

Advisory Notes

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The Second Quarter “Rollercoaster”

By Joseph M. Valicenti
President/CEO

The 2nd quarter returns turned sharply negative in the month of May as the European crisis heated up and let all of the air out of the sails of the economic growth that occurred over the previous two quarters (See Market Table). The year-to-date numbers are still in positive territory, but uncertainty has come back into the forefront of consumers’ and investors’ minds. Bull markets do not trend upward in a straight line - pullbacks are normal and actually healthy for the markets.



As mentioned in the last quarterly newsletter, we were on the “look out” for “speed bumps” in the economy and the second quarter delivered some.

Unemployment figures came out worse than expected and Greece and the Eurozone took over the headline news again which caused investors to become concerned and to move money to the sidelines. As we continue to watch the foreign slow down and consumer confidence waiver, we do have silver lining economic data points. Consumers and the private sector have the highest cash flows in recent memory due to the deleveraging process that has occurred since 2008/2009 and the extreme low interest rate environment. Housing has firmed up and is improving on a comparative annual basis. Energy prices have decreased substantially since the beginning of the year. U.S. manufacturing is starting to transition back to domestic soil as overseas wages and import and transport costs have reduced the economic advantage.

While we believe the Fed’s stance on easing monetary policy will continue to help in the short term, the mountain of debt our government has accumulated is the “elephant in the room” problem on a longer term and will likely get serious attention in an election year. We continue to believe that the market is slightly undervalued compared to its growth rate, but we remain cautious as these volatile issues continue to show up on the front pages. We have taken a disciplined approach to managing our clients’ assets with regular rebalancing and diversification in order to achieve their individual goals and needs.

VALICENTI ADVISORY SERVICES, INC. COMPARATIVE INDEX PERIOD RETURNS FROM 03-31-12 THROUGH 06-30-12						
	DJIA	S&P 500	NASDAQ	Lehman Muni Bond Index	Citi Corp Corporate Bond Index	US Treas. Bill Index (90 day)
03-31-12 to 04-30-12	0.19	-0.60	-1.46	1.29	1.34	0.06
04-30-12 to 05-31-12	-5.99	-6.14	-7.19	0.93	0.64	0.03
05-31-12 to 06-30-12	4.15	4.14	3.81	-0.12	0.43	0.00
Cumulative Returns 03-31-12 to 06-30-12	-1.90	-2.84	-5.06	2.10	2.42	0.09

“Every one’s got it in him, if he’ll only make up his mind and stick at it. None of us is born with a stop-valve on his powers or with a set limit to his capacities, there’s no limit possible to the expansion of each one of us” – Charles M. Schwab

June 2012

Limited Options and Short on Time

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

The European debt crisis continues to escalate on a daily basis as investors grow more concerned about government defaults and a restructuring of the European Union (EU). While we have outlined the pending crisis and the importance of a well-defined strategy in previous Advisory Notes and Bull & Bear Bulletins, the number of potential policy responses continues to dwindle and time is growing short. We believe there is now only a short list of possible resolutions and each outcome may have completely different effects on the global economy and markets.



The most optimistic outcome involves a tighter fiscal unity amongst European nations and the creation of a centralized tax authority. A central fiscal authority could levy taxation across the Eurozone and police reckless deficit spending among its member nations. A tighter fiscal union would also allow for the creation of a Eurozone bond, which would allow for the sharing of debt repayment risk amongst member nations versus each nation being responsible for its own financial solvency. While a Eurobond would not solve any nation's potential insolvency, it would create much needed time for the prospects of the nation growing its way out of the debt crisis. After all, there are two main components to managing debt: spending and tax revenue. While massive budget cuts would reduce current spending obligations, it would likely produce a greater recession and yield even less tax revenue. If, however, spending cuts are enacted over a prolonged period of time and are accompanied by positive economic growth, the debt crisis can be reduced over time.

The most concerning outcome to the escalating debt crisis is a disorderly collapse of the EU. Without a comprehensive plan to stabilize the growing costs of government borrowings and a way to backstop the European banking system from declining sovereign debt prices and depositor withdrawals, the ramifications would be felt across the world. While a government default would clearly be a shock to the global economy, a credit crisis, similar to the recent subprime led banking crisis of 2007-2009, would materially impact not just

economic growth but the ability for companies to finance even basic operations. The inability to reinvest or to expand operations is typically followed by job reductions in an effort to preserve capital to survive the economic recession (Chart 1). It is the significant risks associated with a credit crisis that create the biggest concerns for investors and households, both domestically and abroad.

While there could be other variations to the two discussed outcomes, likely a blend of some countries ultimately defaulting on their debt and/or other nations exiting the EU, our primary concern is that the process sustains enough investor confidence that the global financial markets will remain fluid and liquid despite any major reshuffling of the existing EU. As we have often noted, without investor and consumer confidence neither the markets nor the economy can improve (Chart 2- with the recent peaks in consumer confidence denoted by the vertical dotted lines).

It is our current belief that every member of the EU has an interest in seeing the Union survive with minimal fallout and is likely to act in the most prudent manner to ensure the least amount of economic collapse. The degree of political posturing and inactivity is only accelerating the end game moment, as the bond markets are effectively prohibiting the weaker EU nation's access to additional stand-alone credit. Without collective action, the crisis could soon pass a point of redemption for policy makers. While the clock is winding down, we remain optimistic that a long-range strategy will be developed to prevent a credit crisis. The only question is if there is enough time left on the clock to enact the policy.

"Time is more valuable than money. You can get more money, but you cannot get more time."

Jim Rohn

"A big part of financial freedom is having your heart and mind free from worry about the what-ifs of life."

Suze Orman

"Before you can really start setting financial goals, you need to determine where you stand financially."

David Bach

Chart 1

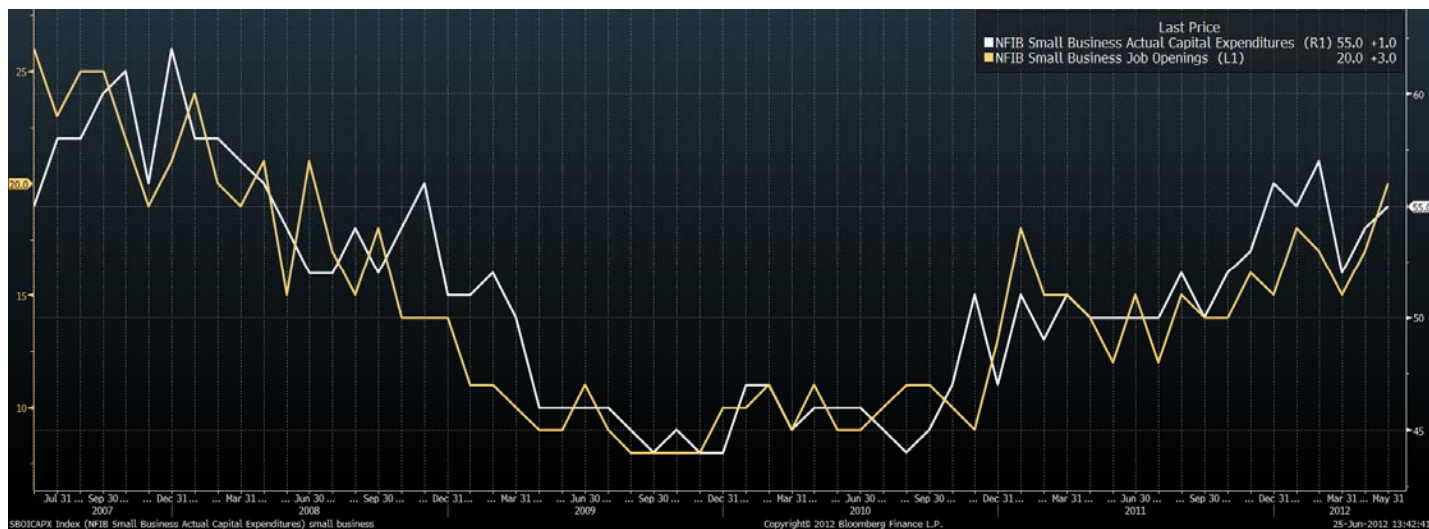


Chart 2



Investment Strategy

*By Jeffrey S. Naylor
Executive Vice President/CFO*

In review of the first half of 2012, we have seen U.S. corporate earnings continue in an upward movement, while investor confidence has taken a plunge.

Investor confidence was shaken for many reasons including, but not limited to, the Eurozone debt crisis, sluggish economic data, high unemployment levels and the U.S. political environment. These uncertainties have also pulled the markets lower over the last 2 months.

Even if we consider all of the above, there are still reasons to be optimistic. U.S. corporations continue to produce good earnings data, show continued strength in their balance sheets and are having share buybacks and increases in dividends. The housing market is showing signs of improvement and stock valuations seem attractive at these levels.



Our asset mix remains flexible in this volatile market with cash between 10% to 20%, fixed income between 30% to 35% and equities between 40% and 60%. This asset mix will vary based upon specific directives, needs for income and risk tolerances.

Welcome to the Firm

*By Ralph H. Roberts, Jr.
Vice President/Client Services*

Please join us in welcoming Andrew (Drew) Cartwright to our firm as of April 16, 2012. Drew has served internships with us over the last couple of years.

He is a graduate of SUNY Brockport with a Bachelor of Science Degree in Physical Education and Health Science. He has assisted in several school systems focusing on elementary methods and early childhood methods and has been a long term substitute teacher in the Elmira City School System for reading, social studies, special education and science.



At VASI, Drew is the Systems and Reports Manager in the Operations Department. In this position, he posts and reconciles daily account transactions and monitors system information ensuring the accuracy of all data. He also opens and closes accounts on the system.

Market Symmetry:

By Andrew R. Clark, CFP®

We are happy to introduce a new feature to our Advisory Notes aimed at educating our clients on the major market influences we are following and how we expect each variable to influence the markets. We will update the list of variables as they gain or lose influence and share these updates on a quarterly basis.

Positive Influence	Negative Influence
Strong Corporate Profitability	European Debt Crisis
Extremely Low Interest Rates	Deceleration in Asia-Pacific Economies
Improving Household Balance Sheets	Loss of Consumers' Purchasing Power
Savings Exhaustion & Replacement Cycles	U.S. "Fiscal Cliff"
Cheap Equity Valuations	Stronger U.S. Dollar vs. Foreign Currencies
Adequate Financial Sector Liquidity	Restricted Bank Lending
	Investor Caution Over Owning Stocks
	U.S. Presidential Election
	Agricultural Commodity Prices

Positive Market Influences:

- Strong Corporate Profitability – U.S. corporate profits are above levels last achieved in 2006.
- 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 recessions.
- 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.

- Cheap Equity Valuations – The equity markets have factored in a decent amount of negativity and trade at a historical discount based on record profits
- Adequate Financial Sector Liquidity – The Federal Reserve has pumped the U.S. banking sector full of money, with banks now holding over \$1.56 trillion in excess reserves.

Negative Market Influences:

- European Debt Crisis – The growing debt crisis has put the investment world on notice of another possible credit crisis should the European Union collapse.
- Deceleration in Asia-Pacific Economies – China in particular has engineered a slow-down in their economy to minimize inflationary pressure, but concerns exist over their ability to reinvigorate growth and help offset European weakness.
- Loss of Consumers' Purchasing Power – Consumer wage growth continues to trail the rate of inflation, reducing the purchasing power of each dollar earned by individuals.
- U.S. "Fiscal Cliff" – With over \$1 trillion in government spending cuts and a return to higher tax rates planned for 2013, there is concern that the economy would enter a recession due to the anti-stimulus measures.
- Stronger U.S. Dollar vs. Foreign Currencies – While a stronger dollar has helped reduce commodity prices, the stronger dollar makes U.S. exports less competitive on the global market and reduces economic activity domestically.
- Restricted Bank Lending – While banks have plenty of cash available to lend, cautious lending practices have been prohibitive to economic growth.
- Investor Caution Over Owning Stocks – Money flow into equity markets have been below-average since 2008-09, reducing the level of buying activity within the equity markets.
- U.S. Presidential Election – While both candidates are likely to face and react similarly to the same economic variables starting 2013, the uncertainty surrounding the election and the ability to restore America's growth prospects are likely to create some volatility leading up to the election.
- Agricultural Commodity Prices – Warm and dry weather throughout the Midwest may produce smaller commodity yields, in particular corn crops, which could lead to higher food prices.