NORTH STAR ASSET MANAGEMENT, INC.

July 2017

INVESTMENT UPDATE

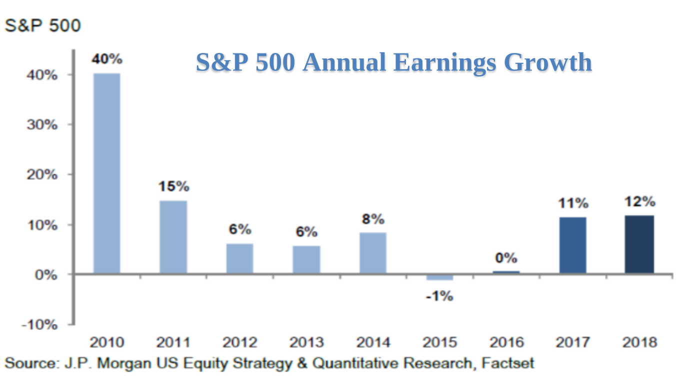
Executive Summary

- Improving economic fundamentals are poised to drive modestly accelerating economic growth over the next year.
- Stocks generated strong returns through the first half of the year as improving economic fundamentals and strong corporate earnings growth expectations continue to support higher stock prices over the next 12-24 months.
- With three rate hikes in the past six months, the Fed appears to have gained confidence in the underlying strength of the economy. Despite expectations for continued gradual hikes, Federal Reserve policy should remain stimulative to economic growth for several years.

Improving Fundamentals to Drive Modestly Accelerating Economic Growth

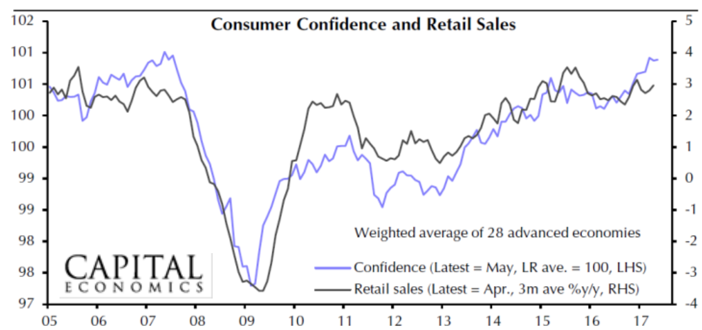
After a year of relatively slow growth, underlying economic fundamentals have improved and are pointing to a modest acceleration in economic growth over the next year aided by increased consumer spending, a strong rebound in business investment, and improving exports. This improvement in economic growth can be seen in the renewed growth of corporate profits, the lifeblood of the stock market, with double digit growth expected in 2017 and 2018 (see Graph 1).

Graph 1. Strong S&P 500 Earnings Growth Expected



Consumers are in great financial shape, with household debt relative to assets at the lowest level in over 15 years, debt service payments at the lowest level in over 35 years, and hourly wage growth poised to accelerate with the continued tightening of the labor market. What has been missing throughout most of the economic recovery has been strong consumer confidence. Since the Presidential election last November, consumer confidence has improved (see Graph 2) to levels not seen since before the recession on the back of low gas prices, record-high stock indices, and continued strength in the job market. This boost in consumer confidence, combined with already healthy balance sheets and growing incomes should encourage increased spending and accelerated economic growth. In fact, this is already starting to occur with retail sales over the past three months, excluding volatile auto sales, growing at a +5% annualized pace through May, up from +2% a year ago.

Graph 2. Improving Consumer Confidence Should Drive an Increase in Retail Sales



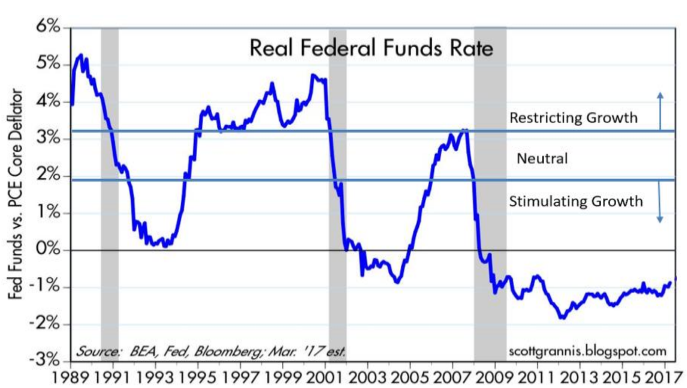
Businesses have also experienced a return of confidence since the election, aided by the new administration's more business friendly stance on taxation and regulation, as well as a more favorable global economic environment. This confidence is starting to show up in businesses investment. After declining by -0.5% last year, business investment grew at an +11.4% annualized rate in the first quarter of 2017. Even though approximately half of this strength was due to a surge in oil drilling related to the recovery in oil prices compared to the first quarter of 2016, growth outside of oil drilling was also strong. While we don't expect oil drilling to remain as big of a driver for business investment during the remainder of the year, the recent strength in business confidence, strong new orders for manufactured goods, and the need for productivity improvements should continue to support an increase in business investment over the next year.

Exports are also expected to turn into a positive tailwind to economic growth this year, benefitting from a stabilizing dollar and an improving global economic environment. The U.S. dollar has acted as a headwind to U.S. exports and economic growth, having appreciated by over +20% relative to a basket of foreign currencies throughout 2014 and 2015. However, it has recently started to stabilize, and in fact has declined by around -7% since the beginning of the year. This should allow U.S. manufacturers to better compete on a global scale, driving an improvement in U.S. exports. Exports have also been negatively impacted by slower global economic growth, particularly in Europe, where GDP growth has averaged less than +0.5% over the past eight years, compared to around +2% in the U.S. The European economy is starting to show signs of life as demonstrated by the Markit Manufacturing PMI index (a measure of the economic health of the manufacturing sector) recently hitting a six year high. If this strength translates into better economic growth for Europe, it should provide support for better U.S. exports in the near future.

Federal Reserve Policy Continues to Support Faster Economic Growth

The Fed, having raised rates three times in the past six months, appears to have gained confidence in the underlying strength of the economy and is starting to be more concerned about the long-term potential for higher inflation as a result of its highly accommodative stance over the past nine years. Some economists fear that the Fed raising interest rates will act as an offset to the improving economic fundamentals. However, with the real Federal Funds rate still negative, we believe that Fed policy continues to be quite stimulative to economic growth (see Graph 3). If the Fed stays the course with its gradual pace of rate increases it will take several years before rates reach a level that has historically been considered neutral to economic growth, let alone restrictive.

Graph 3. Real Fed Funds Rate is a Long Way from Neutral and Supports Faster Economic Growth



We believe a key fundamental risk to the economy and the stock market is if the Fed fails to continue to gradually raise interest rates, as this could allow inflation to begin to accelerate, forcing the Fed to eventually raise interest rates too quickly, causing a slowdown in economic growth.

Fiscal Policy Changes Could Provide an Additional Boost to the Economy

While the economy is poised to accelerate on its own, the potential exists for even better growth if some of the new administration's pro-business policies intended to reduce the regulatory and tax burden on consumers and businesses would be enacted. While many of the pro-growth policies have been stalled by the political theatre in Washington, the pro-business rhetoric is showing up in improving consumer and business confidence which is helping economic growth.

A Strong Start to the Year for Stocks

The S&P 500 has started the year off strong with a total return of +9.3% through the first six months, largely driven by continued modest economic growth, strong corporate profit growth, and prospects for business friendly policy changes from the new administration. Small capitalization stocks (Russell 2000) have trailed the large capitalization S&P 500 so far this year, with a total return of +5.0%, while foreign stocks (EAFE) have outperformed with returns of +13.8%. Bond returns have totaled +2.3%, benefiting from a flattening of the yield curve since the start of the year.

The recent strength in the stock market has pushed the S&P 500 P/E ratio to 17.5x forward earnings, above the historical average of around 16x. The above average P/E ratio may be a sign that the market is starting to become too optimistic and that future returns may be more muted. Therefore, we recommend clients rebalance their portfolios back towards their equity targets. We do not believe it is time to reduce overall equity targets as the improving underlying economic fundamentals and growing corporate profits continue to support higher stock prices over the next 12-24 months. With equity valuations at above average levels, we anticipate some turbulence in stocks throughout the remainder of the year. However, we continue to believe investing in high quality consistent growth stocks at a reasonable price will help our client achieve strong returns over the long term.

With the Fed pushing short-term rates higher and consumers ultimately demanding a greater real rate of return on their fixed income investments, we anticipate interest rates moving higher across all maturities and therefore continue to recommend a defensive bond portfolio with shorter than market average durations.