The Bryn Mawr Trust Company
Wealth Management Division

Economic & Market Quarterly

AUTUMN 2013

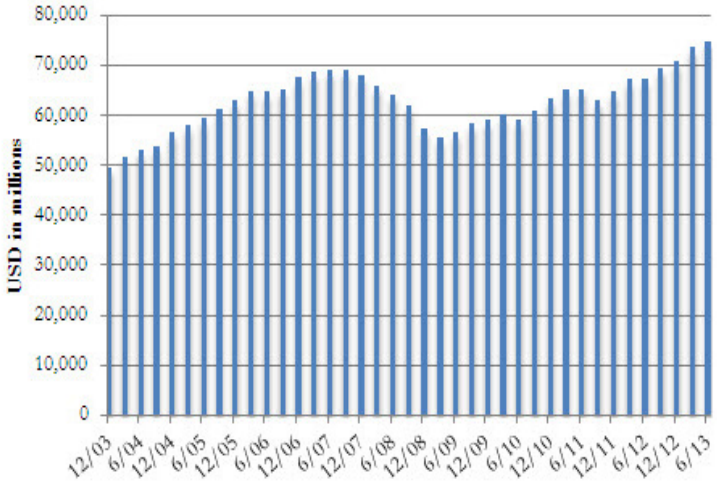
As we move through the fourth quarter of 2013, the domestic economy continues to show slow positive growth resulting from the ongoing gradual improvement in consumer and business investment spending. These modest gains are impressive given the near-term economic and geopolitical turbulence created by the continued political bickering in Washington over the US budget negotiations as well as the dysfunctional brinksmanship focused on the temporary shutdown of the Federal Government and the impending debt ceiling. Economic growth during 2013 has also been dampened by the sequester induced federal spending cuts, the increase in Social Security withholding, and the downward pressure on overall federal and state spending levels. In spite of these ongoing negative pressures, Gross Domestic Product (GDP) growth in the United States is expected to be close to 2% for 2013.

While the Federal Government shutdown was short-lived and the potential government default was avoided, the time constraint for reaching a more permanent agreement is relatively brief at less than three months. While this political uncertainty will remain elevated over the near-term, it is our view that political pressure from both sides of the aisle created by historically low congressional approval ratings will hopefully lead to a significant compromise.

While the domestic political and economic uncertainties have captured the attention of the media and the investment community, there are a number of positive trends that have garnered less attention. Corporate America has shown solid earnings growth during 2013 with profits for the S&P 500 at record levels. Internationally, the nations of the European Union have begun to show improving economic growth trends following negative growth over the past 18 months, and both China and other emerging markets appear to be showing renewed strength following recent slowdowns.

While a number of these recent domestic political concerns will persist, the domestic economic climate has improved over the past year. The fiscal cliff has been turned into a fiscal slope that has taken place without dramatically impacting positive consumer and corporate spending patterns. While politicians have continued to squabble, budgetary savings that have been made to date combined with tax revenue increases have produced half of the savings needed to stabilize the U.S. Debt to GDP ratio at satisfactory levels. In the summer of 2012, the US Debt to GDP ratio was projected to reach 100% of GDP by the year 2023. Given the spending cuts made to date, the implementation of the sequester cuts, the drawdown in military spending in Iraq and Afghanistan, and the tax revenue gains implemented to date, the Debt to GDP ratio estimate for 2023 made one year later is projected to be at 77%, approaching the initially stated goal of 70%.

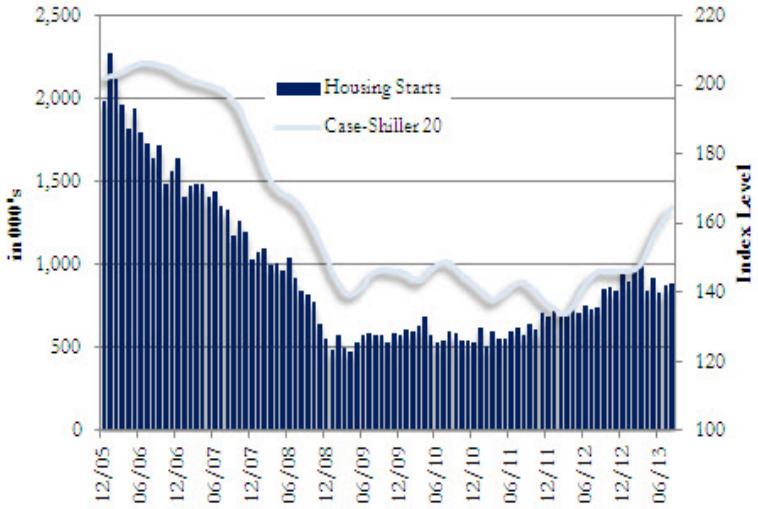
U.S. Household's Balance Sheet



source: FactSet

Consumer balance sheets have strengthened over the last five years with the total aggregate net worth of consumers now recovered to the previous peak level of $67 trillion reached in mid-2007. Household debt payments and financial obligations have been reduced to their lowest level in relation to disposable personal income since 1992. Banks have now recapitalized their balance sheets to the strengthened levels required by recently enacted legislation and will be more proactive within the lending markets as they begin to put this increased capital to work. The housing market is now showing a reasonably steady recovery in many areas of the country based on increasing consumer demand focused for a limited availability of unsold homes.

Housing Starts and 20 City index of Home Prices

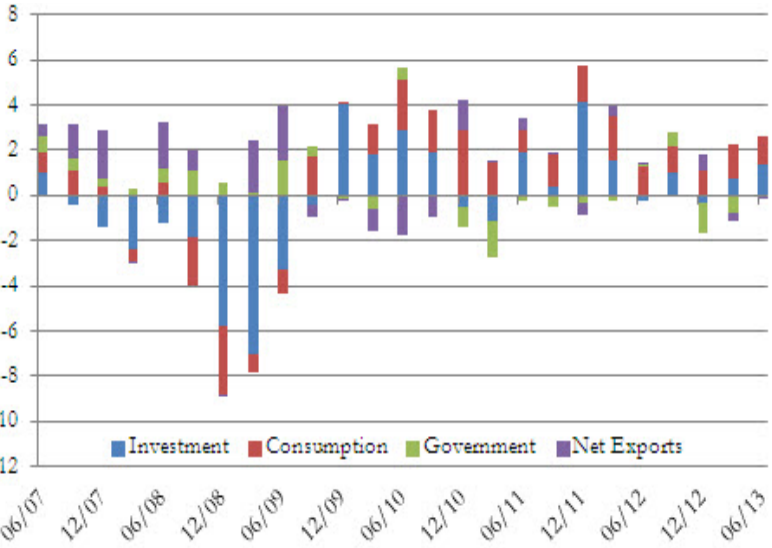


source: FactSet

Employment trends should show continued positive growth in 2014 as private sector hiring gains benefit from an increasingly positive housing and capital goods spending cycle. These resulting gains should not be as adversely offset by the required incremental cutbacks within the public sector labor force.
For 2014, we see a gradual increase in economic momentum from 2% in 2013 to 3% in 2014. Consumer spending is projected to increase by 3.5% in 2014 based on improving consumer confidence coupled with improvements in disposable personal income and overall employment levels.

Business Investment spending is expected to grow in the area of 8% to 10% in 2014 based on the sector's currently strong and relatively liquid balance sheets and the need for heightened investment spending. This is due to the business investment programs that have been delayed during the past three years as a result of continued economic and legislative uncertainty. While both the consumer and business sectors will show significant improvement in 2014, the governmental sector will continue to be under pressure at the Federal, State and local levels until longer-term spending cuts and tax reforms are implemented. In 2014, improving economic trends internationally should also provide economic support to the domestic recovery as Global GDP gains are projected to improve from the 2.7% growth range in 2013 to around 3.6% growth in 2014.

Contribution to GDP Growth: Government Drag Offsets Private Sector Gains



source: FactSet

The Markets

During the first three quarters of 2013, the domestic stock market as measured by the S&P 500 rose by 19.8%, representing a rate of gain that was well above optimistic forecasts. This significant appreciation was made even more impressive when viewed against the recent background of political bickering and the lack of any longer-term governmental guidance on tax policy or entitlement reform. Current Wall Street estimates for the S&P 500 Index call for earnings of $109.00 for 2013, representing a gain of 5% over reported earnings of $103.80 in 2012. Based on recent market levels, the stock market is being valued at 16 times 2013 estimated earnings and 14.6 times projected 2014 earnings of $120.00.

While the equity market has made dramatic gains over the past four years since the stock market lows of 2009, valuation levels do not appear over-extended. Fourteen times expected 2014 earnings represent a valuation level that remains attractive especially given the absence of any near term inflationary pressure. Stock market valuation levels are also viewed as very attractive relative to the alternatives within the bond market. The current earnings yield (earnings divided by price) of the S&P 500 stock market index exceeds the current yield of high quality corporate bonds by 3%. This differentiation remains at the upper end of the comparative range over the past 30 years and has been caused by the combination of the stock market's strong earnings growth, coupled with the artificially depressed bond yields that are being facilitated by the Federal Reserve.

Throughout the past four years, the Federal Reserve has held interest rates at artificially depressed levels to add liquidity to the system and aid in the economic recovery. During this period both institutional and individual investors placed increased emphasis on their bond portfolios to take advantage of the reduced risk and volatility that fixed income investments represented during this period of economic uncertainty. In 2013, this rotation into fixed income investments at the expense of equity holdings has begun to reverse as the Federal Reserve has positioned itself for the start of "tapering" expected to begin in early 2014. With corporate balance sheets strong and economic growth expected to continue in 2014, both institutional and individual investors are increasingly moving their incremental cash flow from fixed income securities back toward a more balanced position in common stocks. This longer-term rotation has been a significant contributor to the market's relatively strong appreciation over the past year and with interest rates expected to continue to rise in 2014, the rotation does not appear to be over.

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