Advisory Notes

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Second Quarter Review "The Fed Sparks Fireworks"

The end of the second quarter provided some "Fireworks "in the market as Fed Chairman Ben Bernanke began laying the groundwork for a monetary tightening process. The process will take some time to implement over the next 12 months, but the markets used it to sell and to take profits in the equity markets, about 2% in mid-June and, after a brief recovery, another 4% in the latter part of June. The first consecutive three day loss in over five months for the Dow Jones Industrial Average (DJIA) occurred and this pared the gains for April and May to close around 2.82% for the quarter for the DJIA. The bond market started to move negative in May as rates on 30-year treasuries and 10-year treasuries began to increase. The bond market ended the quarter in negative territory due to fears of rising future interest rates. (See Market Table)

Rising interest rates could be seen as a hindrance to economic growth, but it also shows that the economy is getting stronger and can run on more normalized supply and demand, not from historically low interest rates being subsidized by the Treasury and the Federal Reserve. This process of getting rates normalized should allow banks to lend more and get money into the hands of the people who need loans, which can help stimulate the economy. In the past, the Fed has taken its foot off the stimulus accelerator to test the strength of the economy and could only coast for a brief period multiple times over the past 18 months. The Fed is very concerned about getting out in front of inflation and making sure that the tightening process is smooth and not detrimental to the growth of the economy.

Our investment committee reviews close to forty economic data points every month to monitor trends in the leading, current and lagging indicators. This intense review helps us steer your portfolios through the choppy water of economic seas in order to meet your objectives.

We continue to monitor the slowdown in the Pacific Rim and the impact that it will have on the global markets and our portfolios.
While this late quarter pullback may be viewed negatively in the short term, we believe it is healthy and normal for the markets to push forward into the second half of the year.

Joesph M. Valicenti
President/CEO

Market Table

Valicenti Advisory Services, Inc. Comparative Index Period Returns
From 03-31-13 through 06-30-13

	DJIA	S&P 500	NASDAQ	Lehman Muni Bond Index	Citi Corp Corporate Bond Index	U.S. Treasury Bill Index (90 day)
03-31-13 to 04-30-13	1.95	1.73	1.88	1.22	1.89	0.03
04-30-13 to 05-31-13	2.06	2.20	3.82	-1.35	-2.35	0.00
05-31-13 to 06-30-13	-1.18	-1.11	-1.52	-3.14	-2.58	0.00
Cumulative Returns 03-31-13 to 06-30-13	2.82	2.81	4.15	-3.29	-3.07	0.03

Interest Rates: A Major Adjustment

Interest rates have rallied since the Federal Reserve started discussing the possibility of slowing its stimulus measures. The 5-year Treasury yield has more than doubled since April 30, while the key 10-year Treasury yield has jumped nearly 60%. The dramatic shift in rates has created a significant level of uncertainty and has initiated a debate over the future prospects of the economy and the financial markets. Before presenting our outlook for interest rates, it is worth outlining the impact of higher interest rates.

The primary reason to have designated market interest rates is to facilitate a fair and universally accepted rate to tie to lending. Many interest rates are tied to specific lending products and, in turn, their respective impact on the economy. One of the most popular lending products tied to interest rates is a mortgage. Most mortgage rates are tied to U.S. Treasury interest rates, which allowed many homeowners to benefit from the low interest rate environment. The recent rate increase, however, could have an impact on the growing momentum in the housing market. In fact, since rates began their move higher, refinancing activity experienced one of the harshest declines in several years (Chart 1).

Interest rates also influence more than just loan rates. As interest rates shift, there is a corresponding adjustment by borrowers in the demand for new loans. Traditionally, as borrowing costs grow, there is a subsequent decline in borrowing and economic activity. When the economy is resilient, the reduced credit expansion can be absorbed without pushing the economy into a recession. When the economy is weak or already in a recession, the Federal Reserve looks to lower interest rates artificially in order to entice further borrowing and economic activity. With the Federal Reserve outlining its plan to reduce its attempts to drive interest rates lower, the equity markets are left to decide whether the economy is strong enough to absorb the impact from higher interest rates.

Higher interest rates also influence the return on different types of investments. There is a direct cause-and-effect relationship between interest rates and bond prices. As interest rates increase, bond prices decline and vice-versa. This inverse relationship yields positive price appreciation in bonds when demand for bonds is strong and interest rates are declining but produces negative pricing as yields increase from their lows.

Bonds are not the only investment to experience price adjustments due to a change in interest rates. As yields experience a new trend, there is also a corresponding shift in the demand for low growth, high dividend paying stocks. Many of the defensive stocks that investors seek out in challenging market and economic conditions are the most negatively impacted from higher interest rates (Chart 2). To quantify this relationship, the S&P 500 Index is down roughly 2.0% since April 30, while the Telecommunications Sector has declined 8.0% and the Utilities Sector is off 12%.

> *"Higher interest rates also influence the return on different types of investments."*

In essence, by outlining its plan to reduce its monetary policy efforts, the Federal Reserve has effectively initiated a re-pricing of financial markets. Based on the rapid increase in yields, investors have already discounted an end to the Federal Reserve's indefinite $85 billion per month in asset purchases (QE3). With interest rates already above the levels preceding the announcement of QE3, the market participants are signaling that they believe the economy is strong enough to absorb higher interest rates and a reduced role by the Federal Reserve (Chart 3). While bond investors believe there is sufficient data to support a reduced role by the Fed, equity investors are less certain in the re-pricing of interest rates.

The difficult aspect for investors is assessing not only the timing and speed of the Fed's exit from its asset purchases, but the degree of re-pricing that occurs as investors seek to produce a natural interest rate; that is an interest rate that lacks artificial manipulating by the Federal Reserve. If the re-pricing goes too far too fast, there is greater risk to investors and the economy. The Federal Reserve is aware of this delicate relationship and is likely to use a form of double talk to prevent an explosion in interest rates until the economy is squarely on firm ground.

While in the past we have outlined the wealth effect created by the housing market recovery and an all-time high in the stock market, our general outlook is for an economy that may continue to struggle reaching an above average growth rate. Until the wealth effect and labor market gains produce a significant increase in loan growth, it is our belief that the Federal Reserve may be forced to keep interest rates relatively contained. Any additional jumps in yield are likely to be short lived until these two variables are resolved. Even though we expect interest rates to level off in the near future, we will continue to watch this scenario closely due to its long-reaching impact on investors and the economy.

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

Investment Strategy

During the first half of 2013, the U.S. economy continued to show further signs of modest improvement, along with further upside in the U.S. equity markets. The markets continued their march higher until the middle of June, when all eyes turned to the Federal Reserve and both the U.S. equity and fixed income markets pulled back on concerns over a reduction in asset purchases. Despite hints that the Federal Reserve may reduce asset purchases in the second half of 2013, the Fed left monetary policy the same and target interest rates remain near zero.

We continue to see modest growth in the economy and in corporate earnings. We will continue to focus on those companies with improving fundamentals and will use pullbacks in the market as opportunities. That being said, we remain flexible with our asset mix. Currently, our asset mix is 40-60% in equities, 30-35% in fixed income and 10-20% in cash. The asset mix will vary based on client specific direction, needs for income and risk levels.

Jeffrey S. Naylor
Executive Vice President/CFO

Chart 1

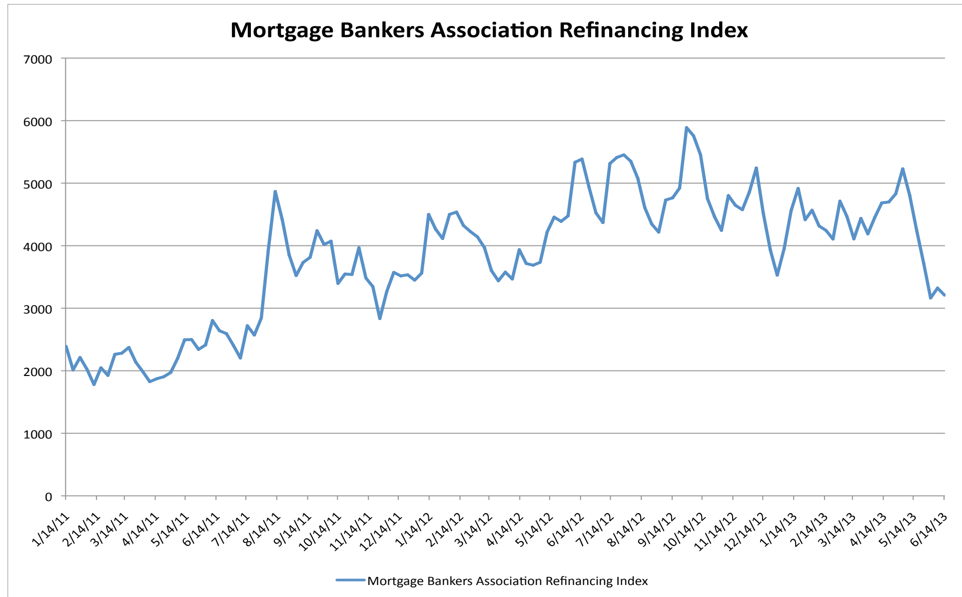


Chart 2

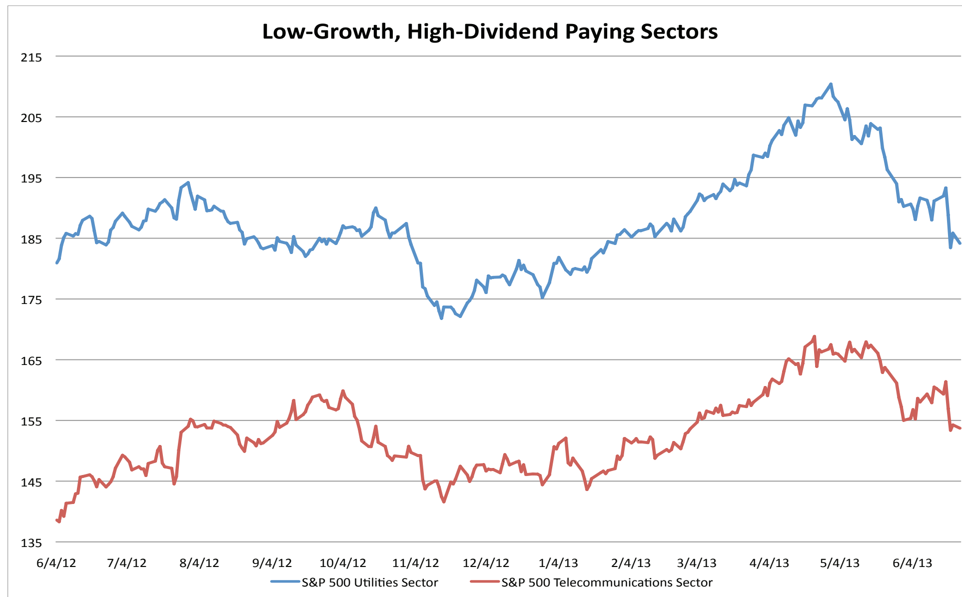
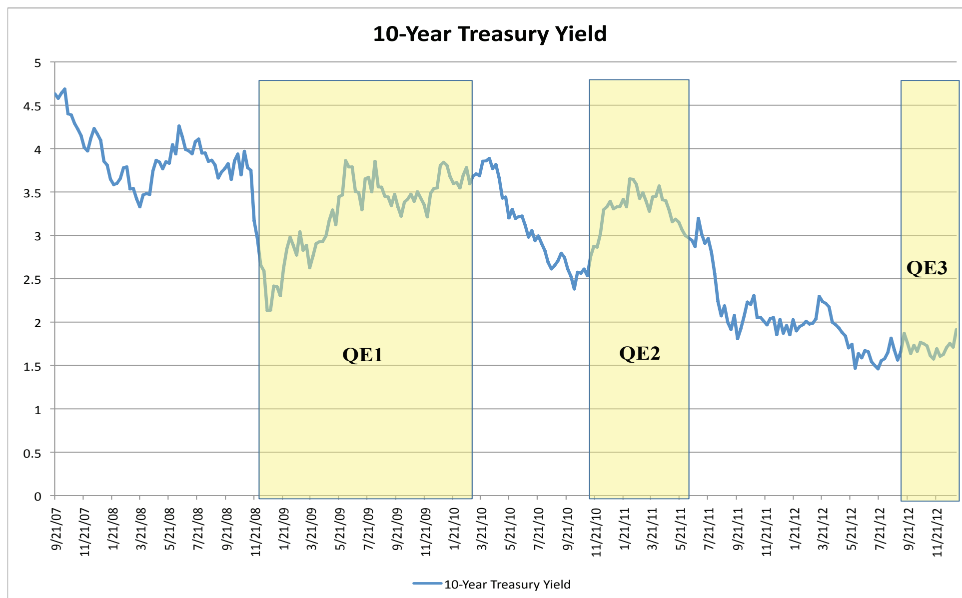


Chart 3



Source of charts: Bloomberg.com

Market Symmetry

The Federal Reserve's outline for an end to its $85 billion in monthly asset purchases dominated the quarter's news headlines. Interest rates have increased significantly from their lows and investors have attempted to assess the degree and timing of such a policy shift. As the U.S. markets focused on the Federal Reserve, China is facing its own bank liquidity crisis. With the potential for the country's banking sector to freeze, similar to the Lehman Brothers default in 2008, there is a heightened sense of concern regarding the Chinese economy and its potential spillover effect on the global economy. Despite the increase in interest rate uncertainty and concerns over China, U.S. consumer confidence ended the quarter at a five-year high, which should help create additional footings for economic growth. At this point, it appears that the strength of the global economy may rest with the U.S. in what may prove to be a volatile summer.

Positive Influence	Negative Influence
Consumer Confidence	Chinese Banking Crisis
Extremely Low Interest Rates	European Debt Crisis
Improving Household Balance Sheets	Deceleration in Asia-Pacific Economies
Savings Exhaustion & Replacement Cycles	Loss of Consumers' Purchasing Power
Adequate Financial Sector Liquidity	Peak Corporate Profit Margins
Housing Market Improvement	Restricted Bank Lending
Automobile Sales	End of QE3
Capital Flight	Currency Wars

Positive Market Influences

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

Negative Market Influences

- Chinese Banking Crisis – The Chinese banking sector is beginning to experience a lack of liquidity that reflects similar characteristics to 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.
- Deceleration in Asia-Pacific Economies – China in particular has engineered a slowdown 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 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.

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

Asset management
as individual as you

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