NORTH STAR
ASSET MANAGEMENT, INC.

October 2022

INVESTMENT UPDATE

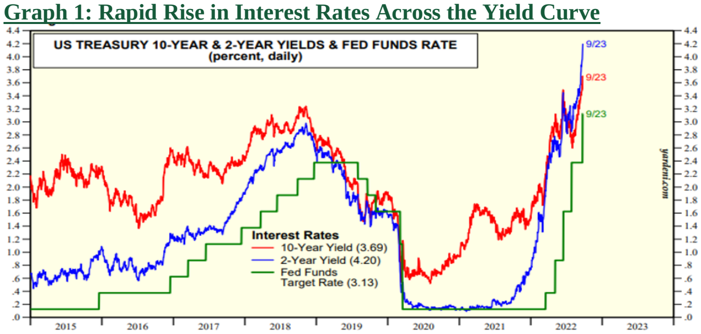
Executive Summary

- Sustained high inflation and rapidly rising interest rates continue to induce fear of an economic slowdown, driving declines in asset prices.
- The U.S. economy continues to be resilient, but in the short-term, good news of a growing economy is bad news, as it likely means the Fed will continue to raise rates.
- The tremendous strength of the U.S. dollar is a headwind to global demand and earnings growth for U.S. businesses.
- Peaking inflationary pressures should allow the Fed to end the hiking cycle soon, enabling markets to recover.
- While painful short-term, the normalization of interest rates is highly encouraging for long-term investors as it strengthens the foundation for sustained economic growth.
- Despite headwinds and extremely negative sentiment, valuations are the most attractive in many years.
- Long-term equity investors should be adding to equities relative to one's target range. Bond investors should take advantage of the highest yields in over a decade and feel comfortable extending portfolio duration.

High Inflation and Rising Interest Rates Continues to Induce Fear of an Economic Slowdown, Driving Declines in Asset Prices

The U.S. and global economy continue to face consequences from the extraordinary monetary and fiscal policy actions during the pandemic, along with supply shocks resulting from the Russia-Ukraine war, which are driving the highest level of inflation in over 40 years. Hence, the Fed and global central banks are in unison doing everything they can to get inflation under control. As a result, interest rates across the yield curve have, in 6 months, moved to levels not experienced since 2008 before the Great Financial Crisis. Short-term rates rose as the Fed raised the Fed Funds Rate from 1.50-1.75% to 3.00-3.25%, and as shown in Graph 1 below, the 10-year Treasury yield has rapidly risen to near 4.0% from less than 1.5% 12 months ago.

Graph 1: Rapid Rise in Interest Rates Across the Yield Curve



Source: Federal Reserve Board & Yardeni

The rapid rise of interest rates, along with expectations of higher rates in the future, continues to be the main reason for negative investment returns and expectations of slower growth.

The U.S. Economy Continues to be Resilient, but in the Short-Term Good News is Bad News

Despite headwinds, the U.S. economy continues to be very resilient. Consumers' net worths are close to record levels, the job market continues to be extremely tight, wages are growing the fastest in four decades, and despite rising rates, debt-service levels are close to all-time lows. In addition, the consumer has $1.0 trillion in accumulated pandemic excess savings. Overall, we continue to believe that the consumer is in good shape to handle tougher economic conditions. Businesses continue to be in good financial shape as well, having generated record profits and cash flows in 2021 along with maintaining strong balance sheets. With supply-chain issues easing, the largest challenge is finding labor, which is driving the rapid growth in wages. Short-term, higher costs are pressuring margins and profit growth, but long-term, it continues to incentivize investments for productivity growth, represented by the record amount of fixed capital investments currently being made, particularly into technology and digitization. These investments should drive productivity gains and ultimately long-term profit growth. In addition, the banking system is in very good shape relative to other periods of Fed interest rate hiking cycles.

Because of these strong fundamentals, even if the Fed tightens financial conditions to such a degree that it causes economic growth to temporarily decline, we believe the economy is well equipped to handle it and quickly return to growth. In the short-term however, investors should be prepared that good news of a strong economy, could be bad news for markets and asset prices, as it likely will result in the Fed raising rates further.

Rapid U.S. Dollar Strength is a Major Headwind to Global Demand and Slowing U.S. Profit Growth

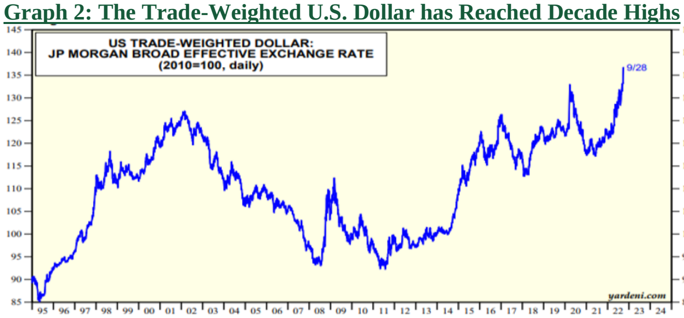
In addition to rising rates, the global economy and businesses are also dealing with a major headwind from the rapid rise in the U.S. dollar. There is an unusual divergence driving this. Over the last several decades, as globalization has increased in the world economy, economic growth and business cycles have become highly synchronized, but today, while the U.S. economy is relatively strong, the global economy is weakening. The Chinese economy is weakening due to its way of handling Covid-19 and the European economy is weakening due to the Russia-Ukraine war, where extreme supply shocks are subduing growth. The Fed has also been raising rates faster relative to European central banks to fight inflation. At the

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

same time, Europe finds itself in a precarious situation, where central banks are raising rates, but governments are continuing large deficit spending to subsidize soaring energy bills, while planning large future investments for energy self-sufficiency.

The material differences in economic growth, large interest rate differentials, and projected deficit spending relative to GDP, along with very large inflows from foreign investors into U.S. debt instruments are the reasons for the rapid and strong appreciation of the U.S. dollar. As shown below in Graph 2, the U.S. dollar has reached near 40-year highs.

Graph 2: The Trade-Weighted U.S. Dollar has Reached Decade Highs



Source: Yardeni

In the long-term, a strong, stable dollar is imperative for a strong U.S. economy, but in the short-term, this strength serves as a deflationary force to global demand and a headwind to revenue and profit growth for U.S. businesses with large revenue exposures internationally. We believe the deflationary impact should give the Fed cause to stop rate hikes sooner than later, while also believing that U.S. businesses will be able to continue to grow despite these headwinds.

Signs of Peaking Inflationary Pressures Should Allow the Fed to End the Hike Cycle, Enabling Markets to Recover

We believe that the U.S. and global economy is likely to continue to experience higher than average inflation for some time due to the 12-18 months lag in effects from the time of policy action to economic impact. Today, we are roughly 6-9 months into the current cycle of tightening financial conditions, and while we believe central banks are doing the right thing, it will continue to take some time to fully take effect. However, we believe inflationary pressures are peaking. Money supply growth has already slowed to below long-term growth trends, commodity and energy prices have begun to fall, and the most interest-rate sensitive sectors in the economy - real estate and auto sales - are also experiencing lower prices. Overall, peaking inflationary pressures should allow the Fed to end the current tightening cycle soon, which will allow equity and bond markets to recover.

Despite Short-Term Pain, Interest Rate Normalization is Highly Encouraging for Long-Term Growth Sustainability

As long-term investors, we believe that the normalization of interest rates should pave the way for a future of long-term sustainable and healthy economic growth. Since the Great Financial Crisis, the global economy has had the lowest interest rate environment in recorded history. While low interest rates generally are good for growth, it has also led to concepts such as NIRP (negative interest rate policies) leading to the phenomena of debt with negative yields, culminating in over $19 trillion of debt with yields below zero last year, as well as theories like MMT (modern monetary theory) and other unsustainable incentives for governments to engage in budget deficit spending without experiencing negative consequences such as high inflation or currency depreciation. Overall, the return of normalized interest rates helps the global economy back to a sustainable path, disincentivizing these types of policies, excessive speculative behavior, and misallocation of capital, while rewarding long-term investors and savers.

Another Quarter of Negative Returns but Valuations are the Most Attractive in Decades

The stock market rallied in July and August as investors began to think the Fed hiking cycle was near the end, but this reversed as the Fed indicated rate hikes were to continue, resulting in renewed declines in both stock and bond prices for the quarter. Year-to-date, large cap stocks (S&P 500) are down -24%, small cap stocks (Russell 2000) are down -25%, developed foreign market stocks (MSCI EAFE) are down -27%, while investment grade bonds (Citi Broad) are down -15%.

The quarter included some downward revisions for earnings for the year, but we continue to expect resilient and growing earnings as inflation-aided revenue growth more than offsets higher costs and foreign exchange headwinds, where 40% of revenues generated by companies in the S&P 500 comes from abroad. However, long-term investors should be encouraged by the prospects of strong future returns as market prices have declined faster than the revisions for earnings growth. We find the current valuations in equities the most attractive in many years as P/E-multiples have rapidly fallen below long-term averages, with the S&P 500's forward P/E now below 16 times. In fixed income, with the rapid increase in interest rates investors should take advantage of the highest yields in over a decade and feel comfortable extending portfolio duration as we find many attractive yields on high quality fixed income securities.

Despite a resilient economy, market sentiment continues to be extremely negative. We believe this to be the time for long-term investors to be adding to stocks and extending bond durations to position themselves for growth in the next 3 to 5 years and beyond. Periods of excessive pessimism tends to be the precursor for strong future returns, and even if it will take time for the economy to fully experience the impact of the Fed's actions, because financial markets are looking ahead by at least 9-12 months, the markets will likely rebound faster than economic results will indicate. We continue to believe the best strategy is to invest in long-term consistent growth companies that trade at reasonable valuations, are durable leaders in secular growing industries, are highly profitable and financially strong, and that can grow through short-term headwinds. These companies tend to be able to consistently compound earnings growth over the long-term, which is what drives higher stock prices and returns 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.