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

Q1.24: Outlook & Market Commentary

Q1 2024 Dashboard

Markets: 10.79% YTD thru 3/28/2024 (S&P 500)

Interest rates: Held steady at both the January and March FOMC meetings

Economy: 3.4% annualized Gross Domestic Product (GDP) growth in Q4 2023

Inflation: 3.2% increase in Consumer Price Index (CPI) over 12 months through February

Q: We talked last time about "Deliberate investing, Intentional value," and how that's a more focused way of talking about HVIA's differentiated investment approach. How is that being received by clients? Can you give an example of something that happened in the first quarter where being deliberate paid off? And what value did that create for client portfolios?

GS: Last year at this time, we looked at the overall economy and saw big government money being directed through fiscal policy into infrastructure, climate change, and reshoring. Because of that, you couldn't just play an overall group, so we researched companies positioned to take advantage of this economic trend.

If you're a company and see interest rates going higher, you're going to want to lease rather than buy or finance equipment and tools. That allows you to free up capital, and we've seen significant progress with many companies in terms of utilization and growth.

There are quite a few companies engaged in infrastructure projects around the country. We had a conference call with one of them approximately a year ago where they said they were hiring back retired engineers and giving them flexible work schedules because of the difficulty finding qualified engineers. When we asked them why, they said they saw opportunities ahead. This was a company that wasn't really covered by Wall Street, and now if they hadn't done that, they wouldn't be able to handle the workflow they have now.

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Economy and Markets in Review (continued)

Q: Artificial intelligence (AI) has been one of the main drivers of S&P 500 returns over the past quarter. How do you apply deliberate thinking to create intentional value in AI stocks?

GS: Graphic chip makers are a good example of this. At the end of 2022, we had a conference call with several of them coming off a bad year. Most were clearing out the last of their old microchips to make room for new chips. We knew the new chips were a step up and incorporated big data, which is what we liked, but we didn't realize just how dynamic those sales would be.

What we did know is that they made one of the chips used during the pandemic to accelerate the COVID-19 drug discovery process. These chips had the ability to crunch numbers much more quickly, but they also could look at certain cell designs and see if the drug was something that would progressively improve. Usually, it takes three years from development to approval, and for Covid, it only took nine months.

Q: Weren't some of these companies core competencies going back a few years making video games run faster?

GS: Yes, they made chips to make graphics better. They also made chips that went into Tesla cars and servers. Back in March 2020 when the market got crushed by Covid, we were looking at tech names no one else wanted to touch.

We were deliberate in our reasons for researching these stocks, and intentional in terms of where we understood the value to be coming from. And we still think some are inexpensive relative to earnings when you compare that to other companies.

Q: What type of data do you look at overall, and how do you acquire the data?

GS: We had more than 120 calls with company management over two years. We have this mosaic of information at our fingertips, and then we work our way through the overall market and ask detailed questions. We look at trucker data and can tell if warehousing companies are going to have a good quarter. We see an uptick in paint utilization at Home Depot stores, and that informs us on how we might own a paint manufacturer in portfolios.

Q: Do you see AI as more of a bubble or the start of a new phase of the economy?

GS: We don't think it's a bubble. When there's a bubble, usually a few things happen. First, merger and acquisition activity usually picks up; that's not happening at the moment. Second, you get an "irrational exuberance" of initial public offerings that excessively pop on the first day and then decline. Third, price-to-earnings ratios during past bubble periods have been about 25-30 times forward earnings; the S&P is only trading at 20 times earnings at the moment. Tech company share prices typically trade at much higher multiples in a bubble environment—currently, it's only 30 times earnings for tech versus 50-55 during the height of the dot-com bubble.

And fourth, past bubbles have typically bid up prices based on less reliable metrics, such as "clicks" or "eyeballs" in the dot-com boom of the mid/late 90s. By contrast, the current rally is based on earnings.

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Economy and Markets in Review (continued)

No, it's not a bubble.

Valuations, as measured by forward price/earnings ratios, are not currently as high as they were during the dot-com bubble.

Q: : Do you see market leadership broadening any time soon? If so, what does that look like?

GS: Yes, we think AI is slowly permeating broader areas of the market. For example, American Express started a 'fraud lab' a few years ago that focuses on transactions that have typically evaded past anti-fraud measures. So using AI and big data to flag multiple purchases of $499 or less, which are hallmarks of abnormal card use. These transactions have traditionally been under the radar for American Express, and they could not sufficiently analyze and reliably identify these red flags in a time-efficient way. They've saved millions of dollars by using this.

JPMorgan uses AI-aided risk analysis to better process very large quantities of data to assess. We've talked about Schlumberger in the past and how they use AI to enhance energy extraction. Today fewer oil rigs are producing more energy than ever before due in part to AI.

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Economy and Markets in Review (continued)

Q: Do AI-related stocks just fade like a fad, or is it perhaps a sign that more industries are starting to see significant AI-driven productivity improvements?

GS: We think we're just in the first inning of this. The larger companies have been investing in this because AI will become the backbone of all these businesses. Chips on current iPhones aren't powerful enough, and a third of Apple's revenue comes from apps. So they'll win by having this phone with new apps, and memory chips they manufacture themselves.

Then if you look at housing, you can take an AI-enabled machine, place it in the room, take measurements, and move on. It allows one to map out an entire housing development, and order materials with much more precision, with much less work. When you think of AI's impact on the creative world, Adobe doesn't just make PDFs anymore. They will be able to tell you if a bit of writing or an image is subject to copyright.

When it comes to insurance, better weather forecasting models powered by AI will bring you to a point, and then have you make a decision. It's a similar process with pharmaceutical approvals—the software can help determine if the drug is viable, then you have to take the data and make the decision.

AI is all about productivity—doing more with less.

Q: How did the US economy and the markets perform over Q1?

GS: Right now, the economy is running at about 2.1% to 2.3% GDP, down from about 4% earlier in the quarter. Why is that? Companies are working off inventories. We had an auto strike, so manufacturers produced fewer cars. We had cold weather putting a hold on new construction projects. And you have full employment now, which is a positive.

Inflation is coming down across the board, except for housing. Consumers are still doing ok, but people are more frugal now—they're no longer spending the way they were. The bottom 50% in income have higher interest rates, which means less spending. The upper 50% have benefitted from higher rates by having an extra trillion in spending capital—primarily 64 and older retirees—so they continue to spend.

But businesses have paused spending because they are just being cautious.

Q: How are markets outside of the U.S. faring?

GS: The rest of the world is not doing that great. China is seeing significant property deflation, and consumer confidence is poor. Germany is China's best trading partner, so that impacts the German economy.

China is seeing deflation overall. Property development and exports were the main drivers, and they leaned more on the former. The development cycle is now unwinding. There's also a demographic problem in China based on the government's "one-child policy" implemented in 1980, which is now causing population decline and subsequent labor shortages as the country's citizens age.

Europe has been impacted in part by the Russia/Ukraine conflict and has seen an increase in inflation and a decline in exports. In addition, the cost of energy has increased as Europe was heavily reliant on Russian natural gas to support their energy needs.

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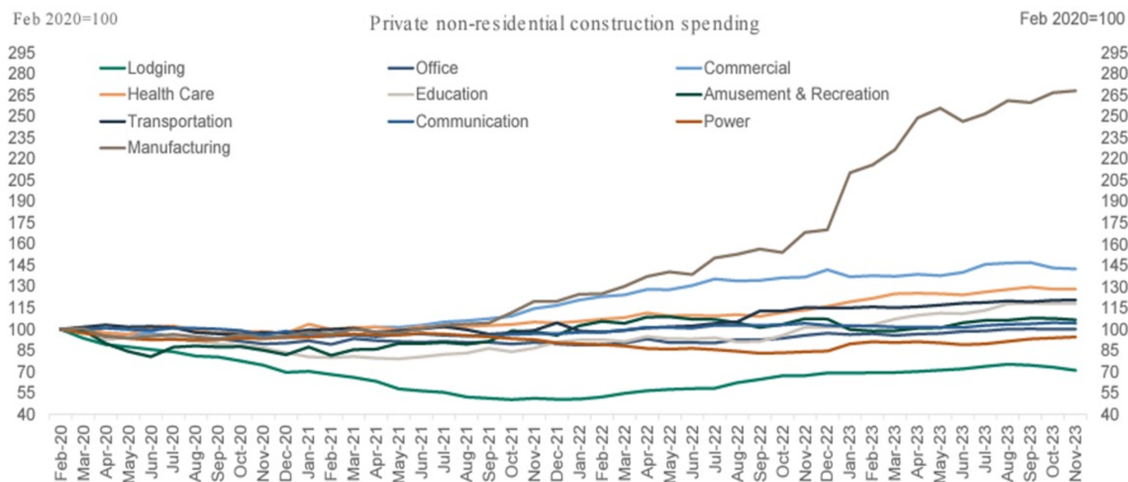
Outlook

Q: How does the next quarter and the rest of the year look for the economy?

GS: We think GDP growth will be positive through this year. We think you'll see improved growth as we move forward. We'll see a pickup in manufacturing that was delayed in part due to the auto workers' strike, and we expect construction projects that were delayed due to the bad weather to pick back up again.

Manufacturing gets its mojo back.



The underlying reasons for manufacturing-related construction spending may continue to drive that spending higher.
Source: Censes, Haver Analytics, Apollo Chief Economist

We also expect to see the cost of housing to be reduced due to lower mortgage rates and an increase in the supply of homes as the year progresses. Housing is one of the last areas that is negatively impacting inflation.

Q: The markets seem to be expecting a rate cut at the Fed's next FOMC meeting in June, but what's a reasonable expectation … and can we expect more cuts later in the year?

GS: Well, you usually lower rates to head off a recession. But we're not in a recession. The Fed has the luxury to wait because the economy is chugging along at a 2% to 2½% clip.
We've said in the past we expect 2-3 cuts this year. If they don't come in June, we believe there is a strong likelihood that you may not see cuts until after the election this year. But we do think they'll cut in June. It's really about the political optics more than anything to do with monetary policy.

Q: What can we expect from markets during this election year?

GS: Historically, in the first three months of an election year, markets generally do well. Then as we get closer to the election, there's an uptick 3-4 weeks in advance if markets feel the incumbent will win. If markets think the challenger will win, markets generally sell off due to uncertainty, and then move higher after policy changes are communicated.

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CREATING INTENTIONAL VALUE

Spotlight: How much of a stock do you *really* own?

With this quarter's rally, several stocks have become a darling of investors. Of course, investors who rely on indexing as a core part of their strategy may own quite a bit more than they realize. This goes for any of the "Magnificent 7" megacap tech stocks that have been leading the recent market run-up.

Because passive portfolios often track a market-weighted basket of securities, that means an investor's portfolio would own a disproportionately large portion of larger securities and smaller portions of smaller securities. That works great when that handful of large stocks do well. But when they perform poorly, the entire basket of stocks also takes a similar hit.

This is one of the reasons we buy businesses, not indexes. We believe targeting your goals makes more sense than trying to beat an arbitrary benchmark. As AI continues to evolve, we will be right there with you to find the companies that will build your portfolio for the future.

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