January 2018

INVESTMENT UPDATE

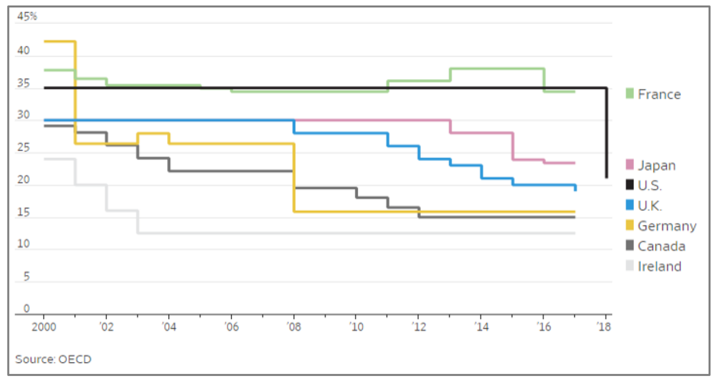
Executive Summary

- 2017 was a transitional year for the U.S. economy as GDP growth began to accelerate on the back of pro-growth policy changes and an improving global macroeconomic environment.
- Changes instituted over the past 12 months, including reducing burdensome regulations and the passage of the Tax Cuts and Jobs Act, should set the foundation for faster economic growth in the years ahead.
- The Tax Cuts and Jobs Act's primary purpose is to increase the incentive for corporations to invest and to make the U.S. more competitive on a global basis, which should lead to the creation of more jobs, increased incomes over time, and faster economic growth.
- While the Federal Reserve is expected to continue its gradual pace of rate hikes in 2018, monetary policy should remain stimulative to economic growth for the next 1-2 years, or longer, before finally becoming neutral to economic growth.
- We believe the passage of the Tax Cuts and Jobs Act reduced a significant portion of the downside risk to the stock market and should return stock valuations closer to the historical average as analysts' raise forward earnings expectations to factor in lower tax rates.

U.S. Economy is Improving

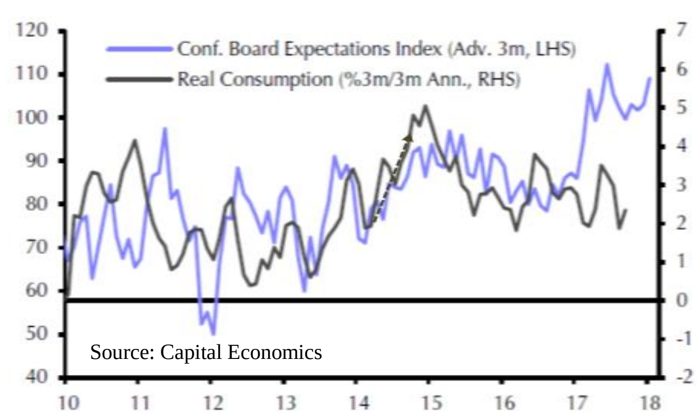
While 2017 was a great year for the stock market, with the S&P 500 generating a total return of +21.8%, it was also a transitional year for the U.S. economy as GDP growth began to accelerate on the back of pro-growth policy changes and an improving global macroeconomic environment. Over the past 12 months, the new administration instituted many changes focused on encouraging stronger economic growth, including significantly reducing burdensome regulations and the passage of the Tax Cuts and Jobs Act. These changes should set the foundation for faster, but more normal, economic growth in the years ahead, primarily through increasing the incentive for businesses to take risk and invest for growth. For example, reducing the statutory corporate tax rate from 35% to 21% and allowing the immediate expensing of capital investment significantly increases the after-tax return on investment for businesses. This should encourage increased corporate investment, leading to improved productivity, the creation of more jobs and higher incomes over time. Additionally, the lower corporate tax rate places the U.S. much closer to other developed countries (see Graph 1), helping U.S. corporations to better compete with the rest of the world. This should result in faster economic growth as investing and operating in the U.S. has just become much more attractive.

Graph 1. U.S. Corporate Tax Rate is Now More Competitive



Though the Tax Cuts and Jobs Act was primarily targeted at reducing taxes for corporations to encourage job creation, the vast majority of consumers should benefit from reduced individual tax rates as well. With job openings remaining strong and unemployment at its lowest level in 17 years (4.1%), hourly wages should start to increase at a faster pace than the 2.0-2.5% rate we have experienced throughout most of the current economic recovery. Faster wage increases, combined with consumers being able to keep more of their wages, should continue to support the recent strength in consumer confidence (see Graph 2) and encourage increased spending and faster economic growth.

Graph 2. Consumer Confidence is High, Spending Should Follow



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Economic growth should also continue to be supported by low, although steadily rising interest rates. While the Federal Reserve continues to gradually raise the Fed Funds interest rate and is likely to raise it 3-4 additional times throughout the year, monetary policy should remain stimulative for the next 1-2 years, if not longer, before rates finally become neutral to economic growth. We continue to believe that in the near-term, higher interest rates will help restore economic balance and boost economic growth, as low rates have started to punish savers more than debtors are benefiting. The key will be for the Fed to continue to raise rates gradually to keep inflation under control and avoid needing to raise interest rates too quickly which would have a negative impact on the pace of economic growth.

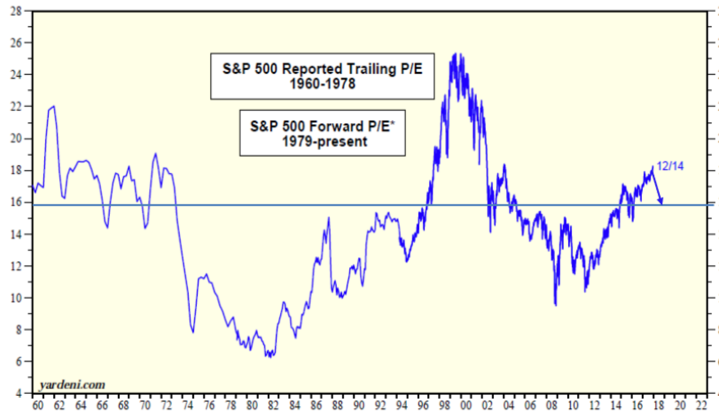
Expect a more Typical Year for Stock Returns in 2018

We expect the bull market in stocks to continue in 2018 as improving global economic growth, low inflation, corporate tax cuts, and a large repatriation of overseas cash should all support higher stock prices. While much of the rally in the stock market since the presidential election likely has been due to improving economic fundamentals and a return of corporate profit growth, with the price-to-earnings ratio on stocks rising from the long-term historical average of around 16x to over 18x, there is little doubt that the market was also anticipating a reduction in corporate tax rates.

We believe the passage of the Tax Cuts and Jobs Act reduced a significant portion of the downside risk to the stock market and should return stock valuations closer to the historical average as forward earnings estimates should rise as analysts' factor lower tax rates into their estimates (See Graph 3). With consensus earnings estimates for the S&P 500 calling for +11% growth in 2018 prior to the passage of tax reform, and with valuations moving more in-line with historical levels following the reform's passage, we expect stocks to generate a more typical year of returns in the high single to low double-digit range for the year. However, we also expect stock market volatility to return to a more typical level after a historically low volatility year in 2017, which saw just the second lowest intra-year decline since 1928 at just -2.8%.

While corrections, defined as a pullback in the market of -10% or more, occur once every 12 months on average, we have now gone two years without a -10% decline, and nearly two years without a decline of even -5%. While we believe stocks are positioned for another year of solid returns, we recommend investors proceed with a bit of caution and continue using the current strength in the market to rebalance equity ratios back towards the middle of one's targeted range. However, over the long term, we continue to believe that investing in high quality consistent growth stocks at reasonable prices is the best way to build capital.

Graph 3. Corporate Tax Cuts to Drive Stock Valuations Towards Historical Average



Yield Curve Expected to Steepen in 2018

Throughout 2017, the yield curve flattened significantly, as yields on bonds with short maturities moved higher with the Fed's rate hikes, while longer maturity bond yields remained stubbornly low. However, we expect yields on all maturities to begin to increase in 2018 and for the yield curve to begin to steepen, aided by continued Fed rate hikes, accelerating economic growth, rising inflation, and bond investors ultimately demanding a greater real rate of return on their longer maturity bonds. Therefore, we continue to recommend clients maintain defensive bond portfolios with shorter than market average durations.

Large Capitalization Stocks Led the Way in 2017

The bull market in stocks continued throughout 2017, with large capitalization stocks (S&P 500) generating an impressive total return of +21.8%, while mid (S&P MidCap 400) and small capitalization stocks (Russell 2000) likewise generated solid returns, though lagged their large capitalization peers at +16.4% and +14.7%, respectively. Foreign stocks (MSCI EAFE) outperformed domestics stocks for the year with a return of +25.0%. Lastly, bonds (Citi Broad Bond Index) generated a return of +3.6% as the yield curve flattened during the year.

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.