The Bryn Mawr Trust Company
Wealth Management Division

Economic & Market Quarterly

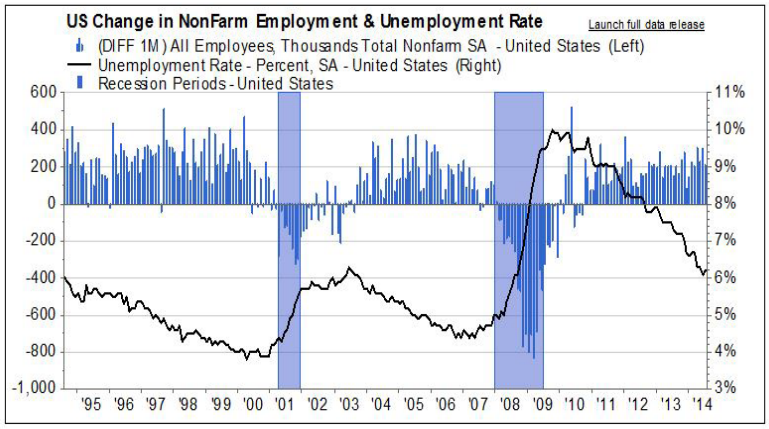
SUMMER 2014

The Domestic Economy

During the first quarter of 2014, the economy contracted at a revised rate of 2.1% as a result of the harsh winter weather. The contraction represented the first quarterly decline in GDP since the first quarter of 2011. Second quarter results registered a very strong 4%, rebounding from the weather-impacted first quarter results. As we move through the summer of 2014, we expect the economy to show continued improvement in consumer spending trends along with positive capital spending trends.

Over the past five years, since the depth of the recession in 2009, consumers have significantly reduced their debt levels following an over-extended position. While U.S. households still carry more than $13 trillion of personal debt, this level of debt has fallen by more than $1 trillion throughout the last five years. Given this decline in debt, combined with the current low interest rate levels, the average consumer's debt service level carrying charge has been sharply reduced. Consumer debt service has fallen from more than 13% of disposable personal income in 2007 to under 10%. This level of debt service represents the lowest consumer debt service burden recorded since the Federal Reserve began tracking the data in 1980. Recent trends in employment have contributed to a more favorable outlook for the consumer balance sheet.

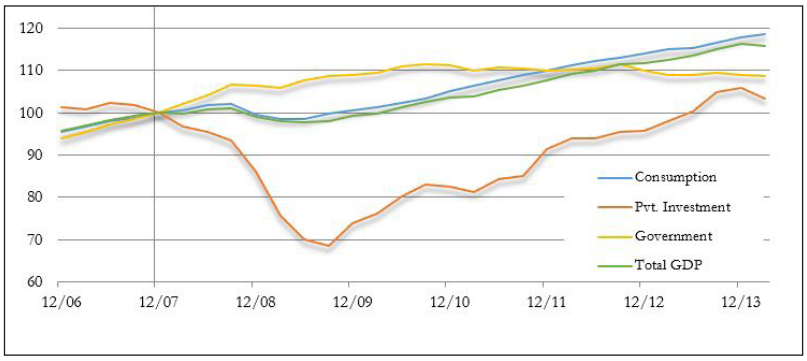
Graph I : Employment



Source: FactSet, Inc.

Private investment spending on plant and equipment, durable goods, and construction fell dramatically during and immediately following the recession. While this spending has shown a significant improvement throughout the past four years, these investment spending levels have only just passed the pre-recession peaks recorded in 2007. While initial reinvestment trends were delayed somewhat by a desire for more clarity on future tax incentive policies that were not forthcoming, the subsequent delay in the normal replacement patterns should add to the current and future investment levels going forward. The weak first quarter GDP and private investment results are evident in the GDP Component graph II. Private investment was negatively affected by weak inventory investment.

Graph II: Trend in Components of U.S. GDP Indexed to 12/07



source:bea.gov. Data through March 31, 2013. Downloaded on 7/1/14

Over the next 12 to 18 months, continuing improvement in consumer and private investment sectors should result in a period of sustained economic growth in spite of the decline in governmental spending patterns. During the remainder of 2014, consumer spending is expected to increase by close to 3.9%. Business investment spending should show growth in the area of 4% for the second half of 2014, as delayed investments from the winter months and pent up demand from the last few years combine to stimulate current consumer and business investment spending patterns. In 2014, domestic GDP is expected to show growth of close to 2.6%, in spite of the depressed first quarter results.

The relatively slow overall economic recovery following the "Great Recession" has been largely the result of a general trend toward the deleveraging of balance sheets by both the consumer and the private investment sector over the past five years. While this trend has caused a slower than normal recovery, it has also prevented an overheating of the economy that could otherwise set the stage for the next downturn. Unemployment rates have fallen to 6.2% in July, while capacity utilization rates are still relatively low at 79%. The Federal Reserve has continued to keep interest rates at low levels and loan demand has not accelerated significantly due to both the consumer and corporate borrower remaining conservative with regard to their near term spending patterns. Corporate profits and revenues are showing continuing growth from current record levels and international economies are also showing improving trends. In spite of this continuing outlook for economic growth, inflation remains under control with gains averaging in the area of 2%.

As the current recovery continues to broaden both domestically and internationally, the positive economic growth is expected to continue over the next twelve to eighteen months, barring any significant geopolitical shock. The Federal Reserve Board is winding down "Operation Twist" by reducing the monthly purchases of fixed income securities in the open market. This program, as stated by the FOMC, should be completed in October. We believe that the current Federal Funds rate will be maintained into 2015.

Developed & Emerging Economies

Forecasts for GDP growth for the Eurozone remain around 1% for 2014. Greece and Italy have improved since the Euro crisis in 2012-13, but projections for GDP growth in these two countries remain negative. Inflation is subdued and concerns about a deflationary environment persist. The European Central Bank initiated historic stimulus measures which will be supportive of economic growth as share prices in the region.

Emerging market economies were under significant financial strain in early 2014 emanating from fundamental and geopolitical unrest. Severe winter weather in the U.S. significantly curtailed consumer spending, as well as inventory investment by the private business sector. Russia's invasion and annexation of Crimea, as well as Russian separatist incursions into eastern Ukraine, further roiled markets and the economies of many of the Eastern European emerging markets. As a group, emerging nations represent about 40% of global GDP but a lesser 13% of global market capitalization. The broadening economic recovery in the U.S. along with an acceleration in second quarter GDP growth in China to 7.5%, have been among the positive developments for these economies.

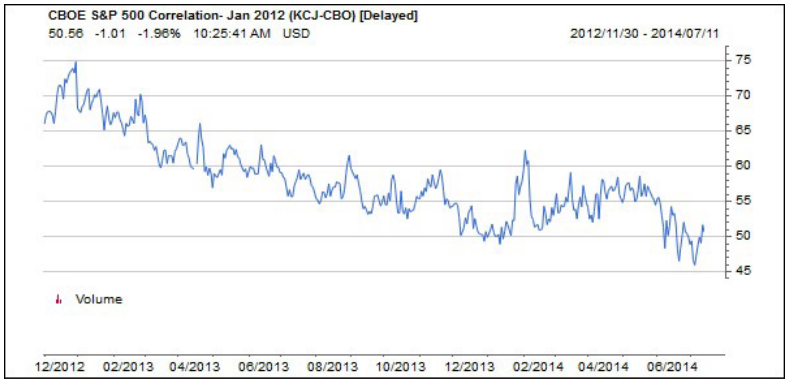
The Capital Markets

Following the depressed fundamental earnings created by the harsh winter weather in the U.S. in the first quarter, investor confidence has gradually regained momentum as corporate earnings comparisons improved and real interest rates remain low. During the recent consolidation period, a good deal of the prior momentum-driven valuation premiums that had begun to become present in selected areas of the market, including biotech, Internet and social media stocks, was brought back into line by profit taking as the market rationalized valuations. The overall earnings outlook for the market has shown considerable improvement with the second quarter earnings reporting season, as temporary weather related issues became more of a rear view mirror event.

The strength of the economic recovery to date has been below historic trends. The sustainability of the recovery is viewed as being better than normal due to the balance sheet strength of the consumer and business sectors, as well as the excess capacity remaining in the economy following the first five years of recovery.

The Federal Reserve will continue to unwind its Quantitative Easing. More fundamental drivers of capital asset pricing, such as revenues and earnings, will dominate valuation metrics.

Graph III: Selectivity Matters



Source: FactSet, Inc.

In our view, the transition in capital markets from dependence on extraordinary measures of monetary easing to support from real growth is underway and is expressed in a lower correlation between the general market index and individual securities, as noted in Graph III.

The stock market has experienced dramatic gains over the past five years, however, valuation levels do not appear to be over-extended. The current price/earnings ratio of the market, based on the S&P 500 Index, is currently 15.4 times estimated forward twelve month earnings of almost $126. This multiple valuation level is in line with the market's longer term average valuation level. We see the U.S. equity market as fairly valued on an historical basis, given current levels of GDP growth, inflation, employment, valuation and the extremely low level of interest rates.

We view selectivity within and between asset and sub-asset classes becoming more critical in portfolio construction. Appreciation will be a function of revenue and earnings and not valuation expansion. M&A activity, share buybacks, dividend hikes and top line sales growth should be part of the second half landscape. Further, the replacement cycle for equipment has room to run.

In this environment, we view U.S. equity markets as more attractive versus their global counterparts on the bases of growth, valuation and stability. However, we see selective opportunities in the emerging markets, as well as the Eurozone. Conversely, we remain cautious on the fixed income markets and believe the headwinds will build as the economic recovery broadens.

Interim Division Head
Marjorie Snelling
Senior Vice President
610-581-4748
msnelling@bmtc.com

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

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

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

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

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

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

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

Private Banking
Albert B. Murphy III
Senior Vice President
610-581-4949
amurphy@bmtc.com