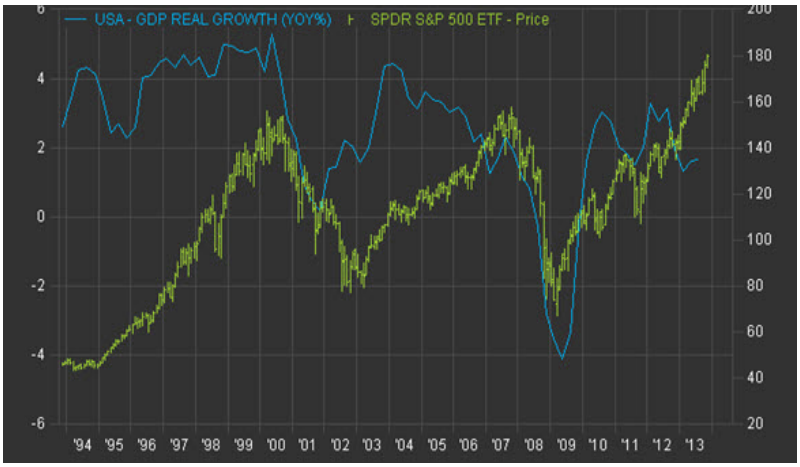
December 2013

The Bryn Mawr Trust Company
Wealth Management Division

Is the Market Really Overvalued or Are There Legs Left on this Bull?

Source: iStockphoto/GlobalStock



Graph 1: US Real GDP Growth versus the S&P 500 (SPDR)
Source: FactSet

Is the Market Really Overvalued or Are There Legs Left on this Bull?

The rise in equity prices has been dramatic and should give one pause in evaluating future market appreciation. The S&P 500 has risen 166% to new highs and the Dow Jones Industrials rose 146% from the depths of March 2009. The tech-laden NASDAQ Composite, which had decreased by more than 50 % from the previous market peak in the fourth quarter of 2007, has risen 213% from the market lows of 2009. There are many variables that affect security pricing; including global, domestic macro and political events. Do the significant price increases in the market indices translate into equally significant valuation excesses? Addressing key factors will help draw conclusions as to how to best view the horizon.

Six Data Points

We selected a number of economic, monetary, profitability and valuation criteria to evaluate. The six data points we evaluate below are not intended to be all inclusive, but rather to be an objective set of important and diverse inputs.

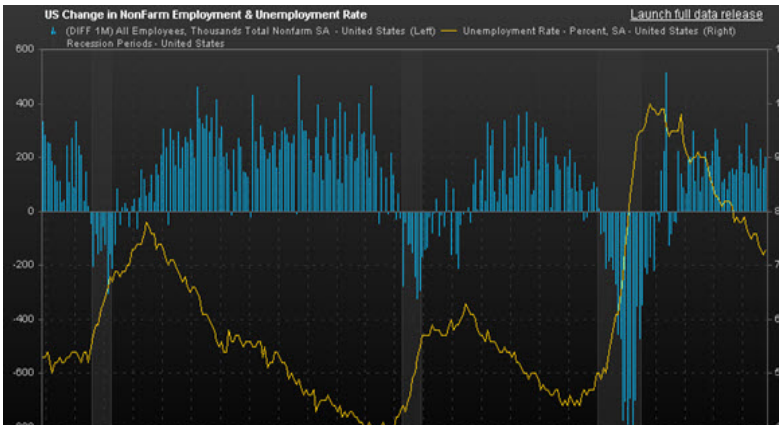
GDP Growth

The current economic recovery is now over 50 months in duration and, on average, stock market peaks occur when economic recoveries are closer to five years. We examined GDP growth and its correlation to market peaks, using the S&P 500 SPDR as a proxy for the S&P 500 and the general market. As Graph 1: US Real GDP Growth versus the S&P 500 (SPDR) indicates, the economy grew at over a 4% annualized rate in the second half of the 1990's with the market rising steadily and then peaking in early 2000. The Index was then 50 percent less by 2003. After the recession of 2001, GDP began to accelerate and reached a rate in excess of 4% by 2003 and then experienced plus/minus 3% growth for the next several years and with it, the S&P 500 rose to new highs by autumn of 2007. The significant leverage built in to the financial system due to synthetic securitizations, leverage, along with regulatory abuses, created a severe financial collapse leading to the demise of Lehman Brothers and other well-known financial houses. This sent global markets into a virtual downward spiral. The S&P 500 declined over 55% on a peak-to-trough basis before bottoming in March of 2009. Since 2009, the economic recovery has been slow by historical standards, with GDP growth hugging the plus/minus 2% line for the last couple of years.

Employment Growth

The propensity of businesses to add employees is both a driver as well as an outcome of accelerating growth in GDP. The current recovery has been characterized by below average employment gains and grudgingly high levels of unemployment (currently 7.3%).

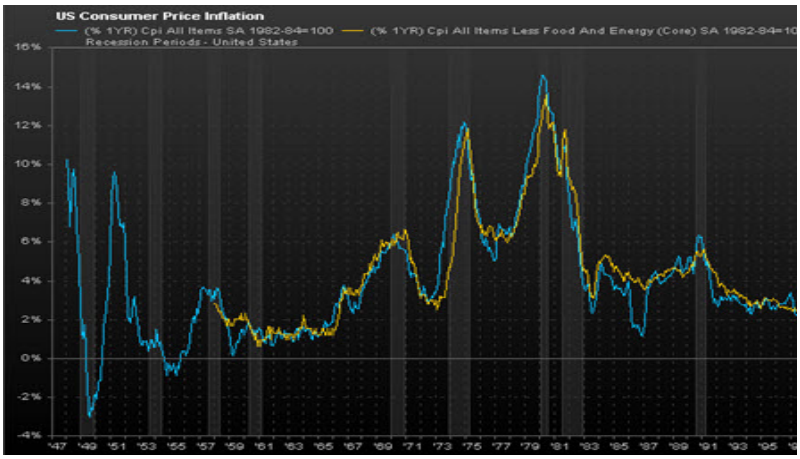
Graph 2: US Change in Nonfarm Employment & the Unemployment Rate depicts the monthly changes in non-farm employment growth (left hand scale) and the unemployment rate (right hand scale) since the late 1980's. Periods of recession (at least two consecutive quarters of negative real GDP growth) are indicated by the lightly shaded areas. Market peaks (1990, 2000 & 2007) were associated with higher sustained levels of non- farm employment growth (>200,000/month) and much lower rates of unemployment. The Federal Reserve Bank has stated they are not satisfied with the current level of employment growth and view the current level of unemployment as unacceptable. The employment rate is much higher than it has been at previous market peaks. In a speech to the National Economists Club on November 19, Chairman Ben Bernanke stated that "the target for the federal funds rate is likely to remain near zero for a considerable time after the asset purchases end, perhaps well after the jobless rate breaches the Fed's 6.5 percent threshold", as reported by Bloomberg.



Graph 2: US Change in NonFarm Employment & the Unemployment Rate
Source: FactSet

Inflation

As shown in Graph 3: US Consumer Price Inflation, since the large inflation spikes of the 1970's, inflation has declined along with interest rates. Higher levels of inflation are associated with higher levels of GDP growth and final demand. Current levels of inflation are not historically associated with market tops.



Graph 3: US Consumer Price Inflation
Source: FactSet

Interest Rates

The Federal Reserve has adopted an extraordinarily accommodative monetary policy dating back to the financially driven crisis that commenced in 2007. The Federal Funds Target Rate has been cut to zero since the crisis of 2007. Prior to the stock market peaks of 2000 and 2007, the central bank had been raising the Fed Funds Target Rate – to 6.50% in 2000 and 5.25% in 2007.

In 2009, the Fed began an aggressive program of buying treasury and mortgage securities on a monthly basis ($85 billion/month). This program, known as Quantitative Easing, was designed to drive down interest rates, particularly those tied to consumer borrowing for homes and cars in an effort to revive consumer spending. Looking at the Ten Year Treasury Bond as a barometer of rates, the level was above 6.50% in the first quarter of 2000 and touched just over 5% by mid-year 2007. Inflation rates stood at about 3% in both 2000 and 2007, producing a real rate of return on the Ten Year Treasury (nominal less inflation) of over 3% in 2000 and over 2% in 2007. The real rate of return on the Ten Year Treasury Bond over the last 30 years is slightly in excess of 3%. The real rate of return is virtually zero at the current level on the Ten Year Treasury Bond (2.85%).

Corporate Profits

One of the drivers of the current recovery has been the growth of corporate profits, which continue to grow at a modest rate. Early in the recovery, profit margins were expanding as revenues rebounded and lowered cost structures provided a favorable scenario for earnings to drop quickly to the bottom line. Since the middle of 2012, margins have been contracting as revenue growth has slowed and the ability for corporations to further reduce costs is problematic.

Valuation Metrics

- **P/E:** One of the more popular metrics used is "P/E" or Price to Earnings Ratio. In examining P/E for the market on a forward twelve month (FTM) earnings basis since the late 1990's, the average P/E ratio or "multiple" is around 16.4 times. Other than the period from the late 1990's through early 2002, the FTM P/E has been at or below this average and currently, it stands at around 15 times FTM earnings.
- **P/BV:** Price to Book Value is used as a valuation tool and associated with companies that have more significant tangible assets (plant & equipment). On a forward basis, P/BV was well over 3.5 times in 2000 against an average of 2.8 times since the late 1990's. In the autumn of 2007, the ratio stood at 2.7 times and is currently at 2.4 times.

Summary

- The economic recovery, as measured in terms of GDP growth remains slow by historical standards. It does not appear that the current level of GDP growth is creating hyper demand conditions similar to that of previous market tops.
- The well-advertised and elevated unemployment rate and slow growth in payroll employment leave plenty of room for upside gains and are not normally associated with previous market peaks.
- Price inflation is not yet evident, leaving demand elasticity in pricing.
- One of the most telling indicators is the level of "real" interest rates. The current "real" rate on the Ten Year Treasury Bond is essentially zero, well below the historical average and providing an unfavorable alternative to other asset class, such as equities.
- Corporate earnings have been growing but there is concern that revenue growth has been under pressure. At some point, we want to see final demand accelerate sufficiently to raise sales and pricing levels.
- Valuation metrics, such as P/E and P/BV are lower than market peaks when taken in the context of the other indicators noted above.

Conclusion

The rise in global equity prices since the market bottom in March of 2009 prompts many to conclude that equity markets, specifically the US domestic equity markets, are therefore extended and overvalued. Risks to the market advance remain but data driven metrics are supportive of further advances in equity prices. Risks to this conclusion include the impact of external events (continued dysfunction in Washington, Middle East concerns, etc.) as well as the differentials in sub asset class and individual security returns. Equity market advances are often uneven but the "bull" markets of the late 1990's, early 2000's, as well as the current bull, are often punctuated with periods of rapid declines. We conclude that equities remain the preferred asset class and see continued risks in the bond markets.

Division Head
Francis J. Leto
Executive Vice President
610-581-4730
fleto@bmtc.com

Investments
Ernest E. Cecilia, CFA
Senior Vice President
610-254-2030
ececilia@bmtc.com

Retirement Services
Kurt W. Angstadt
Vice President
610-581-4944
kangstadt@bmtc.com

Multi-Family Office
Judith W. Lau, CFP®
President
302-792-5955
judy.lau@lauassociates.net

Fiduciary Services
Elizabeth Shevlin Roberts, Esq.
Senior Vice President
610-581-4755
eroberts@bmtc.com

Custody Services
Anrita McGinn
Group Vice President
610-581-4722
amcginn@bmtc.com

BMT Asset Management
Richard K. "Chip" Cobb, Jr.
Senior Vice President
610-581-4770
ccobb@bmtc.com

The Bryn Mawr Trust Company of Delaware
Robert W. Eaddy
President
302-798-1792
readdy@bmtc.com