Q3 21

Midland Wealth Management

Market Outlook

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Ready, Set, Go!

You don't realize to what extent humans need personal interaction until you have been deprived of it and suddenly it is at your doorstep again. As the economy has reopened and face-to-face interaction has increased, it certainly has been wonderful to see the optimism and positive exchanges between individuals. This has also carried over to the economic environment. Pent-up demand for social interaction and travel is driving the services area of the economy with strong airline and hotel bookings. Growth in the 1st quarter exceeded 6% annualized, and we wouldn't be surprised to see a similar, if not higher, level in the 2nd quarter. The economy is firing on all cylinders with demand from both consumers and businesses.

One of the challenges in this economic recovery for businesses is the ability to fill open positions. Everywhere you go, there are Help Wanted signs with promises of signing bonuses and higher wages than previously offered. There is a belief by many that the extra unemployment benefits are the reason for the worker shortage but in reality, there is more to it. Yes, the extra benefits could be part of the problem, and several states have recently ended the federal subsidy to the unemployed. The impact on employment numbers should show up in new jobs created in July and August. The real impact will be seen after the federal subsidy ends on September 6, and the extra funds are no longer being received in any state. There are several other reasons for the shortage of workers, too, including lower immigration over the last 18 months. With closed economies and limited international travel, the number of immigrants declined dramatically from a little over 1 million per year to less than 250,000 in 2020, leading to a shortage of available workers. Our economy is dependent on immigration to continue growth in the working population, and the decline in 'new' workers certainly has impacted the current employment picture. In addition, there has been a substantial number of people deciding to retire and not return to the workforce following the pandemic. The strong markets and increased asset values have allowed individuals to step back, review goals and determine that the option to retire is available to them. During the pandemic, individuals have also relocated to different areas of the country. As we have reopened, there are fewer job seekers in areas where there are rising employment opportunities. While many careers can work remotely, manufacturing, hotels, restaurants and basic service industries cannot offer that as an option, leading to the shortage of workers in certain markets.

While the Federal Reserve (Fed) believes that the increase in inflation is transitory, there is a risk that the shortage of employees will lead to wage inflation. There are many reasons to believe it may just be transitory and will level off to the 2% range targeted on a long-term basis by the Federal Open Market Committee (FOMC). A year ago, the inflation rate was flat, and as discussed previously, inflation year-over-year will be high through the summer. Lumber prices have already declined, shortages of semi-conductor chips will be worked through in the next 6 to 12 months leveling off those prices, and the shortages of many products will become less problematic. The canary in the coal mine regarding inflation is the wage pressure. Companies are beginning to increase wages to attract employees, which increases costs. These are not temporary increases but long-term increases. Will companies be able to pass on these increased costs leading to higher prices on services and products? If so, inflation may run higher than expected over the next year. With travel and international borders reopening and the end of the supplemental federal unemployment benefit, this may work itself out with more available workers. The markets will continue to monitor this and will respond accordingly. The risk to the markets and economy 12 to 24 months out, which at this time is minimal, is that the FOMC doesn't react quickly enough by pulling back the excessive accommodative stance, causing the need to swing the pendulum the other direction, which typically leads to a slowing economy.

Until we see the full impact of the labor shortage, we continue to believe the global economy will continue to expand and provide investment opportunities. The past 12 months have provided strong returns for investors, and we would anticipate lower returns over the next year. While we may have lower returns, the extremely accommodative monetary policy across the globe, the excess liquidity and continued low interest rates provide a favorable backdrop for equity markets. Considering this outlook, we continue to have an overweight position to equities along with a slight underweight to fixed income.

Supply Versus Demand

Following negative returns in the 1st quarter, fixed income provided positive returns during the 2nd quarter. However, major bond index returns remain slightly negative year to date. During the quarter, intermediate- and long-term yields declined while short-term maturities increased slightly after the June FOMC meeting. The increase in the overnight bank rate and the indication that the first interest rate hike will occur in late 2022, rather than 2023, sparked a move higher in the short end of the yield curve. Yields remain extremely low overall with the short end continuing to be anchored near zero, and the 10-year Treasury hovering near 1.50% as of this writing.

There are several reasons for continued low rates. One of the primary reasons is the enduring bond purchase program by the Fed. The monthly purchase amount remains at high levels and the FOMC has just begun to discuss starting to taper the amount purchased each month. There has also been limited issuance by the U.S. Treasury in the last few months. In 2020, the Treasury bond issuance exceeded $1.3 billion in April and exceeded $600 billion in both May and June. This resulted in large Treasury cash balances at the Fed and the need for less issuance. The Treasury has been running off the excess cash and has not needed to issue many bonds since the middle of 2020. Limited supply with continued demand support lower rates. Issuance of new debt will increase in the next several months as the cash balance moves closer to more normal levels and the need for additional cash to cover payments will be necessary.

Global interest rates remain extremely low. The United States continues to have the highest and most liquid rates in the developed economic markets. There is still demand for U.S. bonds from foreign investors. It brings us back to the supply versus demand position that favors lower rates.

Will this change anytime soon? While rates have remained persistently low, the dynamics of the bond market may change over the next 6 to 12 months with the FOMC potentially beginning the tapering of purchases, which will likely lead to less demand. At the same time, the Treasury will need to issue greater amounts of bonds to cover cash needs resulting in greater supply. The outcome of less demand and greater supply may lead to higher rates in the future. In addition, as the global economies continue to recover from the pandemic, the monetary policy may become slightly less accommodative, and interest rates in the developed markets could potentially increase. The timing of this is yet to be determined but similar to previous comments, the increased supply relative to demand will have an impact on interest rates.

During the quarter, spreads on investment-grade and high-yield bonds continued to tighten, relative to similar maturity Treasuries, and are at or near historically narrow levels. They could remain at these levels for an extended period of time without additional risk due to excess liquidity in the markets and the desire to seek higher returns. As long as the FOMC continues to be very accommodative and provide excess liquidity in the markets, the risk-on trade will continue in high-yield bonds similar to the equity markets.

What are other risks in the fixed income market? Inflation has become a buzzword these days, and the conversation around whether it is transitory or a more permanent issue is still being debated. The FOMC continues to believe it is the aforementioned but is monitoring it closely. As supply chains clear up, many of the factors influencing inflation may dissipate. The biggest concern to the inflation outlook is wage pressure. If corporations offset higher wages with higher prices, inflation is no longer transitory if the labor market remains tight or mismatched. The biggest risk is if the FOMC doesn't act soon enough, and the bond market begins to unravel and interest rates move higher. The probability of this happening in the next 3 to 6 months is minimal, but we will continue to monitor it.

While interest rates remain low, we do envision that yields will move higher in the next 6 to 12 months. This belief leads us to position our fixed income portfolios slightly short the portfolio neutral duration target. We remain focused on non-government securities to enhance the income level. We believe this structure will protect our fixed income portfolios as interest rates gradually rise.

As Good As It Gets

As the 2nd quarter comes to an end and the summer season begins, investors are beginning to wonder if the returns we experienced thus far will continue to build or fade as the year progresses. With a very accommodative Fed and more fiscal stimulus on the way, we could see more of the same. However, stocks could face several headwinds as we navigate our way through the second half of the year.

In general, cyclical value companies have produced the best returns for the first five months of the year, with value stocks outperforming growth stocks by nearly 12%. This is not unusual coming out of a recession, even a pandemic-induced recession. However, in June, growth companies made up significant ground as interest rates began to

stabilize and inflation concerns seemed to fade. In fact, as of this writing, value stocks are only outperforming growth stocks by about 5% for the year.

Small-company stocks, which tend to do well early in the economic cycle, hit some turbulence this spring after posting stellar returns prompted by Covid vaccine approvals last November. The Russell 2000 index, a small-cap benchmark, is currently up 16% for the year, compared with 13% for the large-cap S&P 500 benchmark.

After a 13% return for the S&P 500 year to date, it certainly does not seem like there has been much volatility on the surface. When you dig deeper, it is clear that most sectors experienced rotating leadership this year with over 40% of the S&P 500 companies seeing a 10% or greater decline from their recent highs. The S&P 500 volatility index (VIX) continues to indicate a fairly complacent stock market, however, the underlying market rotation seems to paint a different picture.

All eyes continue to be on the latest FOMC meeting held in mid-June. The Fed's liquidity measures have certainly been a tailwind for investors, however, it will eventually have to take away the punch bowl. After the meeting, stocks initially declined as the Fed unexpectedly forecasted two interest rate hikes in 2023. One regional Fed president even went so far as to suggest the first increase could come next year. This revised viewpoint of "higher interest rates earlier than expected" was met with a thumbs down by investors. Markets may have overreacted to the latest Fed meeting as stocks quickly rebounded from the initial sell-off, and the S&P 500 remains near all-time highs.

Investors may be slowly moving away from the early phases of the recovery and beginning to focus on mid-cycle investing strategies, which should include a combination of value and quality factors. Since 1962, stocks have delivered their highest absolute performance during the early cycle, with an average total return of more than 20% per year during this phase, which has typically lasted one year on average.

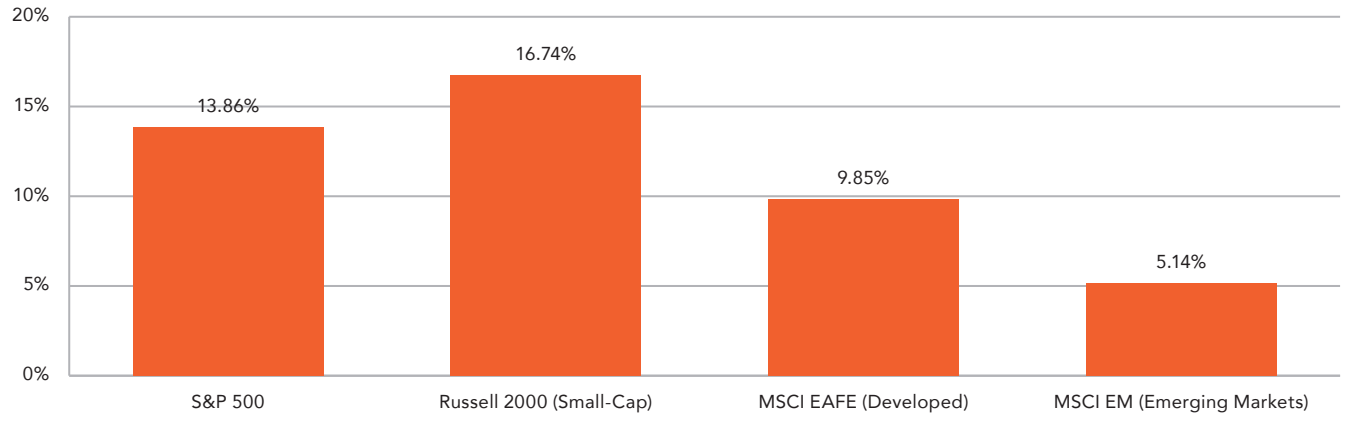
Corporate earnings growth has been another main driver of positive equity returns this year. Earnings will likely continue to grow, albeit at a slower pace, which could develop into a headwind for stock prices. Corporate earnings for the 2nd quarter are estimated to grow by 61.9% year-over-year. This would mark the highest earnings growth rate reported by the S&P 500 index since the 4th quarter of 2009. Even though the 2nd quarter may mark the peak in earnings growth, earnings should remain strong through the remainder of this year and will likely be more than 20% above their prior peak.

Stock valuations continue to remain on the high side compared to historic standards. The forward 12-month P/E ratio for the S&P 500 is around 22.4, which is above the 5-year average of 18x. However, higher earnings growth could lead to lower valuations in the future. Corporate stock buybacks could help dampen some volatility from future Fed news as companies are resuming share repurchase programs after many shuttered them down during the COVID-19 pandemic.

According to Ned Davis Research, stocks as a percentage of household financial assets represent about 46% of their financial assets, which is the highest level since the late 1990s. Looking at past history, this sentiment indicator has been highly correlated with subpar equity returns when households are so heavily invested in equities.

As we head into the second half of the year, it will certainly be difficult to match the returns from the first half as various stimulus programs begin to fade, including unemployment insurance, which is set to expire in early September. Despite several headwinds, stocks should continue to offer opportunities in the latter half of this year as the economy continues to reopen. According to several sources, there is nearly $5 trillion parked in money markets, and the average U.S. savings rate remains elevated, near 14% versus the average around 7%.

Stock Market Returns as of 6/22/2021



Midland
Trust Company

is proud to announce the acquisition of

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Kathy Van Eeuwen

Maura Mannix	Chris LaPorta	Lucia Pelayo
Catherine Bross	Leslie Martinez	Janet Pepich
Kathie Butts	Nancy Mckee	Sara Ashman Smith
Sara Gonzalez	Beth Neiman	Jake Stapleton
Shannon James	Barb Nelson	Cindy Tolan

join Benjamin Malsch and Deanna Haught in our new Chicago office.

Join Midland Wealth Management for a mid-year outlook webinar!

Grab your lunch and listen in

Tuesday, July 13th, at 12:00pm (CDT)

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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Estate Planning for Digital Assets

Midland Wealth Management

How would you feel about losing over $220,000,000? Stefan Thomas said, "time heals all wounds," and he is at peace with losing over 220 million dollars' worth of Bitcoin. Mr. Thomas's potential loss is the result of forgetting his password to the USB hard drive containing the digital wallet holding 7,002 Bitcoins! He has already failed 11 attempts to access the account and if he reaches 13 failed attempts, the Bitcoins are lost forever.

If you think you don't have digital assets, think again. For purposes of this article, a 'digital asset' is an electronic record in which an individual has a right or interest. We all have a digital presence, and that digital presence has increased significantly over the last year and a half since the pandemic. How can we best plan and manage our digital assets?

Digital assets management is complicated due to various laws and agreements in effect. The Federal government enacted the Stored Communications Act in 1986, which provides statutory privacy protection for customers of network internet service providers. Meanwhile, 46 states have adopted the Uniform Fiduciary Access to Digital Assets Act to give access to digital assets for authorized parties. To complicate it further, each platform or service provider has its own Terms of Agreement which controls access to and disposition of assets. The Terms of Agreement is the seemingly endless document that most of us do not read and just click accept before establishing an account.

Digital assets can be divided into several categories:

- Personal assets can include photographs, videos, music and other creative montages.
- Social media assets encompass your Facebook, Instagram, Twitter, YouTube, Pinterest and other comparable accounts.
- Digital financial assets may be your Venmo or PayPal, as well as Bitcoin and cryptocurrency that you own.
- Finally, don't forget your loyalty programs and earned miles or points that may be transferable upon death.

While not considered digital assets, many people have online account access offered by banks, brokerage firms and other financial institutions. Due to a desire to reduce costs, many former monthly paper statements are now only accessible online. If anything happens to you, your digital assets may not be easy to locate. For instance, many millennials do all their transactions on smartphones. If they lose their phone, they may have trouble restoring assets without proper planning.

To start planning for your digital assets, take inventory of your computer equipment such as a desktop, laptop or notebook, tablet, smartphone and external storage drives. Document any unique user IDs and passwords to access them, too.

Next, make a list of all your online financial accounts and digital assets. These can include social and digital media accounts such as Facebook, Twitter, LinkedIn or Pinterest. For your banking and financial institutions, include the account number, account type and whether it is set up for paperless. Keep account of Cloud storage providers you use, such as iCloud, DropBox, Microsoft One Drive or Google Drive. Be sure to record what is stored on each one. Jot down any domains or blogs that you maintain. Include online shopping accounts in your name. Also, a list of any subscriptions you subscribe to is helpful to know in order to cancel them when they are no longer necessary.

For every online account, make a note of the associated username and password. Don't forget security questions and answers. Be sure to keep this list in a secure place and update it regularly. If you utilize an extra layer of protection with Two-Factor Authentication, remember to note it with your instructions.

How can you ensure your personal representatives and heirs can access your digital assets? Think about who you would want or need to have access to these accounts if you became incapacitated or upon your demise. Write a letter to that person or executor that includes access credentials and instructions. Tell the person what you want to happen with each account. Maybe there are accounts that you want no one to see. If you don't want anyone accessing certain digital assets, say so. Keep the letter in a safe place with your other important documents. Remember that your will is a public document so do not include this information in your will.

Discuss with your attorney about including a provision in the Power of Attorney to access online accounts. You can consider appointing a separate digital executor under your will or specify that your executor has authority to deal with social media accounts and other digital assets. Remember to check the Terms of Agreement of each of your Internet Service Providers or platforms.

With proper planning and ongoing management, you can make sure your digital assets are accounted for and that your loved ones will be able to access them, when needed.

If you have any follow-up questions or concerns, please contact your relationship manager.

Edward Avery, J.D., CTFA
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.

Midland Wealth Management Investment Team

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Senior Portfolio Manager

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Senior Portfolio Manager

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