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

Second Quarter Outlook

As of July 2, 2018

The second quarter generated strong economic growth at a pace not seen in an over a decade. The U.S. showed extremely strong GDP growth while the rest of the world was solid but slowing from just a few months ago. Geopolitics was a main focus for investors and the uncertainty that it created. This uncertainty is a risk that is difficult to measure and was a main culprit in the higher level of volatility seen in the financial markets. In addition, the pace of inflation picked up during the second half of 2017 and has continued into 2018. The increase in inflation has added to the uncertainty of both equity and fixed income markets while coinciding with an improved economy. This higher level of inflation pushed up interest rates across all maturities while narrowing the yield spread between shorter and longer dated bonds.

The economy is currently showing vibrant business activity that is expected to continue and will support corporate earnings growth. The growth of global GDP is one of the few worldwide coordinated growth periods that has been seen over the past fifty years. Volatility also increased as markets try to move back to pre-crisis interest rate levels. We would expect the macro underpinnings for the markets to remain solid for risk assets but the geopolitical cross currents to increase relative to the tranquil environment seen last year.

The elephant in the room during the quarter was the dispute over trade. This has been publicly fought out with approximately $200 billion in GDP being focused on potential tariffs. This dispute is seen as a way to level the playing field and present a more equitable trade environment for all parties involved. The reaction to the disputes won't necessarily signal the start of a trade war. Retaliation is standard protocol in a trade dispute and is usually the first step toward resolution. Often one country takes action against another country which then hits back with a proportional response, at which time both parties call a de facto truce. The key is whether the U.S. will follow the standard protocol.

The Federal Reserve continues to move to normalize interest rates while the Treasury reduces the size

of its balance sheet. The lowering of rates and the increase of the U.S. balance sheet were put in place to help stimulate the economy at the depths of the financial crisis. Ten years later the markets are unwinding their simulative positions. This normalization will reduce liquidity, increase interest rates and cause volatility to rise. The Federal Reserve increased the Fed Funds rate during the quarter with potentially two more rate increases expected during the remainder of the year.

We anticipate that the year will continue to be volatile but will maintain an upward bias for equities. We also anticipate interest rates being in a trading range with rates finishing higher than that seen at the start of the year. For the second quarter, earnings continued to be above expectations with revenue growth of approximately 8.8% and strong earnings that benefitted from solid sales and the continued improvement of margins providing earnings growth of approximately 20.0%. HVIA is maintaining our outlook for 2018. We see potential of high single digit revenue and 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, seven of eleven groups reported positive returns for the quarter. Quarterly returns included Energy (12.69%), Consumer Discretionary (7.84%) Technology (6.75%), Real Estate (5.13%), Utilities (2.80%), Health Care (2.66%) and Materials (2.05%). Negative returns were seen in Industrials (-3.66%), Financials (-3.58%), Consumer Staples (-2.34%) and Telecom Services (-2.33%). 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 which may continue to cause the growth in the economy to outpace the growth of the markets.

Outlook

GDP growth continues to expand at a strong rate with the Atlanta Federal Reserve indicating the potential of a 4.1% rate for the second quarter at the writing of this letter. The most noteworthy factors that continue to play out are seen from economic barometers such as Institute for Supply Management “ISM” and Purchasing Managers Index “PMI”. These are leading indicators that provide insight as to future demand. The most recent reading for PMI was 60.2%. This is indicating continued expansion for the next six months. The ISM index has also reported strong results with components of the index such as new orders, production and employment all showing continued strength. In addition, the level of inventories have remained at historically low levels which indicates that additional production would be need to return to get back to a normalized inventory level.

The concerns that remain are the increased conversation by companies regarding tariffs and the need to find alternative sources of supply in order to meet demand. Our conversations with various management teams point to varying time needed to change supply chains or develop new resources for production ranging from 12 to 24 months. We believe that in the end cooler heads will prevail and a compromise solution will be developed regarding the tariff dispute.

Consumer and business confidence remains strong and near record levels. Since consumption accounts

for approximately 70% of U.S. GDP we would expect the economy to continue to grow over the short to intermediate terms. While the shadows of tariff discussions and other factors may have put risk in the markets, investors must remember the amount of simulative firepower that has been placed into the economy. We previously described that approximately $200bn in GDP may be affected by tariffs. The offset is that the U.S. has added over $800bn in combined tax cuts, investment and repatriation of funds that should help to maintain growth over the next year.

Valuation of the S&P 500 appears to be neither expensive nor cheap. We would call it fairly valued at 16.1x forward earnings with growth that should be strong double digits in ’18 and high single to low double digit growth in ’19. The expect earnings per share of $160.94 for the S&P 500 continues to move higher due to better than expected revenues. 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 and 2019.

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. Today, as the Federal Reserve unwinds Quantitative Easing, correlations have declined and differences among assets have started to widen. We expect it will increase during the remainder of the year. Interest rates had 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.

We welcome you to take a look at our website http://www.hviaonline.com which now has videos and updates on the markets as well as informational pieces on investing. In addition, our Facebook page, Hudson Valley Investment Advisors, Inc., was recently launched which provides insight that investors should find useful.

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