NORTH STAR ASSET MANAGEMENT, INC.

January 2019

INVESTMENT UPDATE

Executive Summary

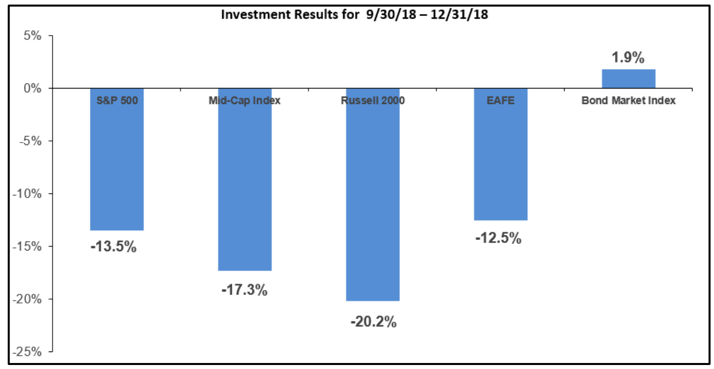
- Despite a strong year for U.S. economic growth (around +3%) and an exceptionally strong year for U.S. corporate profit growth (likely over +20%), large capitalization stocks (S&P 500) generated a negative return of -4.4% for 2018.
- Growing concerns around rising interest rates, global trade disputes, and Federal budget negotiations pushed stocks sharply lower throughout the final three months of the year.
- With the S&P 500 now trading at just 14.3x 2019 EPS expectations, stocks appear to be pricing in a recession, however, none of the factors that normally signal a recession are currently prominent.
- While a slowdown in economic growth is likely in 2019, we believe the economy is poised for continued growth for at least the next couple years.

Stocks Disappoint as Fear Overtakes Fundamentals

Despite a strong year for U.S. economic growth (around +3%) and an exceptionally strong year for U.S. corporate profit growth (likely over +20%), large capitalization stocks (S&P 500) generated a negative return of -4.4% for 2018. Small capitalization domestic stocks (Russell 2000) and foreign stocks (MSCI EAFE) fared even worse, with returns of -11.0% and -13.8%, respectively. Lastly, bond market returns (Citi Broad Bond Index) were flat for the year as rising interest rates pushed bond prices lower, offsetting interest earned for the year.

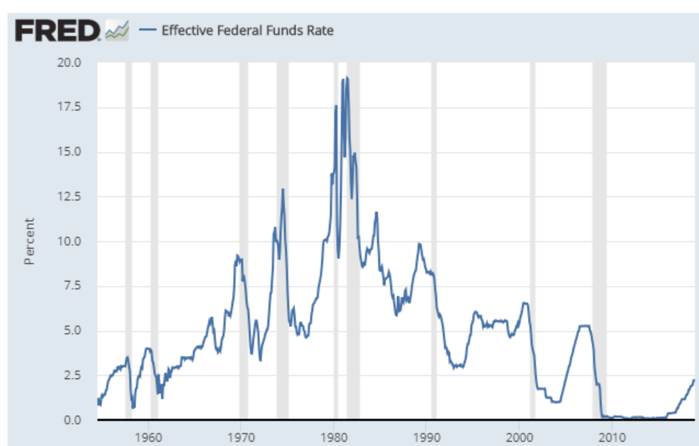
While investor optimism around strong underlying fundamentals were reflected in solid stock market returns through the first nine months of the year, growing concerns around rising interest rates, global trade disputes, and Federal budget negotiations pushed stocks sharply lower throughout the final three months of the year (see Graph 1), including a decline of -9.0% in December, the worst December performance for the S&P 500 since the Great Depression. With these fears having such a profound impact on the stock market, it is worth reviewing them in more detail.

Graph 1. A Difficult 4th Quarter for Stock Investors



Interest Rates: Investors have become increasingly concerned that the Fed is raising rates too quickly, and that this could cause a recession. However, this appears unlikely in the near term as rates remain historically low (see Graph 2) and stimulative to economic growth with the real (inflation-adjusted) Fed Funds rate just slightly in positive territory and the 10-year U.S. Treasury yield at just 2.7%. While data around employment, economic growth and inflation will determine the pace at which the Fed raises rates, it is likely to slow its pace of rate increases this year and could potentially even pause hiking rates unless inflation begins to accelerate. Therefore, Fed policy will likely remain stimulative at least through 2019 before potentially becoming neutral to economic growth in 2020.

Graph 2. Federal Funds Rate Remains Low by Historical Standards



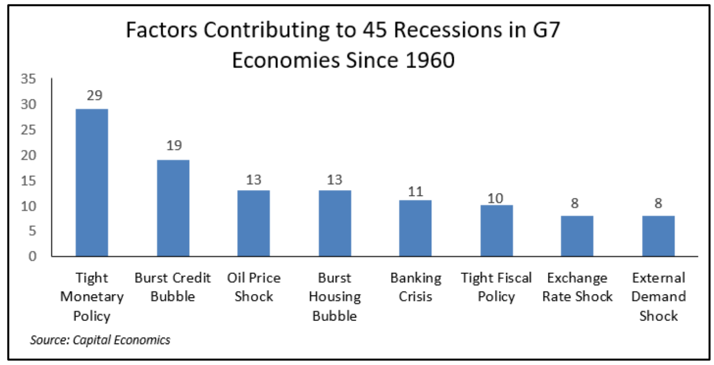
59 Racine Street, Suite A, Menasha, WI 54952
phone: (920) 729-7900 *fax*: (920) 729-7904 *website*: www.northstarinvestments.com

Global Trade: While the U.S. made progress on the global trade front with its North American and European trading partners in 2018, the biggest market moving headlines during the year came from its impasse with China. While negotiations between the world's two largest economies can understandably take some time, the public quarrel has raised investor anxiety. However, the recent agreement to hold off on implementing new tariffs until February should provide investors some relief that both sides understand the importance of reaching an agreement. Additionally, recent data showing the trade dispute is negatively impacting both countries should provide both parties with an added incentive to reach an agreement. If negotiations go well, we could see a resolution soon, which would likely be viewed positively by investors.

Budget Negotiations: As the year was coming to a close, partisan disagreements over budget proposals resulted in the third partial government shutdown of the year and the 22nd since 1976. The biggest disagreement appears to be around funding for President Trump's signature campaign promise of a wall along sections of the U.S. and Mexico border. While the shutdown certainly received its share of press, past partial shutdowns have resulted in continued negotiations and eventual resolution with no lasting impact to the economy. There is no reason to think that it will be different this time.

While these issues are worrisome, and the market is correctly reflecting this concern, we believe the nearly 20% correction in the S&P 500 appears to be overdone as valuations, at 14.3x forward earnings estimates (well below the historical average of approximately 16.5x), appear to already be pricing in an imminent recession. However, this is the 12th correction since the recession ended in 2008, and so far, the ability of the market to predict the next recession has been very poor. As we enter the 10th year of economic expansion, which historically have averaged just under 5 years, it makes sense that the economy is due for a recession. The problem we see with this is that none of the factors that normally cause a recession are prominent right now. The Fed is still easy, credit markets are functioning properly, oil prices are falling, the housing market remains healthy, banks have adequate liquidity, fiscal policy is loose, and exchange rates are fairly stable. The only factor that typically causes a recession that is left is an external demand shock, which by definition is unpredictable (see Graph 3).

Graph 3. None of the Factors that Normally Cause a Recession are Currently Prominent



Even though we believe the U.S. economy is likely to continue to grow over the next couple years, weakening exports, rising corporate debt levels, and decelerating growth in China could result in a slowdown from the 3% rate we experienced during 2018. Except for 2018, the economy has grown at a rate of around 2% each of the past 10 years. This modest pace of growth is one of the key reasons why the expansion has lasted as long as it has as it limited the buildup of excesses that normally occur during periods of rapid economic growth. We believe growth will likely decelerate to around this pace in 2019, which could be what the economy and the stock market need in order to prolong the economic expansion and for corporations to be able to continue to grow profits to support higher stock prices. Faster growth could force the Fed to raise rates more quickly to restrict growth and keep inflation in check as 3% growth in an economy with less than 4% unemployment would strain labor resources and put upward pressure on labor costs, causing inflation to accelerate. If growth remains modest, inflation should stay contained and Fed policy can remain stimulative.

It is in volatile markets like these that we truly appreciate our philosophy of investing primarily in high quality, consistent growth companies. No matter how bad market psychology gets, we can take comfort in knowing that our clients own strong companies that have proven their ability to grow in both good and bad times. While their stock prices may fall, considerably in some cases, the underlying value and long-term growth potential of these companies have not changed. In time, the current concerns will be overcome. In the meantime, the companies that we have invested in are doing their best to grow their earnings, which will eventually be reflected with higher stock prices.

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.