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ECONOMIC & MARKET UPDATE: FEBRUARY 28, 2011 "WHEN INFLATION FUELS DEFLATION"

Economic Data - Previous Week

Date	Series	Actual	Survey	Prior	
2/22	S&P/CS 20 City MoM	-0.41%	-0.50%	-0.55%	19 of 20 cities down for 3rd consecutive month
2/22	Consumer Confidence	70.4	65.5	64.8	Sharp increase as labor outlook improves
2/23	Existing Home Sales	5.36M	5.20M	5.22M	Unexpected increase, but prices down sharply
2/24	Durable Goods Orders	2.7%	3.0%	-0.4%	Volatile transportation component rebounds
2/24	New Home Sales	284K	300K	329K	Moderation after Dec. spike, despite price declines
2/25	GDP - Q4 2nd Est.	2.8%	3.3%	3.2%	Estimate down on revisions to imports, govt spending

Economic Data - Upcoming Week

Date	Series	Actual	Consensus	Previous	
2/28	Personal Spending	--	0.4%	0.7%	Auto, retail sales data point to increase
2/28	Pending Home Sales	--	-2.3%	2.0%	Decline expected in home contract signings
3/1	Construction Spending	--	-0.4%	-2.5%	Estimates slightly negative, public construction weak
3/1	ISM Mfg Index	--	61.0	60.8	Little room for improvement from 7 year high
3/3	ISM Non-Mfg Index	--	59.2	59.4	Analysts see continued expansion in service sectors
3/4	Nonfarm Payrolls	--	190K	36K	Significant job gains expected after weak Jan.
3/4	Unemployment Rate	--	9.1%	9.0%	Labor force participation to drive headline rate

Source: Bloomberg

GLOBAL HEADLINES SHIELD ONGOING IMPROVEMENT IN DOMESTIC ECONOMY

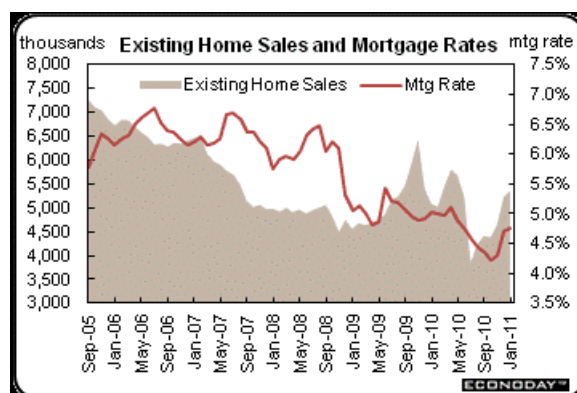
Global macroeconomic concerns led to the sharpest weekly sell off in the S&P 500 Index in three months. For the week, the S&P 500 Index was down 1.7% and the Dow Jones Industrial Average fell 2.1%.

A multitude of catalysts were behind the selloff, including concerns about the situation in North Africa and the Middle East, surging commodity prices, in particular crude oil, and finally, a feeling that equity valuations were moving into overbought territory.

There were only a handful of important domestic economic releases last week, including several data points on housing and the state of the consumer.

Beginning with housing, existing home sales rose 2.7% in January to a seasonally-adjusted annual rate of 5.36mln. Unfortunately, the average sales price fell almost 6% in the

month as distressed sales accounted for 37% of the total activity.

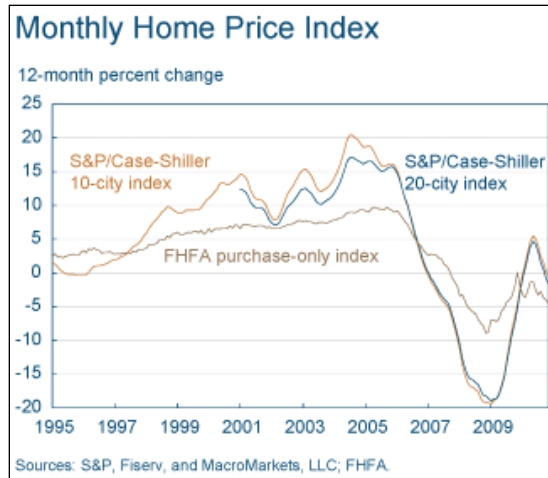


Source: Econoday

The direction of home sales was confirmed by both the S&P Case-Shiller Home Price Index and the FHFA purchase only index. Both indices, which measure repeat sales activity, are in negative territory on a year over year basis, owing to the fact that excess supply and the disappearance of the home buyer tax

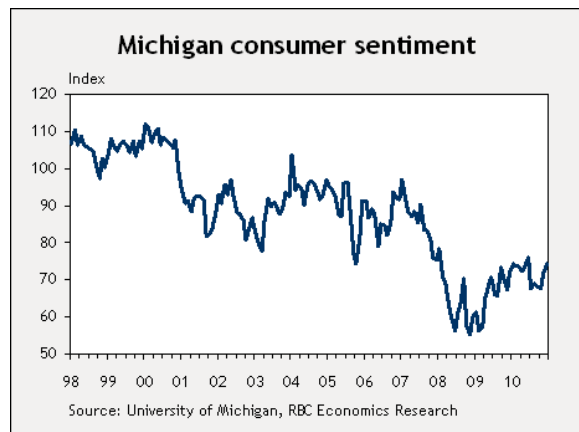
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credit are placing downward pressure on prices.



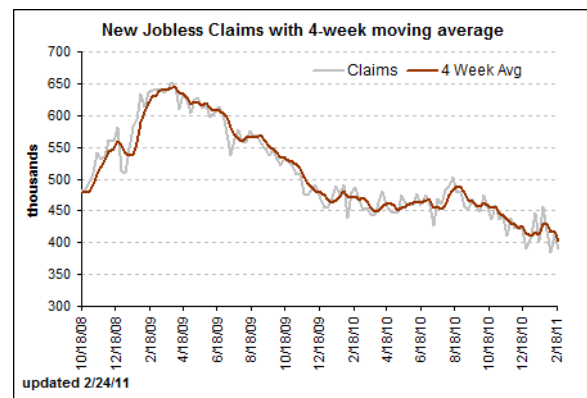
Source: Federal Reserve Bank of Cleveland

Despite the ongoing weakness in housing, consumers are becoming more confident in the recovery. The University of Michigan Consumer Sentiment Index rose from 75.1 to 77.5 in the most recent period. While the index is still well below its pre-crisis levels, there is a notable improvement in the 12-month expectations component of the survey, suggesting that consumers believe the recovery is here to stay.



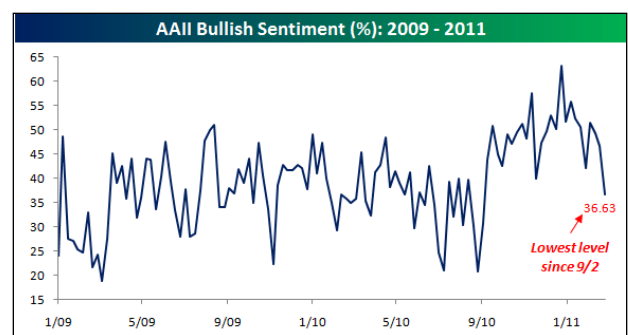
Source: Royal Bank of Canada

There are other reasons for consumers to be optimistic, specifically, the retrenchment of initial jobless claims. For the week ending February 19th, initial claims for jobless benefits fell from 410k to 391k, offering hope that a permanent break below the important 400k level is upon the economy. If initial claims hold below 400k on a consistent basis, the economy could be set up for strong positive job growth, finally.



Source: Econoday

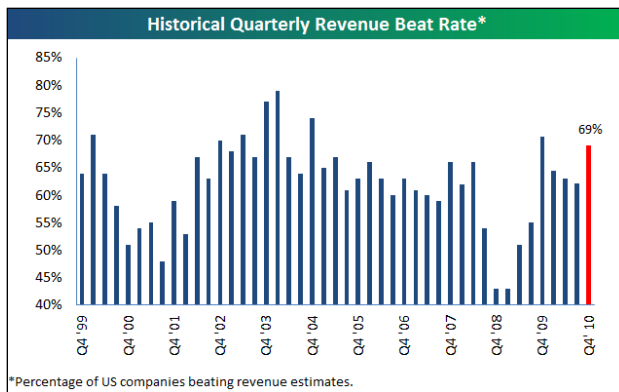
One of the biggest concerns during the equity market rally of the last several months was an overly-optimistic retail investor base. Interestingly, individual investor sentiment retreated below its long-term historical average last week with nary a correction in sight. At 36.6%, bullish optimism was about 2.5% below its long-term average, the first such time it was below the average in 25 weeks.



Source: Bespoke Investment Group

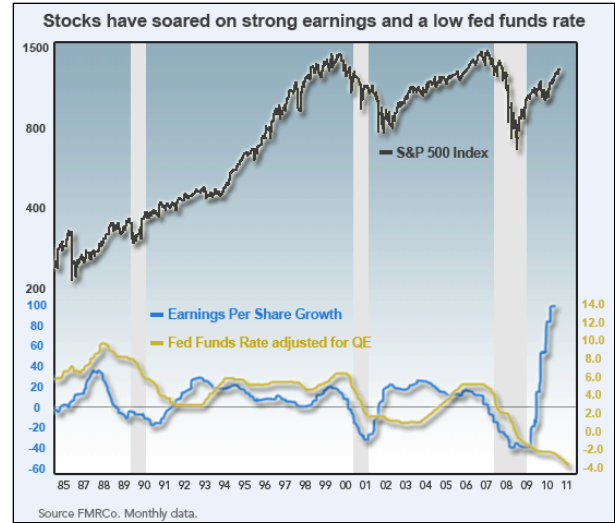
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One reason stocks continue to do so well is the improvement experienced in corporate earnings. During the fourth quarter, 66% of companies beat per share earnings expectations and 69% beat revenue estimates, according to Bespoke Investment Group. The per share earnings beat rate was a slight improvement from last quarter, but the revenue beat rate was one of the higher readings from the past decade.



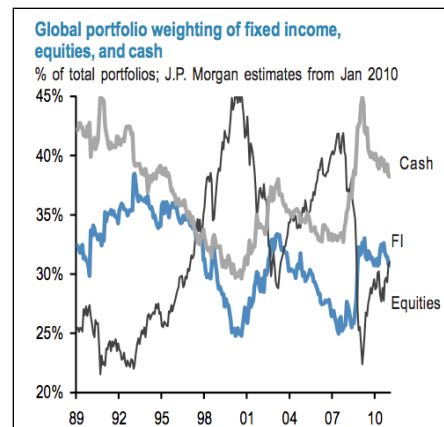
Source: Bespoke Investment Group

The second, and undoubtedly more important, factor behind the rally is the role of quantitative easing on the markets. Earnings per share growth soared once the Fed Funds rate neared 0%. When adjusting the rate to include the impact of QEII real interest rates eventually dipped into negative territory, further encouraging corporate earnings and subsequently, equity prices.



Source: Fidelity

Even accounting for the strength of the rally, investor allocation to equities is only now returning to its 20-year average, based on data from JP Morgan. With sentiment retreating, QEII ongoing and equity allocations only now returning to average, the environment for equities remains supportive, but investors should be careful when the excessive liquidity of QEII starts to get sucked back out of the system.



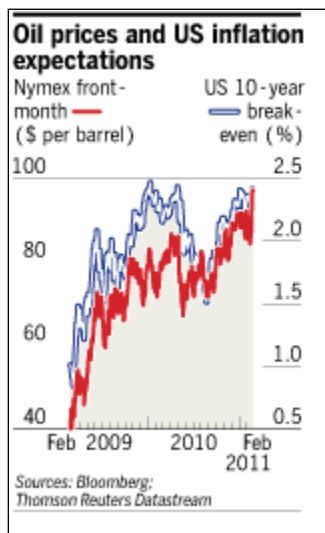
Source: Business Insider

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AN INFLATIONARY MIRAGE FROM THE DESERT

In the rush to jump on the inflation bandwagon, many investors and economists alike forgot one small problem. Surging energy costs are an inflationary phenomenon in the short term, but on a sustained basis pose a major deflationary threat to the global economy.

Since troughing in early 2009, energy costs more than tripled, with a barrel of West Texas Intermediate Oil costing roughly \$100. At the same time, inflation expectations, as measured by the breakeven rate between 10-year Treasury bonds and 10-year Treasury Inflation-Protected Securities, jumped from nearly 0% to almost 2.5%.

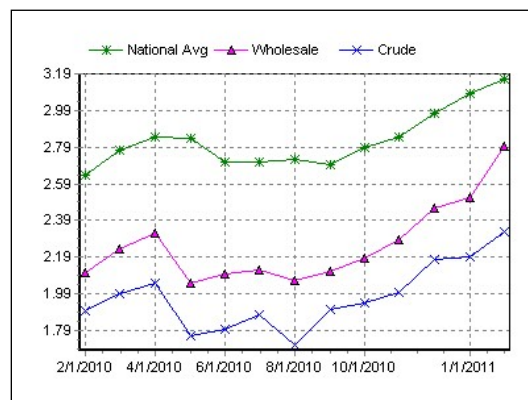


Source: *Financial Times*

It comes as no surprise that higher energy costs naturally act to increase investors and consumers expectations of future inflation. That is good news, because consumer expectations of future inflation tend to be self fulfilling. What the Federal Reserve desperately wanted to avoid at the peak of the crisis was a deflationary cycle, which is exactly what many common inflation indicators were suggesting.

When energy prices surge and inflation expectations along with them, however, there is a different result. In a typical credit expansion cycle, rising inflation expectations lead to rising wage growth or credit spending. During commodity inflation, corporate profit margins fall under pressure as companies struggle to keep up with higher costs. Consumer wage growth stagnates in a corporate effort to control costs and consumers also struggle to balance higher energy costs in everyday life.

As an example, average retail gas prices in the US are up almost 60 cents in the past 12 months. Each one cent increase in a gallon of gas reduces consumer disposable income by \$600mln annually.



Source: *AAA Daily Fuel Gauge*

Eventually, consumers allocate a greater and greater portion of wages to cover energy costs. This detracts from discretionary spending elsewhere, reducing overall purchasing power. Ultimately, that results in increased risk of recession.

Many are quick to brandish the recent energy cost surge as an inflationary event. That is true in the short term, but a continuation of this trend will be very dangerous to the economy.

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THE WEEK AHEAD

Economic data will garner attention this week, but headlines from the Middle East will continue to play a large role in market activity.

Of importance this week will be the ISM Manufacturing Index on Tuesday. Manufacturing activity has been a rare bright spot in recent quarters, but with a diminishing role in the overall economy, it will not be enough to sustain the recovery. On Wednesday, the Beige Book will provide an update on economic conditions in each of the Federal Reserve districts. Friday brings about

the all important February payroll report. January brought about a fairly disappointing nonfarm payroll gain of 36k, but the unemployment rate plummeted to 9.0%. Economists expect more robust job growth in February, but foresee a reversal of fortunes for the unemployment rate.

While earnings seasons is all but over, a handful of companies will report this week, including Allied Irish Banks, Costco, Staples, Continental, Del Monte, HJ Heinz, Kroger, and Hermes.

LIGHTER SIDE



Source: *The Toronto Star*



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