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Midland Wealth Management

Market Outlook

What a Difference a Year Makes

Over the last 12 months, it seems as though we have been living in the middle of a science fiction movie. Mask wearing, social distancing and economic shutdowns would not have seemed within the realm of possibility prior to March 2020. As of this writing, we have been enduring this for a year. The reopening of the economy is under way and our lives are slowly returning to a more normal pace. When reflecting on the past year, it is mind-boggling that scientists and pharmaceutical companies were able to create and receive approval for three vaccines, as well as produce and distribute substantial amounts to U.S. citizens. By mid-March, over 128 million doses have been given in the United States with greater than 45 million people or 14% of the population fully vaccinated. With the speed of production and distribution increasing daily, we are hoping to reach 75% of the population by mid to late summer. By attaining this level, the U.S. will reach herd immunity allowing for extensive travel, large venue events and a return to a more normal life.

The economic recovery has been strong, with 2021 GDP forecasted to exceed 6%. There are several reasons for the strong recovery, including over $5 trillion in government stimulus, swift monetary policy action from the Federal Reserve (Fed) and the state of the economy prior to the shutdown. We have covered this several times in these writings, but this was not a normal recession caused by overheating and tightening monetary policy. Individuals and corporations were in fairly strong financial positions heading into the short downturn, allowing for a fairly quick recovery when the economy reopened. The stimulus has provided incentive for additional spending, as well as saving. This is all positive, but the higher level of government debt and the fear of higher inflation are certainly longer-term concerns.

One of the consequences from last spring's shutdown is a diminished supply chain and potential for higher inflation numbers. In January, the bond market became concerned about inflation risk, resulting in higher intermediate and long-term interest rates. As manufacturers ceased to do business from March to May and shipping containers stopped moving, inventory levels declined as demand exceeded supply. This continues to be an issue today. It is prevalent in the automobile industry, where semiconductor chips are needed for automobiles and manufacturers are unable to obtain enough supply. These shortages have led to slowdowns in production lines for new cars and trucks, limiting supply at dealerships. Many of us learned in our basic economics class that when demand exceeds supply, prices typically increase. This occurs in both the new and used car markets. If individuals cannot buy a new car, there will be a shortage of used cars in the market from sale or trade-in. This is just one example of manufacturing supply chain issues, but there is also limited availability of appliances, as well as furniture and lumber, resulting in longer wait times for delivery and higher prices.

Weather, ranging from hurricanes to deep freezes to flooding, has also impacted the supply chains. Oil supply declined dramatically last year with a decrease in rig count, but as the economy has recovered, demand for gasoline has increased. It is believed that gasoline alone will lead to a 2% higher inflation rate than a year ago. In addition to supply chain issues, a common thread in the manufacturing sentiment measures is the shortage of employees and the need to hire more. As a result of this manpower shortage, wage pressures may increase. Summing up all these concerns leads to a higher inflationary environment. Spring 2020 was a deflationary environment, but the strong economic recovery and demand will certainly lead to a spike in inflation on a year-over-year basis during the 2nd quarter. The real question is whether this is transitory (short-term) or a longer-term issue. We will continue to monitor the situation.

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Inflation fears, along with a strong economic recovery and increased government debt, have resulted in higher intermediate and long-term interest rates. With rising interest rates and a stronger economy, the equity markets have begun a rotation from higher-valued technology stocks to cyclical companies that perform well in an expansionary environment. The past 12 months have provided phenomenal returns to stock investors and we believe there is still upside in the markets, but there will also be increased volatility as the market comes to terms with a higher interest rate environment. Considering this outlook, we continue to have an overweight position to equities, along with a slight underweight to fixed income.

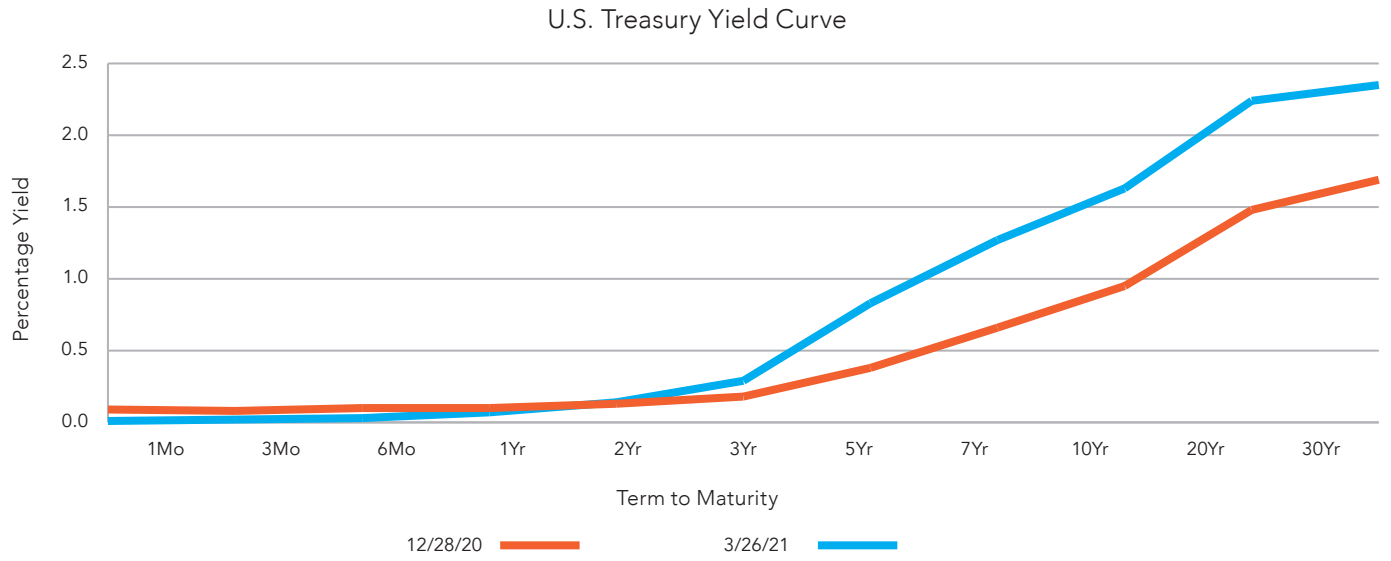
Federal Reserve Policy and the Fixed Income Market

During the 1st quarter of 2021, most global and domestic bond indices posted losses. Treasury notes and bond prices fell as interest rates rose, a trend that started from last summer's record low levels. Only the short-term rates, anchored by Fed policy, remained relatively unchanged. Even with the trend higher, interest rates are still relatively low. The move in yields suggests many investors believe the upward trend could continue as the global economy recovers.

Several market forces were responsible for pushing intermediate- and long-term interest rates higher. First, the U.S. economy is recovering at a better pace than originally forecasted last year. Second, the huge supply of new Treasury debt to fund the federal stimulus programs will cause investors to demand higher compensation in yields. Third, there is an expectation or fear that inflation will spike higher as the economy recovers. Finally, the market knows that as time passes and the economy expands, the Fed will eventually reduce its easy monetary policy.

After its mid-March FOMC meeting, the Fed stated that while the U.S. economy is heading for its strongest growth in nearly 40 years, the economic recovery remains uneven and far from complete, and the path ahead remains uncertain. Despite statements from the Fed that they anticipated no short-term rate hikes until 2023, along with their confidence that any increase or spike in inflation will prove short-lived, the bond market focused on the "strongest growth in 40 years" recovery statement. The market's negative response demonstrates market participants are not convinced that an inflation spike will be temporary. To them, the period of low inflation is over, and they are preparing for the worst. The market believes the Fed's current strategy and even possible changes to fight off inflation may not work because monetary policy actions have been overtaken by massive fiscal policy stimulus. The talk about a new fiscal infrastructure stimulus bill is yet to come and is certainly not helping.

For the rest of this year, we believe Fed policy will remain the same: Keep short-term rates close to zero percent while buying $120 billion of Treasury and mortgage securities every month to safeguard market liquidity and provide monetary stimulus. The Fed seems comfortable watching interest rates move higher and how stocks, credit spreads and other indicators of capital market access responded. However, there is a time limit on how long the Fed stays on its current policy course. If the anticipated spike in inflation turns out to be not so temporary as the Fed expects, then we may see a definite shift in Fed policy. Their first move would be a signal to reduce monetary stimulus by announcing a reduction or tapering of the monthly purchases of securities. Right now, the Fed faces a problem as the market feels expected faster economic growth will force them to make the initial announcement later this year to be followed by an actual reduction in purchases in early 2022.



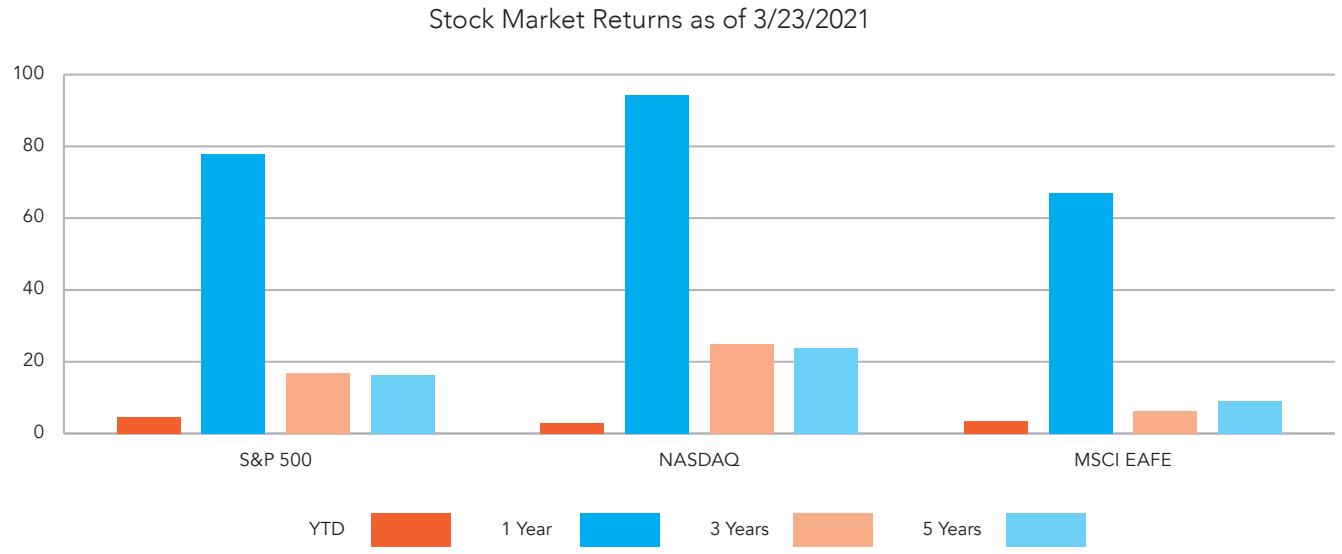
Based on the shape of the yield curve, the market has priced in possible rate hikes as early as 2022. Bond investors now have the steepest curve in over a year, which presents new investment opportunities for fixed income investors. If the Fed is as patient as it has telegraphed, fixed income investors may get rewarded.

Over the next five-year period, we find it reasonable interest rates will be higher than currently. We favor 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. An uneven recovery, which seems remote at this time, would accelerate downgrades and defaults. High yield securities are priced for perfection in a still uncertain economic period. While a fixed income portfolio has recently exhibited losses, it does offer value in a 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. The recent steepening in the yield curve may entice investors to take advantage of the rolldown in maturity. In managed fixed income portfolios, we are targeting the portfolio duration close to the Bloomberg Barclays U.S. Intermediate Government/Credit Bond index. At this time, we find this level of duration prudent considering the current pace of the economic recovery, the level of assets purchased by the Fed, and the high level of market liquidity.

Fundamentals Matter

Nearly a year after one of the sharpest and quickest declines in stock market history, equity markets have recovered and remain near all-time highs, albeit with increased volatility and significant market rotation. With the help of an "ultra-dovish" Fed and unprecedented fiscal stimulus, the financial markets have now turned their attention to reopening the U.S. economy following the COVID-19 pandemic. As the U.S. vaccine rollout continues to pick up speed, the anticipated "return to normal" may be just around the corner. With this outlook in mind, stock and bond investors have begun to price in a higher inflationary environment. Intermediate- and long-term bond yields have risen sharply in conjunction with higher stock prices, reflecting greater investor confidence and a stronger economy going forward. Value stocks, which include cyclical stocks such as banks, energy companies, industrials, and materials, have come to life after significantly underperforming growth stocks in 2020 and for most of the last 15 years as they anticipate a powerful economic rebound. As of March 19, large-cap value stocks are up 10.5% versus -0.9% for large-cap growth. Small-cap stocks have rallied even more with small-cap value up 25% and small-cap growth up 7.8%. The easy money has likely been had, but we could see the value stock rotation continue as investors focus on the global reopening trade. As of this writing, the S&P 500 is up 4.5% and the MSCI EAFE (developed international stocks) is up 3.5% year to date.

The popular NASDAQ market has been one of the biggest under-performers so far this year and actually experienced a brief 10% correction in the 1st quarter. Last year, the pandemic created a trading environment which we have referred to as "Growth at Any Price", regardless of P/E multiples. Today, there are a record number of technology companies with zero or negative earnings trading at very high valuations. As the 10-year Treasury yield has quickly moved higher, many of these longer duration technology companies have fallen back from their all-time highs. The outperformance of growth stocks has been highly reliant on low interest rates and low expectation for future rate increases. As interest rates begin to normalize, these



highly valued growth names will typically see a repricing of shares as their future earnings are worth less.

Corporate earnings, a key driver for higher stock prices, continue to recover. In the 4th quarter, 79% of S&P 500 companies reported a positive earnings surprise and 76% reported a positive revenue surprise. The blended earnings growth rate was 3.9% for the quarter. Looking forward to 1st quarter earnings, the estimated growth rate for the S&P 500 is 22.6%, which would be the largest earnings growth rate since the 3rd quarter of 2018. Overall, equity valuations remain elevated with the current price to earnings ratio for the S&P 500 at ~21.5x next year's earnings and the historical average being around 16.6x. As we have reiterated over the past several months, 2021 will be all about the "E" in the Price / Earnings multiple. Significantly stronger earnings growth could prove that stocks are not as overvalued as the current forward P/E may imply.

After a huge and unprecedented recovery over the past year, investors should likely expect smaller returns and increased volatility going forward. That being said, many positive factors remain that should continue to provide support for the market. First, there is a tremendous amount of liquidity in the markets, especially given the latest $1.9 trillion stimulus package passed this quarter and talk of a large infrastructure bill later this year. A recent survey showed millennials were planning to invest up to 50% of their stimulus checks into the stock market. In fact, investors poured a record $56.8 billion into equity funds as stimulus checks arrived, up sharply from the previous week. Second, the Fed continues to portray lower rates for longer which should continue to support higher valuations. Third, there remains plenty of pent-up demand for travel and leisure which should continue to pick up as global economies reopen. It's important to keep in mind that the stock market is typically forward-looking by 6-12 months, so much of the good news may already be priced into the market. Therefore, we wouldn't be surprised to see smaller gains and increased volatility, especially if we see a spike in COVID cases, if corporate earnings growth disappoints, or if inflation accelerates at a faster pace than expected, forcing the Fed to begin raising rates sooner than they would like.

We are excited to announce the following --

Midland Trust Company, a wholly-owned subsidiary of Midland States Bank and part of the Midland Wealth Management group, announced that it will acquire ATG Trust Company, a subsidiary of Attorneys' Title Guaranty Fund, Inc. in a transaction expected to close in the second quarter of 2021. The transaction brings Midland Wealth Management's group to more than $3.8 billion in assets under administration.

Read more in our Press Release here:
https://www.midlandtc.com/midland-trust-company-announces-signing-agreement-acquire-atg-trust-company

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

https://www.midlandsb.com/wealth-blog

https://www.midlandsb.com/wealth-newsletter

https://www.linkedin.com/company/midland-wealth-management/

Improve Financial Health, Increase Financial Security

Midland Wealth Management

It is hard to go through a day and not hear or feel the effects of COVID-19. The pandemic has impacted everything from our physical and emotional health to our financial health. Companies are asking now more than ever, "Are we in a good financial position?" and "Do my employees feel financially secure?" Having the right vehicle and programs in place are key to boosting your company and employees' financial health. **When employees feel financially secure, your company will benefit[1].**

One way employers can provide financial security is by offering a retirement plan to their employees. No two retirement plans are the same, and Midland can help weigh the options. A common question or concern then surrounds the cost of a retirement plan. With the passage of new laws, there are a couple tax credits available to offset this –

Start-up Credit

When starting a retirement plan for the first time, it can feel overwhelming. One important factor employers should spend time reviewing and understanding is cost, including administrative and investment costs. Administrative costs comprise recordkeeping, plan creation, payroll processing and education meetings. Investment costs cover monitoring and providing recommendations on when to add or remove different investment options. All these costs can be confusing and can add up when there are no assets in the current plan.

There is help to offset the costs of a start-up plan with a start-up credit. This credit was recently increased in the Setting Every Community Up for Retirement (SECURE) Act.

The maximum tax credit for start-up costs increases from $500 to $5,000 per year (that is an increase of 10 times!). The actual dollar amount is the greater of:

1. $500, or
2. The lesser of:
   a. $250 for each employee of the eligible employer who is not highly compensated and an eligible employee to participate in the plan
   b. Or $5,000

This credit applies for up to three years, so your total credit can be up to $15,000. Keep in mind this credit is for plans that have tax years beginning after 12/31/2019. The three-year credit period allows your company to become comfortable with the plan as it gets up and running.

Automatic Enrollment Credit

If your plan is already up and running, is there any credit out there for you? Yes, there is another option through an automatic enrollment credit. A retirement plan that has this feature, automatically enrolls new eligible employees. That employee then has the option to elect out, but if they don't, the new employee is on the path to becoming financially secure.

Small employers that have automatic enrollment, can take advantage of a newly created credit under the SECURE Act. The credit is up to $500 per year to help new and existing plans defray some of the plan expenses. If this is a start-up plan, this credit is in addition to the start-up credit allowed under present law. Keep in mind this credit, just like the start-up credit, is only available for three years. Therefore, the credit can be up to $1,500 and is only for start-up plans and existing plans that add this feature beginning after 12/31/2019.

Financial security can also be enhanced with a financial well-being program. We work with many employers who offer both the 401(k) benefit and the opportunity for their employees to learn and participate in well-being programs.

Well-being Programs

These programs go by different names in the marketplace, such as financial wellness or financial literacy, but they all have the same goal – educate and provide resources to employees based on their individual situation and concerns. Scenarios can obviously change over the years (look at 2020 with COVID-19), but the programs adjust accordingly and can help reduce employees' financial and emotional stress.

Well-being programs cover topics such as budgeting, saving for retirement and retirement account types. A recent study by Alight Solutions shows that over the last few years, employers are increasingly seeing the importance of well-being programs[2].

of employers believe the importance of financial wellbeing programs has increased at their organization over the last two years. Nobody says the focus has decreased.

Ultimately, you can help strengthen your company's and employees' financial health and security – by starting or continuing a retirement plan and providing a well-being program administered through an education platform. Midland Retirement Plan Services strives to simplify the process with an all-in pricing model to remove any confusion surrounding costs. We also focus on the overall service experience and help provide guidance and answers for all parties involved – from the employer to the employee. Contact us to learn more.

Stephen Hofmann
Retirement Plan Officer
Midland Wealth Management

1 Employee Financial Wellbeing: The impact of employee financial health at work. Willis Towers Watson, December 27, 2018, Employee financial wellbeing: The impact of employee financial health at work - Willis Towers Watson, Accessed March 15, 2021
2 Hot Topics in Retirement and Financial Wellbeing 2021. Alight.com, 2021 Hot Topics in Retirement and Financial Wellbeing | Alight, Accessed March 15, 2021

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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