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1st Quarter 2013 Moves Forward as Fiscal Cliff Issues Are Pushed Down the Road

By Joseph M. Valicenti
President/CEO

In the first quarter, the markets moved towards all time highs on the Dow Jones Industrial Average and the S&P 500 Index (see Market Table). This was evidenced by Washington's "band aid" fiscal cliff resolution on January 4, 2013, delaying the tough decisions on the debt ceiling until later this year.



While we continue to be optimistic in the near term, we are continuing to monitor the positive building blocks in the current economic data.

Housing continued its upward trend as individuals found value in the residential real estate market. New housing starts moved higher and inventories were at near record lows relative to the working populous.

The Federal Reserve continued its easy monetary policy with its \$85 billion monthly purchases of mortgage backed securities and treasuries, which added to its ever increasing balance sheet. The late, great market legend, Marty Zweig, coined the axiom "Don't Fight the Fed". While we can heed that advice, appropriate profit taking should be executed in order to reallocate and rebalance portfolio strategies.

The Eurozone has been on a path to slow recovery. Japan's future is looking at sustained inflation and China's economic pause could be of concern due to its growing reliance on debt.

While we believe in this current interest rate environment that equities have a better risk/reward over fixed income and cash, we will be opportunists with a looming pullback in the equity markets in the short term. We will continue to monitor the individual goals and objectives of each portfolio and to tailor the asset allocation to meet its needs.

Market Table

VALICENTI ADVISORY SERVICES, INC. COMPARATIVE INDEX PERIOD RETURNS FROM 12-31-12 THROUGH 03-31-13						
	DJIA	S&P 500	NASDAQ	Lehman Muni Bond Index	Citi Corp Corporate Bond Index	US Treas. Bill Index (90 day)
12-31-12 to 01-31-13	6.07	5.06	4.06	0.46	-0.96	0.03
01-31-13 to 02-28-13	1.60	1.23	0.57	0.34	0.68	0.00
02-28-13 to 03-31-13	3.94	4.12	3.40	-0.48	-0.02	0.03
Cumulative Returns 12-31-12 to 03-31-13	12.02	10.73	8.21	0.32	-0.30	0.06

"I measure what's going on, and I adapt to it. I try to get my ego out of the way. The market is smarter than I am so I bend." Martin Zweig

Lessons in Market Psychology

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

When investing in the stock market, it is difficult to ignore the herd mentality, especially when it may be contra to your respective outlooks. Economist John Maynard



Keynes is credited for having said “the market can remain irrational longer than you can stay solvent”. Or put another way, the market often elects a path that generates the greatest frustration for investors. Over the past few months, the market has provided several long standing examples for deciphering investor psychology. The examples have ranged from extremes in short-term market sentiment, individual stock rallies in the face of

adversity and shifts in long-term investor perception. Each example has corresponded with sizeable returns that are worth noting and learning as an investor.

Starting in early October 2012, an 8% selloff leading into the U.S. Presidential Election and ending the week of Thanksgiving, the U.S. stock market reached oversold levels on investor fears that the unlikely repeal of the Patient Protection and Affordable Care Act (often referred to as Obamacare) and the Fiscal Cliff were going to push the economy into a recession in 2013. During the selloff the American Association of Individual Investors (AAII) recorded the highest level of “bearish” investors since the disastrous debt ceiling debate in the summer of 2011 (Chart 1). The high level of fear, which ultimately proved unwarranted, created a great entry point for stock investors with the market up over 15% since the November low.

The existing rally off the November low has also exhibited an intermediate term shift in investor psychology. Over the past three months, there has been a sizeable change in investor risk tolerance in favor of U.S. stocks. The Investment Company Institute® reported the first major positive influx of money to domestic stock funds in nearly two years, with over \$15 billion added to equity funds since the beginning of the year (Chart 2). Some of the change in investor appetite for U.S. stocks may be buyers’ remorse, as investors have shunned U.S. stocks since 2008 due to concerns about the U.S. economy and lagging psychological effects from the 60% sell off during the recession. However, with investors facing greater international uncertainty and the bond market showing signs of distress, U.S. stocks may continue to see positive investor attention and further purchasing activity.

A third market lesson for stock investors has been recorded by Apple’s stock (AAPL). With concerns over increased competition and the company’s ability to develop new technology, Apple’s stock fell 40% from its all time high of \$705 in September 2012. While the market may have correctly discounted the potential for increased competition from Samsung and BlackBerry tablets and phones, investors who like the long-term value of Apple’s stock and technology

have been waiting for the selling pressure to subside. Many times the bottoming of a stock will occur when investor fears are most likely to be realized. In Apple’s case, there has been a 10% rally coinciding with the launch of both Samsung and BlackBerry’s latest product lines, which investors expect to hinder Apple’s dominance and profitability within both the tablet PC and smartphone market. While the current rally is unlikely to carry Apple’s stock back to \$700, it does reinforce the market notion that the worst case scenario is often factored in before the actual fear occurs.

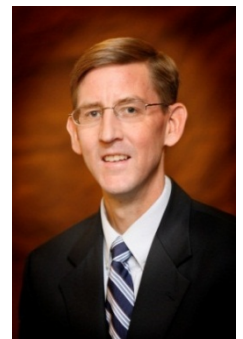
Looking at the market’s current position, it is easy to say that investor sentiment has moved to an extreme bullish sentiment (Chart 3). There are still 40% of market respondents who claim to be “bullish” off the January high of 52%. The net number of stocks achieving new 52 week highs on U.S. exchanges remains above average, although the reading is also off the January highs. Lastly, the market valuation is the most expensive since April of 2011, which was just before the market experienced a 7.5% selloff.

The difficult part for an investor is not only recognizing patterns in investor psychology, but also assessing the beginning and/or the end of a pattern. While the current rally appears to be over extended and poised for a pullback, there is always the possibility that the market will only consolidate before moving higher. Such a scenario would catch net sellers off guard and leave them playing catch up to the market, which may only reinforce the market rally. Conversely, when the market psychology begins leaning too heavily in any one direction, there is usually a violent snapback towards or beyond the average. With corporate earnings season fast approaching, it is safe to say that a market rally and investor psychology will either face a new test or will be further supported by positive earnings. In either scenario, investors need to focus on the level of sentiment preceding the important weeks before making any significant portfolio shifts.

Investment Strategy

By Jeffrey S. Naylor
Executive Vice President/CFO

The first quarter of 2013 showed continued improvement in both the U.S. economy and the equity markets. While Washington continued to deal with political gridlock on several issues including the debt ceiling, the equity markets have shown resilience. Led by strong corporate fundamentals, better than expected economic numbers and a very accommodating Federal Reserve, markets closed out the first quarter at multi year highs.



While we continue to see modest growth in the U.S. economy, we remain flexible with our asset mix. Currently, our asset mix is 40-60% in equities, 30-35% in fixed income and 10-20% in cash. The asset mix will vary based on client specific direction, needs for income and risk levels.

Chart 1

AAll U.S. Investor Sentiment Bearish Readings

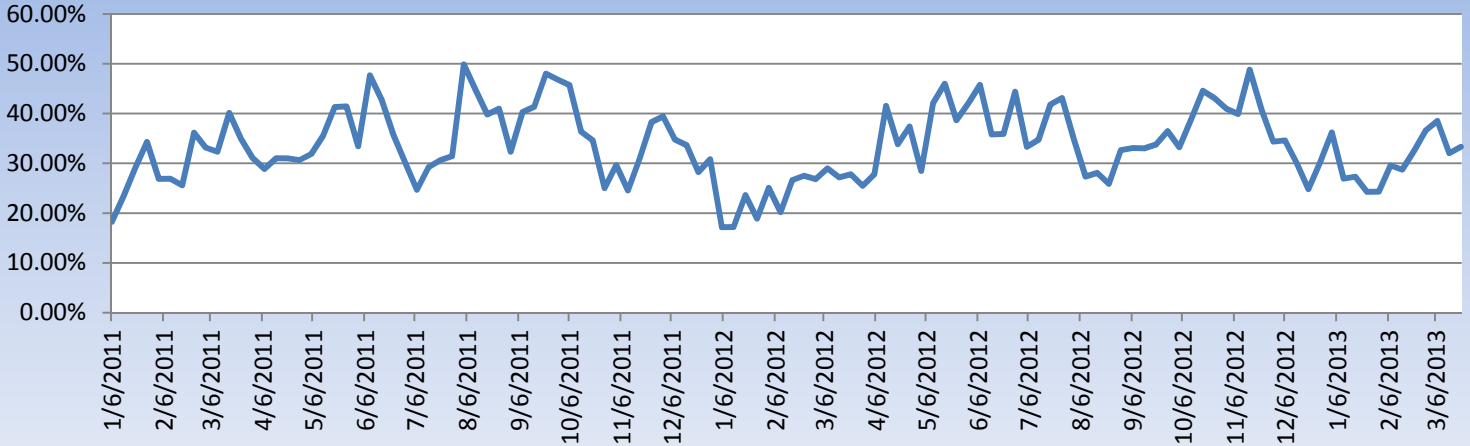


Chart 2

ICI Domestic Equity Estimated Weekly Net New Cash Flow (\$ Millions)

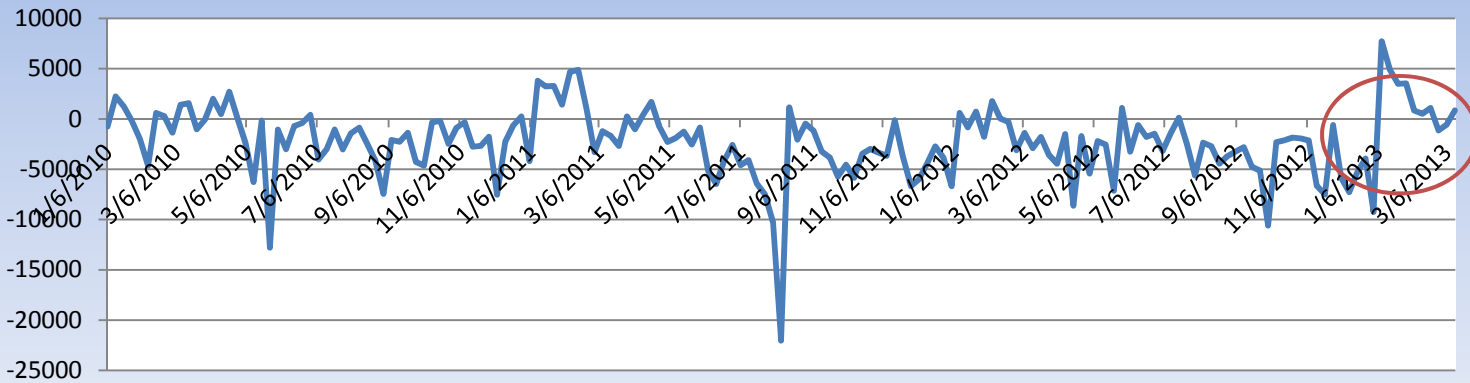
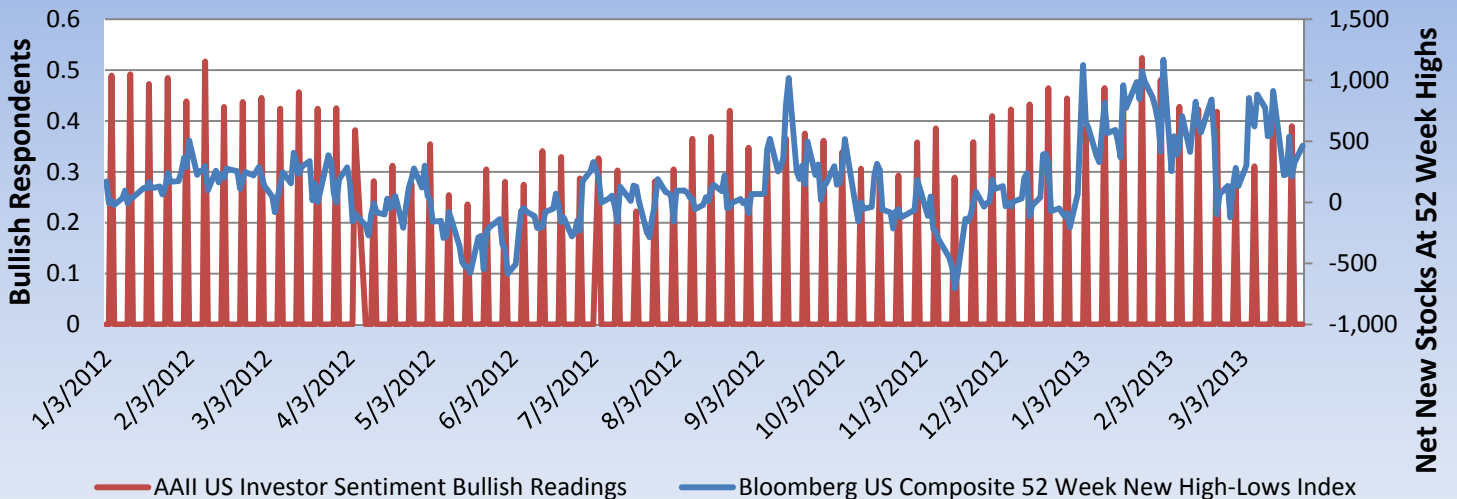


Chart 3

Investor Sentiment and 52 Week Price Highs



Market Symmetry

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

Over the past three months there has been a significant shift in our Market Symmetry scale. We have seen investor caution over holding U.S. stocks improve, agricultural commodity prices have moved off their highs and business confidence has improved since the end of 2012. The reduction in overall risks has produced a strong market rally, especially as the housing market continues to show gradual signs of improvement. Looking forward into the second quarter, there are some general concerns about slowing corporate profit growth, the market valuation and further cracks in the stability of Europe. While a 5%-10% market pullback is probable, any selloff will be temporary in nature.

Positive Market Influences:

- 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 over \$1.56 trillion in excess reserves.
- Indefinite Monetary Stimulus – The Federal Reserve announced it will purchase \$85 billion of mortgage and treasury debt per month, until the pace of economic growth and/or the labor market improves to a desirable level.
- Housing Market Improvement – The U.S. housing market continues to recover from its post bubble lows, aiding the overall 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.

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 its economy to minimize inflationary pressure, but concerns exist over its 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.
- 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 been prohibitive to economic growth.

- Prolonged Market Rally – The existing market rally has been nearly uninterrupted since December, leaving market conditions overbought on several metrics.

<u>Positive Influence</u>	<u>Negative Influence</u>
Extremely Low Interest Rates	European Debt Crisis
Improving Household Balance Sheets	Deceleration in Asia-Pacific Economies
Savings Exhaustion & Replacement Cycle	Loss of Consumers' Purchasing Power
Adequate Financial Sector Liquidity	Peak Corporate Profit Margins
Indefinite Monetary Stimulus	Restricted Bank Lending
Housing Market Improvement	Prolonged Market Rally
Automobile Sales	

Employee Spotlight

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

Billee K. Robbins (left) joined our firm in September 2012. Billee holds a Bachelor of Science degree in Accounting and Business Administration from Elon University in North Carolina. Prior to joining us, she was employed for seven years at Leavell & Associates, PC and CPA in Jackson, Wyoming. She is a member of the professional business fraternity, Alpha Kappa Psi.

Billee's responsibilities include payroll and sales tax preparation, bookkeeping, bank reconciliations and monthly account summaries for our clients.

Judy M. Westerheide (right) joined our firm in October 2012. Judy holds an Associate of Arts degree from Corning Community College and a Bachelor of Science degree from the University of Oklahoma. Prior to joining us, she was employed for eight years in the administrative support staff at BKD, LLP in Kansas City, Missouri, one of the largest CPA firms in the Midwest.

Judy's responsibilities as the Administrative Office Assistant/Accounting Clerk in the Tax and Business Services Department include being a receptionist, assessing tax returns and scheduling appointments.

