

## ECONOMIC & MARKET UPDATE: JANUARY 30, 2012 "AMERICA'S ECONOMIC ENGINE STILL HEALING"

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### Economic Data - Previous Week

| Date | Series             | Actual | Forecast | Prior |   |
|------|--------------------|--------|----------|-------|---|
| 1/26 | Durable Goods      | 3.0%   | 2.0%     | 4.3%  | Strongest ex-transport reading since March    |
| 1/26 | New Home Sales     | 307K   | 322K     | 314K  | Disappointing report due to weakness in South |
| 1/27 | GDP - Q4 Adv. Est. | 2.8%   | 3.0%     | 1.8%  | Growth fueled mostly by inventory growth      |
| 1/27 | UMich Confidence   | 75.0   | 74.0     | 74.0  | Consumer sentiment up on better expectations  |

### Economic Data - Upcoming Week

| Date | Series              | Actual | Forecast | Prior  |  |
|------|---------------------|--------|----------|--------|--|
| 1/30 | Personal Spending   | --     | 0.1%     | 0.1%   | Retail sales data points to sluggish spending report |
| 1/31 | S&P/CS 20 City MoM  | --     | -0.40%   | -0.62% | Home price declines picking up in recent months      |
| 1/31 | Consumer Confidence | --     | 68.0     | 64.5   | Labor market gains to boost confidence               |
| 2/1  | ISM Manufacturing   | --     | 54.5     | 53.9   | Regional surveys point to uptick in manufacturing    |
| 2/3  | Nonfarm Payrolls    | --     | 145K     | 200K   | Payroll growth may ease after seasonal-related gains |
| 2/3  | Unemployment Rate   | --     | 8.5%     | 8.5%   | Size of labor force will likely drive headline rate  |
| 2/3  | ISM Non-mfg Index   | --     | 53.2     | 52.6   | Modest improvement anticipated in services index     |

Source: Bloomberg

### GDP DISAPPOINTS, FED SURPRISES

Stock markets paused for the first time in 2012, with mixed performance from the S&P 500 (+0.07%) and the Dow Jones Industrial Average (-0.47%). A thin week of economic data and renewed focus on the European sovereign debt crisis may have prompted profit taking by some investors.

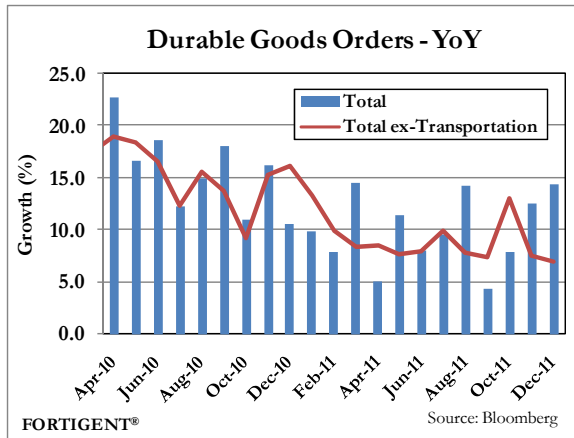
Arguably, the biggest development last week was the Federal Open Market Committee's (FOMC) press release on Wednesday. For the first time, the central bank's decision makers released forecasts for the federal funds rate and the timing for the first rate increase. In that release, the FOMC unexpectedly announced that it expected to hold rates near zero until at least late 2014. This far exceeded previously stated expectations of a mid-2013 rate hike.

The FOMC's decision to extend out its accommodative rate policy is made easier by soft price pressures. The group noted in its forecast that it expected inflation to remain

below their target rate of 2.0% until at least 2014. This was the first time the FOMC provided an explicit inflation target, another in a series of firsts for the increasingly transparent monetary authority.

On Thursday, the Census Bureau released its December report on durable goods. The initial reading was very strong, as growth in the headline new orders index rose 3.0% in December. This followed a very robust 4.3% expansion in November, representing an upward revision from 3.8% last month.

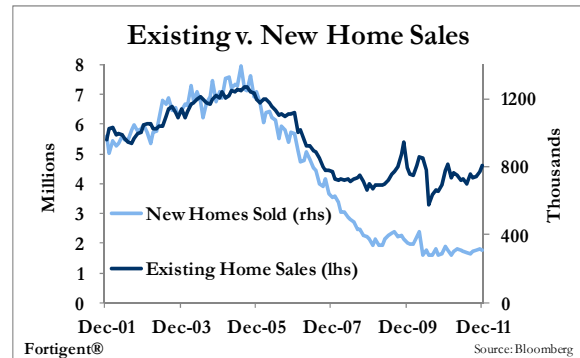
The underlying data for durable goods was very positive, providing more evidence that the US manufacturing sector is quite healthy. Most major subcomponents, including primary metals, machinery, computers and electronics, and transportation, displayed positive advances. Excluding the volatile transportation component, durable goods orders increased 2.1%, the strongest monthly gain since March.



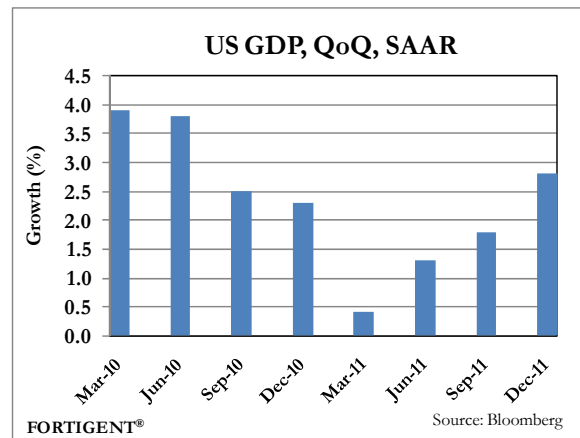
Housing data was mixed during the week. The Federal Housing Finance Agency's monthly Home Price Index had its biggest monthly gain in more than six years in November. However, the figure may be overcompensating for a sharp decline in the prior month. Nevertheless, the year-over-year data has slowly improved since early 2011. This is somewhat at odds with Case-Shiller data that has shown continued declines in home prices.

On the negative side, new home sales were reported at just 307,000 for December – the first decline in six months. This sharply disappointed expectations for a 320,000 rise, and conflicted with the NAHB's strong home building index report last week. Supply overhang remains, as the stock of new homes edged up to just over six months.

The large disconnect between existing home sales and new home sales that opened up in 2008 continues to persist. The steady flood of foreclosures and short sales has buoyed sales of existing homes, but no such stimulus exists in the new homes market. The level of new home sales has been stuck at the mid-300K mark now for well over two years.



On Friday, the Bureau of Economic Analysis released its first estimate of fourth quarter GDP. Although it was the strongest reading in six quarters, Q4's 2.8% annualized growth rate failed to match consensus estimates for a 3.0% expansion. The composition of Friday's GDP report was less than stellar: almost 2.0% of GDP was due to inventory growth, as production unfortunately outpaced demand.

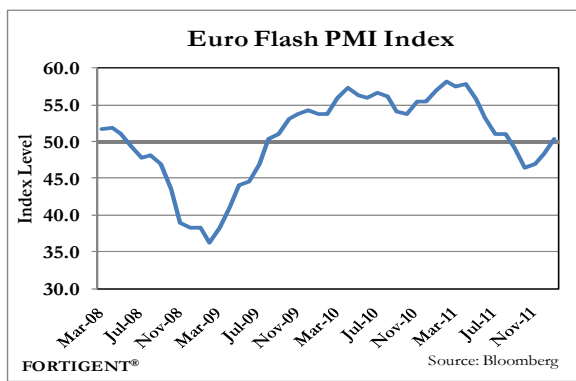


Q4 GDP was disappointing as it seems to contradict some of the forward momentum many were expecting heading into 2012. While there were some positive takeaways, like a modest uptick in personal consumption expenditures, the report should serve to temper some of the enthusiasm for the health of the US economy.

The annual World Economic Forum in Davos, Switzerland refocused some negative attention on the yet unresolved sovereign debt

crisis, but Europe did release some encouraging economic data during the week.

Most notably, the flash PMI composite for the Euro region returned to expansionary territory in January, rising from 48.3 to 50.4. Germany was the primary driver of this advance, as the country's manufacturing PMI improved for the third consecutive month, finishing at 54.0.



Germany's IFO Business Index for January also rose to 108.3, outpacing expectations. While enterprises' view of current conditions

## AMERICA'S ECONOMIC ENGINE STILL HEALING

Consumers are an integral cog in the American economic engine, but since the financial crisis hit its crescendo, consumers have been under high attack. By most traditional measures, the economy is larger today than any time in our history, but it is hard to argue that consumers are feeling the benefits of that expansion. That said, consumers seem to be taking a new view on debt and spending, all in the name of prudence.

With the benefit of hindsight, virtually everyone can agree that consumers came

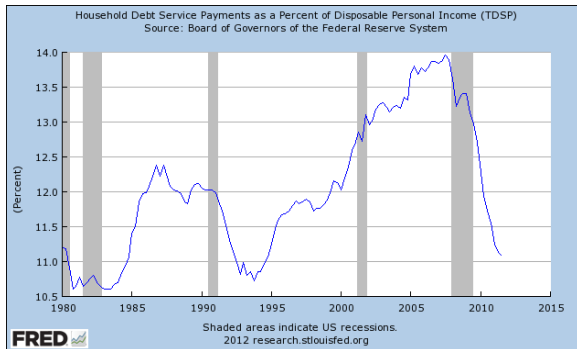
was little changed, sharp improvement was observed in business expectations – suggesting brighter days ahead.

Last week's improvement was notable given heightened recession fears for Europe. Stabilization in Germany's economy is especially important, as it is the engine of European growth. Tuesday's PMI data suggests German GDP should rebound to positive territory after a momentary dip in Q4.

through the mid-2000s with too much debt, and too little concern about how to pay that debt. Measures such as the household debt service ratio, which measures debt payments on mortgage and consumer debt, reached record highs, nearly hitting 14% in the third quarter of 2007. The good news is that those figures have actually fallen faster than they rose.

Since 2008, the debt service ratio has fallen nearly 3 percentage points and stands at levels last seen in the mid-1990s.

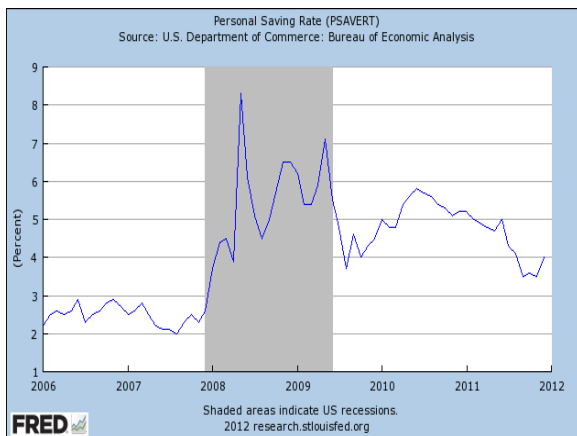
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Source: Federal Reserve Bank of St. Louis

As consumers started to feel mildly better about the economic outlook and about their personal financial situations, they naturally began spending more money.

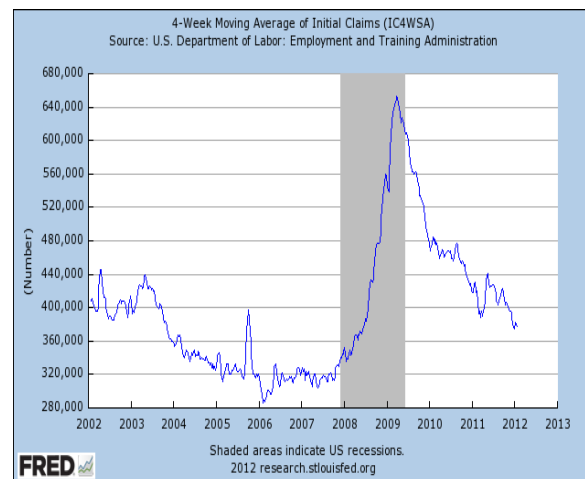
Throughout 2011, for instance, consumer spending posted a 2.2% gain, after rising a similar 2.0% in 2010. However, those gains are largely coming from a drawdown in savings as opposed to wage growth. After peaking at above 7%, the personal savings rate has steadily declined over the past two years and fell as low as 3.5% in November before a slight rebound in December.



Source: Federal Reserve Bank of St. Louis

One of the primary reasons consumers have been reticent to spend has been a simple lack of sustained wage growth. In recent months, wages have bounced around in a volatile fashion, falling over the summer, before jumping in the fall and weakening again as winter approached.

Consumers have at least one reason to be optimistic. Labor markets are inching toward definitive improvement for the first time since the recession ended. Initial claims for unemployment benefits have consistently tracked below 400,000 since early November, the longest such period since mid-2008.



Source: Federal Reserve Bank of St. Louis

Consumers are in better shape than 2007-08, be it from “strategic defaults” or through intentional efforts to act responsibly, but there remains a long way to go to reignite such a vital cog. The good news is that labor markets are gradually thawing, and such improvement should lead to higher wages and better employment prospects.

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## THE WEEK AHEAD

This week provides a full slate of economic data for investors to digest. Data spanning employment, spending, manufacturing and service sector growth, and housing are due for release. The ISM Manufacturing Index and the Employment Situation are the headline items to watch.

Earnings season continues in the US and abroad with Q4 reports on tap from Pfizer, Honda Motor, Banco Santander, Roche, AstraZenaca, LVMH, Unilever, Sony, Royal Dutch Shell, and Deutsche Bank.

Russia is the only major central bank meeting this week. It is expected to cut its primary refinancing rate by 25 bps.

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