

ECONOMIC & MARKET UPDATE: JANUARY 9, 2012 "CORPORATE PROFITS HIT A WALL, BUT STOCKS A BUY?"

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Economic Data - Previous Week

| Date | Series | Actual | Forecast | Prior | |
|------|-----------------------|--------|----------|-------|--|
| 1/3 | Construction Spending | 1.2% | 0.5% | -0.2% | Surprise uptick in single and multifamily housing |
| 1/3 | ISM Mfg Index | 53.9 | 53.5 | 52.7 | Activity accelerates in most index components |
| 1/4 | Factory Orders | 1.8% | 2.0% | -0.2% | Aircraft orders boost; 0.3% gain ex-transportation |
| 1/5 | ISM Non-Mfg Index | 52.6 | 53.0 | 52.0 | Services index ticks up, employment improves |
| 1/6 | Nonfarm Payrolls | 200K | 155K | 100K | Every major sector adds jobs, ex-government |
| 1/6 | Unemployment Rate | 8.5% | 8.7% | 8.7% | Surprise fall in jobless rate mirrors daims data |

Economic Data - Upcoming Week

| Date | Series | Actual | Forecast | Prior | |
|------|-----------------------|--------|----------|----------|---|
| 1/9 | Consumer Credit | -- | \$7.00B | \$7.65B | Auto sales point to uptick in credit outstanding |
| 1/10 | NFIB Sm Bus Optimism | -- | 93.9 | 92.0 | Economic momentum should boost small business |
| 1/10 | Wholesale Inventories | -- | 0.5% | 1.6% | Stocks to rise more modestly after Oct. spike |
| 1/12 | Adv. Retail Sales | -- | 0.3% | 0.2% | Preliminary reports point to continued gains in sales |
| 1/12 | Business Inventories | -- | 0.4% | 0.8% | Inventory build should moderate after strong Oct. |
| 1/13 | Trade Balance | -- | -\$45.0B | -\$43.5B | Trade gap expected to widen in November |
| 1/13 | UMich Confidence | -- | 71.5 | 69.9 | Sentiment should improve on rising labor data |

Source: Bloomberg

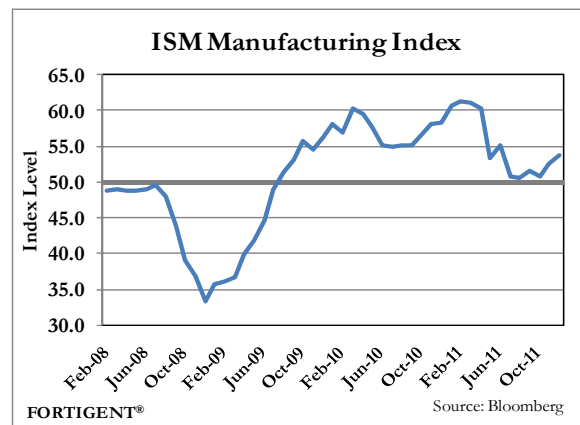
MANUFACTURING PICKS UP STEAM

Equity markets finished their first week of the New Year with positive gains, with the S&P 500 and Dow Jones Industrial Average rising 1.6% and 1.2%, respectively. Those gains, and more, occurred in the first 30 minutes of trading on Tuesday, the first trading day of 2012. From there, markets traded choppy through the remainder of the week, as lingering problems in Europe dampened risk appetites.

Investors returning from holiday break received more positive news regarding the US economy, particularly within manufacturing and employment.

On Tuesday, the Institute for Supply Management's (ISM) Manufacturing index indicated that business activity accelerated in December. The index level of 53.9 remained solidly in expansionary territory (above the expansion/contraction demarcation line of

50.0), and rose 1.2 points from November. It was the 29th straight month of such expansion.



The underlying components of the ISM report were also encouraging. The new orders index, which often portends future months' activity, rose one point to 57.6. A sharp improvement in the employment

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component, from 51.8 to 55.1, lent support to recent labor market gains. Finally, and perhaps most surprisingly, the new export orders index also registered a strong gain, despite perceived slowdowns in Europe and China. Overall, Tuesday's report revealed America's manufacturing sector is in good health and continuing to improve.

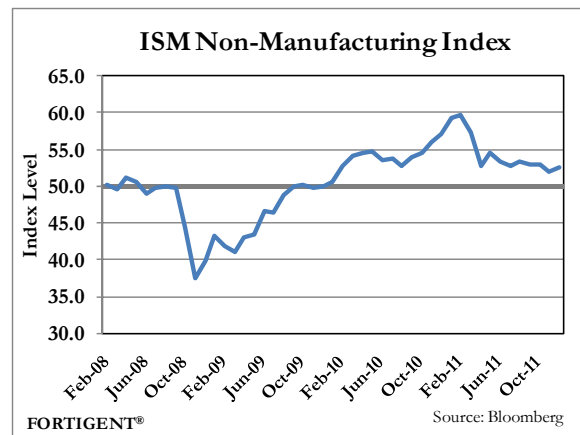
Also on Tuesday, the Federal Reserve released minutes from its December 17 Federal Open Market Committee (FOMC) meeting. This release was more notable than usual, as the Fed revealed a change in its communication policy.

Starting with the FOMC's January 24-25 meeting, the committee will now announce interest rate forecasts four times a year. The move marks another in a series of moves by Fed Chairman Ben Bernanke to increase transparency at the Federal Reserve. In 2011, the Chairman began to hold press conferences following FOMC policy meetings for the first time. Separately, James Bullard, president of the Federal Reserve Bank of St. Louis, revealed that the Fed was nearing explicit inflation forecasts.

The impact of the new rate forecast policy is uncertain. Some believe that greater clarity on the path of the Federal Funds rate will remove uncertainty and help lower long-term interest rates (already an explicit goal via "Operation Twist"). There is concern that the Fed could

lose credibility if forced to deviate from its script due to a sharp change in economic conditions. Either way, the change will have little effect in the near-term, as the committee has already pledged zero interest rates until mid-2013.

On Thursday, the ISM released its follow-up to Tuesday's Manufacturing index – the Non-Manufacturing index. Though not quite as healthy as its better-known sibling, December's reading remained in expansionary territory for the 25th straight month. Non-manufacturing is not as volatile as manufacturing and typically moves in a gradual, measured fashion.



The headline index improved to 52.6 from 52.0 in November, though this was below consensus expectations. The report's underlying components were mixed. The employment index improved, but remained in contractionary territory for a second month. New export orders grew at a much slower rate than November, falling from 55.5 to 51.0. Business activity/production remained robust at 56.2 but unchanged from the month prior.

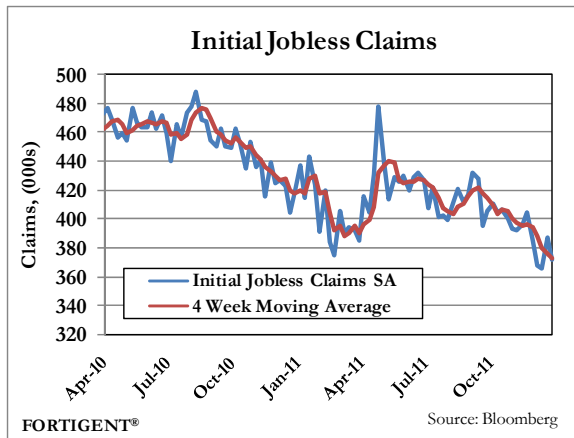
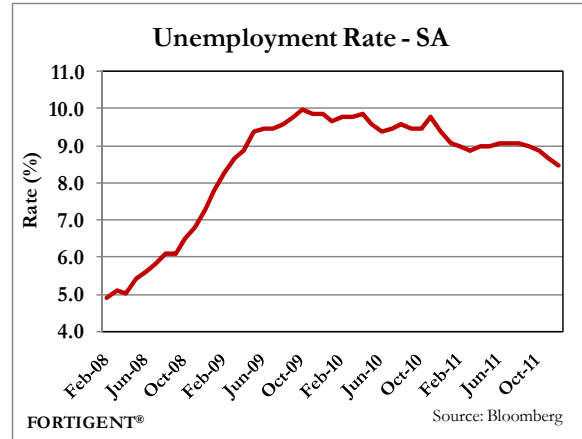
LABOR MARKET STRENGTH CONTINUES

In a similar script to December, payroll processor ADP set the stage for a strong government jobs report with its own

surprising release. On Thursday, the firm reported a 325,000 gain in private payrolls, more than double economists' expectations.

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More good news came on Thursday via the weekly initial unemployment claims report. Claims for the week ending December 31 declined to 372,000 – the fifth week in a row below the 400,000 mark. The dramatic improvement in initial claims in the last month mirrors that seen in continuing claims. That measure fell to 3.595 million for the same period, which is 70,000 claims below the level at the end of November. Both reports are at their best levels since the recession ended.



The underlying data was generally positive, with positive gains in every major sector except government. Government continues to be a sore spot for employment, with the sector posting a net loss for the 17th time in the past 19 months. The majority of these losses occurred at the state and local level, as municipalities continue to struggle under the weight of budgetary shortfalls.

Friday’s Employment Situation report by the Bureau of Labor Statistics also surprised consensus forecasts. In the establishment survey, nonfarm payrolls increased 200,000 in December, while mixed revisions for October and November resulted in a modest net decline of 8,000 jobs. In the household survey, the unemployment rate declined to 8.5% from a revised 8.7%. November’s rate was originally reported at 8.6%, but this shifted slightly because of the BLS’ annual modification to seasonal adjustment factors.

Critics point to the 90,000 job gain in trade and transportation as a sign of distortion in the data, as that sector’s couriers and messengers component alone posted a 42,000 net increase in jobs. Seasonal factors could be at play here, as that industry would typically be eliminating workers following a holiday-related build (increased gift/letter shipping). A lower than expected reduction could lead to an artificial inflation of job gains by the seasonal adjustment process.

Overall, this was a positive employment report, even if one were to remove the odd gain in transportation jobs. Notably, hours

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worked and wages improved during December. Underemployment, the broader measure of joblessness that captures people working part-time who would like to be full-time, as well as those marginally attached to the labor force, saw a sharp decline from

15.6% to 15.2%. That measure declined a full point in just four months. With several employment indicators pointing in a direction of improvement, the outlook for labor certainly appears brighter in 2012 than it did in 2011.

CORPORATE PROFITS HIT A WALL, BUT STOCKS A BUY?

By Monday evening, Alcoa will unofficially begin first quarter earnings season. Corporations have been the shining beacon in an otherwise cloudy economic environment over the past two years, offering signs of hope that things must be getting better. Just in time, however, corporate profits look set to move in a new direction.

Aluminum manufacturer Alcoa, first out of the earnings gate, represents a prime example of what companies are facing this time around. Last week, Alcoa announced intentions to reduce production capacity in response to weakening aluminum prices and slowing demand from countries such as China. That, in turn, caused analysts to ratchet down earnings expectations, now at a fourth quarter per-share-loss of \$0.03.

Alcoa is not alone this quarter. According to Bespoke Investment Group, since the start of the fourth quarter, analysts quickly reduced earnings estimates. After beginning at 14.1%, estimates of year-over-year earnings growth dropped by more than half, to 6.2% in early January.

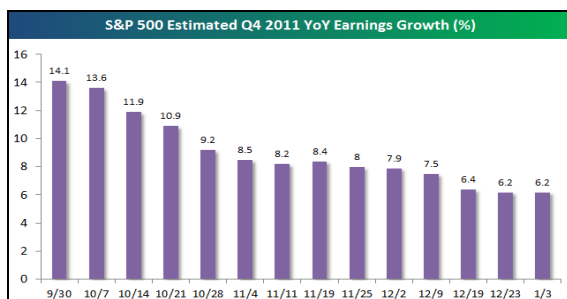
If those projections come true, it would represent the slowest growth rate in two years.

Domestic companies are facing headwinds from all sides, including concerns about a Chinese slowdown, austerity measures in Europe, and a strengthening US dollar.

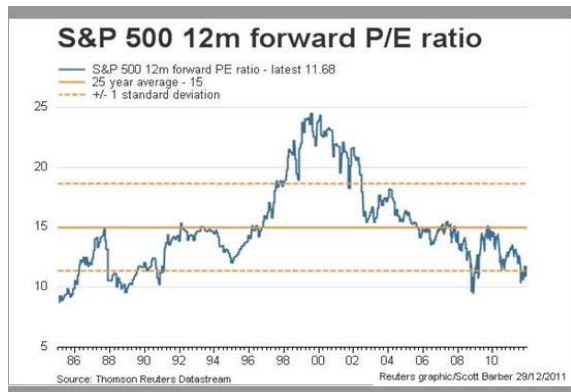
With growing concerns about the corporate outlook, it may seem like an opportune time to avoid stocks altogether. It is important to remember that analysts have been struggling to reconcile the corporate and economic outlook in recent quarters, though.

As an example, Sam Stovall, chief investment strategist at Standard & Poor's, reported that heading into each quarter in 2011, analysts reduced their earnings outlooks, only to see companies report higher than expected earnings in each case. In the third quarter, analysts were looking for a 12.5% increase in earnings, only to be caught flatfooted when earnings came in at a 17.5% growth rate. We are hard pressed to see another quarter of such robust growth, but it is not out of the question that corporations will once again beat aggressively reduced earnings estimates.

From an investment standpoint, even if earnings are less than stellar, markets are surprisingly cheap. Based on the forward 12-month price/earnings (P/E) ratio, S&P 500 companies are priced one standard deviation below their 25-year average. Stocks are trading at a forward P/E of 11.7x versus an average of 15x.



Source: Bespoke Investment Group



Source: Reuters

For some, attractiveness is purely a function of where your client base resides. Certain

analysts are avoiding large multinationals because of sluggish demand from Europe and an appreciating dollar. That leaves many analysts focused on companies with a domestic client base, especially considering a somewhat healthy consumer spending environment over the holiday season.

Investors should ready themselves for a difficult earnings season, but at the same time, corporations are in much better shape than 2008, allowing them to weather the overseas storm. It appears the worst of the news is already priced in to the market, making this an opportune time to consider wading back into the treacherous waters of the equity markets.

THE WEEK AHEAD

The week is not especially heavy on economic data in the US, but there are some items of note.

On Tuesday, the National Federation of Independent Businesses releases its Small Business Optimism index. The measure has been on the upswing since August and is an important indicator for the US economy.

On Wednesday, the Federal Reserve releases the first Beige Book of 2012, a compendium of economic activity across the country. Market participants scrutinize these reports closely as it influences the Fed's opinion of the economy.

Finally, the Census Bureau releases advance retail sales on Thursday. Expectations are for a 0.3% increase. Aggressive discounting by

department and other retail sales likely boosted sales.

Abroad, the most significant release due for the week is China's first estimate of Q4 GDP. Growth is expected to moderate from 9.1% to 8.6% in year-over-year data. Measures of inflation, trade data, and money supply are also due from the country.

On the corporate front, Q4 earnings season begins this week with Alcoa on Monday and J.P. Morgan on Friday. The first of the major banks to report, J.P. Morgan is expected to report a decline in earnings from \$1.02 to \$0.93 per share.

Rate announcements are expected from Poland, Indonesia, United Kingdom, Chile, Peru, and South Korea. Chile is expected to cut its key rate by 25 bps.



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