NORTH STAR
ASSET MANAGEMENT, INC.

April 2018

INVESTMENT UPDATE

Executive Summary

- After a historically calm year for the stock market in 2017, volatility returned in the first quarter sparked by uncertainty around inflation, interest rates, and trade. Despite the volatility, stocks declined only modestly, with the S&P 500 down just -0.8% for the quarter.
- Economic fundamentals remain strong as GDP growth has accelerated from the +2.2% average pace of the past 9 years to an average of just over +3% in the last 3 quarters of 2017 on strong consumer spending, improving business investment, and strong global economic growth. These fundamentals should continue to support faster economic growth in the near-term.
- While President Trump's recent protectionist talk and new tariffs are worrisome, it appears to be a way to force other countries to open their markets to U.S. goods and services. We currently believe the risk of an all-out trade war is low.
- New Fed Chairman Jerome Powell is likely to continue the gradual pace of Fed Funds rate increases. However, the real Fed Funds rate remains low and should continue to stimulate economic growth for at least 2 more years.
- Due largely to rising earnings estimates, stock market valuations have gone from somewhat overvalued at the beginning of the year to attractively priced for long-term investors.

Volatility Returns

After a historically calm year for the stock market in 2017, volatility returned in the first quarter of 2018 with more 1% or greater daily moves in the first three months of 2018 than all of 2017 combined (see Chart 1). Stocks started the year with the S&P 500 increasing over +7% in January on continued momentum from the passage of the Tax Cuts and Jobs Act. Those gains were quickly forfeited in February as the market experienced its first 10% pullback in almost two years, triggered first by inflationary concerns around stronger than expected wage inflation within the January jobs report and followed up by trade war concerns resulting from President Trump's proposed steel and aluminum tariffs. Despite this volatility, the S&P 500 ended the quarter with only a modest decline of -0.8%, its first negative quarter since the third quarter of 2015. Small capitalization (Russell 2000) and foreign (MSCI EFEA) stocks also experienced similar declines for the quarter, with total returns of -0.1% and -1.5%, respectively. Bond yields moved higher in the quarter on higher expectations for economic growth and inflation, resulting in bonds (Citi Broad Bond Index) generating a negative return of -1.5% in the quarter.

Chart 1. More 1% or Greater Moves in the 1st Qtr. than all of 2017

Daily Market Moves

	# of Trading Days		
Year	>1%	>2%	All-Time Highs
2009	117	55	0
2010	76	22	0
2011	96	35	0
2012	50	6	0
2013	38	4	45
2014	38	6	53
2015	72	10	10
2016	48	9	18
2017	8	0	62
2018	22	6	14
Long-Term Avg	**67**	**18**	**16**

Note: S&P 500 returns; Long-Term Avg based on 2009-2016
Source: Standard & Poor's, Haver Analytics®, Credit Suisse

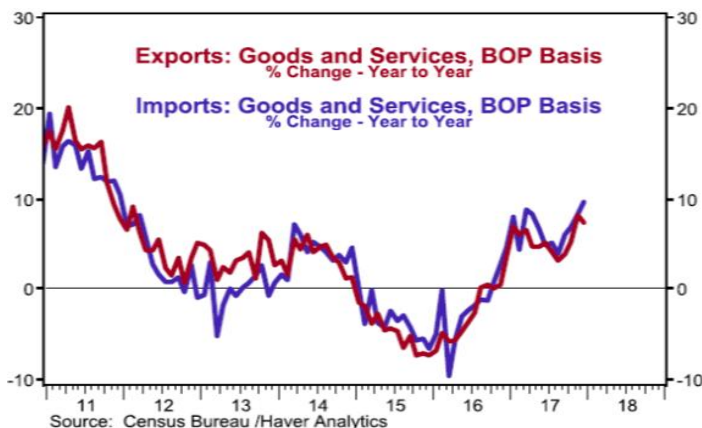
Fundamentals Continue to Support Higher Stock Prices

While volatility has returned to the stock market, fundamentals should continue to provide support for higher stock prices. Economic fundamentals are particularly strong, helping to accelerate the pace of economic growth from a modest pace that averaged 2.2% throughout most of the economic expansion of the past 9 years, to a faster, but more normal, pace that has averaged just over 3% during the last three quarters of 2017. This faster economic growth has largely been driven by strong consumer spending, a recovery in business investment, and improving global economic growth. With household net worth at record levels, debt relative to assets at the lowest level since 1998, a tight labor market poised to drive hourly wages higher, and consumer confidence at its highest level since 2001, the consumer is well positioned to increase spending and support faster economic growth. Additionally, business investment should continue to improve as corporate tax reform and rising capacity utilization provides business owners an added incentive to invest in their businesses. These investments should lead to faster economic growth through improved productivity, the creation of more jobs, and increased incomes over time.

A Rising Tide Lifts All Boats

In addition to strong economic fundamentals in the U.S., global economic growth has also improved, as demonstrated by accelerating growth in both imports and exports (see Graph 1), and should continue to support faster economic growth domestically, as a rising tide lifts all boats. However, President Trump's recent protectionist rhetoric and new tariffs on steel and aluminum are worrisome as they have the potential to evolve into a trade war, which would slow global economic growth. For now, this appears to be a heavy-handed way to force other countries to open their markets to U.S. goods and services. We view the likelihood of these trade negotiations turning into an all-out trade war as low, since all parties involved have much to lose as tariffs are just a tax on each countries consumers. Furthermore, if Trump is successful, the end result could actually provide for better trade agreements for the U.S. and act as a tailwind to economic growth.

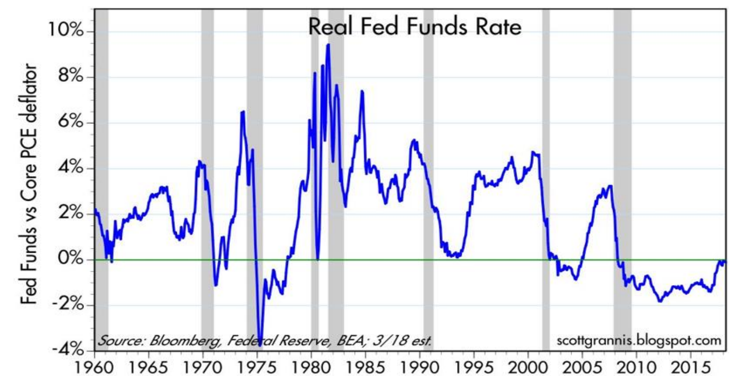
Graph 1. Both Imports and Exports Accelerated in the Past Year



Monetary Policy to Remain Expansionary Under New Federal Reserve Chairman

While many investors worry that monetary policy is about to become restrictive to economic growth, we believe the Fed, under new Fed Chairman Jerome Powell, will continue to normalize interest rates at a gradual pace and that monetary policy will support economic expansion for at least the next couple years. With the real (inflation adjusted) Fed Funds rate currently sitting just below 0% (see Graph 2), it remains below the 2-3% real Fed Funds rate that has historically been considered neutral to economic growth, and well below the 3% real Fed Funds rate that has historically been restrictive to economic growth. Even if the Fed increases the Fed Funds rate by an additional 0.75% this year and 1% next year, the real Fed Funds rate should remain supportive to economic growth. The primary factor that could cause the Fed to accelerate its pace of rate increases would be a sudden increase in inflation to a level substantially above the Fed's targeted inflation rate of 2%. However, inflation currently remains low and under control, though we are seeing signs of building inflationary pressures that are worth monitoring, including a tight labor market that is starting to drive faster hourly wage growth and producer price inflation that is approaching 3%.

Graph 2. While Rising, the Real Fed Funds Rate Remains Low



Rising Earnings Estimates Create Attractive Stock Market Valuations

Despite the increased market volatility, strong corporate profit growth and reasonable valuations should provide support for higher stock prices in 2018. At the end of last quarter, the S&P 500 appeared to be slightly overvalued selling at 18.3x 2018 expected earnings per share (EPS). However, since the passage of the corporate tax reform, EPS estimates for the S&P 500 have increased by approximately 10%, resulting in expectations for nearly +20% growth in 2018. This increase in EPS estimates combined with a slightly down stock market has quickly lower the price-to-earnings ratio on the S&P 500 from 18.3x to 16.3x, which is in-line with historical averages.

When combined with our outlook for strong economic fundamentals and continued expansionary monetary policy, the S&P 500, at 16.3x forward earnings, once again appears attractive for long-term investors. 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 long-term wealth.

For bond investors, we expect bond yields to continue to increase, aided by continued Fed rate hikes, as well as modestly rising inflation, and bond investors ultimately demanding a greater real rate of return on fixed income investments. Therefore, we continue to recommend clients maintain defensive bond portfolios invested in high quality securities with shorter than market average durations.

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.