Q3 20

Midland Wealth Management

Market Outlook

Contents:

A New Normal 1
Fixed Income Markets and Monetary Policy 2
A Tale of Two Markets 3
TIE Save the Date, Upcoming Discussion 4
Facing the Possibility of Incapacity 5

A New Normal

The carefree thought about going out to dinner, traveling or gathering in large groups no longer exists, and social distancing is now the norm. Business closures during shelter-in-place were devastating for many, but a positive outcome has been the ingenuity of businesses and people to make things work in this new environment. Some restaurants figured out a way to stay open by providing takeout and delivery service, when it was not offered prior. Some businesses found a way to operate remotely, when it was previously not an option. Virtual connections replaced traditional meetings and services and in many instances, greater productivity was achieved. The human spirit craves personal interaction but in times of desperation, people find ways to connect and endure.

The U.S. economy moved into a recessionary period in February after hitting a peak in growth. First quarter GDP declined 5% and the Atlanta Fed GDP estimate for the second quarter is -45% as of this writing. It may be one of the shortest recessions in history and at the same time, the largest decline in one quarter. Similar to the equity market as you will read, this is a tale of two economies. There are industries that have been devastated by the shelter-in-place order and fear of contracting the virus. Airlines, hotels and anything related to long-distance traveling have been negatively impacted. Entertainment such as movie theaters, live theatres, sporting events and concerts have all been canceled, and the trickle-down effect on the economy is impactful. The number of workers that support these businesses from food service workers to ushers to drivers is substantial with little chance of many being reemployed soon. With more employers realizing that remote work may be the new normal, the supply of commercial office space may increase leading to defaults or at a minimum, lower market values.

State and local governments have also been impacted. Not only has there been a loss in income tax revenue, but there have also been additional costs incurred from COVID-19. In many communities, the damage incurred during the most recent protests has also had a financial effect. The long-term impact will be potential higher taxes and reduced services to communities. The federal deficit has ballooned with the stimulus provided and led to more debt issuance, which may result in higher interest rates and increased tax rates.

On a positive note, the $1,200 stimulus checks and additional $600 per week unemployment benefit have led to greater spending on home improvements, appliance updates, exercise equipment and even automobile sales as people spend more time at home. Contractors, tradespeople and businesses that supply these products benefit from this spending. Other industries like grocery stores and online shopping also reap rewards of people staying home with increased spending on food and supplies. Residential real estate has increased with both existing and new home sales higher than a year ago. Low interest rates and an exodus to the suburbs from major metropolitan areas have led to this increase.

While the world has changed due to COVID-19, the global economy is beginning its recovery process and returning to a new normal as economies reopen. We envision a fairly sharp spike upward in growth over the next two to three months with the reopening of businesses and people getting back to work. At the peak of the economic crisis, over 35 million people had filed for unemployment. Many will return to work, but the unemployment rate will not return to the 3.5% level seen earlier this year.

Unemployment will most likely fall into the 7% to 9% range during the second half of the year. Once we see the initial spike in growth, there may be a leveling off and a slow trudge upward. It may be two to three years before the U.S. economy returns to pre-recessionary levels.

During the first quarter, credit spreads widened and stock market indices declined with the fear of economic slowdown and an impending recession. Immediate and strong action by the Federal Reserve and the federal government in late March and early April provided the catalyst for markets to begin to recover. Stock indices have increased over 40% from the lows and credit spreads have tightened. A portion of this recovery is justified, but have we gone too far too fast? There is considerable uncertainty regarding earnings for the remainder of this year and next, which has created historically high valuations for the stock market at this time. There are still concerns about how quickly we will recover, as well as the upcoming election in November. The unknown outcome from both of these scenarios may lead to increased market volatility during the next few months. With this in mind, our current portfolio allocation to equities remains slightly underweight the neutral position. We do not believe that interest rates will rise dramatically in the near term and remain neutral to our duration target with emphasis on credit.

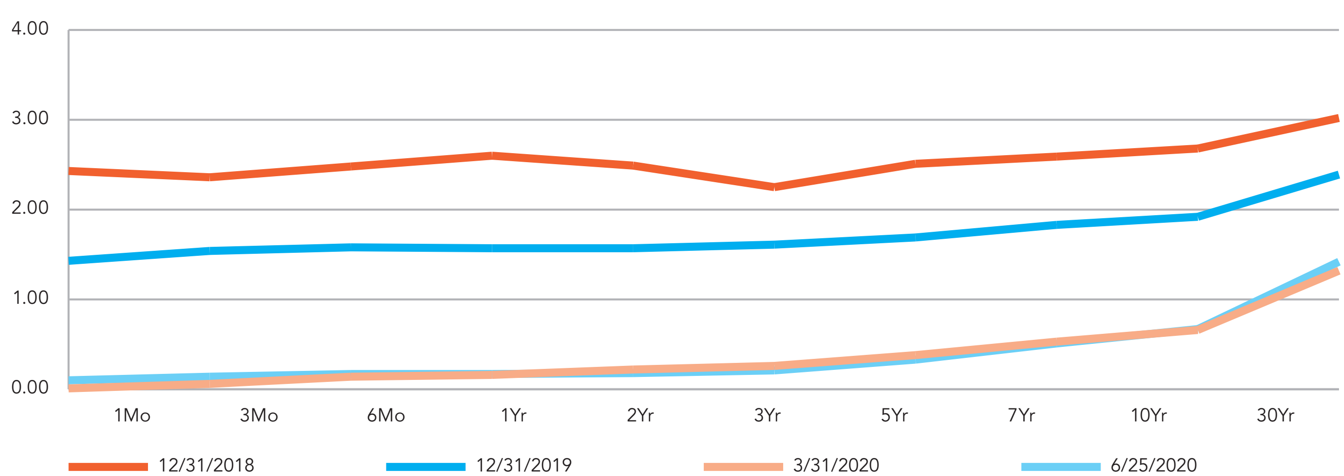
Fixed Income Markets and Monetary Policy

We are reminded this year why less glamorous bonds play a defensive role in diversified investment portfolio management. As an asset class, bonds are considered a defensive because they are typically less volatile than stocks. Bonds are important to reduce overall volatility and portfolio risk. Depending on the U.S. fixed income benchmark, the bond market has increased 5% for the year while the S&P 500 stock index has lost roughly 5%.

The next six months should bring a calmer realism to the credit markets. After spiking higher during the first quarter, corporate and mortgage credit spreads narrowed significantly during the second quarter. Over the past three months, Treasury yields were relatively unchanged after sharply declining during the first quarter. For the second quarter, the average yield on the 10-year Treasury was roughly 0.70% but ranged between 0.55% and 0.95%. Interest rates remain low by historical standards, but longer-term rates have had recent bouts of creeping slightly higher given the huge increase in Treasury issuance to fund fiscal stimulus programs. We are unclear how soon rates will rise and how high they will go. Investors would be wise to understand how to respond when Treasury rates begin to inch up. For starters, avoid longer-term bonds that are riskier than shorter maturities. A longer-term bond may pay a higher interest rate but has more exposure to inflationary pressures over time and the bigger risk that rising interest rates could result in a price decline. While we all may make a reasonable estimate about where interest rates might be a year or two from now, nobody can possibly know over the long run.

The Federal Reserve (Fed) initiated dramatic monetary policy actions to prop up the economy and the fixed income market near the end of the first quarter. Its actions cut short-term interest rates to nearly zero helping borrowers access cheaper funding sources. To provide operational liquidity to the fixed income trading market, which nearly froze in late March, the Fed initiated a new phase of quantitative easing (QE) by designating increased purchases of Treasury and mortgage securities. This action

U.S. Treasury Yield Curve



was followed by new Fed purchasing of commercial paper and municipal securities. In April, they announced plans to purchase both investment grade and certain high-yield corporate bonds in June. This new initiative also began purchasing bond ETFs on May 12. Since the beginning of the year, the Fed's purchases of bonds, both government and corporate, have increased its balance sheet to over $7 trillion, a net $3 trillion jump since the end of 2019. Its recent purchases of Treasury securities have all but absorbed most of the new Treasury issuance that funded COVID-19 fiscal spending programs.

All praise for the decline in credit spreads during the second quarter goes to the Fed. Credit spreads should continue to stabilize over the next few months as global economies recover. Until an all clear is given or a therapeutic solution is discovered, the Fed will continue its aggressive monetary policy stance and be the market's backstop for credit and liquidity risk. Our base case assumptions are that the Fed maintains its policy stance, progress is made toward a vaccine that will be available early next year and economies continue to reopen while keeping a second virus wave largely under control. The second half of the year will offer a clearer sense of the macro- and micro-economic impact of the virus. The U.S. election could also move the market in ways that are beyond scope of this quarter's outlook.

We feel it is important to take a step back and understand the current bond environment. Interest rates are at historic lows, pushed lower by demand for riskless assets and an aggressive Fed monetary policy easing. Credit spreads are lower but still above last year's averages. Even in this near zero rate environment, the Treasury yield curve is positively sloped, where longer-term yields exceed shorter-term ones. In the near term, as investors ponder the effects of gradually rising rates, consider paring down longer-term and lower-credit-quality bond holdings. When looking for value in bonds in this low rate environment, we prefer credit over duration. Credit spreads are still above last year's levels. Regarding duration, we favor the short- and intermediate- term as opposed to longer-term maturities. With the Fed maintaining low short-term interest rates and providing a backstop for market liquidity, investors may be willing to or need to take on risk for added income and yield. Investors can take advantage by allocating dollars into credit-based fixed income securities and/or funds. While the fixed income sectors may not repeat their great second quarter performance, they still offer value in a diversified portfolio.

A Tale of Two Markets

As we approach mid-2020, the new decade has brought us one of the most volatile markets experienced since the Great Depression. The first quarter saw a waterfall decline of nearly -38%, only to be followed by a 40% advance from the March 23 lows. Investors placed a high probability on a V-shaped recovery from the COVID-19 shutdown. In our opinion, recent optimism for the economy slowly reopening, additional federal and fiscal stimulus packages, and hopes of a vaccine may be premature and possibly exaggerated. We believe downside risk to equities still remains on the horizon with increasing COVID-19 cases, the upcoming presidential election, and continuing trade tensions between the U.S. and China. Therefore, we feel some degree of caution is warranted during these unprecedented times.

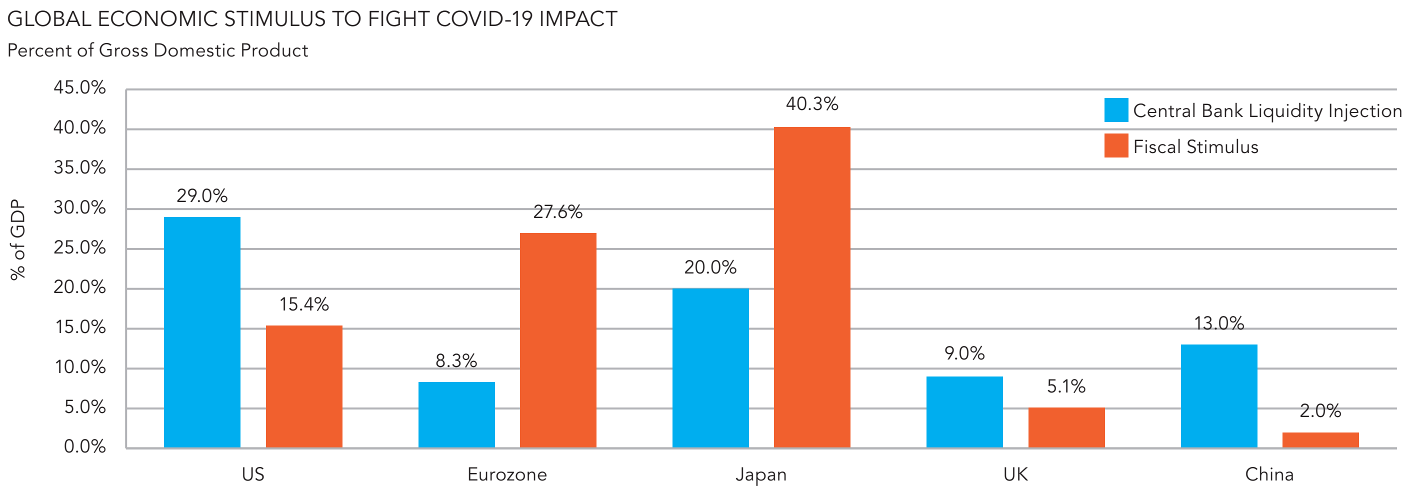
The stock market has rebounded nicely from the March 23 lows. However, it has been "a Tale of Two Markets," namely coronavirus winners and losers. The NASDAQ, which includes companies such as Microsoft, Facebook, Apple, Amazon, Netflix and Google, recently reached all-time highs: the coronavirus winners. On the other hand, coronavirus losers are highly correlated to the U.S. consumer such as airlines, cruise companies, casinos, hotels, restaurants and retailers. More concerning may be the extreme concentration we are seeing today in the S&P 500 Index. These six companies, the coronavirus winners, now account for nearly 25% of the entire market-cap of the S&P 500 Index. With the exception of Technology and a few essential consumer companies (i.e. Walmart, Costco and Target), most sectors of the S&P 500 Index are negative on the year with Financials, Energy, Industrials and Utilities still down double-digits.

It seems surreal for markets to have advanced this far, given the turbulence and unknowns facing our economy including the health crisis, high unemployment and civil unrest. Policymakers around the globe certainly contributed to market recovery and stabilization as they flooded trillions in stimulus into their economies in an effort to stem off a deep recession caused by the global pandemic.

The true value of the equity market is all about corporate earnings. Currently, there is minimal visibility for the second quarter as expectations remain bleak given the evolving nature of COVID-19 and impact from the global shutdown. Lack of company guidance concerning earnings estimates for the remainder of the year adds to the prediction challenge. Market valuations certainly look stretched with the S&P 500's current price-to-earnings ratio of 24x for 2021 and 20x for 2022, its highest in nearly

A Massive Fiscal and Monetary Response

As of May 31, 2020



Source: Cornerstone Macro

20 years. In the past it has taken several years to get back to the same earnings power as seen before a recession. The good news is the second quarter should represent the trough in earnings as we are already seeing the bottom and an improvement in economic data.

After the waterfall decline, many investors were caught on the sidelines with a higher allocation to money market funds as they waited for market volatility to slow and the U.S economy to stabilize. In fact, money market funds reached $4.6 trillion, the highest level since 1992. There is plenty of dry powder for investors to deploy once they feel comfortable. However, this also shows a level of fear that perhaps major stock indices have become overextended.

Within our investment strategy, we continue to remain cautious with a slight underweight to our equity target as we expect volatility to continue. The strong market rebound has led to elevated valuations across equity markets at a time when the global economy is only in its early stages of reopening. We believe there is significant optimism already factored into the market at current levels, which could set the market up for some disappointment. We recently increased our allocation to value companies as their valuations remain more favorable, and they should benefit as the economy continues its reopening phase. Although we remain optimistic about the economic recovery, we also need to be aware of potential risks associated with the election cycle, corporate earnings and the reopening process.

TIE into Midland Wealth Management with

Trust, Investments and Expertise

T . I . E

Tuesday, July 21st at 3:30 PM (CDT)

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.

Facing the Possibility of Incapacity

Even with modern medicine and interventions, it is a real possibility that you or your spouse could become incapable of handling your own medical or financial affairs. A serious illness or sudden accident can happen at any age. Advancing age can bring senility, Alzheimer's disease or other ailments that affect your capacity to make sound decisions about your health. These can also impact the way you manage your finances, including your ability to pay bills, write checks, make deposits or sell assets.

If you were to become incapacitated without any documents appointing someone to act on your behalf, a **Guardianship** would then be needed for someone to intercede and make medical or financial decisions. With a guardianship, the Probate Court will appoint a guardian(s) on your behalf. This can be a very public, time-consuming and expensive process. However, planning ahead can eliminate the likelihood that you will need a guardianship. Once you identify individual(s) you trust with the authority to manage your affairs, an attorney can help prepare the necessary legal documents.

A **Durable Power of Attorney (POA) for Health Care** allows you to appoint a representative to make medical decisions for you if you cannot. You decide how much power your representative will have. They will also determine when to provide or withhold life-sustaining measures. You can direct your wishes within your POA for Health Care or create a Living Will. Along with your POA, a **Living Will** allows you to approve or decline certain types of medical care, even if you could die as a result of the choice.

If you feel you would not want to be resuscitated, you can create a **Do Not Resuscitate** order (DNR). A DNR is a doctor's order that tells all other medical personnel not to perform CPR if you go into cardiac arrest. There are two types of DNRs, including one that is effective only while hospitalized and the other to be used outside the hospital.

In order for someone to manage your financial responsibilities as well as protect your property, there are several options to utilize. First, you can transfer ownership of your property to a **Revocable Living Trust.** While you are living and competent, you are the trustee and retain complete control over your affairs. If you become incapacitated or upon your death, your successor trustee (the person you designate to administer your trust if you cannot) automatically steps in and takes over your property management. All of your assets should be owned by your trust, therefore your successor trustee can easily pay your bills and oversee your assets. You can appoint a Durable Power of Attorney for Property to handle any assets not in your trust.

A **Durable Power of Attorney (DPOA) for Property** allows you to authorize someone to act on your behalf regarding financial assets in your name. Your DPOA can manage all assets which are in your name alone (i.e. not in your trust or joint ownership). A DPOA for Property is a fairly simple and inexpensive option to implement. It is important to remember that your DPOA for Property will end at your death. At that time, your successor trustee or executor will need to act.

Another possible choice is to hold your property in concert with others. This arrangement may allow someone else to have immediate access to the property and use it to meet your needs. **Joint Ownership** is a straight-forward and economical alternative to execute. However, there are some disadvantages to a joint ownership arrangement. Examples include (1) your co-owner has immediate access to your property, (2) you lack the ability to control the use of the property for your benefit, (3) naming someone who is not your spouse as co-owner may trigger gift tax consequences, and (4) if you die before the joint owner, your property interests will pass to the co-owner without regard to your intentions, which may differ.

It is important to plan ahead and think about how you would want your medical care and finances managed if you were unable to handle them yourself. Schedule time with your attorney to determine documents needed to make your wishes known today, in the event someone else needs to make decisions for you in the future.

Nicole Fasano, J.D., CTFA
Senior 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.

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

If you would like to receive a digital copy of the quarterly newsletter, please send your preferred email address to dmccormack@midlandsb.com.

Midland
Wealth Management

midlandsb.com | 1-888-637-2120