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## ECONOMIC & MARKET UPDATE: MAY 9, 2011 "THE FINANCIAL IMPACT OF AN AGING DEMOGRAPHIC"

### Economic Data - Previous Week

Date	Series	Actual	Survey	Prior	
5/2	ISM Mfg Index	60.4	59.5	61.2	Slight moderation in new orders & production
5/3	Factory Orders	3.0%	2.0%	0.7%	Positive report shows strength across components
5/4	ISM Non-Mfg Idx	52.8	57.5	57.3	Slowdown in new orders mitigates services growth
5/6	Nonfarm Payrolls	244K	185K	221K	Surprise report even stronger ex-govt jobs
5/6	Unemployment Rate	9.0%	8.8%	8.8%	More jobless, labor force participation unchanged
5/6	Consumer Credit	\$6.02B	\$5.00B	\$7.55B	Rare uptick in credit card use boosts cons. credit

### Economic Data - Upcoming Week

Date	Series	Actual	Consensus	Previous	
5/11	Trade Balance	--	-\$47.0B	-\$45.8B	Higher oil prices should increase value of deficit
5/12	PPI	--	0.6%	0.7%	Energy to keep producer costs up, core prices softer
5/12	Retail Sales	--	0.6%	0.4%	Jump in energy costs to distort sales upward
5/12	Business Inventories	--	0.9%	0.5%	Factory data points to increase in inventories
5/13	CPI	--	0.4%	0.5%	Energy to boost headline rate, core prices softer
5/13	UMich Confidence	--	70.0	69.8	Analysts expect sentiment reading to remain stable

Source: Bloomberg

### DASTARDLY WEEK FOR EQUITY MARKETS ENDS WITH NOT SO BAD NEWS

A volatile week of trading resulted in the S&P 500 Index losing 1.7% and the Dow Jones Industrial Average falling 1.3%. However, those losses were tame relative to the rout experienced in commodity markets. According to the Wall Street Journal, crude oil dropped 14.7% last week, while the Dow Jones-UBS Commodity Index lost 9.1%.

There was no single cause for the sudden risk aversion, but it appears that recognition of a slowing US economy, along with tighter monetary policy in developing economies, contributed to the renewed caution.

The Citigroup Economic Surprise Index (CESI) is a prime example of the deterioration occurring across the globe. The CESI tracks economic data in each of the G10 economies. When it is in positive territory, economic data is beating economists' forecasts; when it is in negative territory, economic releases are surprising to the downside.

After consistently holding in positive territory since early 2009, the CESI plunged at the end of April. The Index dropped from 14 to -20 in little more than one week. Similar weakness was apparent entering the summer season in 2010, but the CESI was able to avoid a dramatic entry into negative territory.



Source: Bloomberg

The picture in the US is comparable. Positive economic surprises reached a peak in March before data began disappointing. However, unlike the G10 data, the US went through a

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series of fits and starts over the past several years and drops into negative territory were common.



Source: Bloomberg

That is not to say domestic news was entirely disappointing last week, but the lead up to Friday's payrolls report left many investors with a queasy feeling.

Manufacturing growth, for instance, slowed moderately last month with the headline PMI falling from 61.2 to 60.4. Even though PMI fell, it remains well above the expansion/contraction demarcation line of 50 and is tied for the ninth strongest reading of the past decade.



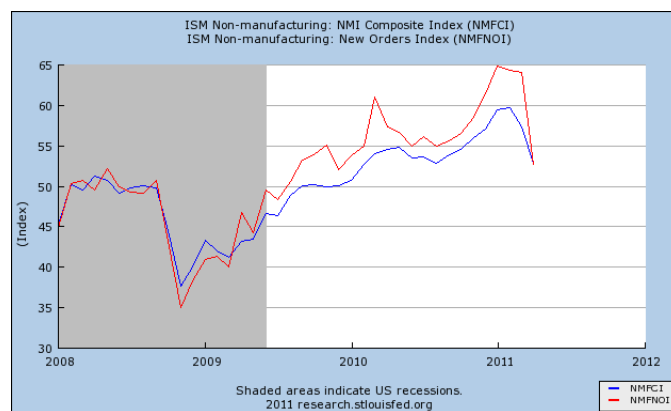
Source: Econoday

The larger concern for manufacturers is the decline in the new orders index, dampening growth momentum for the quarters ahead. A similar pattern was evident entering the

summer season last year, however, this was before both the new orders index and the PMI rebounded.

The ISM Non-Manufacturing (NMI) slowed dramatically in April, plunging from 57.3 to 52.8. The headline NMI is dangerously close to a contractionary reading of below 50, and underlying trends are not offering much support for the future.

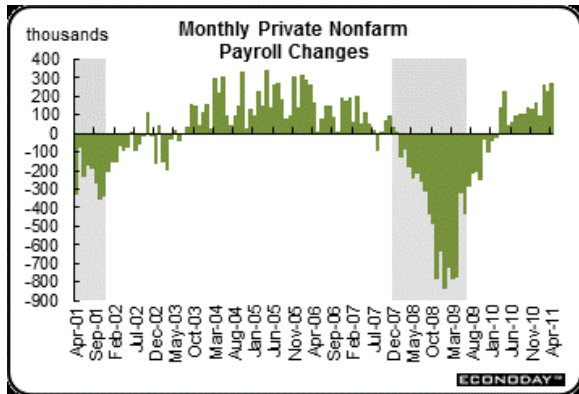
Behind the April decline was an accelerated drop in the new orders index, which plummeted from 64.1 to 52.7. NMI and new orders move virtually in tandem so the slower growth in new orders bodes poorly for the service sector looking forward.



Source: Federal Reserve Bank of St. Louis

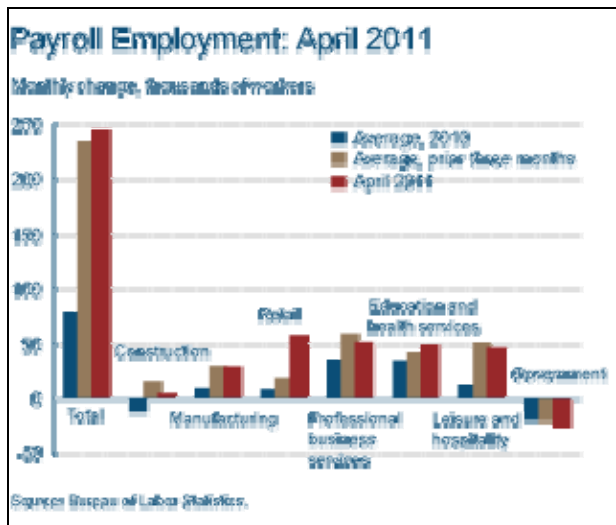
A potential coup de grace arrived Friday morning in the form of nonfarm payroll employment for April. Already jittery markets were on the verge of a further decrease if labor growth disappointed to the downside. Fortunately, job growth provided a positive surprise at 244,000 for April. Private sector payrolls grew 268,000 in April, outperforming headline job growth due to the ongoing contraction in state and local government.

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Source: Econoday

Sectors experiencing the strongest employment growth last month included retail, manufacturing, professional services, health care and education.

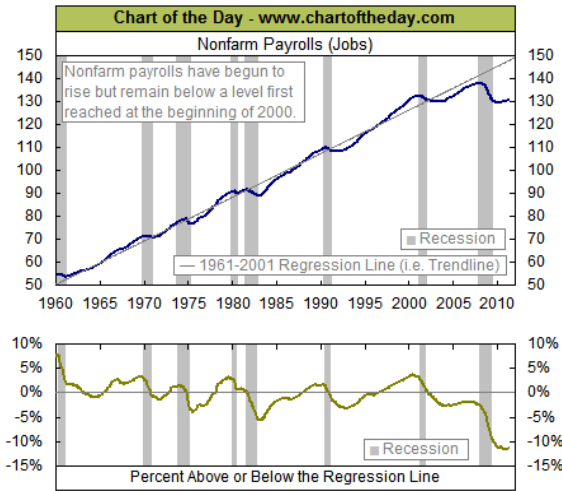


Source: Federal Reserve Bank of Cleveland

Offsetting strong job growth was a 0.2% rise in the unemployment rate to 9.0%. In recent months, the unemployment rate fell faster than job growth would indicate, so this appears to be a case of the unemployment rate converging back toward nonfarm payroll trends.

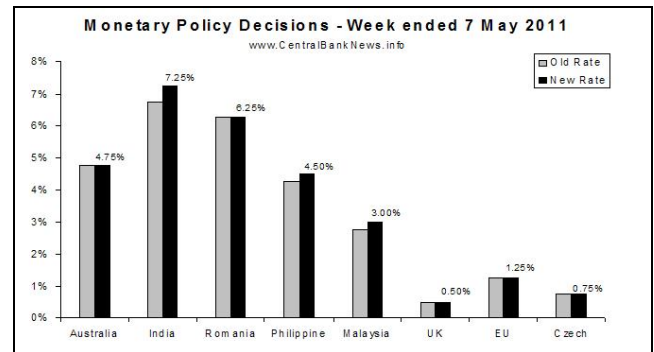
At the current level, nonfarm payrolls are more than 10% below the 40-year trend rate which began in 1960. In order for the US to

recapture the long-term trend line, job growth needs to grow much faster than the pace seen over the past few months.



Source: Chart of the Day

The final headwind for markets occurred outside of the US last week, specifically in several emerging market central banks. Three countries in particular (India, Philippines and Malaysia) elected to tighten monetary policy. India raised interest rates by 50 basis points while the Philippines and Malaysia elected for 25 basis point rate hikes.



Source: CentralBankNews.info

The Bank of England and the European Central Bank (ECB) also held policy meetings, but there was no change to interest rates in either case.

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## WHAT'S AGE GOT TO DO WITH IT?

At the start of this year, baby boomers began the move towards retirement. With all the attention given to social security and entitlement programs, investors are ignoring the biggest trend that will shape the financial landscape in the next 50 years - demographics.

For anyone who watches the nightly news, it will come as little surprise that the US and global population is aging. Between 2010 and 2050, the Population Reference Bureau estimates the number of people 65 or older will grow from 40 million to 89 million in the US alone.

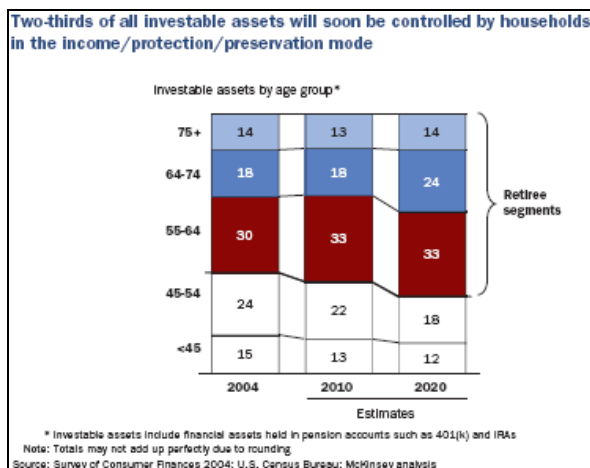
The implications from such a move are obvious – retirees will sell assets, dampening the return potential of those securities, especially equities. McKinsey & Company estimates that by 2020, individuals 55 and older will control 71% of household investable assets. However, there may be reason to believe that equity markets will outperform even as retirees liquidate those assets.

Italy found that demographics strongly influence equity market performance.

MY is a little known calculation that looks at the ratio of a population in its 40s relative to the number of individuals in their 20s. Researchers discovered that as the middle-aged portion of the population grows relative to the young population, equity markets outperform. Vice versa, as the younger population grows faster than the middle-aged population, equity market performance declines.

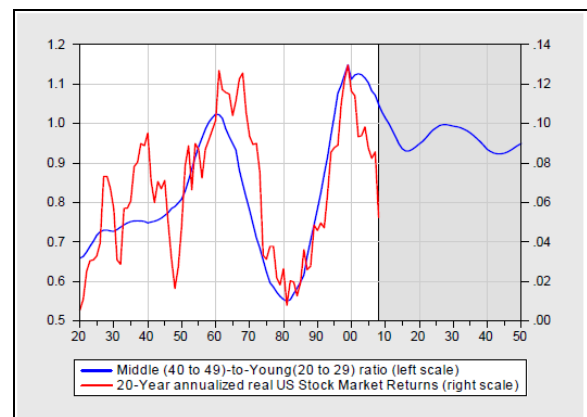
The reasoning behind such a phenomenon is intuitive. Younger generations tend to make less and thus spend less money, resulting in weaker corporate revenue growth.

The work done by Bocconi University shows the MY ratio in the US will continue a decline that began in 2000 until at least 2014 or 2015. However, at that point, the ratio reverses and begins a 10-year upswing. This suggests volatile equity market performance will continue in the next several years, but a favorable demographic profile will benefit US equity market performance in the latter half of this decade.



Source: McKinsey & Company

Using a ratio known as the middle-young ratio (MY), researchers at Bocconi University in



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Taking the experiment one-step further, the same researchers estimated the equity risk premium for the next forty years. Contrary to popular opinion (which believes baby boomers will depress equity market valuations), researchers found the equity risk premium for the next four decades to be 5%.

Investors are continually inundated with bearish news about the financial markets, but for investors with the ability to eliminate the noise in the markets and look beyond next week, or even next year, there is reason to be optimistic. Just remember, this requires a very, very long time horizon.

## THE WEEK AHEAD

There is a full economic calendar scheduled for release this week, with particular focus on inflation and the pace of consumer spending. The release of the Producer Price Index will shed light on the degree to which soaring energy costs are affecting producers. Consumer inflation, scheduled for release Friday, is equally likely to show the impact of rising energy costs, but core inflation will be modest. Retail sales for April should show a moderate gain, but again, the jump in energy costs will distort headline sales.

Three Treasury auctions scheduled for this week include \$32 billion of 3-year notes (Tuesday), \$24 billion of 10-year notes

(Wednesday) and \$16 billion of 30-year bonds (Thursday).

The corporate earnings carousel is beginning to slow, but a mix of notable companies will report in the week ahead. This list includes Toshiba, Toyota, Nissan, Nordstrom, Kohl's, Macy's, Sysco and Wendy's.

On Monday and Tuesday, Chinese officials will hold strategic and economic talks with their US counterparts in Washington, DC. Revaluation of China's currency is likely to be a key point of discussion.

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