NORTH STAR
ASSET MANAGEMENT, INC.

October 2018

INVESTMENT UPDATE

Executive Summary

- The U.S. stock market continued its strong performance in the third quarter as strong underlying fundamentals drove S&P 500 returns of +7.7% in the quarter and +10.6% through the first nine months of 2018.
- U.S. economic growth is expected to exceed 3% in 2018 and appears sustainable into 2019, driven largely by long-term benefits from deregulation and permanently reduced corporate tax rates.
- Strong economic growth should continue to drive growth in earnings over the next several years, which along with reasonable stock market valuations, should support higher stock prices over time.
- Slowing growth outside of the U.S. and ongoing trade disputes could lead to increased volatility in the stock market in the near-term.

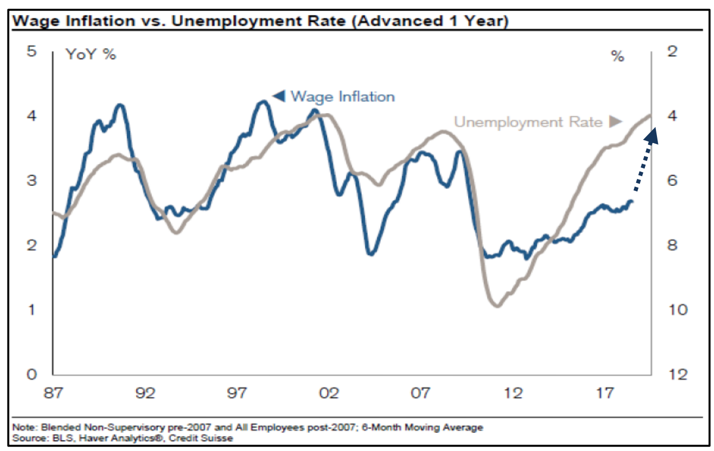
Faster Economic Growth Should Be Sustainable

U.S. GDP growth during the third quarter is likely to have exceeded 4% for the second quarter in a row. Growth for the full year is expected to exceed 3%, which would be the fastest annual rate of growth since 2005. This growth has been aided by deregulation and corporate tax reform, which has spurred increased business investment and strong new job creation by removing barriers to growth for business owners, particularly small business owners.

Small businesses have historically been the growth engine of the U.S. economy, and the lack of a recovery in small businesses was a key reason economic growth had been relatively modest over the past eight years. However, this is changing as small business optimism has improved significantly and is now at a 45-year high. This optimism should encourage increased investment and hiring, and help to sustain 3% economic growth beyond 2018, a significant improvement from the 2.2% average growth over the previous eight years.

In addition to business investment, consumers remain well positioned to drive strong economic growth over the next several years. Throughout the recovery, consumers have been using part of their growing incomes to reduce debt and increase savings. However, with household net worth at record levels and household debt relative to assets at the lowest level since 1985, consumers are in a good financial position to increase spending. Additionally, hourly wage growth is starting to accelerate as a tight labor market, with fewer than one unemployed worker available for each job opening, is starting to force employers to pay more to attract and retain talent. Amazon recently increased its minimum wage to $15 per hour. Others, including Target and Walmart, have increased their minimum hourly wages to $11, with Target committing to raising all worker's wages to $15 per hour by the end of 2020. We expect hourly wages to continue to grow (see Graph 1), which when combined with an 18-year high in consumer confidence, should drive increased consumer spending, helping to sustain faster economic growth.

Graph 1. Tight Labor Market Should Continue to Drive Hourly Wages Higher



Interest Rates are Rising but Remain Accommodative

While rising hourly wages are good for consumers, they can also apply upward pressure on inflation, which after six years of running below 2.0%, is now slightly ahead of the Fed's 2.0% target. In order to stay ahead of the curve on inflation and to give it some capacity to fight off the next recession, we believe the Fed will continue its gradual pace of rate increases at least through 2019. Currently, the Federal Funds rate remains low by historical standards (see Graph 2) and continues to support economic growth.

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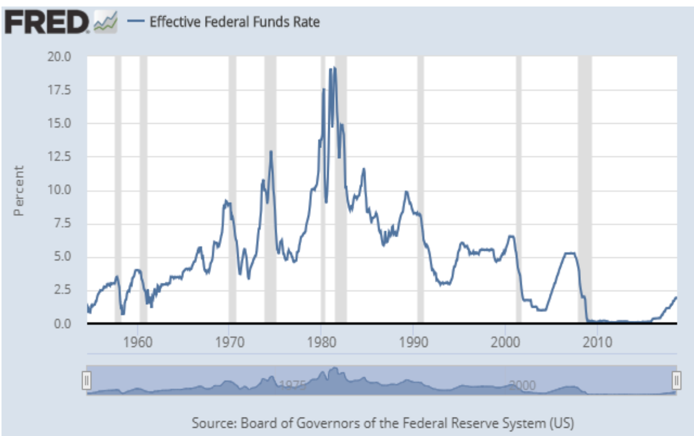
However, if the Fed stays on its current pace, the Fed Funds rate will be approaching a level that would be considered neutral to economic growth within the next 1-2 years. Since Fed policy typically works with a 1-2 year lag, interest rates should continue to support economic growth for at least the next few years before becoming neutral to economic growth, and even longer before rates start to impede growth. The key risk to the economy is if inflation accelerates rapidly and forces the Fed to raise rates faster than they would otherwise like, which has the potential to disrupt economic growth.

Graph 2. Federal Funds Rate Remains Low by Historical Standards

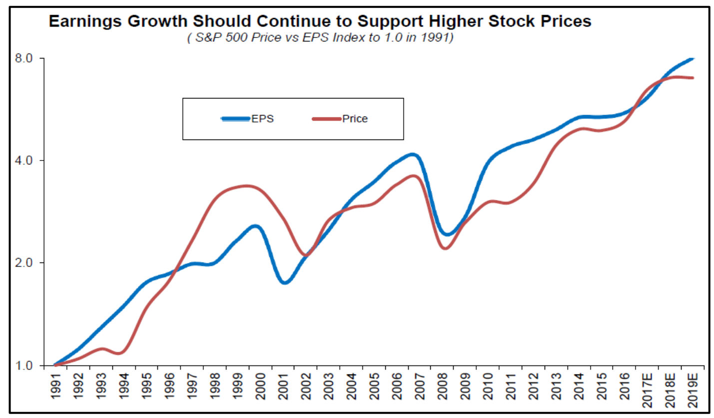


Earnings Growth Driving Domestic Stocks Higher

Both large capitalization (S&P 500) and small capitalization (Russell 2000) U.S. stocks have generated strong returns so far this year (+10.6% and +11.5%, respectively) as the strong economy and rising earnings are driving stock prices higher. Earnings are the lifeblood of the stock market, and while fear can move the market in the short-term, earnings growth is ultimately what will drive the market over the long-term (see Graph 3). For 2018, earnings for the S&P 500 are expected to increase by +23%, which has provided support for rising stock prices so far this year. While nearly half of this growth in earnings can be attributed to a one-time boost from the passage of the Tax Cuts and Jobs Act which permanently lowered corporate tax rates, accelerating revenue growth is also contributing significantly with revenue growing at +8.4%, its fastest rate since 2011. This strong revenue growth is a product of an accelerating U.S. economy, which we believe is sustainable and will help drive earnings growth of around +11% for 2019 as well.

Foreign stock market returns (MSCI EAFE) have fared much worse than their domestic peers with a total return of -1.4% through the first nine months. Fundamentals are the key to understanding the divergence between the two markets, as an improving U.S. economy is driving strong domestic stock market returns, while slowing growth in economies outside of the U.S. is causing their markets to significantly underperform. In addition, we believe the lowering of the U.S. corporate tax rates to a more competitive level with the rest of the world has erased much of the tax advantage that many foreign companies have had, which has contributed to the underperformance of foreign stocks.

Graph 3. Earnings Growth Drives Stocks Higher



Though fundamentals remain strong domestically, slowing growth outside of the U.S. and ongoing trade disputes could lead to increased volatility in the stock market. However, with earnings growth for the S&P 500 in 2019 expected to be around +11%, and its P/E multiple at a reasonable 16.9x forward earnings, we believe stocks should continue to appreciate along with growth in earnings, and that investing in high quality consistent growth companies at reasonable prices is the best way to build wealth for long-term investors.

While the strong economy has been good for stocks, it has not been good for bonds. Bond yields moved higher through the first nine months of the year on expectations for faster economic growth and higher inflation, resulting in bonds (Citi Broad Bond Index) generating a negative return of -1.6% so far this year. We continue to believe that bond yields will move higher across all maturities, aided by continued Fed rate hikes, modestly rising inflation, and bond investors 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.