

ECONOMIC & MARKET UPDATE: JANUARY 3, 2011 "NEW YEAR FRAUGHT WITH NEW RISKS?"

Economic Data - Previous Week

Date	Series	Actual	Survey	Prior	
12/27	S&P/CS 20 City MoM	-0.99%	-0.60%	-0.96%	6 cities hit lowest price levels since 2006 peak
12/28	Consumer Confidence	52.5	56.3	54.3	Unexpected drop attributed to negative labor outlook

Economic Data - Upcoming Week

Date	Series	Actual	Consensus	Previous	
1/3	ISM Mfg Idx	--	57.0	56.6	Recent orders data point to continued expansion
1/3	Construction Spending	--	0.2%	0.7%	Analysts look for minor uptick after 2 mos of growth
1/4	Factory Orders	--	-0.2%	-0.9%	Aircraft may weigh on otherwise healthy orders
1/5	ISM Non-Mfg Idx	--	55.7	55.0	Recent orders data point to continued expansion
1/7	Nonfarm Payrolls	--	140K	39K	Falling claims may point to modest rebound in jobs
1/7	Unemployment Rate	--	9.7%	9.8%	Re-entrants to labor force may offset falling job cuts
1/7	Consumer Credit	--	\$0.5B	\$3.4B	Soft auto sales should moderate credit expansion

Source: Bloomberg

FEW REPORTS OFFER MARKET SUPPORT DURING HOLIDAY WEEK

Equity markets finished the year in much the same fashion that they trended throughout 2010 – higher. The S&P 500 Index closed with a gain of 0.1%, for a full year increase of 12.8%. Similarly, the Dow Jones Industrial Average rose marginally to finish the year higher by 11.0%.

There was a dearth of economic news released last week, on account of the various holidays. Several items did grab what little attention was left in the markets, though.

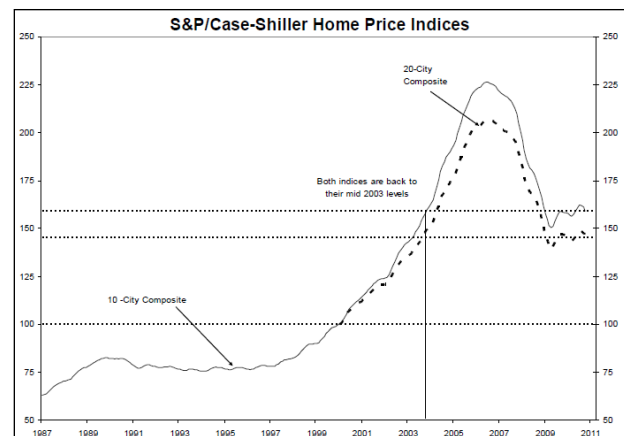
First was the renewed weakness in the Case-Shiller Home Price Index for October. The 10-city composite rose 0.2% and the 20-city composite fell 0.8%, causing many economists to surmise that a “double-dip” in housing prices is in the works.

What's Hot - and Not		How different investments did last week.	
INVESTMENT	PERFORMANCE	Last week	52-week
Gold	STOCKS	3.0%	29.8%
Commodity futures	BONDS	2.2	16.7
Emerging-markets stocks	CURRENCIES/COMMODITIES	2.2	16.4
REIT stocks		1.8	27.7
Global stocks		0.8	11.9
U.S. investment-grade bonds		0.8	9.5
U.S. corporate junk bonds		0.5	15.2
Emerging-markets bonds		0.1	11.8
S&P 500-stock index		0.1	12.8
Dow Jones Industrial Average		0.03	11.0
Crude oil		-0.1%	15.2
Nasdaq Composite Index		-0.5	16.9
Russell 2000 (small stocks)		-0.7	25.3
U.S. dollar, trade weighted		-1.6	-3.8
European stocks		-2.1	8.9

Notes on data: European stocks: Dow Jones Stoxx Index; emerging-markets-stocks: MSCI price index for free markets; corporate-bond prices: Merrill Lynch Global Bond Indexes; U.S. dollar and U.S. Treasuries: J.P. Morgan; REIT stocks: Dow Jones Equity REIT Total Return Index; emerging-markets bonds: J.P. Morgan EMBI-plus price index, in U.S.-dollar terms; commodity futures: Dow Jones-UBS Commodity Index; global stocks: Dow Jones Global Stock Index

Sources: WSJ Market Data Group; Dow Jones Indexes; Reuters; Merrill Lynch

Source: Wall Street Journal



Source: Standard & Poor's

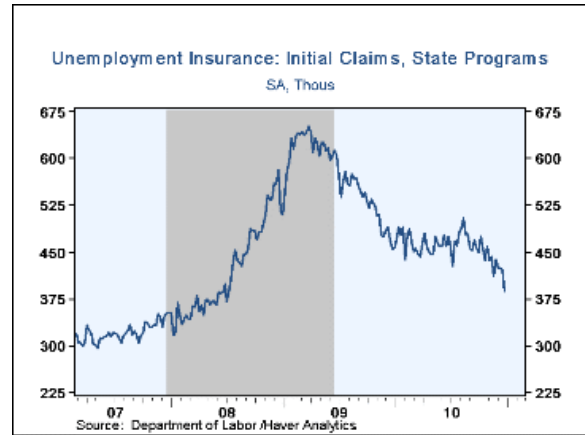
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Housing affordability, which drove many buyers into the markets over the past 18 months, is already on the decline. The National Association of Realtors, which factors median home prices and family income into its calculation, reports that housing affordability is near all time highs. But, with the government no longer playing as large of a role in the mortgage markets, affordability is falling.



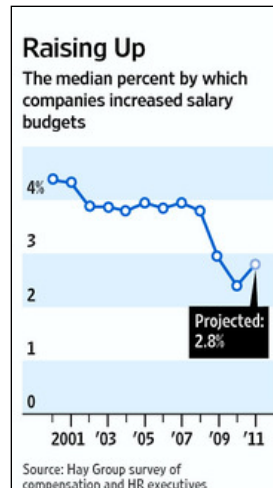
Source: Business Insider

More encouraging news came from the employment market where the number of claims for initial unemployment benefits fell to 388k in the week ending December 25th. That represents a drop of 34k and is the first time claims have fallen below the 400k barrier since early 2008.



Source: Haver Analytics

The outlook for employment is improving at a very tentative pace but for those individuals already with a job, there are signs that 2011 will be better than 2010. Companies report that median pay is expected to increase 2.8% this year, a modest bump up from the 2.4% in 2010.

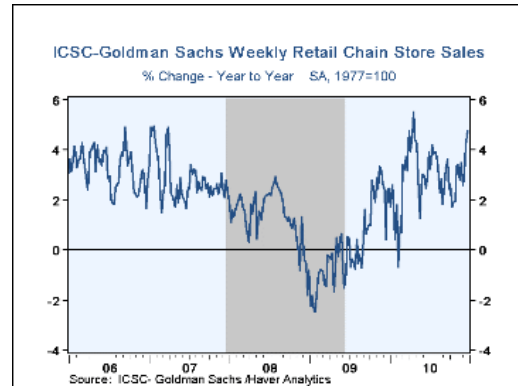


Source: Wall Street Journal

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The final (and most newsworthy) item last week was related to the holiday shopping season, which proved to be quite positive. MasterCard Advisors' SpendingPulse, an aggregated view of holiday spending, found that from November 5th through December 24th, consumer spending was up by 5.5% from 2009.

A similar assessment came from the ICSC-Goldman Sachs chain store sales index, which registered a 4.2% year-over-year gain in the week leading up to Christmas.



Source: Haver Analytics

ALL SIGNS POINT HIGHER...WITH A FEW CAVEATS, OF COURSE

With 2010 officially behind us, it is time to consider what risks and opportunities lay ahead for investors for 2011. Just as 2010 proved to be the year of the sovereign credit crisis, 2011 will not be forgotten as a year without its own potholes.

From the economic side of the ledger, the biggest concern remains employment. Despite improving economic growth and a Federal Reserve that has shown a penchant for doing everything in its power to stimulate the economy, employment growth is virtually nonexistent since the recovery began.

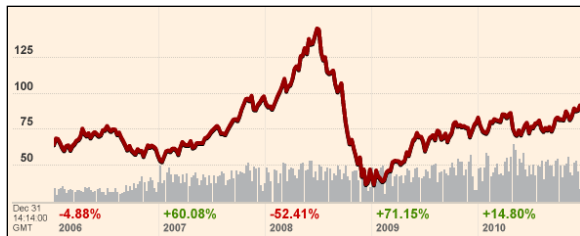
Since the end of the fourth quarter in 2007, the percent change in GDP is roughly flat in the US, but employment is off by more than 5%.



Source: The Economist

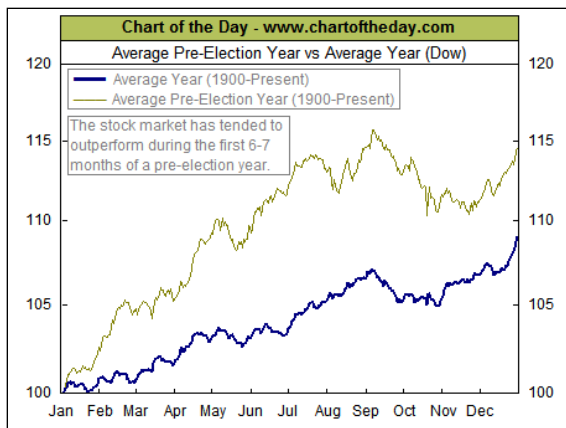
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Another issue that is already seeping into the economy is higher retail gas prices. The cost of a barrel of oil surged past \$90 at the end of 2010 and according to AAA's Daily Fuel Gauge Report, the average price for a regular gallon of gas is \$3.07. As gas prices cruise higher, consumer spending retracts, at the expense of the broader economy.



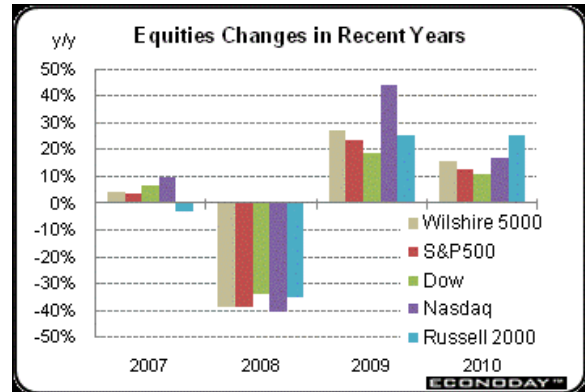
Source: Financial Times

Equity markets may prove immune to economic performance due to one simple fact – the Presidential Cycle. It is well documented that equity markets perform better in year three of a Presidential Cycle than in any other year. This is particularly true in the first six months of said year.



Source: Chart of the Day

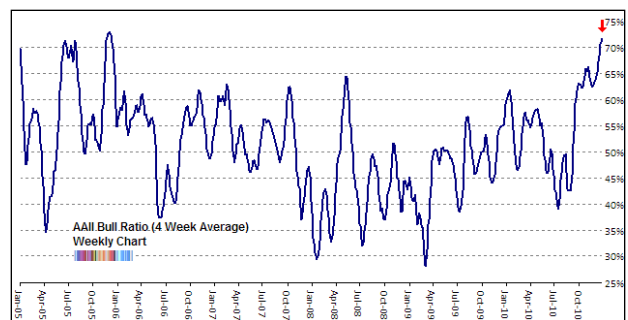
However, after suffering a generational meltdown in 2008 and subsequently a spectacular recovery in 2009 and 2010, is it greedy to expect additional gains?



Source: Econoday

There are several traps that equity investors should account for before jumping into the markets at this point. For one, bullish sentiment is near all-time highs. Based on a survey of retail investors from the American Association of Individual Investors (AAII), 51.6% of investors were bullish on the six month outlook for stocks and 20.1% were bearish.

Bullish sentiment is down substantially from the prior week (11.7 percentage points to be exact), but viewed on a four-week moving average window, sentiment remains quite stretched.

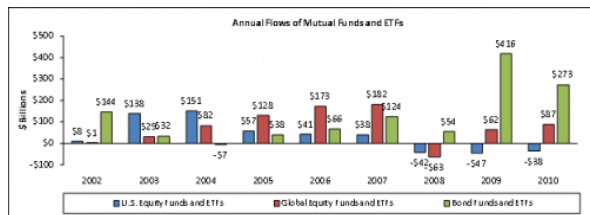


Source: Trader's Narrative

The second concern from the retail standpoint is that after several years of withdrawals from domestic equity mutual

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funds, investors finally began reallocating to domestic equity funds. Investors last began to toe back into equity fund managers in March and April, just prior to the meltdown in the European sovereign debt markets.



Source: Zerohedge

Retail investors are receiving support from the institutional market though, as a recent survey from Reuters found that equity allocations at US fund managers stood at 65%, the highest point since February. State Street's Investor Confidence Index, a measure of institutions' attitude towards risk, also surged in the final month of the year after tracking in mostly bearish territory for 2010.



Source: State Street

A sudden improvement in the labor markets appears unlikely at this point, but regardless of the state of the economy, the markets are poised to move gradually higher through at least the first few months of 2011. The Federal Reserve has no qualms about offering enormous amounts of liquidity to the economy, and in turn the markets. That liquidity alone will offer support to equity prices. This is a market that is fraught with a high degree of uncertainty, however, and outstanding issues such as the sovereign debt crisis in Europe, the state of municipal finances and high unemployment levels should elicit a measure of caution from investors.

THE WEEK AHEAD

Investors will be afforded little time to shake the holiday doldrums. On Monday, the ISM Manufacturing Survey will be released with expectations of a solid growth trend remaining intact. The Non-Manufacturing ISM Survey will be released on Wednesday, with similarly strong results expected.

The marquee report of the week will be the December nonfarm payroll employment release on Friday. A recent drop in initial jobless claims below the 400k mark suggests

some healing in labor markets, but it is difficult to say whether that will translate into labor expansion and hiring.

Minutes from the December FOMC meeting will be posted on Tuesday afternoon. Clarity about the state of the economy and the decision behind a second round of quantitative easing will be of particular interest.

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LIGHTER SIDE



Source: Investment Postcards from Capetown

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