Q4 19

Midland Wealth Management

Market Outlook

Cautiously Optimistic With a Side of Risks

Market volatility was certainly evident during the most recent quarter. Both interest rates and equity prices moved like a yo-yo, with dramatic moves up and down. However, both ended the quarter at slightly lower yield and higher price levels. Trade and tariff headlines had the greatest impact on these moves.

Fears of a global recession remained throughout the quarter, but we continue to believe the U.S. will not experience a dramatic slowdown in the next 6 to 12 months. The consumer remains resilient with strong labor markets and increasing wage growth. The number of new jobs created each month has declined but continues to average around 150,000, exceeding the number of monthly new job entrants. The unemployment rate of 3.7% remains at a level only experienced during World War II, going all the way back to 1890. Wages for lower income earners have increased more than 4% year over year, and overall wages have increased 3.5%. Consumers remain confident in their job status and have continued to spend. Retail sales have increased more than 4.1% and excluding gas, are up 4.7% over the last twelve months. Housing affordability has improved as a result of the decline in mortgage rates during the quarter, leading to stronger housing numbers. Housing starts for single family homes increased more than 4% during August, and existing home sales increased 1.3% during the same month. In August, 49% of the homes sold were on the market for less than a month, and inventories remain at low levels.

Concerns surrounding consumer debt levels and the risk this debt may pose to economic growth are overblown. While the actual dollar level of this debt is at all-time highs, the debt payments as a percent of disposable personal income are at the lowest level in 40 years, at 9.9% at the end of the second quarter. The lower interest rates, higher incomes and full employment levels have allowed consumers to remain less leveraged and have more financial flexibility.

While the consumer remains confident, CEOs have become less confident as a result of trade concerns, slowing global economies and the 2020 election. World trade volume has declined year over year and global manufacturing sentiment represented by the Purchasing Manager's Index has fallen below 50, indicating contraction rather than expansion. The U.S. manufacturing sentiment indicator fell under 50 in August for the first time in more than three years. Interestingly enough, while the confidence levels of CEOs have declined, the outlook for hiring has remained at expansionary levels. The trade discussions have caused angst at the corporate level, but when you look at the bigger picture, U.S. exports are only 12% of GDP and only 2% of that 12% are exports to China. This is in contrast to Germany, where exports are 47% of GDP and declining auto sales in China and across the globe have negatively impacted its manufacturing economy. China is also a relatively high exporter, delivering 20% of its GDP to other countries. These nations are much more trade dependent, and a delay in any resolution may have a more negative impact on their economies. Although, a delay could be a drag to the U.S. economy as well.

While trade is a risk to the economic environment, there are still signs of stabilization and even optimism in the economy. Architectural billings are typically a leading indicator to economic slowing or strengthening and have remained fairly neutral with little change in activity levels. This indicator is not reflecting strong growth, but is also not pointing to a recession in the building industry. There are ten economic indicators closely followed that typically indicate an impending recession and at this time, only CEO confidence is at a recessionary level. The other nine indicators remain at levels above those that would indicate an impending recession.

The bigger question is whether we have seen a trough in global slowing. The most recent economic data releases have exhibited better than expected levels. The Citigroup

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Source: J. P. Morgan

Economic Surprise Index has moved up off lows seen in July, not only in the U.S. but developed international and emerging markets as well. Central banks across the globe have continued to provide accommodative monetary policy by lowering short-term interest rates with the goal of improving economic conditions. Has it truly worked? Has the global economy troughed and if there is a trade deal, is there more upside potential? While the outlook for a resolution to the trade discussions is somewhat murky, the continued hope for an improving global economy provides support to the risk asset markets.

We are monitoring several risks to our economic outlook. The first is the geopolitical tensions arising from the Middle East. Tensions with Iran and the impact on the price of oil could be a damper to economic growth. Oil under $70 a barrel will not have a negative impact, but if it goes higher, it may lead to more pressure on businesses and consumers globally. Another risk that continues to linger is Brexit. Will it be a no deal exit, or will it be delayed again? The political uncertainty and potential shift in leadership continues to weigh on markets and economic outlooks. Lastly, the upcoming presidential election in 2020 is weighing on business leaders. No matter what party you support, the political dysfunction in Washington leads to uncertainty. The uncertainty surrounding the regulatory and tax environment following the next election is causing business leaders to pull back on expansionary plans. If leaders know the rules, they can plan accordingly, but with a potential shift from today's environment to a different one, businesses are only investing what is needed to maintain the current level of activity.

Trend growth during this expansionary period has averaged 2%, and we believe we are at trend growth. While we do not believe a recession is imminent, there are more risks today than exhibited during the last three to four years. We remain cautiously optimistic on the equity markets at this time. We have maintained a neutral asset allocation in our portfolios this year and believe this position remains the prudent approach in the current economic and market environment. We continue to have a tilt towards growth over value in the equity portion of our portfolios. As always, we will continue to monitor the market and economic environment, making adjustments as needed.

Stocks need more than hope!

As the dog days of summer wind down, the equity markets continue the path back to all-time highs, but not without some added volatility and uncertainty. Perceived improvement in the "on again/off again" U.S. – China trade negotiations and better than anticipated U.S. economic data helped ease investors' concerns about an impending recession. Sentiment has improved, but investors still remain cautious as recent history has shown trade negotiations can quickly dissolve and lead the market lower again. With this continued uncertainty, a fairly dovish Federal Reserve (Fed) has given some insurance to the equity markets by cutting interest rates for the second time this year. It remains to be seen if this will be enough as the financial markets seemed disappointed with the Fed's "data dependent" forecast, which anticipates only one or no further rate cuts this year.

As of this writing, the S&P 500 had increased by 2.70% during the 3rd quarter, adding to an already impressive YTD return of 21.73%. In comparison, international equities continued to lag the U.S. markets with emerging markets down 1.80% and developed markets slightly positive for the quarter.

With the announcement of a resumption in trade talks, the market saw a sharp rotation in early September from the highly popular momentum and growth companies to the out of favor value companies, which include industrials, energy and financials. Today, value stocks are concentrated in cyclical sectors, or those that tend to do better when the economy is growing quickly and consumers have extra money to spend. Financial companies could benefit from a steeper yield curve as the 10-year Treasury yield has spiked from the lows of 1.45% to 1.90% in a matter of a few weeks. A steeper yield curve would contribute to improved profit margins at a time of slowing economic growth. We will be closely monitoring this rotation to determine if it has staying power or if it reverts back to the previous leaders, which have been growth companies. With the current global economic weakness, we are skeptical of a value rotation at this time.

It has been a sub-par year for small-cap stocks as this sector has significantly underperformed its large-cap counterparts for most of 2019. In fact, the Russell 2000 index still has a 1-year return of -6.83%. Historically, the small-cap sector has underperformed large-cap

companies when entering the latter part of an economic expansion. Years ago, small-cap companies received a majority of their revenues domestically, which would bode well for them during both trade concerns and a global slowdown. More recently, however, small-cap companies have averaged nearly 50% of their revenues from international operations. Technological advancements and globalization are likely responsible for this increase in global revenue, which has also increased recession fears and caused some of the small-cap relative underperformance this year versus large-cap stocks. During the market's latest rotation, small-cap stocks were able to make up some ground as the Russell 2000 index rose by 6.4% in September compared to the S&P 500 advancing by 2.4% as of this writing.

The continued trade uncertainties and debates about a recession are causing a divergence between stock returns and bond yields, and it remains to be seen who is going to be right. There are approximately $15 trillion of global bonds with negative yields prompting foreign investors to flock to the U.S. in search of higher yields, driving our yields lower. At one point in September, the yield on a 30-year Treasury bond (1.91%) briefly fell below the S&P 500's average dividend yield of 1.95% for the first time since 2009. Bonds continue to look expensive compared to equities, and equities appear to be fairly valued with a forward P/E ratio of ~17x next year's earnings.

Investors will start to tune into corporate earnings over the next few months to get an indication of where the stock market and economy are headed. For the 3rd quarter, S&P 500 earnings are estimated to decline by 3.6% with revenues growing by 2.9%. This decline would mark the first time the index has reported three straight quarters of year-over-year earnings declines since 2015. The market's top concerns for this earnings season will be the unknown impact of trade tensions and slower global economic growth, especially for companies with higher global revenue exposure. In fact, companies that generate more than 50% of their sales outside the U.S. are expecting an earnings decline of 10.7% versus an expected earnings growth rate of .4% for companies that generate greater than 50% of their sales within the U.S. Looking ahead, analysts are projecting earnings growth of 3.4% for the 4th quarter, followed by high single digit growth for the first two quarters of 2020.

Our portfolios continue to remain neutrally allocated to stocks with an overweight to growth companies as we continue to closely monitor corporate earnings, trade tariff consequences, and the recent sector rotation trends. U.S. stocks continue to be a heavier emphasis in the portfolios with an equity allocation of 80% U.S. and 20% International.

The Fed Lowers Rates Again

In a global market flooded with negative yielding debt, U.S. Treasury yields were pushed lower during the 3rd quarter. Why not buy positive yielding securities in the U.S. rather than negative rate global debt? This further decline in U.S. yields continued a trend that started 12 months ago. When equity markets fell in August, a flight to quality occurred, pushing short-intermediate and long-term interest rates to their lowest level of the year by month end. A late quarter recovery in the equity markets reversed this and pushed rates higher by the end of September. In early August, the 2 year to 10 year Treasury yield spread inverted, joining the 3 month to 10 year Treasury rates, which inverted earlier in the summer. While the predictive accuracy of recessions is not 100% when the yield curve inverts, inversions gave the markets and the Fed increased concerns about future global growth and credit stability.

The Federal Open Market Committee (FOMC) meets eight times a year to review U.S. economic and financial conditions. During these meetings, the FOMC determines the appropriate course of monetary policy and assesses the risks to its long-run goals of price stability and sustainable economic growth. At both the July and the most recent September meetings, the FOMC decided to lower the Fed Funds rate by 25 basis points. Each decision was described as a "mid-cycle adjustment" and labeled an insurance policy rather than a reversal of the cycle of raising rates that started in December of 2015. These rate cuts came even though U.S. economic growth is positive and inflation is tame. However, against a backdrop of major global uncertainties, slowing global growth, and a driving desire to eradicate an inverted Treasury yield curve, the Fed found it necessary to take out an insurance policy to keep the U.S. economy growing.

According to the Fed, any further accommodative monetary policy actions will be data driven. We find it difficult for the Fed to be mindful of the economic data when the markets and the economy are principally headline driven. In addition, not all of the members of the FOMC agreed with the rate cut decisions. Two believed current economic growth did not warrant any additional stimulus, while one wanted a larger rate cut. One official even believed that current low rates are allowing "zombie" companies to stay alive, which could make the credit markets worse in a recession. Low global interest rates are a major reason for falling U.S. interest rates. The Fed does not want negative U.S. interest rates. Nonetheless, the market believes the Fed will lower rates again by year end and what action will be taken in 2020 is unknown.

One positive sign of U.S. economic health in the credit markets has been the relative stability in corporate credit yield spreads. Investors require additional yield when credit conditions worsen and less when conditions are

good. Analysts watch the corporate credit spreads as a guide to economic conditions. The recent equity market correction in August did see investment grade and high yield corporate credit spreads increase but far below the levels experienced during last year's 4th quarter sell-off. To us, this behavior suggests most companies' credit is not overextended. However, the possible cracks in the overall credit markets will likely come from private credit issuers, both domestically and globally, due to their lack of liquidity.

Negative rates are not always positive. Driven by the need to stimulate their economies, Japanese and European central banks' monetary policies have pushed their sovereign debt yields negative for several years. Nearly $15 trillion in sovereign debt has negative yields. Almost 25% of all global debt has negative yields. We would argue that negative interest rates have not worked the way these central bankers intended. Negative and lower global yields alter the way investors view debt. Borrowers have little incentive for taking on new loans in a slow growth economy. For savers, negative yields act as an additional tax. Rather than an investment, these debt securities are trading vehicles for capital gains, putting them at risk for huge capital losses if interest rates were to secularly increase. The more these speculators force global interest rates lower, the greater the demand for higher yielding U.S. debt.

The continued drop in interest rates does not make a compelling case for fixed income securities. Some of our clients consider the benefit of the higher yields offered by money market funds. However, money market funds offer a limited sense of security. Their current yields have dropped and will continue to drop with every Fed easing. The recent September Fed move will work against money market yields during October. While income from U.S. shorter-term securities, money market funds, or even high dividend paying equity securities offer a temporary yield incentive and lower duration risk if rates were to reverse course, we believe the prudent strategy would be to hold a portfolio with a laddered maturity structure. The most recent decline in yields before the September FOMC meeting strongly promotes the merits of a laddered portfolio. Whether this strategy utilizes individual securities or mutual funds, our fixed income duration goal of approximately four years remains. Our typical fixed income portfolio is diversified but with a domestic investment grade bias over a global debt and high yield exposure. Right now, the market is only speculating that the Fed will ease again at year end. Rates will be determined by global growth and tariff negotiations. Remember, we are just a tweet away from the risk of a major interest rate move in either direction.

Sometimes overlooked

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How asset titling and beneficiary designations can derail an estate plan

Putting together a will is often the first step in creating an estate plan, but the mere act of creating this document does not guarantee property will transfer according to your wishes. There are assets that can pass outside of your will or estate if you do not consider the ramifications of proper titling during your lifetime. Below are some of the more common and well-utilized forms of property ownership.

The maximum ownership interest a person may have in property is known as fee simple or absolute ownership. This type of ownership gives the owner the right to use, possess and dispose of the property in any way he or she chooses during life and at death. Since there are no survivorship rights in this kind of arrangement, property must generally pass through probate. In other words, a person's will dictates to whom this property passes. Bank accounts, investment accounts and real estate owned by one individual and titled in his or her name only are all examples of absolute ownership.

Joint tenancy with rights of survivorship (JTWROS) is property owned by two or more people, each owning an undivided, equal interest in the entire property. This is one of the most common ways married couples title accounts without giving it another thought. Property owned in JTWROS passes to the surviving owner(s) by right of survivorship. It is often desirable for spouses to hold at least one account in JTWROS form so that the surviving spouse has immediate access to funds at the death of the first spouse. Property owned this way avoids probate altogether and passes by operation of law.

When two or more people own an undivided and possibly unequal (fractional) interest in an entire property, such an arrangement is referred to as tenancy in common ownership. The undivided interest of each owner is treated as being owned outright, and this interest can be sold, donated or passed at death. Unlike with JTWROS, when one tenant or owner dies and property is titled as tenancy in common, the remaining tenant(s) do not automatically receive the interest by operation of law. The tenant in common must specifically provide for the disposition of the property in his or her will. Real estate owned by multiple parties in unequal shares is often titled as tenancy in common.

In addition to account titling, coordinating beneficiary designations with your will or trust is an important, yet often neglected, component of a successful estate plan. Wills and trusts pass most assets titled in your name or trust name to the beneficiaries named in the document. However, assets such as life insurance, annuities and individual retirement accounts (IRAs, 401(k)s, etc.) pass directly to third parties through a beneficiary designation. If your will or trust names different beneficiaries for these assets, they will not pass according to either document. Assets with beneficiary designations pass to heirs by contract only. Additionally, payable on death (POD) or transfer on death (TOD) accounts, also common forms of legal agreement, pass directly to designated beneficiaries by contract at the account owner's death without going through probate. Assets titled in these ways will not pass according to any instructions in your will or trust. It should also be noted that beneficiaries of these assets do not have access to the accounts during the owner's life.

As you can see, the estate planning process does not begin or end at the creation of a will or trust. The titling of assets and accounts during your lifetime is also an important component of estate planning. It is essential to be mindful of your property's disposition at death if you have more than one person inheriting your estate. A diagram or flowchart can be a good visual depiction of what will happen at that time and will ensure your estate plan is consistent with your wishes.

In addition, a simple call or consultation with your trust administrator can help uncover issues with your current plan. We stand ready to help you in any way we can.

Ronald Glenn
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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