EVERMAY

ECONOMIC & MARKET UPDATE: JULY 25, 2011
"IS THE 'CONSUMER-LESS' ERA THE NEW NORMAL?"
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Economic Data - Previous Week					
Date	**Series**	**Actual**	**Forecast**	**Prior**	
7/19	Housing Starts	629K	575K	560K	Starts jump nationally for single and multi-family
7/20	Existing Home Sales	4.77M	4.95M	4.81M	Disappointing report, though median sales price up
Economic Data - Upcoming Week					
Date	**Series**	**Actual**	**Forecast**	**Prior**	
7/26	S&P/CS 20 City MoM	--	0.00%	-0.09%	Home prices showing recent signs of stabilization
7/26	New Home Sales	--	320K	319K	Weak existing home sales foreshadow sluggish report
7/26	Consumer Confidence	--	56.0	58.5	Debt ceiling, weak labor weighing on outlook
7/27	Durable Goods	--	0.3%	2.1%	Volatile orders data likely to slow after strong month
7/29	GDP - Q2 Adv. Est.	--	1.8%	1.9%	Consumer data not indicating improvement from Q1
7/29	UMich Confidence	--	64.0	63.8	Sentiment likely held up by econ and policy worries

Source: Bloomberg

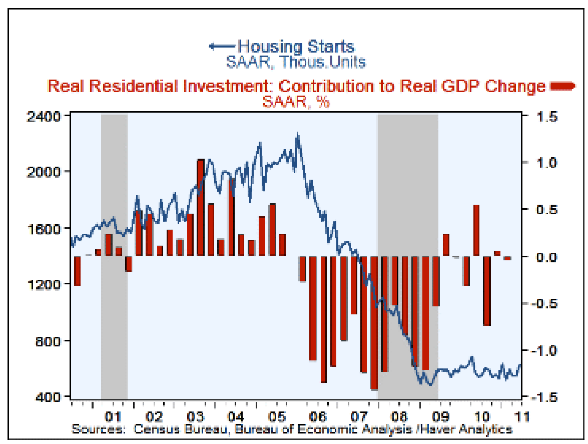
HOME PRICES APPEAR TO FIND BOTTOM

In the face of numerous headwinds, equity markets regained confidence last week, as the S&P 500 Index rose 2.2% and the Dow Jones Industrial Average increased 1.6%.

Markets stared down concerns about the deficit discussions in Washington by focusing on corporate profitability and the seemingly positive news on the debt crisis in Europe.

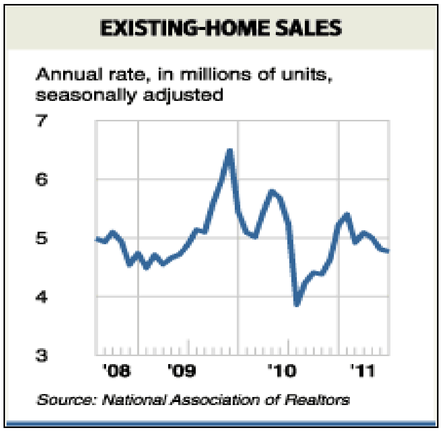
In a relatively light week of economic releases, market participants were pleased to see positive news beginning to build. Housing data in particular, excluding the existing home sales report, trended in the right direction.

Beginning with the housing market, the news was largely positive. Housing starts unexpectedly jumped 14.6% to 629,000 in June. Strength was apparent across single- and multi-family housing units. Residential investment, an important component of GDP, will offer little support to second quarter GDP figures, but the upward momentum experienced in June should put the economy on a better trajectory in the third quarter.



Source: Haver Analytics

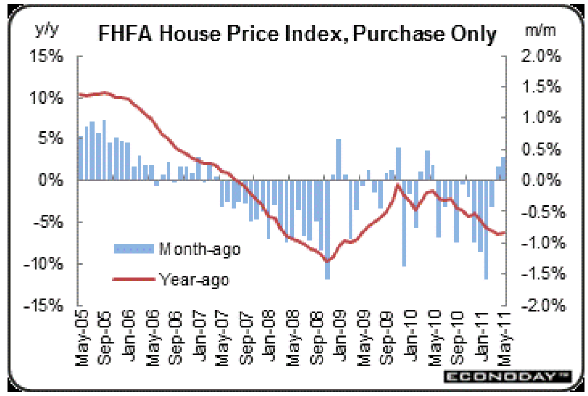
Existing home sales, on the other hand, were disappointing. Sales of existing homes fell from 4.81 million in May to 4.77 million in June, a 0.8% month-over-month decline. Positive sales in the Midwest and South were offset by weakness in the Northeast and West.



Source: Wall Street Journal

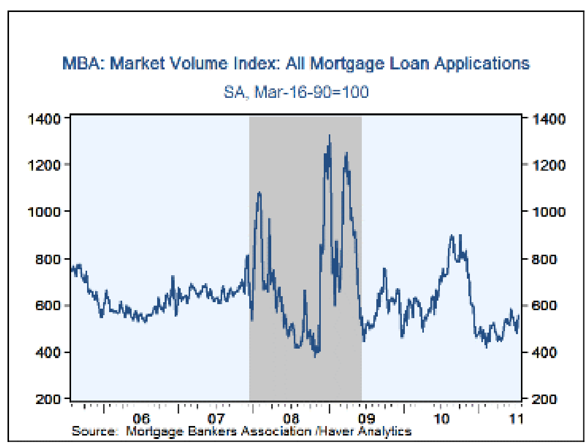
The report revealed one bit of good news: the median sales price of existing homes rose from $169,300 in May to $184,300 in June. Sales prices are not seasonally adjusted, which needs to be taken into consideration, but even on a year-over-year basis the median sales price was up 0.8%. This is the first such positive reading since last November. June's figure was also the highest sales price since October 2008.

One day after the existing home sales report, the Federal Housing Finance Agency (FHFA) confirmed that home prices were no longer falling. Data from FHFA is based on mortgages that were sold or guaranteed by Fannie Mae of Freddie Mac. According to FHFA, home prices for May rose 0.4%, the second consecutive monthly increase.



Source: Econoday

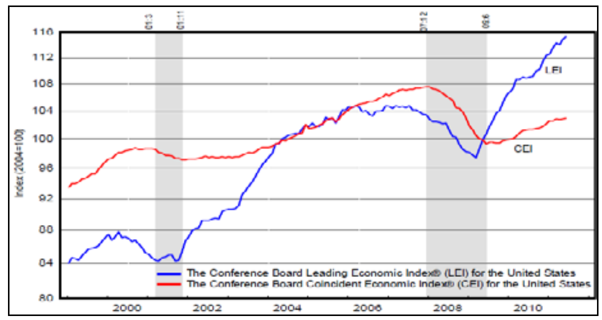
The last bit of good news for the housing markets came from the Mortgage Bankers Association, which tracks the number of mortgage applications filed on a weekly basis. In the week ending July 15, the number of mortgage applications rose 15.5%, the first increase following four weeks of declines. Refinancing is the driving force behind recent activity, accounting for 70% of all mortgage applications in the week. With rates on 30-year mortgages at 4.51%, according to Freddie Mac, homeowners are looking to take advantage of favorable rates while they last.



Source: Haver Analytics

Another reason for the uptick in activity comes from the government itself. In 2008, Fannie Mae, Freddie Mac and the FHFA increased the conforming loan limit to $729,750 from $417,000. Without approval from Congress by October 1, the conforming loan limit will drop to $625,500 for the most expensive counties. Borrowers who have yet to lock in under the current limits are actively doing so before their mortgages become jumbo loans that require a higher interest rate.

The final piece of good news came from the Conference Board's Leading Economic Indicators (LEI) Index. According to the Conference Board, the LEI increased 0.3% in June after a 0.8% gain in May. Positive gains in the LEI occurred due to an expansion of the money supply and the spread between 10-year Treasury bonds and the Federal Funds rate. With the LEI once again expanding, this is hopefully a sign that second half economic growth will be stronger than in the first half of the year.



Source: The Conference Board

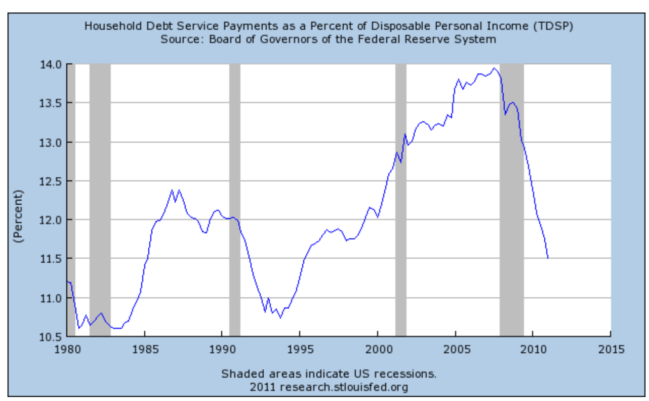
CONSUMERS DECIDE ENOUGH IS ENOUGH

In the past several weeks, questions arose about why the recovery is as slow as it has been. Economists and strategists alike are baffled by the sluggish nature of this recovery, particularly considering our previous experiences after deep recessions. The answer this time around may be very simple – consumers' inability and unwillingness to leverage their personal balance sheets is constraining spending and hampering the economy in ways previously unseen.

Two weeks ago, the Federal Reserve Bank of San Francisco released the most troubling paper on this development. In its paper, the FRBSF found that, resulting from the 2008 recession, consumer spending per person was $7,300 less per year than would otherwise be expected.

Citing an "accommodative interest rate environment, lax lending standards, ineffective mortgage regulation, and unchecked growth of loan securitization," FRBSF determined that consumers underwent one of the most expansive credit binges in history prior to the recession.

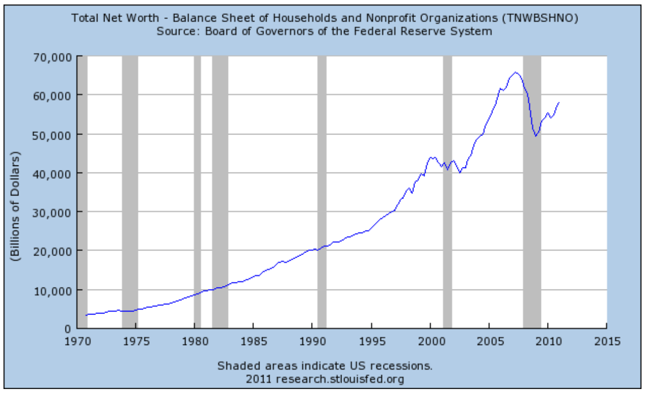
The household debt service ratio, as an example, jumped from 12% at the start of 2000 to near 14% by the end of 2007. While this is a small percentage increase on the surface, it masks the fact that total consumer debt grew by 152% in that period.



Source: Federal Reserve Bank of St. Louis

It is often said that a rising tide lifts all ships, and never was that more true than during the middle of the last decade. As consumers embraced debt in its many forms, household net worth also benefitted, growing at an exponential pace.

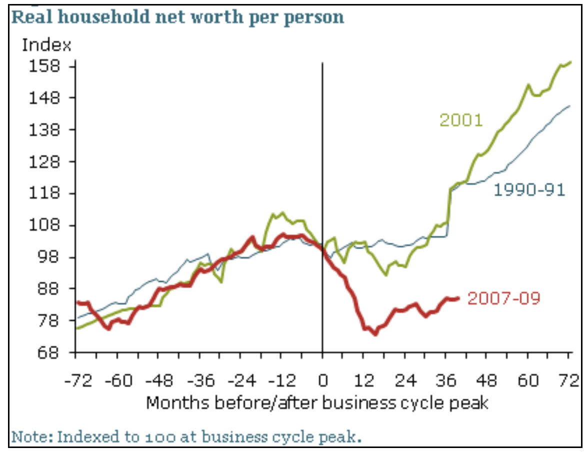
On a non inflation-adjusted basis, household net worth grew from $44 trillion in 2000 to $62 trillion by the end of 2007.



Source: Federal Reserve Bank of St. Louis

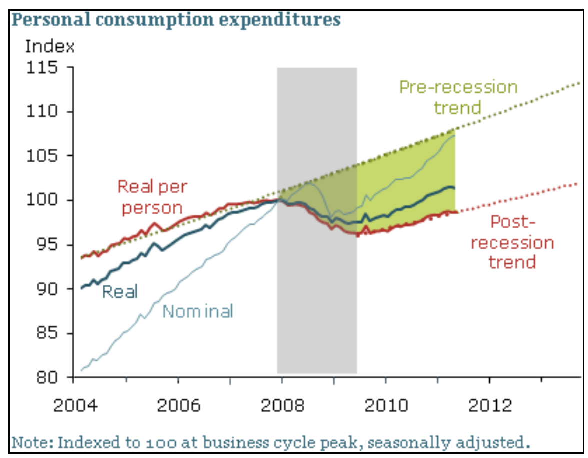
Unfortunately, just as quickly as it came, it disappeared. From the end of 2007 through the end of 2008, more than $12 trillion of net worth vanished. The market rally in the ensuing years brought back some sense of normalcy, but the damage was already done, particularly because net worth is not recovering as quickly as in previous recessions.

Not only was the decline in net worth more severe, but the recovery has been far below the prior two recessions.



Source: Federal Reserve Bank of San Francisco

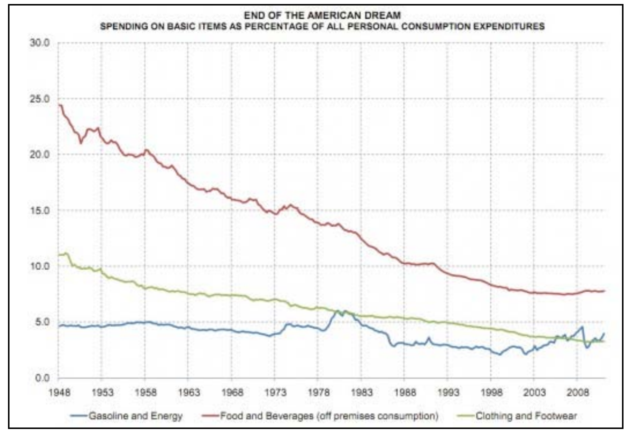
When the FRBSF charted pre- and post-recession trend rates for consumer spending, it found that consumers spent $175 less per month on average after the recession.



Source: Federal Reserve Bank of San Francisco

Sadly, the story does not end there. In a simple chart titled "End of the American Dream," Reuters columnist John Kemp demonstrated why American consumers are in for a long, arduous recovery. Spending on basic goods such as food, energy and clothing is reversing its multi-decade slide. Food and beverage costs alone fell from 25% of consumer spending in 1948 to well below 10% in recent years.

During previous recessions, consumer spending was bolstered by the declining cost of basic goods. This allowed consumers to shift money to discretionary spending, effectively propping up the economy. Those days appear to be behind us, as costs for everyday staples are beginning to trend higher.



Source: FT Alphaville

Repeatedly, the economy has relied upon consumers to reinvigorate the economy. That is simply not going to happen this time around, due to any number of factors from excessive unemployment to an unwillingness to increase borrowing. We should all prepare for the realities of a long, sluggish recovery without the stimulative impact of consumer spending.

THE WEEK AHEAD

Earnings remain the dominant force this week, but investors will also focus on the debt ceiling impasse plaguing Washington.

Economic data is once again on the lighter side in the US, centering on regional manufacturing reports and second quarter GDP. First quarter GDP was modest, at best, and the second quarter is not looking much better, based on recent consumer consumption figures.

Earnings reports to watch this week include Amazon.com, BP, Deutsche Bank, UBS, Boeing, ConocoPhilips, Nissan, Visa, Alcatel Lucent, Credit Suisse, DuPont, Exxon Mobil, EADS, Royal Dutch Shell and Samsung.

The US Treasury holds a series of auctions this week including $35 billion of 2-year notes (Tuesday), $35 billion of 5-year notes (Wednesday) and $29 billion of 7-year notes (Thursday).

On Wednesday, the World Trade Organization meets in Geneva, Switzerland for two days of meetings. Numerous central banks are meeting to discuss policy this week including those in Israel, Hungary, India, Nigeria, Kenya, New Zealand, Philippines and Pakistan.

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