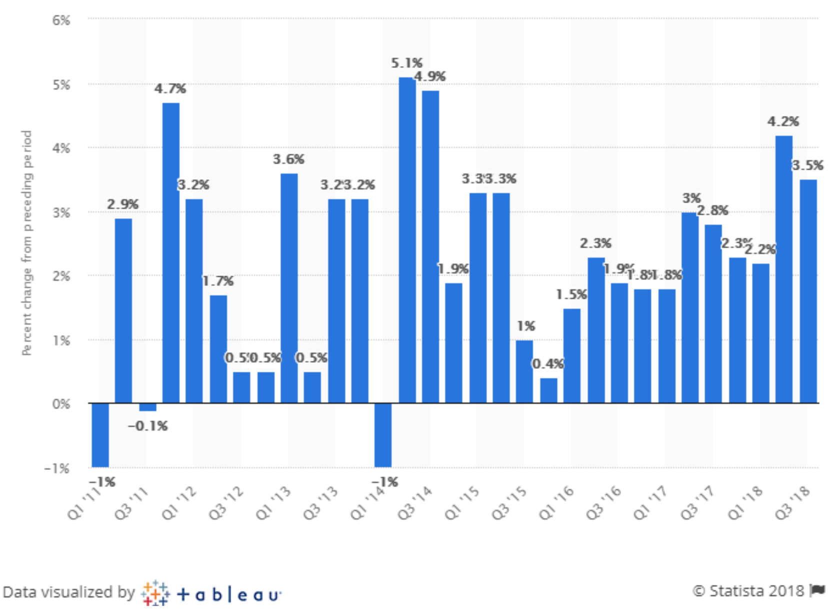
Hudson Valley Investment Advisors, Inc.
A subsidiary of Orange County Bancorp, Inc.

Fourth Quarter Outlook

As of January 3, 2019

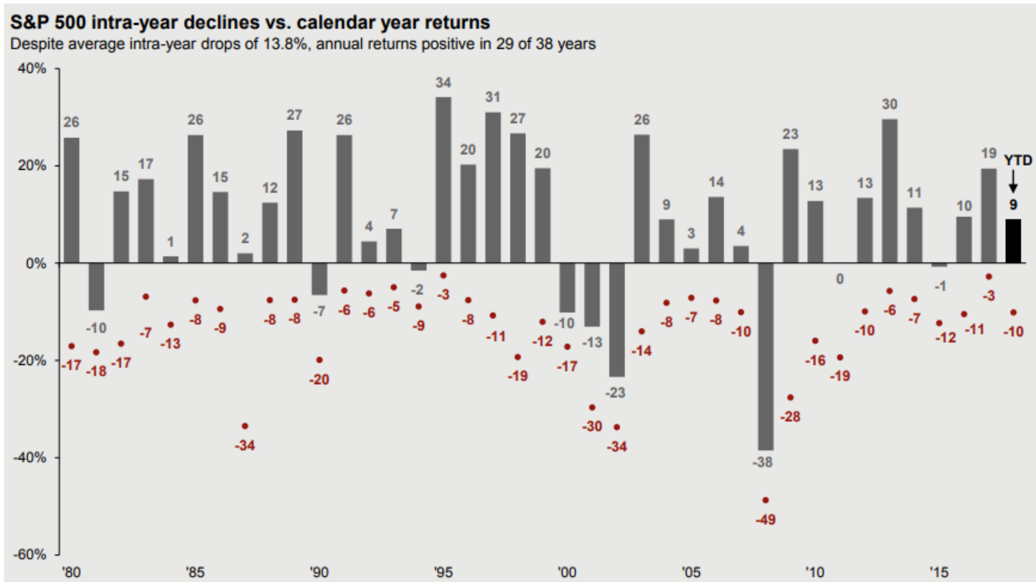
The fourth quarter of 2018 closed with one of the weakest December's in the equity markets in over 50 years. The S&P 500 index was down over 8% in the month of December. Fixed Income markets remained under pressure as the F.O.M.C. (Federal Reserve) raised the Federal Funds rate at their final meeting of 2018. U.S. economic fundamentals remained strong but did soften from levels seen in earlier quarters. This continued strength in the economy did not translate through to either the equity or fixed income markets.

<u>Quarterly U.S. GDP</u>



There are a number of perceived risks to the U.S. economy and markets. They range from tariff escalation, political strife and a policy error by the Federal Reserve (raising rates too high, too soon). In addition to interest rate hikes, the Fed is in the process of unwinding its balance sheet from the large growth it incurred during Quantitative Easing. This process of selling off bonds, or not reissuing maturing bonds, has the effect of reducing liquidity in financial markets. These factors, among others, have increased market risk and volatility in the short term.

In order to provide perspective on recent market volatility, please view the chart below. The chart goes back approximately 40 years. It includes year-end returns (bars) and the intra-year lows (dots) for the S&P 500. It illustrates that we have seen an annual average intra year downturn of 8% to 10% and in spite of these downward moves; the S&P 500 has seen a positive annual return in four out of every five years.



Source: FactSet, Standard & Poor's, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Intra-year drops refers to the largest market drops from a peak to a trough during the year. For illustrative purposes only. Returns shown are calendar year returns from 1980 to 2017, over which time period the average annual return was 8.8%.

The most important long term driver for the stock market is underlying company earnings. The S&P 500 continues to report strong earnings, as well as, record operating margins. We do anticipate some pullback from the record operating margins but believe they will remain toward the upper end of historical levels in 2019. After the pullback at the end of the fourth quarter, the market seems to be valued as if we have a 100% chance of recession in 2019. Whether we got into a recession over the next 12 months is an unknown but there have been many false signals in the past. As an example, the markets have dropped 20% or more 9 times since World War II but never entered a recession. We would expect a continuance of a strong economic backdrop given the most recent data available.

Despite a strong economy, market risk has increased over the past 12 to 18 months. Tariffs and trade are factors that are influencing volatility in the markets. The U.S. dispute with China is really more focused on technology transfer versus “unfair” trade practices. This concern is difficult to police, enforce and change over the short term. We would expect this to be an extended process which may cause additional risk to the markets. It may cause the discounting of reduced margins from record levels. The heightened concern on trade, a strong U.S. dollar and declines in commodity prices have pressured both developed and developing economies. Equity valuations are being discounted by investors in the U.S. markets in spite of its current economic strength. These are a few factors that could lead the economy to outpace the stock market in the short term.

The bullish sentiment in the market that we have seen from the start of the year has receded, even with the record U.S. earnings delivered throughout 2018. The downward move in markets was not confined to the U.S., as only 5% of the worldwide indexes posted a positive return this year. An example would be in the Energy markets. Energy prices weakened from one point in 2018, where there were calls of oil headed to $100 per barrel, with a drop in price of nearly 50% as supply unexpectedly increased. This is important because Energy markets can provide insight into economic strength. The consumer makes up 70% of U.S. GDP. We expect the drop in oil prices to limit inflation and help maintain consumer spending, which will in turn, bolster economic strength in the U.S.

Finally, we will turn toward the shape of the yield curve. An inversion of the yield curve is often an early predictor of an oncoming recession. The yield curve has become quite flat but still has not inverted. We caution that this predictor is often quite early, with equity market advances of close to 20% over the 2 years after an inverted yield curve appears. In addition, it is possible that the long end of the yield curve has been suppressed as a result of the unwinding of the Fed's balance sheet and this may cause it not to be the predictor it has been in the past. The raising of interest rates will pressure the short end of the curve and will likely keep it flat during this process.

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, ten of eleven groups reported negative returns for the quarter. Only Utilities (0.50%) reported positive results while negative returns were seen in REITS (-4.71%), Staples (-5.95%), Healthcare (-9.10%), Materials (-12.81%), Communications Services (-13.56%), Financials (-13.59), Consumer Discretionary (-16.70%), Technology (-17.68%), Industrials (-17.74%) and Energy (-24.40%). At quarter end we expect continued economic strength and the Federal Reserve to be focused on trying to normalize interest rates in 2019.

Outlook

U.S. GDP growth has slowed but remains solid and above the levels seen prior to the current Presidential administration. We continue to expect at least 2.25% GDP growth over the short term and it will likely outpace consensus expectations. To illustrate, consumers reported strong retail sales during the Christmas season and unemployment remains near a record low of 3.7%. This is important, as we mention again, that the U.S. consumer makes up 70% of the economy, this bodes well for continued economic growth in 2019.

We expect revenues, margins and earnings all to remain strong but potentially decline from record levels over the coming quarters. The market could remain in a wide trading pattern until further clarity is found on trade, interest rates and political strife. Headwinds to the current environment include tight labor markets, higher input costs and the potential disruption in supply chains. The recent tax reform act and reduced regulation have helped support growth in business investment and capital expenditures in the face of these headwinds. This has resulted in productivity gains that can help reduce inflation and provide support to margins of U.S. companies.

After weighing the economic positives and noted risks, the S&P 500 appears to be attractively valued. As the U.S. economy continues to expand, the overall market is trading at a 13.5x forward P/E which is by no means historically expensive. We continue to believe that the economy may outpace the stock market in the short run with both of them having an upward bias. On the fixed income side, economic strength and the Federal Reserve continuing with interest rate increases may put bonds in a trading range for the foreseeable future.

Fourth Quarter Outlook

As of January 3, 2019

Summary

Hudson Valley Investment Advisors, Inc. continues, over the longer term, to favor equities over fixed income. The recent market volatility has provided us with an opportunity. HVIA has taken this opportunity, where appropriate, to rebalance portfolios to take advantage of the market pullback, better positioning portfolios for the future. This includes adjusting sector weightings, removing companies, as well as, adding companies that previously had valuations too high to be considered for our strategy and your portfolios.

The Fed is in the process of "normalizing" interest rates, the economy is now working in a more traditional manner and a differentiation among investments has begun. It is important to remember that interest rates had been declining for close to 30 years and that has now changed. A change to interest rates generally happens slowly and this may be the start of a multiyear process. Overall, even though growth in the U.S. has slowed, we feel that equities are still better positioned to have future appreciation over fixed income.

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 educational videos, market updates, thought pieces and recent TV appearances. In addition, our Facebook page, Hudson Valley Investment Advisors, Inc., provides insight that investors should find useful. We welcome your feedback and thank you for your support as clients.