April 2021

INVESTMENT UPDATE

Executive Summary

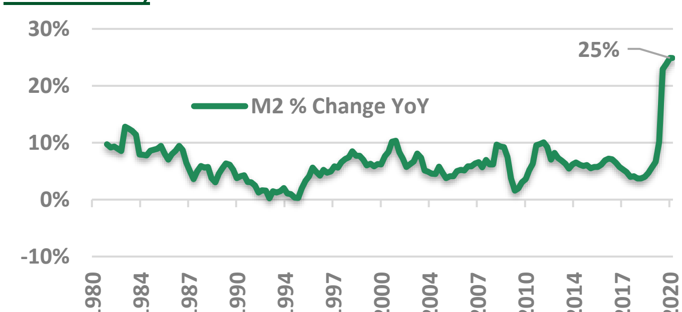
- Economic growth is recovering quickly as pent-up demand and excess savings are driving a recovery in consumer spending as the vaccination rollout increases confidence.
- The Federal Reserve remains extremely stimulative resulting in strong growth expectations continuing over the foreseeable future.
- Record money supply levels and continued stimulative policies have increased the prospects for above average growth to continue into 2021 although at the expense of a potential acceleration in inflation.
- Stocks remain attractive for long-term investors and much more attractive than bonds in a higher inflationary and rising interest rate environment.

Economic Growth is Recovering Quickly

The underlying economy continues to show signs of strong growth and has already caused one of the most conservative institutions, the Federal Reserve, to increase its GDP forecast for 2021 to 6.5%, from 4.2%, lower its unemployment expectations to 4.5%, from 5.0%, and raise its expectations for price increases to now exceed its 2.0% target reaching 2.4% by the end of 2021. With all these sizable positive expectations for 2021, there seems to be a slight disconnect between interest rate policy and economic growth, as they continue to signal no Fed Funds increases until the end of 2022.

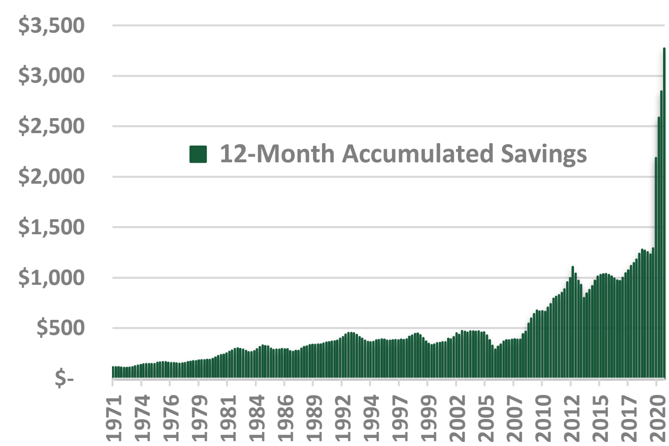
Additionally, the money supply (Federal Reserve's M2) has increased by +25% versus a year ago, much higher than the typical increase of +5% to +7%. With money supply growing much faster than GDP, this indicates that there is more money chasing a smaller amount of goods, raising the probability of a higher inflationary environment (see Graph 1).

Graph 1. U.S M2 Growth (Total Amount of Money in Circulation)



A contributing factor that has kept broad inflation levels in check has been the significant reduction in spending by the consumer at the onset of the pandemic due to isolation measures enforced by local governments or based on personal safety concerns. These have resulted in year-over-year personal consumption spending turning sharply negative in April of 2020 and slowly recovering as the pandemic matured. During this same time and unlike in any recession before, the numerous stimulus payments and increased unemployment benefits resulted in consumer incomes actually increasing, creating a large accumulation of savings (see Graph 2).

Graph 2. Record $3.2 Trillion Saved Over Past 12 Months



As vaccination levels continue to expand and confidence improves, consumers are beginning to show signs of increasing their spending levels but have yet to begin spending down the ~$3.2 trillion (~15% of US GDP) in savings accumulated during the pandemic. As social distancing restrictions continue to be lifted, the consumer should regain its normal consumption growth behavior. Based on normal seasonality trends applied to February's personal consumption levels, year-over-year spending growth is expected to exceed 20% over the next several months with +8% to +15% growth continuing through the remainder of the year. These growth rates do not include any additional pent-up demand spending if the consumer feels confident enough to spend down its accumulated savings or the recent $240 billion of new stimulus checks being issued from the most recent $1.9 trillion stimulus bill. Over the next several months it seems highly likely consumption growth will exceed current expectations and drive GDP levels well above the Federal Reserve's newly increased forecast.

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Federal Reserve Focusing on Growth at the Expense of Higher Inflation

One of the most significant outcomes of the COVID-19 pandemic is that the Federal Reserve appears to have switched from erring on the side of restraint to erring on the side of growth. It is not yet apparent if this is a short-term shift in policy to help recover from the COVID-19 recession or a long-term change in policy. However, with the Federal government on its third trillion-dollar stimulus plan with no restraint in excessive spending in sight, and with the economy expected to be more than fully recovered by the end of 2021 (and exceed its theoretical potential in 2022 and 2023), the Federal Reserve either appears asleep at the wheel or they are fully committed to faster growth over the long-term.

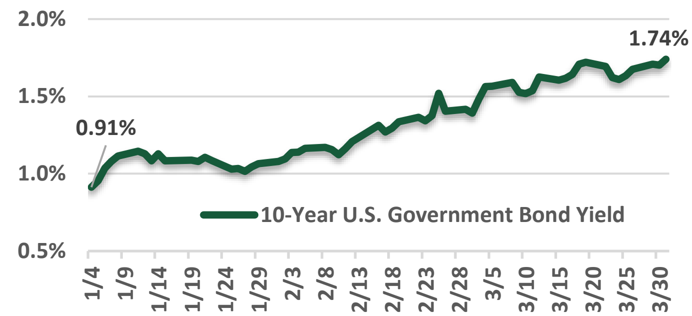
The reason the economy needs to stay in balance is because the consequences of being out of balance results in either much higher inflation (too fast of growth) or too much unemployment and social unrest (too slow of growth). Both too fast or too slow of economic growth causes a multitude of problems for investors and the public as well. This balancing act falls on the hands of the Federal Reserve Board and it primarily acts as a countervailing force when the Federal government is too restrictive (too much regulation or taxes) or too stimulative (too much spending or too little taxes). For the past 40 years the Federal Reserve erred on the side of restraint/less inflation at the expense of modestly slower growth. This has resulted in 40 years of falling interest rates, healthy but not great economic growth, and a very strong stock and bond market.

While we welcome this accelerating growth trend, we are cognizant of the potential negative implications of a higher inflationary environment and the effects of a policy switch that may lead to a period of higher, and potentially increasing, interest rates over the next several years. We are already seeing pockets of inflation in home prices, raw materials, oil, etc. With the addition of even more stimulus and the potential for the consumer finally having the opportunity to spend down its excess savings, we could see much faster and longer economic growth than most experts are currently forecasting. However, this growth could come at the expense of much higher inflation than we have experienced in a long time.

Fed Policy Creates Divergence in Stock and Bonds

The opening of the economy and shift in Fed policy to a higher growth orientation, is a positive for equity returns at the expense of bonds in the near-term. In addition, higher economic growth typically favors small capitalization stocks over large capitalization stocks. This was evident in the first quarter with small capitalization stocks (Russell 2000) up +12.7%, while large capitalization stocks (S&P 500) were up +6.2%. The primary reason for the divergence in performance has been due to the market rotation away from higher growth technology stocks to more economically cyclical sectors such as energy, industrials, and financials which have a higher allocation within the Russell 2000 index. International markets (MSCI EAFE) lagged, up only +3.5%. Bonds (Citi Broad Bond Index) were the hardest hit by the rapid increase in interest rates as the 10-year Treasury yield increased from 0.91% to 1.74% (see Graph 3), resulting in total returns down -3.5% in the quarter.

Graph 3. Rise in U.S. 10-Year Bond Yield



We continue to expect periods of increased stock and bond market volatility throughout 2021, as the market continues to digest the rapid rebound in economic activity, increased short-term inflation pressures, and potential Federal Reserve policy change toward higher nominal growth.

Stocks Remain Attractive for Long-Term Investors

The strong performance of the U.S. stock market over the last two years has driven the valuation of the S&P 500 close to historical highs. However, with the S&P 500 poised to experience earnings growth of +30% and +10% in 2021 and 2022, respectively, and given the ongoing highly stimulative backdrop of both fiscal and monetary policy, stocks remain attractive for long-term investors. This is especially true when compared against bonds. At current yields, the 10-year U.S. Treasury note is yielding a negative real (after-inflation) rate of return, as investors continue to overprice safety at the expense of long-term purchasing power. With strong economic growth expected over the next couple years, and the potential for accelerating inflation, we believe bond yields are likely to continue to move higher, putting negative pressure on bond prices, especially for intermediate to long-term bonds. Therefore, we continue to recommend maintaining a conservative bond portfolio with below average durations, while maintaining stock allocations near the middle of one's targeted equity range.

Having recently passed the one-year anniversary of the March 23rd low in the S&P 500 during the early days of the pandemic, we can reflect positively on our philosophy of investing primarily in high-quality, consistent-growth companies that we believe have the ability to grow their earnings through almost any environment. This is what has given us the confidence to continue to maintain our stock holdings throughout one of the most difficult times in history, and what continues to give us confidence that investing in these types of companies is the best way to build wealth over the long-term.

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.