

BULL AND BEAR BULLETIN

The Buyer of Last Resort

By: *The Investment Committee*

As we begin to set our sights on 2010, the equity markets maintain their stair-step pattern higher. The majority of the equity markets' ascents have been the result of a slowing in the deterioration of the economy, as global demand and government spending have replaced the spending of U.S. consumers. Likewise, fixed income annualized yields across all credit ratings and bond types have normalized as fear and uncertainty are more quantifiable and general signs of improvement have become more evident. While the initial signs of economic growth have all but erased concerns over whether we remain in a recession, it is worth reviewing those variables that reflect stable growth and those variables that remain in question.

With an economy based on credit expansion and consumer spending, the most important component to a sustainable economic recovery is the amount of credit available to consumers. Consumer credit outstanding (Chart 1) continues to contract on both the supply side and demand side. From a supply perspective, banking institutions and credit card companies maintain a lending strategy involving historically tight lending standards, lower lines of credit and potentially higher interest rates. In addition to less available consumer credit many consumers have decreased their reliance and dependability on credit, in an effort to increase their savings and to repair their personal balance sheets. As consumer credit outstanding continues to contract, there remains downward pressure on the overall demand for goods and services – Gross Domestic Product (GDP) – in our society.

Offsetting the lack of consumer driven demand is our government. Over the past twenty-four months, the government has engaged in an unprecedented effort to stimulate economic growth by maintaining a Federal Funds rate near zero percent, indirectly suppressing mortgage rates and offering tax credits to help stimulate the housing market, using taxpayer money to bailout multiple industries and orchestrating a weakening of the U.S. dollar. All of these actions were with the intent to return to a period of normalized economic activity.

While our country remains far from normalized growth, there have been certain areas of the economy that have benefited from government intervention. We have recently witnessed stabilization in housing values, consumer sentiment above the 2009 lows and the banking sector's profitability dramatically improved from the beginning of the year (Chart 2). It is the government's hope that if enough favorable conditions are generated for consumers and their assets then consumers and banks will jointly return to a state of credit expansion, forming the base for a subsequent normalized economic expansion.

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It is our investment belief that many of the economic improvements remain tied to government intervention and that as long as credit conditions remain constrained the economy may grow in “spits and bursts” and that the underlying market fundamentals may be susceptible to volatile swings. In addition, the longer it takes to return to a period of normalized economic and credit expansion, the more the government will become engrained in our economic system. With such a cautiously optimistic outlook, we expect a return of equity market volatility and a continuation of the government’s accommodative strategy over the next few months.



Given the previously discussed variables, the 60% recovery in the S&P 500 from the March bottom and the likelihood of interest rates remaining unchanged, we continue to consider the risk/reward relationship of short-term corporate bonds more favorable than the general equity markets. As always, we will continue to monitor the evolution of the economic recovery to ensure the appropriate adjustments for optimizing the risk reward relationship across all asset classes.

Chart 1

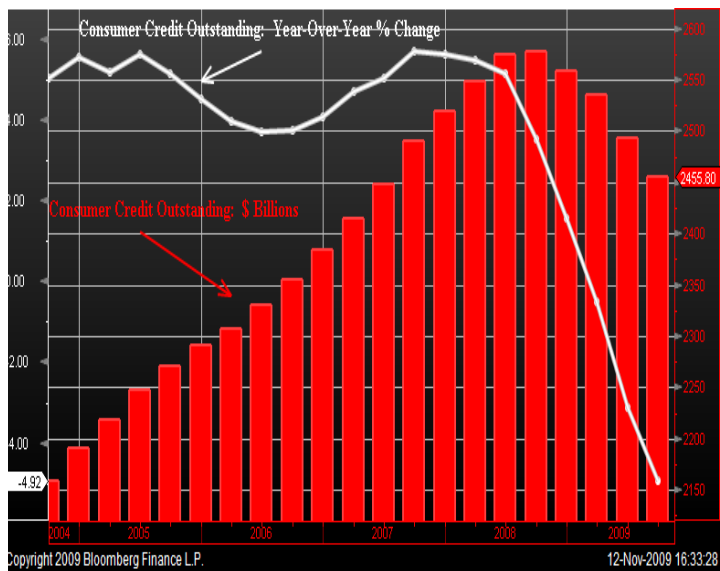


Chart 2

