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ECONOMIC & MARKET UPDATE: NOVEMBER 28, 2011 "IS 2012 DESTINED TO BE A REPEAT OF 2008 FOR BANKS?"

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Economic Data - Previous Week

Date	Series	Actual	Forecast	Prior	
11/21	Existing Home Sales	4.97M	4.80M	4.90M	Lower home prices boost sales nationally
11/22	GDP - Q3 2nd Est.	2.0%	2.5%	2.5%	Downward revision to inventories crimps GDP figure
11/23	Durable Goods Orders	-0.7%	-1.2%	-1.5%	Excluding transportation, new orders positive
11/23	Personal Spending	0.1%	0.3%	0.7%	Spending sags in October despite higher incomes
11/23	UMich Confidence	64.1	64.5	64.2	Consumer opinions unchanged from early November

Economic Data - Upcoming Week

Date	Series	Actual	Forecast	Prior	
11/28	New Home Sales	--	315K	313K	Recent home price declines may lift sales in October
11/29	S&P/CS 20 City MoM	--	-0.10%	-0.05%	Home prices showing deceleration in recent months
12/1	Construction Spending	--	0.3%	0.2%	Modest growth in construction outlays expected
12/1	ISM Mfg Index	--	51.7	50.8	New orders momentum points to uptick in the PMI
12/2	Nonfarm Payrolls	--	120K	80K	Economists look for modest jobs gain in November
12/2	Unemployment Rate	--	9.0%	9.0%	Unemployment rate to hold steady amid lower claims

Source: Bloomberg

POOR ECONOMIC DATA, POLITICAL RESULTS, SHAKE MARKETS

Mounting concerns in Europe and the failure of Congress' super committee weighed on investor sentiment during the holiday-shortened week. The S&P 500 fell 4.7% while the Dow Jones Industrial Average declined 4.8%. Both major indices are now in negative territory for the year.

As expected, the congressional super committee failed to negotiate a \$1.2 trillion deficit reduction by Wednesday's deadline. The move triggers automatic cuts to the federal budget starting as early as this year.

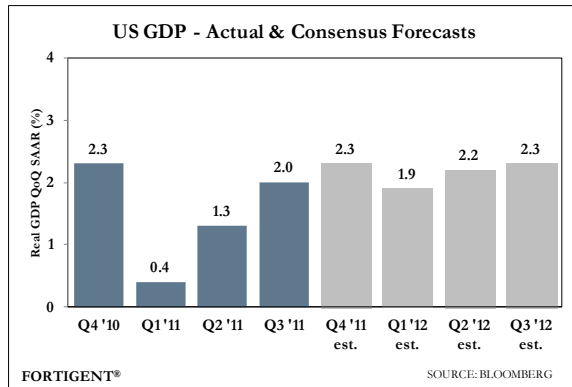
Near-term effects are mostly in the form of program non-renewals – for example, the expiration of 99-week unemployment benefits, the payroll tax cut, and other Recovery Act stimulus. Next year and into 2013, the Bush tax cuts are set to expire and the 10-year sequester (automatic spending

cuts imposed by the Budget Control Act) begins. In total, \$744 billion of government spending is set to be removed from the US economy in the next 14 months (as estimated by *The Economist*), representing substantial fiscal austerity in the not-too-distant future.

In Europe, yields on Italian sovereign debt spiked above 7%, unsustainable levels that previously prompted bailouts for peripheral countries Greece, Italy, and Portugal. More troubling, on Tuesday the German Bundesbank was forced to purchase 39% of its €6 billion debt auction after it failed to attract enough investor interest. The event marks a new phase in the crisis as contagion has seemingly spread to Europe's most powerful core country. Investors remain wary given Germany's slowing growth and uncertainty surrounding its liabilities in the ongoing debt saga.

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Economic data in the US and abroad was disappointing last week, punctuated by the downward revision in third quarter Gross Domestic Product.

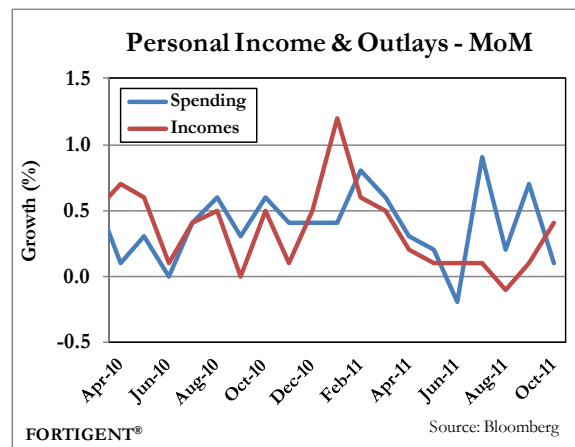


The second estimate for Q3 GDP was revised down to 2.0% from the initial figure of 2.5%. A larger-than-estimated reduction in business inventories was the primary factor behind the revision, as companies have managed their supply more carefully given the uncertain environment. Many economists believe the drawdown in inventories may spur production growth in the fourth quarter and beyond as corporations work to meet resilient consumer demand.

An additional revision within the report increases scrutiny of the US consumer. As has been noted here before, consumers have largely financed their spending habits by dipping into savings, as real wages have sagged. A downward revision to incomes in both the second and third quarters has triggered a sharp revision to the savings rate: falling to 3.8% from 4.8%. Absent more durable employment and income growth, the recent economic support provided by consumer spending will likely not be sustained.

October's personal income and outlays report did offer a brief respite from this trend,

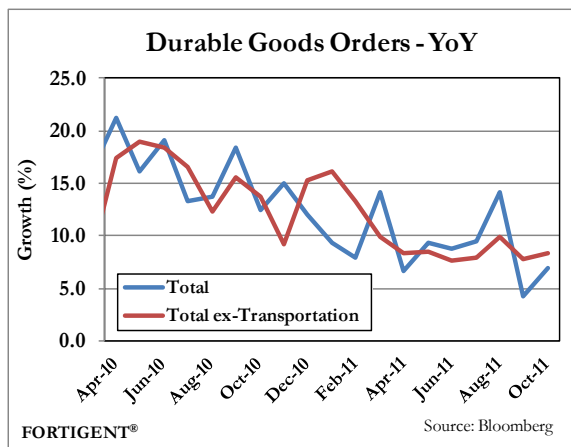
however. Data released by the Bureau of Economic Analysis on Wednesday showed personal incomes rose 0.4%, the largest gain since March and slightly above economist expectations. When accounting for inflation, it is the largest gain in over a year. Spending was less robust, rising just 0.1%, though this did provide a modest boost to the personal savings rate.



Soft October spending data may have been reflective of consumers holding out for post-Thanksgiving holiday purchases. Preliminary data indicates retailers had their best Black Friday ever, with retail sales increasing 6.6% to \$11.4 billion year-over-year. Last year's gain, in comparison, was just 0.3%. A bigger emphasis on online shopping by retailers is partly responsible – online sales were up 39.3% on Thanksgiving Day and 24.3% on Black Friday on stores' aggressive promotions.

On Wednesday, the Census Bureau released durable goods data for October. While the headline figure was negative – a 0.7% decline month-over-month – this was skewed by the notoriously volatile transportation component. Specifically, civilian aircraft orders fell 16.4% after a 26.8% decline in September. Excluding the transportation

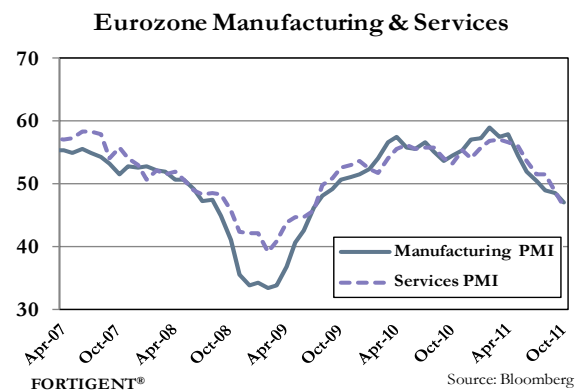
component, new orders grew a positive 0.7%. Underlying data was mixed, with components like primary metals and machinery rising and fabricated metals, computers, and electrical equipment contracting. Durable goods have proven resilient over the past several months at the “core” level (excluding transportation), representing a pocket of strength for the US economy.



Outside of the US, the most notable headline during the week was a sizeable drop in China’s preliminary manufacturing PMI. A projected reading of 48 for November from 51 in October represents the sharpest decline in two and a half years. It also pulls the index into contractionary territory, increasing fears of a “hard landing” for the world’s second largest economy. The data unfortunately aligns with other recent data points from China that indicates a slowdown in both its domestic and external sectors. Chinese officials may feel compelled to initiate pro-

growth policies in the months ahead if slower economic growth is confirmed.

In Europe, a contraction in economic growth for Q4 now appears a foregone conclusion amidst severe austerity measures and poor consumer and business confidence. Several research firms point to a third straight month of contraction in the Eurozone’s PMI as evidence, with the headline indicator posting a 47.2 reading in November. Both the manufacturing and services components remained below the all-important 50 level, at 46.4 and 47.8, respectively. A measure of new orders, which often projects forward momentum for business activity, also fell for the fourth straight month.



As the US’ largest trading partner, Europe’s tepid – but still positive – economic growth has been a headwind, but not outright detriment to the US economy. If the region slips into a full recession, which appears likely at this point, the prospects for continued US recovery are undoubtedly dimmed.

RELATIVE HEALTH OF US & EUROPEAN BANKS

When the financial crisis began in late 2007, banks became public enemy number one. With the recent sovereign debt flare-ups in Europe, banks are once again the target of public anger. Is 2012 destined to be a 2008

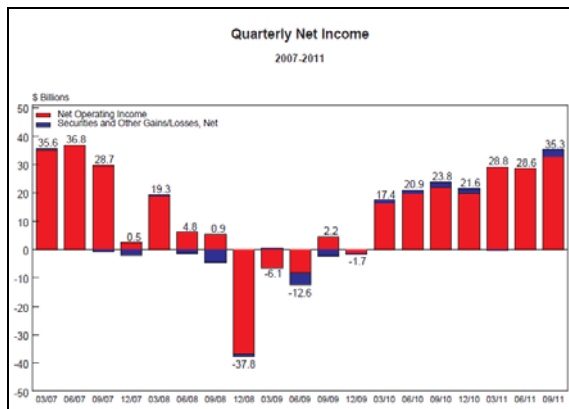
repeat for the banking sector? Well, not exactly.

Last week brought the release of the FDIC *Quarterly Banking Profile*, a review of financial

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results for the banking industry in the US. As it turns out, US banks are doing quite favorably, despite negative macroeconomic headlines that are dominating the markets.

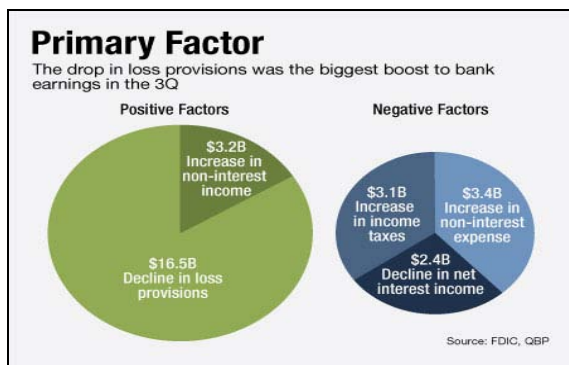
In aggregate, banks reported net income of \$35.3 billion in the third quarter, \$11.5 billion higher than the same period in 2010, and the highest reported quarterly net income since 2007.



Source: Federal Deposit Insurance Corporation

The better condition of the US banking sector is notable, but it comes with a caveat.

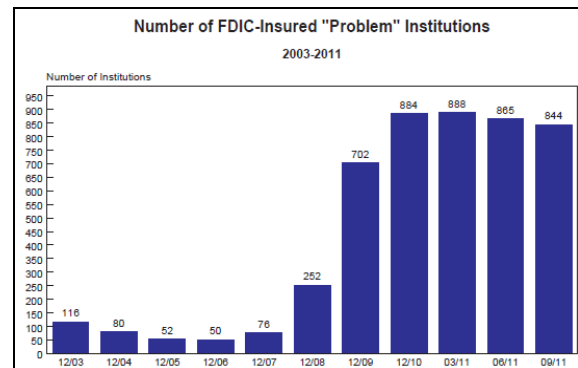
First, the primary force behind improved profitability was lower loan loss reserves. Said differently, banks are putting aside less money to cover bad loans. That is not a sustainable road to profitability.



Source: American Banker

Second, loan growth is relatively stagnant. Total loans and leases rose 0.3% in the third quarter, entirely the result of commercial and industrial loan growth. Residential and consumer loans continued to decline. Without some degree of lending, banks will struggle to gain firmer footing.

Lastly, the number of problem banks, while declining, remains elevated. There were 844 “problem” banks with \$339 billion in assets at the end of the third quarter. Those figures are on the decline, but very, very slowly.



Source: Federal Deposit Insurance Corporation

Overall, it is safe to say the US banking system is in a better position than it was at the end of 2008. Unfortunately, the unraveling situation in Europe is creating a starkly different story across the Atlantic.

Around the time the burden of focus shifted from US banks to European banks, the focus also transitioned from US sub-prime loans to over-levered European nations. The “debt super cycle,” as it was coined, moved quickly from the private to the public sector. Both European and US banks had significant exposure to the sub-prime crisis, but an unfortunate reality was soon to be discovered: European banks hold a greater amount of public debt than their American counterparts.

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Morgan Stanley hammered that point home last week when it brought forth parallels to the 2008 US financial crisis. The firm stated that European banks might need to deleverage their balance sheets by €1.5 to €2.5 trillion over the next 18-24 months. By some estimates, banks need to rollover €1.7 trillion in the next three years.

As an example of the troubles facing Europe, French banks alone held \$416 billion of exposure to Italy as of the end of June. Throw in \$151 billion of French bank exposure to Spain, \$26 billion to Portugal, and \$32 billion to Ireland, and suddenly it becomes obvious why this is such a concern for the banking system.

Unfortunately, banks in Europe are in a difficult spot. New capital requirements put forth by Basel III will force banks to increase core capital reserves by June of next year, a move that will require a minimum of \$149 billion of additional capital.

Banks could sell assets to raise capital, but given the recent turmoil in financial markets, prices are depressed and liquidity is scarce.

The second option is to restrict lending by closing existing lines of credit and not offer new credit. This is likely already occurring and will prove painful for many businesses that are already having a difficult time accessing capital.

In the meantime, the European Central Bank (ECB) continues to act as the lender of last resort, providing €247 billion in short-term loans to 178 banks last week. With European banks unable to issue new debt and feeling

shunned by private markets, the ECB is the last option.

Shifting focus back west, US banks are not entirely in the clear. The Federal Reserve is preparing to conduct its annual bank stress tests, a new requirement of the Dodd-Frank legislation. The stress tests are designed to mimic extreme environments of 13% unemployment, a 52% fall in stock prices, and a 21% decline in home values.

Prominent financial analyst Dick Bove fears a recession will occur as a result of the overly harsh stress tests and required capital raises. Most other firms disagree with his assessment, however, and believe banks are in a far better position today to withstand additional losses. That is particularly true for the six largest, and most closely watched, banks: Bank of America, Citigroup, Goldman Sachs, J.P. Morgan Chase, Morgan Stanley and Wells Fargo.

The good news is that US banks have only a modest amount of exposure to European borrowers. Fitch Ratings did warn that contagion is a realistic problem and a severe shock emanating from Europe would do serious harm to US banks. In the meantime, investors can only wait and watch, much as they have been doing for the last few years.

For Europe, the situation will continue to be tenuous. There is talk of common eurobonds, encouragement of quantitative easing from the ECB, and coordinated bailouts from the EU/International Monetary Fund. Any of the above are possibilities, but few alone are likely to do anything to stem the tide of negativity. Again, we can only wait, and watch.

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THE WEEK AHEAD

There are several important indicators set for release this week, highlighted by the ISM Manufacturing Index on Thursday and the Employment Situation report on Friday. Unemployment claims have recently stabilized below the 400,000 mark, providing optimism that job growth can get back on track. Economists are looking for a 120,000 gain in the nonfarm payroll report and no change in the unemployment rate.

On Wednesday, the Federal Reserve releases the Beige Book, a compendium of economic activity across the country. It will be examined closely for clues to the Fed's

thinking. Minutes from November's FOMC meeting confirmed that several committee members are arguing for additional accommodation.

Third quarter earnings season continues this week with results expected from Tiffany's, Ralcorp, Barnes & Noble, American Eagle, Aeropostale, Express, PVH, Talbots, Kroger, Lululemon Athletica, and Seadrill.

Several central banks meet this week, including Hungary, Thailand, Brazil, the Philippines, and Mexico. Thailand and Brazil are expected to cut key interest rates.

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