HUDSON VALLEY INVESTMENT ADVISORS, INC.

A subsidiary of Orange County Bancorp, Inc.

Q1.2023 Outlook and Market Commentary

Gus Scacco

CEO and Chief Investment Officer

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/hvia-insights

Our Office location:

117 Grand Street, 2nd Floor
PO Box 268
Goshen, NY 10924
845-294-6127

Email:

operations@hviaonline.com

Appointments are also available at:

4 W. Red Oak Lane
White Plains, NY 10604
914-290-5978

Economy and markets in review

Q: There was a lot going on in the first quarter.
What are some highlights, and what did you think was noteworthy?

GS: Overall, the US economy is doing better than anticipated. With the Fed increasing interest rates, many assumed that it would slow economic growth. This has been a big experiment in that the government has thrown a lot of money into the economy over the past few quarters, and we're still working through that—it doesn't get deployed all at one time.

There are a number of industries that are performing much better than expected. In construction, for example, there is tremendous demand and not enough supply. I recently attended a construction conference, and growth is significantly stronger than they've seen in the past and the pace of growth has not slowed. That strong demand is expected to continue, with major commercial construction projects planned over the next several years. On the retail side, there are just not enough homes. While housing prices may come down slightly (we anticipate mid-single digit percentage declines) from where we are today, there is still significant demand and not enough supply. Vacancy rates—as measured by the number of unoccupied homes, both owned and rented—are at all time lows, and the largest group of first time homebuyers (with an average age of 33) are coming into the market over the next 10 years. The jump in existing home sales reported in March was the largest year-over-year rebound since 2020.

Overall we've seen inflation moderate during the quarter. Housing was one of the most noteworthy trends specifically in housing where prices have peaked and are coming down slightly, per Zillow statistics on rent prices and existing home sale prices over the quarter. In addition to housing, we're seeing inflation impacting the services sector in the form of wage hikes. Because companies in areas such as leisure are having to pay more to bring people back to work, it has become a choke point for labor within service-based industries. The prices of goods are down—there was a lot of inventory that had to be worked off. Now you are finally seeing things like clothing on sale. Additionally, both used and new car prices have moderated over the quarter. And gas prices are coming down as well.

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Economy and markets in review (continued)

Q: What are your thoughts on the bank failures toward the end of the quarter?

GS: The first thing to know is that this is not 2008. That was all about credit. What we've seen so far is about funding. It's totally different. What we've seen over the past few weeks were classic "runs on the bank" where customers withdraw a large amount of their deposits—and it happened to a few specific institutions. In the case of Silicon Valley Bank and Signature Bank, there was a high concentration of funding sources from one industry.

Part of why this happened was company mismanagement, and part was regulatory. The challenge was that federal regulators were "fighting the last war"—asking more about credit risk than about a bank's funding. Put another way, they were worried more about the loans going out the door than the money coming in.

Q: So if it's only a handful of banks making bad bets, why are some people still worried?

GS: Much of this is about fending off a crisis of confidence. The government stepped in to protect all deposits, providing assurance for both individual customers and business owners.

They did this because they know that bank runs have a way of becoming self-perpetuating and that once confidence is lost it's hard to get it back. They want to make sure this crisis of confidence doesn't spread any further. But so far, it has been from one group (very high net worth bank clients located on the coasts), in one industry (tech), in essentially one location (San Francisco/Silicon Valley).

Q: So is the economy slowing down, enough to push us into recession?

GS: Six months ago and even at the beginning of the first quarter, prognosticators were predicting a recession. We're just not seeing that—there's just too much momentum right now. We saw GDP growth of 2.5 to 3.5 percentage points over the quarter. There are a number of drivers of that, but a lot of it is on the services side. And we continue to see this growth trend in spite of the bank issues.

> **Delta's 10 largest booking days <u>ever</u> occurred in the first quarter of this year.**

As long as employment is solid, most people aren't looking at their 401k balances—they're looking at "What am I doing Saturday night?" Post-Covid, the majority of Americans want to be out and doing things. It's very reminiscent of the newfound freedom people had after the 1918 flu. Once people emerged from that pandemic, it marked the start of the "Roaring '20s." And in this economy, we're not just seeing this spike in activity continue here in the US—we're seeing it in Europe and worldwide. We also expect to eventually see this in China. This pent-up demand is the driving force behind the surge in the services sector.

Another interesting point on services, specifically travel. In mid-March, we attended an industrial conference where the airline companies – Delta specifically – stated that the 10 largest booking days they've <u>ever</u> reported had occurred in the prior 30 days. Travel is an important bellwether because it's not just people buying airline tickets—they're also eating out, booking hotels, and spending money on other things along the way. So travel spills over into so many other areas of the economy that are consumer-driven. And two-thirds of the US economy runs on consumer spending.

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Economy and markets in review (continued)

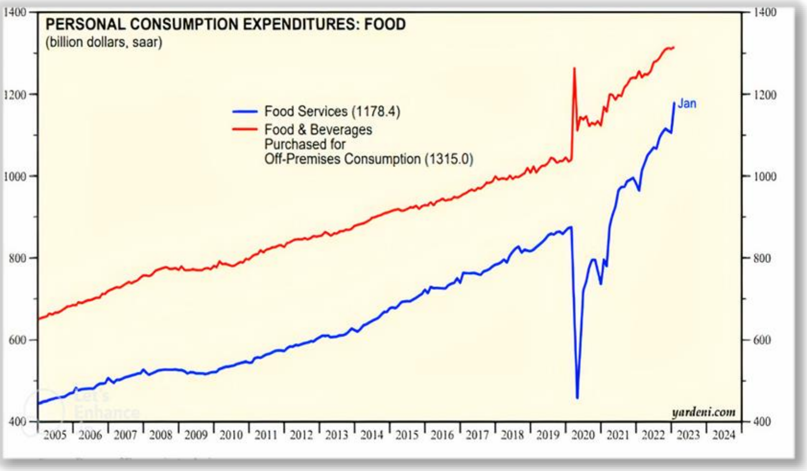
Q: So the goods-to-services transition you mentioned in last quarter's newsletter is continuing despite high inflation?

GS: That's right. Supply chains have improved. People are continuing to buy fewer goods and more services. That trend of people wanting to go away on vacation, dine out and be with friends is continuing.

> **They may not be having a steak, but they're still going out.**

I just came back from a trip to Baltimore. As I sat on a packed plane getting ready to take off, they asked if I was willing to give up my seat for a free flight - plus $150. That might happen on a flight to Miami, but it doesn't usually happen on a flight to Baltimore. And all the restaurants there were packed as well. That's a sign of the times.

WINE, DINE, AND UNWIND



The post-Covid urge to let loose and enjoy life is showing up in consumer spending on dining out, as well as activities across many other service-based sectors.

Q: What other indicators are driving the continued resilience of this economy?

GS: The US auto industry is absolutely one of those indicators of economic health, and first-quarter stats underscored the industry's strength. Over the 12 months through February of this year, 15.7 million cars and light trucks were sold in the US according to the Bureau of Economic Analysis. That's the highest rolling 12-month period for US vehicle sales since May 2021 during the height of Covid—and represents numbers you generally see in a strong economy. Right on trend, GM sold nearly all of their product, making Q1 one of their best quarters ever. The largest US automaker expects this trend to continue for at least the next 3-6 months.

Also, state and local governments across the country continue to have flush budgets. Overall tax revenues are up 16%, while spending is only up 5%. And 22 states are looking at actually cutting taxes.

Despite all the job cuts that have gotten a lot of coverage in the press, job growth during the quarter was running way above average. In the first month of the quarter, 500,000 people were added to job rolls. In February, 311,000 people were added. And March will likely still be well above the 65,000 additional jobs we need every month to maintain current employment levels.

Q: How are capital markets responding to all these economic factors?

GS: Markets have been well-behaved – stocks are positive year to date, despite all of the risks and uncertainties. And in the bond market right now, there's a relatively small difference between the yields on risk-free Treasury bonds and corporate bonds. For example, if you can buy a Treasury bond yielding 4% with almost no risk versus 4.5% for an AAA-rated corporate bond that comes with a lot more risk, it's an easy decision. And the market is bearing that out.

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Outlook

Q: What do the data and trends suggest about the economy in Q2 and through year-end?

GS: We don't see a recession over the next six months, because we are going in with such strong economic growth. Recessions don't happen when you're adding 200,000+ jobs to the payroll every month. Roughly 70% of the economy is comprised of service-based companies. As long as employment holds up, we still expect positive GDP growth.

One of the reasons we're so positive on the construction trades is that we're currently seeing the lowest amount of investment in structures - as a percentage of GDP - in many years. Because of this shortage and the expectations that demand will continue to grow, we expect a commercial building boom. We think that's an important economic bellwether.

We don't think interest rates are going back to the 0% to 1% level - they are going to stay in the 3½% to 5½% range for a while. Rates had been artificially depressed due to the Fed moves, but now we will get some relief where you can invest in them again.

We expect inflation to come down by 2-3 percentage points. More people are coming back to work, so wage inflation is moderating.

We think the US is the place to be, for all the reasons we've discussed—particularly because it remains a leader in innovation.

We see some caution in the banking sector, but with US Treasury Secretary Janet Yellen reassuring the public we are hopeful that will put a stop on bank runs for the moment.

So in summary, we see a continued strong economy, moderating inflation and increasing capital investment.

Q: Any other interesting trends you see developing over the foreseeable future?

GS: I think the re-shoring phenomenon is going to continue. For perspective, the US only exports 8% of GDP - more people send goods into us than we send out.

To give you an example, if you walk into Walmart or Target, you're going to pull something off the shelf that's made in Asia because it's the lowest cost of labor. Re-shoring is happening because 60% of manufacturing costs used to be labor—it's now 30%. You may not realize it, but the Midwest is a new emerging market—more than 25 battery facilities are opening there. There are nearly 1200 companies right now moving manufacturing jobs back to the US.

WHAT GOES AROUND, COMES AROUND

Reshoring continues to grow, as the cost of labor and lower risks make manufacturing in the US more attractive

And the Micron plant being built here in New York State is one of six under construction across the country. In fact, Micron is investing money in STEM programs at schools in those communities so they can boost their pool of qualified talent.

You're also going to see a lot more automation. The rationale is: if you can automate labor-intensive tasks, why not do it and keep the manufacturing here in the US?

Q: Is the war in Ukraine or geopolitical dynamics, in general, exacerbating that?

GS: Absolutely. It's all about risk. And right now, there's more desire to manufacture here at home. It's less risky for companies, and the government is supportive of 'made in America' for national security reasons as well. So those trends have converged.

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What this means for your portfolio

Q: How are HVIA portfolios positioned in terms of the banking sector?

GS: We've always looked at quality, which means we look at cash flow. So the companies we own are relatively large. As a result, we had very minimal exposure to the affected banks. We did own a few bonds from Credit Suisse, but they were not the ones affected by the Credit Suisse issues and represent a very small slice of our portfolios.

Q: How else are portfolios diversified against risk?

GS: We own US-based companies because you have the rule of law and standardized financial reporting, which makes it easier to compare financial statements and understand what the legal ramifications are. It's worth noting that while our portfolio is comprised of US-based companies, 40% of revenues come from *outside* the US due to those companies' global operations.

And to my earlier point, the relative size and quality of these companies - and the cash flow they generate -means they are able to withstand risk better than smaller companies.

Q: How does HVIA think about its investment strategy given the interest rate landscape?

GS: Because we believe rates are going to stay in the 3½% to 5½% range, that's going to change the investment outlook. It's going back to looking more closely at companies' balance sheets and earnings based on business prospects and investments they are making. When interest rates are zero, you can look out 20 years, but today people want to get paid in a shorter period of time – so you have to look at companies differently.

Q: Have you made any changes to the portfolio, and where are you keeping things the same?

GS: We've made some changes to the portfolio, but we are staying the course with much of our investment strategy. We are still investing in tech. And we're investing in industrial companies because we believe there's an industrial renaissance happening. We are still investing in banks, but we are looking at larger banks that can better weather risks or volatile market conditions that may come along. We still think energy is not a bad place to be. As China comes back from its zero-Covid policy, that will push up demand for oil.

Women Guiding Women

Upcoming Events:

Thursday, April 13th at 5:30 PM

"Planning for your Financial Future" panel discussion

La Terrazza, 291 South Main Street, New City, 10956

RSVP: Michele Piscani at mpiscani@orangebanktrust.com

Wednesday, May 17th at 5:00 PM

"A Gathering about Empowerment & Leadership"

Honoring Maureen Halahan, President & CEO

of the Orange County Partnership.

Stagecoach Inn, 268 Main Street, Goshen, NY 10924.

Space will be limited

RSVP: womenguidingwomen@orangebanktrust.com by May 5th

Helpful hint:

Now that tax season is coming to a close, it's a great time to visit some of those issues that you may not have previously addressed:

- If you own real estate in more than one state, you'd be remiss in your estate planning if you didn't investigate the implementation of a trust.
- Probate, which can often hold up the disbursement of an estate, takes place at the state level and multi-state ownership would obviously compound this situation.

Hudson Valley Investment Advisors' sister company is **Orange Bank and Trust, Co**.
If you'd like to investigate implementing a trust or even reviewing an existing one, please contact us and we will make an introduction accordingly.

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