Q1 23

Midland Wealth Management

Market Outlook

Contents:

Good Riddance 2022, Welcome 2023?

This last year has certainly been a challenging one for investors. There were few places to hide unless you were invested in commodities or cash. 2022 will go down in history as one of the worst years for the 60% equity/40% bond investor with double-digit negative returns. The S&P 500 index return was the lowest since 2008 and bond returns, as measured by the Bloomberg Barclays U.S. Aggregate Bond Index, were the lowest since its inception in 1976. Moving from a zero-interest policy to an aggressive rate-hiking cycle weighed heavily on fixed income returns and bled over into the equity markets.

Is the 60/40 portfolio dead?

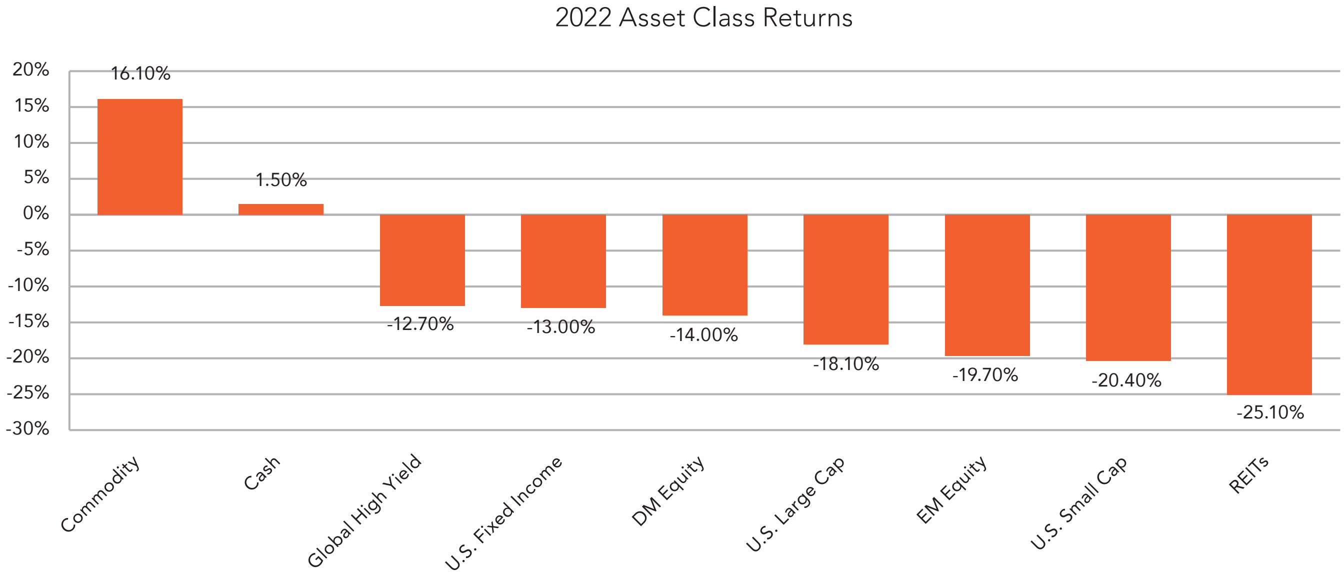
One year does not make a trend, especially considering that interest rates are now back to levels we have not seen in a decade. Over the last year, the dramatic increase in rates led to lower prices on bonds with no income to offset the price movement, which resulted in a negative total return. The yields now available on bonds can protect on the downside where they could not in 2022, assuming interest rates increase gradually. Also, while the Federal Reserve (Fed) is still leaning towards more interest rate hikes, it is 85% to 90% complete barring any dramatic increases in the inflation rate. Looking at it from this viewpoint, if interest rates remain stable, the fixed income component in the 60/40 portfolio should provide an estimated return of 4%*. This will vary depending on the direction of interest rates, but we do not anticipate negative fixed income returns in 2023. Regarding the equity portion of the portfolio, there may still be pressure on returns during 2023 as we move through this Fed tightening cycle and the business cycle. However, historically since 1926, equities have returned 10% on average. While many pundits do not believe that this will play out in the future, if you look at the average annual return of the S&P 500 over the last 3-year, 5-year, 10-year, and even 30-year period, the return is close to 10% annually despite the market ups and downs.

Inflation has been so high in 2022, and the Fed has responded aggressively. Will inflation fall closer to the Fed's target rate?

All inflation numbers indicate that it peaked sometime during summer. The Consumer Price Index (CPI) peaked at 9.1% year over year in June and declined to 7.1% year over year in November. The Core CPI (excluding food and energy) peaked in September at 6.6% year over year and most recently was at 6% year over year. While the numbers are nowhere near the Fed's 2% target rate, the trend is moving in the right direction. If you look at CPI annualized in the last 3 months, the rate is less than 4%, and there has been little inflation since it spiked in May and June. As mentioned in our last outlook, money supply growth has declined dramatically and was negative in the most recent release. Money supply growth leads inflation by about 18 months and has been declining rapidly since its peak in 2021. Inflation is following according to the norm and has rolled over on cue. If this trend continues, the inflation rate will be close to the Fed target within the next six to nine months. Of course, this does not mean that prices will decline from current levels but will not increase substantially more. If this follows course, the Fed will slow down or even pause the tightening cycle by mid-2023, if not earlier.

With the aggressive Fed moves in 2022, will there be a recession in 2023 or will a soft landing be achieved?

Whether there is a soft landing or a recession, economic growth will be slower than in the last two quarters of 2022. The second half of 2022 grew at greater than a 2% annualized rate. Several economic and market indicators lead us to believe there will be a recessionary period sometime in mid-2023. The inverted yield curve, including but not limited to the 3-month to 10-year Treasury, became inverted in mid-October and continues to maintain that position. The leading economic indicators have been negative for the last nine months and over the last 60 years, which have historically led to a recessionary period. While



no indicator is 100% accurate in predicting a recession, there are many signs that the U.S. will enter a recession sometime in the next six months. Economic activity has slowed, especially in the housing market. Higher interest rates have made homes less affordable due to the higher monthly mortgage payments. While many of us remember rates at 6% levels, there is a whole generation that has not experienced mortgage rates above 5%. In addition to homes being less affordable, current homeowners with 2.5% mortgage rates are hesitant to sell and move up to a 6% or higher mortgage. As a result, home prices are declining in many markets, which was one of the Fed's goals with the aggressive rate hikes. The labor market continues to be one area that has not shown strong signs of easing, but the labor market is a lagging indicator and is typically the last to fall. Regarding the labor market, there continue to be more job openings than unemployed persons, but the number is slowly tightening. There have been announcements of layoffs at several large companies that hired extensively following the pandemic. In a normal recession, job losses mount and the unemployment rate increases. While the unemployment rate may increase in this potential recession, it may not rise as dramatically since many mid- and small- businesses never reached full employment following the pandemic. The labor market mix has changed. The baby boomers are retiring, and new job entrants are not as great as in past recessionary periods. If we have a recession, it does not appear that it will be a deep and long recession like the Great Financial Crisis in 2007-2009. Consumer and business balance sheets are in decent shape, many of the market excesses have been washed out this year, and the supply chain issues that are still working themselves out will help balance the excess usually experienced in recessionary periods.

Looking into 2023, what are the risks and what should investors expect?

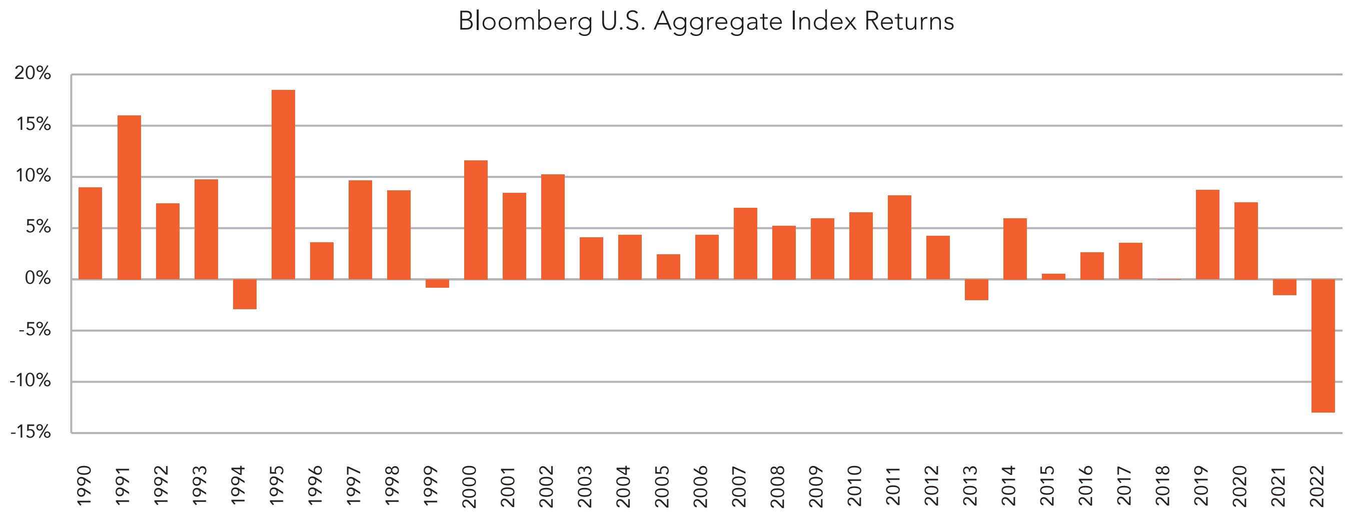
As a long-term investor, there are always risks that will impact markets year to year. The negative returns experienced in 2022 were dramatic and painful. Until this past year, there had not been a true bear market in stocks since March 2009. Fixed income never had a bear market like this past year. Typically, equity bear markets last 18 to 24 months but can be shorter or longer. Looking at where we are in the market cycle, equity markets could continue to experience volatility and potential negative returns over the near term, but market timing is exceedingly difficult to achieve. As a long-term investor, the opportunities in both fixed income and equities are greater today than a year ago. Investing in the appropriate allocation for individual risk tolerance, staying the course, and remaining invested will benefit investors despite the short-term risks.

It is extremely important for investors to take a step back during these volatile times and remind themselves of their long-term goals. Investing in an appropriate investment allocation is the long-term driver of returns, and a diversified portfolio of bonds, stocks, and alternatives is appropriate.

Fixed Income: Poised for a Better 2023

Fixed income investments and interest rates are rarely hot topics to discuss. However, 2022 was different. Interest rates continued to be discussed and closely watched throughout the year and constantly made headline news.

In total, the Fed raised interest rates seven consecutive times during the year for a total increase of 4.25%. Interest rates are back to levels not seen since 2007-2008. The first rate increase was in March, less than one year ago. It is hard to remember, but 2022 started with interest rates near zero. We are now in a more normalized interest rate environment.



In addition, continued rate increases are expected this year, but most of the tightening is behind us. Rates are projected to increase 75 basis points, or 0.75%, throughout 2023. The reality of rate increases this year will heavily depend on inflation data and the labor market.

Our investment strategy committee will continue to review and monitor the current investment environment and will pay close attention to the Fed statements. Its first meeting of the year will conclude on February 1.

The bad news to rising interest rates: negative fixed income performance.

The federal funds rate is currently 4.25%-4.50%. Again, the consensus estimate is for this rate to reach 5-5.25% before the Fed will pause. Lowering inflation continues to be the motive behind raising interest rates, and there has been progress on that front. As mentioned above, headline CPI inflation has eased from a peak of 9.1% year over year to the most recent reading of 7.1%.

"We welcome these better inflation reports for the last two months, but we're realistic about the broader project," Chairman Powell said. "It will take substantially more evidence to have confidence that inflation is on a sustained downward path."

The bad news to rising interest rates: negative fixed income performance. These negative numbers could be remembered as a historical outlier and the worst year on record! The Bloomberg Barclays U.S. Aggregate Bond Index, which is representative of the U.S. bond market, will also make history for doing something it's never done before: lose value for the second year in a row.

2022 fixed income performance:

- Bloomberg Barclays Agg Bond: -13.01%
- Bloomberg Barclays Agg 1-3 Year: -3.72%
- U.S. High Yield: -11.19%
- Municipal Index: -8.53%

I want to reiterate just how awful these fixed income returns are. Please see the chart above. It is unusual for fixed income to have a negative annual return, but the return we just experienced was a dramatic drop! The investment strategy committee made several strategic adjustments to fixed income throughout the year and utilized losses to offset gains. The 2023 fixed income outlook is not expected to be a repeat of 2022.

The good news to rising interest rates: fixed income investments are now better positioned to provide steady, reliable, low-risk income and returns to portfolios. For the first time in nearly 15 years, bond yields are supporting retirees by yielding enough to cover a 4% withdrawal rate. Our client portfolios are fully invested, and for most investment objectives, this means an allocation to fixed income. Investors may feel let down by the poor performance fixed income had last year, but again, fixed income still deserves a place in almost all portfolios.

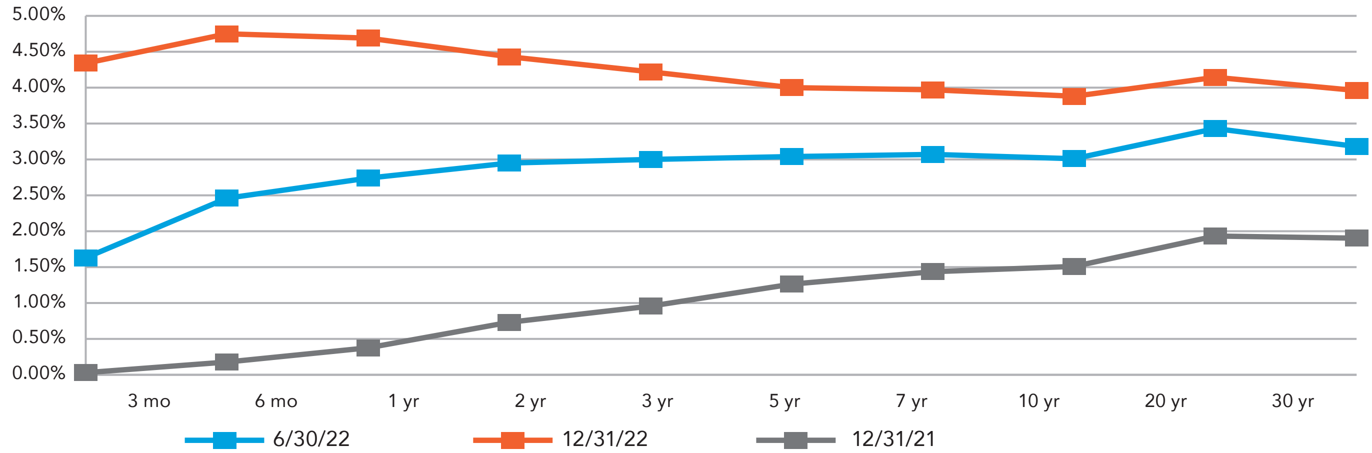
The good news to rising interest rates: fixed income investments are now better positioned to provide steady, reliable, low-risk income and returns to portfolios.

The 10-year Treasury yield, which influences rates on mortgages and other loans, began the year around 1.52%, peaked in October at around 4.25%, and ended the year at 3.88%. Shorter-term rates had an even more dramatic move higher, with the 2-year Treasury yield starting the year around 0.78% and ending the year at 4.41%.

The yield curve is fully inverted, which is an ominous sign for the economy. We are still in a rate hike cycle, and it is easy to be pessimistic about 2023. However, a long-term investment strategy and continued conversations about goals and asset allocation should remain the focus.

As interest rates have moved higher, savings and money market rates have also moved up substantially. In preparation for a bumpy 2023, building and maintaining an emergency fund should be a priority.

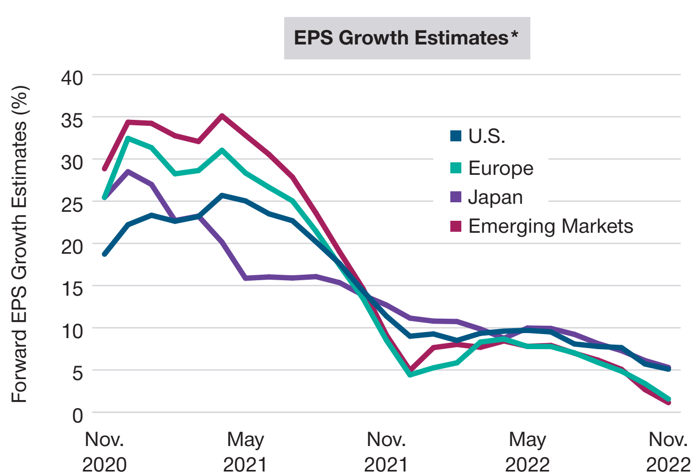
Treasury Yield Curve



Our investment strategy committee will begin 2023 with an elevated cash position and will maintain an underweight to our fixed income position with a neutral duration target.

Equity Volatility Likely to Continue

Brutal! That is the only description we can come up with to describe the 2022 market returns. Google defines the word brutal as savagely violent, which accurately describes the volatility we experienced throughout 2022. High and persistent inflation drove central banks to rapidly and significantly tighten financial conditions, threatening economic growth and corporate profits. This led to a valuation reset of global equities in 2022 with capital markets now pricing in a significant global economic slowdown. The key question is whether this deceleration will end in a soft landing with positive but slower growth or in a full-fledged recession that drags down earnings. Much depends on the Fed and the world's other central banks as they continue efforts to bring inflation under control by hiking interest rates and draining liquidity from the markets.



*U.S. = S&P 500 Index, Europe = MSCI Europe Index, Japan = MSCI Japan Index, Emerging Markets = MSCI Emerging Markets Index.
Source: T. Rowe Price

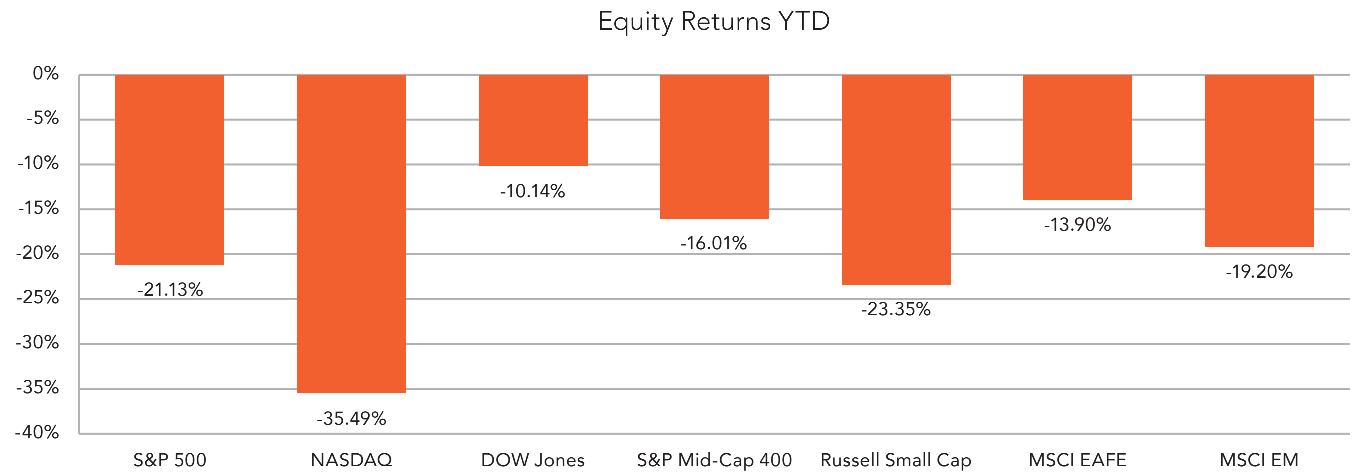
After a miserable 2022, valuations in most global equity markets have improved markedly, although U.S. equities still appear expensive relative to their history. Even with the geopolitical concerns facing several foreign economies, the MSCI EAFE International Index outperformed the tech-heavy S&P 500. Generally, when domestic equities return less than 4% for the year, developed international equities tend to outperform; and 2022 was no exception to that rule. Soaring bond yields largely drove equity bear markets in 2022 by compressing valuation multiples. However, in 2023, earnings growth could move to the top of the list of investor concerns.

As we enter 2023, we continue to maintain our cautious view on the equity markets.

Fourth quarter earnings are off to a rough start, setting the tone for what could be a weak start to the new year. The S&P 500 earnings growth rate is expected to decline -4.80% in the first quarter of 2023 and -5.44% in the second quarter of 2023 according to Hamilton Lane. This is a stark downward revision from the 2.87% and 0.88% posted on 9/1/2022. The overall earnings growth rate for the S&P 500 in 2023 is set to be 5.5%, 3% lower than the 10-year average.

We believe 2023 will be the "tale of two markets."

Equity valuations continue to flat line. The Buffet Indicator (a measure of how overvalued vs. undervalued a security is) remains relatively high. The Buffet Indicator is calculated by taking the Wilshire 5000 Total Stock Market Index divided by the U.S. GDP, which puts it well above the 90th percentile average of 151%. This once again indicates that equity valuations are still relatively high. While still not



close to the 2021 P/E high of 45, quarter four S&P 500 P/E ratios are hovering around the COVID-19 lows of 18-21; still a large 30% premium from the long-term average. Our primary concern is the current P/E multiple of 18-21 could be even higher if earnings estimates continue to fall, which will place added pressure on stocks.

As we enter 2023, we continue to maintain our cautious view on the equity markets. The war in Ukraine, China's Covid-19 struggles, high inflation, and tighter monetary policy will all be relevant factors as we move through the new year. Global supply chains will continue to be reconfigured with less reliance on China. Unfortunately, moving manufacturing out of China will increase labor costs and likely supports stickier inflation going forward. Investors stand at a major turning point in capital market history. The global economy has moved from decades of declining interest rates into a new regime marked by persistent inflationary pressures and higher interest rates. The era of cheap money and high asset valuations is likely over.

As for valuations, small-cap stocks have taken a beating this year. Currently, small-cap valuations are at the lowest point since the 2000 tech bubble relative to large-cap stocks. The large-cap to small-cap index has remained relatively flat as of late. This could be an indication that small-cap stocks have been keeping up with the large-cap performance. The combination of the two could create a good buying opportunity for small-cap equities as we progress through the new year. We will be looking for an opportunity to increase our exposure to small-cap stocks at some point in 2023, which is why we are maintaining on overweight position in cash.

We believe 2023 will be the "tale of two markets." We see the first half of the year being dictated by slower economic growth and weaker corporate fundamentals; namely declining earnings growth and weaker profit margins. This would then give way to a stronger second half as investor sentiment improves as we see an end to central bank tightening and continued improvement on the inflation front. As investment managers, we will have to balance the possibility of disappointing global growth against the backdrop of a central bank pivot, less volatility, and the potential of a return to growth later in the year. We expect 2023 to include recoveries and present opportunities with most central banks ending their tightening cycles; however, it will not come without volatility.

Start the year off right with a review of your financial plan.

While we are committed to frequent and timely communication with you, we also welcome the opportunity for you to connect with us and your advisory team.

Call 888-637-2120 or click to schedule an appointment.

Market Insights

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Navigating the Trustee Selection Process

Trusts have been part of the estate planning conversation for over a thousand years and have become the primary estate planning vehicle in use today. The Trustee is charged with certain duties relative to their role.

Trustee Duties

- A Trustee must serve in a Fiduciary capacity and act on behalf of the beneficiaries of the Trust, always putting their interests ahead of the Trustee's own. Loyalty to the Trust's beneficiaries is a fundamental duty.
- A trustee must demonstrate impartiality by administering the Trust in a fair and reasonable manner that is unbiased with respect to the often-competing interests of all beneficiaries.
- All qualified beneficiaries are entitled to sufficient information allowing them to be reasonably informed of the administration of the Trust and all material facts necessary to protect their respective interests.
- Maintenance of clear, complete, and accurate books and records regarding the Trust property and the administration of the Trust is required.
- The Trustee must take control of all property belonging to the Trust and preserve it. With real property, a Trustee is tasked with maintenance, repairs, taxes, insurance, etc.
- Regarding liquid assets, a trustee has an obligation to invest those assets in a manner that reflects what a 'Prudent Investor' would do. The purpose, terms, distribution requirements, and the totality of the circumstances surrounding the Trust must be considered. Tax considerations, diversification of the portfolio, and risk management are all part of the analysis. A Trustee may delegate investment functions to a qualified professional.
- With certain trusts, the Trustee has additional specific administrative duties required to maintain the integrity of the Trust vehicle involved.
- The Trustee must understand the terms of the Trust. Those not well-versed in the meaning of certain legal jargon will struggle to fulfill their duties.

Trustee Selection Process

With a basic understanding of the job requirements, the first decision in the Trustee selection process is to choose between two categories of potential Trustees: an individual or a professional Corporate Trustee.

Individual Trustee Pros and Cons

An individual, often a family member, will usually have a good understanding of the family dynamics but must follow the terms of the document, not what they think the Grantor wanted.

The individual will most often not have the background or knowledge of the job requirements to properly manage the Trust. As a result, while the individual may not charge a fee for their services, they will hire advisors such as attorneys, accountants, and investment professionals to assist them.

The individual Trustee may have difficulty carrying out the Grantor's wishes making a discretionary principal distribution to a beneficiary under a defined distribution standard. It can be difficult to say "no" to a beneficiary you later sit across the table from at Thanksgiving. The benefit of a close familial relationship can quickly be spoiled irrevocably, compromising the Grantor's expectations.

An individual may be ill-equipped to handle the myriad tasks required to properly administer an irrevocable trust, and thereby avoid potential liability for mismanagement, however innocent the actions were. Should an issue arise that would lead to litigation, the aggrieved beneficiary would be in the awkward position of filing suit against "Good Uncle" who may not have sufficient 'deep pockets' to satisfy any judgment entered by the Court.

Consistent with the human condition, individual Trustees eventually die. Provisions can be made within the Trust document for a successor; however, the transition can be difficult unless clear and concise records have been kept.

Benefits of a Professional Corporate Trustee

A professional Corporate Trustee brings a wealth of experience and expertise to the role of Trustee and will never die. A Corporate Trustee employs trained professionals well-versed in the specific duties outlined above. These professionals work together as a single Fiduciary entity. A Corporate Trustee has longevity, is unlikely to take sides in family conflicts, will spend the time needed to manage the Trust properly, has investment and money management skills, keeps clear records, and has a deep understanding of the legal requirements of Trust administration.

As a highly regulated and audited institution, a bank serving as a professional Corporate Trustee will maintain the processes and procedures to ensure that all processes are properly completed and documented. Discretionary decisions are made following the terms of the Trust and as required by law. The Corporate Trustee does not have a 'Thanksgiving dinner' problem, so tough decisions are made based on proper analysis. The Trustee will professionally deliver any unwanted news to the beneficiary without any disharmony within the family.

A professional Corporate Trustee will charge a fee for their services. When compared to the expense an individual would incur hiring appropriate professional advisors in tax, legal, and asset management, the Corporate Fiduciary can provide the comfort of knowing that your family dynamic will not be damaged through a change in roles.

A professional Corporate Fiduciary is positioned to serve the varied and dynamic needs of the Trust. Anticipating developments and changing circumstances, the Corporate Fiduciary is prepared to take appropriate steps to honor the settlor's plan and carry out their legacy and maintain family harmony.

If you have any questions or need assistance with selecting your trustee, please do not hesitate to reach out to your relationship manager.

**This article has been condensed for print.*
To read it in its entirety, please visit
midlandsb.com/market-outlook-newsletter-1st-quarter-2023

Jeffrey Schmidt, JD
Director of Trust Services
Midland Trust Company

Important 2023 Dates for Client Tax Forms

- **Forms 1099-R and 1099-MISC will be mailed out by end of January**
- **1099-DIOB combined tax forms are targeted to be mailed out by February 17th**
- **Other tax forms, including grantor letters and Schedule K-1s, begin mailing February 17th through end of March**
- **Form 5498s will be mailed out in May**

Join Midland Wealth Management for a 2023 Outlook webinar!

Grab your lunch and listen in Wednesday, January 25th, at 12:00pm (CST).

Register here.

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

Tracey Garst
Senior Portfolio Manager

Chris LaPorta
Senior Portfolio Manager

Tonia Maly
Senior Portfolio Manager

Daniel Zeigler
Senior Portfolio Manager

Denise Melton
Portfolio Manager

Nino Ciaccio
Assistant Portfolio Manager

Gay Jack
Assistant Portfolio Manager

Jake Stapleton
Assistant Portfolio Manager

Chris Zabel
Assistant Portfolio Manager

Kaleb Gottfred
Research Analyst

Noah Spencer
Research Analyst

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