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Advisory Notes

Asset management as individual as you

2012 and the Turbulent 4th Quarter

By Joseph M. Valicenti
President/CEO

From all of us at Valicenti Advisory Services, Inc., we wish all of you a Happy and Healthy New Year.

The year 2012 was especially memorable as our extended staff family has expanded with four healthy new additions – three boys and one girl!

As we look back, the fourth quarter was certainly volatile with the anticipation of the presidential election, the looming “Fiscal Cliff” and the devastation of Super Storm Sandy, which ravaged the East Coast. We witnessed negative equity returns and consumer confidence waivered while Washington D.C. negotiations on the “Fiscal Cliff” stalled. (See Market Table) The yearly market return ended positive but certainly struggled throughout the quarter.

Lately, the markets have continued to focus on short-term events and have ignored some of the underpinnings of the economics. The challenges in Washington D.C. have continued to overshadow what the Federal Reserve (Fed) has been doing to keep the economy moving forward with its accommodative policies to foster growth. We believe that this policy will continue into 2014. Washington must get serious about how the U.S. tax structure, debt structure, budget deficit and how spending mandates will impact our nation in the current cycle, as well as in the future. Congress needs to focus on fixing the problems but most likely won’t get anything materially changed until the mid term elections in 2014.

Some positive statistics worth mentioning are that the housing sector has bounced off the bottom and is trending in the right direction. The employment numbers are trending upward as are corporate balance sheets. (Cash to debt ratios are at an all time high.) With an accommodative Fed, we should see some positive results from 2013 as long as the government can get a plan in place before all consumer confidence is lost due to our politicians’ inability to work together.

The Eurozone is not out of the woods just yet, but is certainly less desperate than it was last year. We will continue to keep a close eye on the developments in Europe. China’s recovery looks to be more modest as it continues to develop into a maturing country. Japan may consider changing its deflationary ways in order to stimulate its economy.

While 2012 was certainly challenging, 2013 will most likely be equally as demanding due to the short-term variables from our nation’s capitol. We will continue to monitor events and to manage your individual goals and objectives within this framework. Again, I wish you and your families a Happy and Healthy 2013!

Market Table

VALICENTI ADVISORY SERVICES, INC.
COMPARATIVE INDEX PERIOD RETURNS
FROM 12-31-11 THROUGH 12-31-12

	DJIA	S&P 500	NASDAQ	Lehman Muni Bond Index	Citi Corp Corporate Bond Index	US Treas. Bill Index (90 day)
12-31-11 to 03-31-12	8.91	12.66	18.67	1.96	2.13	0.06
03-31-12 to 06-30-12	-1.90	-2.84	-5.06	2.10	2.42	0.09
06-30-12 to 09-30-12	5.05	6.40	6.17	2.58	3.96	0.06
09-30-12 to 12-31-12	-1.84	-0.45	-3.10	0.75	1.12	0.09
YTD Returns 12-31-11 to 12-31-12	10.16	15.95	15.91	7.58	9.97	0.31

“Those that fail to learn from history are doomed to repeat it.” Winston Churchill

December 2012

Simple Facts Regarding Our Nation's Deficit:

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

By now, nearly every American and global investor is aware of the growing concerns of the U.S. "Fiscal Cliff". With so much at stake, including the growth of the U.S. economy, hundreds of thousands of jobs, entitlements and the nation's solvency, our elective officials need to avoid the political posturing of their supporting constituents and thoroughly understand the facts that could crumble this nation's foundation.

The root cause of the "Fiscal Cliff" is the nation's annual budget deficit and the growing aggregate deficit. Congress's failure to resolve the imbalance between spending and tax collection has resulted in an annual debt of $1.3 trillion and total debt of over $10 trillion held by the general public. In order to address the growing deficit, our politicians possess only two tools: spending cuts and tax collections. While both parties constantly bicker over the best ways to address the deficit, the real facts are straightforward and require a combination of higher taxes and spending cuts.

According to the Congressional Budget Office (CBO), mandatory spending items now account for 88% of all revenue collected by the U.S. government (Table 1). Unless our politicians address these mandatory spending items, which consist mostly of entitlements and other social assistance programs, any tax collection will have little success in reducing the overall deficit. While the CBO has projected a reduction in the annual deficit to just $200 billion by 2015, this assumption fails to incorporate any possible recessions that would severely impact tax collections and would produce additional government spending in an effort to reduce the recessionary impacts on individuals. Furthermore, the CBO assumes that the economy will grow at nearly 4% per year through 2015, which is nearly twice the average growth rate we have experienced over the past two years. These lofty expectations are likely to prove to be less than realistic as we progress towards 2015.

It should also be noted that a tax on just the top 1% is also unlikely to generate sufficient revenue to fix the government's budgetary dilemma. According to the IRS, in 2009, the top 1% of individual income tax earners paid 37% of all income taxes collected by the government (Chart 1). Furthermore, the top 10% of individual taxpayers paid 70% of all income taxes collected. Lastly, the top 50% of all individual income tax filers accounted for 98% of taxes collected, leaving the remaining 2% to be paid by the other half of our nation's taxpayers. To put these groups into perspective, the top 1% paid an average tax rate of 24.0%, the top 10% paid 18.1% and the bottom 50% paid an average tax rate of 1.9%. If the government is looking to find ways to solve its budget deficit through taxes, it will have to focus on more than just the upper class who have the financial means to leave the country if pressed too hard.

While increasing the top marginal tax brackets has been a major point of contention between Republicans and Democrats, the issue is more about "fanfare than substance". Taxpayers in the top two tax brackets paid $356.9 billion in income taxes before any credits, according to the most recent IRS statistics. Assuming the US government was successful at increasing this amount by another 10% through tax increases and reductions in credits and deductions, the IRS would only collect an additional $36 billion. $36 billion in additional tax revenue is barely enough to cover "Other Programs" under the government's mandatory spending obligations.

Higher capital gains rates have been another hotly debated item during the "Fiscal Cliff" negotiations. Assuming the government could double its tax collection on capital gains through higher rates and fewer tax exemptions, the government would only collect an additional $50 billion. Again, the additional tax collections would be insufficient to solve the nation's annual deficit without a reduction in government spending.

Turning back to spending, the continual battle over acceptable spending cuts is more noise than a practical solution. Our politicians continue to debate spending cuts of approximately $1 trillion, but the cuts would occur over a 10-year period. With an annual deficit exceeding $1 trillion, there is little chance that a $1 trillion reduction over 10 years or any other non mandatory spending cuts will reduce the overall deficit (Table 2).

What is worth noting from the current political debates is the present need to address the current deficit. The longer our elected officials wait to address the deficit, the greater the tax hikes and the eventual spending cuts will have to be in order to resolve the crisis. Any household that reviews its own budget recognizes that spending 50% more than is brought in every year is a path to bankruptcy. While there may be willing lenders to help finance a household's budget deficit, eventually this source of extra "income" dries up as the debt-to-income ratio climbs. The U.S. government will, at some time, face a similar scenario. While our government can continue issuing Treasury obligations to pay for its $1.3 trillion yearly deficit, eventually, lenders will become concerned about the ability to repay the obligation.

Our hope is that our elected officials appreciate the importance of dealing with the growing deficit and its long-term impact on our society and will develop a comprehensive solution before the market and consumers lose confidence in their ability to manage the situation. A failure to provide a long-term framework, which reflects both higher taxes and entitlement reforms, should be viewed as only a stopgap measure that is based on unrealistic economic growth assumptions and will surely fail to avoid further deficit spending.

Despite the unlikely odds of a comprehensive resolution, a timely makeshift measure would still be sufficient to keep the markets buoyant and would avoid a collapse in consumer confidence and a potential recession. The Federal Reserve continues to inject nearly $100 billion monthly into the economy in an effort to maintain an extremely low interest rate environment and to promote consumer activity. The Federal Reserve's unprecedented actions appear to be aiding the overall housing market, which may hold the key to further employment gains and economic momentum.

As we prepare for 2013, we hope for the best but are prepared to implement several strategies aimed at evolving with the various political and economic conditions that may develop throughout the year.

"The point to remember is that what the government gives it must first take away." John S. Coleman

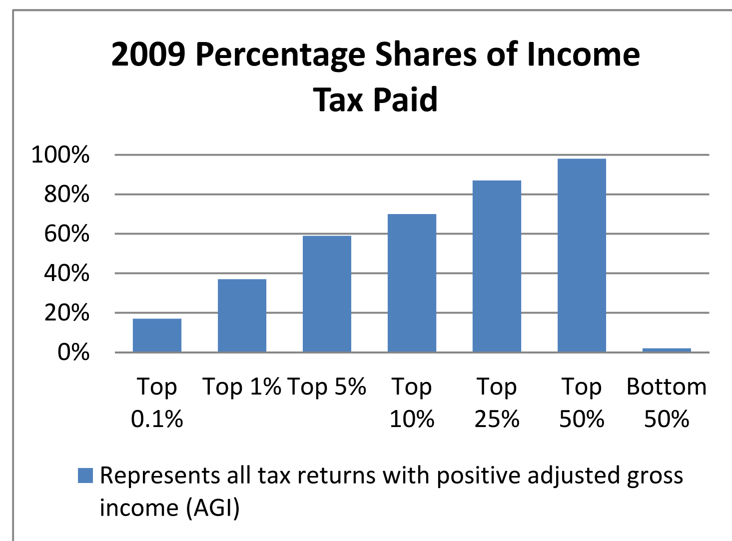
Table 1
(Source CBO)

U.S. Budget	2011	2012	2013	2014	2015
			In Billions of Dollars		
Revenues					
Individual income taxes	1,091	1,123	1,425	1,543	1,719
Social insurance taxes	819	851	958	1,020	1,074
Corporate income taxes	181	235	298	363	440
Other	212	225	232	283	308
Total	2,303	2,435	2,913	3,208	3,541
Outlays					
Mandatory	2,027	2,053	2,105	2,174	2,311
Discretionary	1,346	1,289	1,231	1,194	1,199
Net interest	230	220	218	227	244
Total	3,603	3,563	3,554	3,595	3,754
Deficit (-) or Surplus	-1,300	-1,128	-641	-387	-213
Debt Held by the Public	10,128	11,318	12,064	12,545	12,861
Gross Domestic Product	14,953	15,538	15,855	16,386	17,435
Debt Held by the Public as a % of GDP	67.7	72.8	76.1	76.6	73.8

Table 2
(Source CBO)

Mandatory Outlays (Billions of Dollars)	2011	2012	2013	2014	2015
Social Security	725	768	809	853	900
Health Care Programs	856	828	877	969	1,072
Income Security	404	357	333	291	288
Federal Civilian and Military Retirement	144	143	150	154	158
Veterans	71	69	74	74	76
Other Programs					
Agriculture	15	16	22	15	16
Troubled Asset Relief Program	-37	24	-5	3	2
Higher education	-31	-18	-26	-28	-26
Deposit insurance	-9	7	7	-7	-8
Other	82	62	67	60	57
	20	91	65	44	40
Offsetting Receipts					
Medicare	-80	-84	-87	-91	-96
Federal share of federal employees' retirement	-63	-67	-66	-67	-69
Receipts related to natural resources	-13	-14	-13	-13	-14
MERHCF	-11	-11	-9	-9	-9
Other	-26	-27	-27	-32	-35
	-193	-203	-203	-212	-224
Total	2,027	2,053	2,105	2,174	2,311

Chart 1
(Source IRS)



Investment Strategy

By Jeffrey S. Naylor
Executive Vice President/CFO

With 2012 now behind us, we wish everyone a Happy New Year.

We had many challenges in 2012 ranging from continued elevated unemployment, inconsistent consumer spending, political gridlock, the outcome of the presidential election to concerns over the "Fiscal Cliff", to name a few. The U.S. equity and fixed income markets, however, remained resilient. While challenges remain on both the economic and political fronts, corporate fundamentals should continue to show modest improvements through 2013.

Our asset allocation strategy remains flexible going into 2013. Using cash for future opportunities, our asset allocation is currently cash from 10% to 20%, equities from 40% to 60% and fixed income from 30% to 35%. This asset mix could change based upon client specific directives, needs for income and risk levels.

Market Symmetry

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

Our latest market symmetry chart incorporates the continual strength in the housing market and its benefits to the overall economy but a near-term concern over consumer and business confidence in the wake of the "Fiscal Cliff". We have also removed the year end tax lot harvest and the U.S. Presidential Election from the negative influences, which leaves a balanced market symmetry as we exit 2012.

Positive Market Influences:

- Strong Corporate Profitability – U.S. corporate profits are above levels last achieved in 2006.
- 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.
- Cheap Equity Valuations – The equity markets have factored in a decent amount of negativity and trade at a historical discount based on record profits
- 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 $40 billion of mortgage debt a 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.

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.
- U.S. "Fiscal Cliff" – With over $1 trillion in government spending cuts and a return to higher tax rates planned for 2013, there is concern that the economy would enter a recession due to the anti-stimulus measures.
- Restricted Bank Lending – While banks have plenty of cash available to lend, cautious lending practices have been prohibitive to economy growth.
- Investor Caution Over Owning Stocks – Money flow into equity markets has been below average since 2008-09, reducing the level of buying activity within the equity markets.
- Agricultural Commodity Prices – Warm and dry weather throughout the Midwest may produce smaller commodity yields, in particular corn crops, which could lead to higher food prices.
- Loss of Consumer and Business Confidence – Concerns over the "Fiscal Cliff" deadline will have a negative impact on both consumer and business confidence, which could severely impact the overall economy.

Positive Influence	***Negative Influence***
Strong Corporate Profitability	European Debt Crisis
Extremely Low Interest Rates	Deceleration in Asia-Pacific Economies
Improving Household Balance Sheets	Loss of Consumers' Purchasing Power
Savings Exhaustion & Replacement Cycle	U.S. "Fiscal Cliff"
Cheap Equity Valuations	Restricted Bank Lending
Adequate Financial Sector Liquidity	Investor Caution Over Owning Stocks
Indefinite Monetary Stimulus	Agricultural Commodity Prices
Housing Market Improvement	Loss of Consumer and Business Confidence

Thank you!

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

As this is being written on December 19th, the Investment Committee and the Tax Department are anxiously awaiting the outcome of the "Fiscal Cliff" negotiations in Washington. The Business Development / Marketing Department is putting the final touches on a number of new accounts and the Operations Department is doing its best to make sure that the new accounts paperwork is processed promptly in order for the new accounts to be set up at Schwab before December 31st.

As we complete our 28th year, we are ever grateful for the opportunities that our wonderful clients have afforded us. We hope that we are meeting their needs.

A thank you to our dedicated and hard working staff that truly believes in our mission of "Our Clients Come First".

We wish you all a safe, happy and healthy holiday season. Enjoy your families. Happy New Year!

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We would appreciate your referring friends and family to us, so that we can deliver the same level of service that we provide you.

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