

ECONOMIC & MARKET UPDATE: DECEMBER 5, 2011

"WHAT ARE INVESTORS UP TO?"

CHRIS MAXEY, CAIA, SENIOR ANALYST &
RYAN DAVIS, SENIOR ANALYST

www.Evermaywealth.com

Economic Data - Previous Week

Date	Series	Actual	Forecast	Prior	
11/28	New Home Sales	307K	315K	303K	New home sales positive but below expectations
11/29	S&P/CS 20 City MoM	-0.57%	-0.10%	-0.29%	Higher short sales may be accelerating price declines
12/1	Consumer Confidence	56.0	44.0	40.9	Jump in optimism centered on better jobs situation
12/1	Construction Spending	0.8%	0.3%	0.2%	Private outlays exceed dip in public sector spending
12/1	ISM Mfg Index	52.7	51.7	50.8	New orders drive surprise jump in mfg PMI
12/2	Nonfarm Payrolls	120K	120K	100K	Healthy gain in jobs driven by retail trade sector
12/2	Unemployment Rate	8.6%	9.0%	9.0%	Fall in labor force, more jobs boosts headline rate

Economic Data - Upcoming Week

Date	Series	Actual	Forecast	Prior	
12/5	ISM Non-Mfg Index	--	53.9	52.9	Recent momentum in econ data lifts services outlook
12/5	Factory Orders	--	-0.3%	0.3%	Recent durable goods report points to decline
12/7	Consumer Credit	--	\$7.00B	\$7.39B	Auto sales may sustain non-revolving component
12/8	Wholesale Inventories	--	0.3%	-0.1%	Slight uptick expected in merchants' stocks
12/9	Trade Balance	--	-\$43.9B	-\$43.1B	Deficit to widen after unexpected Sept improvement
12/9	UMich Confidence	--	65.8	64.1	Consumer confidence indicator points to uptick

Source: Bloomberg

STOCKS SURGE ON CENTRAL BANK ACTION, EMPLOYMENT NEWS

Markets rebounded in the final week of November following coordinated action by central banks and better-than-expected economic results. The S&P 500 rose 7.4% while the Dow Jones Industrial Average spiked 7.0%. The best week for these indices in over two years was enough to pull them back into positive territory for the year.

For the month of November, the S&P 500 finished essentially flat – down 0.2% – mostly the result of performance during the last three trading days of the period. US large cap stocks outperformed riskier segments of the market, including small caps, which fell 0.4%, and non-US equities. A broad measure of international companies – measuring both developed and emerging market stocks – fell just over 5% during the month.

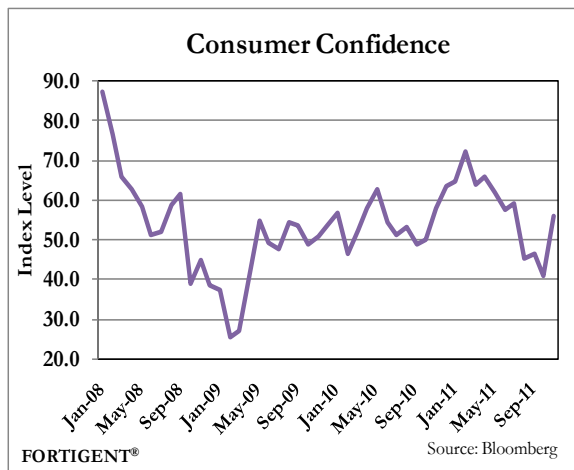
The biggest macroeconomic development of the week occurred on Wednesday, when central banks from the US, Japan, Canada, the UK, Europe, and Switzerland agreed to lower the cost of dollar swap lines by 50 basis points. The group also extended the arrangement to February 1, 2013, removing near-term uncertainty about the program.

The move alleviates the cost of dollar funding at the European Central Bank (ECB) and, in turn, provides better liquidity for European banks. Wednesday's agreement is seen as a major sign of international cooperation in support of the Eurozone and should ease strains on global financial markets. Equity markets around the world rallied after the announcement.

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Economic data in the US was mostly positive last week, spanning consumer confidence, manufacturing, and employment data.

The Conference Board's Consumer Confidence survey, released on Tuesday, revealed a sharp uptick in optimism among Americans. November's reading of 56.0 represented a 15-point gain from October, and was the highest level since before August's debt ceiling debacle and subsequent market sell-off. November's gains centered primarily on employment, as the number of consumers saying jobs were difficult to obtain fell sharply. Income expectations for the next six months also improved. Although the overall level of sentiment remains historically weak, November's improvement (particularly in employment) is encouraging given other positive economic data.



On Wednesday, the Federal Reserve released the final edition of its Beige Book for 2011. The report compiles commentary on economic activity across the 12 Federal Reserve Districts, and is typically scrutinized for clues about the Federal Open Market Committee's thinking. The most recent version provided a relatively optimistic snapshot of the US economy, as 10 of the 12

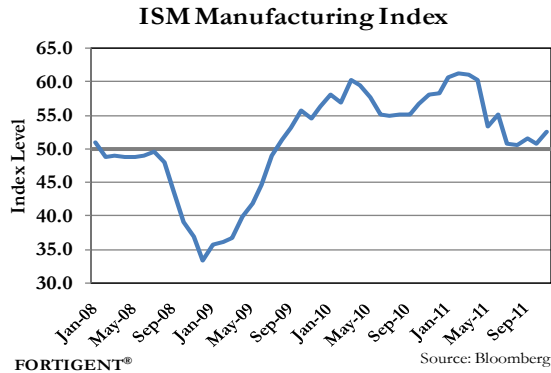
districts reported an increase in activity. The report noted consumer spending, motor vehicle sales, tourism, and manufacturing activity as areas of strength.

Housing was a noticeable exception in the Beige Book's findings, with several districts experiencing further declines. The report characterized the overall market as "depressed." This mirrors recent data that generally reveal another leg down in the residential housing sector.

The S&P/Case Shiller Home Price index, released on Tuesday, was the latest such indicator. The report revealed a 0.6% decline in month-over-month prices in their 20-city composite – much larger than expected. This represents a sharp acceleration in home price declines, and falls in line with data from recent home sales reports. The nation's overhang of foreclosure inventory may be hitting the market at an increased pace, leading to more distressed sales.

Ultimately, the excess stock of foreclosed homes needs to be cleared in order to restore the health of the residential housing market. We have seen a stabilization in the number of existing and new home sales over the past few months as that process plays out and prices decline. However, the process will involve much pain for current homeowners as years of market distortion is slowly brought back into equilibrium.

On Thursday, the Institute for Supply Management (ISM) released its monthly manufacturing index. The headline composite reading jumped to 52.7, an improvement of 1.9% from October. The index remains clearly in expansionary territory (above the 50 expansion/contraction line), and November marked the 28th straight month of expansion.



Encouragingly, the ISM manufacturing index was bolstered by a surge in new orders. The new orders component index rose 4.3% to 56.7, the second month of expansion after three months of decline. As we often note, new orders project forward momentum for the manufacturing sector. On the heels of improvement in various Fed regional manufacturing surveys, the manufacturing sector indeed appears to have rebounded from its late-summer slowdown.

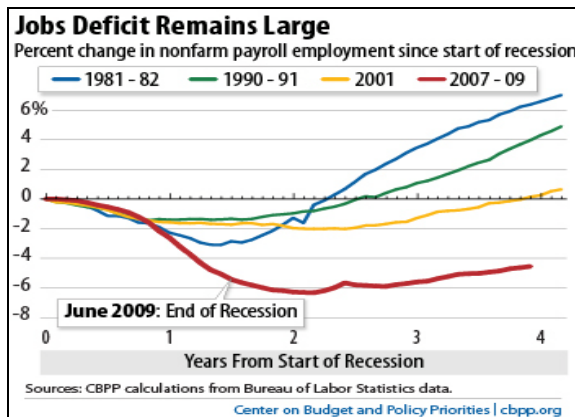
JOBS GROWTH TAKES A STEP FORWARD IN NOVEMBER

On Wednesday, payroll processor ADP released their private employment estimate for November. The firm reported a 206,000 gain in private payrolls, in addition to an upward revision of 20,000 jobs in the prior two months. The data set the stage for a strong government jobs report on Friday.

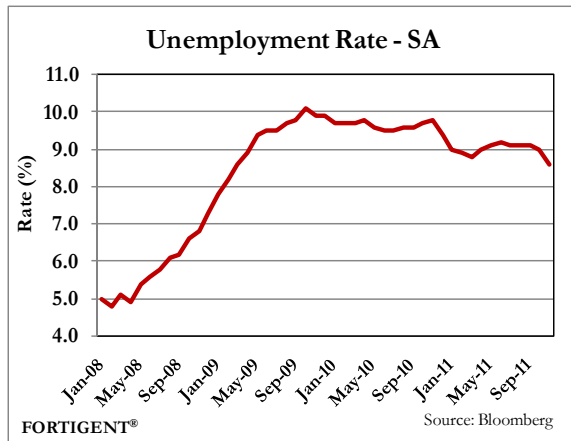
Several analysts cautioned that 50,000 of November's gain occurred in retail trade, perhaps the result of an earlier start to the holiday season this year. Retailers were more aggressive than usual in promotional campaigns, and thus may have hired more seasonal workers than in the past at this stage of the holiday period. The unfortunate byproduct is that November's gains could be given back in just a few months' time.

The Bureau of Labor Statistics' (BLS) *Employment Situation* did not disappoint, with a reported gain of 120,000 jobs for November. While this figure was in line with consensus, it came on top of an upward revision of 72,000 jobs in the prior two months. Private payrolls rose for the 21st straight month, increasing 140,000 in November.

The bigger headline from Friday's report was a sharp reduction in the unemployment rate. The jobless figure, based on a household survey as opposed to the payroll estimate's establishment survey, sank to 8.6% during the month. About half of the drop was due to a reduction in the labor force, but the number of employed persons still rose by nearly 300,000.

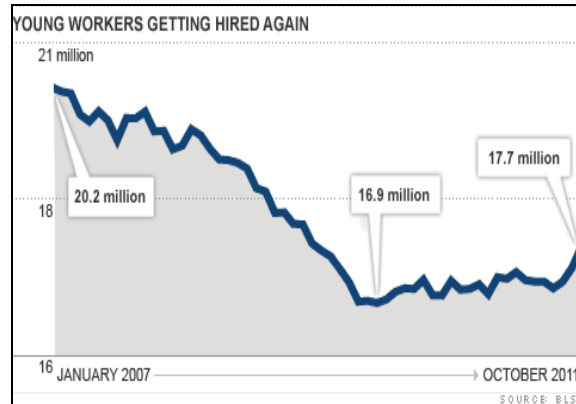


Source: Center on Budget and Policy Priorities



Similar improvement also occurred in the broader U-6 measure of unemployment – or rather, “underemployment.” U-6 measures the total number of persons marginally attached to the labor force (not actively seeking work) and those working part-time who would prefer to be full-time, in addition to the traditional unemployment figure. In November, the indicator fell from 16.2% to 15.6%. Improvement was partially a result of part-time workers moving to full-time status.

One segment of the labor market that is showing notable improvement is younger workers. Though the group gave back some of its gains in the November report, 16 to 24 year olds experienced a gain of 650,000 jobs between August and October. This was the biggest increase since the recession began, and a welcome respite from what has been a difficult climate for the younger demographic. The unemployment rate for this age group hit record highs during 2009.



Source: CNNMoney.com

A final note from November’s employment report: the BLS announced its preliminary benchmark adjustment for 2011 data. This annual modification is based on more complete data from employers obtained through unemployment insurance filings. The initial estimate was an upward revision of 192,000 jobs. This represents a revision of 0.1%, well inside the recent historical average of plus-or-minus 0.3%.

It will be interesting to watch benchmark revisions over the next few years. In 2009 and 2010, the total net revision to nonfarm payrolls was negative 1.28 million. This sharp adjustment was a result of the BLS’ birth/death model, which severely underestimated the level of business destruction during the financial crisis. It is possible this adjustment factor could once again be behind the curve as economic activity recovers, hopefully, in the next few years. Admittedly, such a level of recovery still seems a ways off at this juncture.

WHAT ARE INVESTORS UP TO?

With markets ebbing and flowing and making it virtually impossible to differentiate up from down, it has become all the more difficult to determine what qualifies as an attractive investment. While equity markets rallied strongly into the end of November, volatility

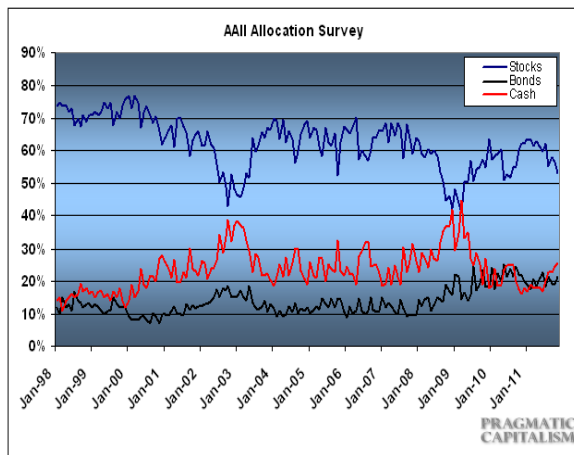
remains well above its long-term average, causing most investors to question their equity allocations.

It should come as no surprise, then, that individual investors are anything but

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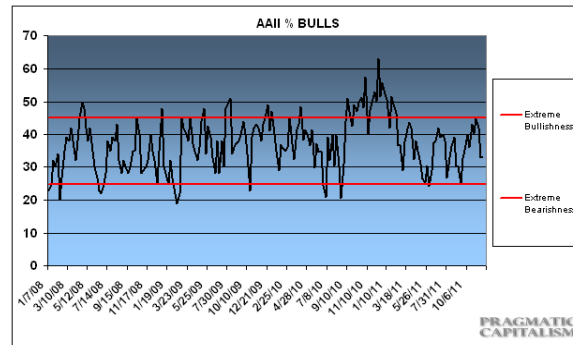
confident in the latest rally. Macroeconomic headlines and excessive volatility are dampening even the most hardened investors' faith in financial markets. With that said, investors are only gradually reallocating their portfolios.

In the most recent monthly survey of individual investor allocations from the American Association of Individual Investors (AAII), it was reported that allocations to stocks and stock funds fell 3.4% to 53.1%, while investor allocations to bonds and bond funds increased 2.3% to 21.2%. The remaining 1.1% found its way to cash, which currently stands at a 25.7% weight.



Source: *Pragmatic Capitalism*

Relative to long-term averages, investors are now heavily underweight equities in favor of bonds. AAII's weekly sentiment survey also confirms that trend. According to the survey, 33% of investors are bullish on the six-month outlook for stocks and 39% are bearish. From a historical perspective, investors are typically 39% bullish and 30% bearish, suggesting investors are taking a moderately more bearish stance at the current juncture.



Source: *Pragmatic Capitalism*

Growing pessimism is also reflected in recent mutual fund flow data from the Investment Company Institute (ICI). In the past six months through October, investors pulled \$122 billion from equity mutual funds, with nearly all of that coming from domestic equity funds. Foreign equity funds experienced outflows of “only” \$7.5 billion.

Naturally, money is flowing into the relative safety of cash and fixed income funds. During the same six-month period, bond funds picked up \$61 billion. Bonds continue to receive favorable treatment from investors, despite the fact they allocated more than \$620 billion into bond funds in 2009 and 2010.

November is proving no different. Another \$12 billion fled equity funds through November 22, while \$20 billion found its way into fixed income funds.

Institutional investors are taking a slightly different tact. After a marked deterioration in confidence in August, institutional investors gradually became more optimistic about the market outlook. Domestic investors were likely influenced by the downgrade of the US credit rating at the end of the summer, and the subsequent volatility that gripped the markets.



Source: State Street

Asset managers are apparently feeling quite the same. Despite market volatility and headline risks, a Reuter's poll of US asset managers found the average allocation to equities increased 2.6% to 63.7% in November. Bond allocations shrank 2.7% to 29.3% during the month.

It turns out they might be right. Data from the Stock Trader's Almanac shows that December is the single best month of the year for the S&P 500 since 1950, and the second best month of the year for the DJIA. With an average gain of 1.7% for both indices, holiday cheer appears to overtake the markets and encourage a holiday buying spree.

Only time can tell if this will be another holiday season to celebrate. Given the typically inaccurate positioning of individual investors and ability of institutional investors to position ahead of rallies, it may time to bet on black this holiday. Of course, the lingering crisis in Europe does little to soothe frayed nerves this year, so investors not prepared to endure the volatility should probably watch this one unfold from the sidelines.

THE WEEK AHEAD

The week is relatively light on economic data in the US, though the ISM's non-manufacturing index is a highlight to watch on Monday. Economists anticipate a slight pickup from 52.9 to 53.9. Other data points include factory orders, consumer credit, trade balance data, and the University of Michigan Sentiment index.

Several important releases regarding China's economy are also on deck for this week, including inflation, industrial production, trade, and lending data. Economists anticipate continued relief in the price pressures that prompted Chinese officials to rein in economic growth earlier this year.

This could provide additional room for the government to loosen policy, as occurred last week in the form of lower reserve ratio requirements.

In Europe, the final estimate of Q3 Eurozone GDP is on tap for Tuesday. The last estimate of 0.2% growth is expected to hold, ahead of a key ECB meeting on Thursday. Analysts look for the bank to cut rates by 25 or 50 basis points.

Other interest rate announcements are expected from England, Australia, Canada, Poland, New Zealand, Indonesia, Peru, and South Korea.



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