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## ECONOMIC & MARKET UPDATE: FEBRUARY 22, 2011 "A LAUGHABLE ATTEMPT AT CUTTING THE BUDGET"

### Economic Data - Previous Week

Date	Series	Actual	Survey	Prior	
2/15	Retail Sales	0.3%	0.5%	0.5%	Slight moderation in sales after strong holidays
2/15	Business Inventories	0.8%	0.7%	0.4%	Continued growth in stocks show broad strength
2/16	Housing Starts	596K	540K	520K	Rebound after weather related decline in Dec
2/16	PPI	0.8%	0.8%	0.9%	Producer inflation elevated in headline, core rates
2/16	Industrial Production	-0.1%	0.5%	1.2%	Volatile utilities weighs on mfg expansion
2/17	CPI	0.4%	0.3%	0.4%	Consumer inflation reflects energy costs, core muted

### Economic Data - Upcoming Week

Date	Series	Actual	Consensus	Previous	
2/22	S&P/CS 20 City MoM	--	-0.50%	-0.54%	Continued declines expected in national home prices
2/22	Consumer Confidence	--	65.5	60.6	Analysts look for further improvement after 2 yr high
2/23	Existing Home Sales	--	5.20M	5.28M	Moderation expected after Dec spike, mtg rate rises
2/24	Durable Goods Orders	--	3.0%	-2.3%	Rebound in orders likely after unexpected drop
2/24	New Home Sales	--	300K	329K	Moderation expected after Dec spike, mtg rate rises
2/25	GDP - Q4 2nd Est.	--	3.3%	3.2%	Consensus looks for little change from advance figure

Source: Bloomberg

### THE GOOD NEWS, BAD NEWS TUG OF WAR

After officially doubling its recessionary intraday low of 666, the S&P 500 Index finished with its third consecutive weekly gain, rising by 1.0%. The Dow Jones Industrial Average also rose by 1.0% for the week.

Economic data confirmed the pace of the recovery, while corporate earnings reports largely surprised to the upside.

Retail sales for January came in at a below forecast 0.3%, following a downwardly revised 0.5% gain in December. It appears that consumers lost a bit of spending momentum after the fourth quarter, but weather had more than a passing influence on sales weakness in January. Following a strong rebound in retail sales in the second half of last year, one month of weakness is not cause for concern and there is a high likelihood that sales will snap back in February.



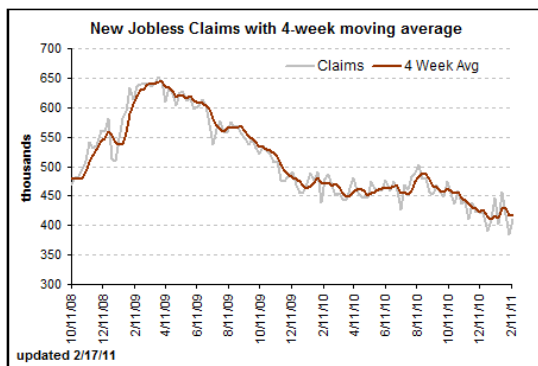
Source: Federal Reserve Bank of Cleveland

For the duration of 2011, the National Retail Federation (NRF) expects retail sales to increase 4%. The NRF noted that a lack of hiring at small businesses will present a major impediment to consumer spending momentum in the months ahead, however.

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The good news from corporate America is that cash stockpiles at S&P 500 companies are beginning to decline. After peaking at \$2.46trln, cash levels at those companies fell to \$2.4trln in the past quarter, according to Bloomberg. Corporate cash has gone to service a number of purposes, from research to capital expenditures, but job growth is the one area left largely in the dark. Companies are signaling that a return to hiring is imminent, but only time will confirm that sentiment.

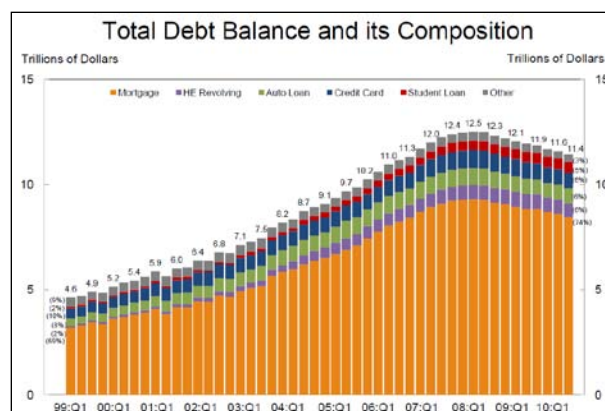
Unfortunately, due to weather complications, initial claims for unemployment also jumped by 25k in the week ending Feb 12<sup>th</sup>, to push back above the 400k threshold. On a 4-week moving average basis, the trend is still pointing decidedly lower.



Source: Econoday

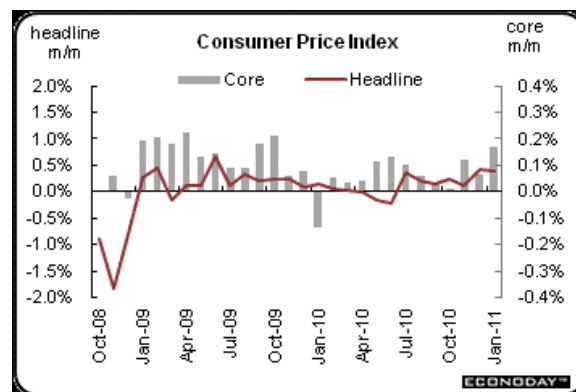
Despite trouble finding employment, many Americans are choosing to pay off debt by any means possible. Since peaking at \$12.5trln in the 3<sup>rd</sup> quarter of 2008, household debt has fallen by more than \$1.0trln to finish the fourth quarter at \$11.4trln. Obviously,

this is due not only to consumers electing to pay off debt, but foreclosing on debt in some form or another. At the end of the quarter, almost 11% of outstanding debt was in delinquency.



Source: Federal Reserve Bank of New York

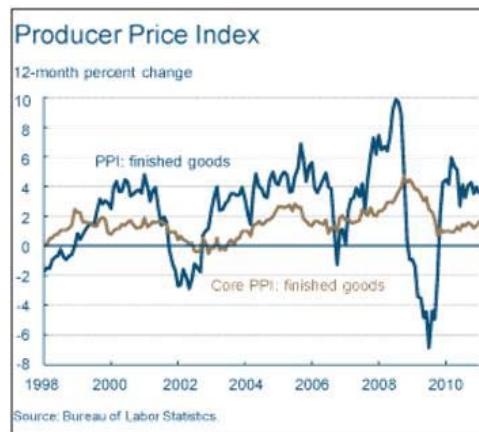
For all of the talk about inflation, consumer prices are still more or less contained after a 0.4% increase in January. The core index, excluding food and energy, was up 0.2% in the month, for a year over year increase of 1.0%. The slower rate of change with which prices are increasing appears to have bottomed out in the middle of last year and going forward, it looks likely that a gradual resurgence of consumer prices will occur.



Source: Econoday

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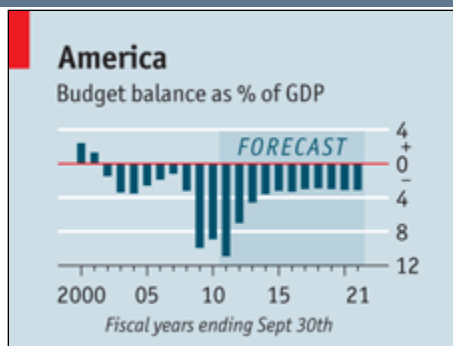
One reason behind the lack of price increases at the consumer level is that producers were stomaching the bulk of higher costs. Even excluding the impact of rising food and energy inputs, producer prices are beginning to catch fire. There is a tremendous way to go before we reach the levels of 2008, but nonetheless, it is obvious that the cyclical trough is in the past.



Source: Federal Reserve Bank of Cleveland

## THEY HUFFED AND THEY PUFFED AND THEY BLEW THIS COUNTRY RIGHT DOWN

In a sadly fitting tribute to the fiscal mismanagement occurring in Washington, D.C. these days, the National Christmas Tree, which stood in the same spot since 1978, was felled by high winds Saturday morning. Not to fear, park authorities had a contingency plan in place and a new tree is on the way. Unfortunately, politicians are not known for the same degree of contingency planning and last week's budget proposals proved that we are in for a torrent of trouble.



Source: The Economist

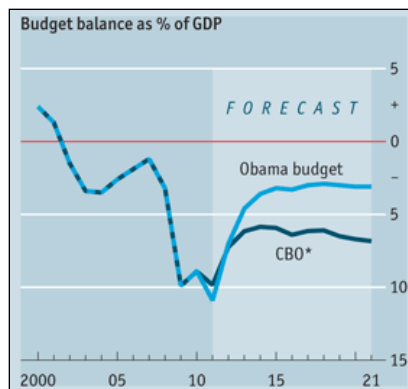
There is a growing sense that high 'financial winds' are set to topple the American fiscal engine and although it is too early to raise the white flag of surrender, last week provided a depressing glimpse into the future that Washington politicians are propelling the economy towards.

President Obama's proposed fiscal year 2012 budget was unveiled to a resounding thud because it was completely out of touch with reality. The positive highlights, if they can be called that, include a proposed deficit of \$1.101trln in fiscal year 2012, or 7.0% of GDP. Long-term, the President expects the budget deficit to fall to 3.1% of GDP by 2021 from 10.9% currently.

By those measures, the outlook is downright rosy, but unfortunately, its assumptions are built on total fabrications.

First, the President estimates average real GDP growth of almost 3.9% between 2012 and 2016, before slowing to 2.6% between 2017 and 2021. The Congressional Budget Office (CBO), a nonpartisan governmental agency, expects real GDP growth of 3.3% and 2.4%, respectively, during those years. This seemingly small statistical change represents a much larger problem in reality. The CBO found that if a mere 0.1% was subtracted from its real economic growth calculations through 2021, the cumulative deficit would increase by \$310bln.

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Source: *The Economist*

Second, the President makes one very bold assumption in his projections, resulting in \$338bln in additional revenue over the next decade. This assumption is based on the President's belief that he can allow Bush-era tax cuts for those making more than \$250k per annum to expire in 2012. The President was unable to secure such concessions last year when he controlled both sides of Congress and now that Democrats relinquished control of the House, he may face an even more difficult time allowing those cuts to expire.

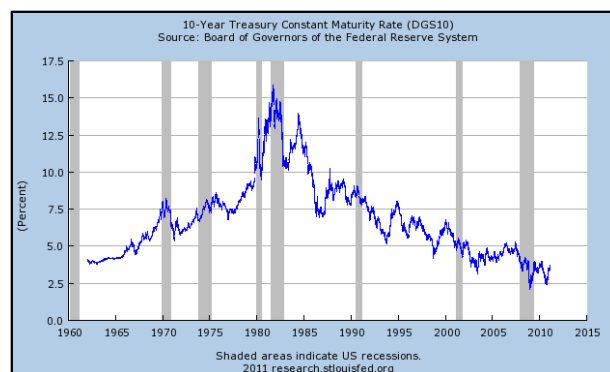
Finally, the President believes it is possible to cut non-security discretionary spending by 11%, from \$507bln in 2011 to \$453bln in 2021, without factoring in the impact of inflation. Excluding the fact that this has never been accomplished previously, cutting such forms of spending in the face of a weak economic recovery would do nothing to bolster growth. As an important aside, non-security discretionary spending only accounts for 12% of all annual outlays. Even if it was possible to entirely eliminate that category of spending, the annual deficit would still be on the order of \$600bln.

The most troubling aspect of the Presidential Budget went almost completely unnoticed, not due to its lack of importance, but merely

because it is becoming accepted as an inevitability. Tucked deep into the 200+ page budget proposal is one line identified as Net Interest.

Net interest equals interest payments on the national debt, a figure that will account for annual spending of a staggering \$627bln by 2017 and \$844bln by 2021, more than the cost of Medicare or Medicaid, respectively.

Again, the President makes an assumption that financing costs will be relatively well behaved throughout the next decade. The President believes the 10-year Treasury will remain at 5.3% from 2017 on. The 10-year Treasury has been in a period of secular decline since the early 80's and as we are all reminded countless times, past performance is no guarantee of future results.



Source: *Federal Reserve Bank of St. Louis*

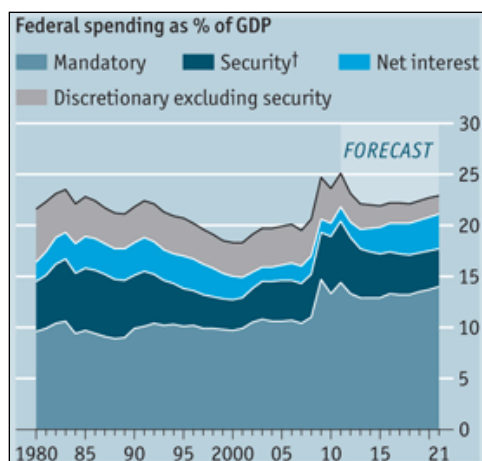
Only a few short months ago, the President tasked a group of bipartisan politicians, the National Commission on Fiscal Responsibility and Reform, with devising new and innovative ways to tackle our dire budget problems. That group issued a report no less than 59 pages in length with numerous grandiose ideas on how to save the future. Rather than embracing the commission's report, the President chose to ignore the key components

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and only embrace those which he knew would be easy to enact.

The budget proposal represented a crucial time for the President to tell our debt holders (China and Japan, in particular) that we are serious about correcting past mistakes. Instead, the President chose to lie down quietly and take the path of least resistance.

Rather than trying to reform areas such as Social Security, Medicare, Medicaid or even defense, the President surrendered.



Source: *The Economist*

## THE WEEK AHEAD

Economic data is relatively light, but the ongoing unrest in the Middle East and a last gasp of corporate earnings reports will play a primary role in driving market action this week.

It is a mostly quiet week for domestic economic releases, but investors will key in on the S&P Case-Shiller Home Index on Tuesday, Existing Home Sales on Wednesday, New Home Sales on Thursday and lastly, the second revision to GDP on Friday. Housing suffered a renewed bout of weakness in recent months and any improvement would be a welcome development.

Moody's, the national ratings agency, was quick to issue a report stating that there is "almost no chance" that the President's budget would pass in Congress. In addition, Moody's offered up the possibility that a negative ratings watch would be placed on the US if long-term structural concerns were not addressed.

This will not be the fiscal budget that brought the house down, but the witching hour is approaching at an increasingly faster pace. Politicians care more about the longevity of their careers than about truly reforming the system. Eliminating funding for discretionary spending programs will provide a modest amount of cost savings on paper, but will do absolutely nothing to improve our fiscal situation over the long term.

The Treasury Department will conduct three primary auctions this week including \$35bln of 2-yr notes (Tuesday), \$35bln of 5-yr notes (Wednesday) and \$29bln of 7-yr notes (Thursday).

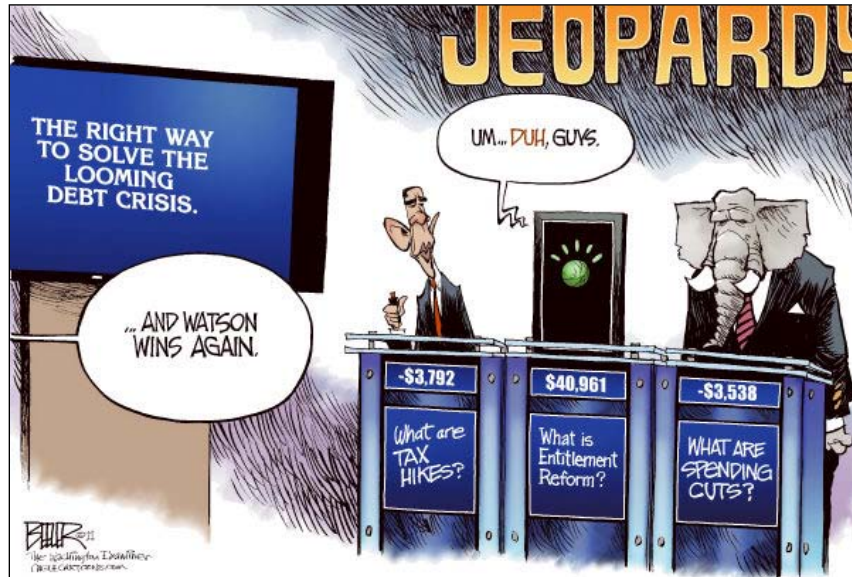
Domestic earnings season is entering its final phase, but there are a few reports that bear watching. This includes Merck, HP, Home Depot, Office Depot, Walmart, Dexia, KKR, Allianz, BASF, Gap, Kohls, Royal Bank of Scotland, Sears, Target and Lloyds Banking.

On Tuesday, oil producing countries meet in Riyadh, Saudi Arabia for the International Energy Forum, an effort to increase dialogue between oil producing and consuming

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nations. Ireland holds general elections on Friday.

## LIGHTER SIDE



Source: *The Washington Examiner*

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