



# 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](http://hviaonline.com/insights)

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## Economy and Markets in Review

Q2.24: Outlook & Market Commentary

### Q2 2024 Dashboard

**Markets:** 14.48% YTD return through 6/28/2024 (S&P 500).

**Interest rates:** Held steady at both the April/May and June FOMC meetings (5.25-5.50% target range).

**Economy:** 1.4% annualized Gross Domestic Product (GDP) growth in Q1 2024, versus 3.4% in Q4 2023.

**Inflation:** 3.3% increase in the Consumer Price Index (CPI) over 12 months through May.

**Q: A lot was going on with the economy this past quarter. Walk us through what happened last quarter through the present day.**

**GS:** We think the economy is in a mid-cycle slowdown. That's normal in a bull market. Think of it as a play. There's the opening splash, then it slows down, then there's the big finish. We've passed that splash beginning. You're running in an environment where the economy is still positive, but not as robust as before in many industry groups.

**Q: What is causing the slowdown?**

**GS:** There's a combination of factors that are causing that. First, you have inflation, which is moving lower. But it's not a straight line; we've been saying this for a while. It's one thing when inflation goes from 9% to 4% but moving from 4% to 2% is a little more difficult. There's certainly a lower trajectory in terms of inflation—which is good—but you're going to have a bit more volatility to get to that 2% inflation target set by the Federal Reserve.

**Q: How about consumers? Are they a factor in the slowdown?**

**GS:** Yes, you definitely have a pullback from consumers. We have a two-tiered consumer. What do I mean by that? You have two groups, and it ties into the housing market.

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## Economy and Markets in Review (continued)

First, you have people who are moving or need to move. If you're younger, this is the first time you're seeing considerable inflation. When you first bought your home, interest rates weren't as high as they are today. That group isn't going to be interested in moving if they have to get a new mortgage with a higher rate.

Where is that money going? It's going to a second group—people who are asset-long, which is generally older Americans—and they are sitting on \$75 trillion in assets. They're sitting on bonds and cash in bank accounts. Higher interest rates help them go out and spend more, but you hadn't seen that for 15 years.

### Q: How does that affect the economy and housing supply and demand?

**GS:** The playbook for the Fed to slow the economy is to raise rates. But when you do that, it reduces construction activity and overall economic fervor, and consumers pull back. **Plus, 40% of all homes have no mortgages.**

### Q: Why is that?

**GS:** That 40% of homes mainly represent the second group—those who are older and own their homes outright.

### Q: OK, but what about the rest of the homeowners?

**GS:** Of the remaining homeowners who do hold mortgages, the vast majority refinanced when rates were lower. (The average 30-year fixed mortgage was at 6.71% as of mid-June.\*) They are in no hurry to get a new mortgage at a higher rate, so that is also exacerbating the tight housing market.

Percent of mortgages...	91.8%	82.4%	62%
...with an interest rate of	<6%	<5%	<4%

Source: Yahoo finance

If you add the first and second groups, that represents the vast majority of homeowners. Since most homeowners either don't have a mortgage or have mortgage rates well below today's going rates, raising interest rates doesn't change the demand situation in housing.

### Q: Any other reasons why home sales have slowed? Any supply-side insights?

**GS:** Consumer confidence is still relatively low, partly due to the job market. Employers aren't hiring as much right now. On the supply side, and this may sound a little strange, but there are too many houses in the wrong places. Much of that had to do with when states reopened after COVID. In states like Florida, Texas, Arizona, and Louisiana, where there was "12-month COVID," over a million homes are coming onto the market in the next few months. That's because they re-started construction sooner.

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*“There are too many houses in the wrong places.”*

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Then you have the Northeast, where "36-month COVID" was more the norm, and there's still a housing shortage because they're just getting started with rebuilding housing inventory. There are also localized issues around housing and population density, where regulations are contributing to the lack of housing.

### Q: You mentioned the job market. What does the employment situation look like?

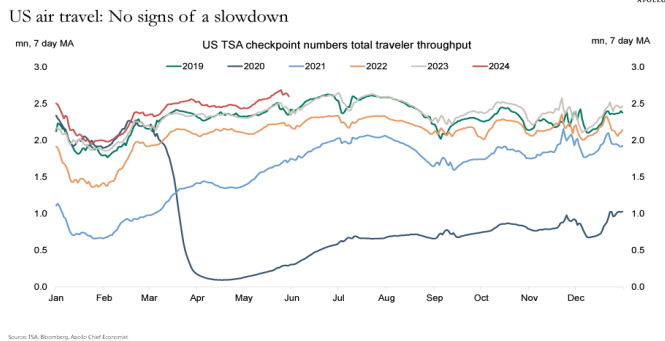
**GS:** As I mentioned, employers are not hiring right now but they are also being careful to hold on to employees. That's because they know if they lay off workers with a particular skill or set of qualifications, they likely won't be able to hire them back when things pick up again. That's one of the reasons we don't see a recession going forward.

### Q: What about retail sales?

**GS:** Two examples. More people are going to airports this year than ever before, mostly older Americans sitting on savings, and Europe is benefiting from all the Americans traveling there.

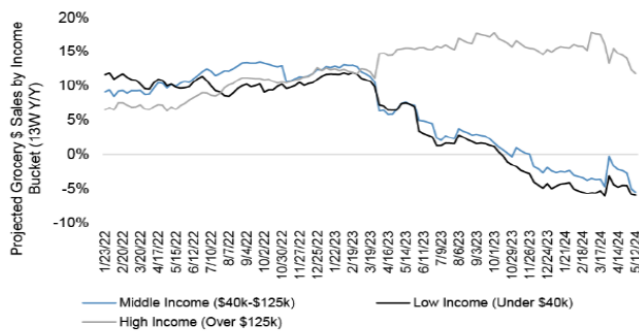
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## Economy and Markets in Review (continued)



The red line says it all. Travel is a key indicator of consumer spending and part of the tale of two consumers that has come to characterize the economy this year.

Everyone buys groceries. If you make less than \$125k per year in income, you're probably pulling back on food spending. But if you're making over \$125k, you may have substitutions but generally, you're not pulling back, you're buying the similar basket of goods.



Food inflation hit sub-\$125k income earners much harder than those who cleared \$125k or more annually. But some in the top bucket were still substituting certain food items to keep their food budgets trim.

**Q: Has productivity increased? If so, how much do you think is stimulated by AI?**

**GS:** Yes, productivity has improved. You can see that in companies' operating margins, which have improved, and earnings have actually gone up. I would say the productivity gain attributable to AI is very limited right now. We've been using the expression, "You're building the road with the chips, but the trucks aren't on the highway yet."

*"You're building the road with the chips, but the trucks aren't on the highway yet."*

**Q: What are some of the metrics you look at to ensure your AI investments are creating intentional value?**

**GS:** People bought utilities over the past month or two in anticipation of seeing a big AI-related uptick in energy companies. But it doesn't happen overnight. It's going to take a lot longer than people expect. The reality is building more power plants is a long arduous process that takes multiple quarters to get state approvals before starting construction.

We listen in on earnings calls to determine capital expenditure spending. If we're considering investing in an AI-related company, we specifically look for four levels a company needs if they are using AI: (1) data, (2) information, (3) knowledge, and (4) expertise.

We think the main AI plays will be either in larger companies or in boutiques. The larger companies will use the full resources to fully deploy AI. The boutiques will experiment and test different technologies and be able to nimbly adapt because of their size. But the ones in the middle will never have the resources that the larger companies do and will not be as nimble as the smaller boutiques.

*"AI-related companies need four levels: (1) data, (2) information, (3) knowledge, and (4) expertise."*

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## Outlook

*“Trucking firms, box manufacturers, and chemical companies are telling us that bookings are up, and things are starting to turn.”*

**Q: What’s your outlook on inflation? Will we ever get to the Fed’s 2% target?**

**GS:** We still think inflation is moving lower, and think we’ll get to that 2%+ level. We’re actually there now if you pull out real estate—rentals or houses. That’s something that’s trailing. While rentals are expensive, the rate of change has been flat. It will be 3-6 months out before we get to a point where we see a major drop in real estate prices.

**Q: How about interest rates?**

**GS:** The Fed is between a rock and a hard place. They’re not political, but they’re partisan. They don’t want to become a main factor in an election. The economy is chugging along fine, and inflation is coming down—so there’s no reason they should be forced to cut rates. They will cut rates because inflation is coming down or the economy is slowing, and if it’s the latter there may be a bit of a selloff.

So, I think you do get two cuts by year-end, but they’ll be further out. It takes a couple of months for rate cuts to filter through the economy, so I think it would be closer to the election, so they don’t get blamed for anything.

**Q: What signs are you seeing that this is a mid-cycle slowdown and not a recession?**

**GS:** Here’s something interesting. When we spoke to trucking firms, box manufacturers, and chemical companies, they were all saying the same thing: things are starting to pick up for them. You won’t see it in their numbers for another quarter. But they’re seeing bookings increase and things starting to turn for them.

**Q: How do chemical companies help you read the direction of the economy?**

**GS:** They make the resin used in car parts, and that’s one of the first things where you see an uptick in demand from car manufacturers anticipating growth.

**Q: Any other signs of green shoots?**

**GS:** Construction. Private construction has slowed down, but on the public side it’s booming. Just drive around and you’ll see some kind of road construction everywhere you turn. It’s easy to see your local and state tax dollars hard at work.

**Q: What would be an example of how you consider specific macroeconomic factors or indicators in positioning client portfolios for the future?**

**GS:** Just look at the upcoming election in November. The concern is you don’t know what is going to happen post-election. As a company, you’re not sure which direction to move. Do I invest here? Do I commit overseas? Generally, within a month of the election, if the incumbent is going to win there’s a very high chance you’ll see stocks rally before the election. The challenger candidate is usually someone who has not been President before. Because people don’t know them as well, there’s a lot of uncertainty around their policies.

In this instance where the challenger is a former president and their policies are known, you could still probably see a rally. Especially because earnings are likely to be strong and interest rates may potentially move lower. We expect the economy should broaden out and get beyond the hesitancy you see now.

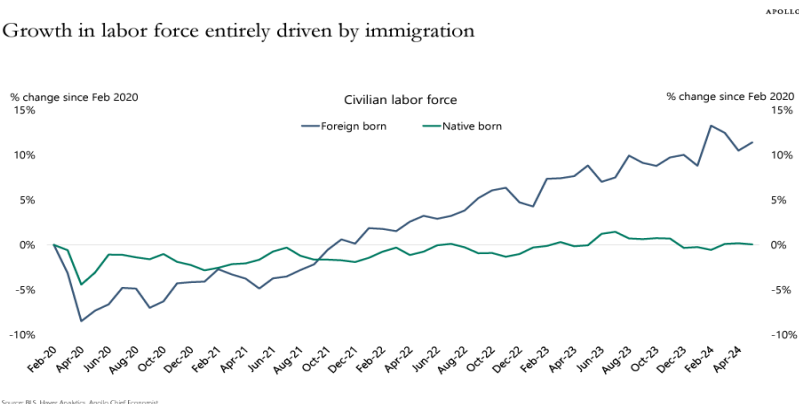
**Q: What is your outlook on GDP?**

**GS:** We think economic growth will continue to be solid and expect GDP growth to hit 2-2½% in the next 12 months. It’s worth noting immigration of all kinds has added quite a bit to the economy. Within a few months of arriving here, immigrants are buying clothing and food and contributing in other ways that help stimulate the economy, and by the way, we need them from a labor perspective. We also expect productivity to increase.

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## Outlook (continued)

Growth in labor force entirely driven by immigration



Source: BLS, Haver Analytics, Apollo Chief Economist

*More than ever, immigrants are the backbone of growth in the US labor force.*

**Q: Any final insights before wrapping up?**

**GS:** Here's an interesting tidbit, the economy can only grow as fast as the combination of productivity growth and population growth. Currently, the U.S. has the capacity to grow GDP at 3½ to 4 ½% but is growing at approximately 2%. This points to the strong likelihood that inflation will continue to decline over the coming quarters and not be a problem.

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