

Advisory Notes

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Asset management
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The First Steps in a New Decade

By Joseph M. Valicenti
President/CEO

In the first quarter of 2010, the stock markets had a short retrenchment in January but returned to strength in February and March with the Dow Jones Industrial Average flirting with 11,000. The return of dividend increases, the heating up of merger and acquisition activity as



well as improving corporate earnings have all fueled the first quarter growth of the equity markets. The bond market started out the year strong but finished the quarter weaker (see Chart 1) because of some poor Treasury auctions in the 5

and 7 year time frame. The bond weakness may be short lived, as weak demand may have been a political statement from foreign countries unwilling to buy U.S. debt at the current rates as a push back to the import regulations that Congress is discussing.

The economy is starting to improve as some of our internal economic indicators are beginning to see positive trends that are leading us to a more optimistic view of the markets. Whether the economy is improving or whether the problem has been pushed further down the road remains to be seen (please see Andrew Clark's article, "Problem Solved or Merely Delayed?"). There are still some speed bumps on the horizon as the U.S. debt continues to increase, albeit at a low cost, unemployment remains high but has stabilized and some foreign countries are having economic solvency issues.

We will continue to monitor the overall economic data to evaluate risk and reward in the marketplace in order to better serve our clients in managing their financial affairs and investment portfolios.

Chart 1

Valicenti Advisory Services, Inc. Comparative Index Period Returns From 12-31-09 Through 03-31-10						
	DJIA	S&P 500	NASDAQ	Lehman Muni Bond Index	Citi Corp Corporate Bond Index	US Treas. Bill Index (90 day)
12-31-09 to 01-31-10	-3.23	-3.56	-5.37	0.59	1.77	0.00
01-31-10 to 02-28-10	2.77	3.05	4.23	1.10	0.34	0.00
02-28-10 to 03-31-10	5.40	6.07	7.14	-0.27	0.21	0.00
Cumulative Returns: 12-31-09 to 03-31-10	4.82	5.41	5.68	1.42	2.33	0.00

Bull and Bear Bulletin

In our September 2009 issue of Advisory Notes, we told you about our upcoming monthly email publication called the **Bull and Bear Bulletin**. We have since published four issues of the *Bulletin* and have received extremely positive feedback from our clients. If you would like to be added to our email list to receive the *Bull and Bear Bulletin*, please contact Elise Clark at clarkea@valicenti.com or (607) 733-9022. This publication is also available on our website.

March 2010

Problem Solved or Merely Delayed?

By Andrew R. Clark, CFP®

Portfolio Manager

We have articulated our belief that the economy is likely to build positive momentum as we transition through 2010, but have the underlying issues of our economy been resolved or have we merely “kicked the can down the road?” The U.S.



Government would like us to believe that the trillions of dollars printed at the Treasury and an unprecedented low interest rate policy have been successful in restoring the economy, but the truth may be that our federal politicians

and policy makers have only compounded the problem.

While the recession was triggered by a collapse in the housing market, the underlying issue stemmed from extreme levels of consumer debt. When society was spending nearly 99% of every after-tax dollar earned, we leveraged our future at the expense of current savings. When the leveraged assets declined in value, we had little savings to cushion the decline and to sustain spending levels. Many consumers were faced with the harsh reality of forced savings, as lending institutions constricted lines of credit and tightened lending standards. While the U.S. personal savings rate improved during the recession, it now appears that the sustained Federal Reserve policy of low interest rates will be successful at persuading consumers to return to their previous spending habits (Graph 1).

As we outlined in last month’s Bull and Bear Bulletin, the return of consumer spending and consumer confidence are reasons that we expect the economy to continue its improving trend.

While we believe that consumer spending is a positive for the current economic recovery, consumer indebtedness has only modestly improved (Graph 2). The level of inflation-adjusted consumer debt outstanding is back to early 2004 levels, but still extremely elevated on a historical basis. So despite the 18 months of improved savings, consumers still remain highly dependent on credit and lack sufficient long-term savings. While the Federal Reserve, the U.S.

Treasury and other policy makers were successful in combating the recent recession, their future effectiveness may be in jeopardy. The government pulled out all stops in the recent recession and, in doing so, incurred trillions of dollars in new U.S. Government debt. The net effect was that our policy makers transitioned private debt into public debt in an extremely unequal manner. Consumer debt declined from a peak of \$2.58 trillion in 2008 to the most recent value of \$2.46 trillion. While consumer debt declined \$120 billion, the amount of U.S. Treasury notes outstanding increased over \$2 trillion, a 1:16 ratio.

Our policy makers may believe that they can simply use the same tactics in the next recession and achieve similar results, but this may be pure ignorance. To use Charles Dickens’ *A Christmas Carol* as a parallel, our policy makers may receive a visit from the Ghost of Christmas Yet to Come as they peer across the Atlantic and view the debt crisis of Greece. The Greek government is facing an extremely large budget deficit that can no longer be financed with additional government debt. Magnifying the problem for Greece is the high level of government debt to the value of the country’s Gross Domestic Product (GDP).

In our country’s history, we have been successful at drawing upon an inner strength and creating innovation when difficult moments arise, but we may be blindly marching down the same path as Greece. Our nation’s public debt, which neither includes the hundreds of billions of dollars borrowed by the mortgage lenders Fannie Mae and Freddie Mac nor the \$1 trillion needed to finance the healthcare overhaul, as a percentage of GDP, has grown exponentially over the past 40 years to just over 80% (Graph 3). To put this percentage into perspective, for every dollar of production and service our country produces in a single year, it can be matched by \$0.80 in government debt. In 2009, the interest expense on federal debt outstanding was \$380 billion or nearly 3% of GDP. So far, the interest cost of increasing the deficit has been minimal, since the general population of investors and foreign central banks have been willing to purchase Treasury obligations, but this may not always be the case. If the government is unable to retire the debt upon maturity, it will be forced to refinance the debt. The refinancing risk could pose a significant problem in the future.

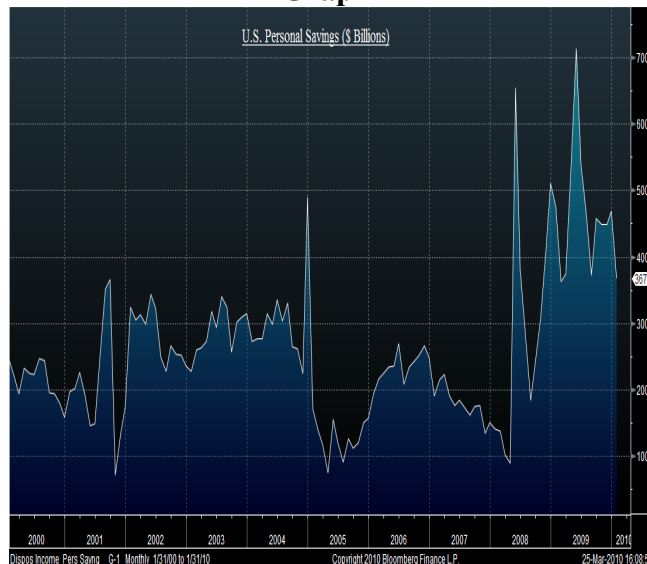
There are only two real solutions to our government's debt problem; the government needs to reduce spending and the economy needs to grow faster than the interest rate on the debt. With spending unlikely to change and the long-term GDP growth rate in-line with interest costs, I doubt the scenario will improve on its own.

The one element that allows our government and our society to continue to finance their twin deficits is global trade. Consider global trade as a simple equation that states that global spending must equal global savings. From a U.S. perspective, U.S. Personal Spending + U.S. Government Spending = Net Foreign Savings. As long as foreign consumers and governments are willing to forego current spending and in turn use their savings to purchase our debt obligations, the continual expansion in U.S. debt may continue. If, however, foreign governments and/or foreign consumers develop an appetite for spending, this equation must be altered. The net effect of higher levels of foreign spending would be forced savings by U.S. consumers and the U.S. Government or a much higher interest rate to entice foreigners to save. This relationship explains why the foreign recycling of U.S. dollars back into Treasuries from the purchase of exports from China and Japan play a pivotal role in financing our debt.

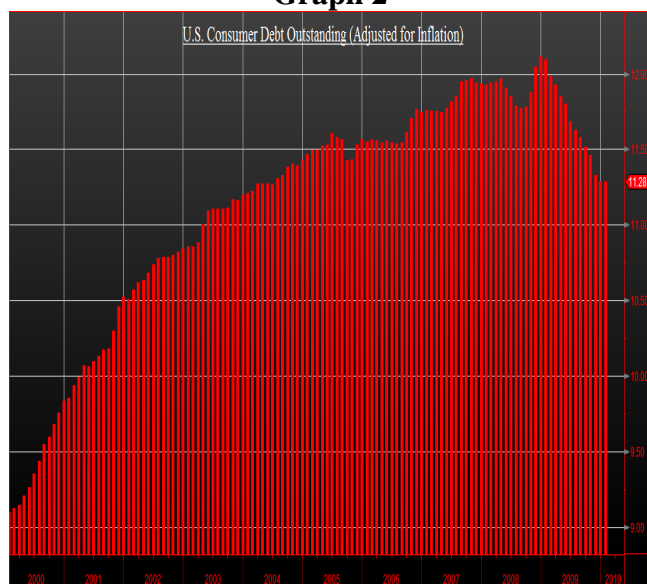
So, where do we stand today? We can see that despite the government's best attempt to improve the underlying strength of U.S. consumers, it has achieved limited success at the expense of running up trillions of dollars in new U.S. public debt obligations. Most of the government's current U.S. debt obligations will come due in the next 5 to 10 years, so the next five years may very well define our country's future. If we are unable to find a successful combination of reduced spending and economic growth, we may find ourselves in a similar situation to Greece.

While the economy is likely to improve over the next few years, the real issues were only compounded and delayed. The next recession could bring about a reckoning that will be insurmountable for the government to solve. Despite the guillotine being overhead, we are not destined for financial Armageddon. As Ebenezer Scrooge's character learns, the future is not set in stone and there is time to alter one's behavior. Let us hope that our politicians and regulators experience the same "epiphany."

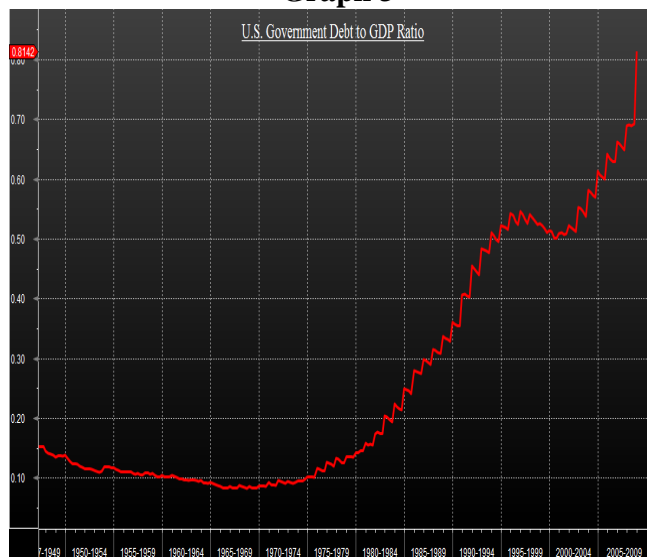
Graph 1



Graph 2



Graph 3



Referrals

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

Referrals are the “life blood” of our business. When a client refers someone to us, he/she is not only displaying a note of confidence in us but is also comfortable that the person being referred probably needs the services that we provide. Most of our clients know of friends who are going through significant life changes such as retirement, the sale of a business, the receipt of an inheritance, the winning of a lottery, etc.

If you have questions about how we handle referrals, please give us a call and we’ll be happy to discuss the process with you.

Don’t keep us a secret! Give us a chance to do for your friends what we have done for you.



IRA’s: To Convert or Not to Convert

*By Joseph M. Valicenti
President/CEO*

The tax laws that restricted individuals with modified adjusted gross income (MAGI) of \$100,000.00 or above to convert an IRA to a Roth IRA have been lifted for 2010 and forward. Previously, this option to convert was only available to earners of \$100,000.00 or less.

We have gone through some extensive calculations based on specific goals to see if converting your IRA or 401k to a Roth IRA makes financial sense for you, your spouse and your estate beneficiaries. While we believe that taxpayers in the highest tax brackets may not be able to enjoy the benefits of converting their IRA’s, those in the \$100,000.00 to \$250,000.00 income range may benefit depending on three basic questions and their personal goals and objectives:

- Are you likely to be in the same or higher tax bracket by the time you retire?

- Can you do without the income and/or principal over the next ten years?
- Do you have sufficient cash on hand (outside of the IRA) to pay the current tax liability of the conversion?

If you answered yes to all of these, you may benefit from a conversion.

For estate planning purposes, those who do not need the assets from an IRA would benefit their beneficiaries with a conversion for the next generation and years to come.

These calculations seem simplistic on the surface, but some detailed analysis and planning to meet your personal financial goals may be needed.

Investment Strategy

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

In the first quarter of 2010, the economy showed continued modest improvement. While there are slight signs of inflation, the Federal Reserve remains committed to keeping rates low in order to allow the economy to continue its advancement. We also continued to see further strength in corporate earnings.



Currently, the Federal Reserve does not view inflation as a problem; however, we remain cautious on fixed income and are maintaining our shorter term strategy. On the equity front, we continue to look for opportunities in solid companies with strong fundamentals.

Our asset mix remains in a range of 5% to 10% cash, 30% to 40% fixed income and 45% to 60% equities, with a continued bias toward equities. Our current asset mix will vary based on client specific directions, needs for income and risk levels.