historical terms with short maturity yields providing greater than 80% of long-term maturity yields. The economic expansion is still in place, leading us to the conclusion that bonds have a place in portfolios. However, we think they should remain underweight relative to a neutral position.

While no one knows for sure what the future holds, our economic and market outlook leads us to position our investment allocations slightly overweight to equity and underweight to fixed income. We will, of course, continue to monitor these market and economic developments. We remain confident that the next 12 months will be a continuation of the current business cycle growth, leading to the longest expansion in the history of our country.

How Long Will the Fed Continue to Tighten?

The strength and longevity of an economic expansion is largely determined by monetary policy. Since the U.S. economy is in the mature stage of the business cycle, the Fed believes continued growth can lead to further asset price imbalances and shortages that will ultimately fan inflation. As a result, the Fed believes further Fed Funds rate hikes are necessary. Fed Chairman Powell pointed out recently that the last two recessions followed financial market excesses rather than inflation, which in previous cycles led to Fed tightening and then an economic downturn. A fair question to ask is how long will the Fed continue its steady rising short-term rate normalization policy? Does the Fed dare risk a decline in asset prices, specifically in the stock and housing markets? Wall Street deflation could be the quickest route to a recession. An economic downturn could have further reaching political and social implications.

Most Fed officials sound confident and comfortable with recent monetary policy decisions. Support within the Fed calls for the continuation of its linear normalization policy, which hikes short-term rates roughly once a quarter into next year. The Fed seems to have a narrow-minded focus on declining U.S. labor shortages as the sole determinant of inflation. With this attitude, the Fed may miss key developments until they grow too big to ignore. The Fed feels monetary policy is still accommodative and finds it hard to justify larger hikes given tight labor markets and on-target inflation.

An economic recession usually begins when money/liquidity becomes tight. Under the Fed's recent policy of quantitative easing, its balance sheet increase since 2009 has helped inflate all sorts of asset prices. Now the Fed's policy of reducing its balance sheet, or quantitative tightening, should result in a deflation in asset prices. The strains are beginning to be felt in the weakest links of the global financial system: the emerging markets, primarily

Turkey, Italy, Argentina, and South Africa. The Fed is far less concerned about the strength of these emerging markets than are individual investors, but even it would likely react if there were sufficient spillover into the U.S. equity markets.

The overriding concern of the markets continues to be the withdrawal of the unprecedented stimulus provided by global central banks after the last recession in the form of trillions of dollars' worth of liquidity. This stimulus inflated asset values and spurred the long but slow recovery of major economies. The real damage may become apparent in the next 12 to 24 months as global central banks gradually move toward the Fed's policy, from an accommodative stance to a tightening one. That action, in turn, could damage an overly indebted world economy.

After refraining from raising interest rates for the first six years of the post-recession expansion, the Fed has increased the Fed Funds target range eight times since late 2015. The Fed seems intent on hiking the Fed Funds rate again this year in late December on its self-determined path for five additional rate hikes into 2019 and even 2020. These actions would put this tightening cycle just beyond the half-way point. Unfortunately timing is always better seen in the rearview mirror, and history is full of examples of the Fed turning expansions into recessions by raising rates two or three times more than necessary. We hope the Fed is more than half way done hiking short-term rates. Certainly the market is looking for one to two more hikes.

The bond market does not completely believe the Fed's narrative about the economy and inflation. As a result, 2019 is setting up to be an interesting year. The markets suggest short-term rates have risen enough. The flat yield curve suggests the Fed Funds rate is already near the Fed's coveted target neutral rate. Whether the 2-year to 10-year yield curve comes close to inverting after the potential rate hike in December will be dependent on the Fed's communication on future tightening and how the market reacts to it. As it stands, two-year notes reflect year-ahead Fed Funds expectations. If the Fed convinces traders the funds rate will be 3.25% at the end of 2019, the Treasury yield curve will invert before the end of this year.

Where do we stand today? Many global central banks are still in the accommodative phase, but those policies are expected to change. If the Fed were to pause because of a widening emerging market recession or lower inflation expectations, it would be in 2019. We are six months away from any indication that the Fed might step away from tightening. Credit spreads across various fixed income securities remain tight, which is typical for this stage of the cycle. Considering the current market environment, our fixed income portfolios continue to have a slightly shorter duration as compared to the bond market benchmarks,

while focusing on investments that offer additional yield over risk-free securities.

What Tariffs? – U.S. Stocks Hit All-Time Highs

It doesn't seem possible that the U.S. stock market should continue to rise to near record levels with all of the trade / tariff headlines. Seemingly every day we see an increasing possibility of a full-blown trade war. For the most part investors have ignored these reports, and stock prices have continued to move higher, fueled by the strong underlying economy and double-digit earnings growth from U.S. corporations. In sharp contrast, international markets have been punished this year due to concerns over the stronger U.S. dollar, trade tariffs, and rising U.S. interest rates.

The U.S. stock market continues to benefit from the tax reform passed last year. With lower corporate taxes, companies have been using their cash windfall on capital spending, share buybacks and dividends. Share buybacks will likely be at record totals by the end of 2018, but it has been fairly concentrated in technology and financial sectors, with those sectors accounting for 64% of buyback announcements this year. Share buybacks are positive for the equity markets as they return capital to shareholders and reduce the number of shares outstanding, which also helps boost the company's earnings per share and share price.

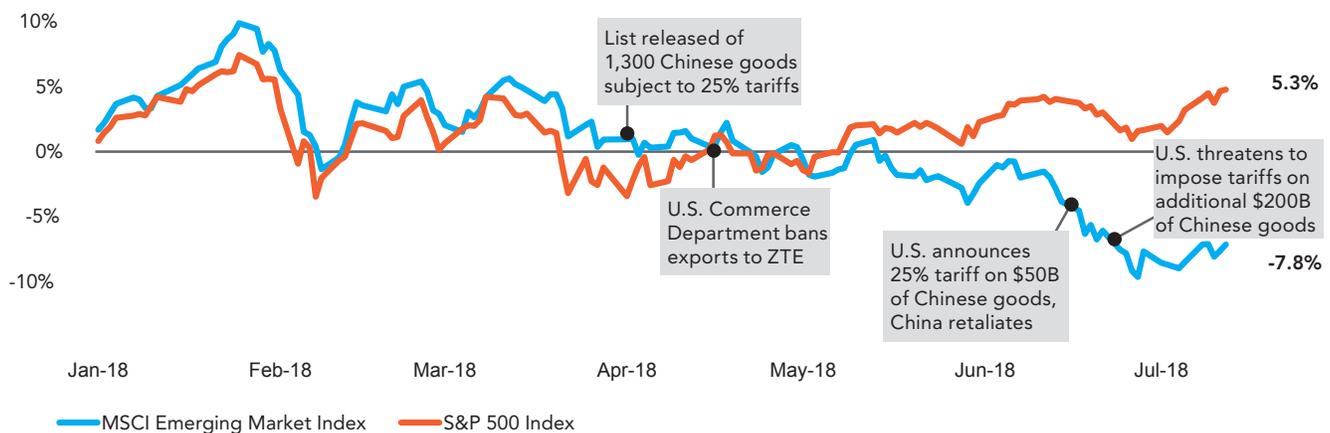
Both lower taxes and share buybacks have contributed to the strongest earnings season since 2010, with the expectation of another 20% increase in the 3rd quarter. Revenue growth has been solid as well, with a robust 85% of S&P 500 companies posting annual revenue growth. The estimated (year-over-year) revenue growth rate for the 3rd quarter is expected to be 7.5%. Five sectors are predicted

to report double-digit growth in revenue (energy, real estate, telecom services, information technology, and materials). However, looking toward 2019, analysts are expecting corporate earnings to moderate and grow by 12.2%.

Technology giants are getting most of the credit for driving this year's stock gains, however small capitalization companies have also been big winners. The Russell 2000, the benchmark for smaller-company stocks, has climbed 13.08% in 2018, eclipsing the 10.18% rise by the S&P 500 as of this writing. Investors continue to reward smaller companies since they tend to have less international exposure and are less impacted by tariffs and a possible trade war.

After leading the way last year, both developed international and emerging markets have taken a breather in 2018. The emerging market benchmark has posted a negative return of 9.23% so far this year, which was mainly driven by the prospect of a trade war with China. Emerging market countries with large amounts of debt outstanding have suffered the greatest, as their large dollar debts became difficult to finance with their weaker currencies and higher U.S. interest rates. On a long-term basis, emerging markets should continue to provide greater growth than other developed markets, although with a higher risk profile. Stock valuations in emerging markets continue to look attractive, but before a recovery can occur we will likely need to see greater clarity with respect to the trade conflict with China and a stabilization of the U.S. dollar. As of this writing, our portfolios continue to have an allocation to emerging markets, however we are constantly monitoring how the trade tariffs with China could impact economic and corporate fundamentals.

EM Performance Turns as "Trade War" Heats Up
Year to Date Daily Cumulative Price Returns



Sources: Bloomberg, MSCI, and Standard & Poor's, 7/18/18. Past performance does not guarantee future results.

S&P 500 stock valuations continue to remain reasonable with a 16.8x forward price to earnings ratio, which is slightly above the 5-year average of 16.3x, but still below the valuation of 18.7x we experienced earlier this year in January. We continue to enjoy one of the longest bull markets in history, and it will likely continue, albeit at a slower pace and with increased volatility. Given the solid economic fundamentals and strong earnings growth, we are maintaining an overweight to stocks, with an emphasis on companies with higher growth potential. So far, trade tariffs have had little effect on U.S. companies. However, we will continue to monitor this issue to see if fundamentals or corporate earnings show any signs of deteriorating, which would likely change our outlook. Let the bull continue to reign!

Charitable Donations and Year End Tax Planning

As the air turns cooler and the days grow shorter, our minds quickly turn to the final three months of the year, with thoughts of spooky spirits in the air, family gathering around the dinner table over Thanksgiving and then quickly turning to the writing of wish lists and the ensuing rush of gift buying for the holiday season. One item on your year-end to do list that may outlast a stylish sweater or the latest electronic gadget may be to contemplate making non-charitable or charitable gifts before the calendar ushers in 2019.

Gifts Impacts from 2018 Tax Reform: Individuals have a variety of ways to plan for their taxes in 2018. The standard deduction for 2018 is \$24,000 for married couples. If a taxpayer typically gives to charities, then grouping a few years of deductions may help get a taxpayer over the standard deduction threshold. A way to group the gifts is to provide the funds or assets outright to a desired charity. Another way is to give the assets to a Donor Advised Fund, which provides the taxpayer the charitable deduction now, but the taxpayer the power to direct gifts in the future. When planning for the tax benefit for the charitable donation, do not forget about cash flow.

Keep in mind gifts are generally fully deductible from both federal gift tax and federal income tax. Since charitable donations are income tax deductible, you essentially receive a double tax benefit if you are inclined to make these kinds of gifts during your lifetime.

Qualified Charitable Distribution: If you are an IRA owner and age 70 ½ or older, you can take advantage of a provision in the tax code that allows you to make a direct transfer to a qualified charity in any amount up to \$100,000 without having to pay income taxes on the distribution. This is an important advantage for a charitably minded

IRA owner who doesn't need his or her required minimum distribution (RMD) for living expenses. Bear in mind you cannot claim the qualified distribution as a charitable tax deduction since you are receiving the benefit of the amount being excluded from your taxable income. However, in deciding to avail yourself of this opportunity, you enjoy two appealing advantages: You satisfy the removal of the required minimum distribution from your IRA, and you pay no income taxes on the amount.

Estate Planning: Gifting can be a powerful estate planning tool, allowing you to transfer wealth to others during your lifetime, as opposed to at your death. You may choose to make a lifetime gift for personal gratification, such as helping a son or daughter with a down payment on a home or funding an education plan for a young grandchild or you may do it for tax reasons, taking advantage of the annual gift tax exclusion (currently \$15,000 per donee, to an unlimited number of donees). Many people who make lifetime gifts are motivated by a combination of nontax and tax factors.

One of the more common reasons for gifting is to remove an appreciating asset from your estate. Real estate, common stocks and antiques are all likely to appreciate over time. By giving away this kind of property, you are removing the appreciation from your estate at your passing when these assets will likely have grown in value.

Even though most gifting is completed in the final three months of the year, these ideas are not meant to be an exhaustive list of possibilities. We would certainly encourage you to consult with your tax and or legal advisor prior to making a decision to ensure the best outcome for you, financially. Especially with respect to gifts made in kind (not made in cash), it is better to initiate these by the beginning of December to ensure proper delivery before year-end.

Letter from the CIO

Betsy Pierson

Some may be curious about the work involved in combining two investment groups and processes into one unified Midland team in a relatively short period of time. The seamless combination of both teams is a credit to each individual in the group. All are experienced, knowledgeable and have your best interests at heart.

In late February of this year, we began the journey to develop one investment philosophy and process for the combined organization. The team met on a weekly basis to review the two philosophies with the objective of combining them into one. Keeping an open mind about best practices and the most prudent way to approach asset management, we made it our goal to take the best ideas from each organization.

After determining the investment philosophy, a review of both companies' policies and procedures was next. An in-depth analysis brought about several minor changes, leading to an even stronger organization going forward. Investment objectives were then discussed. Minor tweaks were made to asset class ranges, which resulted in seven different investment objectives being finalized.

The most time intensive project for the team was reviewing and determining the appropriate investment assets to use in client portfolios. We first determined the criteria necessary to evaluate each mutual fund held in the combined organization. We also decided what circumstances would lead to an asset being removed from our approved list of holdings. It was important to establish this criteria prior to beginning the review of current investment vehicles and subsequently deciding which fund would be the preferred investment within each asset class.

Using Morningstar Direct, we reviewed mutual funds and ETFs in each asset class. In our search, we reviewed our current preferred fund choices and any other funds that met our criteria. As a team, we thoroughly reviewed all of these potential funds and chose the best fund or ETF to be used in our portfolios. As part of our ongoing process, we continue to monitor these funds and ensure each continues to meet our standards.

The final piece of the buildout was implementing a unified and consistent investment strategy. We had lengthy discussions on the structure of the portfolios as a united team. Beginning in early May, we implemented the finalized investment strategy according to each client's individual long-term investment objective and varying levels of risk tolerance.

While it can be difficult to combine two organizations into one, our teams discovered almost from day one that our cultures and investment DNA were nearly identical. We are proactive in our approach to client relationships, starting with our assessment of financial objectives, risk tolerance and liquidity needs. Our goal is to enhance returns while minimizing risk to ensure portfolios are positioned for long-term growth.

Our two teams have come together as one for the benefit of each and every one of our valued clients. We are happy you are part of that equation, and I am personally honored to lead such a talented group of investment professionals.

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
Portfolio Manager



Daniel Zeigler
Portfolio Manager



Gay Jack
Assistant Portfolio
Manager



Denise Melton
Assistant Portfolio
Manager



Nino Ciaccio
Assistant Portfolio
Manager



Chris Zabel
Research Analyst

We would like to offer the opportunity to have your copy of the quarterly newsletter sent to you via email. If you would prefer to receive your copy electronically, please email your preferred email address to dmccormack@midlandsb.com.

Midland 
Wealth Management

midlandsb.com | 1-888-637-2120

Midland Wealth Management is a trade name used by Midland States Bank, its subsidiary Midland Trust Company and its affiliate Midland Financial Advisors, an SEC registered investment advisory firm. Investments are not insured by the FDIC or any other government agency, are not deposits or obligations of the bank, are not guaranteed by the bank or any federal government agency, and are subject to risks, including the possible loss of principal.

The information provided is for informational purposes only. Information has been obtained from sources believed to be reliable, but its accuracy and interpretation are not guaranteed. Midland Wealth Management does not provide tax or legal advice. Please consult your tax or legal advisors to determine how this information may apply to your own situation. Whether any planned tax result is realized by you depends on the specific facts of your own situation at the time your taxes are prepared. IRS CIRCULAR 230 NOTICE: To the extent that this message or any attachment concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law.

Past performance is no guarantee of future results. Returns of the indexes also do not typically reflect the deduction of investment management fees, trading costs or other expenses. It is not possible to invest directly in an index. Indexes are the property of their respective owners, all rights reserved. Midland Wealth Management does not claim that the performance represented is CFA Institute, GIPS, or IMCA compliant.

Copyright © 2018 Midland States Bancorp, Inc. All rights reserved. Midland States Bank® is a registered trademark of Midland States Bancorp, Inc.