NORTH STAR ASSET MANAGEMENT, INC.

January 2021

INVESTMENT UPDATE

Executive Summary

- U.S. economic recovery remains well underway and is looking to continue throughout 2021.
- Consumers remain in a strong financial position with the potential for increased spending to drive strong economic growth over the next several years.
- Vaccine announcements drove robust performance in global stocks, particularly in U.S. small capitalization stocks as they outperformed the S&P 500 for the quarter and the year.
- Stock market valuations remain elevated even with very strong earnings estimates for the upcoming year. However, with economic growth accelerating and relative to historically low bond yields, stocks remain attractive for long-term investors.

U.S. Economy Continues to Make a Strong Recovery

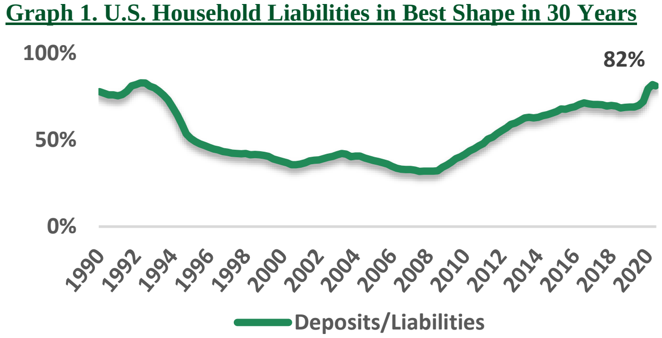
During the 4th quarter, strong economic data points continued to show U.S. economic resilience. Third quarter GDP was up an impressive +33% quarterly with expectations for continued sequential improvements at a strong +4% rate in the fourth quarter and throughout 2021. Wages and salaries continued to rise off of the second quarter lows as they are up +2.4% for the year, despite the current elevated unemployment rate of 6.7%. Corporate earnings for the third quarter were also up +3.5% on a year-over-year basis and are expected to continue growing in 2021 even with second-wave restrictions being imposed in several states. Businesses in aggregate are showing strong momentum for the coming year as November's ISM (Institute of Supply Management) report once again indicated near record highs in new orders and production (which are leading economic indicators). In addition, customer inventories remain at historically low levels and backlogs remain elevated. This should provide a much stronger and lasting recovery throughout 2021 as inventories build back to normal levels.

With the U.S. recovery well underway and an end to the pandemic in sight (with the approval and distribution of COVID-19 vaccines), we remain optimistic that economic growth will continue throughout 2021. GDP levels will likely reach and potentially exceed previous peak levels by the end of the year which was virtually unheard-of just six months ago when "experts" thought the economy would not reach prior levels until 2022 or 2023.

Consumers in Strong Position to Increase Spending

In addition to strong underlying business fundamentals, the consumer remains in good shape to increase spending and sizably contribute to GDP growth in 2021. It is difficult to rationalize that over the past year, during a pandemic, the U.S. consumer was able to save at levels not seen in decades, accumulating over $1 trillion in savings. The U.S. consumer not only increased their savings accounts, but they also drastically reduced their debt resulting in total savings deposits relative to liabilities reaching the highest level in 30 years at over 80% (see Graph 1). Unlike comparing liabilities to net worth (which also improved to 1980's levels), deposits are not subject to market volatility and represent much higher propensity for the consumer to spend or increase borrowing levels.

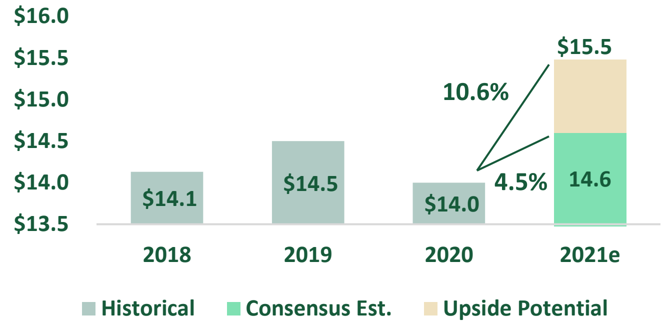
Graph 1. U.S. Household Liabilities in Best Shape in 30 Years



With all this excess spending capacity (savings & borrowing) in the hands of consumers, 2021 has the potential to be a historically strong year in terms of consumer spending and economic growth. The catalyst for this strong growth will be the end of COVID-19 restrictions and consumers feeling safe to restart normal behavior aided by continued progress with the vaccine roll-out.

To put this into perspective, total annualized consumer spending as a component of GDP is approximately $14 trillion (68% of U.S. GDP). If the consumer were to spend most of their financial windfalls accumulated in 2020 (over +$1 trillion), this would drive an additional +7% in consumption growth and could potentially drive total personal consumption to very strong double-digit growth (see Graph 2).

Graph 2. U.S. Consumer Spending Poised for Strong Growth in 2021



While we do not expect consumers to spend all their newfound savings in 2021, this shows the large potential for a strong rebound in spending from a much more confident consumer. Current market expectations have personal consumption reaching 2019 highs by mid-2021 and ending the year with growth of +4.5% along with Real U.S. GDP growth of +4%. We feel these current estimates do not account for the high probability of above average consumer spending as a result of much improved confidence in 2021. Therefore, we believe consumer spending growth of around +7% is attainable (if not conservative) which could produce GDP growth around +5-6% and reach new record levels by the end of 2021.

With these large potential increases in consumer demand, one risk to monitor over the coming year is the potential for elevated inflation. An example of this has been the more than +170% increase in lumber prices from mid-April to mid-September, though this was caused by both rapid demand spikes and supply disruptions. If we see strong pent-up demand by the consumer and a release of the more than $1 trillion in savings, there is the potential for accelerating inflation over the next 12-months. The main risk in a higher inflationary environment will be the pressure it will put on the Federal Reserve to abandon its highly accommodative policy stance and potentially lead to a rising interest rate environment. Therefore, we continue to recommend investors remain conservative with their bond portfolios.

Small Capitalization Stocks Complete a Broad Recovery

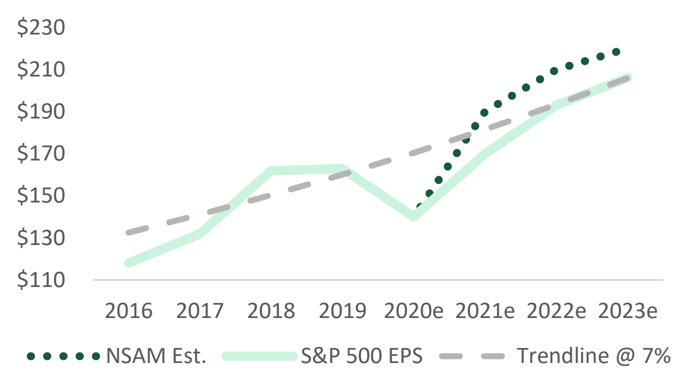
The positive sentiment seen in the stock market over the fourth quarter provided a glimpse of what a post-COVID-19 recovery may look like as the lagging areas of the market responded very positively to the COVID-19 vaccine efficacy and approval announcements. Specifically, small capitalization (Russell 2000) stocks generated a total return of +31% in the 4th quarter and have now outperformed the S&P 500 for the entire year (Russell 2000 +20% vs. S&P 500 +18%). Foreign stocks (EAFE) also performed well generating a +16% return in the quarter but lagged US indexes for the year returning only +8% in 2020. Bonds generated positive returns for the quarter of +0.7% to cap off a strong year with a total return of +7.7% as interest rates remain near record low levels.

Record Stock Valuations May Need Time to Digest

As optimism for 2021 continues to grow and stock market valuations approach historic highs, corporate earnings have much to deliver in 2021 to meet these high growth expectations. Current S&P 500 earnings estimates are projecting +20% growth year-over-year while the price-to-earnings (P/E) multiple remains elevated at around 21x. This leaves limited room for unexpected headwinds such as vaccine delays, geo-political risks, or unexpected tightening in monetary policy.

Even though we are leery of the excess optimism, we remain cautiously optimistic as we believe corporate earnings still have several years of above average growth ahead. Current industry experts have S&P 500 earnings per share reaching the historical trendline by 2022 and then following the trend-line thereafter. We believe these estimates do not fully account for the robust demand potential within consumer spending and the strong rebound in business activity as confidence accelerates over the next few years. Therefore, stocks still have room to move higher over the next 12-months as earnings growth has the potential to be much stronger than expected (see Graph 3).

Graph 3. Above Average S&P 500 Earnings Growth Potential



In addition to the strong corporate earnings growth, the low interest rate environment and recent Federal stimulus should continue to support elevated stock market valuations as investment alternatives to equities remain unattractive on an inflation adjusted basis. While we do not expect valuation multiples to expand further, stocks can continue to perform well with above average earnings growth over the next several years.

Over 2020, our high quality, consistent growth investment philosophy weathered the global pandemic very well. This approach should generate strong returns throughout the recovery as well.

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., One Neenah Center, Suite 300, Neenah, WI 54956.