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
White Plains, NY 10604

Economy and Markets in Review

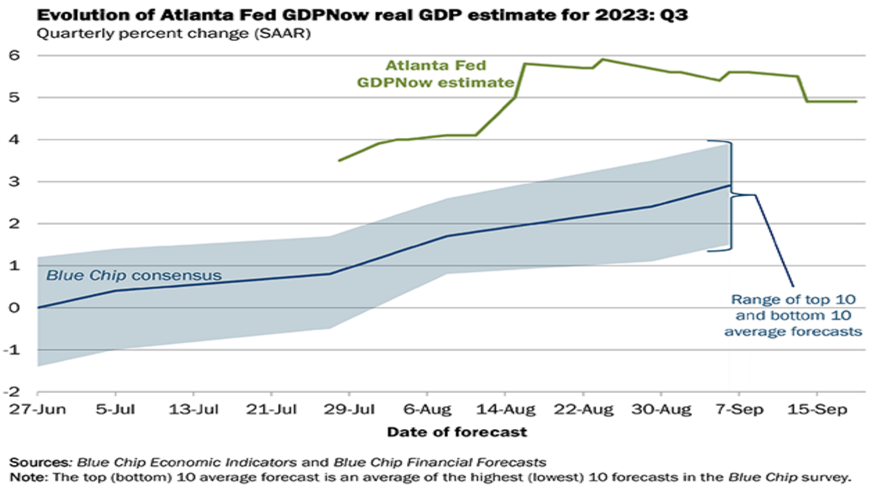
Q3.23: Outlook & Market Commentary

Q3 2023 Dashboard
Markets: 13.1 % YTD thru 9/30/23 (S&P 500)
Interest rates: increased from 5.25% to 5.5% in late July; held steady at the 9/20/23 FOMC meeting
Economy: 2.1% Gross Domestic Product (GDP) growth
Inflation: 3.7% Consumer Price Index (CPI) in Q3

Q: Pundits have been talking about a market recession for quite some time now. Did that materialize in Q3?

GS: The short answer is no. There were earnings expectations that we were going to see a slowdown in the third quarter; that didn't happen. Companies managed their margins very effectively—much better than we have seen historically. That's all part of last year's "rolling recession" that started with tech companies cutting heads and reducing overhead, and then consumers, industrials, and almost every other sector followed suit. So margins in Q3 were finally reflecting those cost-cutting efforts. Companies were still trading at about 12% operating margins as of quarter end, versus the 7½% or 8½% margins you typically see during a recession. GDP growth reflected that still clipping along at about 5%, which is above-trend historically.

GDP continues to power ahead



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*
Note: The top (bottom) 10 average forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

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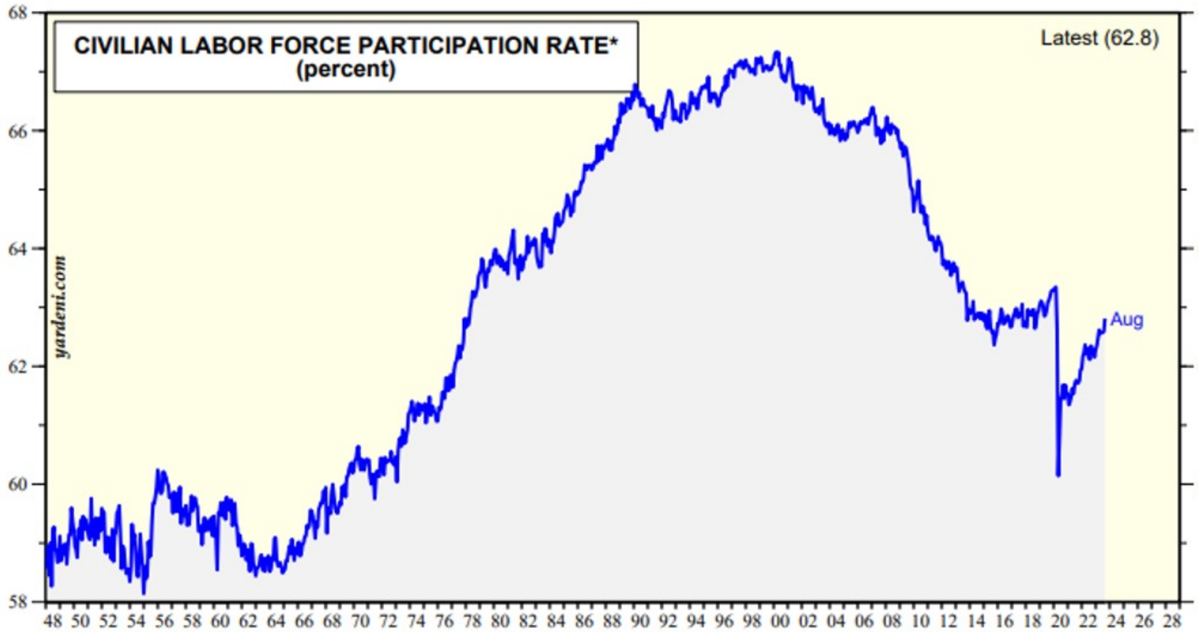
Economy and Markets in Review (continued)

Q: That definitely doesn't sound like a recession. What other factors suggest to you that the economy is hanging in there?

GS: This is a pretty resilient economy. Just look at the unemployment rates; companies are not willing to let people go. Unemployment levels did move up slightly over the quarter, but that's because the participation rate (*see chart below*) increased—that is, the percentage of the population actively employed. Both are back above pre-pandemic levels, which is a good sign of a healthy, recovering economy.

Workin' for a livin'



* Labor force as percent of working-age population.
Source: Bureau of Labor Statistics.

Q: You've spoken in past quarters about the continuing impact of pandemic-era government stimulus. Did we see more of that in the third quarter?

GS: Yes – the parts of the economy that have benefitted from monetary infusion from the government moved forward in Q3. For example, construction-related areas—whether it was battery plants, green energy, or infrastructure—continued to benefit from that stimulus that is still working its way through the economy.

Q: What other factors contributed to the economic picture over the quarter?

GS: Most businesses worked down their inventory levels in Q3. That primes the pump for more economic activity as they need to replace that inventory.

Additionally, there have been a few strikes: the United Auto Workers (UAW), as well as the Hollywood-related strikes from the Writers' Guild and SAG-AFTRA (actors). UAW will likely come to some sort of conclusion but this one will be more contentious than in the past. There are enough cars out there from other resources. For example, Tesla, which is not part of the UAW negotiations, will have a distinct advantage in lowering cost as they capture EV market share.

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Economy and Markets in Review (continued)

Q: That's interesting. Where is Tesla's advantage coming from?

GS: There are basically only 20 moving parts in a Tesla drivetrain, and they're all made by Tesla. This reflects a structural change in building a car. Compare that with over 200 parts for an internal combustion engine, which requires more labor. For this reason, Tesla estimates they'll be able to take the price down by 40% over time from where they are today, and still make the same profit. The cast bodies that Tesla is developing are what make it possible to reduce the number of parts from over 200 to 20.

So there's a big productivity push. And a lot of the unionization out there is looking at things as if it's 50 years ago. But the industry has changed. And if you saddle these companies with too much debt and inefficient work rules, they can go out of business.

Q: And were there other trends globally impacting US investors?

GS: The thing that really changed was energy later in the quarter. You were looking at an environment where supply was restricted slightly by Saudi Arabia and Russia, and demand has held up.

Another big thing is that China has not rebounded the way that economists and prognosticators expected; their growth has definitely slowed—from 5% over the last couple of years to slightly south of that.

Q: What do you attribute that to?

GS: It's a secular change. It has to do with real estate and consumer confidence in China.

Q: Inflation is on everyone's minds these days. How is Fed policy addressing rising prices?

GS: As we got into the quarter, we saw the Fed still trying to fight inflation. As we mentioned before, the majority of the inflation decline is behind us. The Consumer Price Index (CPI)—the most widely recognized measure of inflation in the US—has gone from a peak of 9.1% late last year to approximately 3.7% in August. That's getting close to the long-term average of 3.28%.

We're closer to seeing a slowdown in the Fed's rate increases, but after you see the last rate increase it typically takes eight months from that point to see a rate *cut*. We think it will be mid-2024 before that happens. The economy needs to slow and unemployment needs to increase before the Fed considers cutting rates. And remember at the press conference for the July FOMC meeting, the Fed said there was no recession.

Q: And how about interest rates?

GS: Interest rates here domestically have risen in the past quarter, so that's acting a bit of a headwind at the moment. But it's not getting in the way of growth so much as it's just slowing things down a little bit.

Q: How did capital markets fare? Have valuations come down at all?

GS: On the equity side, the S&P 500 Index reached a peak in late July—right around the time of the July Federal Reserve meeting where they said we're not in a recession. The market has pulled back since that point, with the S&P finishing down by a little over 3% for the quarter. Additionally, the tech names that led everything have seen valuations come back in. Those stocks are trading at 23x (an average price that's 23 times average earnings per share) and the S&P 500 is trading at about 17x, below the 10-year average P/E on a forward basis. So valuation isn't as stretched as it was for the average stock in the S&P 500. And valuations for the "Magnificent 7" [Apple, Microsoft, Amazon, Alphabet (Google), Nvidia, Tesla, and Meta Platforms (formerly Facebook)] are higher, but still below where they were earlier in the year.

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Outlook

Q: How do you see the US economy faring the rest of this year and into next year? What factors will drive that trend?

GS: Employment is still strong, earnings beat expectations and the economy is still running at around 5% GDP growth level, which is above trend—and above consensus estimates from Wall Street economists. Again, construction-related trends continue to be strong, and as companies more broadly rebuild their inventories that will be a tailwind going forward.

Also, stimulus money from the CHIPS Act and the Inflation Reduction Act are still just a trickle, but you'll see more of that money being deployed in a bigger way in '24 and '25. So that should also help support growth.

Q: That all sounds like a strong economy. So, no recession on the horizon?

GS:
No, we don't think we're close to a recession—and if we do see a slowdown, it won't be something very deep.

Q: And how about inflation?

GS: We think inflation is going to continue to come down, probably to 3%-3½% by the end of the year; and we expect it will be some time next year before we get back down to around the 2% level.

Q: Any other major things to keep an eye on?

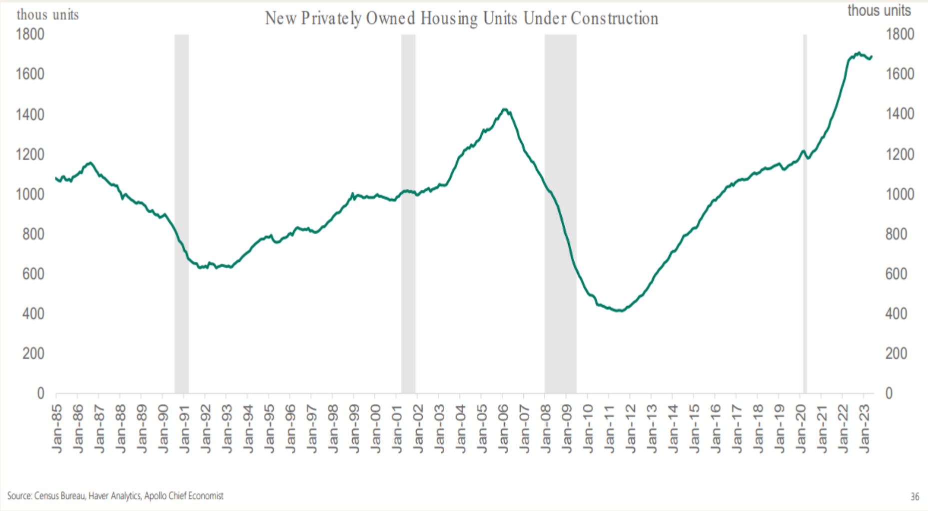
GS: On the political front there's going to be more noise and unknowns in terms of the 2024 presidential election. Anything that's new is always a risk.

And then you have the war in Ukraine, where there doesn't appear to be an end in sight at the moment. It's a war of attrition. But we still think there should be some sort of conclusion to it next year because both sides are running out of resources—whether it's rockets or people.

Q: What's happening with housing?

GS: We expect housing to improve with prices moderating and more supply coming on. That supply is finally catching up to pent-up demand from the pandemic, now to the point where there are more new housing units being constructed than at any point in nearly four decades (*see chart below*).

Hammering out record number of new homes



Outlook *(continued)*

Q: What about Artificial Intelligence (AI)-related technology and productivity improvements, and the idea that it's meant to help humans and not to remove the human element altogether? Could you give an example or two that might provide perspective on this?

GS: Here's one. We were at a conference that included a piece on AI, and Nassim Taleb who wrote The Black Swan was speaking. He pointed out that the greatest navigators who ever lived were from back in the days of Columbus. They only had the wind, the stars, and some rudimentary instruments to direct your travel. Today, you look at the size of ships...they're the size of the Empire State Building turned on its side versus very small ships by comparison from 550 years ago. These ships use AI technology to punch in your route, and it gets you out of the harbor, all the way to your destination, and into that port's harbor. This has yielded so many benefits, has allowed for more trade to flow more frequently, aids countries in terms of growth and manufacturing, and zeroes in on whatever industry-specific areas a company specializes in.

Another example I have has to do with stonecutters. The family who built Fordham University has been in that business for over 100 years. But it's tougher and tougher to find labor for that, which has largely been a very manually intensive job. They now have machines that can produce the cut material in significantly shorter periods of time. It's all computerized. But humans still need to bring a century of craftsmanship and knowledge and make decisions based on a complete set of information from AI-aided computers.

What This Means for Your Portfolio

Q: How are current market valuations presenting opportunities within client portfolios?

GS: We take a very deliberate approach to investing your assets; our goal is to recognize and create intentional value. What does that mean in practice? As valuations have come down over the past quarter, it is presenting new opportunities to buy more shares of businesses we already own or to own newly identified businesses that meet that intentional value criteria.

Q: Although you do research on companies from the bottom-up, what industries are benefitting at the moment from current market conditions?

GS: We still see value in industrials and in construction, and so we continue to hold allocations there. We're going to see continued productivity improvements in these areas of the economy. As productivity improves, wages and standard of living increase. And everybody wins because it keeps inflation down.

Q: How are you diversifying client portfolios against risk?

GS: We have believed since the start of the year that we are not going to have a recession. As we got past the banking crisis, we concentrated positions in our top picks while adding to construction and industrial names. We continue to maintain this strategy as we move into the last quarter of the year.

As a core part of our deliberate investing philosophy, we continue to own US-based companies rather than foreign-listed entities for several reasons that help manage risk. The US rule of law and standardized financial reporting make it easier to compare financial statements and understand any legal ramifications of business activities. It's worth noting that while our portfolio is comprised of US-based companies, 40% of revenues come from outside the US due to those companies' global operations. So you get global and regional diversification without taking on the risk of owning foreign assets. We've also intentionally concentrated in our top picks, while adding to construction and industrial names.

The relative size and quality of these companies—and the cash flow they generate—means they are able to withstand risk better than smaller companies. We'll continue to maintain this strategy as we move in to the last quarter of the year.

ANNUAL CLIENT EVENT

WEDNESDAY, NOVEMBER 15

5:30PM – 8:30PM

The Drowned Lands Brewery
251 State School Road
Warwick, NY 10990

R.S.V.P. by November 3 to Rosanna Fini:
rfini@hviaonline.com or 845-294-6127

Helpful Info:

Hudson Valley Investment Advisors has recently gone through a significant technology upgrade in both contact management and investment management capabilities. As a result, you may see additional correspondence as well as investment portfolio enhancements. These upgrades are meant to improve the overall client experience here at HVIA, and enhance the core of what we do; *Deliberate investing to create intentional value.* If you have any questions, please don't hesitate to call us at 845-294-6127.

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