HUDSON VALLEY INVESTMENT ADVISORS, INC.

A subsidiary of Orange County Bancorp, Inc.

THE DELIBERATE INVESTOR

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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.

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Economy and Markets in Review

Q3.24: Outlook & Market Commentary

Q3 2024 Dashboard

Markets: S&P 500 Index: 21.55% YTD return thru 9/30/2024

Interest rates: September FOMC meeting: dropped rates by 50bps (4.75-5.0% target range)

Economy: Forecast of 3.1% annualized Gross Domestic Product (GDP) growth in Q3 2024

Inflation: Forecast 2.5% increase in Consumer Price Index (CPI) over 12 months through August (vs 2.9% for 12 months through July)

Q: Last quarter you spoke about a mid-cycle slowdown in the economy. Are we still there, or are we on our way out given the Fed's recent half-point rate cut?

GS: The mid-cycle slowdown is here, but we are beginning to exit that cycle. We've seen an improvement in growth; GDP has gone from 2% to 3%. And the Federal Reserve's 50-basis-point cut should help stimulate the economy at this point.

The Fed stated they see growth at 2% going forward. We disagree with that, however, because of two specific factors where we see economic growth coming from. We expect the population to continue growing at about 1½% to 2%, due mostly to immigration, and we see productivity adding another 1% of GDP. So instead of interest rates being higher for longer, we're looking at growth being higher for longer.

Q: Of those two big drivers of GDP growth—immigration and productivity—there is often misinformation out there about the former. So why and how does immigration contribute so much to economic growth?

GS: If we look at immigration, you must feed, clothe and house more people. However, despite what you may hear, those individuals come here because there's opportunity. They come to work so they can pay for food, clothing and housing.

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Economy and Markets in Review (continued)

We had an environment post-Covid where there wasn't enough labor. People were afraid of getting sick, and the labor-intensive businesses were the ones who had shortfalls and couldn't meet demand. That labor is now in the market, and because there is more supply in the system it has normalized the supply/demand balance for labor.

Q: And that means the economy can grow again?

GS: Exactly. It was that labor shortfall holding back economic growth.

So, to sum up, we need immigration for two reasons. First, it helps with economic growth by increasing the supply of labor, providing that much-needed capacity. But because immigrants rent and buy homes, clothes, food etc., it also helps on the demand side.

> *"If you want to open a restaurant and you can't find servers or dishwashers, it's a lot harder to sustain that business."*

Second, it helps with economic vitality because they come here with their ideas. Within the last year, seven out of the eight Nobel Laureates from the U.S. were immigrants or children of immigrants. They're not necessarily coming here to go to Ivy League schools, they are trying to take a risk and build something. Some of the most famous companies that are household names today were founded by immigrants—these are companies that now employ hundreds of thousands of workers in this country.

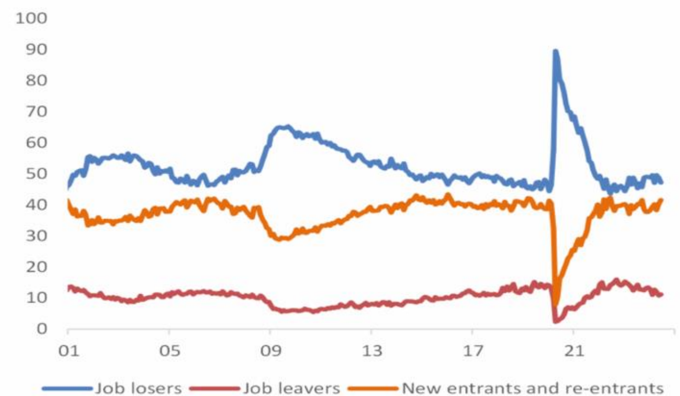
Q: So that leads us to unemployment. Many people wonder how unemployment can go up and the economy keeps going.

GS: Well, that has perplexed some economists as well, especially those who believe in the Sahm rule.

Q: What is the Sahm rule?

GS: The Sahm rule (named after the former Fed economist who developed this rule of thumb) states that if unemployment goes up at least a half percentage point, the chances are extremely high that you'll have a recession. Unemployment went up a half-point over the past year, but almost no one was getting laid off. That's because as more immigrants entered the workforce, it provided a boost. In other words, the uptick was coming from supply, not demand.

So, unemployment has gone up and the Sahm rule was broken, but we don't see a recession any time soon.



A post-pandemic increase in immigration (represented by the orange line) has helped stave off recession by boosting labor supply.

Q: Turning to the other big economic driver, productivity. There's been so much discussion about Artificial Intelligence (AI), but where do you see productivity gains coming from in this economy going forward?

GS: AI is still driving the productivity discussion, but it's sometimes difficult to see it.

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Economy and Markets in Review (continued)

Q: How so?

GS: Well, for example, if you're in the leather business and you think of leather seats in luxury cars, there was a skilled tradesperson who was determining what grade of leather matched with the right level of luxury for that car. Several companies are now using AI to do that. They can now scan it with AI software to ensure it's the highest quality of leather being used as opposed to someone doing it manually.

A major retailer mentioned on their conference call that it took 800 worker hours to put together all info for their online catalogues. That's now being done by AI.

We had a conversation about materials quality with a company that produces the aluminum used by the largest aircraft and car manufacturers. There must be a certain consistency and rigidity to the aluminum so it can withstand the rigors of flight. These companies are also using AI to find defects as they go. Before, the aluminum would have to be remelted if they found imperfections. Now they use AI to find the errors ahead of time. It's all big data, except that it's automated.

Q: It seems like AI-related productivity gains are broadening out beyond technology companies.

GS: Absolutely. We're seeing it in industrial companies, we're seeing it in service companies. And it's not something immediate that goes from zero to 100%. It's more the slower changes behind scenes, but we are definitely seeing those productivity gains.

> A sign of just how unaffordable housing has become, mortgage applications this year are as low as they've been in years.

Q: As we look to the future, where do you see thematic opportunities or other industry-specific applications of AI?

GS: We think right now you're building capacity, so all the big data centers that do the number-crunching are building up their resources. We know that because on conference calls, we saw upticks of $10 billion per quarter from the largest technology companies.

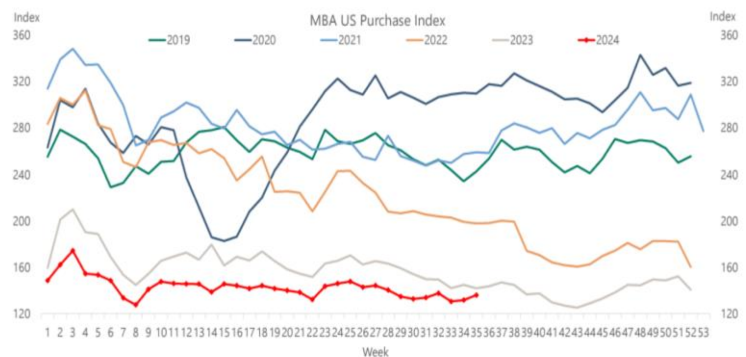
Second, it has to do with quality control, whether it's the leather or aluminum examples we mentioned before, or other areas. Industries are using it as a check, which cuts costs and enhances productivity.

Lastly, by using AI to manage inventory—which is a big cost for industries like retail—you're better understanding what a customer wants, and at the same time limiting bad inventory and product imperfections. That means fewer products you need to put on sale to clear inventory. So, it's really about enhancing margins and improved inventory management. Industrials and retail will be some of the big beneficiaries. Another thing is with service-based industries, you can't always measure broad productivity improvements—and that's 75% of the economy.

Q: Since housing affordability is in the spotlight, especially for the election, what does that look like and how much can interest rate cuts help?

GS: It's complicated. Rate cuts can actually push housing prices up again. But the bottom line is we need more supply—2.5 million homes, which will be difficult to obtain over the short-term. The rate cuts will make things more affordable, but we are still at near-record levels of unaffordability.

Fewer homes + higher rates = fewer buyers



Source: Mortgage Bankers Association, Bloomberg, Apollo Chief Economist

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Economy and Markets in Review (continued)

There are political proposals out there to try to address the problem. Vice President Harris is proposing a $25,000 first-time homebuyer subsidy, but all that will do is push up prices and incite inflation. If you provide an incentive to build, however, it will put more supply out there and it shouldn't increase prices because builders will sell at levels that makes sense.

Q: China's economic outlook has been in the news a good bit this year, what's going on ?

GS: China used to be 25% of the worldwide economy, but now they have a different economic makeup. They're very focused on public investment in housing. They have the exact opposite problem as we have in the U.S., China has too much supply and not enough buyers, so they are dealing with deflation.

The other big area of China's economy is exports, and that's where they are trying to make up the difference. They are flooding global markets with cheap goods. For example, a lot of consumer goods come from China and so that's putting downward pressure on prices. That's why you're hearing more about tariffs from political leaders.

Q: Anything other trends or topics we should touch on?

GS: This is one of the few times the Fed is making a rate cut when the economy is positive. Usually, it's when we end up going into a recession and when markets are tight.

So, inflation is no longer a huge problem, and we're running at 3% annual GDP growth. The Fed was pre-emptive with its rate cut, so it's going to make it easier for people to borrow money from their home. Buying a home also becomes a little easier. Down the road, we think construction will start to increase and financing for inventories goes down. Longer term, business investment will improve.

Even if the Fed had only cut rates by 25 basis points, the economy would still be in good shape.

Q: Why is that?

GS: A few reasons:

- Private sector balance sheets are strong.
- Banks are only 10x levered—the lowest level ever— compared with 40x during the financial crisis.
- Household debt (as percentage of income) is among lowest levels we've seen in 20 years.
- Operating margins are near record levels.
- Consumer sentiment is improving.
- Credit spreads are near record lows.

We're coming out of mid-cycle slowdown at a faster pace than you'd typically come out, and the 50-basis-point cut acts as insurance.

Q: Any other economic trends that are having a big impact?

GS: We have some of the lowest layoff rates ever right now, and the layoffs that we are seeing are mostly high-profile tech companies that overbuilt and over hired, because the 4-5% growth they expected post-Covid never materialized. It's not due to inherent weakness in the economy.

Q: From a stock market perspective, which areas performed well over the quarter?

GS: The best performing sectors were utilities, financials and real estate, all of which were anticipating rate cuts.

Q: And why have small caps done so well lately?

GS: When you get a rate-cutting cycle, those lower rates make it easier and cheaper for smaller companies to access capital so they can expand and grow. These are companies that typically have limited access to capital and/or have a heavy debt load. They tend to perform well as that access to cheap capital generally allows them to grow faster than their larger peers. That's why capital is often called the "mother's milk of growth."

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Outlook

Q: The Fed has penciled in two more rate cuts—a quarter point each—in November and December. Any reason to think that won't happen? Or could the cut be larger?

GS: We think they'll do both cuts, but it will be after the election. If they cut now, it wouldn't help much at all between now and the election anyway, and as we've discussed before that would give the Fed an optics problem. But we'll end up having 100 basis points in cuts by the end of the year (including the 50 basis points from September).

Q: Speaking of the presidential election, how are markets poised?

GS: Generally, markets are more volatile in a presidential election year until you get within a month of the election. If the market starts to turn (get better) a month out, it's the incumbent party who usually wins the election. If things turn closer to a week out, it tends to be the challenger candidate who wins the White House.

This time it's different because we think you're going to have a split government. Therefore, we don't expect major changes since split government doesn't typically allow legislation to get passed.

Q: As we discussed earlier, inflation is now close to 2%, which has been the Fed's target. Where do you see inflation going from here?

GS: We think overall inflation will be at or near 2%. One of the most stubborn areas of inflation—and the biggest remaining segment that remains elevated—has been housing. Prices have come down and will continue to do so over the short term as supply continues to improve. But we anticipate housing will stay in a fairly tight range for the next year or so before prices rise again.

Q: Where will capital investments go over the next year or so?

GS: I think we'll see continued investment in industrials and manufacturing. When interest rates drop, the cost of capital goes down and so more investments are positive for your bottom line.

WHAT THIS MEANS FOR YOUR PORTFOLIO

Q: How is HVIA positioning client portfolios for the future? Any major changes?

GS: No major changes. But given the Fed rate cut and the rotation we're seeing in the market, we are taking a more pro-cyclical focus in portfolios going forward as cyclical stocks tend to perform well in a falling rate environment.

Q: How do these insights on the economy dovetail into HVIA's deliberate investing style? How does that create intentional value in clients' portfolios and in their lives?

GS: On the economic front, the lion's share of money from the CHIPS Act is still available and being deployed. The reshoring of US companies continues, creating more jobs in the economy. And productivity gains continue to enhance the economy's performance. As the government and businesses invest more in infrastructure, employment should continue to move higher.

High productivity means everyone benefits via quality-of-life improvements. If the economy grows at 4% vs 2%, it will double in 25 years instead of 40. That means more opportunities for the next generation, and investments that perform better over the long-term. That translates to better retirements and meeting more of your life goals—and hopefully more enjoyment of life overall.

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"Before you speak, listen. Before you write, think. Before you spend, earn. Before you invest, investigate." – William A. Ward

Join us for an evening to thank you for your business
and to share our 2025 Economic Outlook.

THURSDAY, NOVEMBER 14, 2024 · 5:30 PM – 8:30 PM

West Hills Country Club
121 Golf Links Road, Middletown, NY 10940

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