NORTH STAR
ASSET MANAGEMENT, INC.

July 2016

INVESTMENT UPDATE

Executive Summary

- The surprise non-binding vote by the British to exit the European Union shocked global stock markets, sending the S&P 500 down by -5.3% in the two days that immediately followed. International equity markets fell even further on the uncertainty of what impact the “Brexit” could have on the global economy. Markets quickly recovered most of the losses as investors realized nothing between the EU and the U.K. changed overnight and that the prospects for longer-term growth in the U.K. may have improved as a result.

- Despite the pessimism in the market, the investment environment for stocks remains attractive as U.S. economic growth continues at a modest pace, corporate profits are poised to return to growth, and historically low interest rates make alternative investment options relatively less attractive.

Keep Calm and Stay the Course

The surprise non-binding vote by the British to exit the European Union shocked global stock markets, sending the S&P 500 down by -5.3% in the two days that immediately followed. International equity markets fell even further (Germany’s DAX fell -8.7% in one day, Japan’s Nikkei 225 fell -7.6%, and the French CAC 40 fell -7.5%) on the uncertainty of what impact the “Brexit” could have on the global economy. If you turned on the news over those two days, you would have seen the media interviewing anyone who was willing to stoke the fears and tell you the world was ending, or at least that the bull market in stocks was over. When barraged with all of this pessimism, it is easy for investors to get scared and want to sell stocks. However, it is in times like these that investors can learn from the popular slogan of the British people, “keep calm and carry on.” For investors, this means stay the course and avoid making any rash decisions. It is in anticipation of difficult markets that we as investment advisors focus so much on working with our clients to select an appropriate long-term asset allocation to ensure that they can handle market turbulence and avoid irrationally selling stocks when they fall, only to miss out on the recovery and subsequent long-term gains that follow. Investors who reacted irrationally and sold stocks after they fell on the Brexit vote ended up missing out on the +4.9% recovery that occurred in the three days that followed the initial sell off.

Fundamentally, the Brexit vote did introduce a significant amount of uncertainty into the global market, especially pertaining to the ability of the world’s fifth largest economy (the U.K.) and arguably the financial capital of the world (London) to trade with the remaining 27 countries that make up the EU. However, nothing regarding the relationship between the U.K. and the EU changed overnight. The vote was non-binding, meaning the British Parliament still needs to approve the vote and formally inform the EU that it plans to leave. It is only after this takes place that a 2 year clock starts, during which the U.K. can begin to negotiate the terms of its separation and the trade agreements that follow. Until this 2 year clock runs out or new trade agreements are made, nothing changes.

Over the near-term, there may be some pain for the U.K. as businesses pause investment spending and hiring while they digest the potential impact of Brexit on their operations. However, longer-term we believe that the U.K will prosper as freedom from restrictive trade agreements and regulations forced upon them by EU bureaucrats (ranging from requirements to pay welfare benefits to immigrants to restrictions on the use of teapots and toasters) will allow it to compete better on a global scale.

Still, the panic selling that ensued in the two days that followed the vote and the rapid recovery in stocks in the final three days of the quarter are a good demonstration that investors must stick to their long-term strategy and avoid acting on fear. This will be crucial to remember over the remainder of this year as the ongoing presidential election cycle and the Fed's interest rate policy decisions will likely introduce additional bouts of volatility into the market in the months ahead.

Fed to Pause Rate Hikes

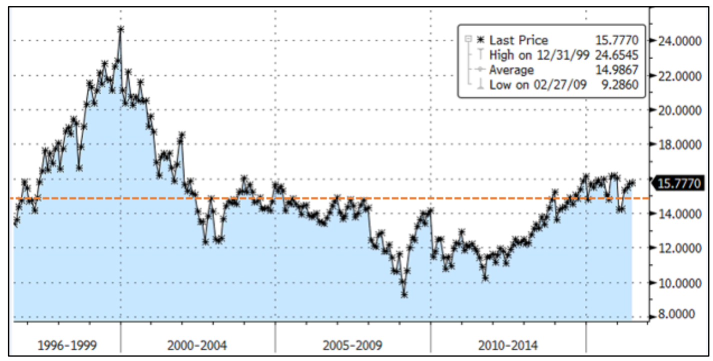
The heightened fear from the Brexit vote pushed investors towards lower risk assets driving further declines of already historically low interest rates around the globe. In the U.S. the 10 year U.S. Treasury bond yield reached record lows, which when adjusted for inflation is providing investors with a negative real yield (see Graph 1), while yields on 10 year bonds in Japan, Germany and Switzerland are now negative on a nominal basis. We believe these rates are too low to be sustainable and that rates need to move higher. Therefore, while we believe the Fed is now likely to be even more cautious and delay the next rate hike until later this year, we still believe interest rates are heading higher over the next several years and recommend clients maintain defensive bond portfolios with a shorter than average duration.

Graph 1. Real 10-Yr. U.S. Treasury Bond Yield Turns Negative

There is Plenty to be Optimistic About

Despite the ongoing pessimism towards the economy, the stock market, and political environment, what is largely forgotten is that there is still plenty for investors to be optimistic about. Economic growth in the U.S. continues at a modest pace, job openings remain at all-time highs, and wage growth is starting to modestly improve. Additionally, corporate earnings are poised to return to growth in the second half of 2016 after declining last year on falling oil prices and a significantly stronger dollar. With oil prices appearing to have bottomed, the U.S. dollar headwind weakening, and nominal GDP growth (the key driver of corporate revenue growth) remaining in the 3-4% range, corporations should be able to return to more normal levels of profit growth later this year. Combined with a lack of attractive alternative investment options given extremely low interest rates on bonds, this creates an attractive investment environment for stocks, despite trading slightly above the historical average price/earnings multiple (see Graph 2).

Graph 2. Stocks Slightly Above Historical Average P/E Valuation



Bifurcated Market Producing Reasonable Returns Halfway through the Year

The historically low interest rate environment has created a bifurcated market in stocks as investors search for income producing assets outside of the traditional bond market, driving up valuations for blue chip and high dividend paying stocks, while valuations on many low to no dividend paying stocks remain relatively low. We believe this creates an attractive opportunity for long-term investors and that our approach of buying high quality consistent growth stocks at reasonable prices will generate strong returns for our clients over time. The bifurcation in the market is evident in the returns for the various indexes for the year, with large capitalization stocks (S&P 500) generating a total return of +3.8% so far this year, while small capitalization stocks (Russell 2000) and foreign stocks (EAFE) are lagging with returns of +2.2% and -4.4%, respectively. Emerging market stocks (MSCI EM) have managed to outperform the S&P 500 so far this year with a total return of +6.5% aided by a recovery in commodity prices. Lastly, bonds have generated strong returns through the first six months of the year with the CITI BIG Index generating a +5.4% return as Brexit fears drove investors into less risky assets.

In accordance with SEC Rule 204-3(b), our Form ADV is available upon request. Please call or write to Susan C. Beaver, North Star Asset Management, Inc. 59 Racine St., Suite A, Menasha, WI 54952.