

Advisory Notes

Celebrating

30
Years

1984-2014

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The Year That Exceeded Expectations, 2013!

As measured by the S&P 500, the equity markets had a great year in 2013, eclipsing the 30% mark for the first time since 1997. The index has topped 25% only 11 times since 1950. The markets continued to climb the “wall of worry” throughout the year, shrugging off the “noise” and paying real attention to the underlying economics and fundamentals of the market (See Market Table). The year began with the government battle over the fiscal cliff that was resolved in early January 2013 by pushing real decisions to later in the year. During the year, we saw political problems in Europe, an international crisis in Syria, another government shutdown and a problematic rollout of the Affordable Care Act (ACA). The phrase “Fed taper” became a household buzzword spelling out the plan that would allow the Federal Reserve to back away from supporting U.S. treasury auctions and essentially to remove the training wheels from the economy.



Looking forward to 2014, we see many positives on the horizon. The unemployment rate is the lowest since 2008 and has dipped to 7.0%, inflation is benign and under control for the near future and The Institute of Supply Management (ISM) manufacturing index posted its highest figure since 2011 in November of this year. Consumer confidence has also rebounded since the October lows surrounding the two week government shutdown. There are many speed bumps to navigate that may give way to natural and healthy pullbacks in the market - a rising interest rate environment, which we believe will be systematic and controlled under the new leadership of Janet Yellen at the Federal Reserve; another government debt ceiling debate in the future; emerging markets getting back on the growth track albeit more moderated in nature; and the continued problems of the ACA that continue to fluster millions of U.S. citizens.

We will continue to monitor the markets and the economic data and its effect on our strategy as it relates to the goals of the portfolios.

The year 2014 will be a special year. This is the 30th year that Valicenti Advisory Services, Inc., has been providing wealth management services to our clients. We are very proud of our success, the professionalism of our staff, and our clients who have chosen us to be their trusted advisor over the past years and for the years to come.

Joseph M. Valicenti
President/CEO

Market Table

Valicenti Advisory Services, Inc. Comparative Index Period Returns From 12-31-12 through 12-31-13						
	DJIA	S&P 500	NASDAQ	Lehman Muni Bond Index	Citi Corp Corporate Bond Index	U.S. Treasury Bill Index (90 day)
12-31-12 to 03-31-13	12.02	10.73	8.21	0.32	-0.30	0.06
03-31-13 to 06-30-13	2.82	2.81	4.15	-3.29	-3.07	0.03
06-30-13 to 09-30-13	2.17	5.28	10.82	-0.21	0.80	0.00
09-30-13 to 12-31-13	10.11	10.50	10.74	0.36	1.10	0.19
YTD Returns 12-31-12 to 12-31-13	29.57	32.44	38.32	-2.84	-1.52	0.28

The Economy: Strong Growth Ahead?

The economy expanded 2.0% year-over-year in the third quarter, the fastest rate of growth this year. The economy benefitted from resilient consumer demand and a significant increase in business inventory spending. As the economy continues to build momentum into year-end, investors are wondering if this trend can continue in 2014 and what the impact will be on the markets.



Since the end of the recession, strong inventory spending in a single quarter has resulted in a contraction in additional inventory spending over the next 3-6 months (Chart 1). The lack of consistent consumer optimism and spending has failed to absorb large inventory builds, leaving businesses with excess inventory and negatively impacting the economy in the subsequent quarter(s). Consumer sentiment, however, is now near a five-year high and orders for durable goods (those hard items that are meant to last more than just a few uses) are back to pre-recession levels (Chart 2). With the labor market slowly improving, housing prices beginning to rebound and signs consumers are starting to resume their replacement cycle of older household items and vehicles, it seems more likely than any other time in the past five years that we could see the recent inventory build absorbed and could avoid a letdown in the

economy that has subsequently occurred after the last two major inventory builds.

With the first signs of genuine momentum since the economy emerged from the recession, the Federal Reserve elected to reduce its monthly stimulus measures. The Fed cut its monthly asset purchases by \$10 billion, to \$75 billion. The small reduction in spending is considered to be a cautious step by the Federal Reserve to remove its influence on the economy and the markets without jeopardizing the economic momentum or roiling the markets. If successful, the Fed hopes to exit its buying plan within the next twelve months. Unfortunately the tail may be wagging the dog and the markets may determine if the Fed can successfully exit its asset purchase program.

While interest rates remained unchanged following the Federal Reserve's decision to reduce its bond purchases, most of the move occurred during the summer months when the markets factored in a September reduction (Chart 3). If investors begin to flee the bond market in anticipation of better economic momentum and further reductions in the Fed's asset purchases, we could see interest rates continue to move higher. The faster investors exit the bond market the greater the risk that interest rates increase at an uncontrolled pace. A rapid change in interest rates would negatively impact the housing market, the lending markets, and ultimately the economy. In order to prevent unintended consequences of unwinding their stimulus measures, the Federal Reserve will be forced to delicately balance investor expectations

and economic strength.

Higher U.S. interest rates could also have a significant impact on emerging markets. Over the past few years, investors have borrowed funds in the low U.S. interest rate market and reinvested the money in higher interest rate foreign bonds. As U.S. interest rates increase, however, there could be a reversal of strategy and an outflow of money from emerging markets back to the U.S. As money exits emerging markets, many countries may experience an adverse economic and budgetary impact.

So far the Federal Reserve has been successful at convincing the markets that they are going to be patient and academic in their efforts to reduce their monthly bond purchases and that they are not going to actively look to increase their lending rate for at least another two years. While the Fed's language is important, the market action is even more important. Our investment thesis on the stock market, emerging markets and bonds will be shaped by the change in interest rates. We will maintain a positive investment outlook if interest rates remain flat or increase in a very controlled fashion. However, if interest rates snap higher, we are likely to become much more concerned about the economy and the markets and are likely to alter our investment outlook.

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

Investment Strategy

With 2014 now upon us, we may reflect on last year's results and look forward to what the New Year will bring.



Although 2013 had a "wall of worries," both the U.S. equity markets and the U.S. economy remained resilient. During the year we had concerns about the government shutdown, the debt ceiling issues, U.S. monetary policy and politics in Washington D.C. in gen-

eral, along with a slowly improving U.S. labor market and slowdowns abroad, to name a few. The economy, however, continued to grow, although at a slow pace. Corporate revenue and earnings showed sustained improvement along with stable balance sheets.

Despite continued headwinds, we look for 2014 to show modest continued growth in the U.S. economy, as well as reasonable growth in corporate and consumer spending. With the Federal Reserve policy likely to continue to move away from quantitative easing, we expect to see fluctuation in interest rates. That being said, our fixed income mix remains in a range of 30% to 35%.

On the equity side, we continue to look for companies with strong earnings growth at a reasonable price. Our current equity range remains between 40% to 60% and our cash range is 10% to 20%. This asset mix could change based on client specific directives, needs for income and risk levels.

Jeffrey S. Naylor
Executive Vice President/CFO

Chart 1

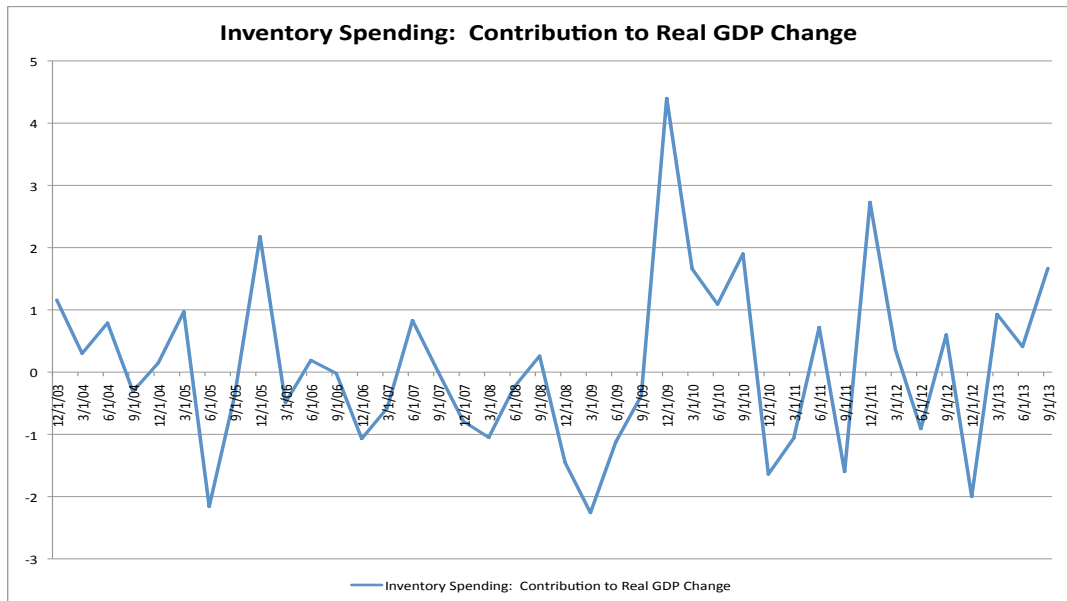


Chart 2

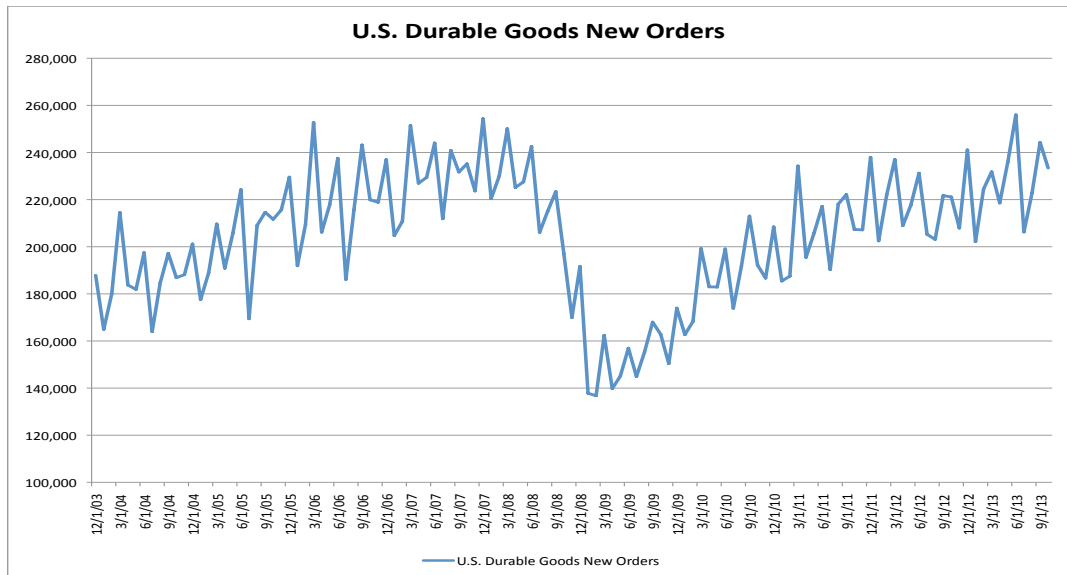
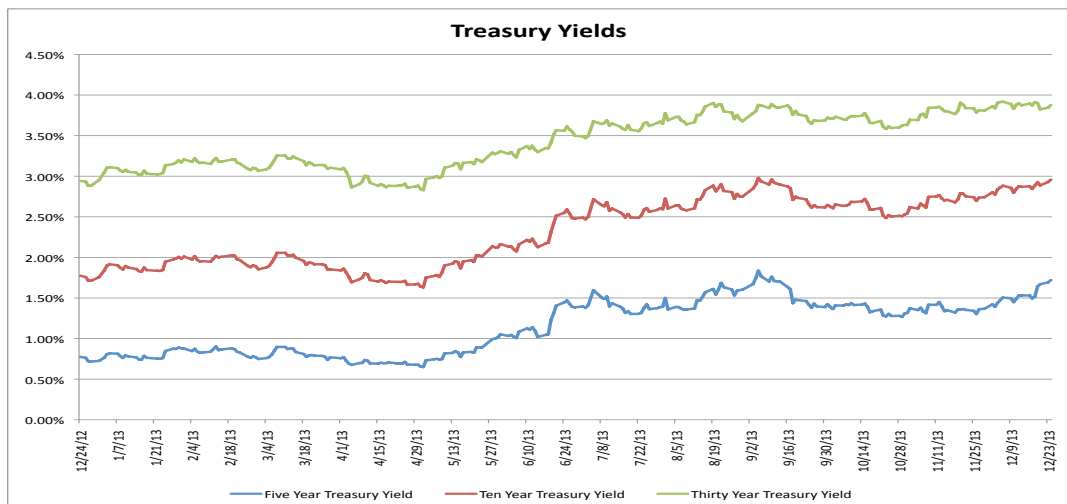


Chart 3



Source of charts: Bloomberg.com

Market Symmetry

The fourth quarter offered little change in the major influences on the global markets. While the Federal Reserve announced the beginning of the much anticipated “taper” of its asset purchases, interest rates were little changed. We did see a short-term compromise achieved in D.C., postponing any government budget conflicts until the conclusion of the next election cycle. We are looking for additional housing market and labor gains in the beginning of 2014 to help reinforce the recent economic and market progress.

Positive Market Influences

- Consumer Confidence – Consumer confidence is at the highest levels 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 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.

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

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.

Tax Season Is Coming

January is here and the holidays are behind us. It is time to get ready for that big annual event. No, not the Super Bowl! Filing your tax return. Even though the filing deadline is months away, it is not too early to set up your tax appointment. The Internal Revenue Service has once again delayed the start of tax season, thus only allowing for ten weeks of preparation time. There are changes in the tax law this year which make it even more important to get your documentation together and to make your tax appointment. For those clients that mail their records to us to prepare their taxes, please send your documents to us as soon as you have gathered everything. We look forward to serving you this coming tax season.



*Paul E. Hornbuckle, CPA
Vice President of Tax
and Business Services*



Asset management
as individual as you

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