

Advisory Notes



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Asset management
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Markets Outpace Wall of Worry

The third quarter bounced back from June's Fed-tightening speech which spooked the markets. Top line growth with strong earnings fueled the rebound. Technology, healthcare and cyclical companies led the way. As the government shutdown looms, we will watch as the politicians heat up their debating skills to "peacock" in front of the world to come to an agreement in order to prove that they did their constituents justice.

The succession plan for the new Federal Reserve Chairman is a top priority for President Obama, as Ben Bernanke navigated the U.S. through one of the worst recessions in history. Larry Summers, one of the top candidates, dropped out of the race and now President Obama has to look toward Janet Yellen, Don Kohn, Roger Ferguson and William Dudley. This next appointment will have a large impact on monetary policy and how the central bank will begin to balance the massive balance sheet it has amassed.

The table below shows the quarterly returns as well as the year-to-date figures.

We will continue to check how the assets affect the portfolios and to monitor the economic outlook and strategy within the guidelines of the goals and objectives.



Joseph M. Valicenti
President/CEO

Market Table

Valicenti Advisory Services, Inc. Comparative Index Period Returns From 06-30-13 through 09-30-13						
	DJIA	S&P 500	NASDAQ	Lehman Muni Bond Index	Citi Corp Corporate Bond Index	U.S. Treasury Bill Index (90 day)
06-30-13 to 07-31-13	4.23	4.99	6.56	-0.97	0.70	0.00
07-31-13 to 08-31-13	-4.24	-3.09	-1.01	-1.59	-0.59	0.00
08-31-13 to 09-30-13	2.36	3.48	5.06	2.40	0.70	0.00
Cumulative Returns-Q3 06-30-13 to 09-30-13	2.17	5.28	10.82	-0.21	0.80	0.00
YTD Returns 12-31-12 to 09-30-13	17.67	19.86	24.90	-3.19	-2.59	0.09

Consumer Strength Pivotal For Further Market Gains:

The major equity markets are up approximately 20% year-to-date and the economy is growing at the fastest pace in over a year. As the third quarter comes to an end, however, we are forced to assess whether or not consumer spending will expand in the seasonally strong fourth quarter and drive the stock market higher.



The stock market return this year has been impressive given the headwinds investors faced so far. We started the year with economic growth of just 0.1% and political gridlock that threatened to bankrupt the U.S. Treasury. We survived sequestration budget cuts in the spring, oil prices surging above \$100 per barrel, the threat of military intervention in Syria and a near doubling of interest rates in less than three months. An investor cannot help but wonder what the stock gains would have been had there been a more optimistic outlook on global affairs.

With so many risks in the rear view mirror and the economy back to a normal growth rate, the obvious assumption would be to expect additional stock market gains. Unfortunately, the continual gains in the market, despite the lack of strong economic conditions and revenue growth, means that stocks now trade more expensively. The price-to-earnings (P/E) multiple for the ma-

ior equity indexes is at historic norms, but the lack of revenue growth has left stocks at the highest level on a price-to-sales (P/S) ratio in nearly 10 years (Charts 1 and 2).

Consumer spending is a major catalyst for revenue growth. The strength of spending in the fourth quarter will be a pivotal factor in the ability of stocks to trade higher. Any weakness in corporate revenue could easily force stocks back to the P/S experienced over the previous three years, which would mean a roughly 10% sell off in stocks.

Consumer confidence, household income and consumer credit outstanding are key sign posts in assessing the strength of consumer spending. Consumer confidence indicators are at the highest level in five

“Consumer confidence indicators are at the highest level in five years but are still only halfway back to pre-recession levels.”

years but are still only halfway back to pre-recession levels. Looking at household income and obligations, we see a mixed picture. While household obligations are at a 30-year low, disposable income growth remains lackluster (Chart 3). What is clear from these data points is that consumers are clearly in a much better financial state, but they lack full confidence in their financial outlook to spend freely.

With spending in a fragile state, it is important that we see greater certainty in the economy and labor market in order to

produce the revenue growth necessary to drive stocks higher. Unfortunately, politics often take center stage in October. Political gridlock over the annual budget and debt ceiling could jeopardize consumer spending in the fourth quarter.

Look for the energy market to also play an important role in consumer spending through the remainder of the year. Analysts at IHS Global Insight have estimated that a 10% increase in the price of gasoline decreases consumer confidence by 1.4% to 1.5% and that for every \$10 increase in the price of oil the economy is negatively impacted by 0.2%. However, gasoline prices typically experience their greatest decline in the fourth quarter, leaving households with more disposable income on a monthly basis, aiding consumer confidence.

With most corporations reporting their third quarter profits in October, investors will get an early look at how consumer spending was trending as we enter the fourth quarter. As the quarter progresses, updates on consumer credit expansion, automobile sales, retail sales and consumer confidence surveys will either substantiate a strong holiday spending season or a further commitment by households to temper their spending in favor of a reduction in their financial obligations. We will use this information to refine our asset allocation strategy and individual investment selection.

Andrew R. Clark, CFP®
Vice President of Investment Research,
Portfolio Manager

Investment Strategy

The third quarter, while climbing a wall of worry, showed continued resilience in both the U.S. stock market and the U.S. economy.



Politics in Washington D.C. are at the front and center of these worries, with concerns over the government shutdown, debt ceiling debates, the Affordable Healthcare Act

and problems in Syria. In addition, there are concerns over the Federal Reserve and its position on quantitative easing measures along with worries over potentially slower corporate earnings, to name a few.

In spite of all these issues, the U.S. economy continued to show further modest improvement and the U.S. equity markets also moved higher. The U.S. equity markets were pushed higher because of improvement in the U.S. economy, signs of improvement in the Eurozone and China and U.S. corporate earnings remaining resilient.

While we see challenges in front of us, we also see modest growth continuing in the fourth quarter. Our asset mix continues to be flexible as we navigate all these challenges. Currently, equities remain between 40% to 60%, fixed income between 30% to 35% and cash between 10% to 20%. Based on client specific direction, income needs and risk level, our asset mix may vary.

Jeffrey S. Naylor
Executive Vice President/CFO

Chart 1

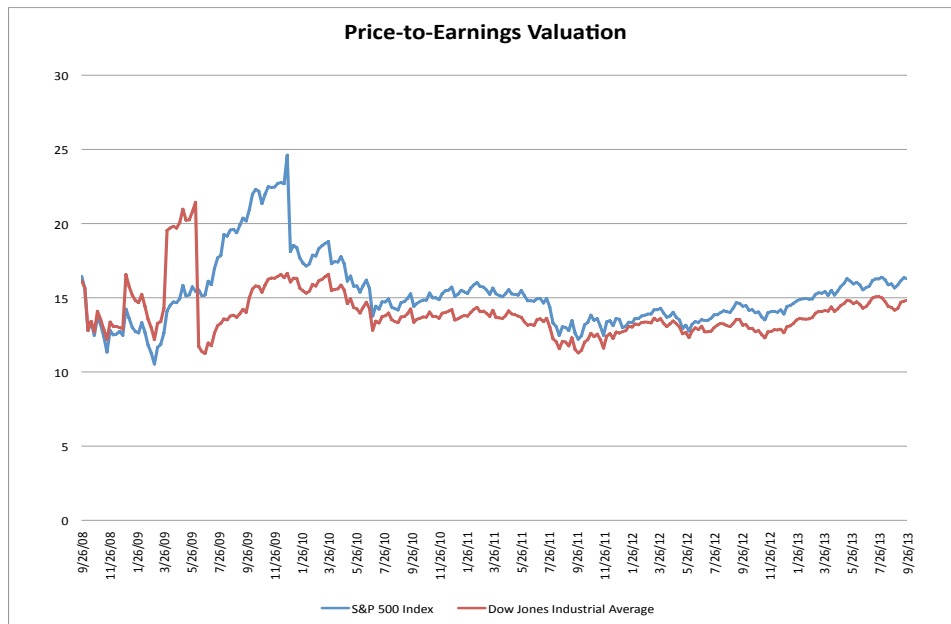


Chart 2

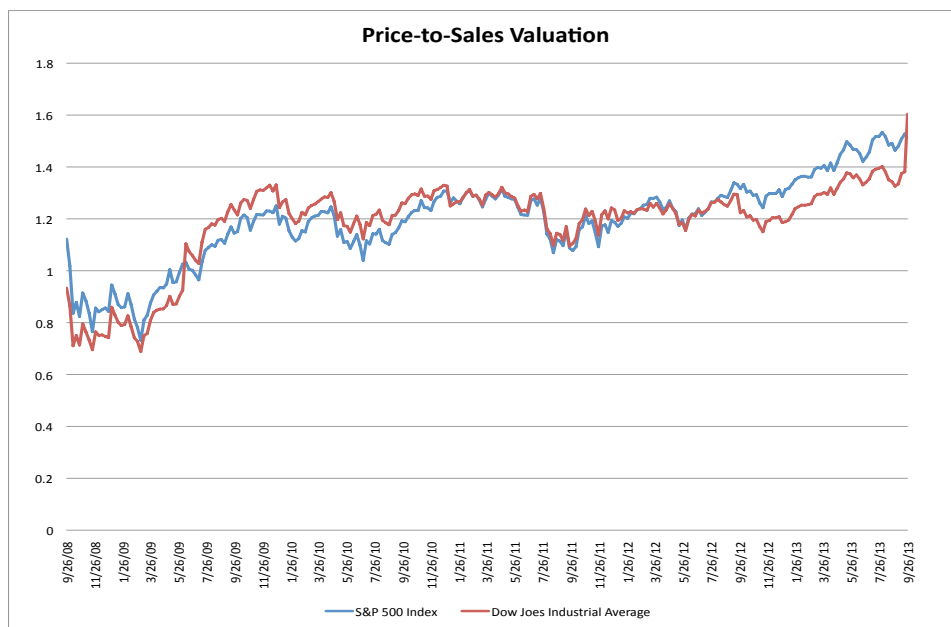
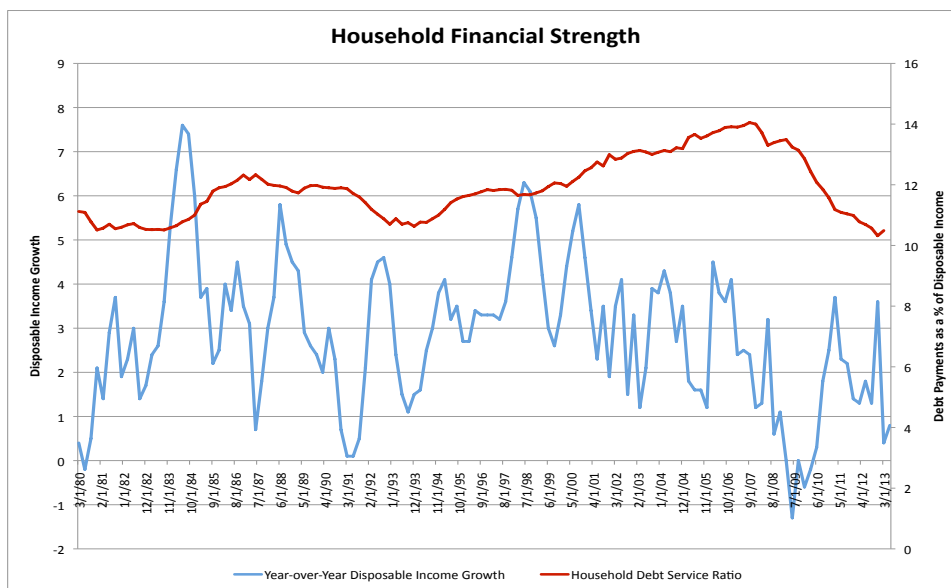


Chart 3



Source of charts:
Bloomberg.com

Market Symmetry

The third quarter was dominated by concerns that the Federal Reserve would taper its \$85 billion in monthly purchases. Despite a continuation of the Fed's stimulus measures, interest rates are still at their highest level in two years, creating concerns that the Fed has lost control of long-term interest rates. The risk of an emerging market financial crisis seemed to elude the front page news, but higher U.S. interest rates pose a significant risk to the global economy. While China's liquidity scare has improved, it has yet to return to a normal level. As we enter the fourth quarter, consumers remain fairly optimistic and major spending has been supportive of corporate profits. Lastly, it would not be a typical fall season if we were not forced to return our focus on Washington D.C. and another round of budget fights.

Positive Market Influences

- **Consumer Confidence** – Consumer confidence is at the highest level since 2007. The increased confidence should help support additional consumer spending.
- **Extremely Low Interest Rates** – Global central bankers have produced record low interest rates to help stimulate the global economy.
- **Improving Household Balance Sheets** – Households have significantly repaired their balance sheets and increased their savings since the 2008-09 recession.
- **Savings Exhaustion & Replacement Cycle** – Consumers and businesses will ultimately grow tired of their self-imposed austerity budgets and will be forced to spend on replacement parts and possessions.
- **Adequate Financial Sector Liquidity** – The Federal Reserve has pumped the U.S. banking sector full of money, with banks now holding nearly \$2.0 trillion in excess reserves.
- **Housing Market Improvement** – The U.S. housing market continues to recover from its post-bubble lows, aiding the overall

Positive Influence

Consumer Confidence
 Extremely Low Interest Rates
 Improving Household Balance Sheets
 Savings Exhaustion & Replacement Cycles
 Adequate Financial Sector Liquidity
 Housing Market Improvement
 Automobile Sales
 Capital Flight

Negative Influence

Chinese Banking Crisis
 European Debt Crisis
 Emerging Market Financial Stress
 Loss of Consumers' Purchasing Power
 Peak Corporate Profit Margins
 Restricted Bank Lending
 End of QE3
 Currency Wars
 Political Gridlock

economy through additional consumer purchases, labor market gains and overall household confidence.

- **Automobile Sales** – Auto sales are one of the largest retail ticket items in the economy and annualized sales have nearly returned to pre-recession levels.
- **Capital Flight** – With the U.S. economy and the U.S. dollar providing foreign investors a sense of security, the U.S. markets and economy could benefit from the money flow.

Negative Market Influences

- **Chinese Banking Crisis** – The Chinese banking sector is beginning to experience a lack of liquidity that reflects similar characteristics with the default of Lehman Brothers in 2008.
- **European Debt Crisis** – The growing debt crisis has put the investment world on notice of another possible credit crisis should the European Union collapse.
- **Emerging Market Financial Stress** – An increase in U.S. interest rates has negatively impacted the flow of money to emerging nations. Those countries that have become reliant on foreign money are now left with significant budget deficits.
- **Loss of Consumers' Purchasing Power** – Consumer wage growth is struggling to match the rate of inflation, reducing the purchasing power of each dollar earned by individuals.

- **Peak Corporate Profit Margins** – Corporate profit growth has decelerated due to a near-term peak in profit margins.
- **Restricted Bank Lending** – While banks have plenty of cash available to lend, cautious lending practices have prohibited economic growth.
- **End of QE3** – The Federal Reserve indicating a potential end to its indefinite quantitative easing program could result in a re-pricing of multiple asset classes and greater market uncertainty.
- **Currency Wars** – As additional central banks look to devalue their currency to gain economic growth, there is a risk that currency wars may develop among multiple countries as they race to the bottom.
- **Political Gridlock** – Budget and debt ceiling debates in Washington D.C. pose a risk to the economy and consumer psyche.



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