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Midland Wealth Management

Market Outlook

Inflation: What Lies Ahead?

If you had to pick a hot topic for the quarter, one of the first things you may think of is inflation. There are conversations and news articles about it almost every day. While inflation has spiked this year from the decade-low levels, the bigger question is whether it is truly transitory like the Fed states or is it a longer-term concern for investors, as well as individuals. We are all paying more for food, gas, and daily purchases, but will inflation continue to increase at higher levels or fall back to the 2% range the Fed has targeted? While no one knows for certain what inflation will be in the future, it may be a good time to look at both sides of the argument.

Let's start with the transitory argument. The Fed believes that the pricing pressure and inflation spike are primarily due to transitory events such as supply chain shock, labor shortages and strong demand for services as the economy reopened. Lumber spiked in 2020 and early 2021 but has now fallen back to levels pre-pandemic. Used cars, rental cars, and airline tickets all spiked in May and June but have since fallen back to more normal levels as demand has declined and more supply is available. These are examples of what the Fed sees as transitory: pricing spikes up, retracement to lower levels and slow, steady price increases going forward. There continue to be semi-conductor chip shortages impacting supply and availability for many products ranging from cars to appliances to computers. As we all know, supply and demand determine price, and shortages can lead to higher prices as the end user will pay more to attain the desired product. As these shortages subside, pricing will become more normal. The risk here is that the supply chain issue may take longer than anticipated to correct.

While the Fed believes the current inflation is transitory, other factors play into inflation and impact the long-term trend. Levels of sustained inflation are dependent on growth factors, fiscal policy, and credit growth. The global economy has experienced a strong growth rebound following the pandemic, but will the growth rate continue at the torrid pace of the first quarter of 2021? We do not believe it is sustainable in the United States and many developed nations. GDP growth is a result of population growth and productivity gains. While productivity will continue to improve, population growth will limit potential GDP growth across developed nations. Even China has an aging demographic, and growth potential has slowed dramatically. Recent news out of China regarding Evergrande and debt worries are unfavorable for their economic growth, and commodity prices other than oil reflect this. Iron ore, platinum and copper have retreated from highs set in the spring.

Global fiscal stimulus since early 2020 has been extensive with excess liquidity in the marketplace. The money supply will create high inflation only if there is sustained economic activity that results in rapid credit growth. At this time, credit growth and the velocity of money (the turnover rate to buy goods and services) are low and without these, inflationary pressures will subside. The shortage of labor and the current state of wage pressures can also be seen as inflationary, but the question is once jobs are filled, will annual wage increases be higher? This phenomenon once again may be a "one-time" jump and then level off. When you add up all these points, it could suggest that the inflation increase is transitory.

If you look at the other side of the inflation argument, you could start with the labor market and wage pressures. Because the participation rate in the labor market has declined and there are fewer available workers, companies may have to continue to increase wages to retain and attract employees. Productivity increases may not offset these additional costs, leading companies to increase prices to the end user. The housing component of the Consumer Price Index (CPI) makes up greater than 30% of the number. Throughout the pandemic, the eviction moratorium put a lid on rents. With the moratorium coming to an end, rent prices may begin to increase again. Historically, rents have tended to lag the Case-Shiller home price index by two years and most recently, the Case-Shiller has increased greater than 18% year-over-year. If rent prices follow

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accordingly, this will impact the housing component in the CPI leading to a higher inflation rate. Taking the opposing side of the impact on inflation with the extremely low velocity of money and slow credit growth, if either sees an uptick, higher inflation may be just around the corner.

Before the pandemic, just-in-time inventories were the standard, but many manufacturers and producers found themselves caught short-handed when the shutdown hit. Demand for products was still there, but the components to produce the products were not available. Will the world move to more local production and more inventories on hand? This action could also result in higher inflation depending on location and the increased demand to get inventories at a comfortable level.

There are many unknowns when contemplating the future inflation rate, but market expectations by consumers and 5- and 10- year forward markets are for lower inflation in 2022 and years after. In addition, growth expectations, as measured by GDP, are likely to retreat to trend growth seen pre-pandemic. Our outlook is for a continued strong 2021 and early 2022 with growth trending to the 2% to 2.5% range longer-term. As pent-up demand subsides and supply chains function, inflation may move closer to the Fed target of 2%. However, it may be closer to 2023 before reaching that level. Historically when the Fed has started to retrace quantitative easing, inflation has declined. Will it be different this time? We will continue to monitor closely and adjust portfolios. A reasonable level of inflation can be a positive for equity markets but may put some minimal pressure on interest rates. The current dynamics in the market lead us to remain slightly overweight equities with an underweight to bonds.

Debt Ceiling and Taper

With the 4th quarter right around the corner, most fixed income investors have their sights set on a few topics. Inflation concerns are of course at the forefront. The August 2021 report showed an increase of 5.3% on all items before seasonal adjustment. While inflation will most likely be transitory, the breakeven inflation rate has remained relatively stable between 2.3-2.45%. However, besides inflationary concerns, most fixed income investors have been focusing on the United States debt ceiling.

In an open letter to the heads of Congress, Janet Yellen expressed concerns over a delay in reviewing the ceiling and issued a stark warning that the Treasury would run out of money by October. The ramifications of not suspending or increasing the debt ceiling could lead to a technical default on short-term Treasuries. However, the odds of this happening are relatively low. If history is any indication of the future, Congress will most likely vote to increase or suspend the debt ceiling. Since 1960, Congress has voted 78 times on the debt ceiling: 49 of those under a Republican president and 29 times under a Democrat president. The biggest concern would come from a downgrade in Treasury ratings because of political bickering. In 2011, Standard & Poor's downgraded the United States' AAA Credit rating. They cited inadequate funding and 'dysfunctional policymaking' as the main drivers for the downgrade. The global economy is still dealing with COVID-19, supply chains are stretched thin, and many Americans are feeling the lingering effects of the most recent recession. It is unlikely that Congress would allow the debt ceiling to expire and not vote to suspend or increase it. This would most likely cause a ripple effect in the overall U.S. economy.

Outside of Congress voting on the debt ceiling this quarter, the Fed has made several comments eluding to a potential decrease or slowing of open market purchases. In March 2020, the Fed began its quantitative easing (QE) purchases. As of July 2021, $80 billion in Treasuries had been purchased each month, along with $40 billion in mortgage-backed securities (MBS). After several meetings, the Fed has alluded to tapering these purchases. The main constraint would be whether economic conditions would hold up here in the United States. The factors the Fed will be reviewing are labor markets, inflation, and general economic growth. Labor force participation will be a key factor. Evidence of high or persistent inflation could also lead the Fed to begin its tapering. Overall, long-term rates have refused to move. We are unlikely to see the same taper tantrum we experienced back in 2013 this time around. However, the Fed will most likely monitor any hiccups as the tapering begins. It is unknown whether the tapering will be evenly spread across Treasuries and MBS or if one will be reduced more than another. Several members of the Fed have cited the strong housing market as a potential reason to decrease MBS more rapidly than Treasuries. However, it is our opinion that the tapering will occur evenly across the two assets. Whatever the Fed decides, the most recent economic data will have the final say in the speed and timeline of the tapering.

Credit spreads have been on a downward trend since the May 2020 highs. The Moody's investment grade corporate yield to 10-year Treasury has been on a slow decline. The spread has been hovering around 1.20% for the last several weeks. Non-investment grade corporate debt has also been on a downward track, falling below 2.0% in May of this year. The tightening spread reflects confidence that the economy is recovering. While the Delta variant still poses an imminent risk of causing further restrictions, we expect vaccination rates to progress with the new mandates by the Federal government. Hopefully business will continue and some of the supply chain constraints that have been affecting companies will ease.

Overall, we expect interest rates to remain relatively unchanged. The odds of a technical default or a large-scale tapering by the Fed seem highly unlikely. The Fed has openly stated that tapering will precede any rate increases. Naturally, with a tapering in purchases, there should be some expectation of a rise in rates. However, we believe rates should continue to remain relatively low with spreads keeping pace with their current range over the next 12 months.

Market Doubles, Headwinds Ahead?

During the 3rd quarter, the S&P 500 officially doubled its return from its pandemic bottom, which marked the fastest bull market rally since WWII. Even more impressive is the fact that it only took the market 354 trading days to get there, setting more than 50 new highs this year. Typically, it takes bull markets more than 1,000 trading days to reach this milestone when exiting a recession.

The equity market has experienced little volatility over the last year as low interest rates, unprecedented fiscal stimulus, robust corporate earnings, and an ultra-dovish Fed have bolstered stock prices; a "Goldilocks" scenario. Unfortunately, September may be living up to its reputation as one of the worst-performing months of the year for stocks. After nearly 42 weeks without a 5% decline in the S&P 500 index, we briefly experienced an intraday decline of ~5% in mid-September. Historically, the index has experienced a 5% correction every ten weeks on average. A correction is probably overdue. Even after this slight decline, the S&P 500 remains up over 18% year-to-date, as of this writing.

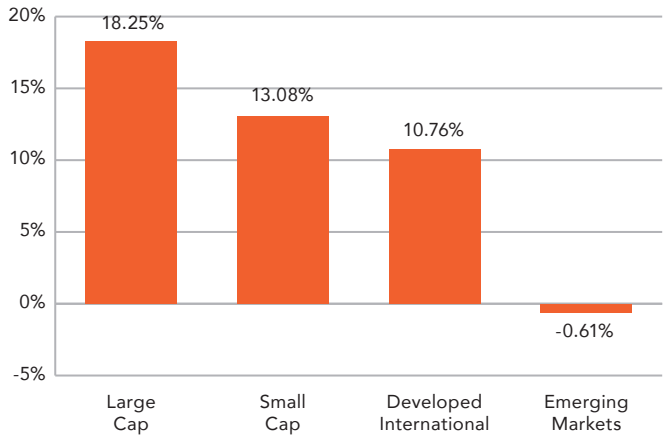
Most market sectors have been trading sideways since May and June when the Delta variant became a real concern within the United States. This has once again created uncertainty for the U.S. economy, driving investors back to the COVID-19 winners of last year, namely large-cap technology stocks. The top 10 stocks in the S&P 500, mostly technology stocks, have pushed the index higher in the 3rd quarter. These top 10 stocks represent approximately 30% of the index, and their earnings contribution is close to 28%. In fact, more than half of the companies in the S&P 500 index are down more than 10% from their 52-week highs. This compares to the overall index, which is only down by about 5% from its peak.

Equity valuations have declined slightly, however, they continue to be stretched with the S&P forward price-to-earnings ratio around 21x versus a 25-year average of ~17x. Extremely strong year-over-year earnings growth has certainly been a bright spot, which is one of the main contributors to the S&P 500 index being up ~18% this year. We believe the 2nd quarter will mark the peak in earnings growth for this cycle with an average year-over-year earnings growth rate of 95%. Although we expect a deceleration in the rate of growth, we are still anticipating 3rd quarter earnings to grow around 30% and revenue to increase by approximately 13.9%. One risk to these projections could be higher inflation, which may lead to lower profit margins for many companies.

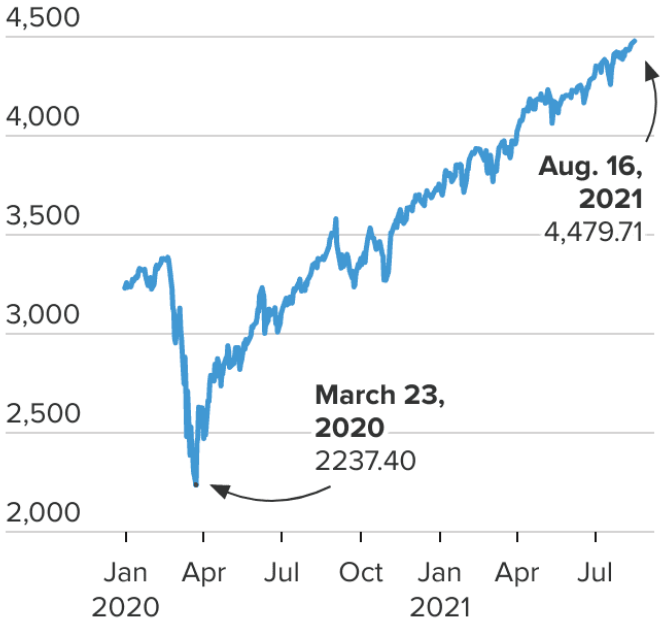
Emerging markets have added volatility to the overall global market throughout the 3rd quarter. China is the largest contributor to the emerging market index, with a 34% weighting. China quickly saw a 10% stock market gain disappear as it continues to shift toward a consumer-driven economy focusing on social equity rather than growth. Adding to this decline continues to be regulatory concern and the possible contagion of China's second largest property developer. This developer will likely fail as its financial strength continues to deteriorate, forcing the Chinese government to step in and limit the systemic risk.

Within our strategies, we remain overweight to equities as they should offer portfolios a better return profile than fixed income in the long run. Our equity allocation continues to have a slight overweight to growth stocks that have provided protection from COVID-19 uncertainties and the potential for weaker than expected GDP growth. As we head into the final quarter of the year, we will continue to look for opportunities as we gauge the risks with China, COVID-19, Fed interest rate policy, fiscal policies, and the upcoming debt ceiling debate.

Stock Market Returns as of 9/22/2021



S&P 500 doubles its pandemic low



Source: FactSet. As of Aug. 16.

Pet Trusts

Although surveys differ, up to 68% of households in the United States are thought to contain one or more animals considered to be a pet.[1] And an astute observer might notice that many pet owners consider their pets to be more than animals. They are beloved members of the family. And like other loved ones, many Americans want to ensure that their furry, feathery, or scaly friends are cared for should they die while their pet is still living.

Currently, all fifty states and the District of Columbia have some type of Pet Trust statute. Minnesota was the last to enact such a statute in 2016. And even though there are statutes on the books, as with any trust, there are many details that should be considered when creating a pet trust.

One of the most important details to consider is the statute in the governing state and the length for which Pet Trusts are allowed to remain in existence. These limits vary from state to state. In many states, the statutes simply require trusts to terminate when the last surviving animal passes away. Other state statutes, like the Minnesota statute, cap the trust term by a certain number of years.

The limits on duration imposed by statutes that define a specific number of years, 21 or 90 for example, can create a problem when it comes to Pet Trusts. What happens if someone in one of those states own a pet whose life span is longer than the duration limitations? For instance, Cocky Bennet, a sulfur-crested cockatoo in Australia, lived to be 120.[2] And cockatoos aren't the only exotic animals kept as pets with a lifespan that wreaks havoc with perpetuity limitations. As of April 2018, Jonathan, a giant tortoise, was a whopping 187 years old and designated as the world's oldest living land animal by Guinness World Records.[3] If his owner died when he was 50, chances are Jonathan would outlive the duration of his trust.

In addition to paying attention to how long the trust can last, the grantor of a Pet Trust must also consider who will care for the pet and what happens should the designated caregiver say "no."

Leona Helmsley, a famous New York real estate investor, was infamous for her pet trust for her Maltese named Trouble. One of the less publicized facts concerned the caregiver provisions. Mrs. Helmsley originally appointed her brother to care for Trouble, but he refused to accept the role. There was no successor designated. Luckily for Trouble, the general manager of the Helmsley Sandcastle Hotel in Sarasota, Florida stepped in and agreed to accept the role.[4] While it may be easy to find a trustee for a twelve-million-dollar pet trust (even though it was later lowered by the court to two million dollars), it might not be so easy for those of us leaving more modest sums to our furry friends.

To ensure that the Pet Trust works properly, it's important to outline specific procedures of the animal or animals' ongoing care. A very good example of that is a trust created for a cat for which we were the trustee. This particular trust required that the trustee set aside the sum of one hundred thousand dollars for the loving care and maintenance of the grantor's cat, Taffy. The document went on to recommend that the trustee pay an amount up to five hundred dollars per month as a gift to Taffy's caretaker to help defray the cost of food, shelter, medical care, and such other necessities as pet ownership requires.

In addition to these general provisions, the trust further stated that Taffy was to be delivered to the possession of the grantor's friend and personal caregiver, (a specifically named person), to care for Taffy as her own for the remainder of the pet's life. During such time as Taffy was residing with the caregiver, the grantor requested that she provide Taffy with healthcare through a particular animal hospital on at least a semi-annual basis, and if the caregiver were

1 Kain Brulliard and Scott Clement, "How many Americans have pets? An investigation of fuzzy statistics," The Washington Post, Jan. 31, 2019, https://www.washingtonpost.com/science/2019/01/31/how-many-americans-have-pets-an-investigation-into-fuzzy-statistics.

2 Zoe Miller, "11 of the oldest animals ever, ranked by age," Business Insider, Apr. 23, 2019, https://www.elephants.com/news/the-sanctuary-in-the-news/posts/11-of-the-oldest-animals-ever-ranked-by-age.

3 Ibid.

4 Cara Buckley, Cosseted Life and Secret End of a Millionaire Maltese, June 9, 2011, The New York Times, www.nytimes.com/2011/06/10/nyregion/leona-helmsleys-millionaire-dog-trouble-is-dead.

to become unable to provide such care, or, if for any other reason Taffy ceased to reside in the possession of the caregiver, then the grantor recommended the trustee seek the assistance of a specifically named veterinarian clinic to aid in placement of the pet with another home. The grantor also required that the trustee inquire from time to time with both the caretaker and the veterinarian concerning Taffy's wellbeing.

The trust created by Taffy's owner was well thought out and specific in terms of who was to care for the animal and what happens if that individual is not willing or able to do so. But what does the trustee do when the trust fails to name a caregiver, caregiver succession, or provide any details of how the funds are to be expended?

A good example of a problematic pet trust was a trust we had for a beneficiary's dog, Bridget. The grantor in that case provided no specific guidance regarding who was to care for Bridget or how she was to be maintained. The trust simply provided that the trustee should retain in trust enough assets to take care of all the grantor's pets for as long as the pets lived. Unfortunately, the dog living in the grantor's home at the time of his passing was a mature dog that had never been housebroken. No individuals volunteered to take him. Fortunately for Bridget, one of the charitable remainder beneficiaries was a no-kill animal shelter. The shelter stepped up to assume responsibility for Bridget and ensured she became trained and adopted out to a loving family. Otherwise, the charity promised they would provide a permanent position for Bridget as their facility mascot.

Not all situations with poor planning resolve as well as Bridget's.

If the care of a pet following the death of the owner is desired, then give as much planning and consideration as one would for any other type of gift left in trust.

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