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

THE DELIBERATE INVESTOR

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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.

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Economy and Markets in Review

Q4.23: Outlook & Market Commentary

Q4 2023 Dashboard
Markets: 24.2% YTD thru 12/31/23 (S&P 500)
Interest rates: Held steady at both the Nov 2023 and Dec 2023 FOMC meetings
Economy: 2.3% Gross Domestic Product (GDP) growth in Q4 (estimated)
Inflation: 3.0% Consumer Price Index (Core CPI) in Q4

Q: Recently HVIA developed some new messaging meant to describe its value proposition to clients. Before we get into what happened last quarter, can you talk a little bit about that new messaging, and why it's important?
GS: Yes, the new messaging is "Deliberate investing. Intentional value." This is how we've always invested, but it occurred to us we may want our clients to better understand what we do and why we do it.

Q: So what does "Deliberate investing. Intentional value." mean exactly? And why should clients care?
GS: It means that we have a specific investment process we follow. We're different than the majority of investment firms you'd be dealing with. Why is that? There's a reason for everything we do, and those reasons are based on time-tested investing principles and centered around a deliberate process. Our principles don't waiver from year to year, and they create value for our clients in very intentional ways.

[You can read more about our investment principles at the end of this newsletter.]

Q: Can you give us an example?
GS: Absolutely. One of our principles is to invest in businesses, not securities. We'll talk in more depth about this later, but when you know a company well, you can ignore a lot of the noise in the market—including when stock prices overreact to short-term news. When you deliberately own a business because you understand how it generates revenue and creates long-term value, that in turn creates long-term value within our clients' portfolios. It's a very intentional approach.

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Economy and Markets in Review (continued)

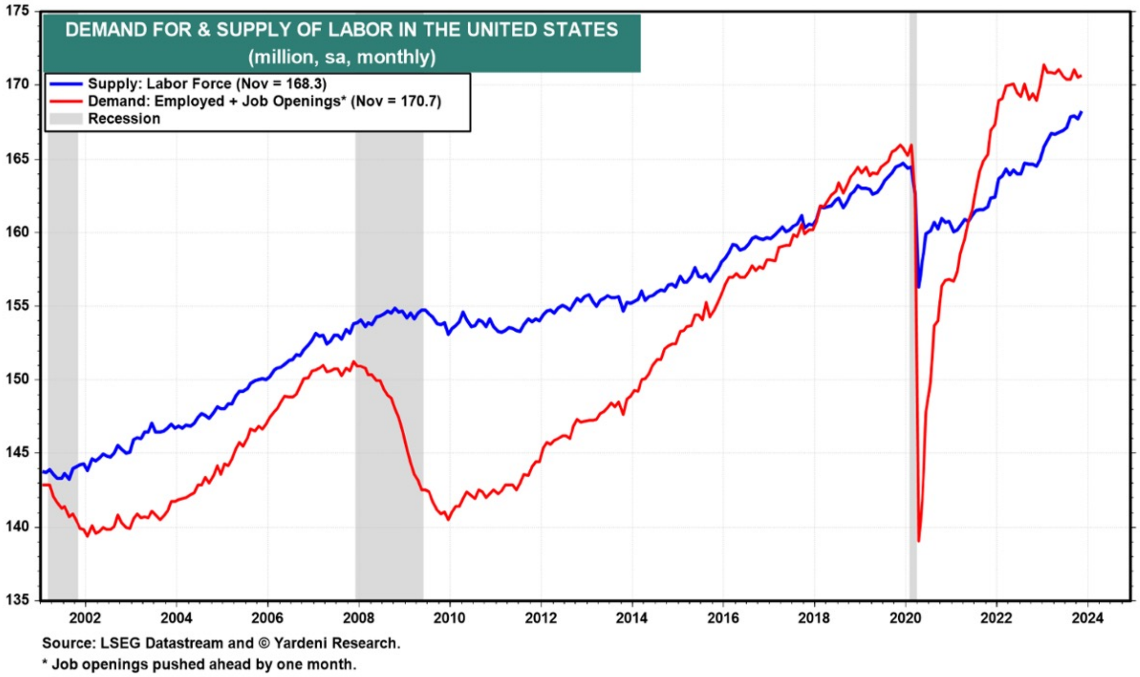
Q: So the "intentional value" is about creating value for clients?
GS: Yes, absolutely. It just also happens that we believe in paying a reasonable valuation for the businesses we invest in. So the value part comes in there too, in that we pay a lower price relative to the company's earnings.

But it's not just about creating value in a client's portfolio. It's about the entire experience of working with HVIA. We're based in the Hudson Valley to serve Hudson Valley business owners and families. We take a personal approach to provide a customized investment portfolio based on your goals. We're here for you whether you want to protect the wealth you've built, or if you are still building wealth.

Q: Ok, so let's talk about what happened in the fourth quarter. How did the economy fare overall? Were there economic factors and trends HVIA saw in 2023 that perhaps others did not?
GS: For 2023 the consensus view was that we were heading into a recession. We didn't see that happening for a few reasons. The amount of cash coming in from government and from private entities. For example, investments in microchip manufacturing plants, electric vehicles and a whole host of other factors. We also saw a consumer that was fully employed and out and about. Most people don't look at how their 401k's are performing on a daily basis—they just worry about where they're going to dinner on Saturday night. And the fact that they were able to do that was an indicator of the strength of consumer demand. We also saw supply chains were healing faster than expected and that interest rates were rising significantly. These factors we expected to tame inflation faster than consensus anticipated —and that actually did happen. That all helped support the markets.

Crossing the streams

Labor demand and supply trend lines are getting closer together, as the two fall more into balance.



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Economy and Markets in Review (continued)

Q: For many years, even decades, the profitable model for companies was not just to outsource but to offshore. Now it's re-shoring, which you've spoken about in the past. What are the main factors contributing to that trend? And do you expect it to continue?
GS: The reason companies ended up going overseas was for cheap labor. Now they're coming back to the US because of the innovation happening here. Labor is not as big of an input for productivity anymore.

And yes, we do see re-shoring continuing. Companies re-shored because of a couple of things coming out of Covid. Supply chains were geographically integrated—now they are being revamped to be more North American-based. The US is the largest economy, we continue to see more and more manufacturing being brought back here. We're replacing labor with software and machinery that's much more efficient.

So we've had record investment, not only in buildings and infrastructure, but also the equipment that goes into it. Companies are making much more efficient machinery, especially for more complex products. That increases productivity in the economy overall. Why is that important? For example, if you grow productivity by 3% a year for 24 years, you're going to double the economy just from that productivity gain.

Q: Ok, so is it fair to say there was embedded risk in offshoring that didn't rear its ugly head until Covid?
GS: I would say that Covid accelerated what was already happening. Instead of happening over 10 or 15 years, the re-shoring and rejiggering of supply chains happened over a much shorter period of time.

Q: What are some of the trends that drove capital markets performance in 2023?
GS: We were actually underweight the so-called 'magnificent 7' stocks, with the exception of Nvidia. Yet we've had strong equity performance relative to the S&P 500.

Why? Because we look at companies that benefited from AI—and not just tech. For example, we own an oil service provider—they're the ones that do the drilling. They instituted AI ten years ago, but now it's a main factor in their business. This company is part of a larger trend. The US produces more oil and gas now than anywhere else in the world. At the beginning of 2023 we had 720 rigs, and by the end of the year we had less than 500 and we're producing 20% more than at the beginning of the year. That's due in part to AI-related productivity gains. We own companies that benefit from that.

Q: So are you looking at companies where AI is replacing workers outright or helping workers do more with the help of AI?
GS: It's the latter. Not just replacing jobs outright, but helping workers improve productivity. In the case of oil services companies, it's twofold: first, the AI technology is helping the companies drill more productively. Second, the companies are hiring more engineers to work on the AI software.

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Economy and Markets in Review (continued)

Q: Can you give a couple examples of companies using AI technology to improve productivity and/or create new jobs?

GS: Sure. In the case of the oil services company, they now know how much friction they need at the wellhead. Less time away from the well, fewer changes to the diamond tip, more efficient. And drilling in harsh environments with added layers of complexity.

JP Morgan has actually been using AI to aid decision making. They're using it to assess and hedge market risk and geopolitical risk among others. It doesn't make the decision for you, it just leads you to a point where an analyst can make a decision.

Just thinking of an example from years ago, when Lotus 123 was introduced in the 1980s, there was a fear it was going to take away accounting jobs. But because of its ability to make sense of a large amount of data, it provided accountants with much more robust information and spurred significant growth in consulting.

Adobe's software not only reduced a document into a PDF, but is taking data and interpreting trends more efficiently for marketing and advertising purposes.

Q: How do these macro-economic factors play into HVIA's investing principles?

GS: Even though we're an active manager and do a lot of bottom-up research on companies, we also have a model that incorporates economic factors into our investment decision making. We look at the economy and put together a profile of where the economy was, where it is and where we believe it's going so we can situate client portfolios to take advantage of the changes we see coming.

Much like a carpenter who puts the ends of two strings in the corners of a room to quickly find the center of the room, we assemble and analyze economic data from the Federal Reserve and various other sources. The data are the "strings" we use to efficiently assess where we think the economy is going. We then establish positions in companies we think are poised to benefit from those trends.

Q: Is there an actual mechanism to connect the macro analysis with the companies HVIA owns? How to you put that into practice principles?

GS: We have something called the IDI – or Investment Diffusion Index – that has more than a dozen inputs, and each one factors into our thought process. It takes into account both US based and overseas factors. When they're all moving in the same direction, it helps us understand the strength of that direction—and vice versa.

Over the last year, inflation was the big issue and we saw that was going to come down. But we also saw there was a lot of money being placed into the economy. Then you realize things aren't going to be as precarious as consensus expectations.

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Economy and Markets in Review (continued)

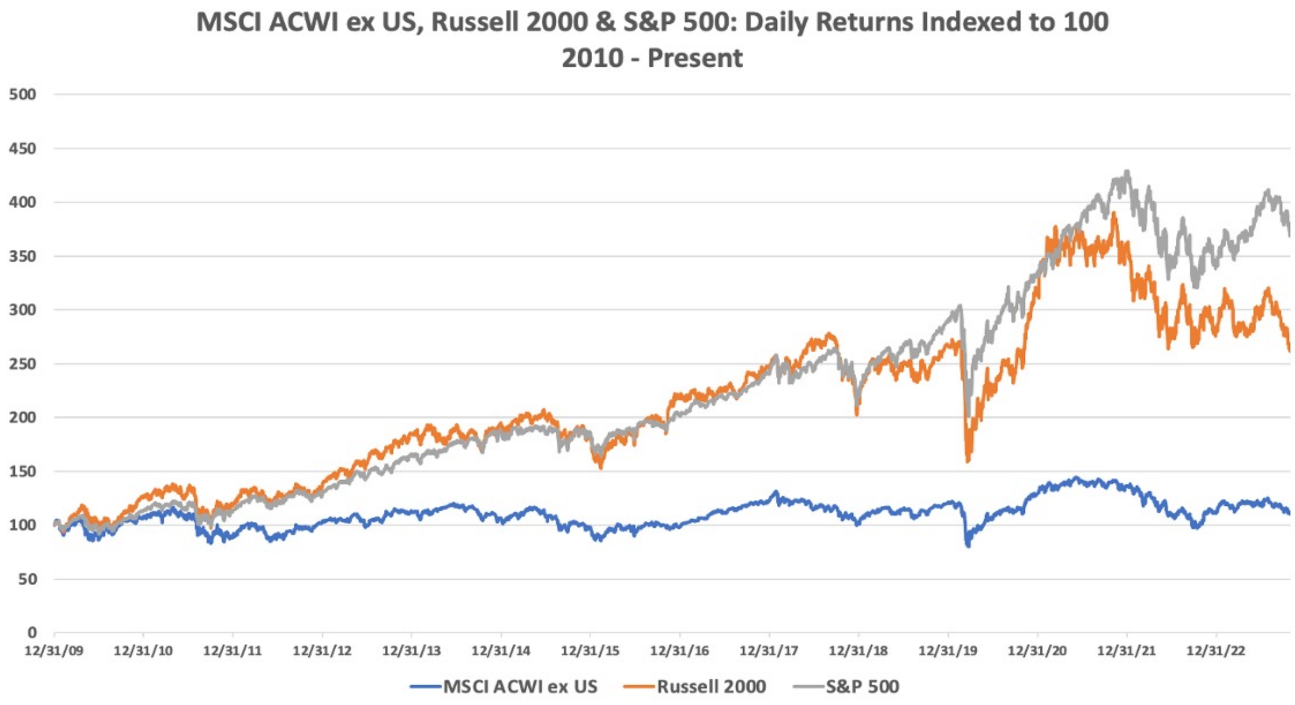
Q: : One of HVIA's deliberate investing principles is a preference for owning US-based companies vs companies headquartered elsewhere in the world. Why is that so important?

GS: From a performance standpoint, there's a big dispersion. US stocks as measured by the S&P 500 have been up roughly 13% on average over the past 10 years. By comparison over the same time period, US small-cap stocks as measured by the Russell 2000 Index have been up 8% on average, and the MSCI ACWI ex-US (All-Country World Index)—which is all international stocks less the US—was up 4% on average. The big investment houses were saying 'There's going to be a reversion to the mean'—but it hasn't happened.

Structural advantage

U.S. innovation and capital allocation give U.S. multinationals an edge.

We think there's a structural difference between the US and other countries because the US is a better allocator of capital, and we have more innovation here than the rest of the world. Of the 10 largest companies in the world, nine are based here in the US and the majority are tech companies.



Source: Datatrek Research

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Economy and Markets in Review (continued)

Q: : But don't investors still need exposure to businesses outside of the US?
GS: Yes, absolutely. We believe investors need exposure to non-US markets, but we prefer that exposure to come primarily through the foreign operations of US-based multinational companies we own. Buying securities listed on foreign exchanges of companies based in foreign countries introduces unnecessary risk.

We'd rather own Google, which has a third of its revenue overseas, and operates under US law including US accounting standards, capital requirements and regulatory structures.

All of that helps avoid a range of risks typically associated with investing in non-US domiciled companies.

Q: What about the notion that markets outside the US are inefficient and therefore easier to seize on an information advantage than US companies?
GS: Twenty years ago, there was a disparity of information… that's no longer the case. But the investment shops are still telling you that you want to invest overseas.

The other thing is that we invest in companies, not sectors or indexes. If you're buying an index, McDonald's and Amazon are in the same sector but they do totally different things. So do I want to own a sector or do I want to own good companies? We focus on the latter.

Q: How did HVIA's principle of investing in companies (rather than sectors) work in practice last quarter? How did you use the IDI to look at different sectors differently for risks or opportunities?
GS: Here's one example. For a long time, balance sheets didn't matter because interest rates were at zero. Now they do. If you were sitting on a pile of debt, it didn't matter because the interest you were paying on that debt was nominal. But after interest rates quadrupled, you're looking at an interest-rate environment that becomes a headwind for you as a company. So we're looking at companies based on top-line growth, we're looking at profit margins—which is the profit a company keeps after deducting costs from its sales or revenue.

Q: So why are profit margins important?
GS: That's been a big factor in the past six months where margins have stayed buoyant even though revenues came in lower (at expectations rather than beating them). So it's now more of a margin story than a revenue story. As interest rates have risen, companies with low levels of debt were able to keep more of what they made—i.e. higher profit margins. And that has benefited the share prices of those companies. Our goal is to own good companies with strong balance sheets, and that benefited our client's portfolios over the past quarter or two.

Q: Some investment firms take allocation bets on sectors. To be clear, though, that's not what HVIA is doing?
GS: Correct, we use macro factors to determine exposure rather than take bets. If I'm looking at the financial sector, banks were hurt last year because of the interest rate dynamics and the availability of capital. So we stayed away from most banks, but we invested in insurance companies and asset management companies. Insurance rates went higher because of all the natural disasters over the past year, and that helped those companies.

Outlook

Q: What are the big trends you see for 2024?
GS: We think you'll see some more upside in the markets in the first half of the year, but not what we had in '23. Because it's an election year, you're going to hear a lot in the market about risk as opposed to the positives.

You can expect to see an inflation environment that's cooling, but also an economy that's cooling while staying positive. I think we'll see interest rate cuts 3-6 months before the election. The earliest we can expect to see those cuts would be March, and the latest would be in June/July. But we're going to a pre-08 environment.

We also think you're going to see a merger cycle. When companies can't grow based off investment, they'll look to get operating leverage by consolidating.

Q: Do you see that consolidation trend happening across multiple industries?
GS: We've had a rolling recession, meaning one industry then another but not at the same time. We think the banking industry will likely be the next industry to consolidate, but probably won't be the last. Looking back at 2023, technology, consumer and industrial sectors all had consolidations and now those sectors are starting to come back. So going forward, companies will be more focused on profitability and margins than they've been in a while. There will be some revenue upside, but more in the back half of the year after the election cycle has settled down.

Q: It seems like the Fed has largely been successful in 2023 bringing down inflation through rate hikes. Now it seems the Fed may start going in the other direction this year. What do we need to look for to glean some clues about how much and how far the Fed will cut?
GS: I think the Fed doesn't want to get caught by lowering rates too soon, because if they do there is a chance that inflation may come back. They'd rather give it time. They can either (a) raise interest rates or (b) keep at this level and wring out whatever excess inflation is still in the market.

The economy is definitely slowing, but we do not believe we're going into a recession. You can't continue growing at 6% and expect inflation not to come back. So the Fed is probably going to keep it at a certain level for a longer period than most people expect just to wring out the last of the inflation. Once it's out and we're back to more of a normalized environment, and we see that with the supply of labor, supply of goods and salaries.

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Outlook (continued)

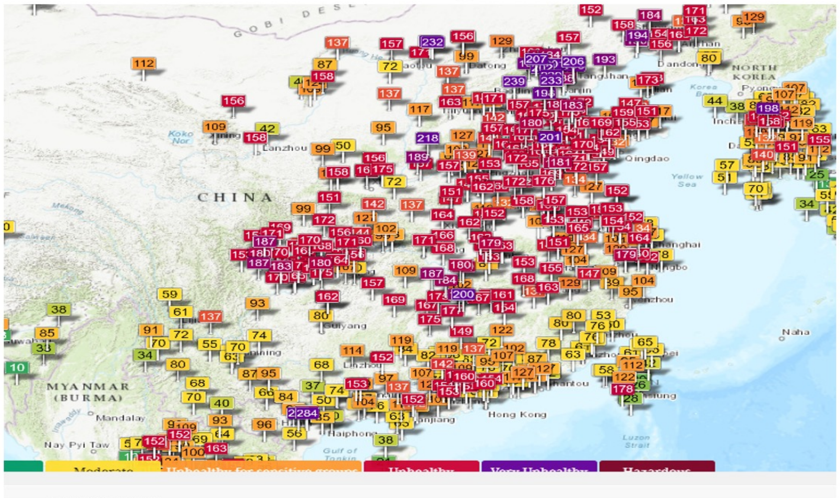
Q: Any other notable trends globally?

GS: China has a big problem with its economy, and it's similar to the US in 2008. It's tied to real estate. How do we know this? Take a look at the chart below; the lack of pollution (the darker areas indicating higher levels of pollution and factory activity) points to a slowdown in industrial activity and a recessionary environment.

China's 2008 moment

China's moderate level of pollution indicates a harbinger of a looming crisis. A good time to be invested in US multinational companies and not foreign exchange-listed stocks.

China Pollution Levels to Gage Economic Activity



Source: ACICN.ORG

THE DELIBERATE INVESTOR

Our 10 Time-Tested Investment Principles

Over the years, our collective experience has taught us powerful lessons about what matters in investing… and what doesn't. That's important because it helps us filter out all the "noise" that can impact good investment decisions. **Below are the 10 core principles that guide our deliberate decisions on how to invest in our clients' best interests:**

1. **Take an active, deliberate approach.**
2. **Know what you own. And know why you own it.**
3. **Do your own research.**
4. **Use experience to identify value.**
5. **Invest in businesses, not indexes, sectors, or domiciles. Disregard traditional classifications.**
6. **Don't overengineer, overdiversify, overbuy or overcomplicate.**
7. **Ignore the noise. Focus only on what matters and take a long view.**
8. **Aim for smoother returns. Make less in up markets, lose less in down markets.**
9. **Minimize the impact of taxes on an individual's portfolio.**
10. **Be a thoughtful and intentional investor.**

If you would like to know more about any of the above investment principles, or have any questions, please don't hesitate to reach out to us.

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