

ECONOMIC & MARKET UPDATE: MAY 16, 2011 "IS INFLATION IN THE PROCESS OF PEAKING?"

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Economic Data - Previous Week

| Date | Series | Actual | Survey | Prior | |
|------|----------------------|----------|----------|----------|---|
| 5/11 | Trade Balance | -\$48.2B | -\$47.0B | -\$45.4B | Oil prices increase deficit despite strong exports |
| 5/12 | PPI | 0.8% | 0.6% | 0.7% | Energy keeps producer costs up, core prices softer |
| 5/12 | Retail Sales | 0.5% | 0.6% | 0.9% | Gasoline prices inflate sales data |
| 5/12 | Business Inventories | 1.0% | 0.9% | 0.5% | Inventory build in line with expectations |
| 5/13 | CPI | 0.4% | 0.4% | 0.5% | Gasoline prices boost headline, core inflation soft |
| 5/13 | UMich Confidence | 72.4 | 70.0 | 69.8 | Positive expectations component lifts confidence |

Economic Data - Upcoming Week

| Date | Series | Actual | Consensus | Previous | |
|------|-----------------------|--------|-----------|----------|---|
| 5/17 | Housing Starts | -- | 568K | 549K | Analysts look for improvement in starts |
| 5/17 | Industrial Production | -- | 0.4% | 0.8% | Mixed indicators point to slowdown in IP |
| 5/19 | Existing Home Sales | -- | 5.20M | 5.10M | Continued improvement expected from weak Feb. |

Source: Bloomberg

INFLATION HEADWINDS GROW, BUT MAY PROVE TEMPORARY

Investors turned away from the equity markets last week, as the S&P 500 Index fell 0.2% and the Dow Jones Industrial Average shed 0.3%.

Stocks started the week in positive fashion, but an uptick in risk aversion on Wednesday weighed on markets. Market participants were caught off guard by unfavorable inflation statistics from China, a tightening of monetary policy in China and recent strength in the US dollar.

At the beginning of May, we mentioned that the US dollar was nearing oversold territory and traders would likely capture profits in the weeks ahead. That is exactly what occurred as the US Dollar Index reached a trough at the start of the month and has since rallied. On May 2nd, the dollar index opened at 73 and by this past Friday hit an intraday peak near 76.



Source: Bloomberg

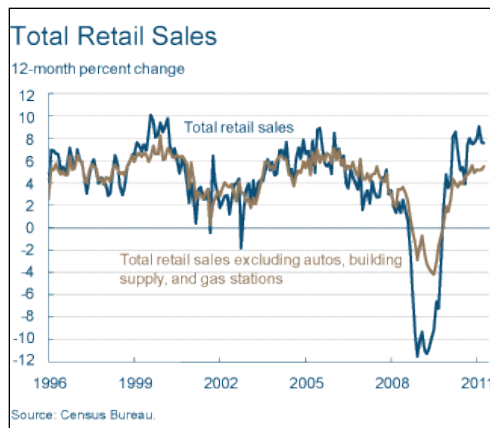
Data from the Commodity Futures Trading Commission confirms that traders are unwinding short dollar holdings. The most recently available data (updated through May 10th) shows that traders exited nearly \$10 billion of short dollar contracts in the prior week. The dollar has thus far been able to avoid its summer 2008 lows, but recent strength may prove fleeting.

Economic news focused on consumers and the impact of inflation last week. So far,

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consumers are proving resilient, but growing inflation pressure could be problematic entering the second half of 2011.

Retail sales increased 0.5% in April for a year-over-year gain of 7.6%. Headline retail sales slowed moderately from a 0.9% growth rate in March. Economists anticipated the slowdown after several strong retail sales prints to start the year.



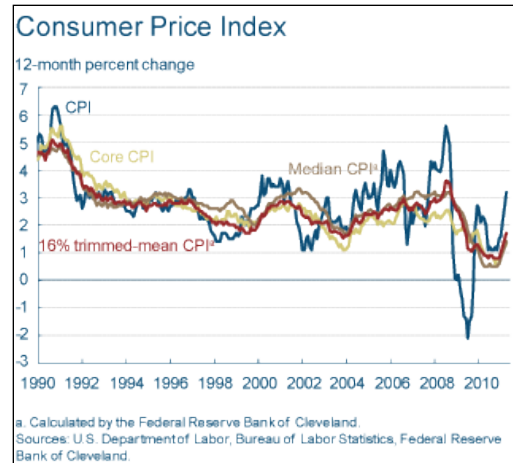
Source: Federal Reserve Bank of Cleveland

Not surprisingly, the rise in gasoline prices is having an outsized impact on headline retail sales. Spending on gas increased 4.1% in March, followed by another 2.7% rise in April. Core retail sales, which exclude gas & autos, posted a weak 0.2% gain in April, the weakest such growth rate in 2011.

Retail sales represented an area of particular strength for the economy in the first quarter, so April's weaker report was not troubling. Gas prices will continue to challenge consumers into the summer driving season and could result in a series of disappointing retail sales figures in the months ahead.

At the same time, inflationary pressure is rising to the surface in certain areas of the economy. The Consumer Price Index (CPI)

rose 0.4% in April and prices excluding food and energy were up 0.2%.



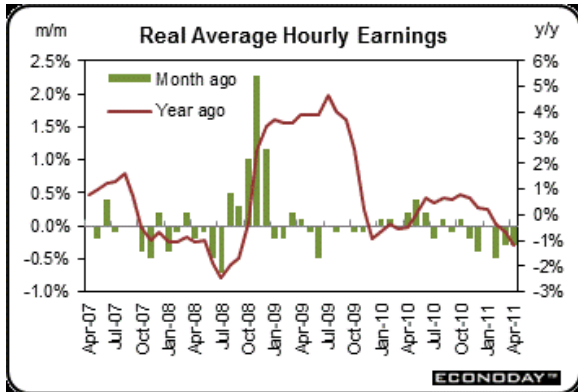
Source: Federal Reserve Bank of Cleveland

Energy prices were up 2.2% in April and have now risen by more than 18% in the past year. Food costs grew 0.4% in April and are up slightly more than 3% year-over-year.

There is little likelihood of a rapid acceleration in consumer prices. Outside of food and energy, costs are mostly contained. Housing remains weak and the ability of service sector firms to pass through higher costs is limited.

The overriding concern for consumers is that purchasing power is declining. Inflation-adjusted hourly wages dropped 0.3% in April and have consistently fallen into negative territory over the past six months. Last month, wages rose 0.1%, far less than the 0.4% jump in inflation.

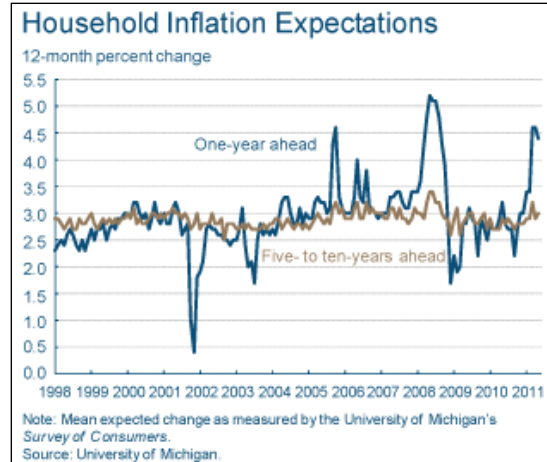
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Source: Econoday

Consumers are hopeful that recent inflation pressure is temporary. The most recent University of Michigan Consumer Sentiment Survey showed that one-year-ahead inflation expectations decreased modestly from 4.6% in April to 4.4% in May. According to the

Federal Reserve Bank of Cleveland, the release specifically pointed to consumers' belief that gas prices will fall as the reason behind the decline in expectations.



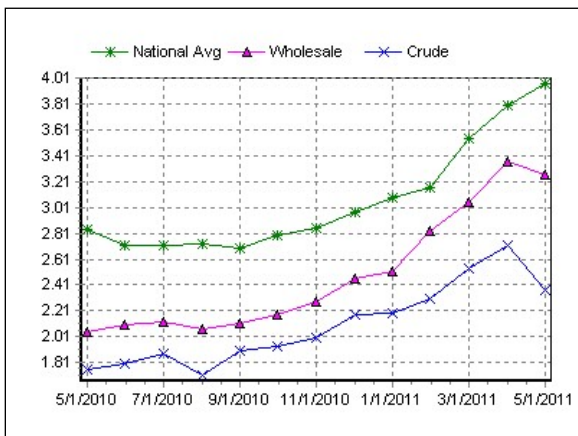
Source: Federal Reserve Bank of Cleveland

AND YOU THOUGHT YOUR GAS WAS EXPENSIVE

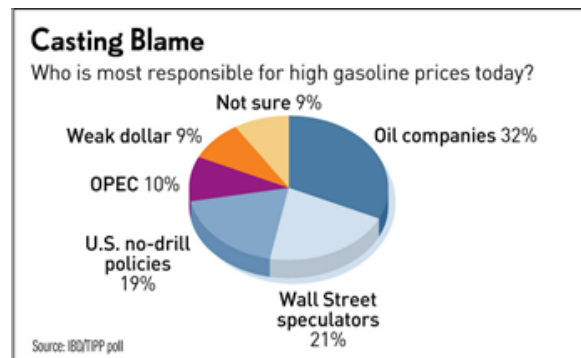
Despite the selloff in crude oil futures, retail gas prices continue to head higher. Behind the ongoing rise is a multi-faceted problem that is unlikely to resolve itself in the near-term.

Consumers are directly blaming oil companies and Wall Street speculators for soaring gas prices. A recent Investor's Business Daily Survey showed that 32% of respondents thought oil companies were responsible for high gas prices, and another 21% thought it was due to Wall Street speculators.

On May 16th, AAA reported that the national average for a regular gallon of gasoline was \$3.96.



Source: AAA Daily Fuel Gauge Report

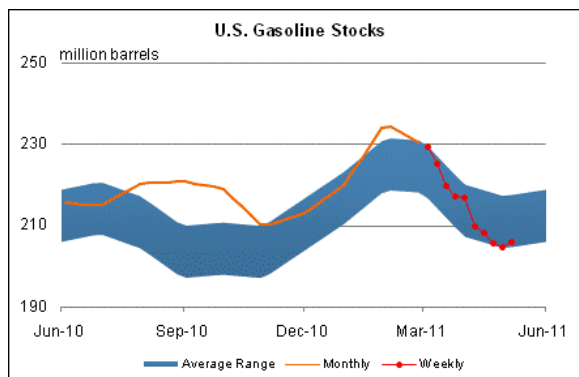


Source: Investor's Business Daily

Supporting that notion, consumers should not be surprised to learn that crude oil stocks are above average for this time of year, suggesting that prices are well above where they should

be. The trouble arises when we look at gasoline stocks. Generally, at this time of the year, gasoline stocks are between 210 and 220 million barrels.

This year, because of growing demand, gas stocks are at the bottom end of the long-term average range.



Source: U.S. Energy Information Administration

For as much as consumers want to grumble about domestic gas prices, they have little room for complaint. Relative to other developed nations, the US enjoys some of the lowest prices in the world. In fact, the price per liter for gas in the US is less than half that of some developed nations.



Source: Pragmatic Capitalism

Favorable tax policies have largely insulated the US from the same exorbitant gas prices seen around the globe. Gas prices are likely to fall in the weeks ahead because of the selloff in crude oil futures, but consumers should recognize that the era of cheap gas is fading.

THE WEEK AHEAD

Any number of events could move the markets this week, from discussions about the US Treasury debt limit to meeting minutes from the most recent gathering of the FOMC.

On Monday, the US Treasury Department is likely to hit its \$14.294 trillion borrowing limit. Through various means, the Treasury will be able to finance itself through August 2nd, but investors will closely watch discussions this week to determine if Congress is any closer to reaching a debt ceiling resolution.

The domestic economic calendar is relatively light, but several indicators will provide an update on the state of housing. Existing home sales rebounded marginally in March, following a steep decline in February. Economists expect a gradual rebound to continue as mortgage rates eased in the second half of April.

Companies reporting earnings this week include Dell, Home Depot, Wal-Mart, Hewlett-Packard and SAB Miller.



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