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## ECONOMIC & MARKET UPDATE: MARCH 7, 2011 "WILL THE GLOBAL RECOVERY BE BROUGHT TO ITS KNEES BY COMMODITY PRICES?"

### Economic Data - Previous Week

Date	Series	Actual	Survey	Prior	
2/28	Personal Spending	0.2%	0.4%	0.5%	Spending cools after string of strong months
2/28	Pending Home Sales	-2.8%	-2.3%	-3.2%	Contracts weak in January, Dec. revised down
3/1	Construction Spending	-0.7%	-0.4%	-1.6%	Jan spending decline led by private non-res
3/1	ISM Mfg Index	61.4	61.0	60.8	Broadly positive indicator points to mfg health
3/3	ISM Non-Mfg Index	59.7	59.2	59.4	Service business activity, employment improving
3/4	Nonfarm Payrolls	192K	190K	63K	Robust job gains stronger in private sector
3/4	Unemployment Rate	8.9%	9.1%	9.0%	Labor force participation little changed

### Economic Data - Upcoming Week

Date	Series	Actual	Consensus	Previous	
3/7	Consumer Credit	--	\$3.5B	\$6.1B	Auto sales should boost credit outstanding
3/8	Small Business Optimism	--	95.1	94.1	Continued improvement expected
3/10	Trade Balance	--	-\$41.5B	-\$40.6B	Trade gap expected to widen slightly
3/11	Retail Sales	--	1.0%	0.3%	Gas prices, auto sales to buoy sales
3/11	Umich Confidence	--	76.5	77.5	Moderation expected from 3 yr high
3/11	Business Inventories	--	0.8%	0.8%	Factory data to boost overall inventory number

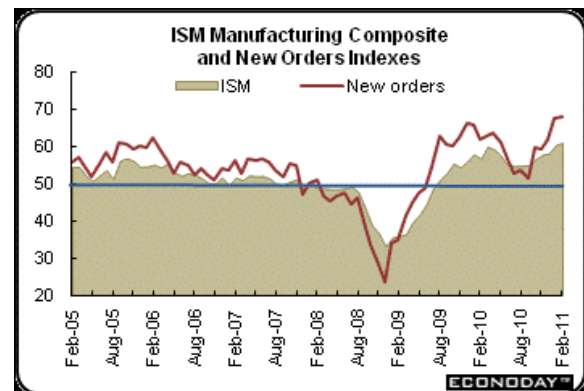
Source: Bloomberg

### STOCKS STUMBLE TO A WINNING WEEK

Both equity indices narrowly avoided consecutive weeks of losses, after buyers jumped into the market with less than an hour left on Friday, allowing the S&P 500 index to close with a gain of 0.1% for the week and the Dow Jones Industrial Average to post a 0.3% gain.

All eyes were affixed on Friday's employment report, but macroeconomic headlines from the Middle East continued to drive oil prices higher, weighing on equity prices.

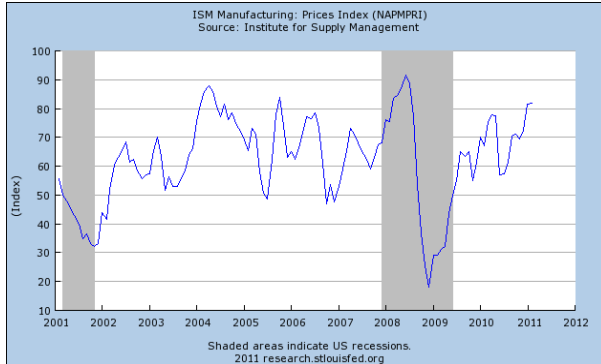
After being left for dead much of the past decade, the US manufacturing sector is experiencing a bit of a renaissance. The Institute for Supply Management (ISM) composite index rose another 0.6% to 61.4% in February (levels above 50% are indicative of expansion in the manufacturing sector). That is the highest reading since May 2004 and is tied with May 2004 as the highest reading in the past two decades.



Source: Econoday

Manufacturers cite exports as the leading cause behind the recent strength, but recognize that a surge in raw material costs is a possible hindrance to future growth. The ISM Prices Index reached a scorching 82% in February and while it remains below the near 92% reading in mid-2008, the trend higher is quite obvious. Activity in manufacturing is unlikely to slow for the time being, however,

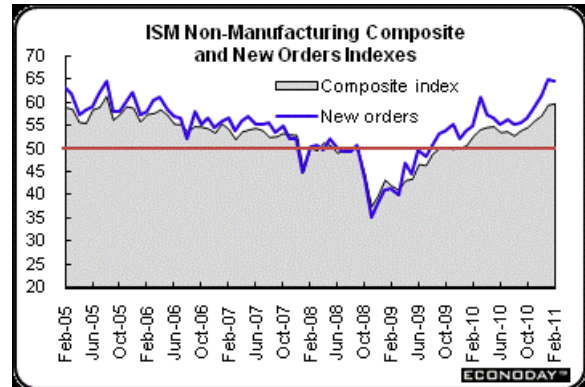
given a new orders index that is signaling growth for the foreseeable future.



Source: Federal Reserve Bank of St. Louis

Industries away from manufacturing are dually benefitting from the ongoing recovery. The ISM Non-Manufacturing Composite Index increased 0.3% in February to 59.7%. With a new orders index above 64%, service oriented sectors should continue to experience positive growth in the months ahead. On the

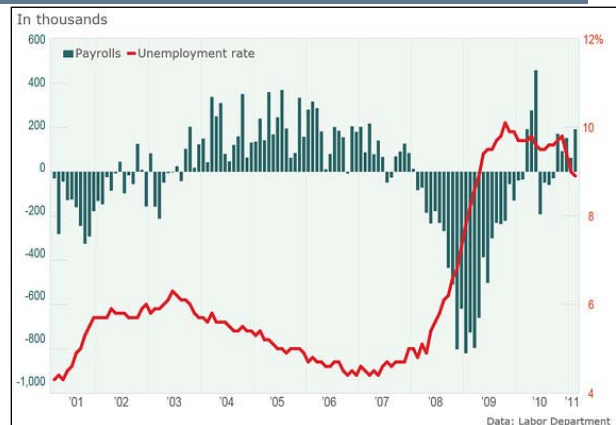
cautionary side, though, input prices are rising just as fast in the service sector and pose a potential stumbling block moving forward. One survey respondent wrote “commodities are once again putting significant pressure on prices and capacity.”



Source: Econoday

## ARE LABOR MARKETS FINALLY ENTERING THE HEALING PHASE?

Following a January employment report that was roiled by snowy weather, expectations were for a gangbusters print for February. That turned out to be the case and although many thought employment growth would surprise to the upside for February, the in line growth of 192k offered support for the notion that the labor markets are healing, albeit at a slower than desired pace.



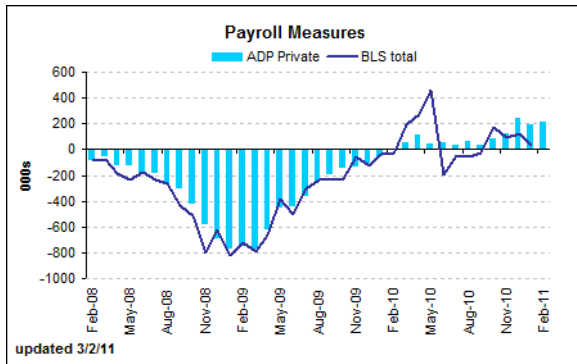
Source: Marketwatch

Leading up to Friday’s employment report, markets received two bullish data points that led to a 1.7% surge in the S&P 500 Index on Thursday.

First was the ADP national employment report, which indicated growth of 217k for

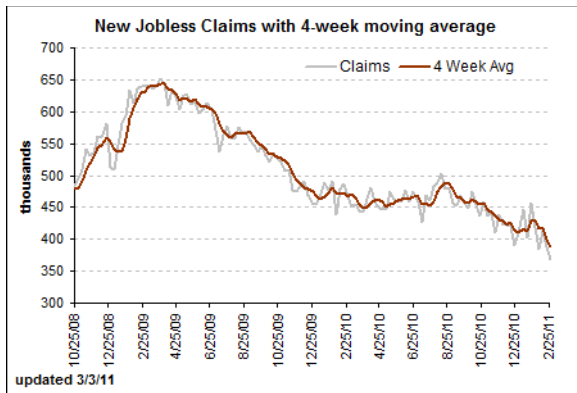
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private company payrolls. Unfortunately, the ADP report is not entirely in sync with the Bureau of Labor Services (BLS) reports in recent months, so traders took this one with a grain of salt.



Source: Econoday

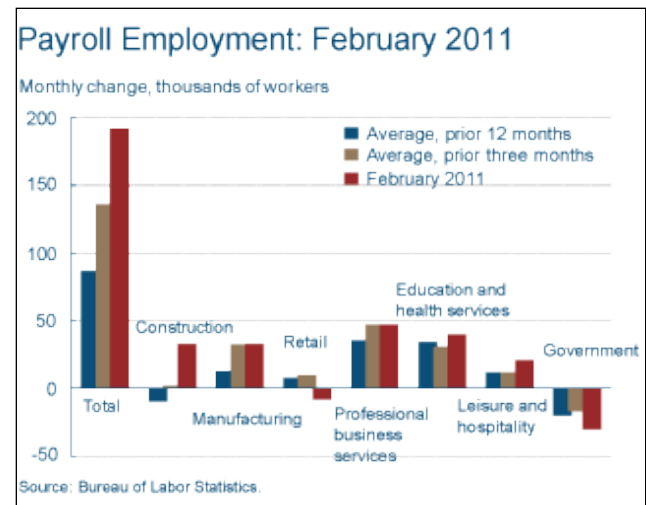
On Thursday morning, however, a substantial drop in initial claims for unemployment insurance bolstered hopes that February nonfarm payrolls would make up for January's disappointment. For the week ending February 26<sup>th</sup>, initial jobless claims fell 20k to 368k and the 4-week moving average was 388k. It marked the first time since July 2008 that the 4-week moving average of initial claims was able to break through the 400k barrier. Unfortunately, the BLS survey occurred in the week prior, possibly negating a portion of the positive improvement.



Source: Econoday

With markets anticipating job growth in excess of 200k, the BLS report turned into a very mild disappointment, eliciting a sell-off in the market. As mentioned previously, nonfarm payrolls experienced growth of 192k in February, while the unemployment rate dipped by 0.1% to 8.9%.

Job growth was fairly broad-based, with the exception of the government sector, which saw another 30k jobs disappear.



Source: Federal Reserve Bank of Cleveland

State and local government workers stomached the bulk of the job losses due to a concerted effort by states to balance budgets through cost cutting. There is no end in sight for this trend with numerous states proposing across the board spending cuts in advance of fiscal year 2012.



Source: Center on Budget and Policy Priorities

From a historical perspective, this recession is far and away the harshest in the postwar period. More than three years after the recession began, employment is still roughly 5.5% below its previous peak, translating into 7.5mln lost jobs.



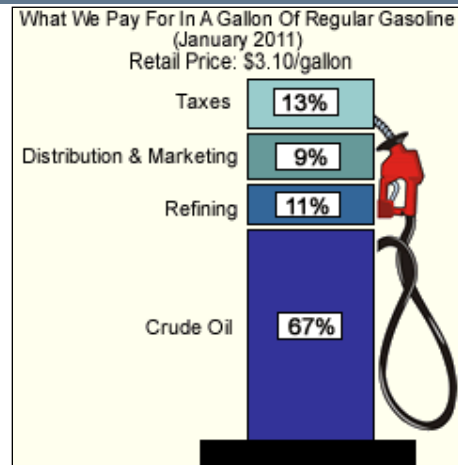
Source: Federal Reserve Bank of Minneapolis

Overall, the February jobs report was a move in the right direction, but there is no doubt that uncertainty remains and there is a long way to go before we return to a period of normal employment.

## BEWARE THE COMMODITY COSTS OF MARCH

It should be no surprise to consumers that crude oil prices have a strong impact on day to day gasoline prices, but that relationship has not always been as strong as in recent years.

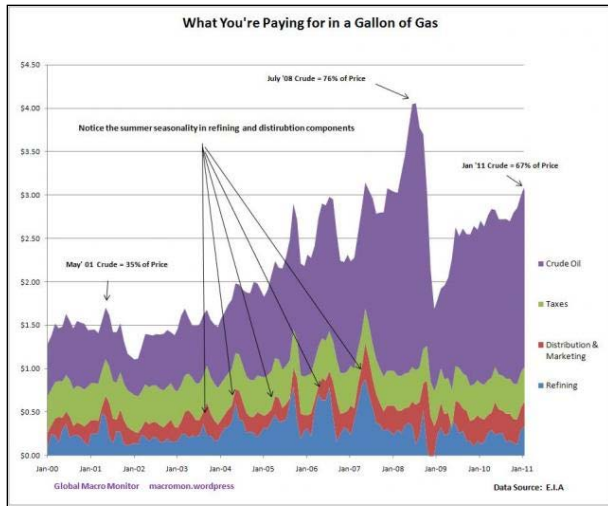
According to data from the Energy Information Administration, crude oil prices accounts for an unsurprising 67% of the cost for each gallon of regular gasoline. Taxes, distribution & marketing and refining costs account for the remaining 33%.



Source: Energy Information Administration

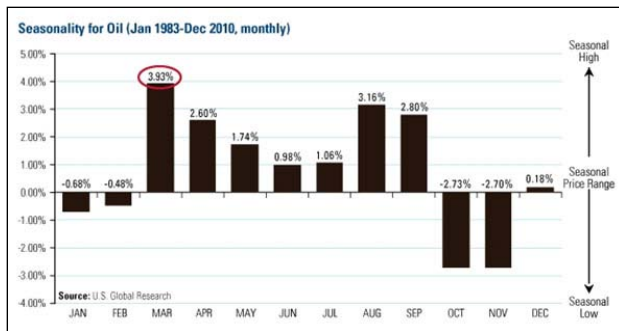
The story becomes interesting when we compare those figures on a historical basis. Barry Ritholtz discovered that early last decade, crude prices accounted for only 35% of the cost in a gallon of gas. At the peak in July 2008, crude represented 76% of the cost.

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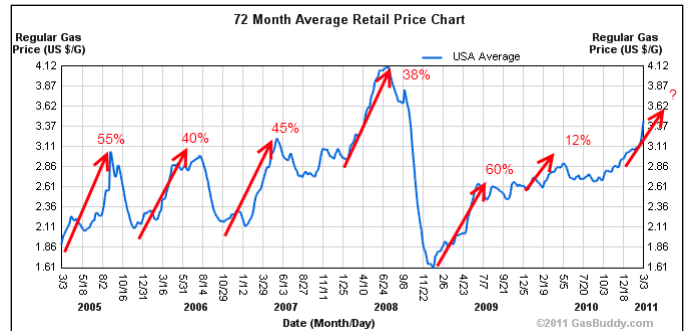
Source: *The Big Picture*

There is an inherent seasonality to crude and gasoline prices that is well documented. Crude prices begin to rise in early spring and generally do not experience an easing until October and November. In fact, crude prices rose an average of 3.9% during March over the past 27 years.



Source: *US Global Investors*

Changes in crude directly filter through to end consumers and four of the past six years, retail gas prices jumped 40% or more through the first half of the year.



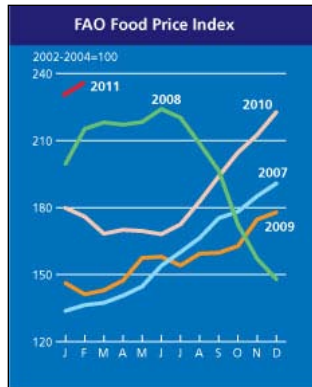
Source: *Pragmatic Capitalism*

Food inflation is regularly mentioned in the same breath as energy these days given the skyrocketing costs of most food commodities. As opposed to energy, though, costs of the farm account for 16 cents of every food dollar spent. The other 84 cents goes towards marketing, broadly defined to include processing, retailing, transportation and advertising – essentially all the steps required once food is cultivated.



Source: *US Department of Agriculture*

As the middle class grows in the emerging markets, though, prices are becoming more susceptible to factors outside the US. The Food and Agriculture Organization of the United Nations reported that food prices reached an all-time high in February behind higher prices for cereal, dairy, oils and meat.



Source: Food and Agriculture Organization

There is a dangerous trend developing in food and energy costs, one that threatens to derail the global recovery. Thus far, consumers are able and willing to accept higher commodity prices. With consumers still feeling the effects of the worst recession in nearly a century, though, there is only so much that people will be willing to tolerate and the second half of the year may be too far away, at least when it comes to crude prices.

## THE WEEK AHEAD

Consumers will receive the bulk of attention this week. Consumer credit outstanding is expected to show a moderate gain for January following the first gain in 27 months for revolving credit (credit cards, predominantly). Retail sales for February will be released on Friday, with expectations of a modest gain due to higher gasoline prices. Later that same day, the University of Michigan Consumer Sentiment Index will be announced.

China will release several important indicators during the week, notably CPI on Friday. Other Asian nations hold central bank meetings next week and it is likely that interest rate hikes will occur as a result of growing inflationary pressure. The countries with central bank meetings are Korea, Malaysia and Thailand. In Latin America, Peru's central bank is also expected to raise interest rates. The Bank of England will meet next week, as well, but economists are not expecting a change to its interest rate stance, despite 4% inflation in that country. England's central bank maintains a target of 2% per annum.

Events in the Middle East may trump all other releases this week, as Facebook users in Saudi Arabia announced a planned 'Day of Rage' protests on Friday, March 11<sup>th</sup>. Revolution in small oil producing nations such as Egypt and Libya has already had an obvious impact on global oil prices. Any whiff of revolution in Saudi Arabia would be downright detrimental to any already fragile recovery. Saudi Arabia accounts for 11% of global crude oil production and 15% of worldwide exports. The Saudi royal family is actively working to appease its citizens through a \$37bln social benefit program. An overthrow of the government is unlikely in Saudi Arabia, however, as the royal family is estimated to include at the minimum 30k people.

Three Treasury auctions are set for this week, including \$32bln of 3-yr notes (Tuesday), \$21bln of 10-yr notes (Wednesday) and \$13bln of 30-yr bonds (Thursday).

## LIGHTER SIDE



Source: Roll Call

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