HUDSON VALLEY INVESTMENT ADVISORS, INC.

A subsidiary of Orange County Bancorp, Inc.

Third Quarter Outlook

As of September 30, 2022

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Summary

After a strong 2021, we are experiencing one of the most difficult investing environments ever for both the stock and bond markets. The S&P 500 Index and other stock markets entered bear market territory in the first six months of 2022 and the bond markets suffered their worst declines in over fifty years. Although 2022 began with solid economic growth, it included increasing levels of inflation. The ever-present inflation combined with the geopolitical uncertainty by the Russia-Ukraine War began to dampen investor enthusiasm and subsequently caused multiple compression in stocks even though the earnings estimates experienced only nominal changes.

Inflation remains stubborn and its drum beat louder as the year has progressed. At the start of 2022, demand for goods still outstripped supply which caused prices to rise and inflation to rear its ugly head as the economy swung into the aftermath of the pandemic. Inflation manifests itself in higher prices for both goods and services and it erodes the purchasing power of consumers unless their wages rise at the same or higher levels than inflation. Inflation also tends to hurt lower-end consumers more than others because lower-end consumers cannot “trade down” anywhere for their purchases.

One of the most important jobs of the Federal Reserve (the “Fed”) is to keep the U.S. economy healthy. The Fed has been given a dual mandate – pursuing the economic goals of maximum employment and price stability. Price stability means that inflation remains low over the long run so that the purchasing power of consumers does not wane. The Fed achieves its goals by using a variety of economic tools to manage financial conditions. One such tool used to keep inflation under control is interest rate hikes. As the theory goes, consumers tend to spend less if it is more expensive to borrow money or carry a balance on a credit card. When spending declines, the prices of goods typically follow. The Fed also can implement Fiscal Policy changes to correct supply-demand imbalances. In the past, Congress has implemented accelerated depreciation plans that spurred investment and resulted in higher supply levels.

S&P 500 company earnings remain a main driver for the stock market. Although the economy slowed from 2021 we expect positive GDP for the remainder of the year. Over the course of the last several months, there has been a shift in end-market demand as consumers pivoted from purchasing “goods” to purchasing “services” which has resulted in slower, but still positive growth. We continue to expect some adjustment, but believe earnings will hold up better than expected despite the economic headwinds. Overall corporate margins have fared better than expected and consumers remain well-positioned given both higher savings and lower debt levels relative to past downturns.

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Bonds, which typically provide stability to portfolios, have had their worst start to a year in nearly 50 years. Historically, the pairing of equities and bonds has been to counterbalance one another. As stocks underperformed, bonds acted as a counterweight. Unfortunately, the sharp, volatile rise in interest rates this year has had the opposite effect because as rates rose, the underlying value of the bonds decreased.

Hudson Valley Investment Advisors, Inc. (HVIA) has remained steadfast in its investment approach during this period of extreme market volatility. On the equity side, all sectors outside of Energy showed negative returns year to date. Nevertheless, we continue to look for opportunities to upgrade our portfolios into companies that offer solid growth and whose management teams are good stewards of capital but now trade at more reasonable valuations. On the fixed income side, we have been positioned for a short duration (i.e. focused on bonds with a small amount of time to maturity) so that we can take advantage of the rising rate environment as bonds mature. We will see an end to the current corrective environment and we want to be positioned for it.

Economy In Review

Since the start of the year, we have seen the Federal Reserve become ever more restrictive to dampen increasing levels of inflation. The economic environment came into the year with strong momentum that was fueled by consumer and business demand. The economic environment still was running above historical trends, and inventory levels were not in balance, relative to demand. Keep in mind that during the post-Covid period U.S. businesses had increased input costs with the most influential impact being higher labor costs. During the first half of the year, we saw an acceleration in inflation that the Fed was late in addressing. The earlier delay in raising rates caused the Federal Reserve to become more forceful and aggressive by accelerating rate increases at one of the fastest paces in recent history. The impact of these rate changes is still not fully reflected in the economy as it takes up to 12 months for changes in rates to be fully digested into the economy. The forward momentum of the U.S. economy was able to take on the rate increases but the housing market continues to slow as mortgage rates rose from 3% to over 7% by the end of the quarter.

Chairman Powell was aggressive on inflation into the quarter, however, his stance needed to ascertain its impact on the economy. This provided the spark for equities to advance earlier in the quarter with inflation continuing to rise. Chairman Powell then changed course and communicated that he would need to raise rates further to quell inflation causing investors to sell equities. This also caused turmoil in the bond markets. We believe this aggressive stance will be maintained until inflation subsides.

The political environment also remains in focus as the upcoming midterm elections may be critical to the political direction of our country. Higher levels of crime, unsettled immigration, the decision on Roe v. Wade, along with inflation and debt forgiveness have further polarized the electorate. We believe that the outcome is a more divided government but one that limits spending. This environment has historically been welcomed by investors.

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As 2022 progressed, supply chains further began to recover but remain below the 2019 level and labor markets remain constrained. U.S. posted two consecutive quarters of negative GDP growth but we didn't see a typical downturn in corporate profits. The Unemployment rate dropped to below 3.6% matching the lowest rate since the beginning of the pandemic. Consumer spending has shifted to services, such as restaurants, hotels, and medical services, and away from goods. Despite the economic cross-currents, we believe the economy will show positive GDP due to job growth and corporate earnings strength. Because of the underlying economic strength, the need to replace inventories, and the labor shortage, we expect that any recession will be mild. We expect to see continued volatility over the next few months as economic data is released and the political environment changes.

The S&P 500 recorded a loss of -4.88% for the third quarter. In terms of sectors, 9 of 11 groups reported negative returns for the quarter as risk reduction influenced multiple compression (the reduction in P/E multiples). Positive quarterly returns included Consumer Discretionary (4.36%) and Energy (2.35%). On the negative side of the ledger were Financials (-3.10%), Industrials (-4.72%), Healthcare (-5.18%), Utilities (-5.99%), Information Technology (-6.21%), Consumer Staples (-6.62%), Materials (-7.13%), REITs (-11.03) and Communication Services (-12.72%). The quarter's economic data has continued to expand despite higher inflationary pressures.

As we look toward the back half of 2022, we expect GDP to become positive to relatively flat, up to 1.5 %. Demand remains strong with supply starting to increase as the economy normalization improves across industries. Longer term we expect interest rate increases to subside. Over the shorter term, we believe that we may remain in a trading range as risk and return both remains in flux. Our biggest concern revolves around potential policy mistakes, as the Federal Reserve continues to increase rates which can cause unforeseen risk and financial stress.

Outlook

We believe that we are not returning to a 2019 pre-Covid economic environment. Higher inflation, labor shortages, and rising energy prices will be with us for the foreseeable future. The other regions for growth, China and the Eurozone, are both seeing recessionary trends.

The U.S. is uniquely positioned. Financially it is in solid shape with both consumers and businesses well positioned. Balance sheets are solid and no overbuilding often occurs during recessions. We also believe that we are at the beginning of a productivity expansion. This is in part due to the limited amount of available workers. The U.S. has always been a world productivity leader in integrating new management practices and advances in technology. Over the coming years, this will be critical in the U.S. as the number of workers declines.

Over the past two years, GDP growth has been above trend. Demand has been strong while supply has needed to increase. At HVIA, we believe that GDP will become positive, however lower than in the past few years. Companies need to rebuild inventories across most industries as service companies are looking to add labor. The labor situation has been in flux as many older workers have taken retirement and COVID-19 restrictions continue to limit the availability of workers. Despite the labor situation, travel, housing, and all things associated with entertainment have seen strong growth. This may slow over the coming quarters as interest rates have risen at one of the fastest paces on record. We expect this to continue and for GDP to move positively.

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We know that earnings growth is what drives financial markets. The earnings projection at the start of 2022 has continued to be maintained. However, the risk that is embedded in P/E ratios has increased and brought values for both stocks and bonds below last year's levels. At HVIA we anticipate that there will be more volatility until inflation and interest rates recede. We also would expect a balance between value and growth stocks. Fixed income has become more attractive as yields are at levels not seen in over a decade. We are expecting rates to recede as we get into 2023 which will make current yields to be more attractive. Hudson Valley Investment Advisors, Inc. favors a balanced investment approach until rates are normalized.

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

- Our ***2023 Economic Outlook*** will be held in person over the coming weeks at the Harness Racing Museum & Hall of Fame located in Goshen, NY. Invitations as well as updates to our Insights page at **hviaonline.com** to follow.

- HVIA's ***Economic Update*** conference call is scheduled for Friday, October 14, 2022, and will be held via Zoom at 3:30 pm. Email invitations will be sent in the coming days with further details.

- We continue to share our insights with various organizations, most recently at the first-ever, Orange County Economic Forum, for which we were a Keynote speaker. We also have continued appearances on Fox Business News.

As always, we are here to 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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