HUDSON VALLEY INVESTMENT ADVISORS, INC.

A subsidiary of Orange County Bancorp, Inc.

THE DELIBERATE INVESTOR

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/insights

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Q2.23 Outlook & Market Commentary

Economy and Markets in Review

Q2 2023 Dashboard

S&P 500 Index return — 15.91% YTD thru 6/30/23
Second quarter Fed rate hikes — increase from 5.0% to 5.25%
First quarter economic growth – Revised to 2% from 1.3%
Second quarter inflation forecast (to be reported in 3rd quarter) — 3.5%

Q: How did the overall economy fare in the second quarter? Where were the surprises?

GS: Overall, the US economy continues to surprise Wall Street and many market observers on the upside. The second quarter was one of the most volatile quarters in recent memory in terms of news flow and expectations, and as a result negative sentiment dominated the quarter. The fallout from the banking crisis at the beginning of the quarter and the widely reported attempted coup in Russia were just two examples. The resulting negative sentiment drove many professional market participants to position themselves for a down market.

We weren't as surprised at the strength of the US economy in Q2.

Q: Why is that?

GS: To give one example, while most of Wall Street was predicting only about 1% GDP growth during the quarter, the economic indicators we look at told a different story—that GDP was actually growing at a 2-3% clip. That's a fairly significant difference when it comes to how you look at the economy.

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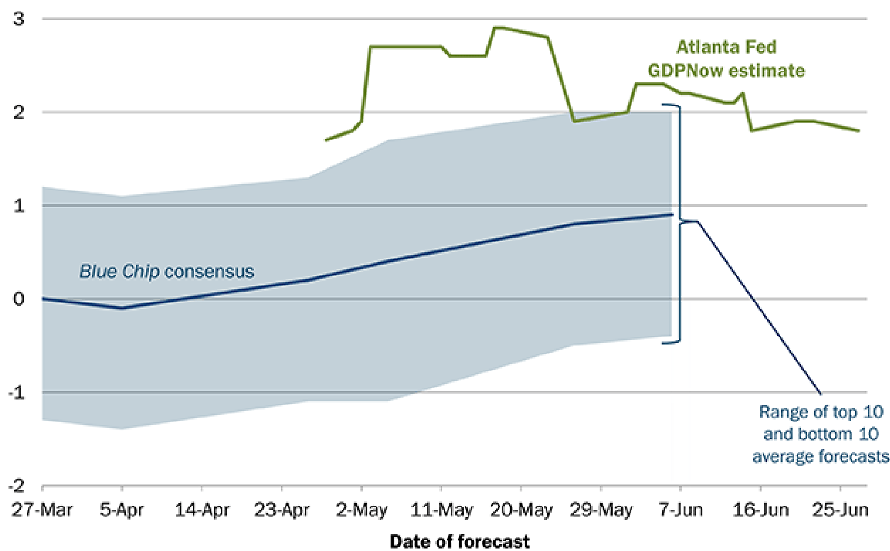
Economy and Markets in Review (continued)

Q: Then what data do you look at for GDP—what are you seeing that Wall Street is missing?

GS: The primary GDP number we look at is the Atlanta Federal Reserve Bank's "GDP Now" data. For the past 18 months, GDP Now has been higher than the median forecast of 20 of the top economists ("Blue Chip consensus" in the chart below).

Evolution of Atlanta Fed GDPNow real GDP estimate for 2023: Q2
Quarterly percent change (SAAR)



Sources: Blue Chip Economic Indicators and Blue Chip Financial Forecasts

Note: The top (bottom) 10 average is an average of the highest (lowest) 10 forecasts in the Blue Chip survey.

So, most of Wall Street has underappreciated the strength of the economy, mainly because they were not factoring in the ongoing impact of the large amount of government stimulus funds distributed during the pandemic.

We also look at high frequency data when it comes to GDP drivers. For example, if a bike manufacturer says they're going to sell 5,000 bikes and they actually sell 10,000, it's a surprise to the upside. That type of data was a positive contributor to GDP during the quarter.

Q: So, what other indicators tell you about the direction of the economy?

GS: Good question. We have our own proprietary model that we use as part of our investment decision-making process. So in addition to GDP, the model looks at four other key economic indicators:

1. the US dollar;
2. rates and inflation;
3. corporate dashboard (including earnings growth and return on equity);
4. market expectations and valuation.

For example, we focus on the dollar because it impacts the revenues of large US-based multinational companies—and 40% of S&P 500 company revenues come from overseas. When the dollar is strong it acts as a tax for US investors. But as other countries have increased interest rates to combat inflation over the quarter, it has weakened the US dollar. When the dollar is weak it acts as a tailwind; this is because it makes US goods less expensive overseas versus competitors in those markets.

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Economy and Markets in Review (continued)

Q: What happened with interest rates and inflation in Q2?

GS: The Fed only increased rates once in Q2—at the beginning of May—from 5% to 5.25%. And at the June 14 meeting, the Fed opted to take no action and keep the Fed Funds Rate steady at 5.25%. This continues a trend of fewer and smaller rate increases over the past 12 months.

And it appears inflation has come down, although going from more than 9% this time last year to 4% now is a lot easier than going from 4% to 2%. Just as one example of slowing inflation, we've seen a sharp drop in wholesale egg prices, which are now $25 per case. At one point, a single case was six times that amount. One of the reasons for that was that with the Avian bird flu during Covid, they had to kill about a million birds. It takes six months to raise new birds, so now all those chicks are mature and ready again to lay eggs.

Surge in Egg Prices

2022 rise of avg price for grade A dozen eggs in the U.S.

The US national average price for a dozen grade A eggs hit $4.25 in December 2022, the highest it's ever been. This 120% increase since the start of the year is mostly due to an avian influenza outbreak.

Return of Affordable Eggs

2023's fall of avg price for grade A dozen eggs in the U.S.

After the US national average price for grade A eggs rose to $4.83 in January 2023, it has since been on the decline backward towards historically typical prices with an estimated $2.13 price for June 2023.

Source: www.bls.gov/St. Louis Federal Reserve/USDA

Restaurants were actually losing money before to make that egg breakfast, but now they are making money hand over fist.

Costs rose dramatically for most industries (not just restaurants), but in many instances they have gone back to near pre-pandemic levels. This is why we are positive on inflation continuing to come down.

Another trend with respect to interest rates: they had moved so far and so fast over the past year or two that home sales had basically stopped. That was a negative drag of almost 1% in GDP growth, but by the end of the quarter people were buying homes again and it was no longer a drag on the economy.

Q: And how about market expectations and valuations?

GS: Earnings expectations have been much lower than what actually has happened. So, while earnings growth was negative in Q2, it came in better than expected.

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Outlook

Q: Where do you see the economy heading for the rest of this year?

GS: We believe GDP will continue to come in above expectations—Wall Street is forecasting anywhere from 0% to 1% GDP growth.

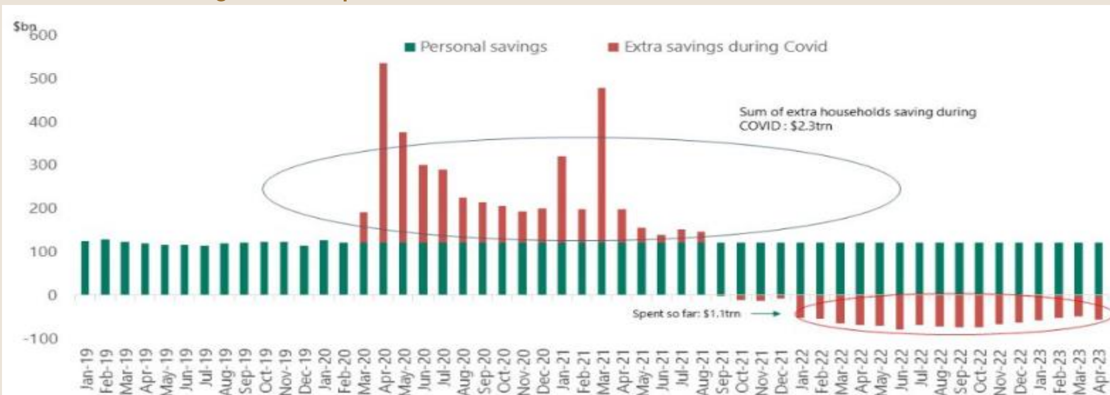
To the extent the dollar remains weak or falls further over the remainder of the year, it will continue to be a tailwind for corporate revenue expectations. Additionally, rising commodity prices should continue to have a positive impact on overseas economies.

We believe interest rates are topping out, despite the Fed's indications that they are not entirely done with increases. Markets believe we're going to get one more rate increase, but we are closer to the end than the beginning of the cycle.

We believe inflation is stickier and will take longer than people anticipate for the inflation rate to drop farther from the current 4% level. But as it moves lower, interest rates should begin reverting to pre-pandemic levels.

Consumers' unspent surplus savings from Covid—totaling $1.2 trillion—could also have a buoyant impact on the economy going forward as these savings have yet to be spent by consumers.

Still more savings to be spent



Most economic forecast models don't include unspent surplus savings that consumers banked during Covid—fueled mostly by government stimulus—and that have not yet been put back into the economy.

Source: Bloomberg, Apollo Chief Economist

Q: What about earnings growth?

GS: We expect to see earnings growth jump from the slightly negative growth in Q2 to 8% growth in Q4.

Q: How about indicators from the corporate dashboard? Do you expect trends you mentioned last quarter—such as spending on services—to continue in Q3 and Q4?

GS: Yes, a few indicators are important here. For housing, which is 25% of the US economy, it appears inventories are rebounding; people are buying homes again, and that should release the drag that low inventories had on GDP last quarter. Automobiles are also starting to see an uptick in sales, and—yes—people are still going out and spending money on services like restaurants. So consumption, housing and labor are holding up, and unemployment remains low. People have more money in their pockets to spend. Consumer confidence has started to improve because of these factors.

Return on equity (as measured by the S&P 500 per the DuPont formula) is one of best ways to measure correlation with future stock prices, and that is holding up very well. We think revenues and margins will continue to come in better than expectations. We expect this to contribute to productivity gains.

Q: With all this better-than-expected news, how are valuations looking at the moment?

GS: Valuations for the S&P 500 have become a little rich, but if you take out the top eight names 28x-35x, it's less so. It's just slightly on the high end for historical ranges, which fall in to the 17x range.

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Outlook *(continued)*

Q: You talked about news flow earlier, and how mainstream media coverage of these events created negative sentiment in the market. How do you see that playing out for the rest of the year?

GS: A lot of what you hear in mainstream media about events is different than what is actually happening on the ground. We read niche publications that are plugged into those realities.

As far as Russia-Ukraine, we obviously don't know what will happen there, so we will be watching it closely. But if we do come to a conclusion on the war in the not-too-distant future, that should have an economic benefit because Ukraine has to be rebuilt. We expect that will benefit both Europe and the US.

But the biggest thing people were worried about during the second quarter was the banks. We think that's ringfenced right now, meaning it played itself out that there weren't any more banks that had issues. As we mentioned in the last letter, this wasn't a credit crisis. Banks are currently levered about 10x, versus during the Great Financial Crisis in 2008 when banks were levered 40x. We are also awaiting more potential regulatory changes, including holding onto more liquid capital if you are a bank. This is the best position banks' balance sheets have been in 80 years to withstand financial shock.

Q: How should people be thinking about the yield environment going forward?

GS: Long-term yields will be moving higher versus moving lower. So they'll be moving more toward long-term historical averages. It's not going to go to 20%—at least in the short term—but people should not expect things to go back to the 0% level. Not even close.

Q: Here's the question everyone wants to know the answer to: Are we headed for a recession? What's the most powerful stat to answer that question?

GS: The US just generated 350,000 jobs in May. That's not a recession.

What This Means for Your Portfolio

Q: Given the current state of the banks, have we changed anything in the past quarter in terms of the names we own?

GS: Our continued focus on the quality of the businesses we own means we look at cash flow and focus on larger companies. This has buffered our portfolios from the effects of the crisis that impacted the limited number of banks in the first half of the year.

Q: How else are portfolios diversified against risk?

GS: As always, we invest in US-based companies rather than non-US domiciled entities as a way to simplify the investment process and reduce risk. US rule of law and standardized financial reporting, makes it easier to compare financial statements and understand the legal ramifications. It's worth noting that while our portfolio is comprised of US-based companies, 40% of their revenues come from *outside* the US due to their global operations.

The relative size and quality of these companies—and the cash flow they generate—allows them to better withstand risk compared with smaller companies.

Q: How is the current interest rate landscape affecting how HVIA views its investment approach?

GS: We will continue to look closely at companies' balance sheets and earnings based on business prospects. While we will be following our investment strategy as always, higher interest rates mean you look at companies slightly differently since investors have less appetite for longer timeframes.

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

GS: We've stayed the course with our investment strategy; our analysis of economic indicators and how we integrate that with company research continues to serve our clients well. We are still investing in tech. And we're investing in industrial companies to take advantage of the industrial renaissance happening. With respect to banks, we continue to focus on larger companies that can better weather risks a range of risks. We still think energy is an important exposure in client portfolios. As China comes back from their zero-Covid policy, that will push up demand for oil.

Upcoming Women Guiding Women Events

Thursday, September 21 • 5:30 PM

Knollwood Country Club
200 Knollwood Road Ext, Elmsford, NY 10523
R.S.V.P. by August 31 to: womenguidingwomen@orangebanktrust.com

AN EVENING WITH MARY CALVI

Fourteen-time New York Emmy award-winning journalist, two-time author, and anchor for CBS2 News This Morning, CBS2 News at Noon, and Inside Edition Weekend

Join us as Ms. Calvi discusses her second novel *If A Poem Could Live and Breathe: A Novel of Teddy Roosevelt's First Love.* The book is based on love letters from the Gilded Age to and from Roosevelt and his first love, Alice Lee. Many of the letters have never been published and were long believed destroyed.

Helpful Info:

Hudson Valley Investment Advisors has recently gone through a significant technology upgrade in both contact management and investment management capabilities. As a result, you may see additional electronic correspondence as well as investment portfolio enhancements. These upgrades are meant to improve the overall client experience here at HVIA, and enhance the core of what we do; *Deliberate investing to create intentional value*. If you have any questions, please don't hesitate to call us at 845-294-6127.

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