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ECONOMIC & MARKET UPDATE: AUGUST 8, 2011 "S&P DROPS A BOMB ON AN OTHERWISE OK WEEK FOR THE ECONOMY"

Economic Data - Previous Week

Date	Series	Actual	Forecast	Prior	
8/1	Construction Spending	0.2%	0.1%	0.3%	Spending ticks up, prior month also revised to positive
8/1	ISM Mfg Index	50.9	54.5	55.3	Weakness in new orders weighs on mfg index
8/2	Personal Spending	-0.2%	0.1%	0.1%	Spending down on lower auto sales and gas prices
8/3	ISM Non-Mfg Index	52.7	53.5	53.3	Weakness in new orders weighs on non-mfg index
8/5	Nonfarm Payrolls	117K	85K	46K	Private jobs grow 154K, offset by govt job losses
8/5	Unemployment Rate	9.1%	9.2%	9.2%	Contraction in labor force lowers headline rate

Economic Data - Upcoming Week

Date	Series	Actual	Forecast	Prior	
8/11	Trade Balance	--	-\$48.0B	-\$50.2B	Narrowing of trade gap expected by economists
8/12	Retail Sales - Adv Est.	--	0.5%	0.1%	Preliminary indicators point to increase
8/12	UMich Confidence	--	63.0	63.7	Equity market declines will likely weigh on sentiment
8/12	Business Inventories	--	0.5%	1.0%	Analysts expect slower growth in inventories in June

Source: Bloomberg

JUST WHEN YOU THOUGHT IT COULD NOT GET WORSE

Economic data took a backseat to risk aversion, with the S&P 500 index falling 7.2% and the Dow Jones Industrial Average losing 5.8%.

By now, everyone is familiar with the sell-off that occurred Thursday, but the biggest news of the week emerged after the closing bell on Friday. After several months of telegraphing its intentions, ratings agency Standard & Poor's downgraded the long-term credit rating of the US from AAA to AA+ with a negative outlook.

S&P's downgrade was based on the view that the "fiscal consolidation plan that Congress and the Administration recently agreed to falls short of what would be necessary to stabilize the government's medium-term debt dynamics."

S&P went on to say that they now project that "net general government debt would rise from an estimated 74% of GDP by the end of 2011 to 79% in 2015 and 85% by 2021."

The timing of the downgrade could not be worse for the US and global economy, which is already grappling with a sovereign debt crisis in Europe and stagnating growth in the US. The downgrade will undermine confidence and create additional headwinds for the economy for the rest of 2011.

Robert Reich, Chancellor Professor of Public Policy at the University of California Berkley, succinctly summed up the mood of pundits and bloggers over the weekend when he said "had Standard & Poor's done its job over the last decade, today's budget deficit would be far smaller and the nation's future debt wouldn't look so menacing. We've paid a hefty price for its nonfeasance."

Do not expect this to be the last of the downgrades from S&P, as a number of entities directly related to the US, including Fannie Mae and Freddie Mac, will be next on the chopping block. Questions about other

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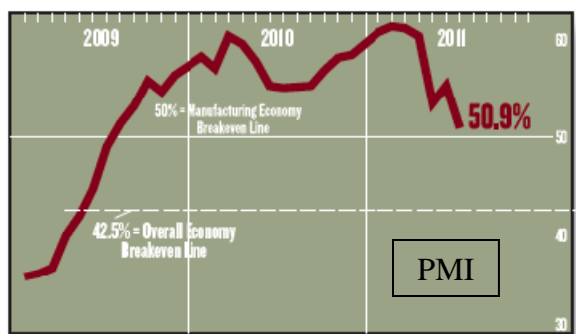
AAA-rated sovereigns such as the UK and France are also beginning to arise.

France currently maintains a net debt to GDP ratio in excess of 60% and current “best guess” estimates are that debt to GDP will soar to 85-95% by 2013. If France is next on the downgrade hit list, it will further challenge investor confidence in an already delicate European Union.

Turning to what we learned about the economy last week, economic releases were mixed, with a dash of positive sprinkled throughout.

Two of the more closely watched reports last week were the ISM Manufacturing (PMI) and Non-Manufacturing indices (NMI), both of which turned in a disappointing performance.

The PMI fell from 55.3% in June to 50.9% in July, well below economists’ expectations of 54.3%. While manufacturing remains above the expansion/contraction line of 50%, the recent slowdown raises fears that a broader economic slowdown is underway.



Source: Institute for Supply Management

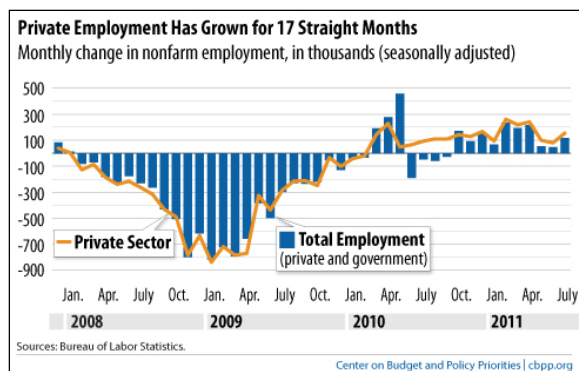
What made July’s report even more troubling was that for the first time since June 2009, the new orders index fell below 50% to 49.2%, indicating that new orders are now contracting. This has been one of the key areas of strength for manufacturing until

recent months, and a slowdown in new orders reduces the amount of forward momentum manufacturers can rely upon.

Switching gears to the NMI, the news was not quite as sullen. In July, the NMI fell from 53.3% to 52.7%, remaining in expansionary range, but 0.3% short of what economists anticipated. New orders also remained above 50% at 51.7%, but the trend is progressively lower. New orders suggest continued growth in the service sector, but should be closely watched heading into the fall for any additional signs of slowing.

Friday brought the announcement of nonfarm payrolls for July. It was supposed to be the premier release of the week, but Thursday’s stock market tumble nearly relegated the jobs report to the back pages. Ultimately, jobs posted an unexpected positive surprise and finally gave some reason for optimism.

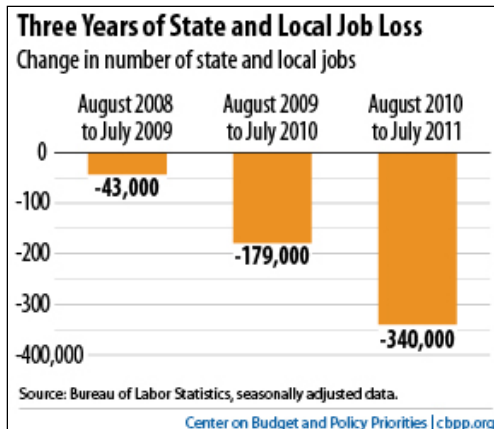
Payrolls in July rose 117,000, with private payrolls expanding 154,000. Encouragingly, revisions to May and June added another 56,000 jobs to the economy. Due to a 193,000-person decline in the labor force, the unemployment rate slipped from 9.2% to 9.1%.



Source: Center on Budget and Policy Priorities
Within underlying hiring trends, the strongest areas of growth occurred in manufacturing, retail, professional services, health care and

hospitality. In its release, the Bureau of Labor Statistics indicated that fewer seasonal auto sector layoffs helped manufacturing employment. This is likely the result of lower production after the earthquake in Japan and a desire by auto manufacturers to “catch up” during the summer, as supply chain concerns eased. That could provide additional support to the PMI figures as we enter the fall.

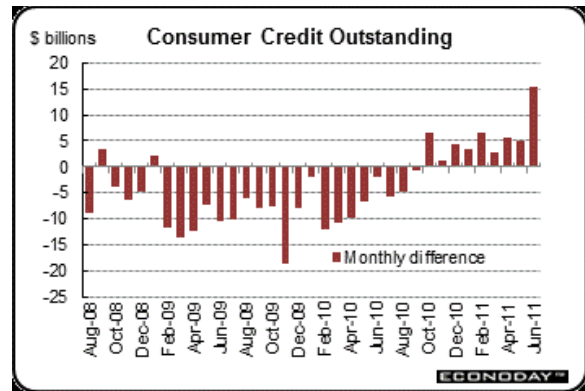
Government workers, particularly those at the state and local level, continue to face layoffs. In July, 37,000 government jobs disappeared, with 23,000 coming at the state level and another 16,000 trimmed from local payrolls. In aggregate, public payrolls cut 611,000 jobs since August 2008, according to the Center on Budget and Policy Priorities. The pace of layoffs is accelerating because of budgetary pressures. In the past twelve months alone, 340,000 workers have lost their jobs.



Source: Center on Budget and Policy Priorities

In a somewhat surprising turn, consumer credit outstanding jumped \$15.5 billion in June, the largest such increase since August 2007. There was a \$10.3 billion jump in non-revolving credit, consistent with recent strength in auto sales, but there was also a \$5.2 billion increase in revolving credit (credit cards, primarily). This could be an indication

that consumers were becoming more confident in their personal balance sheets and more willing to take on debt. That may be a short-lived phenomenon, given the abundance of negative press surrounding Europe, the debt ceiling and now, the US credit downgrade.



Source: Econoday

Just as pundits were set to write off the economy, last week showed that the economy might actually be more resilient than we are willing to admit. The Citigroup Economic Surprise Index continues to trend higher from its June low, suggesting that economic expectations and economic reality are returning to equilibrium.



Source: Bloomberg

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TECHNICALLY SPEAKING

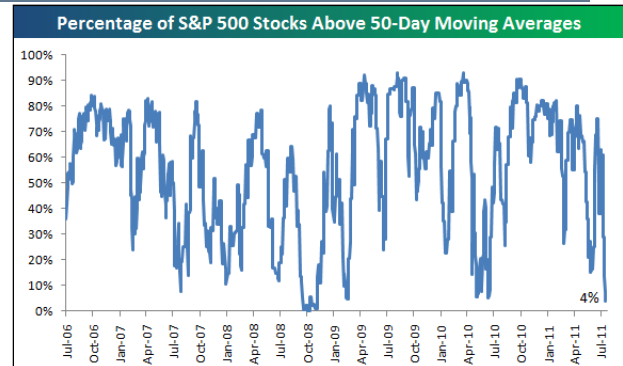
After enduring the worst weekly market sell-off since 2008, many equity investors are probably racing to the equity exits. Is it too late for investors to get out, or are those concerns well warranted?

The numbers are nothing short of staggering – the Dow lost 5%, the S&P was down 7%, the CBOE Volatility Index skyrocketed from the low 20s to more than 32, nearly 16 billion shares were traded, etc. From the market peak in early May, the S&P 500 index is down 12.5%, the second largest peak to trough pullback since the rally began in May 2009. Compared to last spring, when the S&P fell more than 17% over the course of 48 days, this sell-off has been almost routine.

VIX and More 2009-11 SPX Peak to Trough Pullback Summary						
Date	High	Low	Days	Points	%	Rank
Mar '09	832.98	779.81	2	53.17	6.4%	7
Apr '09	875.63	826.83	2	48.80	5.6%	9
May '09	930.17	878.94	5	51.23	5.5%	10
June-July '09	956.23	869.32	18	86.91	9.1%	4
Aug '09	1018.00	978.51	6	39.49	3.9%	13
Aug-Sept '09	1039.47	991.50	3	47.97	4.6%	11
Sept-Oct '09	1080.15	1019.95	7	60.20	5.6%	8
Oct-Nov '09	1101.36	1029.38	8	71.98	6.5%	6
Nov '09	1113.69	1083.74	8	29.95	2.7%	15
Dec '09	1119.13	1085.89	3	33.24	3.0%	14
Jan-Feb '10	1150.45	1044.50	13	105.95	9.2%	3
Apr-July '10	1219.80	1010.91	48	208.89	17.1%	1
Nov '10	1227.08	1173.00	7	54.08	4.4%	12
Feb-Mar '11	1344.07	1249.05	17	95.02	7.1%	5
May-Aug '11	1370.58	1199.54	66	171.04	12.5%	2
Mean			14.2	77.19	6.9%	

Source: Vix and More

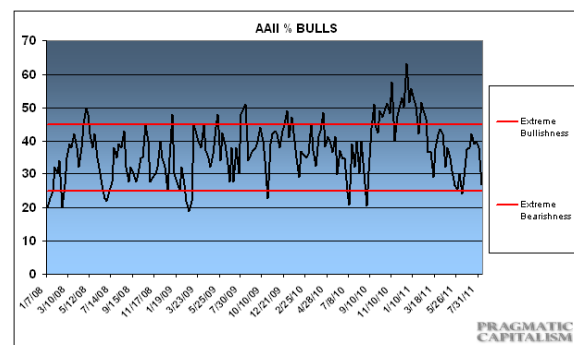
Following the recent rout in the markets, only 4% of stocks in the S&P 500 index are trading above their 50-day moving averages, marginally ahead of the 0% posted in October 2008, according to Bespoke Investment Group.



Source: Bespoke Investment Group

Even with the current sell-off, Wall Street strategists are holding firm to their year-end price target of 1,401 on the S&P, roughly 17% higher than where it currently stands.

As strategists stand pat, retail investors are growing scared, a classic contrarian indicator. However, the number of bullish investors is not yet at extreme bearish territory. In the latest AAI Sentiment Survey, 27.2% of investors indicated being bullish on the outlook for stocks, down 10.7 percentage points, and well below the long-term historical average of 39%. The percent of bearish investors jumped 18 percentage points to 49.9%, almost 20 percentage points above its long-term average.



Source: Pragmatic Capitalism

We all learned in 2008 that markets can collapse in the blink of an eye, but there are

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reasons to believe that the market is entering oversold territory. That does not mean volatility will disappear, but it does suggest

that for investors with the right time horizon, right now is the worst possible time to head for the exits.

THE WEEK AHEAD

Volatility will be the word of the week as the US is now entering unprecedented territory after being downgraded for the first time. Postulating what happens next is complete conjecture at this point. Never has the US been in this situation before and investors should prepare for heightened volatility for the near future.

For the first time since the US credit downgrade, the Treasury Department will conduct a series of auctions this week, including \$32 billion of 3 year notes (Tuesday), \$24 billion of 10 year notes

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

Several central banks will meet this week, including those in Indonesia, Norway and South Korea. In addition, the Federal Reserve meets on Tuesday with no expected change to its 0-0.25% fed funds rate stance. Markets will closely watch for any language about the pace of the recovery or clues about its balance sheet.

Internationally, important releases from China come out this week, including CPI, PPI, industrial production and retail sales.

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