HUDSON VALLEY INVESTMENT ADVISORS, INC.

A subsidiary of Orange County Bancorp, Inc.

Fourth Quarter Outlook

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Summary

Overall, 2021 turned out to be a very solid year for the markets. Underlying economic growth actually was stronger than initially expected despite persistent supply chain shortages which prevented the economy from reaching its full growth potential. Inflation increased to levels not seen in decades and COVID-19 continued to rear its ugly head. Though the Omicron variant is spreading rapidly, vaccines have shown promising results against multiple variants of the virus. With much uncertainty heading into 2022 around supply chain disruptions, interest rates, inflation, and COVID-19, we'll be watching economic indicators closely to see how the Omicron spike impacts consumer demand and overall economic activity. Nevertheless, we do believe that we've made it through the worst of the COVID-19 situation and as we move toward mid-2022, the supply chain bottlenecks should ease and economic growth should remain strong. We expect the economy to benefit from higher consumer wages, an unprecedented surge in consumer wealth, and continued re-openings. Corporate earnings drive the stock market and analysts have undervalued the strength of the economy and the record earnings levels which we believe will continue into 2022. Worldwide synchronized growth is anticipated but we will remain vigilant for potential economic risks given the specter of higher interest rates on the horizon.

2021 also was a year in which Hudson Valley Investment Advisors, Inc. (HVIA) clients benefited from the research HVIA conducted on the economy and specific industry groups. HVIA remained invested during a period of market volatility that saw rotation between sectors that would benefit from the economy reopening and those sectors that would benefit from the economy being closed. HVIA maintained its balanced equity portfolio approach to take advantage of this volatility and we sought bond portfolios that were shorter in duration to hedge against the risk of higher interest rates.

Economy In Review

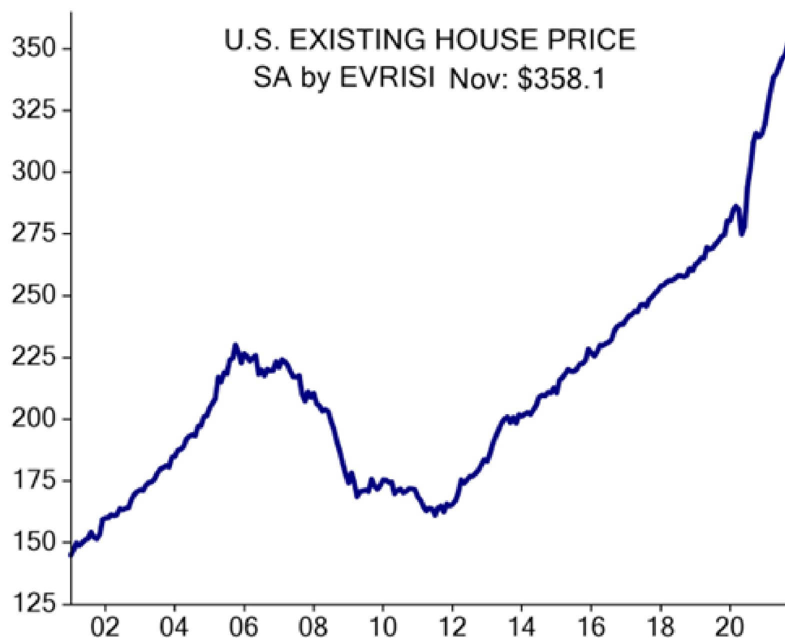
The past year has been one which was impacted by variants of the COVID-19 virus influencing services, logistics, employment, travel, and inflation. Expectations were that as the year progressed the economy would be getting past COVID-19. This has seen various fits and starts. Each variant has been less impactful as a greater level of the population in the U.S., approximately 72% of adults and 60% of all individuals, have been vaccinated. These vaccinations are expected to lower the level of impact from future COVID-19 mutations and move this virus to an endemic level. Over the past year, fiscal and monetary stimulus has helped support the economy, put money in the hands of consumers, and allowed businesses to expand. Economic limitations have become apparent based on labor and logistic areas that have influenced inflation to levels not seen in decades.

As 2021 progressed, the response to COVID-19 shifted as governments, companies, and individuals worked to deal with COVID-19 and be flexible whether at work, school, or at home. Overseas, the COVID-19 impact is still being felt as the percentage of persons that are vaccinated are either lower or have taken vaccines that are not as impactful as the U.S. deployed versions. Outside of the U.S., the higher level of continued lockdowns and slower overseas GDP growth appears to have peaked. Expectations moving into 2022 are that a higher level of dosages will be deployed outside of the U.S. helping to alleviate the COVID-19 impact and get the worldwide economy back to work. Keep in mind that supply chains are international in scope so a nation that closes due to COVID-19 slows the supply chain and influences higher prices.

The limitations on labor caused businesses to raise capital expenditures. This was done to help boost productivity and help alleviate the labor shortage. The use of virtual meeting software was one example of a boost to productivity that allowed U.S. companies to remain flexible and allow for continued growth. Expectations are pointing to a potential renaissance in productivity growth that allows for a cycle of higher GDP growth and an offset to potential inflation. Keep in mind that capital investment today usually impacts an organization over a 2 to 3 year period into the future.

Expectations at year end also included a synchronized level of worldwide growth. The back and forth of the economy getting past the COVID-19 pandemic and opening back up allowing for cyclical sectors of the economy to advance has been delayed. The likelihood for this synchronized advance appears set to move forward outside of an extraneous event.

Problems are still apparent but have lessened with “normalcy” still a few quarters away. It is our expectation that the imbalance of supply chains, shortages of housing, commodities, electronics, and autos, all of which saw increased demand, should come back into balance by mid-2022. This has caused inflation to continue to rise. Based on our conversations with company managements, many believe these factors are abating but inflation may settle at a level higher than seen prior to Covid-19.



At the end of the year the President's Build Back Better bill looks to have failed and a new version of the bill that is less ambitious looks like the only path forward. The failure of the bill may have been a blessing. If it was passed the U.S. may have seen a more significant rise in inflation for an extended period of time. The potential for a tax increase from putting through this bill was also something that was likely. Markets appear to have discounted these facts and again we are expecting some sort of scaled down agreement with limited tax increases.

Labor intensive services made a comeback at year-end 2021. The change in lockdowns is spurring hiring which has pressed the unemployment rate to record lows. As part of this, we are seeing ZERO layoffs for the first time. This points to the fact that we will have a labor shortage that will persist into the coming years as GDP growth continues.

The S&P 500 recorded a gain of 11.03% for the fourth quarter and 28.71% for the year. In terms of sectors, 10 of 11 groups reported positive returns for the quarter as the continued demand surge was felt across the overall economy. Positive quarterly returns included Real Estate (17.54%), Information Technology (16.69%), Materials (15.20%), Staples (13.31%), Utilities (12.93%), Discretionary (12.84%), Healthcare (11.17%), Industrials (8.64%), Energy (7.97%) and Financials (4.57%). On the negative side of the ledger was Communication Services (-.01%). The quarter's economic data has continued to expand despite bottlenecks and limited supply to meet the increasing demand.

As we look toward 2022, we expect earnings to continue to move higher. Demand levels are continuing to advance and the supply chain normalization will help to increase revenues across industries. Longer-term we expect the rebuilding of industries and the inventories required to provide a baseline of economic support to keep GDP levels above the averages seen over the past decade. Our biggest concern revolves around potential policy mistakes, interest rate spreads, and the negative real rates that are being generated. This is an impediment to wealth creation for all types of investors as the fixed income portion of portfolios must be viewed in terms of lower potential returns.

Outlook

Starting 2022 the Omicron COVID-19 variant may not be as impactful as prior viruses but still will add uncertainty and most likely not allow the recovery to reach its full potential. Inflation has been a result of the "choke points" that we see currently but is expecting to see improvement as the year progresses. Our confidence comes from monitoring trends in the uptick in miles traveled in places like Singapore and Malaysia which is the starting point in technology supply chains. We expect inflation to remain above trend during the first part of 2022 and come down more slowly than first anticipated. The current environment is one that we spoke to in our prior letters in that it's not a demand deficit, which is the way most recessions have begun, but supply constrained. We are limited in growth by the level of supply that both consumers and businesses have access to. This dynamic will transition over the next 12 months but we expect greater volatility as anticipated oversupply in select areas becomes apparent and inventories are rebuilt and pent up demand continues to lead our economy.

GDP growth has been above trend from the impact of the stimulus. Companies have been maintaining margins as they are passing higher costs onto consumers. Analysts continue to underestimate growth, revenues, and margins. Despite the higher level of inflation, companies are gaining productivity helping to alleviate higher input costs. We expect this to continue as the rebuilding of inventories, backlog in supply and the robustness of the housing market continue to drive the economy over the coming quarters. Expectations for pent up demand are also robust for services as social gatherings and getting together with friends has been top of mind. This has been seen in the demand for travel, housing, and all things associated with entertaining. We expect this to remain strong and the purchasing power of individuals remains above trend.

Internationally, the U.S. is uniquely positioned as China moved to become more restrictive on companies that are being forced to be aligned to the Chinese government. Larger Chinese companies wanting to become publically listed internationally are being “peeled back” and come under greater working alignment with the Chinese government. The Chinese economy is also more dependent on real estate construction for economic growth. The impact of real estate company Evergrande has not been fully felt but with over a dozen highly leveraged real estate companies that are similar, the government has called for the continued paydown of debt and lower construction growth which will put a drag on their economy. The Chinese slowdown impacts developing markets as China consumes 50% of the developing world’s commodity base. On the other hand, Europe is still growing below trend as COVID-19 forces closures in several markets. The U.S. has a larger percentage of growth from technology which is more recurring and has above GDP growth. We look at data as a huge opportunity. This is a large market and controls how more things are being analyzed, managed, and maintained. Bottom line the largest technology companies are some of the best performing on a cash flow and return basis. As such, they can act more like “staples”, meaning more resiliency than most industry groups.

The Federal Reserve has recently moved to fight inflation. Its first step was to announce its intention to stop its tapering initiative and positioning to be able to raise interest rates. This is expected to slow inflation and will reduce growth. The byproduct will be positioning the economy to have tools to combat future downturns.

We know that earnings growth is what drives financial markets. The earnings projection at the start of 2021 was easily surpassed which helped support equity prices. Earnings continue to outpace expectations and should continue to support equity prices. Currently, the 2022 earnings expectation sits at $224 per share (up from $195 on 12/31/2020) which would point to an S&P 500 that could have a higher valuation over the next 18 to 24 months. At HVIA we anticipate that there will be more volatility with the rise in interest rates and widening of interest rate spreads. We would expect higher valued stocks to see the biggest price change. During 2020 and 2021 the Fed had indicated that it was allowing the economy to maintain a higher level of inflation than in the past to get to full employment. We have seen the Federal Reserve run at a level that achieved full employment but has contributed to higher inflation, putting us in a position that looks to be behind the curve to limit higher prices. Interest rates have not risen as fast as inflation which signals that markets are not expecting inflation to continue at current levels. We are expecting higher rates into 2022 which will be a headwind for bonds. Despite the expected increase in volatility for stocks, Hudson Valley Investment Advisors, Inc. continues to favor equities over fixed income in the near term.

In closing, we would like to make you aware of a few items:

- HVIA's Market Outlook for 2022 was held during the fall at The Harness Racing Museum & Hall of Fame. It was well attended and provided insight on the economy, markets and provided insights that we've gained from communication with the companies that are part of our client's investments. A replay of the event is available on our website.
- Our continued appearances on various Business Media outlets, such as our most recent FOX Business segment, Maria Bartiromo's *WORD ON WALL ST* are available on our website.
- Lastly, 401k salary deferrals have increased to $20,500 per year while IRA contributions remain the same at $6,000 for 2022.
- As always we are here for any questions you may have on the markets, your accounts, and the best ways we can help you achieve your financial and retirement goals.

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