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

Third Quarter Outlook

As of October 1, 2019

Economy In Review

As we close the third quarter of 2019 we look back at a period characterized by uncertainty. Monetary, Fiscal and Regulatory policy changes, in addition to trade tensions, make it difficult to distinguish between short term noise and actual economic strength. This culminated in increased volatility during the quarter. August saw approximately 50% of its trading days return a daily change of 1% or more. Money flows out of equities and into fixed income helped to push interest rates close to all-time lows. Worldwide sovereign debt (bonds issued by countries to support their economies) stood at $57 Trillion with over $17 Trillion of that returning a negative yield. In other words, investors are paying these governments to invest in their bonds. Only U.S., British and Canadian sovereign debt maintained a positive yield at the end of the quarter.

We here at HVIA remain cautious as we focus on the inverted, or negative, yield curve. An inverted yield curve is when the short end of the curve (i.e. 2 year U.S. Treasury) has a higher rate than the long end (i.e. 10 year U.S. Treasury). An inverted yield curve limits the willingness of banks and other financial institutions to lend and often restricts credit to companies and individuals. The banks have to pay depositors higher rates than at which they can lend money, thus slowing economic growth. The yield curve has bounced back and forth from positive to negative in the past quarter. Investors have taken a more cautious stance as a negative yield curve has historically led to recessions here in the U.S. However, the growing interconnection between U.S. and other markets may mean that the inverted yield curve signal may be less predictive than in past market cycles. This is further impacted by many foreign governments lowering interest rates below zero.

We would agree that the U.S. is most likely in the later stages of an economic cycle. It does not mean that the U.S. can't continue to see positive gains as we move forward. This is due in part to much shallower historical growth experienced coming out of the Financial Crisis of 2008. The current economic cycle has not seen the excessive growth as seen in other past cycles. Our philosophy is to look through any impending downturn as a point in time in which to invest in themes that are longer term in nature and will drive the economy both here and abroad. 5G and logistics are examples of such themes.

We analyze factors in the economy and markets that support the advance or decline of U.S. economic growth. Risk is an important factor which can be measured in many ways. One such measurement is through the difference, or spread, of U.S. Treasuries (risk free securities) and U.S. Corporate bonds. The spread between these bonds has contracted over the quarter. This indicates the willingness of investors to take on higher levels of risk. Additionally, trade pressure induced by the rift between the U.S. and China has begun to impact the economy. Continued friction has delayed the ability of companies to invest and has restricted trade in the short term. This has dampened the industrial output of the U.S. economy with a slowdown in production. However, this is offset by a U.S. consumer that continues to show strength and support to U.S. economic growth. This points us to continued, albeit slower, economic growth here at home. Overseas economies continue to see economic contraction and have begun to cut interest rates to help stimulate growth. Finally, the 2020 U.S. Presidential Race has started to heat up. There have been a surprising number of populist and socialist ideas presented that may not be business friendly. As we move forward, these ideas or potential policies can influence markets and may cause a limitation of multiple expansions in the markets. It remains to be seen if this can be offset by the continuation of lower interest rates by the Federal Reserve, which is supportive of equity valuations, the consumer and housing market.

Present

The S&P 500 has seen a slowdown in earnings due to trade tariffs and political friction affecting a number of developed countries. Revenues and earnings are the main factors driving equity valuations. We foresee a continued slowing of earnings in 2019, while earnings forecasts for 2020 continue to hold at this point. The continuation of trade tensions will provide pressure on future financial returns. There is a strong possibility for a trade resolution by year end. This supports the potential 2020 $180 earnings per share forecast for the S&P 500. Currently, there is a dislocation between the economic environment and stock market returns. The longer this continues, the bigger the impact to future earnings results. Current and future interest rates should remain accommodative which, we believe, will keep the S&P 500 in a trading range until we gain clarity from the current trade dispute with China. In addition to trade disputes, geopolitical pressures have been on the rise. Tensions with North Korea, Afghanistan and Russia remain. Issues between the U.S. and Iran have ratcheted up over the aggressive attack which destroyed part of a Saudi Arabian oil complex. We anticipate these tensions to continue into the future. The removal of James Bolton from the President's cabinet does, however, signal that the U.S. does not want another war in the Middle East even as it seeks to tighten the financial pressure and sanctions on Iran.

Domestic tensions had eased, until just recently, as the Democrats called for impeachment of the President. The constant barrage of new information, accusations and tweets has made things definitively more unpredictable. We expect the continuation of unexpected decisions and outcomes but believe that the U.S. is the best house on a struggling block in terms of the Global Economy. A strong U.S. consumer continues to support the economy under the backdrop of improving employment, wages and better personal balance sheets. Housing should continue to move higher with better pricing and solid demand as the Federal Reserve keeps interest rates accommodative.

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). Our fixed income investments are focused on quality income producing securities. Of the S&P 500 sectors, eight groups reported earnings return for the quarter as follows: Utilities (8.4%), REITS (6.9%), Consumer Staples (5.4%), Technology (2.9%), Communications Services (1.8%), Financials (1.4%), Industrials (0.5%), Consumer Discretionary (0.2%), Materials (-0.7%), Healthcare (-2.7%) and Energy (7.3%). At quarter end we expect the economy to continue to see positive growth but slower than the prior quarters. We also believe the Federal Reserve will further cut rates one more time before year end.

Outlook

U.S. GDP growth has slowed to below 2% from almost double that level seen prior to trade disputes with China. There are still lingering effects from the U.S. Government shutdown earlier in the year. The most recent reading of U.S. GDP growth is 1.6%. We expect GDP growth to potentially be held back over the coming months and then rebound. We maintain this belief since consumer and business confidence, as well as, capital investments should improve once trade negotiations with China, Europe, Japan and NAFTA 2.0 are finalized.

Our expectation is for revenues, margins and earnings to all remain under pressure for the balance of 2019. Earnings should normalize in 2020 as the tax cuts that improved earnings in 2018 become fully integrated. We feel as though the economy is growing but at a slower pace than previous years and that a

recession is not imminent. Growth of the economy should continue at lower levels as our current economic expansion continues. As we have noted, the expectation is that equity markets will remain in a trading pattern over the next few months. Relief will likely come once we have clarity on trade, Brexit and the political bickering here in the U.S. Headwinds to economic growth are tight labor markets, higher input costs and the continued disruption of supply chains. It is our stance that these issues will work themselves out over time. This should prove a benefit to the economy over the longer term as greater capital investment is made to improve productivity and support future growth.

Giving full consideration to the economic positives and noted risks, the S&P 500 appears to be fairly valued at a 17.0x Forward Price/Earnings Ratio. This valuation is neither a cheap nor rich measure. Again, with interest rates remaining stable, we expect the economy and equity markets to remain range bound over the next few quarters.

Summary

Hudson Valley Investment Advisors, Inc. continues, in the longer term, to favor equities over fixed income. The increased volatility over the past several quarters has allowed HVIA and our clients an opportunity. We have taken this opportunity, where appropriate, to rebalance portfolios to take advantage market pullbacks. This allows portfolios to be better positioned 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.

The U.S. economy is being held back from its true growth potential. As we inch closer toward a U.S. / China trade resolution, we expect the markets to move in a more traditional manner. Overall, even though growth in the U.S. has slowed, we expect it to continue on an upward path and that equities will be better positioned for future appreciation over fixed income.
Hudson Valley Investment Advisors, Inc. shall always strive 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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