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

First Quarter Outlook

As of April 3, 2019

Recap

2019 opened with one of the strongest quarters that the equity markets have seen in over two decades. This was a complete reversal from the end of 2018, which had been the S&P 500's weakest fourth quarter in over 70 years. The economic backdrop remained strong throughout but less robust relative to earlier in 2018. The U.S. is coming off of some of the best economic conditions seen in the last 25 years. The economy continues to provide solid tailwinds while some concerns still remain. Markets continue to be concerned over negative impacts to growth. These impacts include the closure of the Federal Government, the fear of rising interest rates, trade tensions with China and the ramifications of impending Brexit.

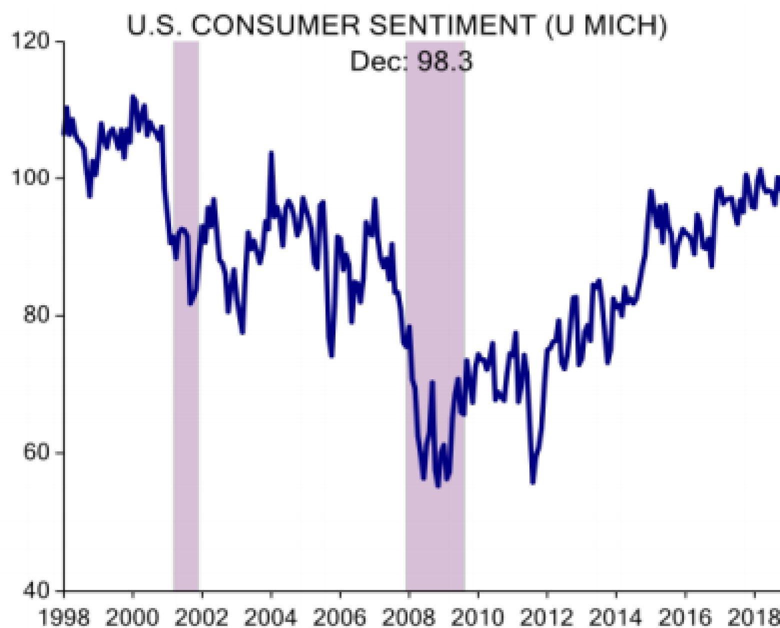
Risks that were actual or perceived in the 4th quarter of 2018 were alleviated as we moved into 2019. The equity markets responded favorably as a result. China trade negotiations got underway with a favorable tone. Jerome Powell and the Federal Reserve announced they would become more flexible and data dependent in regards to interest rate increases. The more dovish stance by the Federal Reserve moving forward alleviated pressure of a policy mistake and concerns over inflation. In addition, we saw fixed income market spreads tighten over the first quarter. This illustrates that investors were more willing to take on additional risk, a reversal from the prior quarter.

Present

The S&P 500 continued to report strong earnings through the 1st quarter of 2019. This is one of the most important factors driving stock market returns. The perception was that we would continue to see downward pressure on financial returns. The strong revenue and earnings growth during the first quarter helped alleviate this pressure and to support equity valuations. We believe that the economy drives financial markets. Dislocation between the economic environment and stock market returns can occur in the short term from time to time. This was the case in the 4th quarter of 2018. It appears as though this temporary reversion has completed and we are back on the path prior to the downturn.

Reductions in risk and the continuance of solid revenue generation following the 4th quarter have driven the equity markets to near historically high levels. The economic backdrop continues to look solid with potential revenue growth of mid-single digits and solid margins. We expect robust revenue growth moving forward but at slightly lower rates relative to recent historical levels.

Market risk has been reduced and volatility has receded despite the economies strong performance. Inflation has been limited and is lower than expectations from only a few quarters ago. These lower expectations coupled with the reversal of the Federal Reserve rate policy has allowed bonds to increase in price and rates to move lower. The strong economic environment and lower interest rates have started to spur housing and maintain consumer confidence as can be seen in the following chart.



President Trump has provided unexpected risks to the markets due to the reworking of trade agreements and political relationships. His adversarial tone and style, on many fronts, has increased uncertainty. This has hurt equity prices in the short term. However, we believe that earnings are the ultimate arbiter of stock valuations. Over time higher earnings levels should propel markets higher. Additionally, we anticipate the growth of overseas markets to rebound once trade agreements with China and Europe are in place. This will solidify willingness to expand capital investment which has been delayed given the uncertain political environment.

Recently, the press has made it a point to highlight the inversion of the yield curve. An inversion has in the past been a warning sign for future recessions. The point less often spoken about is the length of the inversion. It must take place for an extended period of time (on average more than 10 months) to be an accurate predictor. In addition, this is often a period where stocks record strong returns. It is possible that the long end of the yield curve has been suppressed due to the unwinding of the Federal Reserve's balance sheet (Quantitative Tightening). This may cause the yield curve to not be the predictor it had in the past. Increasing interest rates over time will likely pressure the short end of the yield curve, thus keeping it flat during this process. We look to the yield curve to maintain a flat to positive slope over the coming months.

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, all eleven groups reported positive returns for the quarter. Returns by sector were as follows: Technology (19.37%), Industrials (16.64%), REITS (16.64%), Energy (15.42%), Consumer Discretionary (15.32%), Communications Services (13.62%), Staples (11.16%), Utilities (9.88%), Materials (9.68%), Financials (7.90%) and Healthcare (6.12%). At quarter end we expect the economy to continue to remain solid and the Federal Reserve to maintain rates at current levels for the remainder of 2019.

Outlook

U.S. GDP growth has slowed but remains at solid levels. The most recent U.S. GDP reading has come in at 2.25%. This took a hit from the closure of the federal government and we are expecting it to potentially be held back in the next few months and then rebound. We maintain this perspective since confidence and capital investments should improve once trade negotiations with China, Europe and U.S. Government are finalized.

We expect revenues, margins and earnings all to remain strong but possibly grow at lower levels than seen in the prior year. The market could remain in a wide trading pattern. We expect a sense of relief once there is clarity on trade, Brexit and political bickering here in the U.S. The U.S. economy is experiencing tight labor markets, higher input costs and the continued disruption of supply chains. It is our stance that these headwinds will work themselves out over time. This may benefit the economy over the longer term as greater capital investment is made to improve productivity and support future growth.

After considering the economic positives and the noted risks, the S&P 500 appears to be fairly valued. As the U.S. economy continues to expand, the overall market is trading at a 16.1x forward P/E ratio. This falls between the 5 and 10 year averages. We believe the economy and the equity markets will be in a trading range over the next few quarters. We expect interest rates to remain stable as well.

Summary

Hudson Valley Investment Advisors, Inc. continues, over the longer term, to favor equities over fixed income. Over the past few quarters the higher level of volatility has allowed HVIA and our clients an opportunity. We have taken this opportunity, where appropriate, to rebalance portfolios to take advantage of the market pullback. This allows for better positioning into the future. In many circumstances we have adjusted sector weightings, removed companies, as well as, added companies that have previously held valuations too high to be considered for our strategy and clients.

The economy is now working in a more traditional manner and a differentiation among investments has begun. The Federal Reserve is on the sidelines in terms of rate increases. It is important to remember that interest rates had been close to or below 1% for an extended period of time. This allowed lesser quality companies to compete on more equal footing with their better quality competitors. Overall, even though growth in the U.S. has slowed, we feel that equities continue to be 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.

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