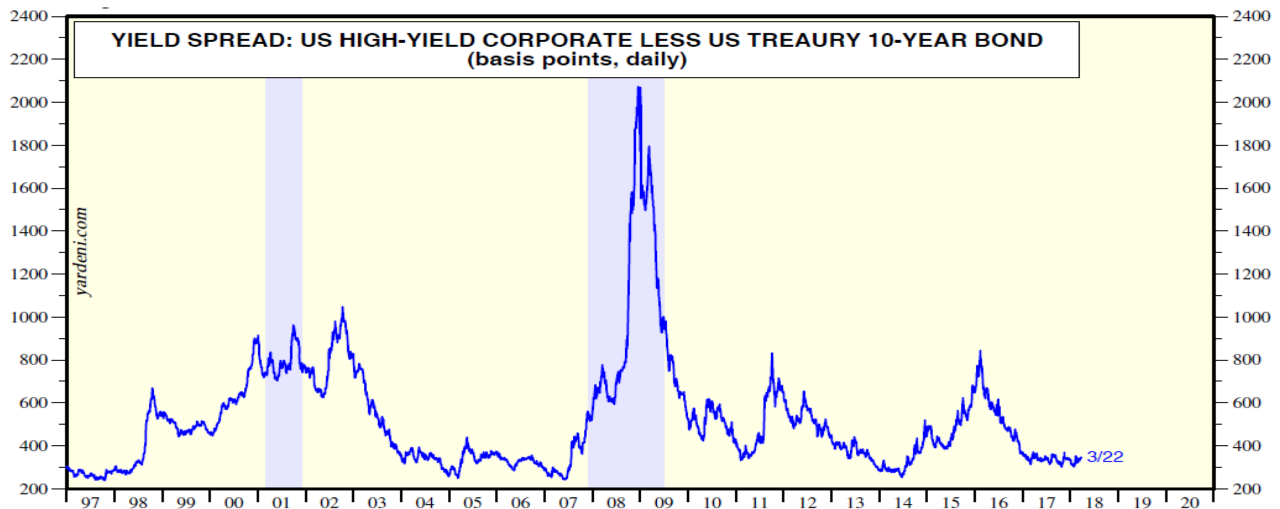
HUDSON VALLEY
INVESTMENT ADVISORS, INC.
A subsidiary of Orange County Bancorp, Inc.

# First Quarter Outlook

As of April 3, 2018

During the first quarter the U.S. markets benefitted from robust economic conditions from both the U.S. and on a worldwide basis. Economic buoyancy flowed through the economy accelerating the pace in both corporate revenues and earnings. Financial markets continued to operate with limited amounts of stress while credit remained available at historically low rates. Economic strength was seen in a number of government statistics and began to worry investors that inflation may be increasing. A perceived higher level of inflation had investors expecting the Federal Reserve to become more aggressive in trying to dampen any inflationary advance. The inflation scare created greater volatility to stock prices. The quarter absorbed the rise in trade tensions with China which also added to volatility.

The current economy is one of the strongest in recent memory. Bond market spreads between high yield and U.S. Treasuries provide insight into the level of perceived risk and remained at low levels. When bond spreads widen it is often an early warning sign that risks are increasing. This muted risk level can also be inferred by the strength seen in both consumer and business confidence over the back half of the quarter.



Note: Shaded areas denote recessions according to the National Bureau of Economic Research.
Source: Bank of America Merrill Lynch and Federal Reserve Board.

In the latter half of the quarter, the Trump Administration negatively impacted the stock market in a trade dispute with China. Tariffs were announced on steel, aluminum, and other products. This riled markets and undermined the benefits from U.S. tax cuts and reduced regulation. We believe the market's reaction to President Trump's trade tariffs is overstated. Analysts believe the tariffs amount to 0.1% of China's economic output. The potential of a trade war overshadowed a more conciliatory tone of North Korea, a compromise on a key NAFTA issues, and 44 African countries negotiated a deal to create one of the largest trading blocks in the world.

In our last few letters we've discussed the normalization process of interest rates by the Federal Reserve. The Fed is looking to balance the normalization of rates by maintaining the current economic expansion. During the quarter, Fed Chairman Jerome Powell replaced Janet Yellen with the priority of maintaining investor confidence and managing the transition to a more normalized rate environment. This normalization process will take time to unwind and will be accompanied by increased volatility.

We continue to anticipate that the year will maintain an upward bias for equities. The cut in taxes, reduced regulatory environment, expectation of an infrastructure bill and repatriation of funds should help to elongate the current economic expansion. The above trend GDP growth should continue and will flow through to corporate earnings. For the first quarter, earnings were above expectations at 7.3% revenue growth flowed through to final earnings growth of 17.3%. In addition, because of the change in tax law earnings expectations increased to 18.5% growth in the coming year. HVIA is maintaining our outlook for 2018 to the potential of high single to low double digit earnings growth.

Since our founding in 1995, our returns have been driven by a formulated investment process that starts with our top down analysis of economic inputs. Our equity investment focus is Growth at a Reasonable Price (GARP) while concentrating our fixed income on quality income producing investments. Of the S&P 500 groups, two of eleven groups reported positive returns for the quarter. Quarterly returns included Technology (3.20%) and Consumer Discretionary (2.76%). Negative returns were seen in Financials (-1.38%), Healthcare (-1.63%), Industrials (-2.02%), Utilities (-4.20%), REITs (-5.79%), Materials (-5.97%), Energy (-6.58%), Staples (-7.77%) and Telecom (-8.69%). At quarter end the economy outpaced the move in markets. We would expect continued economic strength and the Federal Reserve to be consistent on normalization of interest rates.

Outlook

GDP growth remained strong but was slowed in the short term. Harsh winter weather in the northeastern U.S., higher commodity prices, and tighter labor markets caused some short term dislocation. In spite of the labor shortages salaries have seen nominal growth. Consumer demand, industrial investment, housing and international growth all are strong and are helping to contribute to the health of the economy. Another area that has not received attention has been the benefits of reduced regulation. A record number of regulations have been removed freeing up monies for companies to invest or be more productive. This benefit should continue and provide a further tailwind to businesses.

Consumer confidence continues to remain strong and has been supportive of the economy. In spite of the economic positives the markets appear to be close to being fairly valued. As the U.S. economy continues to expand, the consensus 2018 earnings growth is 18.5% for the S&P 500, which is currently trading at 16.1x P/E with expected earnings per share of $157.77. We continue to believe that the economy may be in a position to outpace the stock market with both having an upward bias. On the fixed income side, economic strength and the Federal Reserve raising of interest rates may put bonds in a trading range for the foreseeable future. To summarize, expectations are for a continuation of earnings growth with the prospects for higher interest rates into 2018.

Hudson Valley Investment Advisors, Inc. continues to favor equities over fixed income. The Federal Reserve is in the middle of normalizing rates, the economy is now working in a more traditional manner and differentiation among investments has begun. The term "correlation" refers to how stocks or bonds move relative to one another, with higher correlation, it is more likely that assets trade together. Since the Federal Reserve started to lower interest rates starting in 2008 correlations increased to near record levels. Today, as the Federal Reserve unwinds Quantitative Easing, correlations have declined and differences among assets have started to widen. We expect it will increase in the coming year and continue the increased need for

active management. Interest rates have been declining for close to 30 years and that is changing. Keep in mind changes to rates happen slowly and this may be the start of a multiyear process. Overall, we feel that equities are positioned to have future appreciation.

Hudson Valley Investment Advisors, Inc. continually strives to meet your investment goals in the forever changing market environment. We will continue to apply our process to allow your portfolio to benefit from our insight and investment strategy.

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