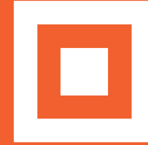
Q2
22

Midland



Wealth Management

Market Outlook

Inflation, Welcome Back!

For the last two decades, inflation across developed economies has been low to almost deflationary with increased globalization and productivity. As we turned the calendar to 2022, the environment dramatically changed. Year-over-year inflation reached 40-year highs with 7.5% in January and 7.9% in February and is expected to exceed these levels in March. At their most recent meeting in March, the Federal Open Market Committee (FOMC) took the first step in the fight against inflation with a 0.25% increase in the short-term rate and anticipates several more rate hikes in the coming months. What is causing this, and how will it impact the consumer, businesses, and the overall global economy?

The primary causes for today's inflationary pressures are the extremely accommodative fiscal and monetary policies enacted two years ago in response to the pandemic. In March 2020, the FOMC instantly lowered rates to zero, provided stimulus by purchasing record amounts of government, mortgage, and corporate bonds, and increased its balance sheet from $4 trillion to $9 trillion. When taken in conjunction with government stimulus provided to consumers via direct payments, these actions resulted in a perfect storm of excess liquidity chasing too few goods. The full impact did not become evident until the economic reopening reached a level where consumers could begin spending their extra cash. The average consumer continues to have surplus cash on hand, increasing money spent on services and travel.

Supply chain challenges continue to drive inflation as well. Shutting down the non-essential portion of the economy for an extended period led to shortages. Due to stimulus received during the pandemic, demand for durable goods such as appliances, furniture, and cars increased. As demand increased, the ability to raise prices became more evident. Inflationary pressures should lessen as we work through the shortages. This was a primary reason the FOMC believed that inflation was transitory. In addition to supply chain issues, labor shortages are another disruption, leading to upward pressure on wages. In the past year through March, wage growth increased 5.7% with non-supervisory workers seeing larger increases than management. In the U.S. economy, there continue to be more job openings than the number of people unemployed. This imbalance may continue to influence businesses to pay higher wages or limit services available.

The final dagger in the inflationary topic was the Russian invasion of Ukraine. This action led to a spike in energy costs as well as future food price inflation, especially in Europe. Europe had finally reopened after the pandemic and showed signs of solid growth. Higher inflation may now have a negative short-term impact on its growth rate. Because the U.S. is fairly energy independent and is a global provider of grains, its economy should see less of an impact in the long term. The events in Europe are still impacting the price U.S. consumers pay at the pump and the grocery store though.

What does this mean for economic growth and the markets? Realizing that inflation is not transitory, the FOMC has initiated a period of interest rate hikes and moved to reduce its balance sheet to slow demand and lower inflation. The first action in March to raise rates by 0.25% was expected, but the FOMC's dot plot chart shows a steeper and quicker reaction to fight inflation. The next move will likely be a 0.50% increase in May, with the short-term rate expected to near 2.25% by year-end 2022. The bigger question is whether the FOMC needs to be more aggressive, which could lead to a recession. The FOMC's goal is to achieve a soft landing that does not result in a recession.

While there are risks to overall economic growth, global growth, especially in the U.S., is in a strong position heading into this tightening cycle. Consumers and businesses have stronger balance sheets and more

Contents:

Inflation, Welcome Back! 1

What's Up with Interest Rates? 2

V-Shaped Bounces 3

Inheritance: Questions & Considerations 5

liquidity at this point in the cycle compared to other market cycles when the FOMC began monetary tightening. In addition, we have seen a substantial revaluation in both the equity and fixed income markets during the first quarter. In the fixed income market, we have seen the largest drawdown in bonds and the most negative total return. While we may not be at the peak of this interest rate cycle, the yield curve out two years and longer has already built in at least a 2.25% short-term rate. If the FOMC does not have to be more aggressive, we may have seen the worst for the bond market, and higher yields may offer some value at this point. In the equity market, valuations in some sectors and individual stocks remain high, but much of the speculative portion of the market has had a substantial repricing since the end of the first quarter last year. Many of the stay-at-home stocks that spiked dramatically in 2020 and early 2021 have receded by over 50%. In the most recent correction, the S&P 500 declined around 10%. However, when looking at individual names in the index, over half declined more than 20% and were in bear market territory.

Overall, we expect economic growth to slow from the rapid pace experienced in 2021 to a more reasonable 3% to 4% GDP growth rate in 2022. While the probability of a recession is higher than at the beginning of the year, we do not envision one in 2022. Talk of an inverted yield curve, high inflation, and all the risks associated with a recession may be valid, but historically an inverted yield curve has not always predicted a recession. Also, a true inversion is when the 3-month treasury yield is greater than other maturities across the curve, which typically happens further into the FOMC tightening cycle. Higher costs for food and energy may limit the amount of discretionary spending by consumers, leading to slower growth and less pricing pressure for these services and products. While higher costs may sound negative, from the FOMC's perspective, they may help lower the inflationary pressures we are experiencing.

We continue to be long-term investors and believe there is a need for a diversified portfolio invested in bonds, stocks, and alternatives.

What's Up with Interest Rates?

Coming into 2022, it was well known and communicated that interest rates would increase. The first official move took place on March 16. The FOMC controls the fed funds rate, and this rate was increased by 0.25%. This moves the fed funds rate off 0 to a range of 0.25%-0.50% and is the first increase in rates since 2018. In addition, the FOMC currently projects six additional increases for this year. Its next meeting takes place on May 3-4, with an announcement coming on May 4. The next rate increase could be 0.50%. How much and how often rates increase will depend on the economy and inflation.

The FOMC's job is to keep the economy moving along at a steady pace. To do this, it operates under a mandate to maximize employment, keep prices stable, and moderate long-term interest rates. A 2% inflation rate is the goal for the FOMC, and we are currently much higher than that. The latest Consumer Price Index (CPI) reading of 7.9% is the highest inflation experienced in 40 years. The FOMC is committed to raising rates to fight the high inflation we are currently experiencing.

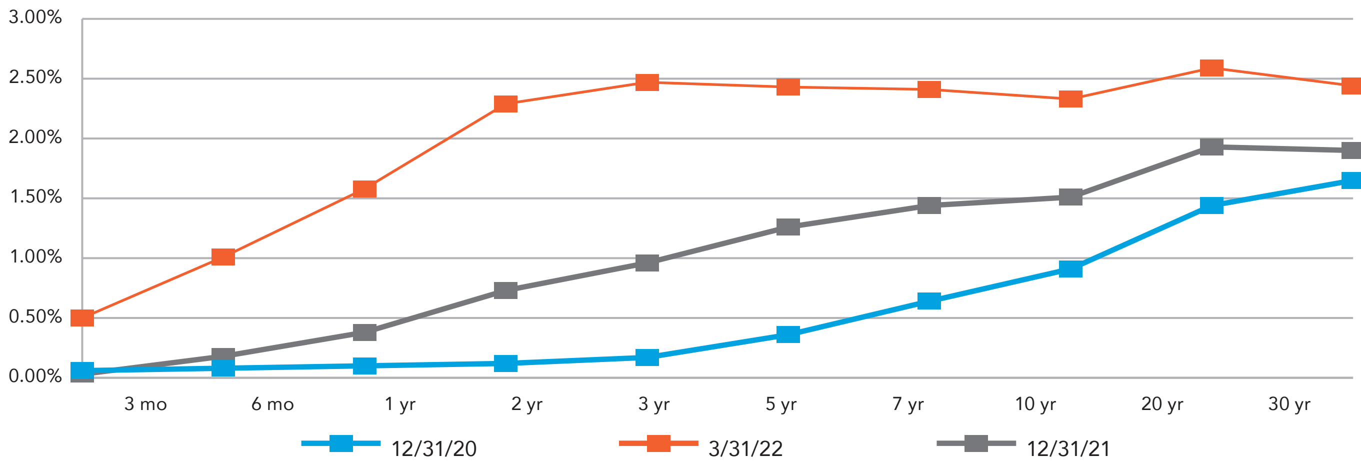
When the FOMC increases rates, the increase has a greater effect on short to medium-term rates, but most interest rates are intertwined. Interest rates and bond prices have an inverse relationship. This means that as rates rise, bond prices fall. It seems inevitable that we will need to move off these currently low interest rates. As we move along in this cycle, fixed income investors will eventually start earning more interest. In a rising rate environment, bonds will experience flat to negative returns. With the dramatic increase in yields during the first quarter of 2022, bond indices provided historically negative total returns. This is evident with the -5.93% return for the Barclays U.S. Aggregate Bond Index during the first quarter.

The U.S. economy is currently on stable ground. In addition, the labor and housing markets remain strong. This strength and stability give us reason to believe a continued increase in rates should not significantly disrupt the domestic markets.

Along with an official move in the fed funds rate, treasury yields have increased steadily since the beginning of the year. The 2-Year Treasury started the year around 0.78% and as of March 31 is yielding 2.29%, a dramatic move up. The 10-Year Treasury started the year around 1.63% and as of March 31 is yielding 2.33%. There is little difference between these two rates, causing the yield curve to flatten. Some areas of the curve are inverted, meaning a shorter-term rate is higher than a longer-term rate. (Please reference the chart below.) An inverted yield curve can be an ominous sign for our economy, and the yield curve inversion is capturing plenty of headlines. This inversion does not however mean a recession is imminent. Rates and the shape of the yield curve will remain on our radar as we continue to navigate through the year. The last time the yield curve inverted was in 2019. As shown in the chart, the short part of the curve remains very steep or has a natural slope.

The overall goal of raising interest rates is to slow borrowing and encourage savings (not spending). A slowdown in spending should in turn lower inflation.

Whether you are borrowing or saving money, an increase in rates will affect you. Borrowing will become more expensive with lending rates increasing. On the flip side, higher rates will eventually increase interest on deposit accounts like savings, checking, money market, and CDs.



However, these increases will move slowly. Changes in interest rates will likely influence you and your finances but to what extent depends on your situation.

Fixed income continues to earn its place in a diversified portfolio by providing income and less price fluctuation than equity. In anticipation of rising rates, our investment strategy committee made several changes to our fixed income portfolios in January. At this time, we are maintaining our underweight target to fixed income.

Interest rates and inflation remain key metrics for the path this year takes. Changing rates do not always have the desired effect. There are many environmental factors in play at any given time, and our investment committee continually reviews and interprets this information as we manage our client portfolios.

V-Shaped Bounces

March 13 was the two-year anniversary of "two weeks to flatten the Covid curve." It was the first day that many states announced the closures of schools and businesses. From there, the rest is history. The S&P 500 Index took a nosedive, dropping over 1,000 points to nearly 2,300. It only took a month to begin the rebound process in the markets, which ended up being a checkmark-shaped recovery. Despite countless spikes in Covid cases, tightening restrictions, and mounting unemployment, the markets ignored it all and kept chugging along to all-time highs. The S&P 500 topped off well over 4,700, the Dow breached the 36,000 level, and the NASDAQ surpassed 14,500. Despite 80% of all U.S. dollars in existence being printed during that nearly two-year period, investors were still hopeful leading into the new year. However, inflation, Putin, and Russia would provide a new reality for investors; stock markets don't go straight up.

Not to the surprise of most investors, inflation has been red hot to start the year with February's year-over-year data being 7.9%, the highest number we've seen in 40 years. After pent-up demand and supply chain bottlenecks over the last 18-24 months, it was only a matter of time until the FOMC began tightening and increasing rates. In an 8-1 vote, the FOMC raised rates 25 basis points (bps) in March. Its hawkish goal is to monitor economic data but continue to raise rates by a total of 200 bps by the end of 2022. The stock market has a mixed relationship with rate increases, especially first-rate hikes after periods of no increases. Since 1983, there have been eight first-time rate hikes by the FOMC. The average return of the S&P 500 Index, 6-months and 12-months after the initial rate increase, has been 7.5% and 10.8%, respectively. Given the extended periods of low returns in the fixed income market, investors found themselves buying back into the stock market to receive a justifiable return. The influx of cash and purchasing have pushed valuations, specifically in the U.S., above long-term median trends. Given the high levels of inflation, investors will likely continue investing new money into the equity markets to outpace inflation and maintain some purchasing power. However, there is a point where investors may look at valuations and determine that the high price of a stock may not be worth it, especially if higher interest rates begin to offer attractive returns in the fixed income market. High-flying growth stocks carry a higher Price-to-Earnings (P/E) multiple, which leads to a potential rotation from growth to value as valuations tend to increase. Mid-cap and value stocks tend to perform well during this time. The only caveat to all of this is that with each period of rising rates, the economic and geopolitical environment is different. There are similarities, but the environment is never identical.

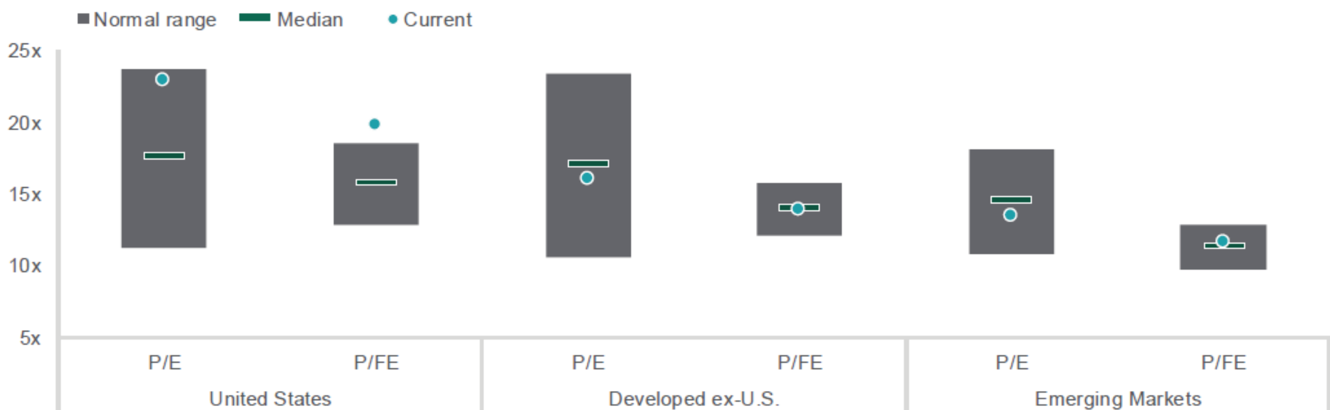
While inflation is creating headwinds in the U.S., Europe has been facing its own set of issues over the past month. With Russia's invasion of Ukraine, the entire globe has been put on notice of the potential for the conflict to escalate outside of Ukraine's borders. The war has brought on global fears of nuclear attacks and a significant amount of uncertainty around Putin's decision-making. The Chicago Board Options Exchange's Volatility Index (VIX)

went as high as 36.45. The war, compounded by inflation, has driven volatility well above historical norms.

As the first quarter of 2022 comes to an end, U.S. markets are beginning to exit correction territory. Excluding corrections that turned into a bear market, the S&P's average return after exiting a correction is 13.96%. However, despite a strong comeback over the past several weeks, a few recession indicators have reared their ugly heads. On March 29, the 2-Year Treasury was trading slightly higher than the 10-Year. It is worth noting that the last four times the 2- and 10-Year yield curves inverted, the S&P 500 was up an average of 28.8% before it peaked on average 17 months later.

Despite all the recent market activity, we still believe there are opportunities in the equity market on a long-term basis and continue to maintain our slight overweight allocation to equities with a slight overweight to international. On a valuation basis, international markets are more attractive and may provide better opportunities as the impact of war becomes more defined.

GLOBAL EQUITIES VALUATION SUMMARY



REGION	P/E		P/FE		P/B		P/CF		DIVIDEND YIELD	
	Current	LT Median	Current	LT Median	Current	LT Median	Current	LT Median	Current	LT Median
U.S.	**22.9**	**17.5**	**19.7**	**15.7**	**4.5**	**2.5**	**16.8**	**10.1**	**1.4%**	**2.5%**
World ex-U.S.	**16.0**	**17.0**	**13.9**	**13.9**	**1.8**	**1.7**	**9.9**	**8.4**	**2.9%**	**2.9%**
Europe	16.1	14.9	13.9	13.4	2.0	1.8	10.0	7.5	2.8%	3.5%
Japan	14.5	20.7	13.2	14.4	1.4	1.9	8.4	8.4	2.4%	1.7%
UK	15.9	13.8	11.9	12.6	1.9	1.8	9.1	8.4	3.7%	4.1%
Canada	16.9	17.6	13.8	14.4	2.2	1.8	11.5	9.1	2.8%	3.0%
Australia	16.0	17.5	15.5	14.8	2.3	2.0	11.0	11.9	4.8%	4.0%
EM	**13.4**	**14.5**	**11.7**	**11.3**	**1.8**	**1.7**	**9.2**	**8.6**	**2.6%**	**2.4%**

Source: Northern Trust Global Asset Allocation, MSCI. Monthly data through 2/28/2022. Indices are MSCI US, MSCI World ex-US, and MSCI Emerging Markets; U.S. and World ex-U.S. data begin in 1970, EM data begins in 1995. Normal Range: +/- 1 standard deviation from the median. LT: long-term.

Congrats!

Steve Lukasik will retire on April 22 after 11 1/2 years of service.

Michele Lind will retire on May 31 after 13 years of service.

Inheritance: Questions & Considerations

Midland Wealth Management

Inheritance is a process that involves passing on material property from one generation to another, usually within the family and traditionally from older parents to their children. As trust officers and wealth advisors, we are often asked, ***"When is the best time to make a transfer to another generation?"***

You as a potential donor must first assess your income needs to maintain your lifestyle for the rest of your life. If you find that you have excess, you may want to consider passing on some of your financial inheritance to your beneficiaries. The next question to deliberate is, ***"Does it makes sense to give to your children or beneficiaries during your lifetime or at death?"***

Early transfers during a lifetime can be tax effective. In 2022, a donor can gift $16,000 as an annual exclusion per donee or recipient. Gifting assets to children or grandchildren during your lifetime allows the younger generation to appreciate your generosity. However, it is wise to help teach that generation to save and invest the hard-earned dollars you gift them. You may want the younger-aged child or grandchild to understand money and the accountability that comes with it. Financial education and discussion of wealth responsibility are critical to their wealth management growth.

Many donors want to make certain that their children have the chance to make it on their own first. So perhaps a trust is a better option. People often prefer to transfer the control of a portion of the inheritance at or around age 35 and then more at a later age of 45. Other aspects you may want to consider include the maturity of the child, their age, as well as their judgement shown at different stages in life.

We had a tragic situation where both parents died in a car accident leaving one child at the age of 16. There were no provisions from a trust to manage his assets or to provide for him. Because he was a minor, a guardianship was created and everything had to be approved by the court. When the child reached 18, the age of majority in Illinois, the court terminated the guardianship and turned the entire estate over to him. The total amount was approximately $600,000. Within 18 months, the assets were squandered through the purchases of four cars and an addiction to drugs. Sadly, the child's inheritance was gone and nothing was left for a college education.

This is just one example of the importance to plan ahead. Whether you are contemplating passing on inherited assets or establishing a trust, now is the time to review your assets and your estate plan. I'll close with a final question to ponder, ***"How do you want to leave your legacy?"***

Patricia Fong, JD, CTFA
Senior Trust Officer
Midland Wealth Management

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

midlandsb.com/wealth-blog

midlandsb.com/wealth-newsletter

linkedin.com/company/midland-wealth-management/

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

Michele Lind
Senior Portfolio Manager

Tonia Maly
Senior Portfolio Manager

Daniel Zeigler
Senior Portfolio Manager

Steven Lukasik
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

If you would like to receive a digital version of the quarterly newsletter, please send your preferred email address to wealthmanagement@mkt-midlandsb.com.

midlandsb.com | 1-888-637-2120

Midland Wealth Management is a trade name used by Midland States Bank and its subsidiary Midland Trust Company. Investments are not insured by the FDIC or any other government agency, are not deposits or obligations of the bank, are not guaranteed by the bank or any federal government agency, and are subject to risks, including the possible loss of principal.
The information provided is for informational purposes only. Information has been obtained from sources believed to be reliable, but its accuracy and interpretation are not guaranteed. Midland Wealth Management does not provide tax or legal advice. Please consult your tax or legal advisors to determine how this information may apply to your own situation. Whether any planned tax result is realized by you depends on the specific facts of your own situation at the time your taxes are prepared. IRS CIRCULAR 230 NOTICE: To the extent that this message or any attachment concerns tax matters, it is not intended to be used and cannot be used by a taxpayer for the purpose of avoiding penalties that may be imposed by law.
Past performance is no guarantee of future results. Returns of the indexes also do not typically reflect the deduction of investment management fees, trading costs or other expenses. It is not possible to invest directly in an index. Indexes are the property of their respective owners, all rights reserved. Midland Wealth Management does not claim that the performance represented is CFA Institute, GIPS, or IMCA compliant.
Copyright © 2022 Midland States Bancorp, Inc. All rights reserved. Midland States Bank® is a registered trademark of Midland States Bancorp, Inc.