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JANUARY FLASH REPORT – FEBRUARY 4, 2011 (MONTH ENDING JANUARY 31, 2011)

DOMESTIC EQUITIES: S&P PUSHES 1,300 DESPITE GLOBAL INSTABILITY

Ticker wires and ticker tapes rattled loudly in January as a cacophony of conflicting macroeconomic events dictated market movements. At the onset, the rally of 2009 and 2010 remained intact, with asset and stock prices supported by a Fed announcement that their stance on QE2 would remain unchanged (i.e., no clear exit). Despite inflation pressures in emerging markets and a less than stellar rise in US non-farm payrolls, equities chugged along into the middle of the month with the S&P nearing 1,300. Then, housing starts data came in at the poorest level in over a year, and the markets went into a period of heightened volatility. For every positive (US consumer confidence rose), there was a negative (inflation pressure, producer prices up 4% YoY), all coming to a head with the events in Tunisia and Egypt. In the background, earnings reports came in strong (331 of the 453 Russell 1000 companies that reported outpaced analyst estimates). For the most part, headline indices finished in the black, with the S&P 500 up 2.4% and NASDAQ up 1.8%. The exceptions were small- and micro- cap indices, which lagged after a tremendous 2010.

According to Bloomberg, of the companies that have reported thus far, all but two sectors experienced EPS growth in Q4. And though consumer staples and utility EPS growth slowed in Q4, all sectors were positive on a YoY basis. The revenue side told a similar overall story, with more than 70% of companies outpacing analyst expectations. One of the few industries underwhelming investors was telecommunication, where Verizon and AT&T failed to meet revenue expectations. Some of the notable positive surprises came from the metals and mining sector where Freeport-McMoRan and US Steel topped revenue and income expectations with the help of renewed demand and higher materials prices.

One would be remiss not to mention Apple when discussing this earnings season. Apple is the second largest holding in the Russell 1000 and S&P 500 (it is not in the DJIA). When the company announced that founder/visionary Steve Jobs was taking a medical leave of absence, the stock fell nearly 6.5% in a day. This alone detracted approximately 20 bps from large cap index returns. When the company reported better than expected earnings shortly thereafter (18% EPS and 9% revenue surprise), the stock rebounded, ultimately pushing the technology sector into second place for the month. The energy sector, which earned top billing in January, benefited from strong oil prices (+15% since end of Q3) and a rebound in natural gas (+14% since end of Q3). Exxon, the largest holding in both the S&P 500 and Russell 1000 indices, reported a 13% earnings and 5% revenue surprise which helping the stock rally 10% in January.

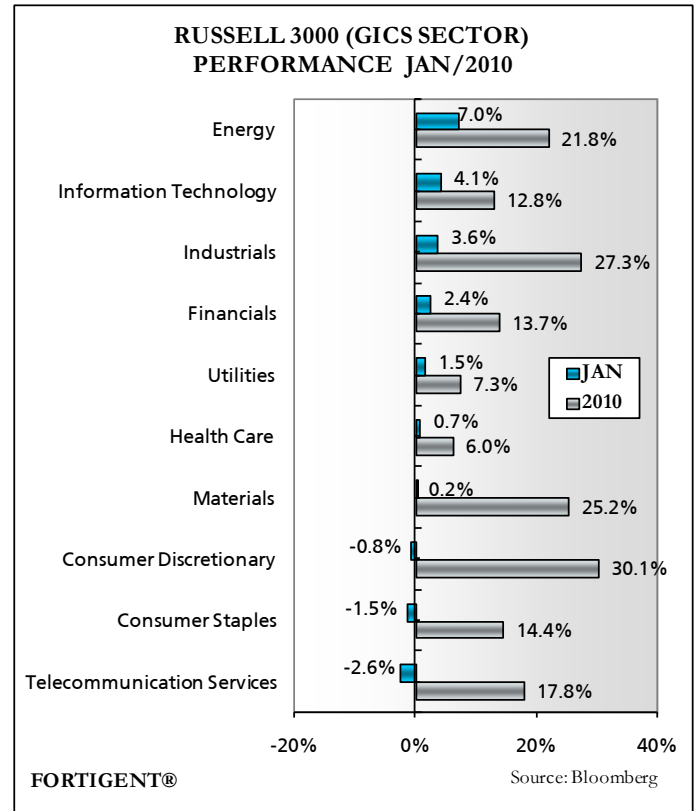
Looking ahead to 2011, analysts continue to favor a cyclical earnings recovery, with materials and energy leading the way at over 20% expected EPS growth. On the other side of the spectrum are health care and technology stocks, which are expected to grow earnings in the low single digits. Utilities are the only sector expected to show falling earnings in 2011.

Beyond earnings, there were several other interesting drivers of performance last month. For example, to review performance attribution Bespoke divided the S&P 500 into ten 50-stock deciles. They found that the best performers for the month were the stocks that performed the worst in 2010, which provided headwinds for momentum investors. Dividend seeking investors fared no better, with the highest dividend yielding stocks falling 0.3% compared to a rise of 2.4% for non-payers. Lastly, and maybe more relevant to large caps' outperformance relative to small during the month, companies with the highest percentage of revenues derived overseas outpaced non-exporters 5.0% to 1.3%. Remember that on average, large cap companies derive approximately 40% of their revenues overseas compared to 20% for small caps.

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The aforementioned tailwinds helped large cap stocks outpace mid, small, and micro. This bucked last year's trend in which micro beat small by 2.0%; small beat mid by 1.4%; and mid beat large by 9.4%. Style performance diverged along the capitalization line, but with little overall disparity (the Russell 3000 Growth index beat Value by 0.2%).

The January Effect: Last year we commented on Donald Keim's observation of the January Effect (i.e., as January goes, so goes the rest of the year) and its predicative power. Since 1929, in positive years the effect played true 78% of the time, with a negative January prompting a negative year 68% of the time. More recent history of negative periods, however, has been less predicative, with only 57% of negative Januaries ultimately resulting in negative years. Presently, following two years in which a negative January actually foreshadowed record positive years for equity markets, it is difficult to depend on January and its crystal ball. But if history has anything to say about eventually repeating itself, last month's positive uptick may be an encouraging sign for 2011.

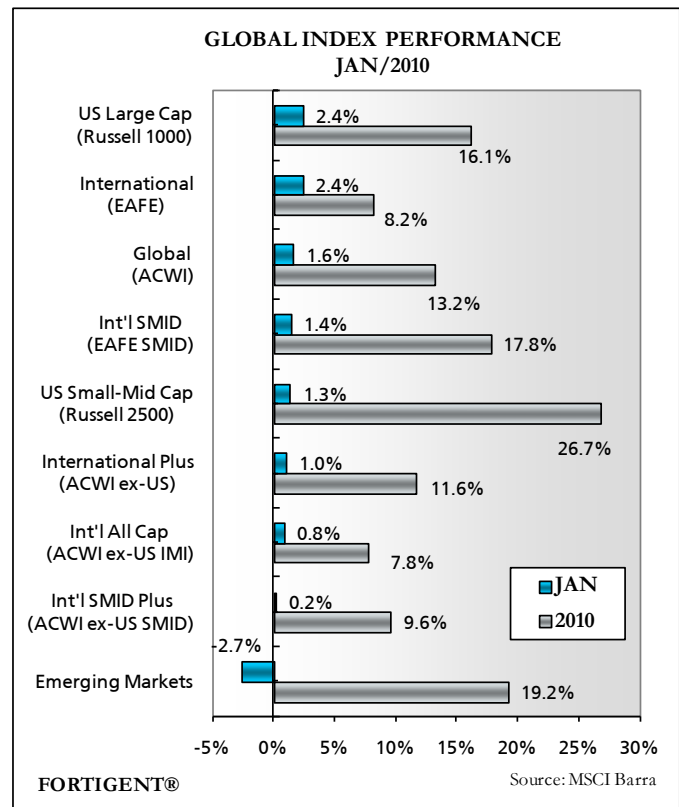


Sources: Bespoke; Bloomberg, S&P, FactSet, Russell

INTERNATIONAL EQUITIES: VALUATIONS RELEVANT AGAIN IN JANUARY

Global equities posted meager returns in January, with the MSCI ACWI ex-US index returning +1.0% for the month. This lagged US large cap stocks (Russell 1000), which returned +2.4% during the same period. Within the broad international index, emerging markets retreated (-2.7%) after a 19% return in 2010, while developed international equities (EAFE) posted a healthier +2.4% return. By region, Europe led global returns at +4.0% and Asia ex-Japan (AC Asia Pacific ex-Japan) lagged at (-1.3%). Japan was virtually flat for the month, with a marginal 1% local return erased by declines in the yen.

Interestingly, the ranking of MSCI country returns in the opening month of 2011 was nearly identical to those seen in 2010 – albeit in reverse order. Many of last year’s worst performers, including the troubled PIIGS countries and certain Eastern European laggards, littered the list of January’s best performers. Conversely, smaller emerging market countries from Asia and Latin America rolled over as investors cashed in last year’s big returns in those markets. While one month does not make a trend, it is interesting to speculate whether global investors have rebalanced into 2011 with a renewed focus on



valuations – something that has been noticeably absent from an insatiably growth hungry market the past two years. While extreme imbalances in global equity valuations have proven to persist for extended periods of time, it may be tough to overlook earnings valuations in Europe currently at 20 year lows. A look at some of the top and bottom performers in January (see chart at right) seems to support this view, at least anecdotally: the month’s laggards look expensive on both a book value and earnings basis, while the month’s leaders looking much more attractively priced. (Note that Egypt’s current political crisis precludes it from a fair comparison to peers in this context.) It will be interesting to see if this performance pattern is a short term reversal or if secular growth trends will continue to buoy Asia and the broader developing world in coming months.

Top 5 Perf. in January	Jan Ret.	2010 Ret.	P/B	P/E
GREECE	17.8%	-44.7%	0.9	10.6
SPAIN	13.8%	-21.1%	1.5	9.7
HUNGARY	11.6%	-9.6%	1.4	13.0
ITALY	11.1%	-14.1%	1.0	13.3
CZECH REPUBLIC	9.0%	-1.7%	2.0	10.2

Bottom 5 Perf. in January	Jan Ret.	2010 Ret.	P/B	P/E
PHILIPPINES	-10.4%	35.5%	2.6	15.9
PERU	-12.1%	53.4%	4.6	18.4
SOUTH AFRICA	-12.2%	34.2%	2.4	18.0
INDIA	-13.1%	21.0%	3.2	20.0
EGYPT	-20.9%	12.4%	1.6	13.8

Data as of 1/31/2011

SOURCE: MSCI BARRA

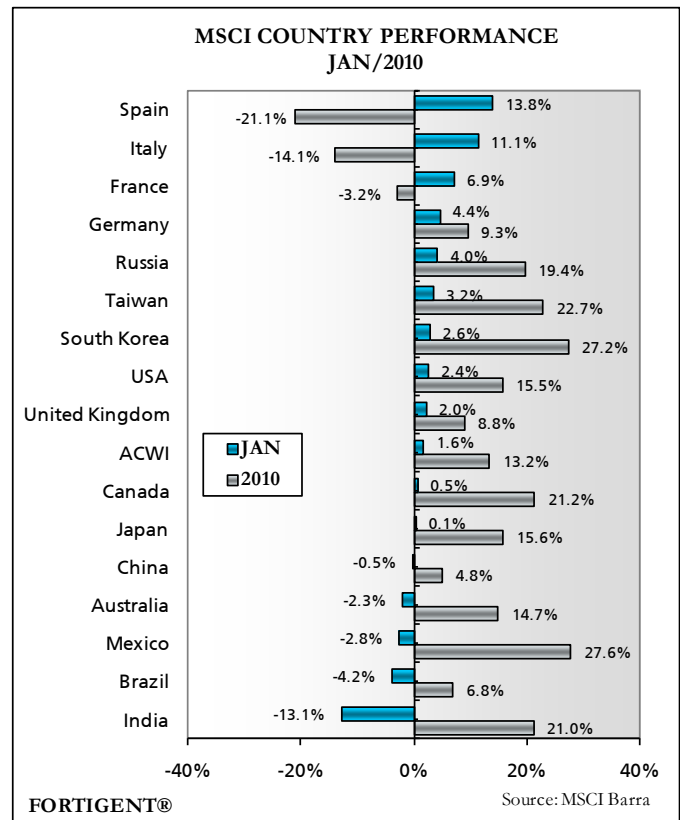
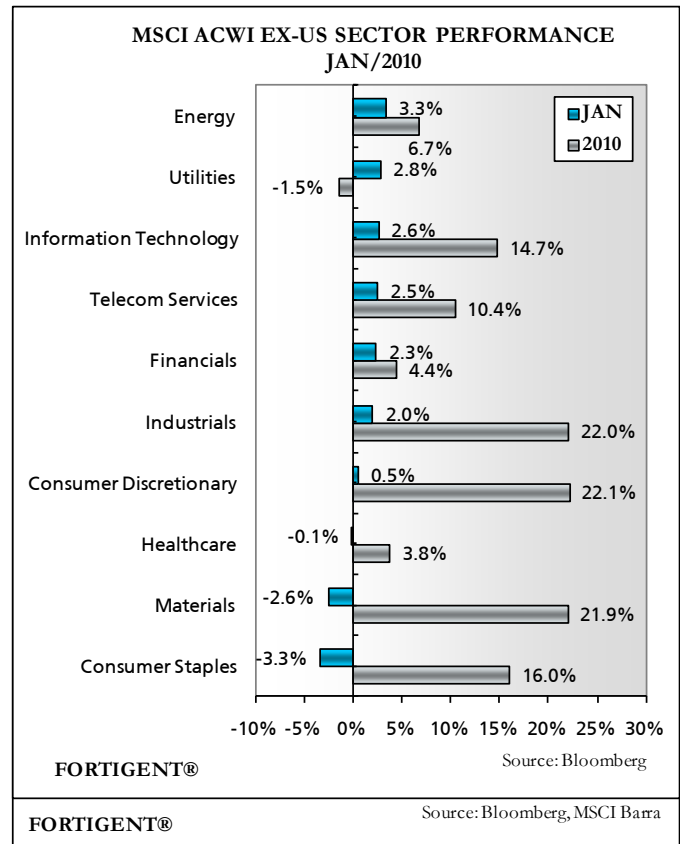
Currency valuations continued to move sharply in January, especially in the euro as it appreciated to \$1.37 against the dollar over the month (+2.3%). The currency has rebounded quickly since falling from \$1.39 to \$1.30 in November when Ireland’s solvency concerns spooked global investors. While helpful, currency alone did not drive performance in the region; several of the area’s most troubled countries still led global performance when compared on a local currency basis. Overall Europe posted an impressive result in January, leading all major regions and nearly matching its 2010 performance of 4.5%. Corporate Europe continues to outpace expectations despite a cloud of negative macroeconomic fundamentals; as earnings trickle in for the largest European companies, the majority have

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thus far surprised to the upside, with double digit results spanning the technology, industrial, and financial industries. This echoes a recent Merrill Lynch report indicating the ratio of earnings upgrades to downgrades in the region sharply outpaced those in the rest of the world.

The majority of individual country returns for Asia ex-Japan were negative in January, including biggest index member Australia (-2.3%). The country saw a slightly positive local return pulled downward by a reversal in the Australian Dollar, one of the best performing currencies in 2010 (propelled by Australia's strength in commodity production and exports). Emerging Asia weighed heavily on the index, led down by India (-13%), Philippines (-10%), and Indonesia (-10%). After posting the best 2010 performance among the BRIC countries, India retreated sharply, with negative currency headwinds playing a role. The country is certainly trading at high premiums against the rest of the world, boasting a price-to-book value of over 3x and a trailing 12 month price-to-earnings multiple around 20x (versus 1.9x and 16x for the ACWI index, respectively). China also lagged, and was one of the few countries not to join the "worst to first" party in January, posting a middling (-0.5%) return after 2010's disappointing performance (+5%). Outside of technology stocks (+13%), the country's index showed relative weakness across most industries. Offsetting declines in Asia were respectable gains in the "more developed" emerging market countries of Taiwan (+3%) and Korea (+3%). Performance in these countries was driven by the strength of technology stocks in January, which dominate both of those countries' market capitalizations. Overall the region still boasts the highest levels of absolute economic growth globally, but earnings expectations have trailed off in recent months by some measures.

Emerging markets were the global laggard in January, led down by small Asian and Latin American countries that displayed robust performance in 2010. Select EMEA (Europe, Middle East, Africa) countries also fell, highlighted most notably by Egypt (-21%). Although the political unrest that has taken place in Egypt just clipped the final days of January, it was enough to push the country's index return down by roughly 15% in the few days following January 25th (the first large scale protest). The Egyptian stock market was closed three days later (and remains so), likely mitigating some of the declines that are in store for the country. Any contagion effect remains largely contained, however, with nearby countries in the MSCI



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Emerging Markets and Frontier indices not showing visible signs of distress at this point. Among the larger countries, Brazil (-4%) showed continued weakness, while Russia (+4%) enjoyed a strong month following a double-digit return in 2010. Russia's outperformance can be tied directly to the success of energy sector, which at 56% accounts for the lion's share of the country's market capitalization.

From a sector standpoint, technology reigned supreme in both the developed and emerging markets indices, while retrenchment was seen in consumer stocks in both indices. There was divergence, however, between the markets in more domestically oriented industries like financials, telecommunications, and utilities. Those sectors rebounded strongly in developed countries, especially in Europe, and struggled in developing markets. Energy was the top performing international sector in January, propped up by elevated oil prices around \$90/barrel.

Sources: The Economist, MSCI Barra, Bloomberg, BofA Merrill Lynch Research, Wall Street Journal

Econ

Economic news continued at relatively the pace with which it ended 2010. Signs of improvement were evident in numerous indicators and segments of the economy, but areas such as housing and employment remain in the doldrums.

Manufacturing is turning into a surprising bright spot for the economy. The Institute for Supply Management (ISM) reported the January Purchasing Manufacturers Index (PMI) surged to 60.8%, well into expansionary territory. Readings above 50% represent expansion in the manufacturing sector. This represents the 20th consecutive month of expansion in manufacturing and the highest reading since May 2004. Forward momentum for manufacturing appears positive, as well, with the new orders index jumping from 62.0% in December to nearly 68% in January. The one note of caution is evident by the prices index, which at 81.5% suggests building inflationary pressure at the producer level.

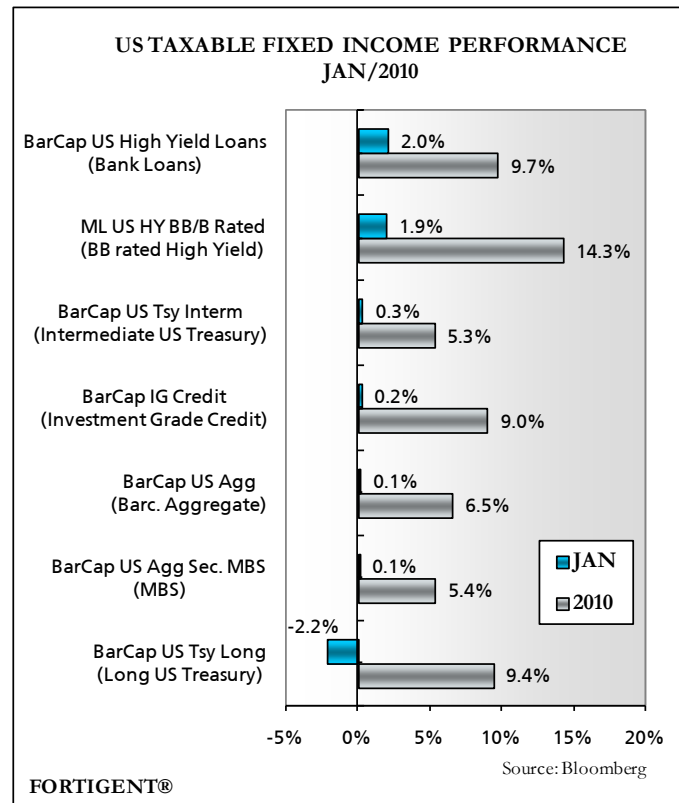
Payrolls for January were relatively disappointing. Nonfarm payroll employment added 36,000 jobs, while the unemployment rate dropped considerably from 9.4% to 9.0%. Growth in nonfarm payrolls was noticeably below economists' expectations, with even the private sector adding a mere 50,000 jobs. To understand just how little the labor situation has improved, consider that the labor force participation rate is now at 64.2%, the lowest reading since 1984.

During the final quarter of last year, gross domestic product expanded at a 3.2% seasonally-adjusted annual rate. This was slightly below economists' expectations, but hid a number of underlying positive developments. Chief among those was a 4.4% gain in personal consumption. That pickup in consumer demand was confirmed shortly thereafter by the consumer spending report for December. Personal consumption expenditures were higher by 0.7% in December, following gains of 0.3% and 0.7% in November and October, respectively.

Unfortunately, that improvement came at the expense of the personal savings rate, which fell from 5.7% in September to 5.3% in December. Consumers were actively increasing savings through much of the recession as they sought to realign their personal balance sheets and build a cushion of safety. The personal savings rate recovered to a more historically normal level, so any gains in spending that come at the expense of savings will be fleeting. Sustainable growth in wages and income is the only way for consumers to truly become a driving cog in the economic growth engine.

Federal Reserve

The Federal Reserve was largely on the sidelines through much of January, choosing to hold overnight interest rates within the historically low range of 0% to 0.25%. The Federal Open Market Committee cited low inflation and comparably weak economic growth as the reasons behind the decision. The Fed's asset purchased program will continue as expected.



US Treasury Yields

Security	12/31/2010	1/31/2011	Change
90 Day	0.12	0.14	0.02
2 Year	0.59	0.56	-0.03
5 Year	2.01	1.94	-0.07
10 Year	3.29	3.37	0.08
30 Year	4.33	4.57	0.24

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SOURCE: BLOOMBERG

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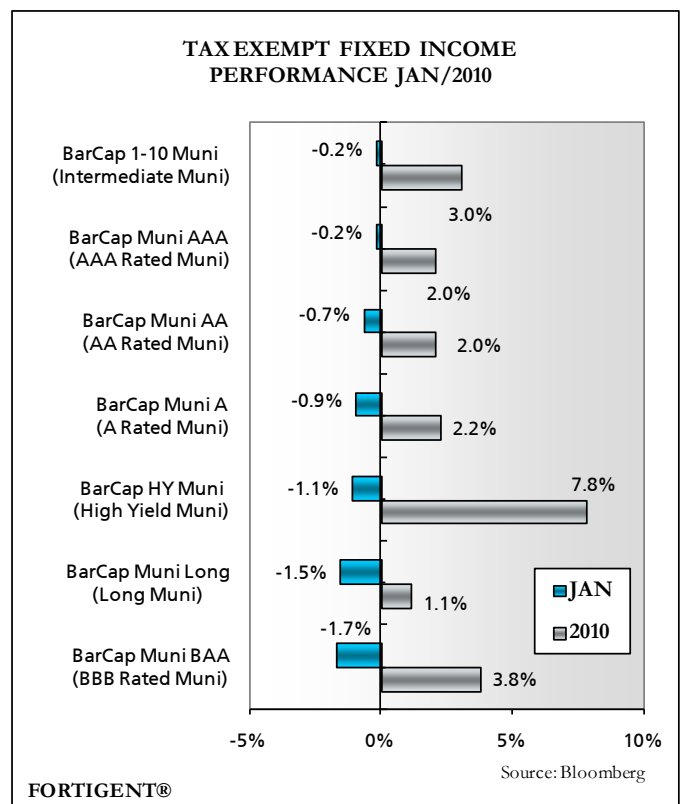
Earlier in the month, the Federal Reserve Beige Book, which provides a compendium of economic activity throughout the country, revealed that economic growth is firming throughout much of the country, but concerns about residential real estate markets and labor markets persisted. Commercial real estate showed indications of recovery, according to the report, but pockets of weakness were still apparent in some cities.

US Taxable Markets: The short to intermediate portion of the Treasury curve remained relatively stable in January, finishing the month with yields within 5 basis points of where they started. Interest rate volatility also declined as 15-day and 30-day trailing volatilities steadily dropped back to levels last seen prior to the Federal Reserve's QE2 announcements in early fall. At the same time, the US Treasury maintained its steady pace of issuance, tapping the market for another \$165 billion in new long term bonds in January, while Federal Reserve purchases reached \$70 billion of long term notes. The net result was flat performance for the month with intermediate Treasuries gaining 30 basis points. Intermediate term TIPs provided a bit better performance in the month, generating 1.1% as 5-10 year TIP yields dropped as inflation expectations rose greater than nominal yields.

Investors placed capital into high yield corporate bonds at a quick pace reflecting a grab for income in January. Flows into the space reached \$2.9 billion in January and were a continuation of strong flows that started in Mid 2010. Corporate treasuries took full advantage of the liquidity and issued a record \$29.5 billion for the month January. Despite the hefty issuance, valuations improved as option adjusted spreads fell from 526 basis points at year end 2010 to 490 basis points at the end of January, as measured by the Barclay's High Yield index. The combination of high income and higher valuations led to a nice month with the index up 2.2%.

Leveraged loans experienced a similar market dynamic with hefty inflows into mutual funds of \$3.4 billion. At the same time issuance of new loans reached \$20 billion; the pace of newly issued leveraged loans is steady but remains at half or less than issuance relative to pre-2008 levels. Leveraged loans performed well in January as pricing for the S&P Leveraged Loan 100 index improved to \$96, up \$3 from year end 2010. This improvement, along with the income in the sector, led to a healthy 2.0% return in January as measured by the Barclay's Leveraged Loan index.

Municipal Market: The woes affecting the municipal market in December carried through into the first three weeks of January, as perhaps, the hangover of Q42010 performance served as a prompt for more investors to reassess their allocations to tax exempt fixed income. According to ICI, outflows from municipal mutual funds escalated and peaked at \$5.7 billion for the week of January 19th. As a point of reference, total outflows from 11/1/10 through 01/12/2011 totaled \$36 billion. In the context of size, that represents a mere 0.10% of the municipal bond market. Nevertheless, it was a significant outflow to digest given the retail driven nature of this market. In review of yields, for the month 5-, 10-, and 30- year AAA rated Muni realized an increase of 20 to 25 basis points with the majority of the action occurring in the first three weeks of the month. By the fourth week yields had reached levels that were attractive to taxable bond investors, which in turn provided some stability to the market. In the end, the intermediate portion of the market lost 0.53% as represented by the Barclay's 1-10 Year index.



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On the supply side of the market, hefty fund outflows resulted in hefty secondary supply. According to Municipal Market Advisors, bonds up for sale in the secondary market (bonds with bids wanted) reached \$1 billion per day and the 10-day average reached \$982 million in mid January, surpassing levels reached this past December and November 2008. While this level of secondary activity is exceptional, the one positive aspect to the market was that broker dealers appeared willing to devote capital to their desks to support the activity, in essence holding bonds in inventory – a vastly different situation as compared to December 2010. This enabled the market to trade in a more orderly fashion. Given this environment, new bond issuance from the investment banks came to a virtual stop as municipalities elected to sit and wait to tap the market in a calmer period. As a point of reference, total new municipal bond issuance was \$12.2 billion making this past January, the slowest since 2001.

AAA Municipal Yields

Security	12/31/2010	1/31/2011	Change
2 Year	0.75	0.90	0.15
5 Year	1.68	1.91	0.23
10 Year	3.16	3.41	0.25
30 Year	4.89	5.10	0.21

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SOURCE: BLOOMBERG

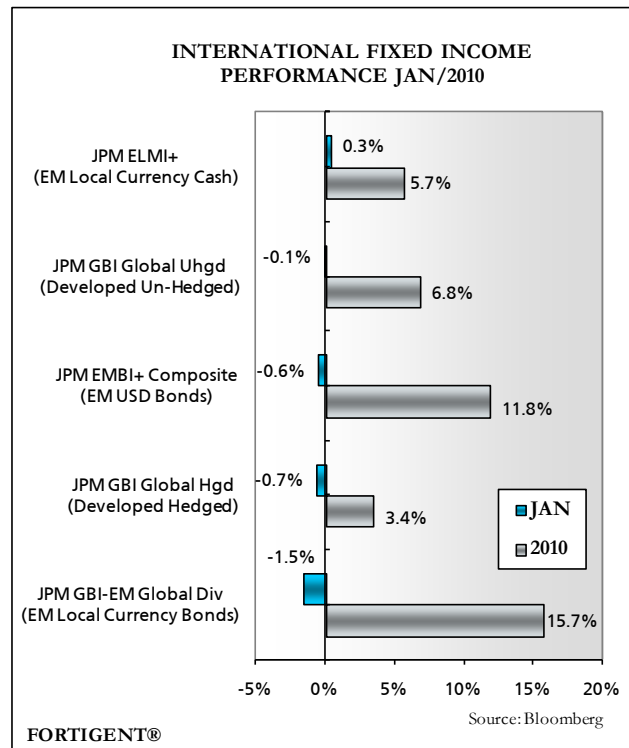
Outside of supply demand issues, the political and press related activity remained high. It was clearly apparent the buy side industry had enough of the Meredith Whitney headlines and went on the offensive via written commentary, or interviews with one or more of your favorite business cable channels. This perhaps calmed some concerns in the market, at least temporarily.

Politically, Newt Gingrich and some Tea-party members have put forth the idea of allowing states to declare bankruptcy under federal bankruptcy protection. This proposal is seemingly counter to the party's 'no bailout' mantra, and if taken in this context, appears more of an attempt to combat public employee unions, rather than bondholders – federal bankruptcy protection would be a significant 'stick' to wield when attempting to negotiate with unions. Nevertheless, the proposal has gained some interest and hearings will be held this month to discuss the possibility of making this a law. Most industry experts believe such a bill would be hard-pressed to reach the full congress for debate – and passage is even less likely.

The reality regarding credit quality in the Muni market is that economic stability breeds improvement in revenue trends. In 2010, revenue trends were broadly positive with the year over year comparison up 3% to 5% through the third quarter of 2010. At the same time spending by states has lowered, down 11% since fiscal year 2008 with further spending reductions expected to occur in 2011.

International Markets: The general view among investors and commentators following the developing economies is that inflation is accelerating and banking authorities are behind the curve. Despite the efforts of some central banking authorities (for example, India hiked its policy rate by 25 basis points in late January) Asia appears at the precipice of most participants concern with many arguing economic boom and FX targeting are setting the stage for a difficult future. These fears are weighing on the market as was apparent when viewing the sub-indices of the JPM GBI EM index series. Case in point, the yield on the Asian index was up 42 basis points in January, second only to yields from Middle Eastern and African sovereigns which increased 43 basis points – due more to political risk than inflation expectations. The net result was a loss of 1.1% for the month in local currency terms for the JPM-EM Diversified index. When accounting for US Dollar activity, the index lost 1.5%. Short duration Emerging Market assets outperformed posting a slight gain of 30 basis points for the month.

Barclays, Bloomberg LLC, JP Morgan Chase & Co, Investment Company Institute, Municipal Market Divisors,



Hedge funds experienced mixed performance in the first month of the year, as some of the best performing strategies from 2010 continued to outperform at the start of 2011. Performance was largely flat to positive, with only one strategy grouping struggling.

Distressed was the best performing strategy in the first month, gaining 1.9%. Mutual fund flows into high yield bond funds were positive in January, to the tune of \$2.9 billion, which allowed companies in the high yield space to issue \$29.5 billion worth of debt, the largest issuance experienced in January on record. Distressed was also a good place to be because there were no defaults in the month, and some popular hedge fund trades, such as AIG debt, were up more than 4%. Ford Motor, another popular trade, and the second largest issuer in the Barclays high yield index, rose nearly 2% for the month.

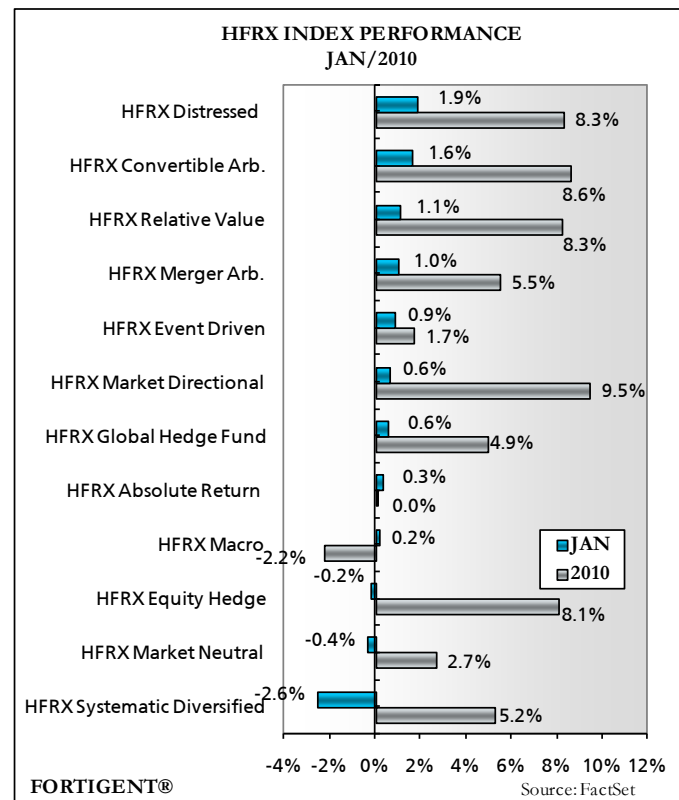
Convertible arbitrage continues to be a positive performer as the HFRX Convertible Arb index rose 1.6% in January. The long-only convertible market gained 2.2% due to increasing equity prices and a rally in corporate debt. Distressed convertibles actually experienced negative performance in January, falling 3.1%, but distressed only represents a small portion of the market. Equity sensitive convertibles now represent 47% of the market and are one reason convertibles performed similarly to the equity markets.

Equity hedge was flat for the month despite being positioned on average between 30% and 35% net long. According to weekly trading data from the CFTC, hedged equity managers are favoring large cap stocks with a high quality bias. It was a difficult environment for fundamental stock pickers due to several sizeable reversals experienced in the month. The situation in Egypt brought about a sharp reversal near the end of the month and hurt manager performance across the board.

Systematic diversified managers were the lone disappointment after falling 2.6%. In addition to periodic reversals in equity indices, commodity markets experienced heightened volatility. One of the most crowded trades is gold, which saw a substantial price increase over the past five years. With an improving economic outlook and increased demand for risky assets, investors shed gold holdings, causing a 6% loss in that precious metal. Government bond yields experienced little movement in the month. Currencies were a volatile area for traders. The Japanese Yen reversed losses from the end of the year to finish January with gains against most major currencies. However, a ratings downgrade later in the month caused the Yen selling off against the Euro and Dollar.

Macro managers fell 2.2% in 2010 and were only able to post a modest 0.2% gain in January. Based on exposure analysis from Bank of America Merrill Lynch, macro managers are slightly long most equity markets, flat US bonds and long commodities.

Sources: HFRX, Bloomberg, FactSet, Barclay's, Bank of America Merrill Lynch, Financial Times





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