

ECONOMIC & MARKET UPDATE: JUNE 13, 2011
"MONEY IS FLOWING, BUT NOT TO WHERE IT IS MOST NEEDED"
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Economic Data - Previous Week

Date	Series	Actual	Survey	Prior	
6/7	Consumer Credit	\$6.25B	\$5.00B	\$4.82B	Auto sales drive non-revolving credit; CC use declines
6/9	Trade Balance	-\$43.7B	-\$48.8B	-\$46.8B	Oil price declines drive contraction in trade deficit
6/9	Wholesale Inventories	0.8%	1.0%	1.3%	First reading below 1.0% in four months

Economic Data - Upcoming Week

Date	Series	Actual	Consensus	Previous	
6/14	PPI	--	0.1%	0.8%	Falling energy prices to slow producer inflation
6/14	Retail Sales	--	-0.5%	0.5%	Lower gas prices, auto sales to weigh on retail data
6/14	Business Inventories	--	0.9%	1.0%	Inventories should grow to keep pace with sales
6/15	CPI	--	0.1%	0.4%	Falling energy prices to slow consumer inflation
6/15	Industrial Production	--	0.2%	0.0%	Regional surveys not supporting significant rise in IP
6/16	Housing Starts	--	545K	523K	Consensus expects rise from historically low levels
6/17	UMich Confidence	--	74.0	74.3	Cheaper gas may offset effects of weak econ data

Source: Bloomberg

DATA REMAINS AT SUB-OPTIMAL PACE, BUT SOME GOOD NEWS ARRIVES

The market selloff continued in full force last week with the S&P 500 Index falling 2.2% and the Dow Jones Industrial Average losing 1.6%.

In light of disappointing economic data, Federal Reserve Chairman Bernanke gave a speech indicating that we might be facing a period of temporary weakness. Bernanke said, "growth seems likely to pick up somewhat in the second half of the year."

Whether Bernanke ultimately turns out to be right is uncertain, but some indicators this week supported that notion.

One depiction of that phenomenon is the Citigroup Economic Surprise Index (ESI) for the US, an index that measures the number of economic releases surprising to the upside or downside. After reaching a peak near 100 in early March, the ESI plummeted, reaching a low of -117.2 on June 3rd.

Since that point, the index gradually began to rebound, closing inside of -100 on Friday. It is interesting to note that at the peak of the financial crisis, the ESI reached -140, only 20 points away from recent levels. Summer 2011 feels uncomfortable, but it is far from the disaster that occurred in fall 2008.

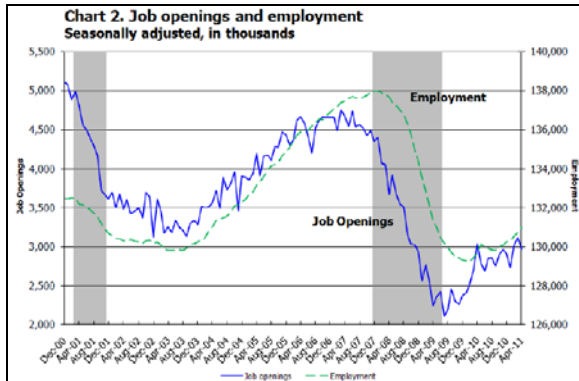


Source: Bloomberg

In a continued disappointing trend, labor markets showed no sign of improvement last week. The April Job Openings and Labor Turnover (JOLTS) report from the Bureau of

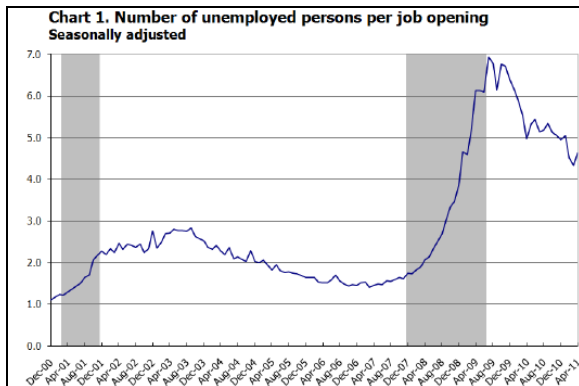
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Labor Statistics (BLS) found that the number of job openings fell from 3.1 million in March to 3.0 million in April.



Source: Bureau of Labor Statistics

Also disappointing was news that the number of unemployed individuals per opening remains elevated at 4.6. When the recession began in December 2007, there were only 1.8 unemployed persons for every job opening.

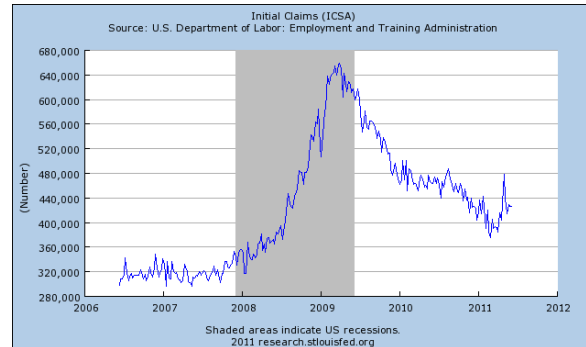


Source: Bureau of Labor Statistics

One positive takeaway from April's JOLTS report is that the number of people quitting their jobs exceeds the number of individuals laid off. When jobs are perceived to be available, there is a higher likelihood that someone will quit their position to find work in another company or industry.

Supporting May's weak nonfarm payrolls report, initial claims for the week ending June

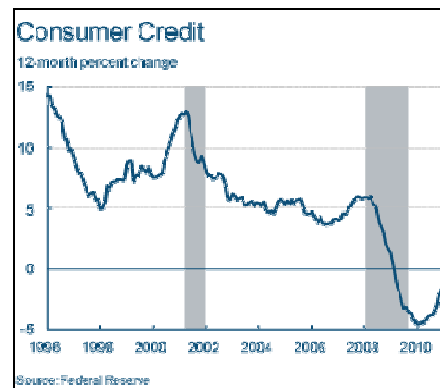
4th continued to be elevated. For the week, initial claims for unemployment benefits rose 1,000 to 427,000.



Source: Federal Reserve Bank of St. Louis

Economists believe that sustainable job growth is not possible until initial claims consistently stay below the 400,000 threshold. The 4-week moving average of initial claims (which eliminates week-to-week noise) moved lower in each of the past four weeks, but remains higher than desired at 424,000.

With an inability to find gainful employment, consumers continue to readjust their balance sheets. In April, consumer credit outstanding rose 3.1% from the prior month, an increase of \$6.3 billion.

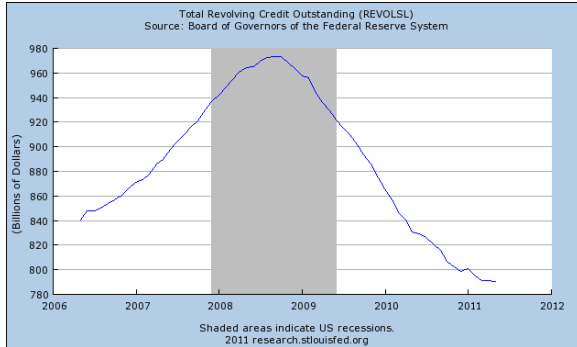


Source: Federal Reserve Bank of Cleveland

That gain was entirely attributable to a \$7.2 billion increase in non-revolving credit,

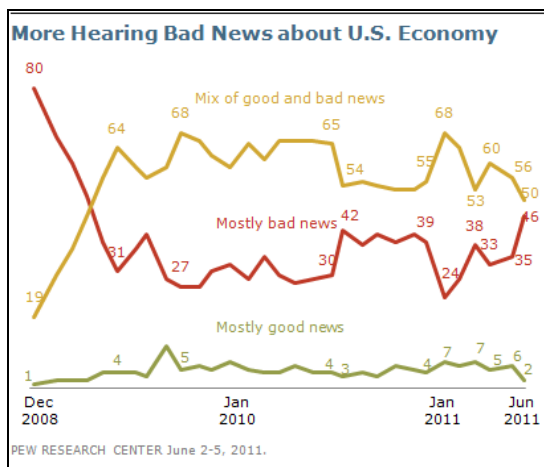
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consistent with ongoing strength in auto sales. Revolving credit (i.e. credit cards) fell \$0.9 billion in April and is down more than \$180 billion since the peak in mid-2008. Revolving credit has fallen in 30 of the previous 32 months.



Source: Federal Reserve Bank of St. Louis

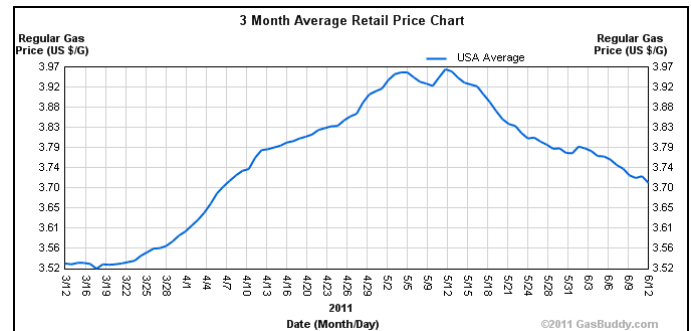
Recent news about the economy is doing little to put consumers in a more optimistic mindset. According to the News Interest Index, a weekly news survey from the Pew Research Center, 46% of Americans report hearing “mostly bad news” about the economy. The last time Americans were this downbeat was March 2009.



Source: Pew Research Center

Economic sectors enduring the highest pickup in pessimism include labor, real estate valuations, financial markets and food prices. On the positive side, the number of persons hearing “mostly good news” about gas prices jumped from 1% to 8% between mid-May and early June. Those hearing “mostly bad news” about gas prices plunged from 84% to 68% in the same timeframe.

Americans have reason to be optimistic about gas prices. Since the top in mid-May, the price per gallon for regular gas is down almost 30 cents. Every one-cent decline provides a substantial boost to consumer discretionary spending. Recent declines should act as a tailwind to spending in the second half of the year.



Source: Gasbuddy.com

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FUNDS ARE FLOWING, BUT TO WHERE?

Since the credit crisis began in earnest in the fall of 2008, US households saw asset values depreciate at an alarming rate. Recognizing the important role consumers play in furthering domestic economic growth, the Federal Reserve sought desperately to reinvigorate asset prices. Some might argue those efforts were successful but others would disagree vehemently.

Last week, the Federal Reserve's quarterly *Flow of Funds* report offered insight into the ongoing consumer balance sheet realignment. On a seasonally adjusted annual basis, household debt contracted 2.0% in the first quarter, led by a 3.4% drop in mortgage debt. Household debt has fallen in every quarter since the beginning of 2008.

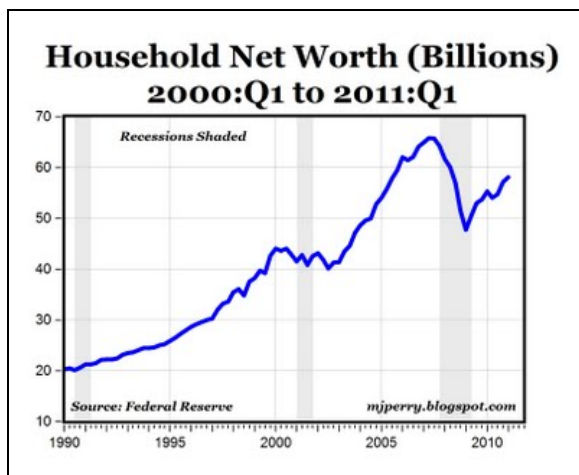
Efforts by the Fed to increase asset prices and in turn stimulate the economy are succeeding to some degree. Household net worth jumped to \$58 trillion at the end of the first quarter, up almost \$7 trillion since the end of 2008. This is more than \$6 trillion below year-end 2007, however.

The good news is that household liabilities are back to 2006 levels, but unfortunately, so are assets.

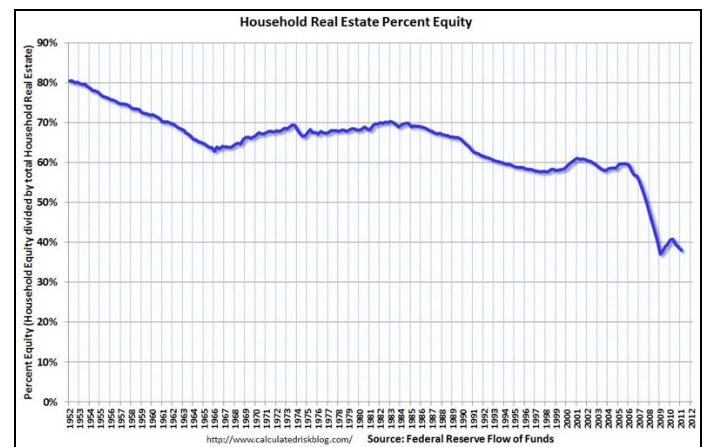
One especially troubling occurrence is that while net worth is increasing, it is happening in a concentrated manner. Holdings of equity securities and mutual funds, for instance, rose \$885 billion in the first quarter. On the other hand, real estate, the largest holding for most households, lost over \$300 billion of value in the quarter.

That is problematic because mortgage debt is not declining nearly as rapidly. Mortgage debt trimmed a mere \$68 billion in the first quarter.

Household equity, or what is left of it, is an ongoing issue for homeowners and one that is unlikely to reach a resolution in the near term. Between the mid-1960s and 2006, homeowner equity ranged from roughly 58% to 70%. In the aftermath of the 2008 credit crisis, homeowner equity is now at 38.1%. As pointed out by Calculated Risk, roughly one-third of households have no mortgage, so those that are left have far less than 38.1% in equity.



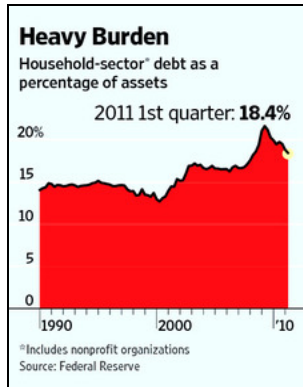
Source: *Benzinga*



Source: *Calculated Risk Blog*

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Even with mortgage debt falling and consumers shunning credit cards, the *Wall Street Journal* reports that Americans need to cut another \$26,172 of debt on average in order to return debt as a percent of assets to ranges seen in the 1990s.



Source: *Wall Street Journal*

In order to offset the consumer credit retrenchment, government debt expanded 7.8% in the first quarter. Federal government borrowing increased 24%, 23% and 20% in each of the past three calendar years, respectively. The last occurrence of federal debt contraction during a calendar year was in 2001 when it decreased by 0.2%.

There was never any expectation that consumer spending would suddenly return to form and push the economy into expansionary mode, but it is clear that in order for the economy to find consistent and sustainable growth, consumers need quite a bit of additional time to improve their collective balance sheets. In the interim, the government will prolong its role as the borrower of last resort.

THE WEEK AHEAD

It will be an interesting, and potentially divergent, week for domestic economic releases. Inflation data is on tap for this week and the recent fall in gas prices should be apparent in both the Producer and Consumer Prices Indices. Also in store for this week is the NFIB Small Business Optimism Index on Tuesday. Small businesses are anything but optimistic and the recent spate of lackluster data will do little to help.

Overseas investors will also deal with important releases this week. On Tuesday, China releases inflation and industrial production for May. Despite efforts by Chinese officials to contain inflation, price increases continue to move higher. Central banks around the globe are set to meet this week, including those in Chile, Japan, Iceland, the Philippines, India and Switzerland.



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