NORTH STAR ASSET MANAGEMENT, INC.

January 2017

INVESTMENT UPDATE

Executive Summary

- Investor optimism surrounding impending pro-business policy changes expected under a Donald Trump administration drove markets higher after the election.
- These policies have the potential to accelerate the pace of growth of the U.S. economy to a healthier rate and to provide a significant improvement to corporate profits.
- After having raised the Fed funds rate in December, for the first time in 12 months, the Fed is projecting three rate hikes for 2017, a gradual pace that will continue to support economic growth for the next several years.
- 2016 began with the worst two-week start for U.S. stocks in history, but ended the year with strong returns. Low interest rates, reasonable stock valuations, and a return to growth for corporate profits position stocks for another solid year of returns in 2017 with potential upside from fiscal policy changes.

Pro – Business Policies to Accelerate Growth

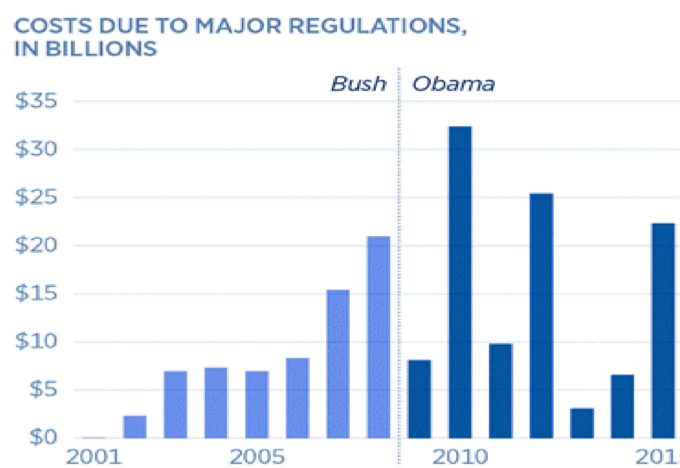
Investor optimism surrounding impending pro-business policy changes that are expected under a Donald Trump administration have moved both bond yields and the stock market higher since the November 8th election. Investors believe that these policies have the potential to accelerate the rate of growth of the U.S. economy, increase inflation, and help corporations generate greater profits. Trump's plan calls for cutting corporate and individual income taxes, allowing businesses to bring some of the $2.6 trillion in cash that is trapped overseas back to the U.S. at a significantly lower tax rate, increasing infrastructure spending, and reducing the regulatory burden on businesses.

Economists are hard at work trying to determine how much of a boost Trump's policies, if enacted, will provide to U.S. economic growth. Many are raising their estimates for 2017 by around +0.5%, mostly attributed to proposed tax cuts. This would return the rate of GDP growth back to a healthier range of +2.5-3.0% following the below average annual rate of around +2.0% experienced since 2009.

Meanwhile, stock market analysts are trying to determine the impact these policies will have on corporate profit growth. Trump's proposal to cut corporate tax rates to 15% alone could significantly increase corporate earnings. According to S&P Global Market Intelligence, the average effective tax rate for all companies in the S&P 500 is around 29%. If Trump is successful at reducing the effective corporate tax rate to his 15% target and is able to make it retroactive to the start of 2017, this would provide an immediate increase in earnings for the S&P 500 of greater than +10%, more than justifying the S&P 500's +5.0% move since the election. Put another way, the earnings multiple on the S&P 500 is slightly above the historical average range right now at 17.0x the current 2017 consensus estimated earnings, but could drop to a more reasonable 15.5x if Trump is able to get his tax cuts passed.

Ultimately, the impact to GDP growth and corporate profit growth may be greater than these quantitative measures can predict. The psychological impact of these pro-business policies and relief from the heavy regulatory burden (see Graph 1) implemented over the past decade by an ever-growing government could ignite the animal spirits in consumers, entrepreneurs, and CEOs, inspiring them to reallocate resources away from unproductive cash assets into more productive assets in the form of increased investment, capital expenditures and new business development.

Graph 1. Cost of New Major Government Regulations



Source: U.S. Government Accountability Office and the Heritage Foundation

These psychological impacts may already be starting to take place, even before Trump takes office on January 20th. Consumer confidence, as measured by the Conference

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Board, has increased by +12.8% since Trump won the election, reaching its highest readings since August 2001. With consumer net worth at an all-time high, debt ratios at 15 year lows, and hourly wage growth starting to improve, this increase in consumer confidence could spark faster consumer spending and help to accelerate overall economic growth.

Additionally, small business sentiment, as measured by the National Federation of Independent Business, recorded its third best reading since 2007 in December. This is important as small businesses (fewer than 500 employees) make up nearly half of total jobs in the U.S. and account for almost two-thirds of all new jobs created. An improvement in the confidence of small business owners could result in an increase in capital investment which has been historically low throughout the current economic recovery. Increased capital investment could jump start the virtuous cycle of economic growth, as it can lead to the creation of more jobs and higher wages, which increases consumers demand for goods, which leads businesses to invest more capital, bringing the cycle full circle. The result should be a sustainably faster growing economy.

While Trump's policies are anticipated to provide a tailwind to economic growth in 2017, there will be some headwinds facing the economy as well. The strong dollar and rising interest rates, both of which have increased significantly since the election, will likely be a modest drag on economic growth for the year as the strong dollar makes goods produced in the U.S. more expensive to foreign buyers and higher interest rates increases the cost of capital needed to make investments. However, we believe these headwinds will largely be offset by continued strong consumer spending and a recovery in investment spending by energy companies aided by higher energy prices.

Trade remains a true wildcard as Trump has left open the possibility of imposing tariffs on imported goods to help U.S. companies better compete with low cost labor and government subsidized competitors in other parts of the world. We do not believe imposing tariffs would be good for the economy, as this would result in the misallocation of capital and ultimately higher prices for consumers. Fortunately, Trump has surrounded himself with economic advisors that are for free trade and want better free trade deals. With the North American Free Trade Agreement (NAFTA) now over 10,000 pages long due to exceptions to free trade, we believe there is a need for better deals and for these agreements to simply state that all trade is free. We are encouraged by his selection of Wilbur Ross for Commerce Secretary, who has clearly stated that there will not be any trade wars.

The Fed Resumes Raising Rates

In December, the Fed raised rates for just the second time in over a decade after first raising rates 12 months earlier. Originally, the Fed had anticipated four rate hikes during 2016, but ultimately completed just one, as weak GDP growth over the first half of the year, low inflation, and worries over slowing growth in China and the Brexit vote kept the Fed from acting until after the election. The Fed is projecting at least three rate hikes for 2017, a plan we believe they are more likely to actually execute this time given the improving pace of economic growth, tightening labor market, and core inflation hoovering around the Fed's 2.0% target. Additionally, if Trump is able to pass his fiscal policies into law, we believe the economy would accelerate its pace of growth, helping to further justify raising rates. Interest rates have already started to climb in anticipation of these additional rate hikes with the 10-year Treasury note rising by +17 basis points since the beginning of the year, including +59 basis points since the election. Nevertheless, we expect the pace of hikes to remain gradual and to continue to support economic growth for the next several years.

Despite a Tough Start, 2016 was a Good Year for U.S. Stocks

2016 began with the worst two-week start for U.S. stocks in history, during which the S&P 500 lost -9.2% of its value, but finished the year with strong returns. Large capitalization stocks (S&P 500) generated a total return of +12.0% for the year, while foreign stocks (EAFE) once again trailed their domestic stock market peers, generating a return of just +1.0% as the strong dollar negatively impacted returns by around -5.2%. Emerging market stocks (MSCI EM) performed well, generating a total return of +11.3%, while small capitalization stocks (Russell 2000), after significantly trailing the S&P 500 for the past two years, outperformed the S&P 500 for the year with a total return of +21.3%. Lastly, bond returns (Citi Broad Bond Index) were modest at +2.7% as rising interest rates following the presidential election caused bond prices to give up much of their previous gains. While we expect continued periods of volatility throughout the year, 2017 looks to be positioned for solid stock market returns as interest rates remain low, stock valuations remain reasonable, and corporate profits are poised to return to year-over-year growth, with upside coming from potential fiscal policy changes. Therefore, we recommend clients maintain equity ratios in the middle of their targeted range.