The Bryn Mawr Trust Company
Wealth Management Division

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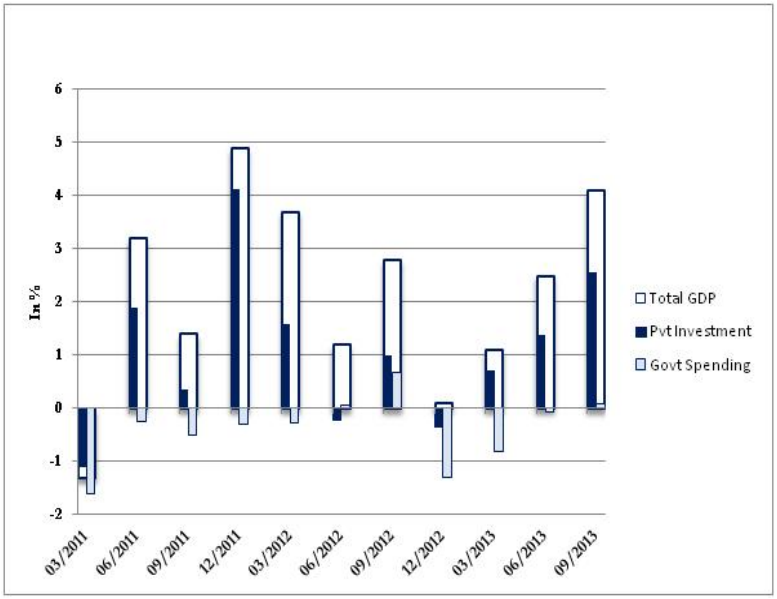
Economic Outlook

In 2013, Real Gross Domestic Product in the United States grew at a rate of around 2%. While consumer and business investment spending recorded positive growth trends, the full year growth comparisons were held back by the negative impact of the government sequestration initiatives instituted in the first quarter of 2013. The continued political uncertainty surrounding the potential for incremental tax and regulatory actions that could result from political posturing during the year negatively contributed to investor confidence.

As we move through 2014, the domestic economy is experiencing increasingly broad economic growth resulting from improving consumer confidence and spending trends and an increase in business fixed investment spending trends. The gradual recovery in the housing industry, as excess inventory has been worked through has been a major driver. Consumer balance sheets have strengthened and bank capital levels have risen to meet the increased regulatory benchmarks that will allow these institutions to reenter the mortgage lending market. Within this firming economic environment, the absence of the fiscal drag that was present last year due to the governmental spending cuts imposed by the sequestration should result in improvement in real GDP growth closer to the area of 3%.

Political posturing in a mid-term election year could once again put a damper on the nation's growth potential. There appears to be an increased likelihood of interim cooperation to avoid further governmental shut downs or disruptive legislation.

Overall US GDP Growth and Contribution From Investment and Government Spending

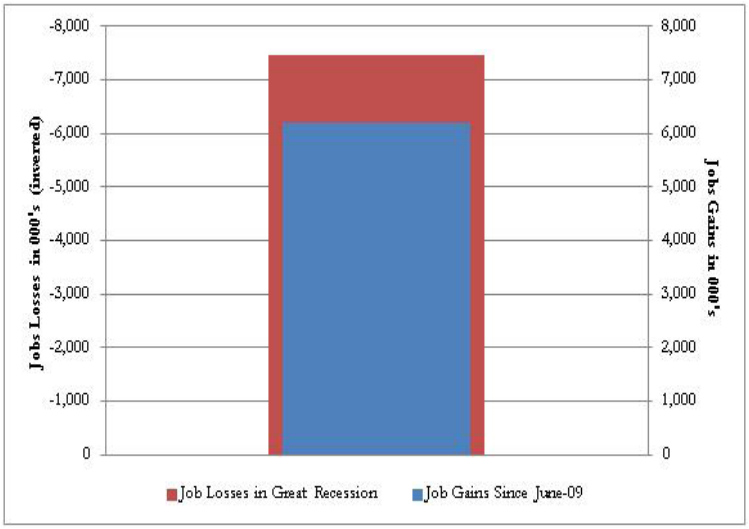


Source: Bureau of Economic Analysis, last revision: December 20, 2013

In spite of the continued concerns about geopolitical uncertainties, positive broad economic recovery trends occurred in the United States throughout 2013. The unemployment rate declined, consumer confidence levels improved, capacity utilization rates gradually increased, business investment spending plans were raised and corporate profits rose to record levels. Overseas, the euro zone countries are beginning to show a gradual improvement in economic growth trends following recessionary trends in the last 18 months.

China and other Asian emerging markets are also showing improving growth comparisons. The steady improvement within the international community should add further support to the domestic recovery as international trade benefits from the effects of the firming economic growth trends.

The recent Federal Reserve Board action is beginning to wind down "Operation Twist" by reducing the monthly purchases of fixed income securities is a reflection of the central bank's growing confidence that the economy has regained a level of recovery growth that is viewed as sustainable without the need for continued Federal Reserve action. While "Operation Twist" has begun to wind down, the Federal Reserve is expected to continue their policy of short term interest rates in 2014, as a means to stimulate continued economic growth.



Source: FactSet. Data through November 29, 2013

During 2014, consumer spending is expected to increase in the area of 3%, aided by improving confidence and modest gains in disposable personal income levels. Employment levels should continue to show improvement as growth in the private sector should not be partially offset by cutbacks within the public sector labor force. Business investment spending should show relatively strong gains in the area of 8% to 10%, reflecting the sector's strong capital position coupled with the need to increase efficiencies and modernize current production facilities.

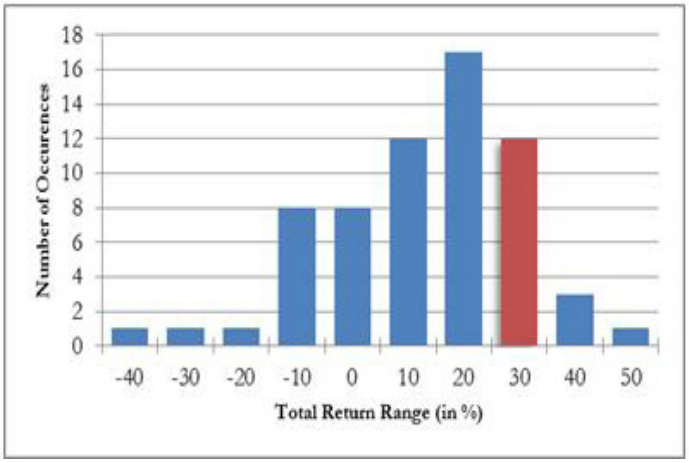
Governmental spending levels should remain relatively flat for the next year as significant cuts initiated in 2013 may be modified but should be allowed to continue in their aggregate effect going forward.

The relatively modest economic rebound experienced during the last five years in relation to the magnitude of the recession has set the stage for what may be a longer than anticipated cyclical recovery period. Capacity utilization rates continue to be relatively low and there is no sign of inflationary pressure on the economy currently as we enter the fifth year of the recovery. As the recovery continues to broaden both domestically and internationally, the positive economic trends that are driving the market currently could be expected to continue over the next two to three years, barring any significant geopolitical shock.

Market Outlook

During 2013, the domestic stock market as measured by the S&P 500 increased by more than 30% in spite of a background of political bickering and the lack of any longer term governmental guidance on tax policy and entitlement reform. This market performance marked the eighth strongest market performance in the post-World War II period. The performance was the strongest in the last five years exceeding the 24% growth in 2009 coming off of the recession market lows.

Distributions of Annual Returns: S&P 500 since 1950



Source: BCA Research January 6, 2014; Morningstar Direct; FactSet

From the market lows in March 2009, the market has appreciated by 160%. In spite of this dramatic gain, valuation levels do not appear to be significantly over extended. Corporate profits have also risen significantly and based on an earnings estimate of $120 for the S&P 500 in 2014, stocks are being valued at 15 times future 12 months earnings. The current price earnings multiple valuation level remains near the average valuation level of the market over the last 50 years. While current valuations are no longer historically inexpensive, they are by no means excessive.

Stock market price earnings multiple valuation levels should not be expected to expand drastically from current levels, but the market itself can continue to appreciate as underlying earnings levels grow in response to the broadening recovery. Stock market valuation levels are also viewed as relatively attractive in relation to the fixed income markets. The current earnings yield of the S&P 500 stock market index (earnings divided by price) exceeds the current yield on high quality corporate bonds by over 3%. This yield differential 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 recent strong earnings growth and the artificially depressed bond yields that are continuing to be facilitated by the Federal Reserve.

While the equity market has the potential to move higher in 2014, performance should be more closely tied to fundamental earnings growth both in terms of the general market and the specific stock selection contained within each individual portfolio. As the recovery continues to mature, rotational consolidations within the market would be considered normal and indeed healthy for the market as individual stock and economic sector appreciation is consolidated in overall market levels. Within this type of investment environment, sound fundamental analysis and a focus on individual security valuation levels will become increasingly important in providing attractive relative investment returns.

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