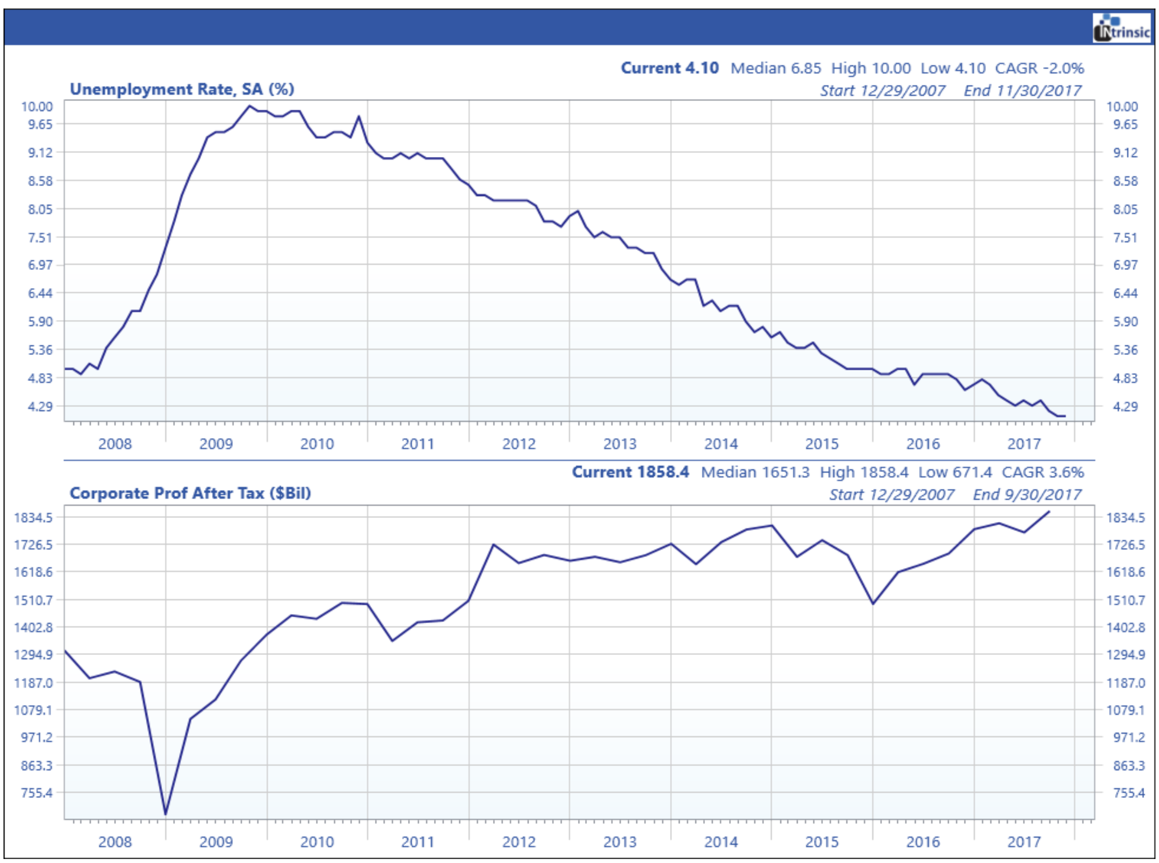
Chemung Canal Trust Company and Capital Bank, a division of Chemung Canal Trust Company

Investment Outlook, January 2018

By any reasonable standard, 2017 was an extraordinary year for investors. While we have experienced years with greater market returns, we have never seen such an extraordinary combination of high returns and low volatility. The equity market neither soared nor plummeted at any point during the year, but climbed persistently upward without so much as a 3% decline from any previous peak. With just a few hours of trading remaining, the S&P 500 is up 20% for the year and the Dow Jones Industrial Average is up more than 25%.

Despite the terrific run in stocks this year, very few analysts are advising caution in their outlook for 2018. The consensus seems to be that the economy appears to be getting stronger, even though this economic expansion is now well into its 9th year, and corporate earnings estimates for next year continue to rise.

The economic numbers are getting better, to be sure. Third quarter GDP was recently revised upward, resulting in two consecutive quarters of 3% or better real growth. The unemployment rate has fallen to 4.1%, and there are currently more than 6-million



new jobs without qualified workers to fill them, very nearly a record number of job openings. After-tax corporate profits are at an all-time high, and have rebounded almost

25% from the earnings recession of 2015-2016. It is worth noting that all of these strong numbers were achieved prior to the recent enactment of “The Tax Cuts and Jobs Act”, as the House of Representatives has officially branded its tax reform efforts.

Estimates for corporate earnings in 2018 are being revised upward, based on a combination of improving economic momentum and corporate tax cuts. Consensus estimates for the S&P 500 are at $147, which would represent a 13% increase over 2017. At its current level, the S&P Index is trading at more than 18x estimated forward earnings, the highest multiple since 2004, and measurably above the long term average of 15-16x. Analysts defend their optimism in the face of such lofty valuations on the basis that such a multiple is reasonable for a market that has so many positives going for it. We have made the same argument ourselves, admittedly, but we are well aware that there will inevitably come a point where all these positives will become “baked in” to stock prices; and the more prices rise, the more vulnerable stocks will become to negative surprises. In any case, stocks are more expensive now than at any time since our recovery from the economic and credit crisis of 2008-2009 began. From the end of 2009 to date, while real GDP has increased 18% and corporate profits have grown 35%, the S&P 500 Index has risen 139%!

By no means are we forecasting the end of this bull market. But we shouldn’t blithely project the status quo into the future, either, and we are certainly overdue for a correction of some magnitude. Whether or not a correction occurs, we think investors should lower their return expectations for the short term, and anticipate that volatility will rise above last year’s absurdly low levels. It doesn’t mean that we’ve already reached the top, it just means that the climb will probably become more difficult and uncomfortable for a time.

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