NORTH STAR ASSET MANAGEMENT, INC.

October 2023

INVESTMENT UPDATE

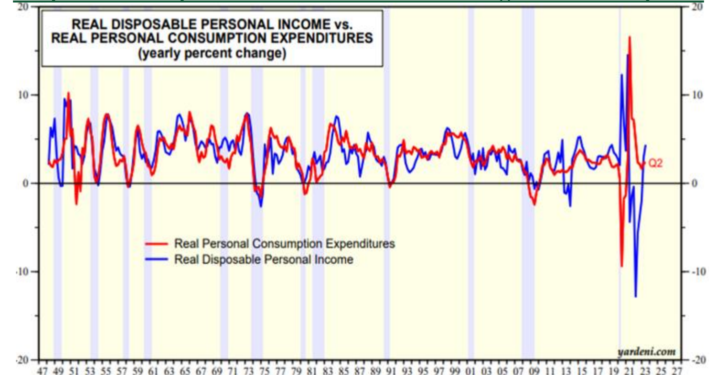
Executive Summary

- After solid returns in the first half of the year, stocks and bonds pulled back in the third quarter as the Fed signaled it will be keeping interest rates higher for longer.
- The U.S. economy remains strong and growing as consumers remain resilient, but tight financial conditions are having an effect and areas of weakness are emerging.
- Inflation continues to fall rapidly and we believe "real-time" inflation is now below the Fed's target of 2.0%.
- Despite mounting evidence of inflation being under control, the Fed raised the Fed Funds rate by another 25 basis points to 5.25-5.50% during the quarter.
- We believe the Fed should already have started lowering rates given how quickly inflation is falling. Eventually, the Fed will get it right and lower rates. We believe this will continue to support growth as well as provide a boost to the stock market.
- The long-term outlook for solid economic and profit growth has not changed and will come into focus again as near-term headwinds and uncertainties abate.
- Return prospects for long-term equity investors continue to be attractive, as strong long-term earnings growth prospects, underpinned by innovation and overcoming pandemic disruptions, are coupled with fair valuations. For bond investors, yields are the most attractive they have been in nearly two decades.
- We believe long-term investors should stay invested but remain patient as there could be some continued near-term market volatility. If that were to happen, that too shall pass, followed by a solid recovery.

Despite Tight Financial Conditions the Economy Remains Strong and Growing

The U.S. economy continued to grow robustly in the second quarter with real GDP (nominal minus inflation) growing +2.5% year-over-year, in line with long-term averages. Growth continues to be driven by strong consumer spending supported by record high net worths and strong wage growth. However, tight financial conditions are increasingly having an effect on the economy. The labor market remains strong but somewhat softening and more interest rate-sensitive parts of the economy, such as commercial office real estate, are showing signs of stress with rising vacancy rates and owners more exposed to high and rising rates. Bank lending also continues to slow with the after-effects of the mini-banking crisis contributing to the slowdown. As of September, commercial bank loan growth was only +0.6% on a 6-month annualized basis, slowing from double-digit year-over-year loan growth last year, and a +6.0% average annual growth rate over the last three decades. This slowdown will continue as long as financial conditions remain tight. Despite some areas showing weakness, the consumer, which makes up two-thirds of the economy, remains resilient. Importantly, real personal disposable income (after-tax) is now growing faster than real personal expenses, as shown in Graph 1 below, as incomes continue to adjust higher, while inflation continues to fall quickly. We believe this will continue to support consumer spending going forward. Additionally, debt-service costs remain low as nearly two-thirds of consumer debt is mortgages, mostly locked in at low, fixed rates. Overall, the consumer and economy continues to be resilient despite high interest rates.

Graph 1: Real Disposable Personal Income is Growing faster than Expenses



Source: BEA (Bureau of Economic Analysis), Yardeni Research

The Fed Should Be Lowering Rates as "Real-Time" Inflation is Now Below Their Long-Term Target

The Fed has done a good job of getting inflation under control, and by doing so, returned to meeting their key objective of economic price stability. It cannot be overstated how imperative this is to enable sustained long-term economic progress, growth, and prosperity. However, despite mounting evidence that the job is done, the Fed continued the hike cycle with another 25-basis point increase in July, taking the Fed Funds rate to 5.25-5.50% before pausing in September. Despite pausing, the tightening of financial conditions is accelerating. The money supply (M2), a key leading indicator of inflation by roughly 12 months, started to decline about a year ago and is down -3.7% year-over-year as of August. Inflation continues to fall rapidly as well. While Core CPI (Consumer Price Index) was up +4.3% year-over-year in August, we believe "real-time" inflation is materially lower. As shown in Graph 2 on the next page, Core CPI excluding shelter costs increased only +2.2% year-over-year, close to the Fed's target of 2.0%. The

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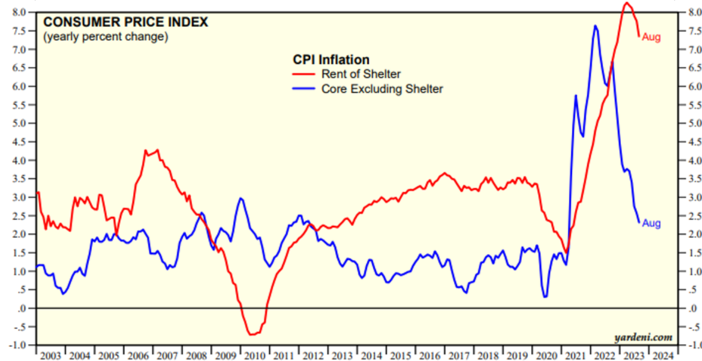
reason for excluding CPI-shelter costs is that they incorporate price changes over the last year, not exclusively the most recent month, making them lag "real-time" changes. As a result, "lagging" CPI-shelter costs grew +7.3% (Graph 2) while "real-time" shelter costs actually fell -1.2% year-over year in August.

Graph 2: Core CPI Excluding "Lagging" Shelter Costs Back to Fed Target



Source: Yardeni Research, Bureau of Labor Statistics

When including the "real-time" changes in shelter costs, the fall in inflation is meaningfully more pronounced, with Core CPI increasing around +1.0%. The effects of this are profound, meaning that real rates are above 4.0%, making financial conditions highly restrictive relative to a "neutral" policy-stance somewhere in the 2-3% range. We clearly believe the Fed should be lowering rates, allowing the economy to continue to grow with low inflation going forward. However, the Fed continues to use lagging indicators, such as the labor market, to guide policy action and therefore continues to keep rates high. As a result, given the lagging impacts of roughly 12 to 18 months from time of policy action to impact on the economy, the impact of previous rate hikes will continue to accelerate the slowdown of the economy as inflation will continue to fall, raising real rates even higher, and further tightening financial conditions. Keeping rates high could continue to cause elevated economic uncertainty and market volatility in the near-term. However, ultimately the Fed will get it right and start lowering rates, the same way they eventually got inflation under control. This will continue to support continued economic and profit growth and enable markets to continue to move higher.

While Stock and Bond Prices Pulled Back in the Quarter Major Pandemic-Related Headwinds are Now Behind Us

Stock and bond prices broadly declined in the 3-5% range in the third quarter, as the market began adjusting to the possibility of higher interest rates for longer. Market returns have thus moderated, but large cap stocks (S&P 500) continue to have the strongest performance, up +13.1% year-to-date. We continue to note that a select few large technology companies have driven the majority of returns, and on an equal-weighted basis, large cap stocks are up +1.8%. Additionally, small cap stocks (Russell 2000) are up +2.5%, and international stocks (MSCI EAFE) are up +7.6%. For bonds (USBIG), higher rates have led to bond returns declining -1.1% for the year.

Despite recent market pressure, underlying fundamentals remain solid and further support improving near-term financial performance as well as long-term growth. We continue to believe companies will grow revenues in the 5-7% range in 2023, in line with nominal GDP growth. Importantly, we are very encouraged that many of the multi-year, pandemic-related headwinds tied to supply chain disruptions, logistics challenges, soaring freight and input prices, and foreign exchange headwinds, have largely abated. Hence, we believe earnings growth will improve in the second half of 2023 and are encouraged as this will continue to enable more normalized business conditions and improved profitability going forward.

Long-Term Growth Fundamentals and Return Prospects Remain Attractive for Long-Term Investors

Stepping back, we continue to be encouraged by the structural trends for long-term economic growth, underpinned by productivity growth and technological innovation, largely driven by the exponential growth in computing power and digitalization. These trends were well underway and gaining momentum before the pandemic, but the pandemic accelerated adoption of new technologies and sped up major shifts within industries and for consumers. This dynamic, coupled with extraordinarily stimulative pandemic policies, increased the amount of capital invested into innovation, further accelerating the pace of progress. Hence, despite the economy adjusting from the disruption and desynchronization of global trade and supply chains, along with the multi-decade high inflation following too stimulative policies, the pace of innovation remains very strong. Additionally, higher costs themselves have incentivized faster technology adoption, as this is one of the major forces to boost productivity, lower long-term costs, and increase competitiveness to ultimately drive profit growth.

Going forward, we believe there is no change to the longer-term outcome of continued solid economic and profit growth leading to the stock market moving higher over time, despite the risk of the Fed keeping interest rates higher for longer. The Fed will eventually get it right and start lowering rates. Once these near-term headwinds abate, the long-term fundamentals will come into focus again, with strong prospects for future earnings growth (the key long-term driver of equity returns) supported by resilient consumers, strong innovation, and having overcome multi-year, pandemic-related disruptions. The companies we invest in continue to be some of the best positioned companies to benefit from these dynamics and many of them have increased their competitive advantages through the pandemic-years, making us constructive on their future earnings growth and return prospects. Additionally, stock valuations remain fair and bond yields are the most attractive in nearly two decades. Overall, this outlook continues to provide attractive long-term return prospects for both stock and bond investors over the next 3 to 5 years and beyond. We believe long-term investors should stay invested but remain patient as there could be some continued near-term market volatility. If that were to happen, we believe that too shall pass, followed by a solid recovery.

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.