NORTH STAR
ASSET MANAGEMENT, INC.

July 2023

INVESTMENT UPDATE

Executive Summary

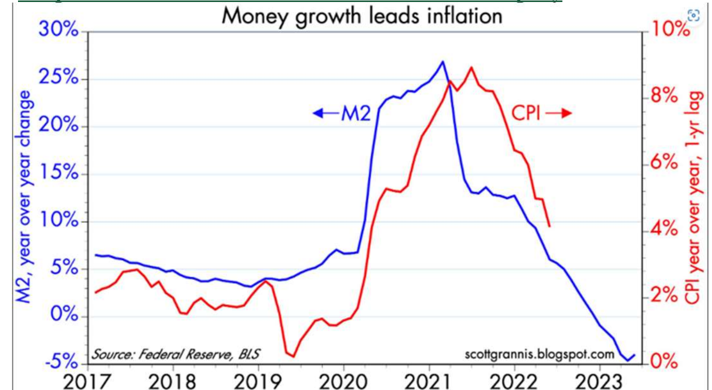
- Stocks generated strong returns in the quarter, while bonds were slightly down, as the end of the Fed's hiking cycle is in sight, the economy continues to grow, and the wave of technological innovation to ultimately drive productivity gains and sustained profit growth, remains strong.
- Inflation continues to rapidly fall toward the Fed's target of 2.0%, as high interest rates and tight financial conditions continue to remove the excess money supply causing it.
- The Fed raised the Fed Funds rate by 25 basis points to 5.00-5.25% in the quarter, but we believe we are close to the end of the hiking cycle.
- The economy continues to grow despite tighter financial conditions as consumers remain resilient with close to record high net worths, high levels of employment, and growing incomes, all factors helping to offset the restrictive Fed policy.
- A few select companies have driven the majority of the strong year-to-date broad market returns. Excluding these companies, valuations remain in line with historical averages and are attractive for long-term investors.
- We believe growth fundamentals and return prospects remain attractive. Long-term equity investors should be fully invested in stocks relative to one's target range. Bond investors should continue to take advantage of the most attractive bond and cash yields in over fifteen years.

Inflation Continues to Fall Rapidly Allowing the Fed to Lower Interest Rates Going Forward

The Fed continued its aggressive interest rate hike cycle that began in 2022 by raising the Fed Funds rate by 25 basis points to 5.00-5.25% in the quarter. These actions have been necessary in order to get financial conditions into balance again and rein in the four-decade-high inflation caused by the extraordinary amount of fiscal pandemic stimulus and keeping interest rates too low for too long in 2020 and 2021. Due to the lagging effects of roughly 12 to 18 months from the time of policy action, the economy is now increasingly experiencing the effects of higher interest rates. Hence, inflation continues to fall rapidly, and financial conditions continue to tighten.

As of May, the Consumer Price Index (CPI) has moderated to a 4.0% year-on-year increase down from the peak of 9.1% last June. When annualizing the latest 6-month change (the rough timeframe from when higher interest rates really started to take effect) the moderation in inflation is even more pronounced, down to a 3.0% year-over-year increase. Importantly, when assessing the future path of consumer prices, the key leading indicators, the changes in money supply (M2) and producer prices (PPI), continue to fall quickly. As shown in Graph 1 below, the change in money supply, which leads changes in the CPI by roughly 12 months, is down -3.9% year-over-year and -5.5% on a 6-month annualized basis. Additionally, the change in producer prices, which leads changes in the CPI by roughly 6 months, is down -0.8% on a 6-month annualized basis. As financial conditions remain tight, we believe inflation will continue to fall rapidly (potentially below the Fed's target of 2.0%) over the coming quarters. Going forward, we believe the Fed should start lowering rates as there will be a lag in easing conditions taking effect, the same way it took time before higher rates started to impact the economy.

Graph 1: M2 Leads Inflation and Continues to Fall Rapidly



Source: The Federal Reserve Board, BLS, and Scott Grannis

The Economy Remains Resilient and Growing Despite Tighter Financial Conditions

After a solid year in 2022 with 2.1% real GDP growth (nominal minus inflation, nominal GDP growth was 9.2%), the economy continued to grow at 2.0% (6.7% nominal) in the first quarter of 2023 despite tighter financial conditions. Consumer spending remains strong and consumers remain relatively healthy, as close to record high net worths, high levels of employment, and the fastest growing wages in four decades, continue to counterbalance tight financial conditions and drive economic growth. Despite higher interest rates and higher prices, consumers continue to have roughly $800 billion of excess pandemic savings and are fairly resilient to higher rates as the large majority of mortgages (two-thirds of consumer debt) have fixed rates meaningfully below current market rates. This is helping to keep debt-service costs close to historical lows. Additionally, while credit card balances are growing, they are normalizing from abnormally low levels. Overall, consumers have been handling tighter financial conditions well and we believe this will continue. We expect employment and

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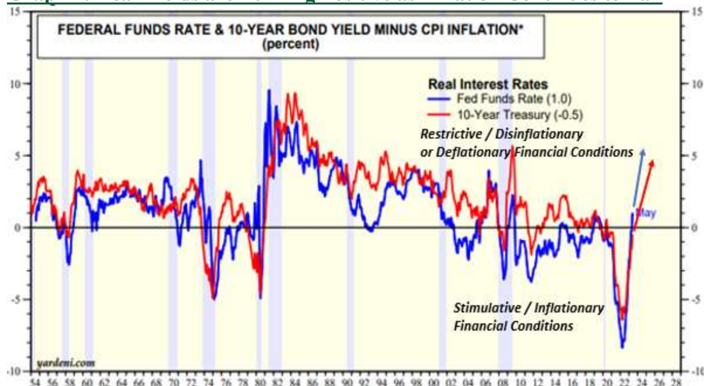
wages to be relatively resilient, as the combination of healthy demand and structural tightness in the labor market will support both. Businesses continue to be in good shape as well, with strong balance sheets after having generated record profits and cash flows over the last few years. They continue to invest in their businesses to increase productivity and drive long-term profit growth. As inflation continues to moderate, interest rates and financial conditions should become less restrictive, enabling the economy to continue to grow going forward.

The Fed Signals Continued Rate Hikes but We Believe Falling Inflation Will Lead Them to Start Lowering Rates

The Fed has done a good job of bringing down inflation and correcting the policy mistake of keeping rates too low for too long. But given the very aggressive hiking cycle, by increasing the Fed Funds rate by 500 basis points in 15 months, the main risk has quickly shifted to keeping monetary policy too restrictive for too long. In May, the Fed achieved an important objective by getting the Fed Funds rate to a positive real yield (Fed Funds minus inflation), as shown in Graph 2 below. This is a healthy sign of financial conditions getting back into balance as negative real yields are either stimulative, or if in excess, inflationary. In contrast, too high positive real yields are restrictive. Given that financial conditions continue to tighten with the powerful impacts of high interest rates increasingly taking effect, boosted by tighter bank lending standards following the mini-banking crisis, we believe inflation will continue to fall rapidly going forward. If rates remain at their current levels, real yields will soon rise sharply, making financial conditions extremely restrictive. Hence, we believe the Fed should start lowering rates to keep financial conditions in balance.

Graph 2: Real Yields are Turning Positive as Inflation Continues to Fall



Source: Yardeni Research, the Federal Reserve System, Bureau of Labor Statistics

Despite leading indicators clearly showing that inflation will continue to fall rapidly if interest rates remain high, the Fed continues to signal further interest rate hikes due to the strong economy. However, we believe that continued falling inflation in coming months and quarters will lead to the Fed changing their stance and starting to lower rates relatively soon despite their continued tough rhetoric. It is important to continue to point out that economic growth in and of itself does not cause inflation but is caused by an imbalance in the money supply relative to the size of the economy. This is getting resolved and will enable continued economic growth with low inflation.

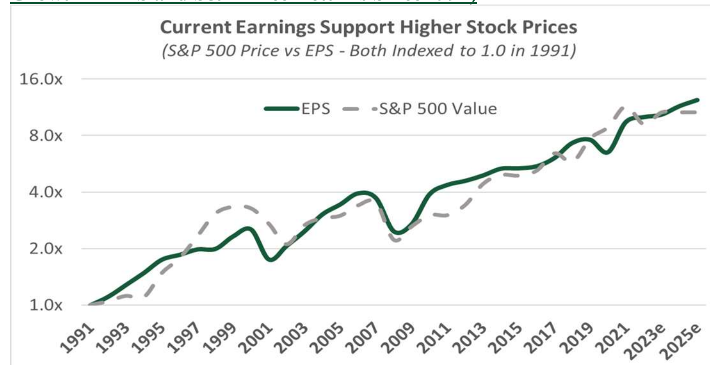
Stocks and Bonds Have Generated Solid Returns Year-To-Date as the Market Is Looking Further Out into the Future

Stocks posted strong returns for the third consecutive quarter as the end of the Fed's hiking cycle is in sight, companies posted stronger than expected earnings results, and the market, given its forward-looking nature, is looking further out in the future where the fundamentals for earnings growth remain strong. For bonds, returns were slightly negative in the quarter, but are positive for the year. Year-to-date, large cap stocks (S&P 500) have had the strongest performance and are up 16.9%. Notably, a few select technology stocks have driven the majority of the strong performance, and on an equal-weighted basis large caps (S&P 500) are up 7.0%. Additionally, small cap stocks (Russell 2000) are up 8.1%, international stocks (MSCI EAFE) are up 11.7% and bonds (USBIG) are up 2.1%.

We continue to expect companies to grow revenues in line with nominal GDP for the year. We also expect them to generate modest earnings growth as profit margins stabilize and start improving with major cost headwinds tied to inputs, supply chains, freight, and foreign exchange continuing to abate, as witnessed in the first quarter. Importantly, while there has been a temporary slowdown in earnings growth, we believe it will resume and be solid for the next several years.

Long-term, we continue to highlight that the undercurrent of technological innovation, led by computing and digitization, is very strong and driving major shifts within most industries to ultimately drive economic progress, boost productivity, and long-term earnings growth. The companies that are leaders and enabling these technological changes, and who drove the majority of the broad market's performance year-to-date, trade at above-market valuations. Excluding these companies, valuations remain in line with historical averages and we continue to be encouraged by the underlying fundamentals for earnings growth for the companies we invest in, which is the main driver of long-term equity returns, as shown in Graph 3 below. Long-term equity investors should stay fully invested in stocks relative to one's target range in order to position themselves for attractive returns over the next 3 to 5 years and beyond. Bond investors should continue to take advantage of the most attractive bond and cash yields in over fifteen years.

Graph 3: Earnings Growth Drives Stock Market Returns over Time (10-11x Growth in EPS and S&P Price Returns Since 1991)



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.