Q2 20

Midland

Wealth Management

Market Outlook

Uncertainty Abounds

Looking back at the end of 2019, we did not envision the world we are living in today. We didn't believe a recession was on the horizon unless there was an exogenous event such as COVID-19. Since the beginning of the year, we have seen this virus spread from China to around the world leaving devastation in its path. In mid-January, the Chinese government decided to force an economic shutdown in response to the virus to stem the tide of new cases and limit the number of deaths. Now, two months later, we are starting to see a resumption of economic activity throughout China. This trend of government-induced economic shutdowns has moved across the world increasing the probability of a global recession with the primary cause being the virus. Within the last 30 days, the U.S. economy has come to a halt, stock indices have moved into bear market territory ending the record-breaking bull market, and credit markets froze up, limiting liquidity in most markets. The rapid rate of decline is nothing ever experienced before in the U.S., and the uncertainty regarding the duration and eventual recovery continues.

In response, the Federal Reserve (Fed) took quick and drastic measures to provide liquidity to the markets by lowering the overnight lending rate to 0%. This move, while working with other central banks to coordinate a quantitative easing (QE) program, encouraged use of the discount window and provided liquidity through U.S. dollar swap arrangements and backing for commercial paper and prime money market funds. It also allowed purchases of short-term quality municipal bonds to provide liquidity to the market. We live in unprecedented times that require unprecedented actions.

In turn, Congress quickly moved to implement a $2 trillion fiscal stimulus package to support businesses and individuals, adding to the earlier stimulus that provided aid to fight the pandemic and supply benefits to workers affected by the virus. Whether there will be more stimulus needed is still uncertain, but these actions certainly provide support to those hardest hit by the government-induced economic shutdown.

While there has not been actual economic data supporting a recession as of yet, we do believe it will be hard to avoid considering the negative economic impact caused by actions taken to flatten the curve of the virus and there is high probability we are already in a recession. Due to the uncertainty surrounding the duration of the current state of economic output, it is difficult to determine the type of recovery we will experience. While the U.S. economy was on strong footing before the virus hit, we are not of the opinion that it will be a V-shaped recovery. Rather, we envision a potential sharp spike in growth as pent-up demand builds, but then a plateau or slight decline in the growth rate as the economy returns to a slow growth environment. The number of unemployed has spiked dramatically and many of these workers will not return to work immediately as the economy slowly moves back to a new normal. We as a nation will experience changes in the way we have historically conducted business and socialized. Large groups will likely be limited for an extended period of time. This measure will impact concerts, sporting events, theatres, crowded restaurants, and any other highly congested activities. Travel will be slow to return due to continued fears of contracting the virus. The most negative impact will be the businesses that will not survive. Despite fiscal stimulus, there will be small businesses, as well as larger ones, that will not have the financial resources to endure this situation and remain a viable operation.

Although the historic expansion period and bull market has come to an end, we do believe this too shall pass. The ingenuity of our scientists and healthcare providers will help bring this virus under control and find ways to prevent and limit future outbreaks. There is hope for the future. In the meantime, we will continue to experience a period of heightened volatility in the markets due to the uncertainty surrounding economic growth and corporate earnings. Historically, remaining in the market

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and investing for the long-term benefits those who can ride through these storms. We continue to maintain our equity positions in our portfolios, albeit at the lower end of the appropriate allocation. As we closely monitor the markets, we do think there will be a time to leg back in and increase our equity positions to the neutral target. The dramatic amount of liquidity and fiscal stimulus should provide a boost to both the economy and equity market when the corner is turned on this emergency situation. The fiscal stimulus will increase the level of debt, which will need to be dealt with, and may put upward pressure on interest rates in the future. In the near term, we do not see higher interest rates as the global economy recovers, but we will continue to monitor.

Fixed Income Markets, Monetary Policy and Forced Liquidation

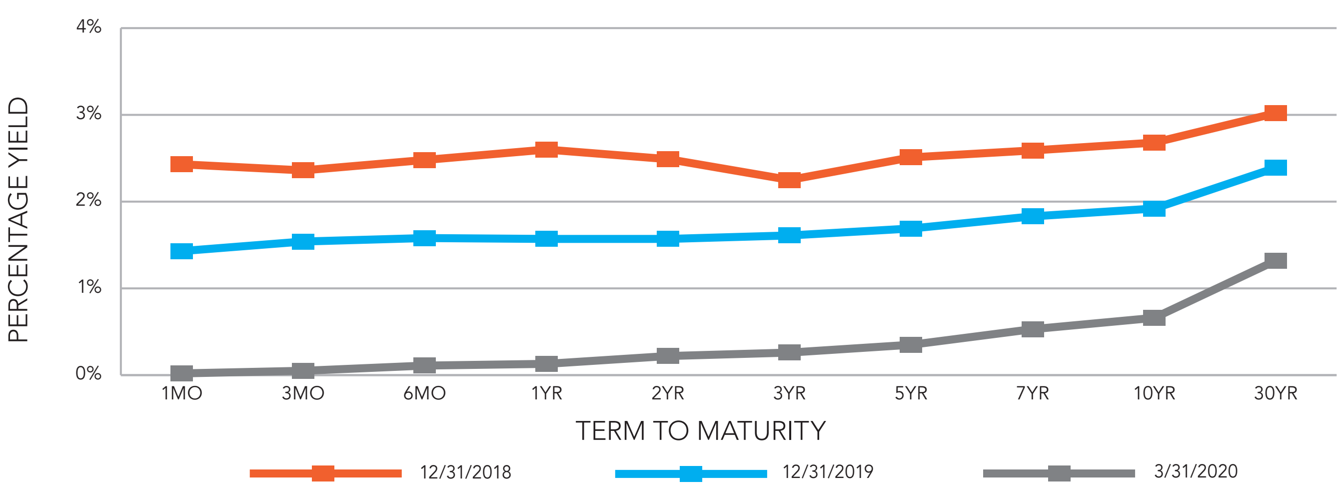
Despite being the traditional safer asset class, fixed income securities traded during March with volatility we have never seen. Bonds provided little shelter from collapsing stock markets. With the quick drop in equity market value, investors were heavy sellers of risky securities that could be sold for cash. The drop in Treasury yields to near record lows during the quarter was not necessarily tracked by other fixed income products. The chart below shows the steep decline in yields from year-end through end of March.

Starting in mid-March, the Fed took dramatic monetary policy actions to prop up the economy and fixed income market. With two rate-cut moves, the Fed lowered the Fed Funds rate to virtually zero. These rate actions were intended to stimulate the economy by easing credit for borrowers to access cheaper funding sources. At the same time, a rush for cash and liquidity strained foundations of the fixed income financial system. With the stock market's sell-off, investors demanded safety and cash immediately. Investors bought safe haven Treasury securities and sold everything else. To provide operational liquidity to the fixed income trading market, which nearly froze due to investors selling non-Treasury fixed income securities no matter the price, the Fed initiated a new phase of QE by designating increased purchases of Treasury and mortgage securities. This action was followed by new Fed purchasing of commercial paper, municipal securities and investment grade corporate bonds. In other words, the Fed threw in the kitchen sink to be the backstop buyer of securities to support fixed income markets. These new security purchases will swell the Fed's balance sheet over time, but that is a problem for another date.

As mentioned previously, fixed income investors sold non-Treasury securities for liquidity. Selling pressures increased and before the Fed stepped in as a buyer, bond credit spreads exploded. Since the beginning of the year, yield spreads on investment grade and high-yield securities nearly doubled, and in some cases, tripled. Buyers demanded greater yields to compensate for the expected risks from an economic slowdown. Investors feared that corporate, municipal and consumer borrowers could have difficulties paying periodic payments due to reduced revenue, tax collections and income. In the case of mortgage securities, investors also want more yield compensation because they are worried about the suspension of monthly principal and interest payments. The Fed's latest QE has helped stem the rise. In fact, while credit spreads are still elevated, they have decreased from their recent cycle highs.

The $2 trillion fiscal stimulus will not prevent a recession; it should prevent the recession from being catastrophic. With U.S. Treasury interest rates near record low levels, funding the new $2 trillion plus deficit spending might not be that easy. To fund this federal cash stimulus, the Treasury Department will increase the amount and maturity composition of its Treasury security auctions for the next year, if not years. For now, investors seem to

U.S. TREASURY YIELD CURVE



be willing and expected to soak up this new supply. This buying is coming as Treasury yields are near record lows. With the Fed fixing short-term rates near zero, some fixed income experts suggest the Treasury yield curve will steepen over time as longer-term rates rise with new supply. Nonetheless, the need for safety and liquidity will keep short-term rates near zero for the next year.

After showing recent signs of inverting, market and Fed forces have steepened the Treasury yield curve. Short-term rates are expected to stay low for the rest of the year as the Fed oversees the expected late year economic recovery. If equity markets show further signs of weakness, we would expect short-term interest rates to turn negative. Over the past week, T-Bill yields were temporarily negative as investors looked for a safe haven. The next equity market sell-off could bring negative Treasury yields out as far as 2 to 3-year maturities.

When looking for value in bonds, we prefer credit over duration. Regarding duration, we favor short- and intermediate-term as opposed to the long end. With the Fed aggressively managing short-term interest rates at low levels and market liquidity needs, investors may be willing to or need to take on risk for added income and yield. Investors can take advantage of this by allocating dollars into credit-based fixed income securities and/or funds. While the fixed income sector suffered this year, it now offers value. In fact, the recent spike in credit spreads offers a once in a business cycle opportunity for investors to ride the economic recovery.

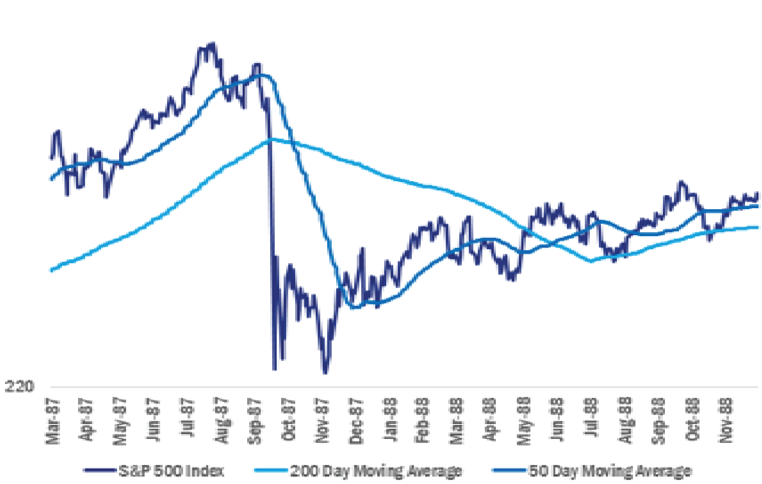
Swift and Unprecedented

Eleven years ago, the longest bull market in history began. No one knew then that it would be the start of a rally that would add over $20 trillion to equities. Now, that bull market has ended the same way it began – amid panic and with little warning. The market reached all-time highs on February 19 and has since seen one of the sharpest and quickest declines since the Great Depression. The S&P 500 fell over 30% in less than a month, and we have now officially entered a bear market. Fears about the novel coronavirus (COVID-19) are to blame for the market's nearly 30% slump. With many global economies already slowing before the pandemic began, COVID-19 poses a serious risk of sending many countries into a synchronized global recession.

Market volatility is certainly unsettling for most people, however, investors need to remain focused on their long-term investing goals. History has proven that investors who stay the course through the market's ups and downs have been nicely rewarded over time. Currently, we are in unchartered and unprecedented territory as no one knows how long our economy will be shut down due to COVID-19. This fear and uncertainty can be seen in the VIX volatility index, which recently increased to a level of 85 on March 18. This level of stock market fear has only been surpassed by the 2008-2009 global financial crisis, which saw the VIX hit 89. (See chart below.) If history is any indication of the future, we know that over time this will likely be transitory. The markets have weathered similar epidemics in the past, including the Swine Flu in 2009 and SARS in 2002. Interestingly, both of these epidemics occurred during

Source: Bloomberg

S&P 500 – 1987 Market Crash



S&P 500 – 2008 Financial Crisis

Source: Invesco

bear markets from which the stock market ultimately recovered.

It's too early to predict with any certainty how corporate earnings will be impacted in the 2nd quarter. We do know earnings will be significantly lower compared to last year. On average, S&P 500 earnings have contracted by -17% during the last several recessions. Another concern that will likely have a negative impact on earnings will be a significant reduction in corporate stock buybacks, which have helped support stock prices over the past few years. The unprecedented shut down of the U.S. economy has forced many companies to suspended stock buybacks and even discontinue their dividends to help preserve cash flow and keep businesses operating.

On a positive note, we have seen a significant amount of fiscal stimulus from central banks around the world in a coordinated effort to supply liquidity and dampen the global economic slowdown caused by COVID-19. Between the U.S. and the G20, central banks are expected to provide approximately $5 trillion of fiscal and monetary stimulus to counteract the disruption caused by COVID-19.

As we headed into the new decade, our investment strategy remained fairly cautious as we anticipated a correction in what we viewed as an overbought market. Little did we know that a virus called COVID-19 would produce a quick and violent bear market not seen since the Great Depression. This sharp market decline will likely prove to be a great buying opportunity for long-term investors, but it will take some time. Bear markets do not bottom over a couple of days. For most bear markets, reaching the bottom is a process that can take months. Similar to what we saw during the bear markets in 1987 and 2008, we expect a strong rally off of the lows and then eventually a retest of those lows. (See chart above.) Given the sharp sell-off, most portfolios are near the lower end of their equity allocation range. Calling the exact bottom of a bear market is nearly impossible. However, we are closely monitoring these unchartered conditions. As volatility subsides, we will look for an opportunity to add to our equity exposure and bring our portfolios back to their neutral targets.

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T . I . E

Tuesday, April 21st 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.

Power of Attorney Checkup

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The Power of Attorney for Property is a core estate planning document that everyone should have. Its relatively straightforward purpose allows you (the "principal") to name someone (the "agent") to take care of your finances in the event you are not able to do so. Due to its simplicity, it can be a document that does not get much attention once signed, but that would be a mistake! In the event you ever need your agent to assist you with your finances, you certainly want clear directives and an up-to-date document. Accordingly, following are 4 easy questions you can use to review your power of attorney document as a check-up tool to make sure it is in good form.

1. Is Your Choice of Agents Still Appropriate?

We all know that life happens, and this necessitates making sure the agents you named in your power of attorney are still appropriate. For example, you may have your spouse named as your agent, but if they have diminished capacity (the beginnings of dementia, for example), you may need to make the difficult decision of naming someone else in their place. The location of your agent is important as well. For example, you may have named your oldest child as back-up agent as a matter of course, but if they live out-of-state or have made poor life decisions, you may want to reconsider your choice.

2. Is Your Power of Attorney in Statutory Form?

Almost every state, including Illinois, has a particular statutory format for their powers of attorney, and your document should be in this format. You can tell if the document is in statutory form because it will notate just that. A statutory power of attorney provides key protections to your agent in using it, and financial institutions are familiar with the document. If you have a power of attorney that is not in statutory form, this could pose risks, including delays if it is ever used (since a financial institution may not be sure the document is valid) or risk that the document is actually invalid (since most states have certain signing requirements for powers of attorney).

3. Did Your Power of Attorney Take Effect When You Signed It?

An important question to ask yourself is when will your agent be able to act for you? In my opinion, it is best to have the power of attorney be effective on the date you sign it. This means your agent decides when they need to step in and act, without having to jump through significant hurdles to do so. Having your power of attorney structured this way has two significant benefits:

- First, your agent does not have to go through the ordeal of getting you declared incapacitated in order for them to act. Having you declared incapacitated can be difficult and embarrassing for your loved ones. For instance, in your diminished state, will you cooperate with the examination? What will it cost? What if you are not yet incapacitated (or the physician is not ready to say so), but you still need the assistance of your agent?

- Second, having a power of attorney that is effective immediately allows your agent to take care of your affairs if you are not incapacitated, but still need assistance due to being temporarily out of state. If you winter in a warmer climate, having an agent who can act now and is located in your home state can be very convenient for you.

4. Have You Named Co-Agents?

Finally, if you have named co-agents in your power of attorney, you may want to consider a change so that your power of attorney names only one agent to act at a time. While there can be understandable reasons for naming co-agents (most people desire a "check and balance" on those acting), in my experience this potential benefit is outweighed by the drawbacks: namely, the undesired administrative legwork that comes from always having to have two agents sign off on every decision. As I have sometimes told my clients, "Two heads is a monster!" Stick to just one agent acting at a time.

If you would like to discuss this further or would like to review your current power of attorney, please do not hesitate to reach out.

Doug Warren, J.D.
Trust Officer
Midland Wealth Management

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

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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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