Q1 20

Midland Wealth Management

Market Outlook

A Decade of Growth: How Long Will It Continue?

A recent headline noted that this is the first time in history the U.S. economy has started and ended a decade without a recession. This expansionary period continues to be the longest in history, although there have been many concerns about impending recessions and cyclical market corrections along the way. For example, last year at this time, the markets were in disarray. The Federal Reserve Open Market Committee (Fed) had just raised the short-term rate for the third time in a year and indicated more increases were on the horizon. The global economy was slowing, and trade talks were causing disruptions that resulted in many market participants speculating an impending recession was a foregone conclusion. During the summer months, fear of an inverted yield curve was the talk of the town and many were wondering when the recession would begin. There have been other periods during this decade when the recession fear arose, such as 2011 with the European debt crisis and 2015 when global growth slowed and oil prices plummeted. All through this, our view was that there was no impending recession and we believed markets were overreacting. In prior market updates, we have discussed how this has been an extremely slow growth period with little overheating occurring, which historically leads to higher inflation, tighter monetary policy and a recession. Throughout this expansionary period, rising inflation has not been an issue and central banks have actually been attempting to raise inflation to a consistent 2% level. Investors who remained in the markets during the past decade have been nicely rewarded. Over the 10 years, the S&P 500 index, from the market low to the time of this writing, has more than tripled in value while the NASDAQ index has increased six-fold. Bond market participants were also rewarded during this timeframe with cash and money market instruments providing substandard returns. Despite the many worries during the past decade, history will look back favorably upon the returns provided by these financial markets.

Can the markets continue to move higher and provide positive returns heading into 2020? We do believe that equity markets can move higher during the next 12 months and bonds should provide a fairly low return, albeit positive. Since mid-July, the Fed has decreased short-term rates by 75 bps providing the backdrop necessary for global central banks to sustain their accommodative policies in the face of slowing global economic data. A typical short-term rate move by the Fed takes 3 to 6 months to impact the economy. Looking back, when the Fed raised rates with the final increase in December 2018, the impact of those tightening moves did not become evident until late spring/early summer. The impact of the most recent easing moves in July, September and October is just starting to be seen in economic releases in December and should follow through into early 2020. All of these actions have provided a positive backdrop heading into the New Year. In addition, as the year comes to an end, trade agreements with Mexico and Canada appear to be close to completed, a phase one deal with China is near, and the government has avoided another shutdown. We view these actions as positive and believe they should help relieve some of the uncertainties that have been hanging over the market. The U.S. economy maintains solid footing with elevated consumer confidence driving demand and labor markets continuing to show strength or at a minimum, stabilization. Unemployment stands at 3.5% while the broadest measure of unemployment, the U-6, stands at near all-time lows of 6.9%. Wages have increased by more than 3% year-over-year with lower income positions experiencing greater than the 3% average. The most recent housing numbers have been strong, especially in the single family home category. The supply of existing homes on the market is at a 3.7 month inventory level, which is extremely low. Typically when the housing supply falls below 6 months, it is considered to be a tight market. The market is especially tight in the low- and mid-priced home categories. Higher-end homes continue to see a fairly strong supply.

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The current interest rate environment certainly has been an incentive for millennials to purchase homes.

Business confidence remains questionable at best. The never-ending discussion of trade and tariffs, weak domestic manufacturing, and continued global slowing has had a definite impact on CEOs' confidence. The delay in the tariffs that were slated for December 15th was a positive, but uncertainty remains around the details of the final phase one deal with China and whether there will be follow-through from either side. The decline in global growth appears to have troughed, especially in China, but Europe remains a concern. If China has truly bottomed and is in an upward growth trend, it will positively impact European growth as the exports to China are a strong driver of growth in those economies. The most recent election in the United Kingdom has also provided some guidance on Brexit. Strong support for Boris Johnson and his exit plan means that it will happen in the next few months, but there will be many details to be worked out over the next year. The next concern for them will be Scotland's response and if it votes to separate from the U.K. The long-term impact of the Brexit turmoil is difficult to measure but there have certainly been changes since the 2016 vote to separate from the European Union and the tumult will continue to play out over the next few years.

Looking forward to 2020, we believe that a recession is not on the horizon and growth will progress at the 2% pace we have experienced over the last decade. The upcoming election will have an impact on market movements as we move later into the year, but the first few months should be guided by fundamentals, particularly economic data and earnings. While the equity markets may be at the higher end of valuations, the economic backdrop and earnings expectations should allow it to grind higher in 2020. International developed and emerging markets appear to be less expensive on a valuation basis compared to domestic markets, but this has been an ongoing story since 2011 following the European debt crisis. Will it change this year? With a stable or declining dollar, easier monetary policies and stronger potential growth in developed and emerging economies, these markets may provide more opportunities during 2020. Our portfolios are positioned with a slight overweight to international and an emphasis on emerging markets heading into 2020. With the most recent Fed action, short-term rates are anchored for the near term. Intermediate and long-term rates have increased slightly, leading to a more positively sloped yield curve, albeit still relatively flat. We do not envision extreme moves higher in rates, but there is certainly an upward bias at this point. Our fixed income allocation remains neutral to the designated benchmark with an emphasis on high quality credit. We will continue to monitor both domestic and global markets and make adjustments to our allocations as needed.

As the year and decade come to an end, we want to thank you for putting your trust and confidence in Midland Wealth Management to help meet your long-term goals. We wish each of you a wonderful new year!

Fed Pivot Gives Support to Fixed Income Markets

During the fourth quarter of 2019, the Fed lowered the Fed Funds rate for the third time by 25 basis points, completing its 2019 policy pivot from tightening credit conditions. The more accommodative policy has been viewed as an insurance to ward off negative consequences of global and political uncertainties that affected U.S. and global economies. The impact of the 2018 tightening cycle on domestic and global economies had many economists warning of a possible recession in 2020. With this shift from the Fed, the risks of recession have declined.

Earlier this year, the Treasury yield curve inverted when short-term interest rates exceeded long-term rates. Historically, yield curve inversions are a strong predictor of recession and typically occur when the Fed has tightened monetary policy to slow down an overheated economy. Concerns about an impending recession were alleviated when the Fed lowered short-term rates and a phase one trade deal with China seemed imminent. Further confirmation can be seen with longer-term interest rates moving higher, resulting in a more positively sloped yield curve and removing the risk of an inversion.

Following its most recent meeting, the Fed signaled that it is prepared to maintain its current monetary policy unless data shows increased inflation or dramatic economic slowing. The level of inflation targeted is under review as many Fed officials seem willing to allow inflation to run above their previously self-imposed 2% target level. Fortunately, the Fed's preferred and headline inflation indices remain below or at these levels. We do ponder how the Fed may react to increased or even falling inflation later in 2020. For now, we have penciled in no Fed rate increases through mid-next year. If inflation and economic growth remain close to current levels through the summer, we do not expect any Fed action through all of next year, especially with the November elections approaching. However with rates still near historically low levels, the Fed now has a reduced level of ammunition to combat material economic weakness in 2020 and beyond, undermining the potential benefits from easy monetary policy. Such a limited arsenal potentially compounds the need for the Fed to act more aggressively than it otherwise would with ample room to lower rates. While the Fed believes the most recent rate cuts were enough, it may quickly find itself reducing rates to the lower bound of monetary policy and then resorting to further quantitative easing (QE) if the economic environment turns negative.

The era of large U.S. federal budget deficits and consequently heavy Treasury supply is poised to continue. The Congressional Budget Office calls for the deficit to rise an additional $1 trillion in fiscal year 2020. Moreover, we have heard essentially no talk of fiscal restraint from President Trump or the leading Democratic candidates. Unfortunately, this is not a problem to many…until it is one. With the need to increase spending, the need to issue more Treasury debt also increases. Normally, added supply means higher interest rates to attract buyers. With current global rates exceptionally low, this has not put any pressure on rates yet.

One offset against the new issuance of Treasury debt is the Fed's purchasing of securities for its balance sheet. Currently, the Fed is purchasing Treasuries as part of two separate plans. First, the Fed has been reinvesting agency Mortgage Backed Securities (MBS) principal paydowns into Treasuries. This strategy began in August 2019 and the reinvestment is capped at $20 billion per month. This plan is consistent with the Fed's goal to hold primarily Treasuries. Second, since mid-October the Fed has been purchasing Treasury bills to help rebuild reserves in the system. The base case scenario looks for the Fed's reserve management purchases to total $270 billion through mid-April and $468 billion of Treasuries for the entire year, keeping a lid on interest rates.

Domestic Treasury debt purchases are another offset. For many investors near or in retirement, a certain level of investment income is required. However, the current low interest rate environment means less income earned. That brings us to the latest national savings rate for November, which is relatively high at 7.9%. People are saving more to make up for the lower interest rates. Losing an investment that paid 6% several years ago means purchasing three times as many fixed income securities now paying 2% to earn the same amount of income.

The desire for income has also resulted in narrower credit spreads on non-treasury securities. Institutional and retail fixed income buyers have increased portfolio yields by extending average maturities and adding on greater credit risk. This search for yield has raised demand for all fixed income securities and resulted in tighter spreads across a wide range of fixed income securities, no matter how risky. High yield (junk) debt spreads are near historical lows as investors increase acceptable risk levels and the stock markets move to all-time highs. However, these credit spreads could quickly expand if the stock market experiences a pullback from the record levels.

Looking ahead, we expect some continuation of the current low yields as long as central banks remain accommodative. The Fed appears convinced its 2019 easing is already working to stabilize domestic activity, propelling the economy toward sustained 2% growth and inflation. While the consumer and labor market remain strong, there has been weakness in business investment and manufacturing. Fed officials believe the most recent accommodative moves should benefit the economy along with the impending trade deals that were recently negotiated. Our current outlook for the upcoming year is very similar to the Fed's outlook. We believe the Fed will not increase short-term rates through mid-2020. If inflation and economic growth remain close to current levels through the summer, we do not expect any Fed action for the remainder of the year, especially with the November elections approaching. However, the Fed would be irresponsible to allow market conditions to invert the yield curve again in the absence of any real inflationary pressures or irrational exuberance on the part of investors.

While 2019 was a great year for fixed income portfolios as yields declined, we see no need to add either interest rate or credit risk. Rates are low and if interest rates climb, longer structured fixed income portfolios would be adversely affected. While we do expect further near-term increases in interest rates on the longer portion of the yield curve, we do not see a major jump in rates. We see no need to expand our credit risk exposure. Credit spreads are tight. While the pace of economic expansion seems sustainable, any faltering would expand credit spreads. While we monitor the workings of the market, we see no reason to adjust our current fixed income portfolio allocation.

No Coal in Our Stockings This Year!

As the final month of the decade comes to a close, stocks have certainly not disappointed investors as the S&P 500 stock index hovers near record highs and is delivering its strongest annual return since 2013. The period from 2010-2019 was the first decade since 1850 that the U.S. did not experience a single recession. There have certainly been corrections along the way, but every correction turned out to be a buying opportunity. This has led to over 200 new all-time highs on the S&P 500 index this decade alone. The S&P 500 has averaged 13.44% over the last ten years, which is in sharp contrast to the previous 'lost decade' that saw an average annual equity return of only 1.41%.

Despite all trade and political headlines this year, the S&P 500 total return including dividends exceeded 30% in 2019, which outpaced both developed and emerging market stock returns as of this writing. Typically, corporate earnings are one of the main drivers for stock market returns. However, this year's gains are mainly attributable to the Fed's monetary policy pivot, in which it not only backed off its tightening stance but also eased monetary conditions. Hence the adage, "Don't fight the Fed." Additionally, the stock market slump late last year created an attractive buying opportunity with reduced valuations that provided a low starting point this year. If you average

out returns over the last two years, the S&P has averaged approximately 11.50%, which is still well above the long-term trend average.

With all these new record highs in the market, what should investors expect next year? Stocks continue to remain attractively priced versus bonds, but U.S. stock valuations are beginning to look a little stretched compared to their 25-year average. The current forward price to earnings (P/E) ratio is ~17.8x compared to the 25-year average of 16.24x. Due to the global economic slowdown, corporate earnings growth had a lackluster year in 2019, however the good news going forward is analysts are predicting corporate earnings to grow by 5-7% for the first half of 2020. Real earnings growth will be essential for stocks to move significantly higher from current levels. The primary catalysts for stocks in 2019 were an accommodative Fed and multiple expansion. With historically low interest rates, stocks saw their P/E ratios expand from approximately 15x to the current 18x. Essentially, stock prices moved higher with very little growth in earnings. To justify the current P/E levels, we will need to see a resumption of earnings growth, which is anticipated as global growth appears to be bottoming and setting up to improve in 2020.

Stock buybacks from companies continue to have a meaningful impact on stock returns, as demand for buybacks has outpaced demand from other sources, such as mutual funds and ETFs. As we enter 2020, we are anticipating a decrease in share buybacks as companies begin to focus their free cash flow on CapEx spending. If we are correct and begin to see recovery and acceleration in global economies, corporations will need to increase spending on CapEx and productivity enhancements. It will be up to the institutional and retail investors to pick up the slack in equity purchases as companies reduce their share buybacks. If share repurchases fall more than expected next year and we do not see a pickup in global economic activity, it could lead to slower earnings per share growth and increased volatility. Much of this will be determined by mid-year when we know the Democratic nominee for the 2020 Presidential election.

Historically, an election year tends to have positive stock returns leading up to the election. If the incumbent party wins, the market tends to add to its gains for the year; if the incumbent party loses, the market tends to sell-off as uncertainty gets priced back into the market with new leadership in the White House.

We believe markets will grind higher in 2020, although volatility will likely increase in an election year as markets digest both the presidential election campaign and continued progress of the U.S.-China trade deal. We agree with most Wall Street analysts that U.S. stocks may rise by mid-single digits next year, however we do see catalysts that could propel the market to even stronger returns if they should fall into place.

Investors may begin to have a greater appetite for international stocks especially if the U.S.-China trade deal continues to make progress. We maintain a slight overweight to emerging market equities since overseas economies may start to see modest improvement as the global slowdown comes to an end and growth returns to those economies. In addition, an end to further tariffs and trade disputes would be a catalyst for an improving international equity environment, particularly with a stable to weaker dollar. The surprise for the equity markets in 2020 could come from outside the U.S.

At the start of the year, the portfolio team will reposition portfolios to lock in strong gains we have seen throughout 2019 and position portfolios for opportunities in the first half of next year. We will constantly monitor the fundamental, economic and political landscape and stand ready to make changes if needed.

TIE into Midland Wealth Management with

Trust, Investments and Expertise

Tuesday, January 28th at 3:30 PM (CST)

Save the date to join an exclusive group for a stimulating discussion about the economy and market conditions around the world.

Call-in details to follow.

Demystifying Trusts

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The law of trusts was established under English common law. Trusts came into being in the 12th century during the Crusades when the lord of the manor left to save Jerusalem. There are three requirements to establish a trust: grantor with the intent to establish a trust, a "res" (trust property), and a trustee.

Only two types of trusts exist. There is a testamentary trust and an "inter vivos" trust. From these two categories, many different named or titled trusts arise. However, no matter what they are called, they are either testamentary trusts or "inter vivos" trusts.

A testamentary trust is created under the Last Will and Testament of a decedent. It is always irrevocable. This means the trust cannot be changed or reversed; it is final. The terms of the trust are outlined in the Last Will and Testament and if the terms are not fully expressed, the trustee can look to state law concerning the administration of trusts. The Surrogate or Probate Court grants the authority of the trustee to act. The filing of the Last Will and Testament in the Surrogate or Probate Court results in the trust becoming a public document.

An "inter vivos" trust is made during one's lifetime. It can be either irrevocable or revocable. A revocable trust can be changed, revoked or canceled. The grantor gives the trustee authority under the trust document, and it is looked upon as an agreement or contract between them. Thus, it is a private document not subject to public disclosure or scrutiny.

A trust can be established for a variety of reasons and purposes. The only universal restriction is that a trust cannot violate, be against, or circumvent any public policy. The Court that has jurisdiction of the trust agreement determines what the public policy is.

There are at least three parties to a trust arrangement. The grantor, owner of the property or "res", who transfers the legal title of the property to the trustee. The trustee who then manages the property for the benefit of the beneficiary. The trustee administers the trust in accordance with the trust agreement or trust administration statues the state has established.

One of the most common advantages that lawyers put forth for the establishment of a trust is the avoidance of probate. Another aspect is tax planning. Both are valid, but Susan Porter, a renowned trust expert, states there are four main reasons to create a trust: creditors, predators, disability, and inability.

The trust assets can be protected against the creditors of the beneficiary and possibly the grantor if certain language, specifically a spendthrift clause, is included in the trust agreement.

The trustee can protect the assets against predators of the grantor or the beneficiary by exercising the discretion given to him or her under ascertainable standards enumerated in the trust agreement.

Disability of the grantor or beneficiary would not interfere with the management of the assets or the payment of expenses.

Not everyone has the financial acumen to manage investments. An independent professional corporate trustee can overcome this inability. What eighteen year old would be able to manage or retain a financial windfall that might land in their lap?

The law of trusts is not set in stone and is continually evolving over time. Changes in the tax law can have adverse effects on trust agreements that were drafted to take advantage of past tax laws. Thus it is prudent to review one's trust document/agreement to see if it is still viable and will continue to achieve one's personal objectives.

I want to close with a caveat. If you or one of your clients decides to establish a revocable or irrevocable trust and for whatever reason neglects to retitle the assets, they will not become assets of the trust. When you execute a trust agreement, you must undertake the additional step of having the assets you intend to fund the trust retitled into the name of the trust.

One further thought is no one can predict the outcome of the 2020 elections or what future tax legislation may look like, but now might be a good time to make lifetime gifts to take advantage of the current $11.4 million gift tax exclusion ($22.8 million for married couples).

Edward Avery
Senior Trust Officer
Midland Trust Company

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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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.

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