NORTH STAR ASSET MANAGEMENT, INC.

October 2021

INVESTMENT UPDATE

Executive Summary

- The US economic expansion continues to grow above the average long-term growth trend due to strong core fundamentals.
- US monetary policy continues to be highly stimulative and a key driver of above average economic growth.
- The consumer is in good shape with record excess savings, healthy balance sheets, rising wages, and record net worth.
- Corporations posted record results in the quarter and are positioned for multi-year, above average earnings growth.
- The quarter saw several negative cross-currents, and while these headwinds may slow the pace of growth, they are not strong enough to derail the current expansion.
- Inflation remains the main risk, but less accommodative monetary policy should contribute to easing pressures.
- Stocks remain attractive for long-term investors despite above average valuations, due to above average expected growth. Fixed income investments remain less attractive with record low interest rates and higher inflation.

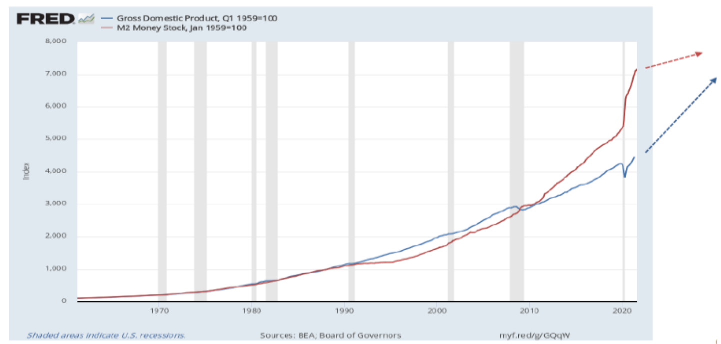
US Economic Expansion Remains Strong

The US economy continues to grow at an above average rate after fully recovering from the self-induced sharp and fast recession that took place during the first half of 2020. There are multiple, robust fundamental drivers underpinning the expansion. These include highly stimulative monetary policy, a strong consumer, and businesses posting record profits and accelerating investments for future growth. We expect economic growth to be very strong in the third quarter, for the full year and next year, well above the long-term growth trends.

Monetary Policy Continues to be Highly Accommodative

The Federal Reserve and global central banks have taken extraordinary actions to aid the global economy during the pandemic. This massive support has come through keeping short-term rates at record low levels and by expanding the money supply (M2) at the fastest pace in modern history, injecting record amounts of liquidity into the economy. While the economy has recovered rapidly, monetary policy has remained highly stimulative. During the quarter, it was a positive sign that the Fed and other central banks have shifted focus towards less accommodative monetary policies going forward. Nonetheless, while the extraordinary growth of the money supply has started to normalize in the quarter on a year-on-year growth basis, the money supply growth is several times higher than long-term average growth trends. Given the long-term correlation between money supply growth and economic growth, this should continue to fuel above average growth for several years to come, see graph 1.

Graph 1: Money Supply Growth and GDP Growth



Source: St. Louis Federal Reserve and NSAM estimates

The Consumer is in a Strong Financial Position and Has Increased Spending Power

The consumer is in good shape, evidenced by an aggregate accumulation of over $2.5 trillion in excess savings, healthy balance sheets with record low debt service costs, and record net worth. The combination of factors leading to this strong financial position include extraordinary fiscal support during the pandemic, lack of ability to spend, a tight labor market resulting in higher wages, and rising asset prices. Retail sales continue to be very strong and are growing above trend, but a lot of the fiscal pandemic relief and rising wages have ended up in excess savings. This combination of factors should continue to generate strong consumer spending above average levels and drive economic growth into the future, see graph 2.

Graph 2: Nominal Retail Sales – Growing Above Trend

Source: St. Louis Federal Reserve

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

Businesses and Corporations Recovering Rapidly and Posting Record Results

The strong demand environment and the acceleration of several secular megatrends in the global economy, including leaps in technological adoption and digitization of business processes and consumer experiences, which are meaningfully enhancing productivity gains and efficiency, have led to another quarter of strong revenue growth and record corporate profits and cash flows. The combination of strong operating results and a favorable business environment with easy access to capital is enabling corporations to accelerate their investments for future growth through a combination of hiring, long-term focused capital spending, R&D, and acquisitions. The quarter saw a high level of business activity across all these areas. Job openings are at record levels and wage growth is taking place, which supports an already strong consumer and, in the end, continues to support economic growth. Despite potential pressures on margins tied to wages, we expect record corporate earnings this year and going forward, as businesses should be able to pass through some of the costs through price increases.

Headwinds Slowing Pace of Growth but Not Strong Enough to Derail the Current Expansion

Despite headlines around geopolitics, domestic political events, and fiscal policy, we believe that the two major headwinds that are affecting the economic expansion are the rise of new Covid-19 delta-variant cases and global supply chain constraints. The Covid-19 delta-variant broke out during 2nd quarter but didn't reach most developed countries until the 3rd quarter. Despite high vaccination rates, the spread of the delta-variant kept a lid on economic growth that could have been even faster, as many intra-regional travel corridors remained shut and other restrictive measures were kept in place. Currently, the rise in new cases appears to have peaked in early September and has continued to fall in most of the developed world. Supply chain constraints and transportation bottlenecks continued to be a global issue during the quarter and have dampened the pace of growth as current level of industrial output is not high enough to meet record demand.

We do not believe these factors will be powerful enough to derail the robust core fundamentals that are underpinning the current expansion. These headwinds may merely put a lid on the growth rate and extend the growth trajectory even further out in the future. We believe that the extraordinary monetary support, the strong consumer, and business environment will overcome these headwinds and economic growth will remain at an above average growth rate going forward.

Less Accommodative Monetary Policy Should Help Ease Inflation Pressures

Over the past several decades, the rise in aggregate price levels has on average grown at +1-3% per annum, but current inflation is running somewhere around +4-6%. The combination of record money supply growth, fiscal deficit spending, and low interest rates has led to increased inflation. The supply chain constraints add to the dynamics of higher prices and are expected to continue over the next coming quarters. In the short-term we believe inflation may stay at current elevated levels. Over time, the combination of less accommodative monetary policies and supply chain constraints easing should help subdue inflationary pressures and put economies on a more sustainable path for durable growth.

Stocks Remain Attractive for Long-Term Investors

Strong earnings results, expectations for faster growth, and low interest rates, continue to support the stock market. While experiencing some volatility in the quarter, returns have been strong year-to-date with large capitalization stocks up +15.9% (S&P 500), small capitalization stocks up +12.4% (Russell 2000), followed by slower but solid returns in foreign developed markets up +8.4% (MSCI EAFE), and weaker returns in emerging markets, with indices meaningfully weighted towards large technology companies in China, down -1.5% (MSCI EM). After seeing good performance over the last couple of years, investment grade bond returns have been negative year-to-date, down -1.6% (Citi Broad Bond Index).

Despite strong stock market performance throughout the year, forward price-to-earnings (P/E)-multiples have come down as year-end profit estimates have adjusted upward faster than the growth of stock prices. We currently believe that large capitalization stocks (S&P 500) will deliver over +60% growth in earnings per share in 2021, from the trough in 2020, and over +12% growth in 2022. This implies forward P/E-multiples at 21.5x and 19.1x, respectively. While valuations continue to be somewhat elevated relative to historical levels, we still believe stocks remain attractive for long-term investors. Since growth in earnings and free cash flows are what drives stock market returns and supports higher stock prices over time, we believe current valuation levels are justified as we expect faster than average earnings growth over the next several years.

In summary, with record low rates, higher inflation, above average economic and earnings growth, we continue to favor stocks over bonds. We continue to appreciate our philosophy of investing primarily in high-quality, consistent growth companies and take comfort knowing that our clients own strong companies that have proven the ability to grow in good and bad times. While stock prices may be volatile in the short-term, the underlying value and long-term growth potential of the companies we invest in does not change that rapidly. We believe the companies we have invested in are well positioned to continue to grow and compound earnings and free cash flows for the long-term, which are key drivers determining stock market returns. Over time, these fundamental factors will overcome short-term concerns and price volatility.

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., One Neenah Center, Suite 300, Neenah, WI 54956.