NORTH STAR ASSET MANAGEMENT, INC.

January 2020

INVESTMENT UPDATE

Executive Summary

- Strong 2019 stock market performance continued in the 4th quarter as positive news on trade, accommodation by the Fed, and healthy economic growth drove the market higher.
- The Federal Reserve appears determined to maintain a highly stimulative monetary policy in 2020 and will keep interest rates at a very low level until inflation surpasses its 2% annual target.
- The U.S. consumer remains in a strong financial position to drive continued economic growth in 2020.
- Record low yields, tighter spreads, and strong fixed income inflows are increasing the risk for fixed income investors.
- Small capitalization stocks (Russell 2000) had a strong rebound in the fourth quarter up +9.9% with large capitalization stocks (S&P 500) remaining the top performer for the year at +31.5%. Foreign stocks also had a strong rebound in the fourth quarter contributing to robust performance for the year at +22%. Bonds took a break in the fourth quarter adding only +0.2% as rates stabilized with the Fed on pause.

Strong Performance as Wall of Worry Waned in 2019

A year ago, investors had a long list of worries that included the Fed's path of increasing rates, an inverted yield curve, escalating trade tension with China, and the beginning signs of a global manufacturing slowdown. In hindsight, most of these concerns were once again proven unfounded with the Fed lowering rates throughout 2019 (instead of raising them), U.S. and China trade tensions easing (with Phase 1 nearly complete), and U.S. manufacturing stabilizing after declining earlier in the year. In addition, the recent positive trade developments (USMCA and Japan) should turn a portion of the trade headwinds of 2019 into tailwinds in 2020.

Fed Remains Accommodative in 2020

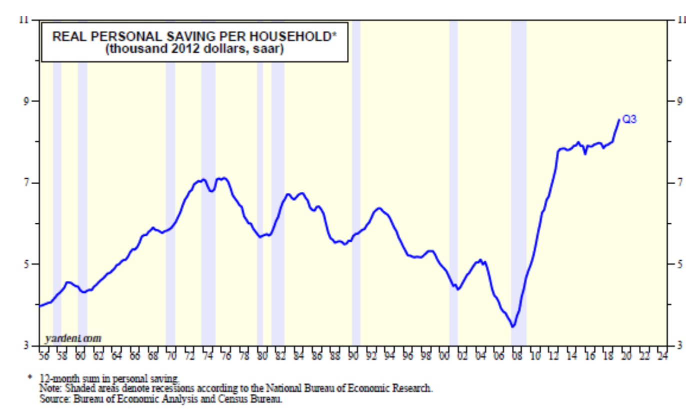
After consistently increasing the Fed Funds rate throughout 2017 and 2018, the Fed quickly responded to the trade tensions and slowing manufacturing sector by shifting its policy to becoming more stimulative. This shift in policy strategy contained three Fed Funds interest rate cuts and a switch from balance sheet contraction to expansion, which provided additional liquidity and support across the markets.

The potential issue with the Fed being so stimulative is it could lead to a typical boom/bust cycle creating an acceleration of inflation well above the 2% target. This could force the Fed to raise rates much higher and faster in the future. At this point we do not see any indications of overheating inflation, but it is a concern given continued strength in consumer spending, a tight labor market, and a recovering manufacturing sector. In the meantime, the Fed appears to be determined to maintain highly stimulative monetary policy, meaning the Fed will be supportive towards faster economic growth over the next few years.

Consumer Looks to be the Key for Growth in 2020

In addition to the positive tailwinds of an accommodative Fed and the improving trade environment, the consumer remains in a strong financial position to continue to support economic growth. Tight labor conditions, with more job openings than unemployed, the unemployment ratio at record lows, and jobless claims remaining stable, are helping to drive continued strong wage growth of approximately +4%, which is near the highs seen in the 1990's and 2000's.

Graph 1. Real Personal Savings Rate at Record Highs



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

Consumers are not spending all of their wage gains, as the savings rate has increased substantially from its historical low of 3% in 2005 to almost 8% today. This is contrary to past recovery periods where savings rates have historically trended lower as the recovery ages. In fact, on average U.S. households are saving nearly $9,000 annually which is the highest level since tracking the statistic. (see Graph 1).

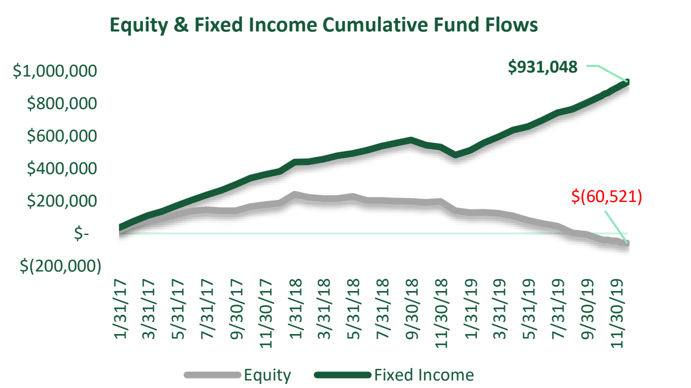
This increased savings rate has dampened short-term consumption growth but provides a strong foundation over the long term for stable consumer spending and may help to limit the boom/bust cycles of the past. If household savings were to revert to historical averages around $5k-$6k annually, it would provide a meaningful boost to at least +3% economic growth as consumer spending represents over 2/3rds of U.S. GDP. Looking ahead to 2020, we believe the consumer will continue to be the key driver of moderate economic growth with a bias towards the upside over the long term as they become more confident and reduce their rate of savings.

Bond Risk Remains After a Strong 2019

The bond market had an exceptionally good year, with benchmark bond performance up +8.8%, as it benefited from the Fed's three rate cuts. With the 10-year treasury yield at only +1.8%, we caution that this level of return is unlikely to continue going forward. In addition, there are signs of excess exuberance in the bond market.

The first sign of exuberance is the large inflows into the fixed income market. Net bond inflows topped $450 billion in 2019. Compared to equity markets since 2017, bond funds have seen total inflows of over $930 billion versus an outflow of $60 billion in stocks (see Graph 2).

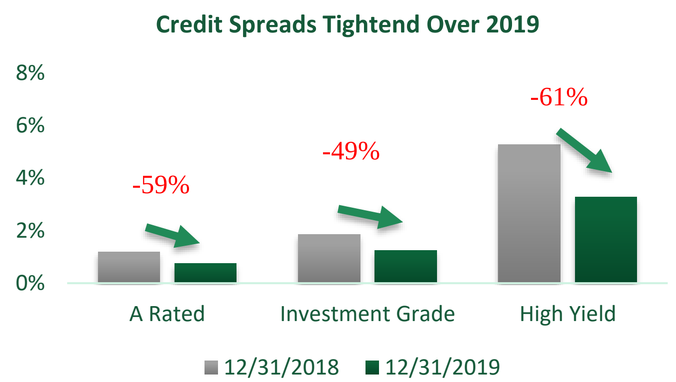
Graph 2. Fixed Income Fund Flows Dramatically Surpass Equity Flows Since 2017



Source: Investmnet Company Institute, Yardeni Research, Inc.

The second sign of exuberance is the decline in the interest rate spread between corporate bonds and U.S. Government yields. These spreads have declined significantly over the last 12 months (see Graph 3) and currently reside near the bottom end of historical averages. This decline indicates a heightened appetite for risk. Borrowing a quote from Warren Buffett, "Be fearful when others are greedy and greedy when others are fearful," we think fixed income markets today are much closer to the greedy side than fearful. This has created a "priced to perfection" environment where any negative credit news or rising rates may result in negative bond returns over the short term. Therefore, we continue to recommend a defensive bond portfolio focused on short-term, high-quality bonds.

Graph 2. Corporate Bond Credit Spreads Tighten



Source: Bloomberg Finance L.P.

Strong Performance Remains Supported by Corporate Profit Growth

Stocks reacted positively to the waning wall of worry, generating solid returns for the year. Large capitalization stocks (S&P 500) led the way up +31.5%, with small capitalization stocks (Russell 2000) and International stocks (MSCI EAFE) lagging slightly, up +25.5%, and +22.0%, respectively. Over the last two years stock market returns (S&P +26%) have closely tracked corporate profit growth (+25%). Therefore, even with the strong 2019 market performance, valuations continue to look reasonable. With the strong consumer economic backdrop and easing trade tensions, corporate profits are poised to improve in 2020. With P/E ratios only modestly above the 25-year average, stocks remain attractively valued for long-term investors. By investing in high-quality, consistent-growth companies at reasonable prices, we believe investors will generate strong returns over the long term. We continue to recommend clients maintain equity ratios at the middle of one's targeted range.

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.