Deliberate Investing. Intentional Value.

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

Our Office location:
117 Grand Street, 2nd Floor
PO Box 268
Goshen, NY 10924
845-294-6127

Email:
operations@hviaonline.com

Appointments
also available at:
4 W. Red Oak Lane, Suite 310
White Plains, NY 10604

Economy and Markets in Review

Q4.24: Outlook & Market Commentary

Q4 2024 Dashboard

Markets: S&P 500 Index: 23.3% YTD return thru 12/31/2024

Interest Rates: FOMC cut rates by a total of 50bps via the November and December meetings to the current 4.25-4.5% target range

Economy: 3.1% annualized Gross Domestic Product (GDP) growth in Q3 (versus 3.0% in Q2 and 1.6% in Q1)

Inflation: 2.7% increase in Consumer Price Index (CPI) over 12 months through November (vs 2.6% through October and 2.4% through September)

Q: Let us start with the election result. How has that impacted markets and how people are feeling about the economy?

GS: Once election results were in, small business owners recorded a significant uptick in terms of sentiment. It was like someone turned on a switch. Small business owners were most concerned with taxes and regulation. Because those two burdens are potentially removed, that drove positive sentiment and ignited the post-election rally.

> *"After the election, small business owners' sentiment spiked. It was like someone turned on a switch."*

Q: Any other big post-election trends?

GS: Business investment looks like it is starting up. First, there is now an opportunity for M&A after the current FTC commissioner—who has restricted most mergers and acquisitions—leaves her post. And overall GDP growth accelerated over the fourth quarter. Because of the potential for tariffs, there may have been some "pull-forward" of goods purchases. In other words, companies may have bought goods in Q4 in anticipation of tariffs being levied in 2025.

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Economy and Markets in Review (continued)

Why is that important? Because you could see higher input prices if companies are forced to buy only American goods, and if it does happen it most likely will be a one-time step-up in inflation. Keep in mind, if we see tariffs on select goods it will cause inflation in limited areas. This was the primary outcome during the first Trump Administration as the inflationary impact was one of the lowest in history at 1.9%.

"If you raise the price of an Egg McMuffin from $1 to $1.10 because of tariffs, inflation goes up 10% for that product. This would cause a price increase, but you maintain U.S. jobs and consumption."

Q: What has the Federal Reserve been up to this past quarter?

GS: The Fed dropped interest rates—by a total of 50 basis points during the quarter—to the Fed Funds Rate's current target range of 4.25% - 4.50%. The Fed began to shift from being focused on inflation to the labor market. Then more recently, the Fed shifted back to focus on inflation because of resurgence concerns. And of course, the Federal Open Markets Committee (FOMC) went from penciling in four rate cuts in 2025 to only two rate cuts in 2025.

Q: Has inflation finally been slayed, or are there still areas in the economy where inflationary concerns linger?

GS: Inflation remains sticky; it has not yet come down to the Federal Reserve's 2% target level. We experienced some exogenous events in Q4 with 2 hurricanes in the southeast and some other weather events, which triggered a nominal uptick in durable goods inflation. For example, some of those impacted by the hurricanes had to replace cars and washing machines which caused short-term dislocation and higher prices for those goods. Then there's housing inflation. As we have talked about in the past, there is still a supply/demand imbalance in housing across the country — there is still a need for an additional 2-3 million homes. This supply shortage continues to put pressure on prices although we do expect prices to eventually come down over time.

Q: While we are talking economic inputs, where does productivity stand?

GS: GDP growth has been above expectations, with productivity being a differentiator. When there is a shortage of workers, companies often go out and put more money into R&D and capital expenditure. Basically, replacing people with machines and software. This leads to fewer workers that produce more goods and services. Because of these technological investments, productivity is much higher than it was just a few years ago.

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Economy and Markets in Review (continued)

Q: Do you attribute that to artificial intelligence?

GS: Not all of it, but a good chunk of it. Companies we have spoken to are using AI in 4 ways:

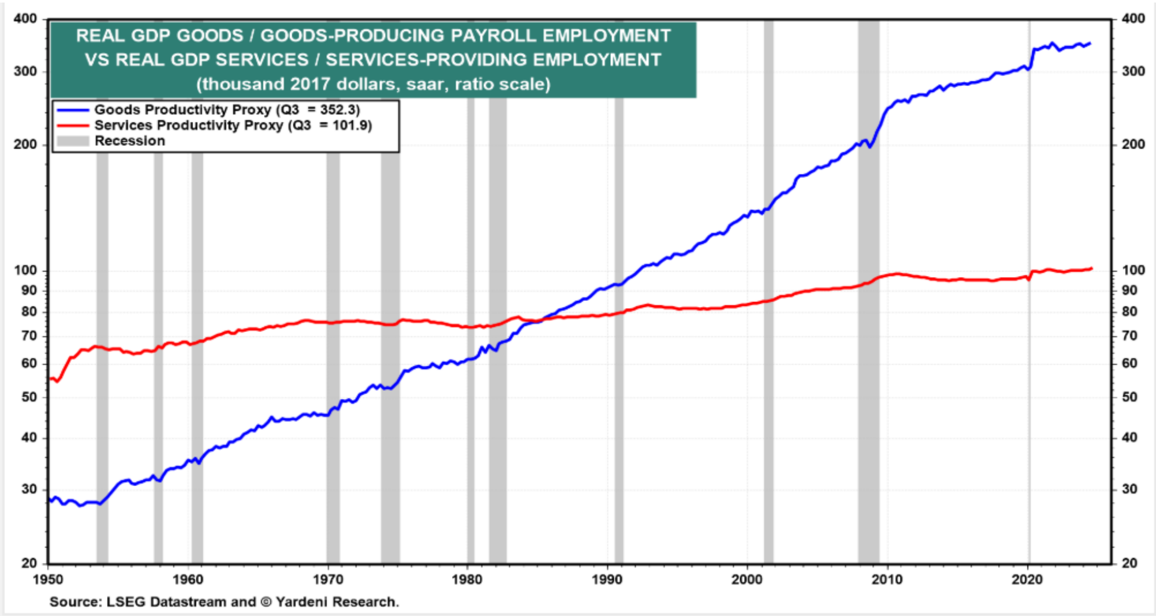
1. Limiting errors
2. Increasing a worker's knowledge base
3. Shortening cycle time to produce a finished product
4. Automating some repetitive tasks

The use of AI allows a company to reach scale more quickly. In many cases, AI technologies act as an extension of your staff.

Q: Do you think size becomes less of a competitive advantage?

GS: Yes, the cost of technology used to be the barrier to entry for many companies, so scale mattered. Now, size is going to be less relevant because the information barriers are down. So, ultimately, you compete with your intellectual capital.

Productivity has Risen, Especially for Goods



Q: Switching gears, what are some examples of proposed federal policy changes that have also contributed to the post-election rally?

GS: The U.S. has an extremely high level of debt at the moment, so Treasury Secretary nominee Scott Bessent has attempted to calm investor fears with his "3-3-3" plan: cut the deficit to 3% of GDP, increase overall GDP growth to 3%, and increase daily oil production by 3 million barrels per day. This plan addresses the deficit, helps to lower future inflation, and focuses on long term economic growth.

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Economy and Markets in Review (continued)

Q: How has the geopolitical landscape evolved over the quarter?

GS: : In terms of geopolitical risks, there are a few. You have the war in Ukraine which has been going on for close to three years, with Russia receiving assistance from China and soldiers from North Korea. Then you have the Israel-Hamas conflict which started with the October 7, 2023 Hamas attacks in Israel. The ensuing conflict has spread to Lebanon and Syria. Syria's Assad regime was supported by Russia for years and it was the gateway for munitions to reach various proxy groups, who waged war and attacked cargo ships. When rebels threatened to overthrow the Syrian regime, Russia was not able (or willing) to come to Assad's aid. Russia's resources were depleted by the war in Ukraine, and Syria was now in play.

Why should investors care? Just one example, if western forces end up neutralizing the Houthi threat, it could cut current shipping times, and costs, in half. That would have a positive effect on the global economy.

Meanwhile, China is closely watching all of this and considering whether to take over Taiwan. Now that threat appears diminished. Long story short, there may be a chance for peace in many of the world's hotspots. That could help the European economy and countries like Poland and Germany, for example, which would be first in line in the post-war rebuilding efforts.

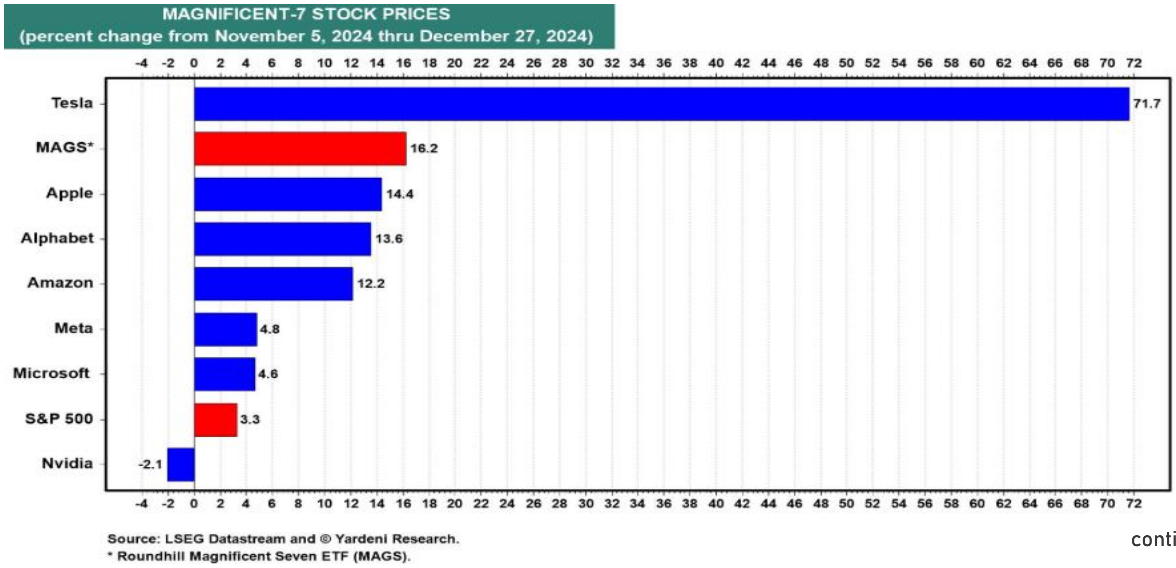
Q: Corporate earnings seem to have improved over Q4?

GS: Yes, corporate earnings have improved. Much of that is about profit margins, which now stand at near-record levels thanks to productivity gains. It is also one of the reasons we are seeing high valuation multiples now.

Q: Speaking of earnings, how has stock market performance reflected those earnings and equity valuations?

GS: If you look at the following chart, you will see that much of the growth since the election has been from the "Magnificent 7"– the largest of the Mega Cap tech stocks. And price/earnings ratios reflect that to an extent. The S&P 500 Index has an overall P/E ratio of 22, but once you strip out the Mag 7 stocks it is only 18. Much cheaper. But the Mag 7 is where the growth is coming from currently. Post election, the best performer was Tesla, which saw +70% returns but now trades at close to 120x next year's earnings (or P/E) despite having +20% earnings growth.

'Magnificent Seven' Driving Post-Election Rally



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Outlook

Q: As we look ahead to 2025, what can we expect?

GS: Barring some outside shock, we can expect margins to continue to improve in Q1 and Q2. It is an earnings-driven market at this point. We think Q4 of 2024 will end up being one of the fastest periods of earnings growth since Q4 '21. The Mag 7 will continue growing earnings at close to 21%, whereas the remainder are growing at 13%.

"We think there is a permanent uptrend in productivity."

We spoke last time about the mid-cycle slowdown, and how we are now coming out of the other end of that slowdown. We see this as a "glass-half-full economy": strong U.S. productivity, easing financial conditions and robust EPS growth.

Q: Do you see the market broadening out from the Mag 7 into other areas of the economy?

GS: Yes, absolutely. We think Mag 7 stocks will go from 40% earnings growth to 21% growth, and as that happens, the other 493 companies in the S&P 500 will go from 4% earnings growth to 13% growth. The narrowness of the market accelerated postelection as investors bought large tech and tech-heavy industry groups.

Q: Any notable, forward-looking trends from Q4?

GS: Yes. Utilities were the 4th best performing sector of the S&P 500 last quarter. And it was powered by this idea that AI is going to drive an exceptionally significant increase in energy demand. Now, it takes a minimum of two years to get a new power generation facility up and running, in part because of all the local regulations and site permitting required. So, it is a long-term play, but that is what is driving those utility stocks. To get a sense of the scale of the energy consumed by AI chips and AI computing in general, nationwide AI energy demand is estimated to be the equivalent of three New York Cities by 2030.

"Nationwide demand for AI-related energy alone will equal 3x the power demand for NYC."

The other trend we have spoken about is that there are two consumer economies: older retirees and younger workers. The former benefits from swelling 401Ks and higher interest on income-oriented investments, while the younger group struggles to find housing and affordable mortgage rates, with inflation cutting in to their ability to save.

Q: There has been a lot of talk about proposed tariffs from the incoming administration triggering higher inflation in 2025. What are your thoughts?

GS: It is most likely going to be a one-time push of inflation. Let us say you impose tariffs on 25 companies, that establishes an umbrella price that U.S. companies can raise their prices to. But it is still a competitive market, so you are limited in terms of what you can price at. It becomes a moot point in 'year 2' because that's when inflation flattens out. Keep in mind, in the first Trump Administration we had the same scenario for things like steel, which received exemptions based on the importance of select imported goods to the U.S., so the overall burden was significantly less than expected.

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WHAT THIS MEANS FOR YOUR PORTFOLIO

Q: There has been a lot of attention on the healthcare sector recently, and public concerns about the healthcare system have put pressure on healthcare stocks. What are your thoughts on HVIA's investments in healthcare, and how they fit into HVIA's "deliberate investing, intentional value" philosophy?

GS: While healthcare companies have suffered recently, we think this is a short-term dislocation in an otherwise positive year. Our long-term thesis on the sector has not changed. The demographic trends are such that older Americans tend to consume more healthcare. Our focus has been on drug discovery-type companies that are well positioned to benefit, as they are building the infrastructure for that research and AI is making those efforts more productive. Our overweight in healthcare benefits from this long-term demographic tailwind.

Q: How else does healthcare benefit the overall portfolio?

GS: Healthcare also acts as a ballast against our technology positions. Healthcare companies have stable and growing earnings, which act as "insurance" if growth stocks in the portfolio see a slowdown.

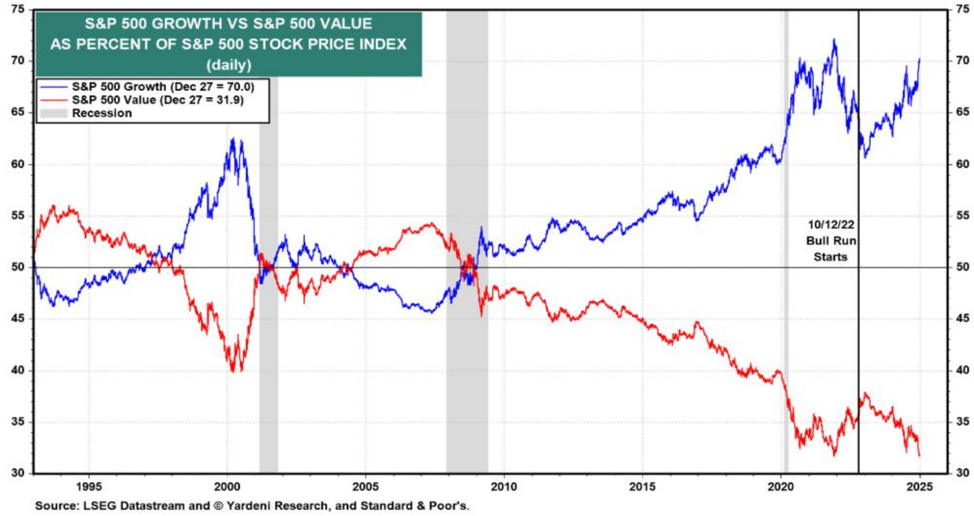
Q: Do you anticipate some of the market extremes we have seen continuing in 2025?

GS: We expect that we will see some reversion to the mean as we move into 2025. Why do we feel this way? In short: concentration risk, volatility risk and valuation risk.

First, keep in mind how concentrated the S&P 500 Index is right now. The top six names in the index at the end of 2024 accounted for approximately one third of the total index weight. We own most of these names but do not own them in the same concentration as the index. Several of these stocks have positions in the S&P 500 Index approaching 7% each.

Second, as we move into 2025, we think there is a good chance for greater index volatility due to the concentration and the extreme advance over the last six weeks of 2024. As you can see, growth stock outperformance and value stock underperformance are near historical extremes, as per the following chart.

Value Underperformance Cannot Last Forever



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WHAT THIS MEANS FOR YOUR PORTFOLIO (continued)

As we discussed previously, the “Magnificent 7 Driving Post-Election Rally” chart illustrates how richly valued those stocks are, and how returns of the S&P 500 are highly concentrated in a very small number of holdings. Only one of the Mag 7 stocks, Nvidia (NVDA), has a lower valuation than the overall index. As we move into 2025, we will continue to look closely at areas of the market such as financials and healthcare where valuations are significantly lower, and earnings growth rates are expected to be better relative to Mega Cap and technology companies.

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Tel: 845-294-6127 | Fax: 845-294-1438 | hviaonline.com