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

Third Quarter Outlook

As of October 2, 2017

During the third quarter the U.S. markets continued to be supported by high single digit earnings growth, solid economic data and low interest rates. Over the past few quarters the S&P 500 earnings estimates have benefitted from an increase in revenues and low double digit margins. GDP growth indicated steady improvement until Hurricanes Harvey and Irma struck in the later part of the quarter. The negative influence on the current quarter is expected to add to growth in future quarters. Third quarter GDP projections prior to the hurricanes were expected to come in above 3%, which is higher than the longer term GDP growth expectations of 2% to 2 ½ %. The more robust economic environment is allowing the Federal Reserve to increase interest rates and reverse the monetary accommodation put in place after the financial crisis.

The Federal Reserve has increased interest rates but still remains accommodative for businesses and the economy to expand. As part of the healing (quantitative easing) of the economy post the financial crisis, the Federal Reserve added funds into the economy and increased its balance sheet. The Fed Chairman has indicated that we are past the point where the expansion of the Fed's balance sheet is needed and that the unwinding effort is beginning. At Hudson Valley Investment Advisors, Inc. we believe that this drawdown of the balance sheet will occur over time and could increase market volatility.

Expectations for fiscal policy changes and the addressing of Affordable Care Act have caused political infighting. Obamacare looks to have been pushed back to a later date while tax reform appears to be moving forward. In spite of the political headwinds for the Trump Administration we believe some type of tax reform will occur. Our confidence is due to the approval by the Freedom Caucus of the initial tax bill. The Caucus was a major obstacle to pushing back the proposed changes in healthcare reform. Internationally, issues with the North Korean government, Brexit and the reformulation of international trade may cause risk levels to increase but should not impact earnings to any major extent.

The political issues that have been present are not impacting either small business owners or consumers, whom will help maintain elevated confidence levels. The improvement in housing starts, building permits and consumer confidence points to continued growth. The solid economic environment may see some negative reports moving forward as labor shortages in some industries influence potential supply. Equity valuation measures continue to be 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 3.96% for the third quarter. In terms of sectors, ten groups reported positive returns for the quarter while one had negative results. A number of top performers for the quarter included a number of more cyclically oriented groups. Positive quarterly returns included Technology (8.28%), Energy (6.03%), Materials (5.55%), Telecom (5.41%), Financials (4.76%), Industrials (3.68%), Healthcare (3.20%), Utilities (1.97%), Consumer Discretionary (.48%), and Real Estate (.10%). On the negative side of the ledger was Consumer Staples (-2.02%). As we've discussed, expectations are for economic growth which may continue over an extended period and see a further acceleration if the administrations tax plan is passed.

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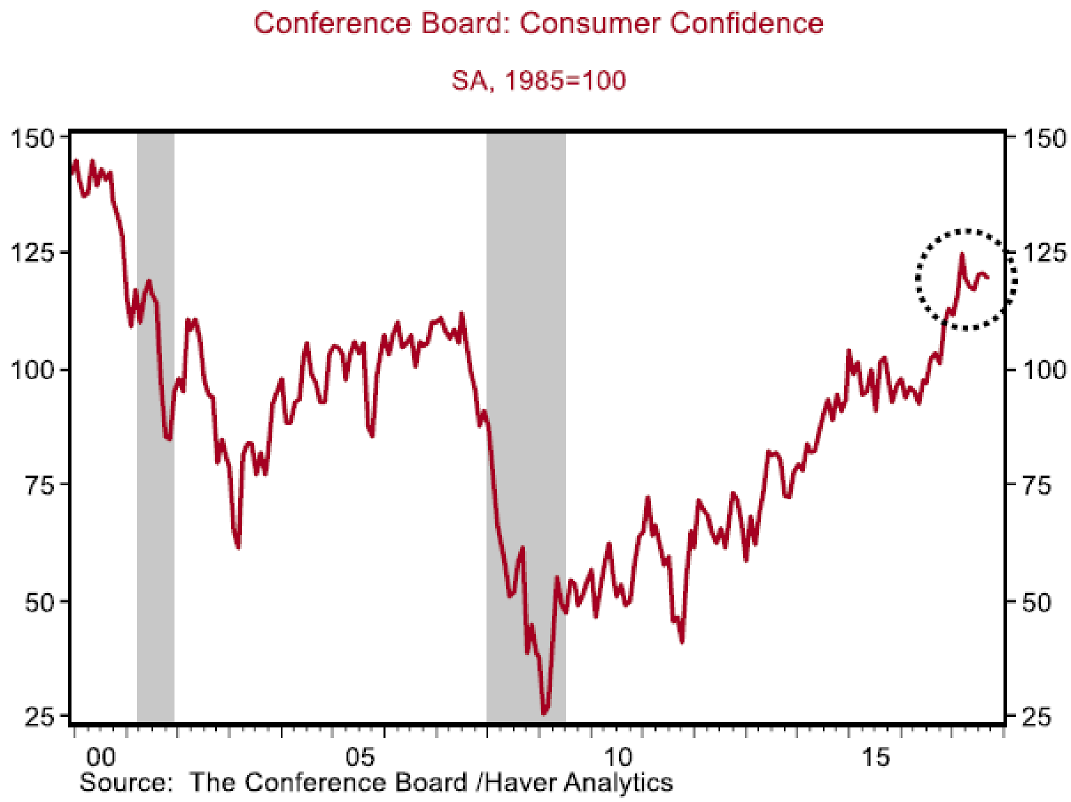
S & P 500

Source: Big Charts

<u>Outlook</u>

At the end of the third quarter, the glide path for the U.S. economy continues to remain strong. Both developed and emerging markets are showing improvement, which is helping to benefit the U.S. economy. As economic growth points to continued improvement, the Fed looks to move to normalize interest rates. This normalization of rates will most likely cause additional volatility in the markets as investors will be less inclined to take on increased risk. The artificially lower rates of the last few years will unwind and force less credit worthy creditors to have increased costs. 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.

We believe that growth will continue to maintain a solid pace into the future as strong sentiment continues from both builders and consumers wanting to purchase a home. The reconstruction efforts post hurricane and the continued high level of consumer confidence should command an added level of economic activity. Inventories continue to fall below sales growth. This shortfall is not only limited to housing but other areas in the economy, which are also trying to catch up to meet sales. This can be seen by the economic indicator called the purchasing manager's index or PMI. The importance of this leading economic indicator is that it provides insight for future demand.



The economic recovery seen in the U.S. has been part of a worldwide synchronized improvement. China, Japan and the European markets are all showing a positive economic environment. This is the first synchronized economic improvement in over 20 years which potentially can help to extend the U.S. economic expansion and provide demand for U.S. goods into foreign markets. The demand for U.S. products can be seen from the strength in capital goods, which are seeing a strong rate of improvement. Both domestic and overseas demand for capital goods should improve.

Our gauging of the stock market is based on the earnings growth of the S&P 500 and the future growth expectations for the companies in the index. We also focus on risk, which is reflected in the level of P/E ratios and potential for expansion. We continue to believe that earnings are in a sweet spot that should continue to move higher and that P/E expansion will be limited. U.S. companies have shown revenue improvement and solid margins which should continue. This positions the economy to have an upward bias, in conjunction with the S&P 500 index, as we move into year-end 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 $143 for 2018. As we've said in past letters we continue to believe that we will see limited P/E expansion over the foreseeable future. Earnings have been 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 $143, the S&P 500 has a potential range of 2,350 to 2,800 as we move into the second half of the year and into 2018.

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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. The raising of rates and reduction of the Federal Reserve's balance sheet will remove capital from the economy but the U.S. economy appears set to absorb the hikes. Overall, we feel that equities are positioned to have continued appreciation. We are moving toward a time when fixed income may continue to see a trend of slightly higher yields.