

Advisory Notes

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Third Quarter Review

By Joseph M. Valicenti
President/COO

The third quarter stock and bond markets showed some resiliency as a follow-up to the strong second quarter. Although most of the economic data during the quarter was not particularly positive, it was not negative. The economic data has



begun to flatten out which may lead to an uptrend in overall fundamentals.

Due to cost reduction initiatives, most corporations were able to meet or exceed Wall Street expectations during the third quarter. The fourth quarter reports and guidance for companies will be more focused

on future top line revenue growth.

All three major stock indexes reported approximately the same return for the quarter and, as the credit market loosened, the bond returns responded positively during the quarter (Table 1). The Fed is doing everything in its power to drive investors from safe assets with very little return to positions further out on the yield and risk curves. Most savings rates are below 1% per annum; therefore, most investors are not achieving the return that they need. By driving down interest rates in order to re-inflate the economy, the Fed has the markets at a tipping point (See Andrew Clark's article "Split Decision") as to whether inflation will take hold and rates will eventually rise or whether

deflation will overtake and delay a further recovery in the market.

President Obama has moved from the economic recovery front to the health reform and possibly the Iran nuclear issue which may distract him from focusing on the overall U.S. economy. Our staff will continue to analyze all relevant economic, fundamental and technical data to make the best decisions for our client portfolios.

Valicenti Advisory Services Inc. Comparative Index Period Returns From 06-30-09 to 09-30-09						
	DJIA	S&P 500	NASDAQ	Lehman Muni Bond Index	Citi Corp Corporate Bond Index	US Treas. Bill Index (90 day)
06-30-09 to 07-31-09	8.78	7.57	7.82	1.92	4.18	0.00
07-31-09 to 08-31-09	3.79	3.54	1.54	1.95	1.99	0.00
08-31-09 to 09-30-09	2.51	3.75	5.64	4.09	1.90	0.00
Cumulative Returns: 06-30-09 to 09-30-09	15.73	15.56	15.66	8.16	8.27	0.00
YTD Returns: 12-31-08 to 09-30-09	13.42	19.33	34.58	16.21	17.20	0.19

We are looking forward to publishing a monthly economic brief in the near future, to be emailed to our clients every month. If this is something you are interested in receiving, please contact Elise Clark at (607) 733-9022, or clarkea@valicenti.com to be added to our list. These articles will also be available on our website.

Split Decision

By Andrew R. Clark, CFP®
Portfolio Manager

With a 50% market recovery since the March bottom, the debate over what to expect going forward has become extremely divided. One set of analysts believes that we are experiencing a normal recovery and that inflation is the greatest concern to our economy. A separate group of market analysts is forecasting below average growth and that deflation will likely take hold of the economy. Such a dichotomy leaves the average investor wondering how there can be such conflicting forecasts.



The group of analysts forecasting a normalized economic recovery, the Pro-Growth group, references the history of low interest rates and the benefits of the Federal Reserve's quantitative easing. In the history of the Federal Reserve, it would be unprecedented for such massive accommodative actions to fail in spurring the economy higher (Chart 1). Coupled with the government's trillion dollar spending spree, it is conceivable that our governmental officials are keeping the economy from contracting.

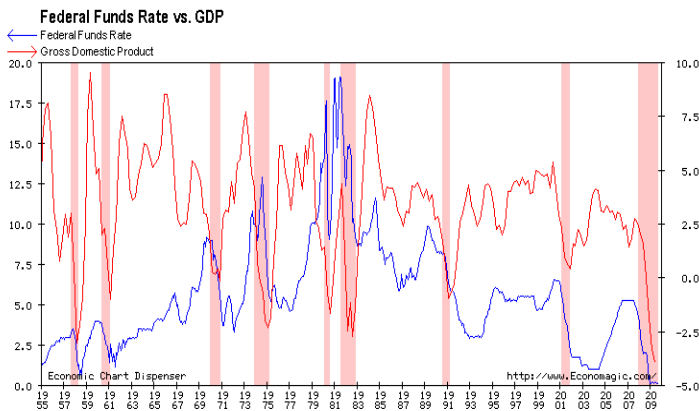


Chart 1

Those accommodative positions, however, also make those Pro-Growth individuals caution that inflation will be an issue as the economy continues to recover. The concern stems from the coupling of extremely low interest rates and the massive expansion in the country's money supply (Chart 2). The government has never accelerated the growth in the money supply as fast as the past year. The Pro-

Growth group is forecasting that all of the dollars flooded into the system by the government will ultimately find their way into the economy. When these dollars enter the economy, they will find an environment where manufacturing levels, known as capacity, have been significantly pared back (Chart 3). When too many dollars (demand) chase too few goods (supply), inflation ensues. If inflation begins to accelerate, the Federal Reserve will have to diligently unwind the billions of dollars of stimulus it has injected into the economy and will be forced to raise interest rates and moderate the money supply.

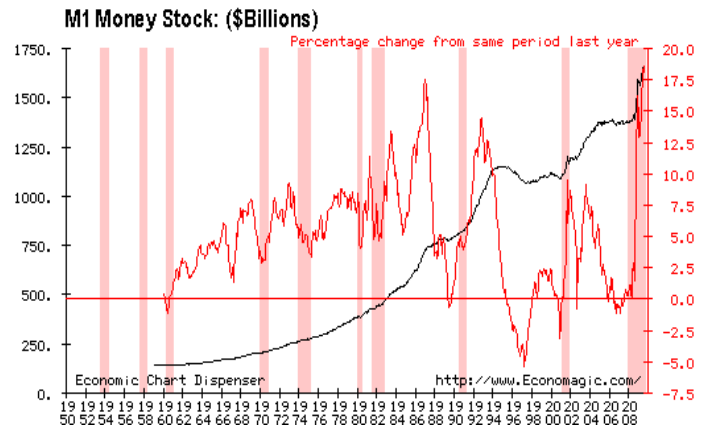


Chart 2

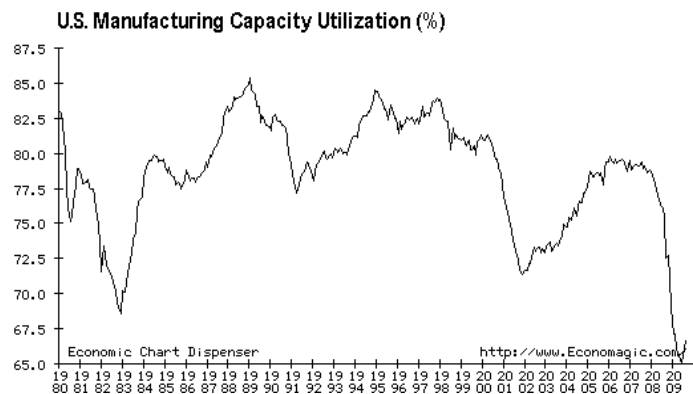


Chart 3

Oposing the Pro-Growth perspective are the Deflationists. The Deflationists believe that our society's debt burden has reached a saturation point, where no incentives can replicate the growth of credit experienced over the past 20 years (Chart 4). The Deflationists will point to numerous consumer-based debt statistics and the lack of improvement in those statistics despite the government's best effort to keep consumers leveraged. Perhaps best illustrating the government's failure to keep credit expansion alive

is the amount of Consumer Credit Outstanding (Chart 5). In the past 60 years, consumer credit has only contracted twice. The first contraction was in 1991, which was only a small percentage for a brief period of time. The current contraction is approaching 5% year-over-year and has lasted for a more prolonged period of time. As long as consumers continue to reduce their debt burden and increase their personal savings, it may negate the government's best efforts to maintain the expansion of credit and subsequently the U.S. economy.

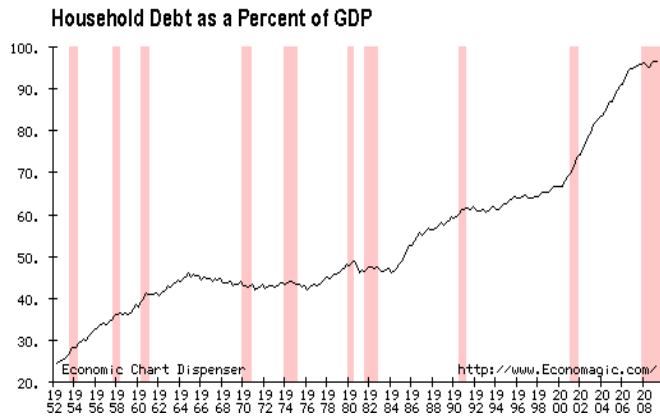


Chart 4

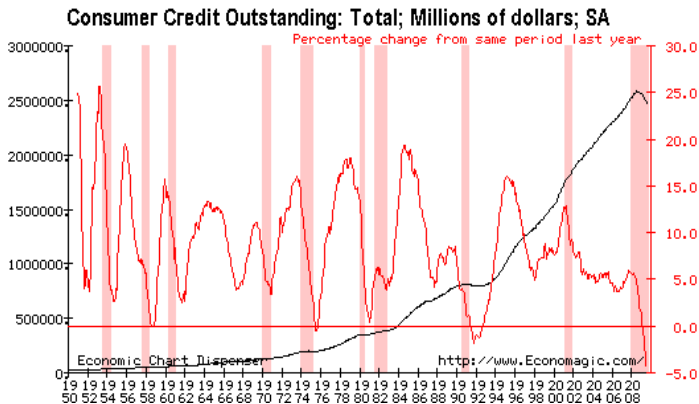


Chart 5

With the lack of credit creation and the possible saturation in household debt, what happened to the billions of dollars our government created? The Deflationists are quick to discuss bank reserve levels. While the government has expanded its balance sheet to help assist the banking industry's recovery, it appears that a bulk of the money has simply found its way to banks' excess reserves or the money set aside by banks beyond the regulatory minimums (Chart 6). Under normal credit conditions, banks would typically lend the excess reserves and help stimulate the economy, but the money provided by the government is currently sitting in bank balance sheets thereby limiting economic expansion and

failing to prevent credit contraction. As credit continues to decline and excess reserves remain idle, it leads to potentially too few dollars (demand) chasing too many goods (supply) or a situation known as deflation. While deflation fails to encompass the price level of every good and service, it materially impacts those areas with the greatest levels of excess capacity. Unfortunately for the Federal Reserve, there is little action to alter the path of deflation directly. In fact, Bernanke and company have already revealed his strategy to fight deflation, low interest rates and quantitative easing.

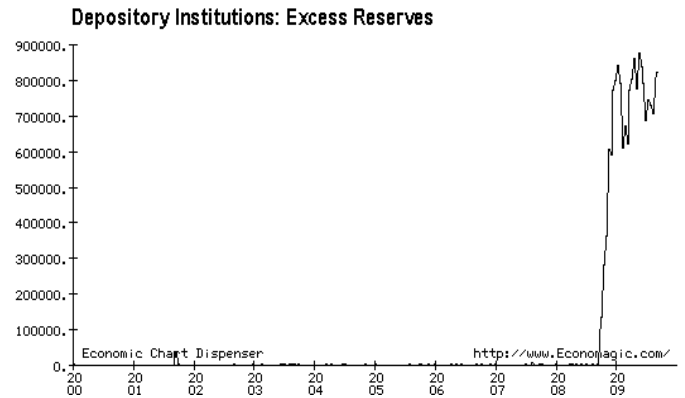


Chart 6

So where does that leave the average investor? The first question one must consider is the degree of recovery the equity markets have factored in? Clearly there has been stabilization in the credit market and the economy, but what is the magnitude of recovery for both variables?

The data indicates that a significant degree of excess capacity has been worked out of the system and interest rates remain favorable for borrowers, but lending continues to decline and consumers continue to remain cautious in the face of high unemployment and high debt levels. At the current moment, it appears that inflation will remain subdued and long term economic growth constrained until credit resumes an expansionary path and/or consumers are able to achieve a more sustainable debt-to-savings ratio.

The stock market discounts numerous variables on a day-to-day basis and may prioritize other variables above the economy but, at the end of the day, the economy will dictate the growth of corporate earnings and the sustainability of the current market rally. So, while a 50% rally may leave many feeling that the worst is over, please be aware that plenty of risk remains.

Employee Spotlight

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

In June, Elise A. Clark earned the designation of CHARTERED RETIREMENT PLANS SPECIALIST (CRPS®) from the College for Financial Planning. To earn this designation, Elise successfully completed the program, passed the final examination and adheres to the professional Code of Ethics. The areas of mastery involved in earning the CRPS® include the characteristics and types of retirement plans, plan design, establishment, administration, operational and fiduciary issues.

Elise has been a part of our Marketing/New Business Development team since 2005.

2010 Roth Conversion: What you need to know

*By Elise A. Clark, CRPS, RP
New Business/Retirement Specialist*

You may have heard the “buzz” about the new rules surrounding converting a traditional IRA to a Roth IRA beginning in 2010. One of the primary differences between a Roth IRA and a traditional IRA is that a Roth IRA consists of after-tax contributions thereby making your distributions tax free. The traditional IRA is all pre-tax dollars so, at 59 ½, you will pay tax at your tax rate at the time that you take distributions from the IRA.

The new rules for 2010 are:

- The \$100,000 Modified Adjusted Gross Income limit for the conversion is abolished, meaning that virtually anyone can contribute to a Roth IRA.
- For 2010 only, you can recognize 100% of the conversion income in 2010 or split it equally between the next two tax years (2011 or 2012), thus spreading the tax burden.

It may make sense for you to consider converting your traditional IRA to a Roth IRA if:

- You think you will be in the same or higher tax bracket when you withdraw.
- You have a long time horizon.

- You can pay the conversion tax from sources other than your IRA.
- You don't need to use the money and want to leave an income-tax-free Roth IRA to your heirs for gift and estate planning purposes.

One thing to keep in mind is that eligibility for a Roth conversion in 2010 doesn't automatically make it a good idea but, in the right circumstances, converting to a Roth IRA can potentially have significant benefits. Every situation needs to be evaluated on its own merits. If you would like more information on Roth conversions, the potential change in your tax situation or to set up an appointment, please contact us at (866) 734-2665. We can help you decide if this change is right for you.

Investment Strategy

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

The third quarter showed continued signs of economic and market improvement. The upward movement of the markets has been helped by many of the economic data points rising from their lows. Both the equity and fixed income markets continue to move forward. The second quarter earnings showed modest advancement, with many companies meeting lower expectations through cost cutting measures. It will be important for the third quarter earnings to show revenue growth.



We remain focused on quality companies with strong fundamentals, as we continue to work through the recovery. Our fixed income strategy still remains on the shorter term, allowing continued flexibility as we move forward. Our asset mix continues to be in a flexible range of 5% to 15% in cash, 30% to 45% in fixed income and 45% to 55% in equities, depending upon the goals and objectives of the account.