The Bryn Mawr Trust Company
WEALTH MANAGEMENT DIVISION

Economic & Market Quarterly

SPRING 2014

The Domestic Economy

Heading into the spring of 2014, the economic recovery is now entering its fifth year. Following an unusually severe winter that dampened many economic indicators, the onset of warmer weather is expected to foster a gradual improvement in economic momentum. The domestic economy is experiencing a broadening of economic growth trends this spring, buoyed by improving consumer confidence and spending trends and an increase in business fixed investment spending.

Consumers have made significant progress over the past four years in reducing their debt levels that contributed to the excesses which brought on the last recession. While U.S. households continue to carry a large amount of debt (over $13 trillion according to the latest Federal Reserve estimates), personal liabilities have declined significantly from their pre-recession highs. Consumer debt service levels have fallen from over 13% of Disposable Personal Income in 2007 to just under 10%, currently. This level of debt service represents the lowest consumer debt service burden recorded since the Federal Reserve began tracking the data in 1980.

This low debt burden coupled with historically low interest rates has made it easier for the consumer to increase their purchasing patterns. Employment growth is gradually improving. The unemployment rate has come down to 6.7% from the 10% level just a few years ago and consumer confidence has improved.

Consumer Debt Service

Source: St. Louis Federal Reserve Bank and U.S. Federal Reserve. Data through December 31, 2013, downloaded 4/1/2014.

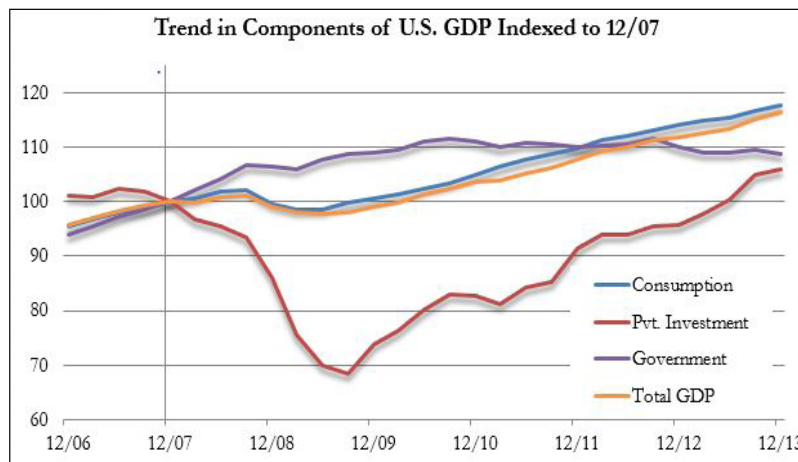
Consumer spending represents the largest component of Gross Domestic Product (GDP) at 68% of the total. The improving balance sheet and spending power of the consumer will be a major contributor to continued positive economic momentum. The continuing recovery within the housing industry coupled with an improvement in employment trends should support economic momentum for the remainder of the year.

Private investment spending on plant and equipment, durable goods and construction all slumped dramatically during and immediately following the Great Recession. While spending has shown a significant improvement over the past four years, levels have only recently passed the pre-recession levels of 2007. The subsequent delay in normal replacement patterns as well as other deferred spending trends should add to ongoing investment growth from current levels.

While both consumer and private investment spending trends will be a positive influence on economic growth in the year ahead, government spending will continue to be a source of weakness. Total government spending peaked in mid-2010 and has since shrunk to the levels last achieved in late 2009. The composition of this spending has also shifted over the past four years as state and local spending increased while federal spending has declined. Government spending should be less of a drag in 2014 versus 2013, as revenues in 2014 will not be subject to the effects of last year's sequestration.

In 2014, GDP growth is expected to increase 2.9%, aided by consumer spending gains of 3%, business private investment spending of close to 8% and a continued modest decrease of less than 1% in the overall governmental sector as congressional and state legislative bodies posture for the upcoming November elections.

GDP Components



Source: bea.gov. Data through December 31, 2013. Downloaded on 4/1/2014.

The Federal Reserve Board is in the process of winding down "Operation Twist" by reducing the monthly purchases of fixed income securities in the open market. We expect the Federal Reserve to stop buying bonds by the end of 2014 and we further anticipate that the Federal Funds Rate is likely to remain at the current level (0.25%) until 2015. As the Federal Reserve unwinds this stimulus program, longer term interest rates are expected to gradually rise over the next 18 months. Much has been written about the slow pace of recovery following the Great Recession, particularly with respect to the depth of the contraction. There is still a good deal of slack in the economy as measured by capacity utilization, unemployment rates and commodity pricing, suggesting the recovery might be longer than typically experienced. As the recovery continues to broaden globally, the positive economic trends driving the market may continue over the next year or two, barring any significant geopolitical shock.

Developed & Emerging Economies

Overseas, the Eurozone is shadowing our domestic experience. Most GDP forecasts for this region of the globe predict growth to be around 1% in 2014.

Current account balances as a percentage of GDP have improved in many of the Euro countries.

Markets in developing countries joined the bright side of the party recently with most indices in Asia, Latin America, Eastern Europe) and Africa having recorded positive gains over the last three months after being left behind in the vapor trails surging developed markets in late 2013. Many emerging countries were attempting to protect their local currencies from rising U.S. interest rates. Long term prospects for a number of the emerging markets are positive, based on population growth, expansion of the middle class in many of these countries and the attendant effects of higher demand for household products, services and protein-based food. Emerging markets represent approximately 11% of global market cap.

The Capital Markets

Following the dramatic stock market appreciation recorded in 2013 (with S&P 500 gaining more than 30%) the general market averages entered a consolidation phase over the last four months. Market volatility has increased and individual momentum driven investment sectors have been hit hard by profit taking: biotechnology and information technology most recently, for example. Index volatility has heighted investor nervousness but general market averages have remained relatively unchanged for the year.

This type of rotational consolidation is considered normal and healthy following the strong appreciation of the past year as it serves to remove overly optimistic expectations from pricing. Within this investment environment, sound fundamental analysis and a focus on security specific valuation have become increasingly important.

The general equity market is no longer substantially undervalued, given its substantial appreciation over the past four years. But it is by no means highly overvalued, either. Current price/earnings (P/E) multiple levels of 16-times estimated 2014 earnings are in line with the market's longer term average valuation level. Any P/E multiple expansion from these levels should be relatively modest. That leaves earnings growth as the source of appreciation, domestically, for the coming 12 to 18 months.

Although equities are no longer viewed as being significantly undervalued, they do offer a better alternative than fixed income or cash for most investors. The accommodative monetary policy of the Federal Reserve has resulted in a ten year Treasury bond yield of 2.70% and a 90-day Treasury Bill yield of 0.02% versus the S&P 500's dividend yield of 2.0%.

As the Federal Reserve gradually unwinds their economic stimulus programs and the economy continues to grow, interest rates will rise toward more traditional levels.

The Risk in High Grade Fixed Income

If Rates Rise by 1% Over:	Total Return of a 10-Year Note* Will Be:	Total Return of a 3-Year Note* Will Be:
6 Months	-6.67%	-2.93%
1 Year	-4.51%	-0.97%
3 Years	+1.34%	+0.64%

** - Analysis uses current U.S. Treasury obligations with comparable maturities. Six-month return is cumulative; 1- and 3-year returns are annualized.Source: Bloomberg. Illustrative of the sensitivity of bond prices to changes in interest rates and not an interest rate forecast.*

As rates gradually rise, bond prices will weaken, creating little gains for investors still over-weighted in their fixed income asset allocation.

With corporate liquidity at historically high levels and corporate profits continuing to record solid gains, the outlook for above average dividend increases remains strong. This outlook for a growing income stream will become even more attractive to investors as inflationary pressures begin to re-emerge over the next few years and investors place a greater emphasis on protecting their real purchasing power.

Outlook

The capital markets will continue their transition from being supported by extreme measures of monetary stimulus to being driven by final demand (revenue & earnings). This transition is positive but will also be accompanied by higher levels of volatility, particularly relative to 2013. For the long term, we remain positive on equities but see a greater focus on asset and security specific selectivity and on stocks with reasonable valuations and cash flow potential. We believe that determining proper valuation is a key ingredient that had largely been absent as the market recovered from the depths of the bear market in 2009. We remain cautious on fixed income and believe the headwinds will build further over the next couple of years. We remain committed to defensive structures and shorter durations.

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