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

Fourth Quarter Outlook

As of January 1, 2020

Economy In Review

What a difference a year makes! The fourth quarter was a complete reversal from one year ago as the markets closed 2019 in strong fashion, erasing the prior year's loss. There were many headwinds and risks in 2019 that included, but were not limited to, the U.S./China trade dispute, heightened partisan politics and the slowing, but still growing U.S. economy. Despite these headwinds, both the U.S. equity and U.S. fixed income markets provided meaningful gains. Hudson Valley Investment Advisors, Inc. (HVIA) remained positive on equities throughout 2019 as we witnessed the U.S. consumer provide support to our economy. We believe that 2020 will be more of the same. Our expectation is that the more cyclical parts of the U.S. economy will start to stabilize and report better results, which will in turn, propel us moving forward. We are also expecting to see increased volatility as the year progresses and the U.S. Presidential election brings political risk back into focus.

As we look at the fourth quarter we find that a number of risks have been removed from the equation. The U.S. / China trade dispute has de-escalated with the Phase One agreement close to ratification. The Federal Reserve has reduced interest rates and we expect they will continue to remain low. Earnings expectations for S&P 500 companies have been better than expected. Recession fears have been reduced. It appears that we are starting to see a bottoming in the decline of growth from the industrial (manufacturing) sector. Finally, improved liquidity is helping to drive asset prices higher through the lowering of interest rates, in turn raising the value of most asset classes. This has made equities a more attractive investment relative to bonds.

Further factors that may provide tailwinds to U.S. markets include an investing environment that is experiencing an accommodative monetary policy. The U.S. / China and the USMCA (NAFTA 2.0) trade agreements are expected to increase capital investment and reaccelerate the economies involved. Next, the industrial sector is positioned for growth. As the headwinds from last year's labor strike at GM and challenges at Boeing, who is the U.S.'s largest exporter, are expected to be accretive to the U.S. Economy in 2020. This comes after negatively impacting U.S. GDP by approximately 0.4% in 2019. Finally, over 50 economies around the world have stimulated their economies through monetary policy. This creates an expansion to the worldwide money supply. This backdrop should help support the equity markets while interest rates remain low by historical standards.

Interest rate spreads (a signal for risk) continued to tighten in the 4th quarter and this points to a willingness to take on risk. As we move into 2020, we see a limited chance for significantly higher interest rates as inflation remains below Federal Reserve targets. This combination of factors has allowed the yield curve to

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- **Come to our "Sip and Learn" event on January 30, 2020. Focusing on women business owners and clients preparing for retirement. Visit hviaonline.com/events for more details.**
- **Keep an eye our for our upcoming "Market Update" event in April.**
- **Our client portal is coming soon. All documents can be sent and received electronically. If you have any interest, please email operations@hviaonline.com**
- **See Gus Scacco's recent appearance of Fox Business News. hviaonline.com/insights**
- **You can view your account online at: investor.pershing.com Please let us know if you need any help.**

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steepen, reversing the negative (inverted) yield curve seen earlier in 2019. This is important because as we mentioned in previous notes, an inverted yield curve is a potential predictor of recessions.

Economies outside of the U.S. continued to see minimal to negative growth in 2019. We do expect some economic pickup in Europe and Asia moving forward. The U.S. / China trade dispute has hurt many developing economies which have depended on China for their growth. This issue should abate to some degree given progress in the trade dispute between the U.S. and China. However, these markets will continue to be challenged due to structural issues. China, the second largest economy in the world, has been adding significant amounts of stimulus in order to maintain growth during the trade dispute with the U.S. This slowdown has forced the Chinese to make a deal with the U.S. as the outlook for future growth continues to deteriorate. The weakness of emerging market economies has been exacerbated by a strong U.S. dollar. A strong dollar lowers the demand for commodities which tend to be a meaningful part of the developing world's economies.

The S&P 500 recorded a gain of 8.53% for the fourth quarter. In terms of sectors, 9 groups reported positive returns for the quarter as many areas benefitted from the positive macro developments during the quarter. Positive quarterly returns included Information Technology (14.00%), Healthcare (13.88%), Financials (9.85%), Communication Services (8.60%), Materials (5.81%), Industrials (5.00%), Energy (4.42%), Consumer Discretionary (4.12%) and Staples (2.79%). On the negative side of the ledger were Utilities (-0.04%) and Real Estate (-1.34%). The quarter's economic data looks to have bottomed and show signs of improvement across a number of sectors.

Outlook

At the end of the fourth quarter, the economy was supported by the U.S. consumer. We expect that the momentum of the consumer and investment spending by businesses will help the U.S. economy exceed current growth expectations. Housing is expected to remain solid based on the increase in housing permits, strong consumer confidence, solid incomes and employment. The industrial side of the economy slowed during 2019 but appears to have bottomed. Our view is that GDP will outpace current Wall Street predictions of 1 ½ % to 2% with results being closer to 2% to 2 ½ % due to improved economic strength as the year progresses.

The Federal Reserve's monetary policy appears to be a wait and see approach. The Fed continues to maintain its data dependent stance. It's expected that the Fed will stand pat on interest rates as the developed world's economies continue to maintain them at historically low levels. The U.S. can remain patient as inflation is

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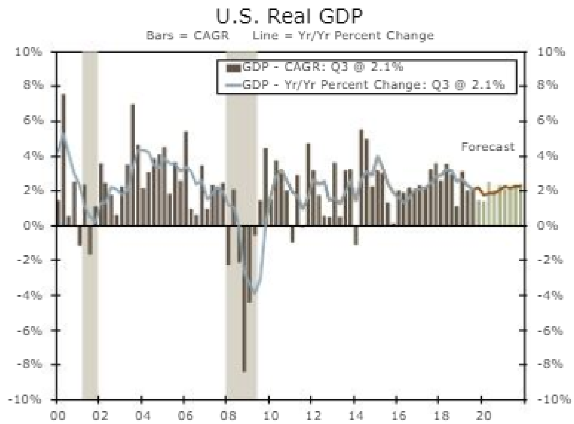
expected to remain low (there may be a slight uptick in Q1 & Q2) throughout 2020. The signing of the USMCA and the U.S. / China trade agreement should allow for greater investment in supply chains and technology. This investment should add to economic growth and allow for a lift in U.S. GDP.



Source: U.S. Department of Commerce, Federal Reserve Board and Wells Fargo Securities

At Hudson Valley Investment Advisors, a common theme from our conversations with clients has been a continued worry over a near term recession. We do not believe that a recession is pending. Recessions come from two sources. First, shocks to the markets, such as the 2008 financial crisis. Second, potential imbalances, such as the technology overhang in 2001. Recessions do not occur due to length of time nor do expansions die of old age. We can’t predict a shock to markets, that is why it’s called “a shock”, nor is the potential for an imbalance readily apparent. Most business, consumer and financial markets currently seem to have limited risks. As long as incentives remain in place, the current expansion should continue into the near future.

The U.S. economy has benefitted from a strong job market and improved productivity. We are expecting the S&P 500 will continue to improve operating margins in 2020 as the cyclical part of the economy rebounds. Inventory to sales ratios are not excessive, the financial industry is in solid shape and the consumer maintains a solid balance sheet along with elevated confidence. This economic recipe should allow the S&P 500 index to grind higher over the coming year. However, by no means will this be in a straight line higher. We expect fluctuations in equity markets. Please be aware that this is a Presidential election year in the U.S. This will add risk to markets as the year progresses and a Democratic front runner establishes their agenda. This often places more risk into the equity and fixed income markets which will likely increase volatility.

The U.S. remains the best situated of all the developed markets. Emerging economies may have bottomed, while developed economies such as those in Europe, could struggle with the aftermath of the Brexit vote. This could dampen

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European investment and lower potential growth. In Asia, economic growth appears stronger. Asian economies, along with India, are set to see an improvement due to the opening up of their economies globally, along with the continuing expansion of their middle class. The U.S. should maintain stronger growth versus its international counterparts as we have the least dependence on international trade and our economy has approximately 70% of GDP coming from consumption by the U.S. consumer.

The continued expansion of the U.S. economy has a consensus 2020 earnings growth of approximately 9.6% for the S&P 500, which is currently trading at 18.7x earnings growth. This is based on earnings per share of approximately $179.00. We anticipate a limited P/E expansion over the shorter term with earning gains being the primary factor in S&P 500 appreciation. The consensus earnings could potentially have an upward bias as many of the cyclical areas of the market are conservatively priced and expectations are low. Based on earnings expectations of the S&P 500 it has a potential range of 3,425 to 3,650 over the coming year.

Hudson Valley Investment Advisors, Inc. continues to favor equities over fixed income in the near term. The Federal Reserve may be limited in raising rates over the shorter term. Yet, in the longer term, they may look to raise rates to maintain economic stability in order to have the resources available to stimulate the economy in case of an economic downturn.

What's new at Hudson Valley Investment Advisors, Inc.?

- On January 30, 2020, we are offering a "Sip and Learn" financial seminar focused on women business owners and clients. This insightful evening will discuss the implications surrounding retirement. Please call our offices at (845) 294-6127 or visit our website hviaonline.com/events for further details.
- HVIA will be holding a market update in April for which you will be receiving an invite.
- In addition, we've been a frequent guest on Fox Business News. Videos of these appearances, along with educational videos and our market updates can be viewed on our website's insights tab. Please go to www.hviaonline.com to find out more!

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