NORTH STAR ASSET MANAGEMENT, INC.

July 2022

INVESTMENT UPDATE

Executive Summary

- During the quarter, equity and bond markets experienced major declines due to continued high inflation and geopolitical risks, rapidly rising interest rates, and fear of the Fed overtightening which could cause a major slowdown of the economy.
- The Fed has decisively changed its monetary policy to fight inflation by aggressively raising the Fed funds rate to 1.50-1.75%.
- There are indicators signalling that inflation may be peaking, as excesses are being reigned in, putting the economy on a more sustainable path going forward.
- The U.S. economy is still solid and positioned for strong nominal growth in 2022.
- The consumer is in good shape to weather a tougher economic climate, supported by $2 trillion in accumulated savings, low debt-service costs, and rapidly rising wages.
- We continue to expect solid revenue and profit growth for businesses as inflation is passed through to customers.
- Earnings-multiples have compressed meaningfully. As a result, most of the companies we invest in can be purchased at the most attractive valuations in many years.
- Long-term equity investors should stay invested in equities and add to the allocation if underweight relative to one's target range. Fixed income investors should continue to be cautious but feel more comfortable investing at higher yields and modestly extending duration in portfolios.

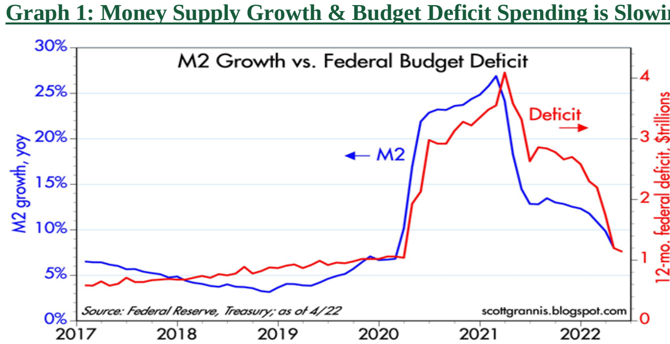
Stock and Bond Prices Declined due to High Inflation and Rising Rates - But There are Signs of Pressures Easing

A combination of factors including high inflation, continued geopolitical uncertainty and war in Ukraine slowing global economic growth, and rapidly rising interest rates, induced fear in the markets and drove aggressive price declines in stocks and bonds. The S&P 500 officially entered a bear market (defined as a decline of -20% or more) during the quarter.

The massive monetary and fiscal stimulus that took place in response to the pandemic, and continued for too long, has put the Fed behind the curve in keeping inflation under control. The Fed's monetary actions drove money supply growth of over +25% year-over-year at its peak in 2021, compared to the long-term trend of roughly +6% year-over-year growth. The government's stimulus payments led to deficit spending of over $5 trillion over the course of two years, compared with less than $1 trillion per year in years prior. These policies supported the economy during the pandemic but are extremely unsustainable long-term. Given the lagging effects of 12-18 months from the point of policy action, the economy is experiencing the inflationary effects of those actions today. Other external factors tied to supply chains and the war in Ukraine are also fueling higher prices, which is leading to the highest inflation experienced in decades.

While it has taken too long, both the Fed and government are reversing these stimulative policies. The Fed finally realized that they needed to act decisively and raised the Fed Funds rate to the 1.50-1.75%-range, while signaling multiple additional hikes in the near future. They also ended their asset purchase program which will help ease money supply growth. The federal government is reigning in spending as well. While deficit spending is not positive in and of itself, the expected $1 trillion of deficit spending in 2022 is much less damaging to the economy long-term. As stimulative polices took over a year to show their effects, it will take time for the reversed policies to work their way through the economy as well. Nonetheless, this should help position the economy on a more sustainable path going forward. As shown in Graph 1 below, money supply growth (M2) is still higher than average but rapidly declining, and fiscal deficit spending is rapidly decreasing, both closer to longer term trends. In all, inflation is high but there are positive signs of inflationary pressures easing going forward.

Graph 1: Money Supply Growth & Budget Deficit Spending is Slowing



Equities and Bonds Poised to Recover as Markets Have Already Priced In High Future Interest Rates

We believe the rate the Fed needs to target in order to keep the economy in balance, supporting growth while not allowing runaway inflation, should be higher than normal for the next 6-9 months (potentially up to 3.0%) because of the massive injected stimulus. However, the markets have already, during a short period of time, started to price in levels above that, expecting a Fed funds rate above 3.0% one year from now. In addition, the 2-year Treasury yield is also up to 3.0%, from around 0.7% six months ago (see Graph 2).

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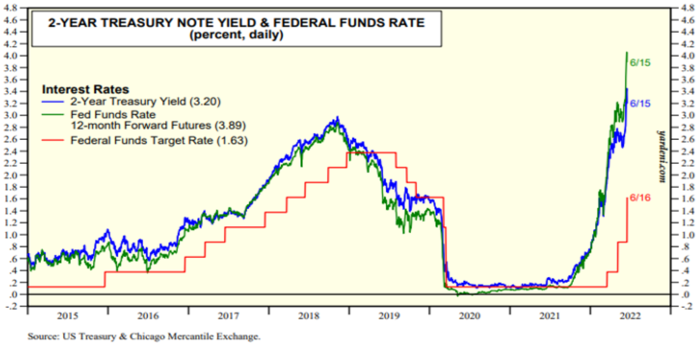
Graph 2: Rapid Increase in Rates & Expectations of Future Fed Funds



As markets do from time to time, we believe they may have overshot the level of where rates ultimately go in the next couple of years, as we are already experiencing tighter financial conditions and other signs of inflation moderating. Combined with our continued solid outlook for earnings growth, this could help support growth in stock prices and provide support to the bond markets going forward.

The U.S. Economy is Still Positioned for Growth in 2022

Despite all the headwinds, the U.S. economy is still positioned for strong nominal growth in 2022 even if real growth (nominal minus inflation) is slowing temporarily.

The consumer continues to be in good shape supported by over $2 trillion in excess savings accumulated during the pandemic, low debt-service payments despite rapidly rising mortgage rates, and wages growing the fastest in over 40 years. The labor market is the tightest in many years, with close to two jobs available for each unemployed person. While the consumer is adversely affected by the rapid increases in energy and food prices, we would like to put in perspective that relative to other periods of rapidly increasing prices such as the 1970's, they are a much smaller component of consumer expenses today. Over the last 60 years, energy and food have decreased from over 25% of consumer spending to roughly 12% today. While painful, today's price increases do not have as large of an impact as they previously did, everything else equal. Overall, the consumer is facing headwinds, but is in good shape to handle a tougher economic climate for some time.

Businesses are also in good shape. They have generated record profits ($2.6 trillion in 2021) over the last couple of years and balance sheets are not overleveraged. Input prices are rising and companies are forced to pay higher wages, but supply chain constraints are easing and higher costs are being passed onto customers. The environment is tougher, but companies are in a good position to navigate through it. We would also like to highlight that the banking system is well-capitalized to handle a tougher environment relative to the Great Financial Crisis. In all, despite facing shorter-term headwinds, the U.S. economy is still solid and positioned for nominal growth going forward.

Negative Returns Have Resulted In Investor Sentiment Falling to The Lowest Levels in over a Decade

Equity and fixed income returns were down meaningfully in the quarter. While geopolitical factors are adversely affecting the global economy, by slowing economic growth and adding to inflationary pressures, the main reason for the rapid decline in valuations was rapidly rising interest rates, as the Fed pivoted to fight inflation. Year-to-date, large cap stocks (S&P 500) are down -20%, small cap stocks (Russell 2000) are down -23%, developed market stocks (MSCI EAFE) are down -20%, and emerging market stocks (MSCI EM) are down -18%. Bond returns (USBIG) are also negative, down -11%.

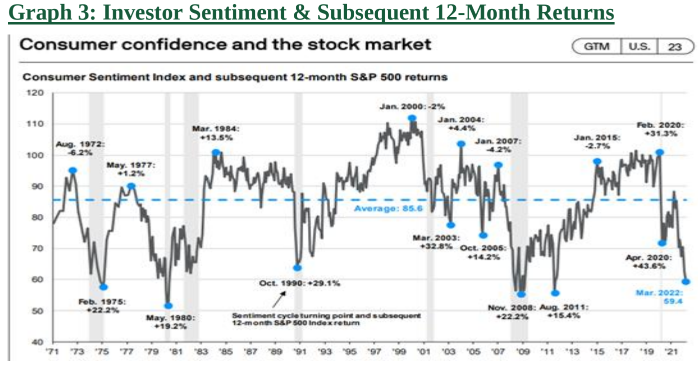
It has been very painful for a lot of investors, but we have reason to believe that the worst may be behind us. While it may take some time for equities to return to new highs, we find three reasons to be constructive on the future outlook.

First, incorporating all headwinds, we still expect solid revenue and earnings growth for equities this year fueled by nominal growth as inflation is being passed through which raises both revenue and profits. In addition to pricing power, most of our companies are leaders in secular growing industries with strong long-term growth prospects where trends of growth are fairly resilient to shorter-term changes in the business cycle.

Second, the rapid decline in equity prices has taken valuations from being above average down to historical norms. When comparing earnings-multiples to interest rate-levels, multiples are low today. As a result, the combination of strong expected earnings growth and multiple-compression is setting up for the most attractive valuations we have experienced in many years.

Third, while broad equity and fixed income indices are down meaningfully, there are certain areas of the market that have experienced declines only encountered during the dotcom-bubble and the Great Financial Crisis. Subsequently, investor sentiment has turned the most negative in decades. As shown in Graph 3 below, historically, equity market returns tend to be strong after consumer sentiment approaches all-time lows.

Graph 3: Investor Sentiment & Subsequent 12-Month Returns



Source: JP Morgan

We also want to highlight that while we don't know where equity prices will go in the short-term, it is normal for equities to experience large intra-year declines and still ending a year with positive or meaningfully less negative returns.

We believe long-term investors should stay invested in equities and add to the allocation if underweight relative to one's target range. Bond investors should continue to be cautious but feel more comfortable investing at higher yields and extending duration somewhat in fixed income portfolios.