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21

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Wealth Management

Market Outlook

Contents:

Farewell to 2020, Hello to Hope and 2021

At the beginning of 2020, there was little expectation of a recession or a bear market. However, a virus originating in China threw the world into one of the sharpest declining growth periods it had ever seen, and the reversal was almost as extreme. While the overall growth rate of the U.S. economy will more than likely be negative for the year, the rate of recovery in the third and fourth quarter has been phenomenal. As we have discussed in earlier writings, this was not a typical recession caused by overheating, supply shortage, or Federal Reserve (Fed) tightening, but rather an exogenous event that basically shut down the economy in a quick fashion. Rapid action by the Fed to provide substantial amounts of liquidity, as well as fiscal stimulus by the government, helped deter the economy from falling into an abyss that may have resulted in a much longer recession and painful recovery. As the economy began to reopen in late spring and early summer, it was evident that there was pent-up demand in housing, home improvements, car sales, and most areas of the economy not related to travel or large gatherings. The human spirit found a way to make things work in a new environment. The equity market responded with a quick upward trajectory off the lows seen in March. As of this writing, most indices are near all-time highs, and interest rates are near all-time lows.

As we roll into 2021, there is reason for optimism and hope. Two vaccines for COVID-19 are approved and being distributed with additional vaccines in the works. Frontline and essential workers and the elderly should be immunized by the end of the first quarter, and a majority of the population being vaccinated by the third quarter is likely. The third of our economy that has been in limbo since March will be able to reemerge and begin functioning in a more normal environment. This alone will lead to growth in the second half of the year with an increase in travel and entertainment. We realize that there are many that have suffered during this time from loneliness, unemployment, and business closings, and the long-term effects are yet to be determined. As it was once said, it is darkest before the dawn, and we may be at the darkest point this winter with an increased surge in cases and additional lockdowns and restrictions. Continued stimulus from the government is being provided to help small businesses and workers impacted by the pandemic.

While the first half of 2021 may exhibit slower growth, we do envision the U.S. GDP growth for the upcoming year to exceed 2%. Inflation may move slightly higher with pent-up demand in certain markets driving prices higher due to limited supply. Interest rates will likely remain anchored at ultra-low levels on the short end, while the longer end of the treasury curve may slightly steepen. Earnings should increase year over year with an improving economy, especially for companies whose business was more dramatically impacted by the lockdowns. With the election results, other than the Georgia Senate runoff, known as of this writing, the Biden presidency may provide some changes to the business climate, but businesses adjust to changes. Increased employment in the second half of the year will add to demand for products and services. With the pandemic ending, both U.S. and foreign economies will be stronger and provide more earnings growth and market opportunities. We cannot minimize the impact of massive stimulus from governments and central banks heading into the New Year. Putting all these factors together leads us to believe the equity markets should provide positive returns in 2021. With interest rates so low, fixed income investors will struggle to earn returns that exceed inflation. Considering

all these points, our asset allocation leans us to slightly overweight equities heading into 2021. In addition, we are underweighting fixed income and shortening the average maturity, or duration, in our fixed income portfolios due to increased interest rate risk from these levels.

This past year has been challenging, to say the least, for everyone - on a personal and business level. We have survived a recession, experienced a once in a lifetime pandemic (we hope) and went through the election cycle with minor upheaval. The one thing this past year has demonstrated is that people are innately strong and resilient to disruptions, coming out on the other end better for the wear. It has taught many of us what is important in life and to value every minute we can spend with family and friends. Here's to a wonderful 2021 and to the day that we can all meet face to face and enjoy each other's company again.

Fixed Income Forecast

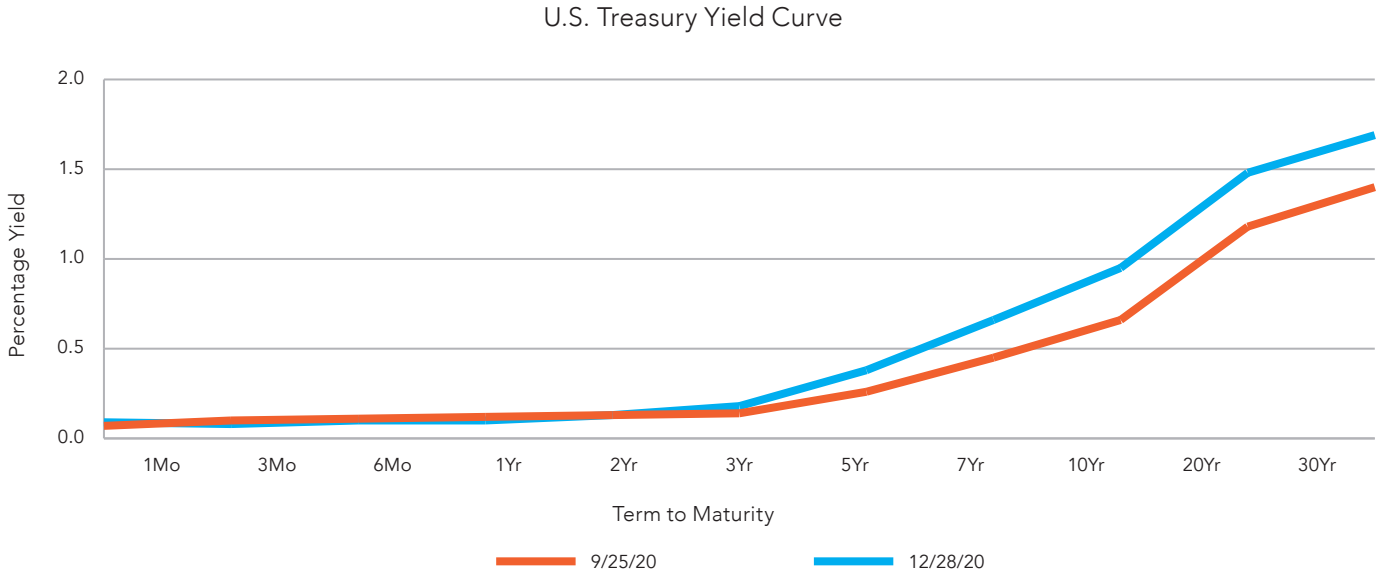
For the second quarter in a row, fixed income investors did not miss much when it came to Treasury yields. Short-term interest rates remained low and range-bound while longer-term maturities inched slightly higher. Investors felt confident the Fed would continue its very accommodative monetary policy that is holding short-term yields close to zero.

The most exciting fixed income market news is related to declining credit spreads. These risk premium spreads declined again in the fourth quarter, a move that continued to reverse the late February and March COVID-19 spike in credit risk and thus produced healthy returns for the asset class.

The 2021 forecast for Treasury yields and Fed monetary policy remains highly dependent on COVID-19 related economic outcomes. Even as the anticipated economic reopening and recovery progresses, the front end of the yield curve (short-term interest rates) should remain anchored by a patient and accommodating Fed. The Fed stated in its December FOMC meeting that it will keep rates low for a longer period of time to sustain the recovery. Longer-term yields are estimated to inch upwards during 2021 as the market awaits renewed economic growth, a small uptick in cyclical inflation, and a record amount of newly issued Treasury and other debt. Although we may see another surge in COVID-19 cases following the holidays, the available vaccine should promote economic recovery and yields should remain relatively low for the foreseeable future.

The Fed's aggressive monetary policy since the start of the pandemic remains accommodative, adding much needed liquidity and stability to fixed income markets. Liquidity in credit markets is working well for bond buyers and sellers. Qualified borrowers can raise funds at cheap relative rate levels. Current policy helps smaller businesses affected by the pandemic that have a hard time operating or even staying open. Access to cheap borrowing sources, mostly from banks, is important for these businesses to remain operational.

To foster that needed liquidity, the Fed buys $120 billion of fixed income securities, $80 billion in Treasury and $40 billion in mortgage securities monthly. These purchases help control potential increases in longer-term yields and mortgage rates. Recent statements from the Fed imply it will maintain its stance pending an increase in the level of consumer inflation to a 2% target. In fact, the Fed has



stated its willingness for the inflation rate to exceed 2% for a period of time before tightening. This policy suggests the Fed is concerned about a possible period of deflation occurring before the economy is strong enough to produce the higher inflation target. With the Fed relentlessly pursuing maximum employment (assuming inflation doesn't get out of hand), economic and inflation data will not affect Fed policy until much later in this recovery cycle. Considering how this pandemic recession has affected lower income and service workers disproportionately, the Fed wants to pursue its full employment mandate. In other words, any Fed action to reverse current accommodative monetary policy faces a high hurdle.

In a search for income during this pandemic period, investors pushed U.S. Treasury yields and credit spreads to near record lows. Some investors feel the bond market is overvalued and that they are not getting paid enough for the current level of interest rate or credit risk. With relatively low yields across various fixed income products, the risk is that interest rates will rise, which means bond prices may fall. Over the next five-year period, we find it reasonable that interest rates will be higher than they are currently. Evidence of this can be seen as corporations act on that expectation, issuing bonds now in anticipation of paying off current issues as soon as they can be called. However, a segment of money managers feel we are in borrower's paradise or fixed income hell. These managers have rotated more into stocks with dividends that pay higher yields instead of Treasury and corporate securities.

We feel interest rates could remain under Fed control for the next few years but recognize the eventual risk from rising yields. Our managed fixed income portfolio's duration will be neutral to the duration of the Bloomberg Barclays Intermediate U.S. Government/Credit Bond Index. We find this level of duration prudent in light of the current pace of economic recovery, level of assets purchased by the Fed, and high level of market liquidity.

We favor the short- and intermediate- term as opposed to riskier longer-term maturities. Investors can take advantage by allocating dollars into credit-based fixed income securities and/or funds. We are emphasizing higher quality investment grade credit in this environment in recognition of an evolving credit cycle that could lead to downgrades and defaults in 2021 against a backdrop of what may be a long and uneven economic recovery. While a fixed income portfolio may not repeat the good returns of previous quarters, it does offer value in a diversified portfolio. Rates are low, but we believe the defining features of a core bond position – diversification, reduced volatility and return potential – continue to make it a critical component of a well-balanced portfolio.

Equity Markets in the New Year

The year 2020 saw the global economy plunge into economic turmoil. Unlike many past crises, this one was unique in that it was not economic in origin but began as a health crisis. The COVID-19 pandemic rapidly impacted the economy through global lockdowns, slowing economic activity and causing an unprecedented destruction of demand. If the coronavirus was the unknown external shock of 2020, it will be the "known unknown" of 2021.

The final quarter of 2020 will be remembered for the extraordinary development and approval of several COVID-19 vaccines, as investors anticipate an end to the global pandemic in 2021. At the start of the pandemic, not many investors would have predicted that nine months later the equity markets would be making all-time new highs! Now that the election is mostly behind us and vaccines are on the way, investors remain bullish as they forecast a more normal economy in the upcoming months as the world re-emerges from this post-pandemic lifestyle.

Global stocks are entering 2021 in a broad uptrend and are anticipating that reopenings and continued global central bank accommodation will support a robust global economic recovery later in the year. Both cyclical value stocks and small-cap stocks, which were beaten down most during the COVID crisis, staged a late-year surge over growth stocks. In fact, since the vaccine's efficacy rate was announced on November 9, the Russell 2000 (small-cap stocks) is up ~20%.

A return to normal by the second half of next year should help extend the rotation that began in early November away from technology and growth leaders and toward cyclical and value stocks. As lockdowns end and economies begin to reopen, normal early-cycle recovery dynamics should resume, with investors rotating towards relatively cheaper value stocks that will benefit from the return to more normal economic activity. With the Fed continuing its accommodative monetary policy stance, we expect the dollar to further weaken, which should provide an attractive environment for international and emerging market equities.

With the markets at all-time highs, there is certainly a lot of great news already priced into the market. The current price to earnings ratio of the S&P 500 is ~ 22x next year's earnings. Although higher than the 25-year average of ~16.5x, investors are expecting strong earnings growth

in 2021, which is being reflected in the forward 12-month earnings revisions at record highs. Risk assets appear to remain supported at these levels, given the global central bank support on monetary stimulus and support for low-interest rates for the foreseeable future.

The consensus for equity markets next year is for the S&P 500 index to continue to rise further, propelled by a stronger global economy, robust profit growth, and massive stimulus from governments and central banks around the globe. As we head into 2021, below are a few of our themes that we plan to implement early:

- Tactical overweight to equities, which continue to be more attractive on a long-term basis versus bonds
- Continued shift towards value and cyclical stocks as their valuations are cheaper, and they should benefit from the global reopening
- Slight overweight to developed international stocks with a continued emphasis on emerging market equities (a weaker dollar, China's early exit from pandemic lockdown, and global demand recovery should benefit this sector)
- Increase allocation to the Russell 2000 segment of the market (small-cap companies should continue to benefit as the economy reopens)

As we all know, markets don't just go up in a straight line as there is always risk on the horizon. Just recently, the markets sold off slightly with news of another COVID-19 strain in the U.K. that may be more infectious, but it is still too early to conclude anything. We will be closely monitoring the recovery and make adjustments as needed.

Join Midland Wealth Management for a special year-end wrap-up and 2021 outlook webinar!

Grab your lunch and listen in
Wednesday, January 27th, at 12:00pm (CST).

Call-in details to follow.

Market Insights communications are now shared in place of our Quarterly Webinar - save **wealthmanagement@mkt-midlandsb.com** in your email contacts!

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Tax Planning in Extraordinary Times

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COVID-19 and 2020 will be forever known for its unprecedented challenges. But what about opportunities? There may be tax planning advantages to the unique characteristics we faced in 2020 and may still face in 2021.

While there were not significant changes in tax law from 2019 to 2020, there are changes that occur every year as rates adjust for inflation.

Standard Deduction- The standard deduction for 2021 will be **$12,550** (up $150) for single taxpayers and **$25,100** (up $300) for married couples filing jointly. If you are blind or over the age of 65, then these amounts will be increased by $1,350. These amounts will again influence the number of taxpayers that itemize their deductions.

Income Tax Rates- The 2020 tax brackets are the same as the rates in effect for the 2019 tax year: 10%, 12%, 22%, 24%, 32%, 35% and 37%. However, the amounts that fall into each bracket are adjusted every year. That means you could wind up in a different tax bracket when you file your 2020 return than the bracket you were in before – which also means you'll be paying a different tax rate on some of your income.

Tax Rate	Taxable Income (Single)	Taxable Income (MFJ)
10%	Up to $9,875	Up to $19,750
12%	$9,876 to $40,125	$19,751 to $80,250
22%	$40,126 to $85,525	$80,251 to $171,050
24%	$85,526 to $163,300	$171,051 to $326,600
32%	$163,301 to $207,350	$326,601 to $414,700
35%	$207,351 to $518,400	$414,701 to $622,050
37%	Over $518,400	Over $622,050

Capital Gains Rates- Income on capital gains are taxed at lower rates than income taxes. However, the rate of the tax depends on your taxable income.

Long Term Capital Gain Tax Rate	Taxable Income (Single)	Taxable Income (MFJ)
0%	Up to $40,400	Up to $80,800
15%	$40,401 to $445,850	$80,801 to $501,600
22%	Over $445,850	Over 501,600

There are a lot of reasons that a person may have earned less income in 2020 (or even 2021). The economy slowed down and many people were faced with unemployment or reduced wages. Additionally, with the passage of the CARES Act, Congress suspended Required Minimum Distributions (RMDs) for 2020. This came after the SECURE Act which modified IRA distribution rules and extended the time to take RMDs to 72, so some will delay the onset of RMDs. Therefore, many people will have less taxable income and smaller tax bills as a result. Here are some ways that you can use the lower taxable income to your advantage.

Distributions- Because there is no set RMD amount in 2020, you can take an IRA withdrawal by either taking the money or moving to an investment account within the above-referenced tax brackets if you are typically in a higher bracket. However, be aware that distributions before age 59½ are subject to a 10% early withdrawal penalty.

Convert Traditional IRA Funds into a Roth IRA- With lower tax rates, you may wish to consider converting some or all of your traditional IRA into a Roth IRA. When you convert your traditional IRA to a Roth IRA, you must pay taxes on the amount converted. If you have less income in a given year, this will result in a lower tax rate and provide you with an opportunity to convert to a Roth IRA at a lower tax amount.

Defer Deductions- If you are able to overcome the standard deduction and itemize your deductions, you may wish to put off the deductions to future years where your income may be higher and take the standard deduction this year.

Zero Capital Gains Rate- As noted above, there is a 0% capital gains rate for those taxpayers whose taxable income is lower. If the lack of RMDs makes for a lower capital gains rate, it may be a good idea to sell some appreciated securities that you have owned for more than a year and pay no or very little tax on the gain.

You may not be able to take advantage of all these strategies in 2020 or 2021. Indeed, it is typically better to make more money in a given year. However, you may have a year with lower income or high deductions. Often with the right planning, people can take advantage of those years through their taxes. We are all looking forward to better times in 2021.

Robert Torbert, JD, MST
Trust Officer
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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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