January 2023

INVESTMENT UPDATE

Executive Summary

- Stocks and bonds recovered in the quarter, but broad investment returns ended negative for the year.
- Clear signs of peaking inflation should allow the Federal Reserve (Fed) to end the tightening cycle relatively soon.
- One of the main risks to the economy has rapidly shifted (due to inflation falling) to the Fed keeping monetary policy too restrictive for too long, causing a recession.
- While economic growth is slowing, the U.S. economy is well positioned to handle a potential economic downturn.
- Investors will likely continue to face short-term market volatility as market participants assess the future path of the Fed's hiking cycle. But once it is evident the Fed is done raising rates, the markets should move higher.
- Despite temporary headwinds, volatility, and negative sentiment, we are constructive on the long-term outlook and believe that current valuations and prospective returns for long-term investors are the most attractive in years.
- Long-term equity investors should be fully invested in stocks relative to their target range. Bond investors should continue to take advantage of the most attractive fixed income and cash yields in over fifteen years.

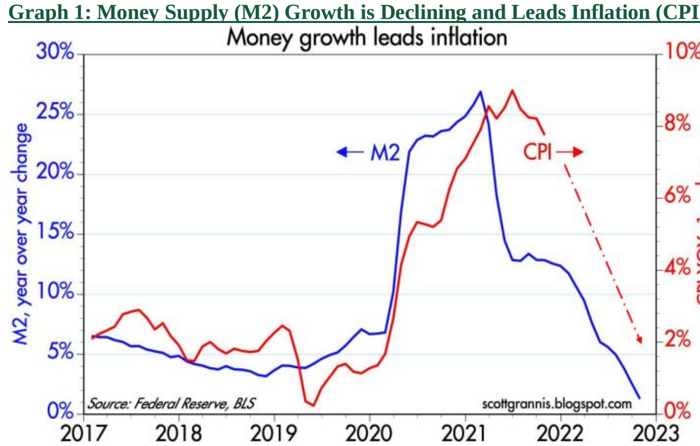
Clear Signs of Peaking Inflation Have Brought Us Closer to the End of The Hiking Cycle

The Fed and global central banks continue to rapidly raise short-term interest rates to fight inflation. During the fourth quarter, the Fed raised the Fed Funds rate by 125 basis-points to 4.25-4.50% continuing its record pace and magnitude of tightening financial conditions. The high inflation and subsequent rapid pace of tightening throughout the year have led to broad-based declines in asset prices. However, both stocks and bonds started to recover in the quarter as it became evident that inflation was peaking, with several of the key leading inflationary indicators now declining.

First and foremost, money supply growth is rapidly declining. As of December, the money supply (M2) was down -2% from the peak in March and have also started decline on a year-over-year basis. While inflation could stay higher than average for some time, this is a great indicator that inflation will be moderating as the change in money supply leads changes in prices, as shown in Graph 1, in the next column.

Other key leading inflationary indicators that have declined are commodity and energy prices, which fell rapidly in the fourth quarter. Producer prices (PPI), which lead consumer prices (CPI), as inputs are paid for before products are manufactured and sold to customers, have started to decline rapidly as well. When annualizing the change that has occurred over the last six months, the PPI is increasing 2.8%, a significant fall from the peak earlier in the year when prices increased 7.4% on average. Finally, while the most interest rate-sensitive parts of the economy (housing, auto prices, etc) started to decline first, more broad-based consumer price declines are now also evident with CPI appearing to have peaked in October. As with PPI, the 6-month annualized change in CPI is moderating quickly, down to 4.8% from a peak of 7.1% earlier in the year. Given the lagging effects of monetary policy actions by 12-18 months from time of policy implementation, the effects of meaningfully higher rates will continue to reduce inflationary pressures even more going forward. Overall, while inflation may continue to be higher than average in the near-term, the worst is likely behind us. This will allow the Fed to end the hiking cycle relatively soon, enabling markets to move higher.

Graph 1: Money Supply (M2) Growth is Declining and Leads Inflation (CPI)



Source: BLS, Federal Reserve, Scott Grannis

The Fed Overtightening Has Become a Main Risk

Despite clear signs of inflation decreasing and tightening monetary policy working effectively, the Fed has signaled that their main objective near-term is reigning in the four-decade high inflation, even if this negatively affects economic growth in the short-term. Hence, the Fed is determined to continue the current path of rate hikes until lower inflation becomes evident in lagging inflationary indicators such as the labor market and services. Thus, one of the main risks in the near-term has shifted from keeping policy too stimulative for too long, causing the inflation we are experiencing today, to tightening too much for too long, risking putting the economy into a recession. In effect, this would continue to magnify, instead of smooth, the ebbs and flows of the business cycle and financial markets.

The U.S. Economy is in Good Shape to Handle a Potential Economic Downturn

Despite headwinds and pessimism, the U.S. economy remains strong and is expected to have grown somewhere between 8-10% in nominal terms and around 3% excluding inflation in 2022. The outlook is more muted going forward, as economic growth is expected to slow due to tight financial conditions. However, we believe the underpinnings of the economy remain robust enough to endure a period of weakness before returning to growth. Consumers are facing higher prices and rising rates, but are in good shape overall, as their net worths are close to all-time highs and debt-service costs remain low in aggregate. While there is some softening, the labor market continues to be strong due to cyclical and structural reasons, leading to continued solid wage growth. Businesses are facing higher costs, but the majority of price increases are being passed onto customers. Business balance sheets are solid, having generated record profits and cash flows in the last few years, allowing them to weather headwinds while investing for the future. In addition, and in contrast to previous downturns, the banking system is also in good shape, aided by stringent regulatory requirements imposed after the Great Financial Crisis.

Near-Term Uncertainty May Persist but the Long-Term Return Outlook is the Most Attractive in Years

Stocks and bonds posted gains in the quarter as the market reacted positively to lower inflation data. However, returns were muted as the Fed reaffirmed its path of higher rates and these gains did not offset declines from earlier in the year. Earnings are expected to have grown in 2022 but this growth has been more than offset by valuations declining due to higher rates, with large cap stocks (S&P 500) down -18%, small cap stocks (Russell 2000) down -20%, developed markets stocks (MSCI EAFE) down -14%, and bonds (USBIG) down -13%.

Going forward, investors may continue to face near-term market volatility as market participants, with increasing scrutiny, try to assess the state of the economy and the future path of interest rates and growth. As mentioned earlier, one of the main risks is the Fed keeping monetary policy too tight for too long, causing a recession and negatively impacting corporate earnings. However, when looking beyond the near-term uncertainty, we are constructive about the future for long-term investors for several reasons.

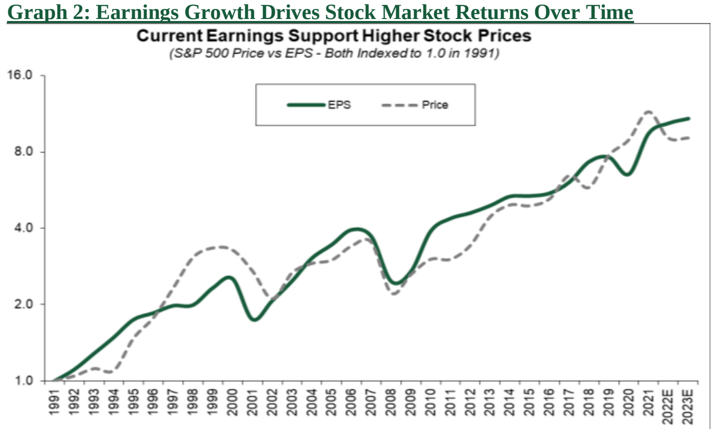
First, companies continue to be well positioned to grow revenues in 2023 as revenues are closely tied to nominal economic growth (that includes inflation) which is expected to grow by 5% or more this year. In addition, earnings have the potential to grow modestly as many of the major cost headwinds are abating. Higher wages will likely persist, but slower growing input costs, normalizing supply chains, freight and logistics costs rapidly decreasing, and less foreign exchange headwinds, are all factors providing support to earnings growth and making it more resilient, albeit not immune, to slowing demand.

Second, the broad-based market declines and normalized interest rate-environment have achieved several objectives at once, creating favorable and more sustainable conditions for long-term investors and returns going forward. A tremendous number of excesses have been reigned in, as many of the most speculative areas of the market have declined at a magnitude and speed only experienced a few times in history. In addition, several of the most dominant global companies, which are widely owned and have led the markets over the last decade, have declined more than the broad indices. For bonds, which usually provide stability during volatile times, rising interest rates have resulted in prices falling as well. These declines have simultaneously caused valuations to quickly move in-line with long-term averages and induced the worst investor sentiment in decades. There could be more downside if the Fed overtightens, but a meaningful amount of downside is already reflected in current market prices.

Lastly, the market could recover quickly once the Fed stops raising rates. The market fears uncertainty but when it feels confident that the Fed is done raising interest rates, it will likely start to stabilize and move higher. Since the market is forward-looking by roughly 9-12 months, it will soon look beyond short-term headwinds and further into the future where fundamentals for growth remain solid. This forward-looking nature has also historically led to markets bottoming and moving higher several months ahead of the bottom in the economy. In addition, there is a possibility that the Fed will have to cut rates at some point this year if they go too far. That would aid stocks and bonds moving higher as well.

In summary, we continue to believe it is a good time for long-term investors to position themselves for attractive returns over the next 3-5 years and beyond. The long-term growth outlooks for the companies we invest in have not changed meaningfully. We believe many of them will come out even stronger through these volatile times. They continue to be well positioned for strong earnings growth, which is the key driver of higher stock prices over time, as shown in Graph 2. History also suggests that times when sentiment is at its worst, like it is today, have been the best times to invest. We believe long-term investors should be fully invested in stocks relative to their target range and bond investors should continue take advantage of the most attractive fixed income and cash yields in over fifteen years.

Graph 2: Earnings Growth Drives Stock Market Returns Over Time



Source: North Star Asset Management

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.