HUDSON VALLEY INVESTMENT ADVISORS, INC.
A subsidiary of Orange County Bancorp, Inc.

Second Quarter 2017 Outlook

As of July1, 2017

The S&P 500 extended its advance in the second quarter. For the first time in the eight year bull market, U.S. stocks benefitted from a synchronized global economic expansion with both developed and developing countries experiencing accelerated economic growth. In the U.S., the Federal Open Market Committee (FOMC), the policy making body of the Federal Reserve System, is estimating annual GDP growth of 2.2%, with a nominal level of inflation. The U.S. economy has been running at a solid clip. Automobile manufacturing is averaging over 16 million vehicles, which is down from the record 17.5 million in 2016, but above longer term averages. Housing, which is another economic driver for the U.S. economy, saw a slight slowdown in the quarter but still remains on solid footing and is geared for expansion.

The FOMC has started to increase interest rates but remains accommodative for businesses to borrow. The Federal Funds rate is still below the rate of inflation which is the opposite of historical trends. At HVIA, we have expected the benefit of fiscal policy changes under President Trump but it appears delayed. Congress has slowed down the Trump agenda which had hoped to lower the cost of healthcare, implement tax reform, and enhance the nation's infrastructure. Government officials appear willing to spend more on national defense and infrastructure but given the fractious political climate in D.C. it is possible that very little of the ambitious Trump agenda will actually be accomplished.

Small business, homebuilders and corporate CEO's confidence levels are all showing significant strength. The gains in consumer confidence far exceed what occurred in previous elections and reflect a much more encouraging expectation of both current and future economic expectations. Valuation measures are somewhat high relative to historic levels but appear to be justified based on the low level of interest rates.

The S&P 500 recorded a gain of 2.57% for the second quarter. In terms of sectors, nine groups reported positive returns for the quarter while two had negative results. A number of top performers for the quarter included a number of more cyclically oriented groups. Positive quarterly returns included Healthcare (6.65%), Industrials (4.16%), Financials (3.80%), Information Technology (3.76%), Materials (2.64%), Consumer Discretionary (1.97%), Real Estate (1.84%), Utilities (1.36%), and Consumer Staples (0.90%). On the negative side of the ledger was Telecom Services (-8.14%) and Energy (-7.02%). As we've discussed, expectations are for continued economic growth which may accelerate further if and when the administrations fiscal plan and regulatory changes are adopted.

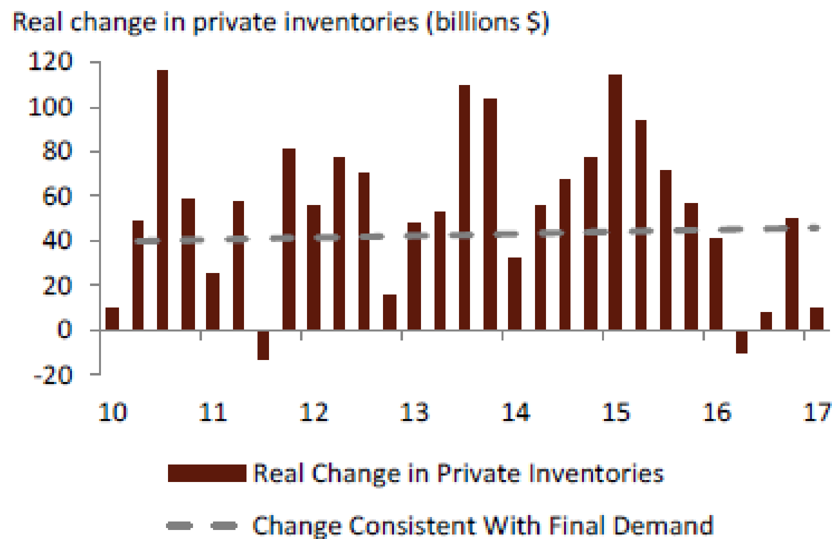
Outlook

At the end of the second quarter, the U.S. economy has seen solid growth. It is benefitting from synchronized growth from both developed and emerging economies which is providing a tailwind for the

U.S. With this as a backdrop, the Federal Reserve has an environment in which it can move to normalize interest rates. This is important as over the last few years capital allocation (credit) has been offered to lower quality companies. This may change in the future and will differentiate between higher quality companies and those that are less credit worthy. Economic data has continued to see improvement in job growth and solid mortgage applications in spite of higher rates. CEO confidence continues to remain strong which is great for future expectations and remains at levels not seen since Q2 2014. Forward looking economic indicators point to continued growth. In addition, if the proposed Trump agenda is put in place

we could be seeing an increase in earnings which would be reflected in higher stock prices.

Another factor pointing to continued growth is inventories. The below chart presents the change in inventory, against demand since the recession. Normally, you would expect inventories to run in line with final demand over the long term. They have been running below final demand and will need to "catch up" in order meet that demand. This implies that the expected pickup in inventories should lift GDP and earnings.



Most developed economies, including the U.S., are looking to reverse artificially low rates. This is reflected in Treasury returns being lower than the rate of inflation (which historically has not happened). HVIA anticipates that the economy can continue to expand and show growth over the next year at a minimum. Risks include the U.S. political environment, protectionism, and a drop in confidence.

Our focus on gauging the stock market is based on the earnings growth of the S&P 500 and the future growth expectations for those companies. We also focus on risk, which is reflected in the level of P/E ratios and potential for expansion. We currently believe that earnings are in a sweet spot that should continue to move higher and that P/E expansion will be limited in the coming months (as it sits at the higher end of its historical range). We continue to believe that U.S. companies will show revenue improvement and strong margins. This positions the economy to have an upward bias, in conjunction with the S&P 500 index, as we move into the back half of 2017.

The U.S. economy has consensus 2017 earnings growth of 9.9% for the S&P 500. The index is currently trading at 17.7x forward earnings with expected earnings per share of approximately $131.61. As we've said in past letters we continue to believe that we will see limited P/E expansion over the foreseeable future. Earnings gains will likely be the primary factor in S&P 500 appreciation. Both revenues and earnings continue to show positive results and should provide support to the underlying equity markets. We continue to expect forward P/E's in a range of 16.5x to 20x. Based on earnings expectations of $131.61, the S&P 500 has a potential range of 2,200 to 2,600 as we move into the second half of the year.

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Hudson Valley Investment Advisors, Inc. continues to favor equities over fixed income. The Federal Reserve started the interest rate raising process which should continue over an extended period. We believe they are looking to normalize rates and may accelerate interest rate increases as the US economy appears set to absorb the hikes. Overall, we feel that equities are positioned to have future appreciation. While we are moving toward a time when fixed income may be favored over equities, we have not arrived there yet.

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