Q3
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Midland
Wealth Management

Market Outlook

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A Record is Broken, Now What?

At the end of June, the current economic expansion will have become the longest on record in the post-World War II era, accompanied by one of the longest equity bull markets on record. We do not see this expansion coming to an end or an imminent recession on the horizon, but the risks have certainly increased over the last three months with continued global slowing, trade wars and political turmoil.

The current U.S. economy continues to demonstrate growth characteristics, albeit at a slower pace than in 2018 and more in-line with the 2% GDP level the economy has experienced since the end of the financial crisis. This is likely "trend growth" level unless the working population increases dramatically or productivity shows greater strength. Consumer confidence has declined from its all-time highs but remains at extremely favorable levels, driven by a strong labor market and increasing wages. Following a dismal holiday season, retail sales in the first five months of the year have increased at a 7.6% annualized rate. The Job Openings and Labor Turnover Survey (JOLTs) report, which measures the number of job openings and labor turnover in the U.S. economy, showed openings at near all-time highs with the number exceeding the number of unemployed. The quits rate (people who voluntarily quit a job) also stands near cyclical highs, demonstrating confidence in the labor market and the current economic environment. Job layoffs in the JOLTs report as well as the weekly jobless claims remain at historically low levels. The housing market has seen some upward movement in the last month, with existing home sales increasing in the month of May due to more homes for sale and lower interest rates.

There is a tale of two economies when looking at the business side of the economy. Services, which account for greater than 70% of the economy, continue to show growth as seen in the most recent Non-Manufacturing ISM release. This index rose to 56.9 (above 50 is positive for growth, below 50 is negative), beating expectations. The service economy continues to show strength in new orders and new business activity, which are both leading indicators of future growth as well as the employment number. On the other side of the coin, the Manufacturing ISM release declined to 52.1, missing expectations. Within the individual areas factoring into the composite number, all reported above 50, which demonstrates continued growth, but the trend has not been positive. Corporate earnings season may prove interesting this quarter as individual companies prepare their post-earnings comments on future growth and potential headwinds.

While the consumer remains positive, there are risks lurking in the background. Many of the respondents to the Manufacturing ISM survey voiced concerns about the future due to trade discussions and slowing global economic growth. Indications of slowing global growth can be seen in the Global Manufacturing Purchasing Manufacturers' Index, which fell below 50 for the first time since 2013. Germany has seen a dramatic decline in manufacturing, and most other European countries are also feeling the pain. Even before the trade dispute, China's growth rate had slowed dramatically, forcing the Chinese central bank to provide additional liquidity to stimulate its economy. While the U.S. is not as dependent on China for growth, many foreign economies are very dependent on China for trade. The continued uncertainty surrounding the trade dispute is creating a difficult environment for stronger global growth. Furthermore, over 50% of the central banks across the globe are now more accommodative, attempting to stimulate economic growth.

The Federal Reserve, in its most recent statement, now believes the biggest risks to the U.S. economy are slowing global growth, trade and geopolitical issues. While interest rates were not reduced at this meeting, the odds of a decrease in the overnight borrowing rate set by the Federal

Open Market Committee (FOMC) are near 100% in the second half of 2019 in an attempt to sustain economic growth. Inflation has remained below the target level due to weaker global economies and a strong dollar. As a consumer led economy dependent on imports, a strong currency enables consumers to purchase more goods for the same dollar amount. This results in disinflation and makes exports more expensive, negatively impacting multinational businesses. If the FOMC lowers rates, we expect a weaker currency that will lead to slightly higher inflation and stronger exports.

More recently, business confidence has declined, leading to lower capital expenditures in the manufacturing sector, as well as, multinational service companies. The uncertainty surrounding the trade issues is in the forefront of global news, as well as, the 2020 election. It is difficult for businesses to develop long-term plans and make capital expenditures when trade policy is not set. From a business perspective, the 2016 election was a more favorable pro-business outcome. After the corporate tax cuts, capital spending in software and technology increased at a healthy rate. In the last few months, as the duration of the trade dispute has lengthened, the uncertainty has led to more businesses thinking and hesitating before investing capital. While there has not been an immediate impact on growth due to the strength of the consumer, trade policy may have a longer term impact with slower business expansion, potentially weaker employment opportunities, and a deteriorating consumer outlook. A resolution to the trade issues would be positive for domestic and global growth.

The longer the trade issues remain unresolved and the closer we get to the 2020 election, the risks to slower economic growth increase. While we do not envision a recession in the near-term, the probability has certainly increased from a year ago. The biggest risk to the stock market and the economy is uncertainty, which typically leads to increased volatility, indecision and a pullback in business spending. A change in Washington, D.C. from a capitalist to a more socialist tilt is not favorable for business and will negatively impact capital spending. The fixed income market is well aware of the risks resulting in an inverted yield curve (lower long-term rate versus short-term rates) from 3 months to 10 years. The Federal Reserve has acknowledged these factors and has moved from a tightening phase in 2018 to a more accommodative phase in 2019.

Despite these headwinds, we are still constructive on the equity market longer term. Recently, both bond and stock markets may have gotten a little overbought, but we do believe long-term investors will benefit from being in the markets. Due to the recent strength of the markets as well as the uncertainty surrounding trade and global growth, we remain at our neutral positions relative to our target allocations. We continue to have a tilt towards growth over value in the equity portion of our portfolios and have a neutral duration in the bond portion. As always, we will continue to monitor the market and economic environment, making adjustments as needed.

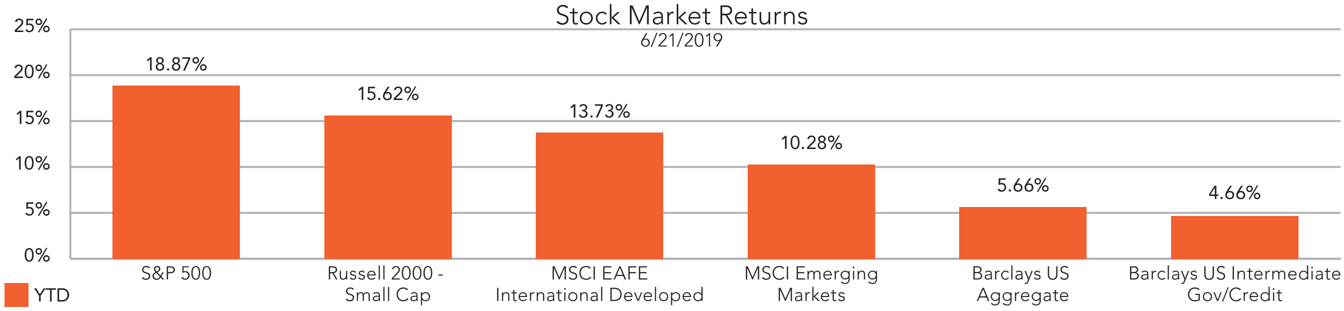
Round and Round We Go

As we head into the heart of the summer months, the stock market continues to search for direction. This event-driven market has been whip-sawed recently by trade disputes, tariffs, slowing global growth, Federal Reserve speculation, and increasing geo-political concerns. Although the underlying fundamentals for stocks remain favorable, these unresolved headwinds will likely make for a volatile and emotional summer for all global stock markets. After one of the worst Decembers on record, U.S. stocks were off to an unprecedented start this year, as most investors began pricing in a deal with China on trade and tariffs. Unfortunately, those trade talks with China began to break down and the deal now looks to be further down the road. If that were not enough, investors had to extrapolate the shocking announcement of potential tariffs on Mexico. With the escalating uncertainty, the markets reacted quickly to this negative news and the S&P 500 promptly retaliated with a decline of 6.3% in the month of May.

Investors will be closely monitoring the outcome of the G20 summit and the upcoming Federal Reserve meeting in late July. Both have the potential to create market-moving news, either positively or negatively. The markets welcomed news from the White House that both the U.S. and China would restart trade talks again to prepare for their G20 summit meeting. Additionally, investors have grown confident that the Fed will need to reduce interest rates before the end of the year, pressured by weaker economic data, U.S. – China trade tensions, and anemic inflation. The prospect of an interest rate cut by the Federal Reserve has propelled the S&P 500 to record its best June return since 1955.

Typically the Fed will begin to cut interest rates in anticipation of slower economic growth with the hope that the cut will spur a rebound in economic activity. Slower economic growth is not the ideal news, however; history has indicated stocks typically perform well after a rate cut, assuming we are not headed into a recession. A lower fed funds rate would allow companies with weaker balance sheets to borrow at lower rates, which could add liquidity to the economy. From an equity perspective, lower yields can also boost valuation multiples enough to more than offset an earnings slowdown.

As of this writing, equity markets remain resilient as the S&P 500 is closing in on its all-time highs. As of June 21st, the S&P 500 is up 18.87% year-to-date. International



index performance has trailed lately as Europe continues to struggle with slowing economic growth, prompting European central banks to announce plans for additional stimulus.

First quarter earnings growth for the S&P 500 came in better than expected. Analysts were expecting a negative year-over-year earnings decline of -4.0%, but as of today the blended earnings decline was only -0.4%, which is the first decline for the index since Q2 2016. Looking forward, second quarter estimates have been coming down as slowing global growth and an ongoing trade war has forced analysts to ratchet down their estimates for Q2 2019, with an expectation that earnings will decline by -2.5%. Stock valuations continue to appear fairly valued with the forward 12-month P/E ratio for the S&P 500 currently at 16.5, which is equal to the 5-year average but above the 10-year average (14.8x).

Our investment strategy continues to lean slightly cautious with a neutral allocation to equities given the uncertainties over the near-term. Recently, many of the defensive sectors such as Utilities, REITS, and Consumer Staples have been outperforming, which typically happens when investors are worried about a steep global slowdown or recession fears. We remain cautiously optimistic but would like to see significant progress made on China trade and tariffs. Given the anemic growth overseas and continued slowdown, we have reduced our international exposure over the last several years and now target ~80% U.S. and 20% International equities. As the light summer trading months begin we will be closely monitoring the progress on China trade, global economic data, and the Federal Reserve.

The Federal Reserve Sends a Message

Back in 1913, the U.S. Congress passed the Federal Reserve Act and thus began the Federal Reserve Bank. The act established three key objectives for monetary policy: maximizing employment, stabilizing prices, and moderating long-term interest rates. The first two objectives are sometimes referred to as the Federal Reserve's dual mandate. At the June 20th Federal Open Market Committee (FOMC) meeting we learned the Fed has effectively adopted a new unofficial mandate, namely to sustain the economic cycle. Fed Chair Powell stated, "My colleagues and I have one overarching goal: to sustain the economic expansion, with a strong job market and stable prices, for the benefit of the American people." Although Chair Powell and the Fed did not lower rates at the June FOMC meeting, they signaled the time for patience is past and the time for accommodation has begun. The Fed opened the door to the first interest rate cuts since late 2008 to keep the economy growing as uncertainties about trade, global growth, and geo-political issues mount.

For the past nine months the fixed income markets have shown a growing level of concern about the weakening global economic outlook. This concern has resulted in declining U.S. Treasury yields and the inversion of the Treasury yield curve, signaling the growing possibility of a recession at some point in the future. The failure of the Fed to achieve its 2% inflation target also signaled to the market that the Fed was not doing enough to counteract the distress to the economy caused by the protracted U.S. trade battles. This belief began when the Fed raised the Fed Funds rate into late 2018 after forecasting higher inflation, which never materialized.

Although the Fed was not ready to cut immediately, it is willing to act sooner rather than later. It is holding out a little longer to see more data before setting the course to reduce short-term rates later this summer or later this year. If the current trade standoff continues, the decision rests on whether the Fed cuts the Fed Funds target by 25 basis points or goes more aggressively with a 50 basis point reduction. At this time, we feel the Fed will make a 25 basis point reduction at the next meeting in July and put an end to the roll off of securities from its balance sheet with a possibility of another rate cut in September. The odds for a swift 50 basis points cut in July are less than 30%, but are increasing. The Fed remains data dependent and growth in the U.S. economy remains stable at this time, but the impact of weaker business sentiment and continued weak growth globally will ultimately drive the decision.

While the Treasury yield curve did not invert between the 2 year and 10 year Treasury notes, it did between the 3 month T-bill and the 10 year T-note. This latter spread, which is monitored very closely by the Fed, has been negative since late May. If nothing else, the 3 month to 10 year yield inversion could be the Fed's wake up call for action. It certainly recognizes the predictive accuracy of recessions when the yield curve inverts. The Fed's pending rate cuts will be an insurance policy to lower short-term interest rates, eliminate the inverted curve, and sustain the current expansion.

We monitor credit spreads within the fixed income markets. These spreads act as a guide to financial stress in the economy and within the markets. Credit spreads spiked higher during the fourth quarter of 2018 as the stock market dropped over concerns of a global slowdown. They then reversed course and fell during the first quarter of 2019 with the stock market rally. During the second quarter, spreads rose again with the May stock market decline. With the announcement of potential Fed rate easing, they have fallen as uncertainties of any imminent recession have faded. What does cause us concern is the relative characteristic of the investment grade corporate securities market. More investment grade corporate securities are rated BBB than those rated AAA, AA, and A combined. This is a result of larger debt balances on corporate balance sheets and is also a consequence of rating agencies becoming risk averse, leading to lower ratings. If and when a financial problem develops, the value of BBB securities could be volatile as they will be hard pressed to remain investment grade. As a matter of strategy and prudence, we try to avoid these securities.

The direction of U.S. yields will soon be at a crossroad. Yields have decreased year-to-date as worries of a possible recession have grown. Expected easing actions by the Fed will, at least temporarily, support lower Treasury yields. Monetary policy works by changing the incentives for borrowing. A small rate change by the Fed will not initially do much for the economy but will help shape the yield curve. The market will be keen to perceive any signs of a global growth turnaround or an increase in inflation before reversing any of the Fed's tilt towards accommodation. One added development to keep U.S. rates from rising is that over $12.5 trillion dollars of sovereign debt have negative yields. These yields are an incentive for foreign buyers to purchase U.S. debt.

The recent fall in interest rates does not make a compelling case for fixed income securities. Many investors are looking at the higher yields offered by money market funds. However, money market funds offer a limited sense of security. Their current yields should drop quickly when the Fed eases. While income from U.S. shorter-term securities or money market funds may offer a temporary yield incentive and lower duration risk if rates were to reverse course, the prudent strategy would be to hold a portfolio with a laddered maturity structure. The most recent decline in yields before and after the June FOMC meeting strongly supports the merits of a prudent laddered portfolio. Whether this structure utilizes individual securities or mutual funds, our fixed income duration goal of four years remains in place. Our typical fixed income portfolio is diversified but with a domestic investment grade bias over global debt and high yield exposure. Right now, the market is only guessing what is going to happen to interest rates next year. We feel interest rates can be lower for longer but can change on a dime. We are also monitoring the risks of the changing inflation and economic growth rates and are positioning our portfolios accordingly.

The Benefits of Using Your IRA for Charitable Giving

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If you're like most people, in early 2019 you sent in your tax return or dropped it off at your accountant's office, never to think about taxes again until January of 2020. However, this is a good time to plan for your 2019 taxes. **Taxpayers over the age of 70 ½ have a unique tax saving opportunity that should not be overlooked.**

One of the biggest changes in the new tax law is an increase in the standard deduction. Since the standard deduction increased and state and local taxes deductions were capped at $10,000, many people who previously itemized deductions were unable to in 2018. While we don't yet know the exact figures for 2018, the Joint Committee on Taxation estimated that 30 million fewer households would itemize deductions in 2018 compared to 2017. This will again be the case in 2019 as the standard deduction will increase again to **$12,200** and **$24,400** respectively ($13,500 and $27,000 if over 65).

This change in standard deduction provides some planning opportunities for taxpayers, particularly those over 70 ½ who are receiving required minimum distributions (RMD) from their IRAs and who give to charity. For these taxpayers, there is a way to "double" your deduction by using a Qualified Charitable Distribution (QCD) from your IRA while still taking advantage of the high standard deduction. A QCD is a direct transfer of funds from your IRA custodian to a charity. QCDs can be used to satisfy your RMDs for the year but are excluded from your taxable income. The requirements for a QCD are as follows:

- You must be 70½ or older to be eligible to make a QCD. Younger beneficiaries who are taking RMDs from either inherited IRAs or traditional IRAs are NOT ELIGIBLE.
- The maximum annual amount that can qualify for a QCD is $100,000 per eligible taxpayer. A QCD can exceed your RMD amount for the year provided it does not exceed the annual limit.
- The funds must come out of your IRA by your RMD deadline—usually December 31st.
- The charity must be a 501(c)(3) organization eligible to receive deductible contributions
    - o private foundations are NOT ELIGIBLE
    - o donor-advised funds are NOT ELIGIBLE
- Funds payable directly to the IRA owner that are then given to charity do not qualify as a QCD. However, the check can be payable to the charity and delivered to the IRA owner who then gives it to the charity.
- When making a QCD, you must receive the same type of acknowledgement of the donation that you would need to claim a charitable deduction.

If we look at an example of a married couple (one or both of whom are over 70½) who earn $120,000 per year and give $15,000 to charity, they can save over $3,000 in federal taxes if they simply have the spouse over 70½ contribute the $15,000 to charity directly out of an IRA.

	Donate $15K to charity w/o QCD	Donate $15K to charity using QCD
Income		
Qualified Dividends	$35,000	$35,000
Interest	$5,000	$5,000
Taxable Social Security	$35,000	$35,000
Taxable IRA Distributions	$45,000	$30,000
Adjusted Gross Income	$120,000	$105,000
Deductions		
State and Local Tax Limit	$10,000	$10,000
Charitable Deduction	$15,000	$0
Itemized Deductions	$25,000	$10,000
Standard Deduction (married, 65+)	$27,000	$27,000
Taxes		
Taxable Income	**$93,000**	**$78,000**
Net Federal Tax	$12,177	$8,972
Tax Savings of **$3,205** or 26%		

As you can see from the example above with the tax law changes in 2018, for most people it is more valuable to reduce income than to increase itemized deductions. Additionally, reducing your income also has other benefits such as potentially reducing the taxability of your social security benefits and lowering your Medicare premium.

In the past when a beneficiary received an RMD and then gave to a charity, any RMD that was donated was simply added to Schedule A as a charitable contribution and deducted from income. Now, most people do not have enough itemized deductions to exceed the much higher standard deduction so the charitable deduction is not utilized. Using a QCD allows you to capitalize on tax incentives for charitable giving by reducing your income while still using the increased standard deduction. For many taxpayers, this can generate significant tax savings. If you qualify and your IRA is here at Midland States Bank, talk to us to find out how to take advantage of this tax savings opportunity.

Robert Torbert, J.D. MST
Trust Officer

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

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