HUDSON VALLEY INVESTMENT ADVISORS, INC.

A subsidiary of Orange County Bancorp, Inc.

Third Quarter Outlook

As of October 4, 2021

Did You Know:

- Visit our website at: hviaonline.com/insights to view our latest Client Event and Economic Update.
- Women's Sip & Learn event co-hosted with Orange Bank & Trust will be held on October 7th at Villa Venezia at 5:30 PM.
- Our client portal is coming soon. All documents can be sent and received electronically. If you have any interest, please email operations@hviaonline.com
- You can view your account online at: investor.pershing.com Please let us know if you need any help.

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Economy In Review

This year has certainly been eventful to say the least. At the end of the third quarter, we have seen an upward bias to equities which maintained its momentum throughout the year. This upward momentum has been marked by rotations back and forth between growth and value, as well as the anticipated opening and then delaying of the economic recovery. Investors have seen the U.S. economy work through a period in which growth was expected to slow despite the unprecedented amount of government stimulus. The unprecedented injection of capital into the financial system has helped to raise asset prices, support the economy, and positioned the markets for continued gains. We expect this economic environment to continue as the underlying economic trends are positive, the risk of Covid appears to have peaked and the opening of the economy should move forward based on what we know at the end of the quarter.

Stocks continued to provide positive performance as the economy shifted into a higher gear but was met with supply shortages that held back potential growth which is expected to persist. We saw the advance of the Covid "Delta" virus which has been easier to catch but not as deadly as the prior version. Outside of the U.S., we have seen significant Delta infection rates which have negatively impacted supply chains and hurt potential worldwide GDP. The S&P 500 ended the quarter with renewed volatility. Interest rates continued in a trading range moving higher into the end of the quarter as higher inflation and risk lifted yields. Interest rate spreads (which indicate risk levels) continue to compress, pointing to the fact that investors are taking on greater risk. The most worrisome point is that we are hoping that there are no policy mistakes that can derail the economy. HVIA is focused on potential government policies which are looking to add additional cash into the system at the point that it's most stressed from supply limitations and strong demand. Finally, we are focused on the Federal Reserve which has positioned itself to have a less accommodating monetary policy in the future which may add to volatility. Remember that tapering is not tightening and this less accommodative position should bring down some of the financial excess building in the system.

Lack of inventory and labor has slowed the potential of the economy. Investors should not confuse slower sales with a lack of demand. Supplies have been influenced by choke points in distribution and have raised inflation concerns. We also are focused on valuations that are at the higher end of their historical range and will remain in that range as long as interest rates remain at historically low levels. Government largeness will most likely continue based on potential legislation for infrastructure and social spending. Both would be stimulative but would increase the U.S. budget deficit to the point of potentially being restrictive. What we are pointing to is the potential inability to handle future crises and/or slowdowns to the U.S. economy.

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Internationally we anticipate that developed markets such as Europe should see an improved economic advance as Covid vaccinations are further administered in other parts of the world and Covid becomes less impactful. China may be a different story as their economy is based on real estate which has been tactically reduced in terms of leverage and further expansion as the quarter ended. The residual effects from this slowdown would impact the developing world which is more commodity oriented and depend on China for a majority of demand.

Productivity levels advanced and revenues continued to increase leading to higher expected EPS that should help to offset some inflation. Margins are approaching record levels and demand is expected to remain robust. Why do we think this strength may continue over the next year? It is due to the record amount of cash that individuals have sitting in bank accounts. At the same time, we are near the lowest level of historical inventories in the automotive and housing markets. For example, the automotive industry historically maintains 45 days of inventory but are now less than 7 days. The housing market has slowed as construction firms have not started construction on over 1/3 of the homes already sold. This has slowed new orders as firms play catch up on backlogs. The catch up for these two groups and the wealth effect for consumers should continue to power the economy into the not too distant future and maintain strong levels for an extended period.

The improved demand and the eventual improved availability for services will accelerate growth which will be limited over the shorter term by labor and supply issues. We believe that the “normalcy” of supply chains will occur during the first half of 2022. Our insight on this comes from trucking service companies that are indicating the problem is based on the West Coast ports being backed up with over 70 ships waiting at ports to unload. This may take months to rectify. The backup is due in part to not having containers to send back to the Far East to refortify inventories. Parts, such as computer chips, are in strong demand and go into everything from washing machines to cars and this limitation in supply has forced greater restriction on supply levels.

HVIA continues to believe that allocation to equities will continue. Interest rates will rise nominally but will remain low, credit is significant and consumer confidence remains strong. Normally economists point to periods before a market downturn to see if interest rates move significantly higher. It appears that the Fed is being cautious on tapering which will limit fixed income appreciation making equities the choice for investment. We believe that earnings will outpace expectations and help drive markets higher over the remainder of the year. This higher level of earnings will be offset by the contraction of multiples for which investors are willing to pay. We continue to believe that the following year’s earnings estimates are also below potential and will see a significant lift and support equity markets.

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The S&P 500 recorded a gain of 0.58% for the third quarter. In terms of sectors, seven of eleven groups reported positive returns for the quarter but returns saw some heavy down days as we moved to the end of the quarter as interest rates moved higher. Positive quarterly returns included Financials (2.74%), Utilities (1.78%), Communication Services (1.60%), Health Care (1.43%), Information Technology (1.34%), REIT's (0.88%), and Consumer Discretionary (01.0%). On the negative side of the ledger were Consumer Staples (-.31%), Energy (-1.66%), Materials (-3.51%) and Industrials (-4.23%). The quarter's economic data looks to have stalled due to the "choke points" with inventories and available labor which we believe will reverse over the coming quarters.

Outlook

As we have been commenting, we should continue to expect strong economic growth moving into 2022. This will translate into higher earnings for equities. This will be offset by potentially higher interest rates which may reduce multiples. Economic growth of mid to high single digits is expected to come from a combination of real growth and productivity gains.

At the time of this writing, we are waiting to see the finality of the Democrats fight over the infrastructure bill that are currently debated as lawmakers are apart on the dollar amount and end uses for the bills' funding. Keep in mind that financial stimulus historically has taken 6 to 9 months to work through the economy. This impact will be seen most likely during early 2022 and will be significant in terms of economic influence.

Our conversations with industry experts indicate that we may be past the worst of the Delta Covid variant and that new drugs may get us back to pre-Covid conditions. The normal process is that when an economy goes into recession it is due to limited demand and too much supply. Under the current scenario, we have too much demand and not enough supply. This scenario would position the economy for an opening of services. What does that mean? We anticipate, based on the lockdowns and limited exposure to events over the past 18 months, gatherings, travel, and going to restaurants will see a strong comeback. We can see this from real time TSA checkpoint volumes and Open Table volumes which have continued to advance. We believe that this scenario will continue to play out over the coming months.

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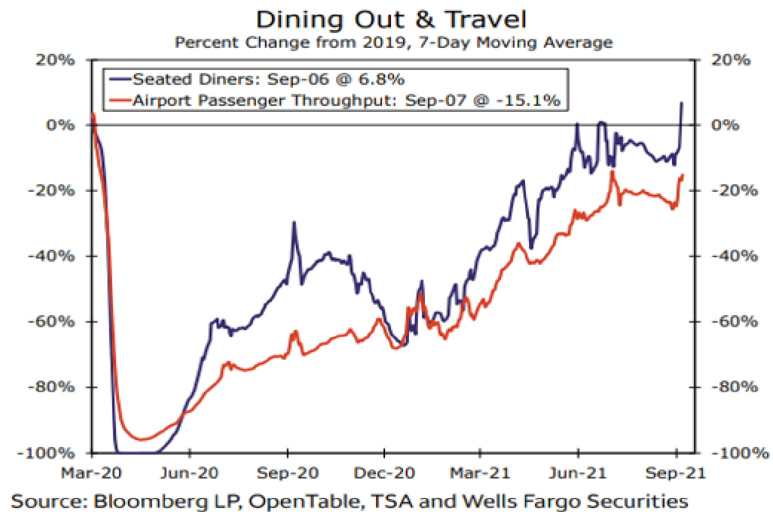

Source: Bloomberg LP, OpenTable, TSA and Wells Fargo Securities

The Biden Administration's has been politically hurt for several reasons ranging from Afghanistan, conflicts with China, southern U.S. border issues and now the potential inability to pass legislation while his party controls congress. This may hurt his future ability to work both domestically and internationally putting the administration in a position of weakness. Moving into 2022 we may see a change in Congress with Republican's potentially gaining control as is often the case in post Presidential election periods that the party out of power historically has gained seats putting Democrats back to a minority position.

We expect that earnings growth is what drives financial markets, and that we are moving into a mid-cycle economic period in which the economy will outpace the markets. Growth for inventory rebuild and the acceleration of spending as supply bottle necks lessen will drive the economy over the coming 12 months. Interest rates are expected to move off of the historical lows that we witnessed this year. If it is based on economic growth, we expect equity markets to continue to advance. If on the other hand it is based on inflationary pressures that don't abate, we would expect multiple compression and a sideways market.

Currently, the 2022 earnings expectation sits at $215 dollars. We expect this to rise into a potential of $238 to $245 which would point to an S&P 500 that could be valued at 4,800 to 5,000 over the next 18 to 24 months. Interest rates will be the offsetting factor along with how managements contend with higher costs and labor shortages. As we have stated in past letters, the Fed has indicated that it is allowing the economy to maintain a higher level of inflation than in the past. As we look at the current economic and financial situation, we continue to believe bond returns will be limited (although there will be a place in investors' portfolios for them). Hudson Valley Investment Advisors, Inc. continues to favor equities over fixed income in the near term.

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Enclosed please find a 9/30/21 statement and invoice. As we move into 2022 we maintain a higher quality bias and position your portfolio to take advantage of market dislocations as they present themselves. Please review these reports and call us to discuss any questions or concerns you may have. We look forward to discussing your portfolio, its performance, and our 2021 investment outlook with you. We appreciate your trust in us and truly appreciate the privilege of working with you to help you reach your financial goals.

Finally, we want to make you aware of a couple of items:

- We recently gave an economic update that was taped and can be found on our website.
- Our holding company Orange Bancorp, Inc. (who also owns Orange Bank and Trust) was uplisted on NASDAQ under the symbol “OBT”.

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