July 2020

INVESTMENT UPDATE

Executive Summary

- U.S. markets rebounded in the 2nd quarter based on a partial re-opening of the economy, positive initial signs of an economic recovery, and the strong support and stimulus provided by the Federal government and the Federal Reserve.
- The Federal government stepped in to provide support to businesses, consumers, and especially the unemployed to limit the economic fallout from the government mandated shutdowns.
- The Federal Reserve is providing an extraordinary amount of monetary stimulus to secure a strong economic recovery.
- Stock valuations are at above average levels but looking past the temporary earnings declines and relative to historically low bond yields, stocks remain attractive for long-term investors.

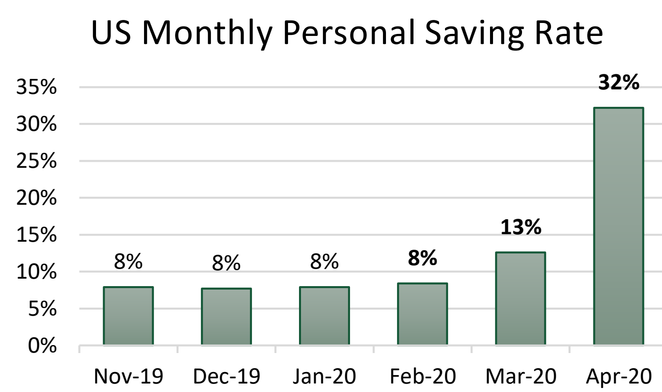
Stock Market Responds Positively to Re-Opening

Despite continued concerns regarding the COVID-19 pandemic, stocks rebounded significantly in the quarter as the combination of a partial re-opening of the economy, positive initial signs of economic recovery, and the strong stimulative effects of fiscal and monetary policy resulted in the largest quarterly gain since 2009. The broad global stock market had strong gains for the quarter with a total return of +25% for small capitalization stocks (Russell 2000), +20% for large capitalization domestic stocks (S&P 500), and a +15% for foreign markets (EAFE). Bonds also generated positive returns attributable to declining interest rates with a return of +3% in the quarter. Although stocks rebounded strongly in the second quarter, results for the first half of the year remain negative with the total return on the S&P 500, Russell 2000, and EAFE at -3%, -13% and -11%, respectively.

The Economy is Showing Signs of Improvement

After one of the fastest and most severe recessions due to the government mandated shutdown of businesses, the economy is starting to recover. Consumer spending has responded positively to the reopening of businesses across the country. Retail sales fell by almost 22% from February to April but have since rebounded by 20% to be down only 6% from a year ago. Although only anecdotal at this point, recent data from Visa and Mastercard have improved from 30-40% volume declines in April to a positive 5% in June. In addition, we believe the consumer has significant pent-up spending that will sustain further improvement in retail sales throughout the year as the consumer has cut back on spending even though they received a net increase in income from the various benefits received as part of the $2 trillion stimulus bill. Through these benefits, along with limited outlets to spend due to “safer-at-home” orders, the average household saved an incredible 32% of their incomes in the quarter. This large one-time financial windfall, along with a resumption in growth of core income from wages and salaries (two months of strong growth in employment), should give consumers confidence and the wherewithal to continue increasing their spending.

Graph 1. Surge in Savings Provide Pent-Up Consumer Spending



Businesses are also showing signs of improvement with unemployment claims falling each week for the past 3 months and the unemployment rate falling from 14.7% in April to 11.1% in June. In addition, after losing over 21 million jobs in March and April, job creation has rebounded with a total of 7.3 million jobs added on a combined basis in May and June. While there is still a long way to fully recover the lost jobs, the strong job growth in May and June is encouraging. Other recent datapoints indicating businesses are starting to heal include both the ISM Manufacturing and ISM Nonmanufacturing Indices which turned positive (a reading over 50 indicates growth) in June. The Manufacturing Index has rebounded from a low of 41.5 in April to 52.6 in June while the Nonmanufacturing Index

134 E. Wisconsin Ave, One Neenah Center, Suite 300, Neenah, WI 54956
phone: (920) 729-7900 *fax*: (920) 729-7904 *website*: www.northstarinvestments.com

has bounced back from a low of 41.8 in April to a very strong 57.1 in June. While this does not mean the economy has fully recovered, it does indicate that the economy is recovering.

Extraordinary Monetary and Fiscal Stimulus

The Federal government and the Federal Reserve have taken extreme measures to support consumers, businesses, and to stimulate a strong economic recovery. The large $2 trillion stimulus package from Congress provided handouts for almost all businesses and consumers and even added extra support for the unemployed. These measures have helped businesses retain employees during the shutdown and gave consumers a significant boost to their income. The Federal stimulus provided much needed short-term help to the economy during the shutdowns and significantly reduced the potential economic fallout.

The downside of this fiscal support is that the 2020 U.S. Federal Budget is on the path to have the largest annual budget deficit in both absolute and relative terms. Current estimates are for a $2.2 trillion deficit which would account for 11% of GDP, surpassing the Great Recession's recorded budget deficit peak of approximately 10% of GDP. The total U.S. Federal debt currently sits at $26 trillion as compared to the aggregate U.S. wealth of over $100 trillion. Once the pandemic is over, the Federal government will need to rein in spending.

In addition to short-term stimulus provided by the Federal government, the Federal Reserve has been engaging in extraordinary measures to provide liquidity for the banks, bond market, and the overall economy. In addition to lowering the Fed Funds rate to near zero, the Federal Reserve has been significantly increasing its balance sheet by buying not only U.S. Treasuries, but also municipal and corporate bonds. The Federal Reserve's balance sheet has hit a record $7 trillion with the recent addition of approximately $3 trillion through the pandemic asset purchasing programs. To put this in perspective, the Federal Reserve has increased its balance sheet in three months more than it did over three years during the credit crisis in 2009-2011. More importantly, the Federal Reserve's stimulative efforts appear to be working as money supply (as measured by M2) is growing by 25% over the past year, one of the fastest yearly growth rates on record. We believe a large portion of the stock market's rebound is due to the Fed's extremely stimulative actions and the anticipation of a sharp economic recovery over the next 2-3 years.

The Fed to Keep Rates Extremely Low/Stimulative

We believe interest rates will most likely remain near historic lows over the next 9-12 months or until the COVID-19 crisis ends as the Federal Reserve is committed to "doing whatever it takes" to support the economy during the crisis. With interest rates at or near historically low levels, bond investors need to be cautious and remain vigilant as the unprecedented amount of stimulus being provided by the Fed could result in inflationary pressures causing a rapidly rising rate environment. We are much more positive on long-term inflation adjusted returns for stocks relative to bonds at current yields and recommend bond portfolio durations remain shorter than our benchmark.

Investors Looking Past Near-Term Earnings Declines

Although stocks have rebounded much faster than the economy, we believe investors need to look beyond the current depressed earnings as economic activity accelerates over the next few years driving a strong rebound in corporate earnings. In looking at forward earnings estimates, the S&P 500 price to earnings multiple is at its highest level since the dot-com bubble at 21x. However, when taking into consideration the extremely low interest rates, the extraordinary stimulus being provided by the Federal Reserve, improving economic activity, and strong rebound in corporate profitability, we continue to believe the stock market is attractive for long-term investors.

In addition, it is natural for P/E multiples to expand significantly in the early stages of an economic recovery, as near-term earnings, particularly for cyclical companies, accelerate rapidly off trough earnings. Looking past the near-term earnings environment, we believe stock valuations are much closer to their historical ranges than they currently appear. While we continue to believe the market is attractive for long term investors, we recommend investors rebalance back to the middle of the range if the current market recovery has taken you beyond the middle of your range.

The primary risk to the market and the economy remains the escalation in COVID-19 hospitalizations and deaths which could derail the economic momentum of the past two months. At this point we do not believe the second wave of cases will be enough to cause another broad-based economic shutdown as the economic cost has proven to be too significant relative to substantially lower death rates than initially feared. Going forward it appears that the strategy to prevent large scale future breakouts will be to focus economic shutdowns on localized virus hotspots limiting the broader economic impact.

It is in these trying times that we truly appreciate our philosophy of investing primarily in high quality, consistent growth companies that have proven their ability to grow in both good and bad times.