NORTH STAR
ASSET MANAGEMENT, INC.

October 2019

# INVESTMENT UPDATE

## Executive Summary

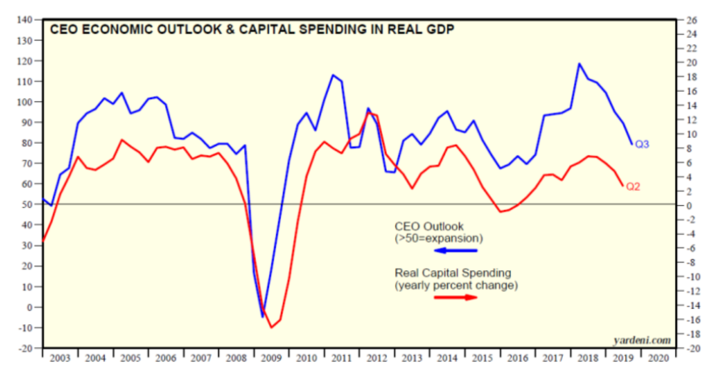
- The U.S. economy remains healthy and positioned to continue its modest pace of growth despite headwinds from the trade war with China.
- An escalation in the trade war with China could pose a threat to this continued growth, but we remain hopeful a deal can be reached soon.
- Large capitalization stocks (S&P 500) continue to perform well, with returns of +20.6% so far this year, while small capitalization (Russell 2000) and foreign stocks (MSCI EAFE) continue to lag, but with still strong returns for the year of +14.2% and +12.8%, respectively. Foreign emerging market stocks lagged even more significantly, with returns of just +6.1% through the first nine months of the year.

## U.S. Economy Remains Healthy and Growing Despite Trade Related Headwinds

Stock market volatility continued in the third quarter as worries arose around increasing trade war tensions, oil prices temporarily spiking, Presidential impeachment talks, and concerns regarding slowing economic growth. The market's most recent sell off at the very beginning of October was tied to disappointing data from the Institute for Supply Management (ISM) regarding the strength of the manufacturing component of the U.S. economy. The September survey marked the second month in a row in which the survey indicated that the manufacturing sector of the economy is positioned to experience a contraction. While many investors are quick to point to this data as an indication that the economy is soon to sink into a recession, we believe these concerns are largely overblown as solid new orders for durable goods and low unemployment claims so far indicate that the actual manufacturing environment remains relatively stable. The same ISM Manufacturing survey has indicated contraction several times in the past, including in 2015 and 2016, yet the overall economy continued to grow. Additionally, the economy is not as reliant on the manufacturing sector as it once was. Since the 1950s, manufacturing has shrunk from over 25% of U.S. GDP to around 12% today. Services are now a much more meaningful component of the U.S. economy. While the ISM Manufacturing data has indicated an impending contraction in the manufacturing sector of the economy, the ISM non-manufacturing survey continues to point to growth for the services sector, which should continue to support overall economic growth.

The continued growth in the services sector of the economy is well reflected in the strength of the consumer who continues to increase spending. In fact, core retail sales through August (retail sales excluding volatile gas and automobile sales) are up +9.4% at an annualized rate, which is the fastest pace of growth since the government started tracking core sales in 1992. With low unemployment, household income growth of around +4-5%, and record net worth, consumer confidence remains high and should continue to support growth in consumer spending and the economy in the near-term, more than offsetting the manufacturing sector weakness.

**Graph 1. CEOs Remain Optimistic and Continue to Invest in Their Businesses**




Source: Business Roundtable, Bureau of Economic Analysis, and Haver Analytics.

Meanwhile, surveys of CEOs also indicate that they remain optimistic on the economy (see Graph 1). This optimism is evident in the fact that we continue to see growth in capital spending, though at a slower pace than in the prior year. The slowdown in the growth of capital spending this year can be partially attributed to a particularly strong year of capital spending in 2018 on the back of corporate tax reform, which incentivized businesses to spend on capital projects. Additionally, some of the slowdown this year can be attributed to the uncertainty caused by the trade war with China, which is causing decision makers to pause spending on certain projects. If the U.S and China were to come to an agreement and clear up the uncertainty around trade policy,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economic growth would likely accelerate as businesses have the capacity to ramp up capital spending given their record levels of profit and cash flow generation.

Small businesses also remain optimistic and should continue to contribute to economic growth. Historically, small businesses have been the leading job creators in the U.S. and the growth engine of the economy as new small businesses inject competition into existing markets and drive innovation. For various reasons, they were largely left behind as the U.S. began to recover from the recession in 2009. However, over the last couple of years, small businesses have regained their footing, aided by deregulation, lower tax rates, and easier access to capital and have recently increased their hiring expectations as a result. We believe small business success is critical to the long-term health of the economy and that its recent strength points to healthy economic growth in the near term.

Despite the relatively strong consumer and business environment in the U.S., the Federal Reserve cut the Federal Funds interest rate by 0.25% for the second time this year in September. These interest rate cuts are intended to act as an insurance policy against escalating trade disputes and a continued slowdown in the manufacturing sector of the economy. Furthermore, this indicates that the Fed will continue to err on the side of expansion with its monetary policy, increasing our conviction that the economy will continue to grow.

## Trade War with China is a Concern

Although we continue to expect healthy economic growth, the biggest risk to this is an escalation in the trade war beyond tariffs, particularly if it begins to impact the investments companies from each country have made into the other. For example, U.S. firms have invested over $400 billion into assets in China and generate over $450 billion in annual revenue from these investments. Any policies that would restrict access to these assets or the revenue from these assets could have a significantly larger impact than the tariffs on the $175 MM in annual exports to China. However, we remain hopeful that the two sides can reach an agreement as the ongoing dispute is causing meaningful pain to both sides. In China, the pain may be more permanent as U.S. companies are leaving China and setting up manufacturing in other low-cost countries, perhaps never to return. In fact, U.S. imports from China through July of this year have declined by -12%, while imports from Vietnam, Taiwan, South Korea, India, and Mexico have increased significantly. The U.S. has also felt pain as export orders have fallen to levels normally only seen during a recession. With both sides feeling the pain of the trade war, we believe a deal could be reached in the coming months, to prevent permanent damage from taking place.

## Stock Market Returns Remain Strong

Despite several bouts of volatility throughout the quarter, large capitalization stocks (S&P 500) generated positive returns of +1.7% and are now up +20.6% through the first three quarters of the year. Interestingly, despite much of the concern in the quarter being about global trade and slowing growth outside of the U.S., small capitalization stocks (Russell 2000), which have less exposure to foreign economies, significantly lagged their large capitalization peers with a negative return of -2.4% in the quarter and are now also lagging year-to-date with a total return of +14.2%. Foreign stocks (MSCI EAFE) lagged their domestic peers with quarterly and year-to-date returns of -1.1% and +12.8%, respectively, while foreign emerging market stocks have lagged even more significantly with quarterly and year-to-date returns of -4.2% and +6.1%, respectively. Finally, with the Fed cutting interest rates in the quarter, bond yields continued to decline, driving bond (Citi Broad Bond Index) returns of +2.4% in the quarter and +8.7% through the first nine months of the year.

While stocks have generated solid returns so far this year, strong earnings growth in 2018 and modest earnings growth in 2019 have provided support for these higher prices. Over the long term, growth in corporate profits is what drives stock prices higher. With valuations on stocks currently in line with their historical averages, and with corporate profits poised to continue to grow in 2020, we believe stocks remain attractively valued for long-term investors and that investing in high-quality, consistent-growth companies at reasonable prices is the best way to build wealth. We continue to recommend clients maintain equity ratios at the middle of one's targeted range.

While stock market valuations remain reasonable, we believe bond prices are relatively expensive. In fact, during the third quarter, the yield on the 10-year U.S. Treasury moved below the dividend yield on the S&P 500. This is something that rarely happens, and we believe that this, along with the fact that the real (inflation adjusted) yield on 10-year U.S. Treasuries is currently around 0%, argue that bonds are overvalued, particularly relative to stocks. We continue to believe that bond yields will move higher over time as investors ultimately will demand a positive real return on their fixed income investments and therefore continue to recommend a more defensive bond portfolio with average durations below the benchmark.