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

Fourth Quarter Outlook

As of December 31, 2022

- **About Gus**

Gus Scacco is CEO and Chief Investment Officer at Hudson Valley Investment Advisors, Inc. Gus brings over two decades of experience investing on behalf of individuals and institutions. If you watch Fox Business, you'll often see Gus as a regular guest talking about the markets. When he's not looking after portfolios, Gus is active with several not-for-profit organizations across the Hudson Valley.

For information on our latest client events and economic updates visit:

hviaonline.com/insights

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A note on this quarter's Outlook:

Based on client feedback, and in the spirit of the new year and a (slightly) new logo, we are trying something different. We've introduced a Q-and-A format to make our quarterly letter more accessible, readable, and relevant for our clients.

As always, we value your opinion so feel free to drop us a line and let us know what you think!

Economy and markets in review

Q: Big picture, what happened in the economy this past quarter and over the year?

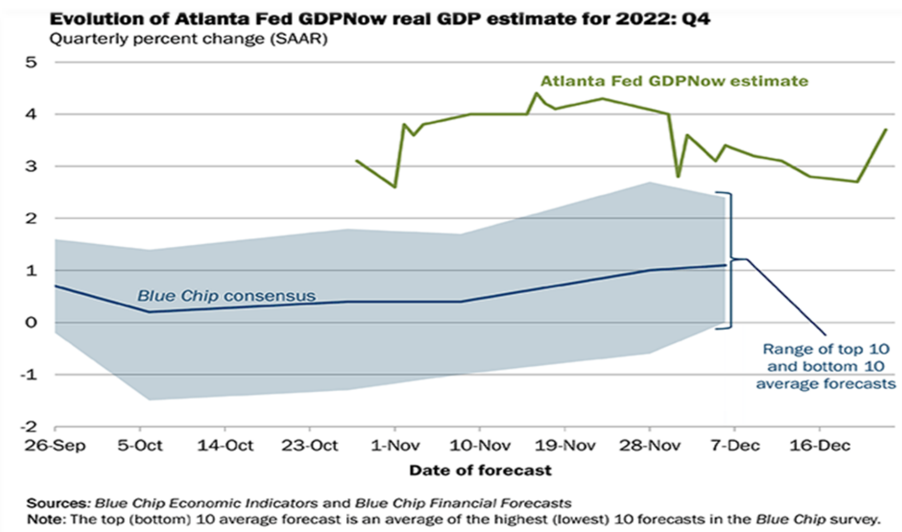
GS: We always look at the economy through the eyes of the investor, from the perspective of risk and reward. The reward is the earnings for the S&P 500 (Index), and the risk portion is represented by the multiples (valuations) attributed to those earnings and interest rates. As the quarter and the year progressed, earnings actually held in really well, and we saw a shift from goods to services. Inflation was a lot more persistent and worked its way through the economy this past year much faster and more broadly than many expected. With respect to interest rates, we witnessed in 2022 the sharpest and fastest (Federal Reserve) rate increase levels ever. Due to rates and inflation among other factors, the S&P 500 was down approximately 20% last year. At the same time, stock valuations contracted. And the economy remains positive and is moving ahead.

Q: Ok, so what's happening now? Why the shift from goods to services?

***GS*:** When the pandemic hit, the lockdown shut down supply chains and manufacturing. If you're missing lugs nuts for a car and that's one of 1800 pieces that get put together, now all of a sudden you can't produce a car. We had too much money chasing fewer products, and that was one of the things that caused inflation to soar. A prime example—house prices were up approximately 30% over 18 months—that's now stabilized and expected to decline slightly. Used cars had become more expensive due to limited supply over the past two years, and that trend is now subsiding. People are no longer purchasing goods like they were while at home during the height of COVID-19. Post pandemic, they're looking to have experiences, they are going out to restaurants, and they are traveling again.

Q: Does that mean the economy is turning the corner? Are all those COVID-19 era trends starting to reverse?

GS: Yes! First of all, supply chains are almost back to pre-pandemic levels, except for select areas such as autos (due to its complexity). Second, when we talk about global supply chains, we're now having a "re-shoring."



There are more companies now looking to move back to the US for manufacturing, which will actually be a tailwind for construction and employment over the next few years . There are an additional 320,000 manufacturing jobs over the next few months coming to the US. Finally, GDP growth is now running around 4% (as shown in the chart to the left). That's not a recessionary number.

Q: So are those jobs coming (back) to the US because of lower labor costs? Or because of the momentum of US economy, or both?

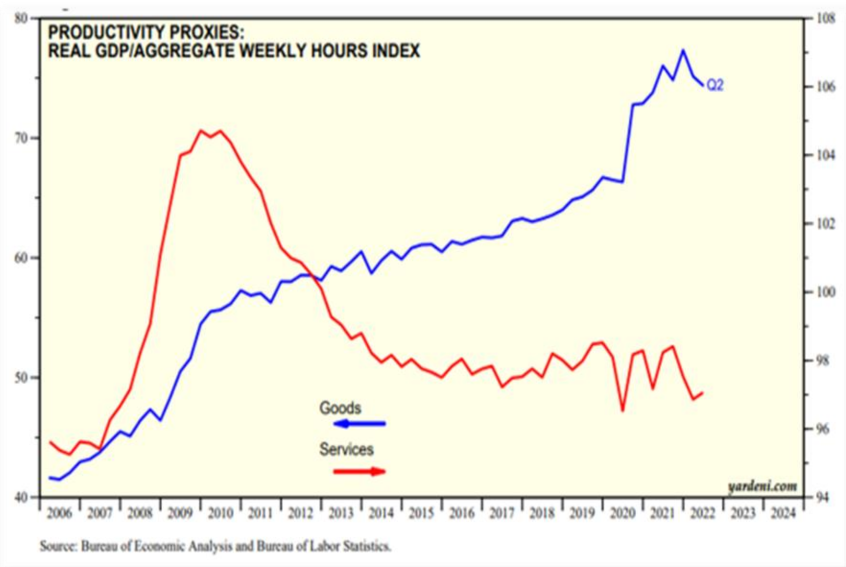
GS: More companies are choosing to manufacture goods in the US for three reasons. First and foremost, concerns remain about supply chains. Companies have not focused on manufacturing goods in the US since 1994 when China was admitted to the WTO. From that point on, companies operating in the US relied heavily on overseas manufacturing. That is, until the pandemic revealed a compromised global supply chain. Second, there's not much of a price differential now between China and the US anymore. Products that used to be manufactured in China are now being manufactured in places like Springfield, Massachusetts. Third, the country has become energy independent. The US now has one of the lowest costs for natural gas. If you think of the automotive industry, it takes a lot of energy to build a car—and energy makes up a significant portion of that cost. BMW's input costs to build a car in Germany are up significantly. For example, the cost of energy is up over 1000% in the past year. By contrast, the cost to build a comparable car in the US is much lower and therefore allows for a profit.

Q: In your 2023 Outlook from a few weeks ago, you spoke about three main factors that will keep inflation at higher levels than over the past 30 years. What were those factors?

GS: The three main segments that drive inflation are: (1) goods inflation, which is down, (2) housing, which has peaked and is coming down, and (3) labor. The only way to improve labor inflation is to either increase productivity, or increase labor supply.

Q: How did inflation show up differently in different parts of the economy?

GS: With the pandemic, housing was a shock to the system because there hasn't been any real growth in housing stock since 2008. We also have labor growth of only about a half percent annually – we need 1½% to keep the economy going. One other factor is reduced productivity.



Source: Bureau of Economic Analysis and Bureau of Labor Statistics.

When COVID-19 hit, three million Americans left the labor force, most of whom were older, more experienced workers. As the chart to the left shows, productivity declined because experienced workers dropped out of the labor force and younger, less experienced workers were added. Productivity levels have come down within the services sector because the balance of the workforce is skewing younger overall.

Q: How have capital markets responded to all these economic factors?

GS: These factors have driven bond prices higher, especially in the short term. It now doesn't make as much sense to lend due to lower interest rates for longer-term bonds, and this restricts the productive capacity of capital. In equity markets, higher multiple stocks saw the biggest drop in price—especially tech stocks. In spite of all this, the economy is still chugging along. It's not going to be a hard or soft landing, but instead the economy will just muddle through.

Outlook

Q: What's the overall economic picture for next quarter and for 2023?

GS: We expect the US economy to continue to muddle through albeit with inflation, as opposed to a hard or soft landing. We think US GDP will continue to grow, fueled by a surge in reshoring and continued demand for services. Over the longer term, productivity gains from better, more efficient application of technology will be a key driver of GDP growth. We expect more productivity gains in energy, and a continued move away from carbon.

Q: Where will we see higher inflation next year? And where will it slow down?

GS: We expect inflation to come down to the 3-4% level by the end of the year. Those same three factors that have driven inflation levels historically—labor, imported goods, energy expansion—will continue to drive inflation. But productivity will be the fourth driver that will help to bring down inflation. Specifically, as the cost of US labor comes down and if immigration can keep up with population decline, that will help to cool inflation across the economy.

The areas of the economy where there's a high level of labor input – such as restaurants and factories – will continue to be impacted the most by inflation. To bring down labor inflation, you need more efficiencies or more labor.

Q: What are some other interesting trends you've noticed?

GS: We're seeing population decline worldwide, including in the US. China, for example, is projected to lose 20% of its population over the next 25 years due in large part to its one-child policy. But many leading economies are facing a similar demographic problem, and that has broad implications for the supply of available workers—and the cost of that labor. Because of this trend we think the US will be the best place to be, going forward, as technology-fueled productivity gains help level the playing field against declining birthrates. Some other trends we've seen that point to a healthy economy and investing environment include: consumer real wages and salaries have moved higher, gas prices are coming down (putting more money back in consumers' pockets), interest rates have leveled out, inventories supporting growth have replenished (except cars, which we expect will correct over the next two quarters), and residents are seeing their state and local income taxes being cut in many areas.

Q: What are the prospects for a recession if the Fed keeps raising rates? Any silver linings?

GS: So there are a number of factors at play that belie the idea that we are headed into a recession. There is still about $1 trillion in consumer cash on the sidelines, state and local government budgets are well funded, and we expect positive GDP growth to continue. Usually when you go into a recession, you have an imbalance. Excess inventory has to be sold off, balance sheets usually have to be repaired to remove excess debt, and employment dries up. None of these things are happening. In fact, approximately 200k new jobs have been created each month for the past eight months. Employers are not letting talent go, and you're not seeing the cutback in consumption.

What this means for your portfolio

Q: What are the implications from an investing perspective?

GS: From a fixed income perspective, bonds are back! Yields are more than three times their 2021 levels. Bonds will now play an even more important role in portfolios. On the equity side, we believe there will be a move away from indexes and toward stock selection because different companies in that index will react differently to all the economic factors at play now. There are many compelling reasons to consider a portfolio of growth stocks with reasonable valuations.

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Q: How can investors separate the noise from the signal? When should they listen, and when should they tune out?

GS: There's always a lot of noise in the market, which can cause panic and confusion among investors. Taking some of this with a grain of salt is a healthy exercise.

Here are a few things we tell clients to keep in mind:

- As of the end of December, ***US GDP growth was humming along*** at a healthy, if not bullish 4% clip. That's a higher GDP than during the majority of either of the prior two administrations.

➢ *Here's an example that illustrates this trend:*

US aircraft manufacturer Boeing is rolling out a new 787 plane. It uses only two thirds of the energy of a Boeing 747, but carries the same number of people. This alone represents about a half percentage point of GDP growth.

- ***Employers are hiring***, at a rate of approximately 200k new jobs per month.

- State and local governments now have ***some of the highest levels of tax revenue***, and they're investing in things like infrastructure. This helps both current and future economic growth.

- ***Think long term*** – things don't fit neatly into a quarter, and you should keep a long-term investment focus to take advantage of long-term value creation.

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

- We made a change to how we invest cash on your behalf. Given the current interest rate environment, a significantly higher interest rate on cash reflects what the market is bearing at this point in time. Please call for further information.

- We will be having an economic update via video in early January. Notification will go out via email, but please feel free to check our website periodically as they are posted at ***hviaonline.com/insights***

As we move out of 2022, and into 2023, the team at Hudson Valley Investment Advisors, Inc. truly appreciates working with you, as well as your ongoing trust in us. We look forward to discussing the markets, your portfolios, and any other questions you may have.

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