NORTH STAR ASSET MANAGEMENT, INC.

April 2016

INVESTMENT UPDATE

Executive Summary

- It was a turbulent start to the year as the S&P 500 fell by -10.5% through the second week in February, only to recover and generate a total return of +1.4% in the quarter.
- While several foreign central banks are experimenting with negative interest rates, the Fed appears poised to raise interest rates two more times in 2016 supported by an unemployment rate of less than 5%, job creation of 200,000 per month, and core inflation running ahead of the Fed's 2.0% target.
- With the earnings growth headwinds of lower oil prices and a strengthening dollar expected to ease, we believe the S&P 500 is on track to return to +5-7% EPS growth in 2016, which when added to a dividend yield of 2% should provide for potential stock returns of around +7-9% for the year.

A Turbulent Start to the Year

It was a turbulent start to the year for stocks with the S&P 500 falling by -10.5% through the second week in February, only to recover and finish the quarter with a total return of +1.4%. The market was resilient despite ongoing fears around falling oil prices, a stronger dollar, slowing growth in China, and continued terrorist activity. Following two years of significant underperformance, emerging market (MSCI EM) stocks outperformed the S&P 500 to start the year with a total return of +5.7% in the quarter. However, small capitalization (Russell 2000) and foreign (EAFE) stocks continued to underperform with total returns of -1.5% and -3.0%, respectively.

Bond yields declined sharply in the quarter, with the yield on the 10-year U.S. Treasury dropping to 1.77% from 2.27% at the start of the year. This was largely due to the adoption of negative interest rates by several foreign central banks, making relatively higher domestic yields more attractive to foreign investors. These declining yields drove returns for the Citi Broad Bond Index to +3.0% for quarter.

The Negative Interest Rate Experiment

Central banks in the Eurozone, Denmark, Japan, Sweden and Switzerland have all lowered their equivalent Fed Funds rates to below zero. Negative interest rate policies (NIRP) are intended to stimulate their economies by weakening their currencies and encouraging commercial banks to increase lending instead of sitting on central bank deposits at negative yields. However, the outcome of this experiment remains highly uncertain. Our belief is that unnaturally low interested rates have the tendency to generate negative consequences and that forcing banks to lend by charging them for deposits has the potential to create an even bigger problem. Ultimately, we don't believe that the issues facing these countries are due to interest rates that are not low enough, but instead they are caused by a variety of issues ranging from over regulation, excessive labor laws, too much taxation, and social and demographic issues. Until these issues are addressed these economies will likely continue to struggle.

Given the uncertain outcome of the NIRP experiment, we believe the Fed should avoid following these foreign central banks and focus on what is appropriate for the U.S. economy. With the unemployment rate at 5.0%, job creation running strong at over 200,000/month, and core inflation above the Fed's 2.0% target, the U.S. economy remains too strong to maintain an emergency level interest rate policy. Therefore, we continue to believe that the next move by the Fed will be to cautiously move interest rates higher, likely increasing rates two more times before the end of the year. While interest rates will be rising slowly, they are rising off of a very low base and should remain stimulative to economic growth for at least the next few years.

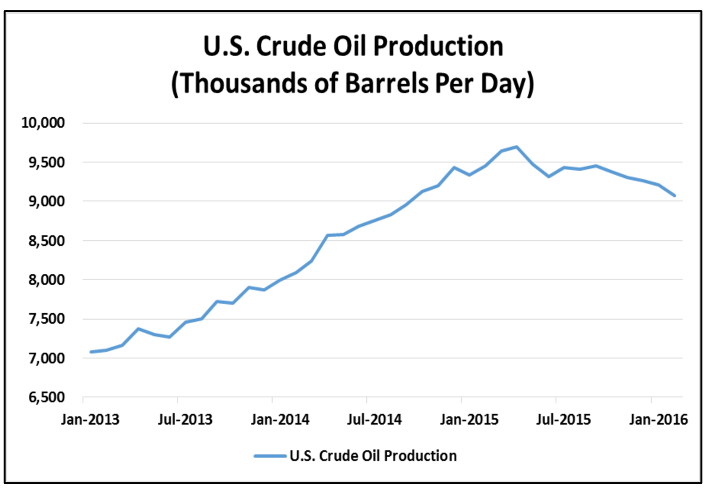
With the Fed expected to continue to raise short-term interest rates, we continue to believe that interest rates will rise across all maturities. However, considering the comparatively high U.S. bond yields relative to other developed countries, there is the potential for a modest flattening of the yield curve. Therefore, we believe it remains prudent to maintain bond portfolio durations relatively shorter than the benchmark.

Low Oil Prices and Strong Dollar Keeping Inflation in Check

The Fed's cautious approach to raising interest rates has been aided by declining oil prices and a strong dollar which have helped to keep inflation in check. Low oil prices have reduced the cost of transportation for both consumers and businesses, while the strengthening dollar has reduced the cost of imports. In fact, while headline inflation was up just +1.0% from the prior year in February, core inflation, which excludes food and energy was up +2.3%, already ahead of the Fed's 2.0% inflation target.

Over the past two years, oil prices have declined sharply as rapid growth in U.S. oil production has driven the market into an oversupplied state. U.S. production has already fallen from its peak of 9.7 million barrels per day (MM bbl/d) in April of 2015 to 9.1 MM bbl/d in February (see Graph 1). These declines are likely to continue as many U.S. oil producers have announced sharp pullbacks in their drilling budgets for 2016, following already steep reductions in 2015. Production declines combined with ongoing global demand growth should balance the oil market in the second half of the year and push oil prices modestly higher. Higher oil prices should stimulate the oil industry, lift S&P 500 earnings growth, and apply upward pressure on inflation.

Graph 1. U.S. Oil Production Starting to Decline



Additionally, the dollar appears to be stabilizing after strengthening over the past 24 months in which it has appreciated by nearly +20% against a broad basket of global currencies (see Graph 2). As we anniversary the impact of this strengthening, the deflationary impact of the stronger dollar on import prices will ease, reducing the downward pressure on overall inflation.

Graph 2. The U.S. Dollar Beginning to Stabilize

China's Slowdown

While the Fed is keeping an eye on inflation, it is also monitoring the global economic environment, particularly China, for signs of weakness that could impact the U.S. economy. GDP growth in China has been slowing since 2010 and many believe that actual growth over the next five years will be below the government's target of 6.5%. While a slowdown in growth is to be expected as the country becomes larger, we believe the fears around China's economic growth are overdone. With the country continuing to work through a multi-decade transition from a infrastructure and export based economy into a consumer driven economy, there are going to be bumps in the road that temporarily slow economic growth. However, we believe that China's rapidly growing consumer class will help it continue to grow through this transition and that ultimately it will be positive for their economy over the long term.

Underlying Earnings Growth Remains Solid

With all of the concerns about slowing growth in China, the Fed raising interest rates, and several foreign central banks resorting to negative interest rates, what appears to be lost on investors is the ongoing strength in U.S. corporate profits. On the surface, with the S&P 500 EPS growth mostly flat through 2015, this underlying strength may not appear so obvious. However, when you exclude the energy segment, which suffered from sharp oil price declines, and the impact of the significantly stronger dollar on foreign profits, underlying corporate profit growth was fairly solid in 2015. With these headwinds expected to ease throughout 2016, we believe the S&P 500 is on track to return to +5-7% EPS growth in 2016, which should provide for potential stock returns of around +7-9% for the year when including dividends. We continue to believe that our philosophy of investing in high quality, consistent growth companies will provide our clients with strong returns over the long term.