NORTH STAR ASSET MANAGEMENT, INC.

July 2021

INVESTMENT UPDATE

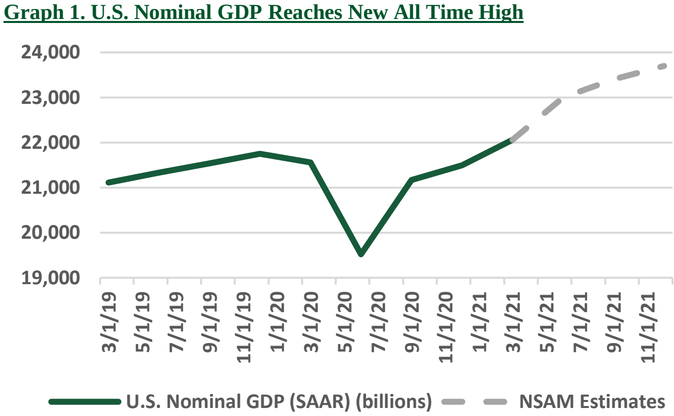
Executive Summary

- U.S. GDP has made a full recovery from the COVID-19 induced recession.
- A financially strong consumer, robust wage growth, record low inventories, and elevated new order growth should support sustained above-average economic growth over the next several years.
- The above-average growth will most likely come at a cost of higher inflation, but with the Federal Reserve beginning to talk about raising rates, we do not fear the highly destructive inflationary pressures seen in the late '70s.
- Stronger than expected earnings growth has driven strong stock market returns, despite elevated valuations at the beginning of the year.

U.S. Economy Has Recovered from the COVID-19 Recession and is Poised for Strong Growth

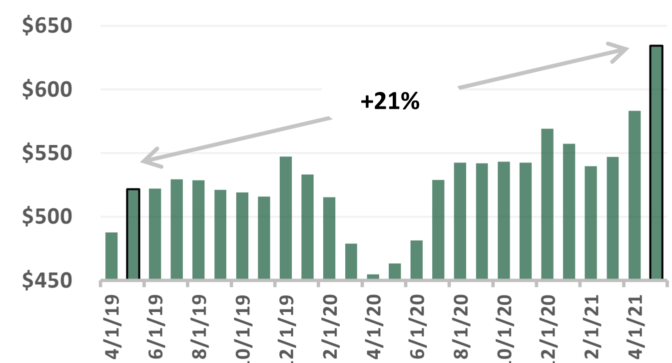
The U.S. economy has recovered quickly from the COVID-19 induced recession as underlying economic fundamentals were healthy prior to the recession and the Federal Reserve and the Federal government successfully provided trillions of dollars of liquidity and stimulus to support the economy throughout the economic shutdowns. As a result, with the U.S. economy reopening due to the broad dissemination of the vaccines, both consumers and businesses are in great shape to not only return to normal activity, but to drive even faster than normal economic growth over the next several years.

Graph 1. U.S. Nominal GDP Reaches New All Time High



First, the consumer has exited the pandemic in great financial shape as they have accumulated record levels of deposits (over $2.5 trillion of "excess" savings), their debt levels declined as a percentage of household assets and as a percentage of household incomes, and strong stock and housing market gains have resulted in record levels of net worth. In fact, the U.S. consumer has added over $11 trillion in net worth since the end of 2019, the largest 18-month gain in history. This strong consumer position, along with broad vaccination levels, have provided increased confidence which is already resulting in a strong retail sales surge (up 21% since May 2019, see Graph 2) and should continue to drive sustained spending growth over the near term.

Graph 2. Retail Sales Hit Record Highs in May



Arguably more important to economic growth and consumer spending is the growth of personal incomes. The labor market is extremely tight and is driving strong wage growth with private wages and salaries up 16% in the past year through May and up 6.3% from pre-COVID levels. More broadly, personal incomes (excluding government stimulus) are up 9.6% from December 2019, much stronger than pre-COVID growth. With job openings rebounding to record highs at over 9 million in April and currently standing above the total number of unemployed seeking a job, the labor market should remain extremely tight for at least the next 6-12 months providing support for continued strong wage gains. In all, consumers have growing levels of cash, net worth, and income to sustain faster spending without needing to take on additional debt, which should provide a strong tailwind to overall economic growth over the next couple years.

Businesses are also quickly recovering and are poised for above average growth over the next few years. Corporate profits and cash flow have fully recovered from the recession and are both at record levels. This cash provides the fuel necessary to invest in future growth by increasing hiring, investment in R&D, and capital spending. The record level of job openings, along with inventories relative to sales at 50-year lows and new durable goods orders at 20-year record highs all indicate the business sector is growing rapidly. The suddenness of the recovery has left many businesses not prepared to meet the demand for their products which has resulted in shortages and price increases. While this will create some short-term bottlenecks and inflationary pressures, this also gives us confidence that the above average growth in manufacturing is sustainable for the next few years as manufacturers need to increase production levels not only to meet the strong demand but to rebuild inventories back to normal levels.

Finally, the Federal Reserve remains highly stimulative to economic growth and is expected to continue being stimulative through at least 2023. Over the past year, the Fed has increased the M2 money supply by more than 25%, which is over four times as much as the 6% average of the past 20 years. This should provide a broad tailwind to growth over the next several years even if they start raising rates in 2022.

In summary, we continue to believe the current economic momentum is underappreciated and will continue to drive markets higher over the next several years. We expect second quarter GDP growth of over 10% (versus 2-3% normal growth) and continued above average economic growth to last for the next few years as the underlying economic fundamentals have improved compared to pre-COVID levels and a significant amount of stimulus money remains in the hands of consumers and businesses, which has only recently begun to flow through the economy.

Higher Inflation Rate Remains the Primary Risk

The potentially negative effect of this above average growth is the possibility for sustained inflationary pressures. Headline inflation has increased to over 4% in the last 12 months however is being considered "transitory" due to the strong recovery in the economy as the COVID headwinds quickly abated. While we expect inflation to soften as the base effect begins to normalize, we also believe that the 25% increase in M2 money supply that has been injected into the economy along with our outlook for strong economic growth are likely to result in inflation that is sustainably above the Fed's 2% target rate over the next several years. While the Fed had been largely ignoring inflation, instead focusing solely on stimulating economic growth, their recent acknowledgement that they are preparing to start removing the extraordinary accommodation later this year or into 2022 is encouraging. We believe the Federal Reserve will begin tapering their bond purchases in 2021 and ultimately start raising the Federal Funds rate in 2022. This gradual removal of the stimulus should prevent inflation from becoming the problem that it was during the high inflation period of the late 1970s, yet still provide a strong tailwind to economic growth over the next several years.

Strong Earnings Supports Record High Stock Market

The stronger than expected economic recovery has resulted in corporate earnings rebounding rapidly, helping to drive strong returns for the stock market despite valuations that were elevated at the beginning of the year. Through the first half of the year, large capitalization stocks have generated a total return of +15.3% (S&P 500), with small capitalization stocks outperforming with a total return of +17.5% (Russell 2000), and foreign stocks lagging although still returning a strong +8.8% (MSCI EAFE). Despite these strong returns, forward price-to-earnings multiples have declined since the start of the year as earnings estimates for the S&P 500 have risen by 20% compared to a +14% rise in the value of the S&P 500 (ex-dividends).

We expect this outpaced earnings growth to accelerate over the second quarter and to end the year with aggregate 2021 earnings over $200 per share with the potential for 2022 earnings to reach $220 per share reflecting P/E multiples of 21x and 19x, respectively. Despite these above average P/E multiples, we believe the markets are fairly valued given our outlook for above average economic growth.

We continue to favor stocks over bonds, particularly as the current 10-year U.S. Treasury note offers a negative real (after inflation) yield. While bond returns (Citi Broad Bond Index) were +2.0% during the quarter, they remain down -1.6% year-to-date as bond yields have moved higher since the beginning of the year. Given our outlook for higher inflation and above-average economic growth, we anticipate bond yields to resume their upward trajectory, which would continue to put pressure on returns for bond investors.

While there remains the potential for a short-term correction in the stock market on periodic concerns over faster than expected inflation or rising interest rates, we believe these concerns can be overcome by the strong underlying economic fundamentals and that long-term investors will be rewarded by staying invested. Therefore, we continue to recommend maintaining stock allocations near the middle of one's targeted equity range.