NORTH STAR ASSET MANAGEMENT, INC.

April 2022

INVESTMENT UPDATE

Executive Summary

- Rising inflation, the Fed raising interest rates, and uncertainty from the Russian invasion of Ukraine reignited investor fears resulting in the S&P 500 being down -10% at one point in the quarter.
- Although the Fed started to raise the Fed Funds rate in March, monetary policy will remain stimulative.
- The U.S. economy is strong and positioned for growth but is facing headwinds from inflation and global uncertainty.
- Long-term investors should continue to be invested in equities due to solid fundamentals and earnings growth despite valuation headwinds. Bond investors must remain cautious due to rising interest rates and high inflation.

The War in Europe is Adding New Global Uncertainty

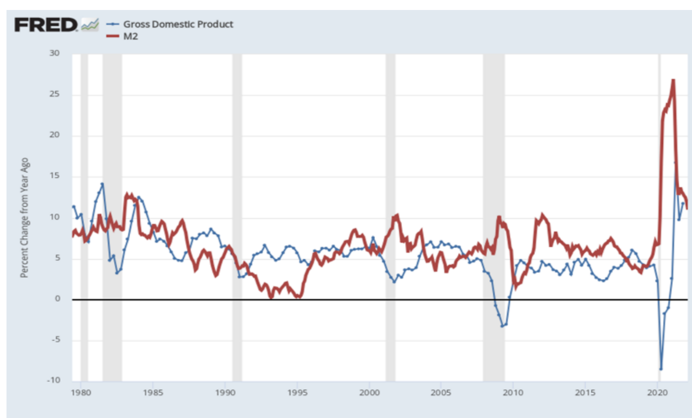
On February 24th, Russia invaded Ukraine, effectively starting the largest armed conflict in Europe since World War II and sending rattling effects throughout the world, the global economy, and financial markets. We condemn the war and the terrible impact this war is having on innocent civilians in Ukraine, which has led to thousands of civilian deaths and millions of people being forced to flee their country. While the intertwining of the global economy makes the issue of sanctions highly complex, the West has worked closely together and been quick to coordinate a response by imposing tough sanctions on Russia to impair their economy. We are also encouraged by the response by many of the largest and most influential global enterprises, in particular consumer, financial services, and technology companies, which pulled their operations out of Russia at an unprecedented speed, providing another powerful set of actions that appear to have large effects on the Russian society. As time goes on, we believe the Russian economy will continue to feel increasingly adverse impacts from these actions which will add to the pressures on them to agree to an armistice and end the war.

The war and geopolitical instability have significantly increased risks for negative human, economic, and political outcomes and the current situation could escalate and have much more destructive effects on the world. While we have less certainty regarding the exact course of the war, it has continued to increase inflationary pressures. Near-term, the war will continue to put pressure on supply chains and prices. Longer term, it has continued to push secular shifts towards regionalization, including trade agreements, building new regional supply chains, regional and less efficient sourcing of energy, materials and inputs, new military spending and alliances, as well as accelerated adoption of technology and other productivity enhancing measures. While technology and productivity enhancing investments are long-term deflationary forces, when combined with all other factors which are inflationary, it leads to an overall less efficient global economy resulting in modestly higher long-term inflationary pressures.

Monetary Policy Remains Very Stimulative

The Fed has been extraordinarily accommodative since the pandemic began. While they are far from restrictive, they raised the Fed Funds Rate by 25 basis points in March to the 0.25-0.50% range and they are expected to continue to raise rates throughout the year. They are also ceasing their asset purchases starting in April, which will affect interest rates further out on the curve, adding to the measures they are using to tighten financial conditions. While current policy is becoming less stimulative, money supply growth has been extremely high the last two years, and given that the economic response to monetary policy comes with a 12-18 month lag, financial conditions will continue to be stimulative for the next few years (see Graph 1).

Graph 1: Money Supply Growth has led GDP Growth and is Expected to Continue to Do So Going Forward



The Fed still has a long way to go in order to get the Fed Funds rate back to a neutral level, which is likely in the 2.0-3.0% range. It may even be necessary to be restrictive for some time in order to offset the imbalances created. The path forward and magnitude of hikes will be dependent on growth and the severity of inflation pressures. Overall, the Fed is walking a tightrope in trying to sustain the expansion, providing business friendly conditions, while not allowing inflation to run away, which would destroy real demand and hence growth.

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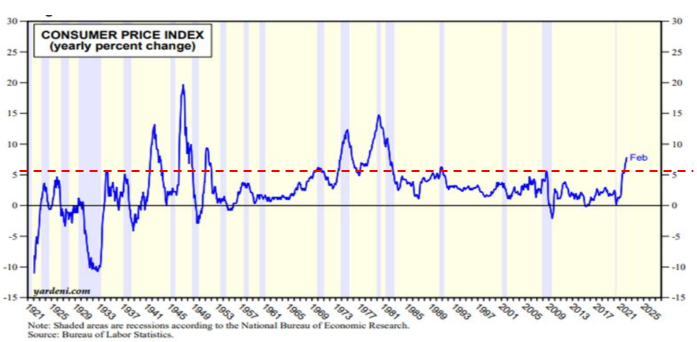
The U.S. Economy Is Very Strong but Facing Headwinds

The U.S economy was booming in 2021 with nominal GDP growth of +11.8%, the fastest growth since 2008. The consumer continues to be in very good shape with continued record net worth, low debt-service levels, and perhaps most importantly, strong wage growth of over +10% due to the labor market being extremely tight. Businesses profits were up +20% in 2021 and are continuing to grow in 2022. These profits are being reinvested into hiring more employees, higher wages, capital investments, R&D, as well as being returned to shareholders, including through dividends, which in turn are used for increased spending or redeployed into other productive uses, completing the virtuous cycle of economic growth. The current headwinds may slow growth somewhat, but we continue to believe the U.S. economy is the strongest in the world and able to withstand many of these pressures. Assuming the war doesn't escalate, and no new rapidly-spreading severe Covid-19 strains (and most importantly continued low death rates) that would force new global lockdowns, the strong fundamentals and reopening of the global economy support continued strong economic growth and nominal U.S. GDP growth of around +10% in 2022.

Inflationary Pressures Accelerating Instead of Easing

Inflation is at the highest level in the last 40 years (see Graph 2) as the combination of very easy monetary policy, strong demand, and long-lingering effects of supply chain disruptions from an uneven global pandemic recovery, have all led to a large supply-demand imbalance putting pressure on prices.

Graph 2: Consumer Prices Continue to Rise Above 40-year Trend Levels



Prior to the Russian invasion of Ukraine, the combination of less stimulative monetary policy, less supply chain constraints and shipping congestions, and a higher level of production, was expected to ease inflationary pressures leading to lower, yet higher than average inflation in 2022. The war in Ukraine has changed this outlook where inflationary pressures now are expected to sustain or increase longer term. The new shocks are due to the large share of energy production and importance to global agriculture and other raw materials that Russia, Ukraine, and Belarus have. Energy prices have soared over +60% since the beginning of the year, with WTI crude trading at over $100 per barrel. Food prices are also experiencing tremendous pressures, as export levels are expected to be meaningfully lower going forward. There are increasing risks of famine in several economies around the world whom are heavily dependent on the region's grain and fertilizer exports, potentially leading to social unrest and new global conflicts. Supply chains also continue to be disrupted by the war and are facing headwinds from the latest Covid-19 outbreak in China. However, despite these headwinds and high inflation, including headline CPI reaching +7.9% in February, the U.S. economy is strong. Presuming no new extraordinarily large price shocks, we believe the strong U.S. consumer will be able to absorb higher costs to a reasonable degree, even though it could put pressure on discretionary spending over time.

Stock and Bond Market Returns Down in the Quarter

The first quarter was volatile driven by inflation and the Fed's resulting change in policy. As the quarter progressed, war and geopolitical uncertainty added to these headwinds. Large cap equities (S&P 500) were down -4.6%, small cap equities (Russell 2000) were down -7.5%, International equities (MSCI EAFE) were down -5.9%, and Emerging Market equities (MSCI EM) were down -7.0%. Despite the weak quarter, it is important to note the great returns equities have generated over the last three years, with large cap equities delivering annual returns of +31%, +18%, and +29%, well above long-term growth trends. Bond returns (USBIG Bond Index) were -6.0% for the quarter also due to inflation and rising interest rates.

Barring no extremely negative outcomes of the war, we continue to expect companies to generate solid earnings growth in 2022, driven by higher revenue growth as businesses pass on higher prices to customers. Valuations have been higher relative to historical averages over the last few years due to higher than average earnings growth and extremely low rates. Despite expectations of higher interest rates, which likely will decrease valuations toward historical averages, as well as continued price volatility, solid earnings growth should more than offset these headwinds and drive returns over time.

Given the current conditions, we continue to favor equities over bonds. While government and investment grade bonds tend to perform better in times of uncertainty, bonds continue to offer a low reward relative to the risk assumed, as a result of very low interest rates and high inflation. Due to solid growth fundamentals, we believe long-term investors should stay invested in equities, targeting the middle of one's range, despite shorter-term volatility. Given our philosophy of investing in high-quality, consistent growth companies at reasonable prices, the majority of companies we invest in are looking more attractive as their prices have come down more than their expected profit and cash flow generation. They continue to be well positioned to compound earnings and free cash flows for the long term. Bond investors must remain cautious and should limit interest-rate risk while considering holding a portion of their bond allocation in cash to hedge the impact of rising rates while providing an option to reinvest at higher yields over time.

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., 134 E Wisconsin Ave, One Neenah Center, Suite 300, Neenah, WI 54956.