The Bryn Mawr Trust Company
Wealth Management Division

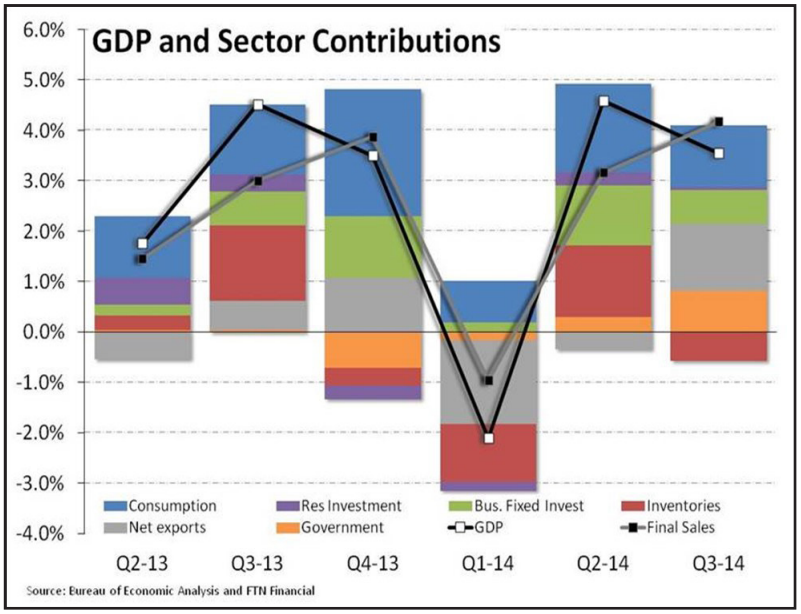
# Economic & Market Quarterly

FALL 2014

## Economic Overview

For the full year of 2014, Real Gross Domestic Product in the United States is expected to increase by 2.3%. Following the negative economic growth of 2.9% experienced in the first quarter the domestic economy exhibited a positive rebound in the second quarter with revised GDP growth of 4.6%. The preliminary release for the third quarter indicated that an economy grew at 3.5%, beating consensus forecasts of 3.1%. Third quarter growth was driven by stronger contributions from Government Spending (+0.8%) and a very strong contribution from net exports, as imports declined 1.7% and exports rose a very strong 7.8%.

### Graph I: GDP & Sector Contributions



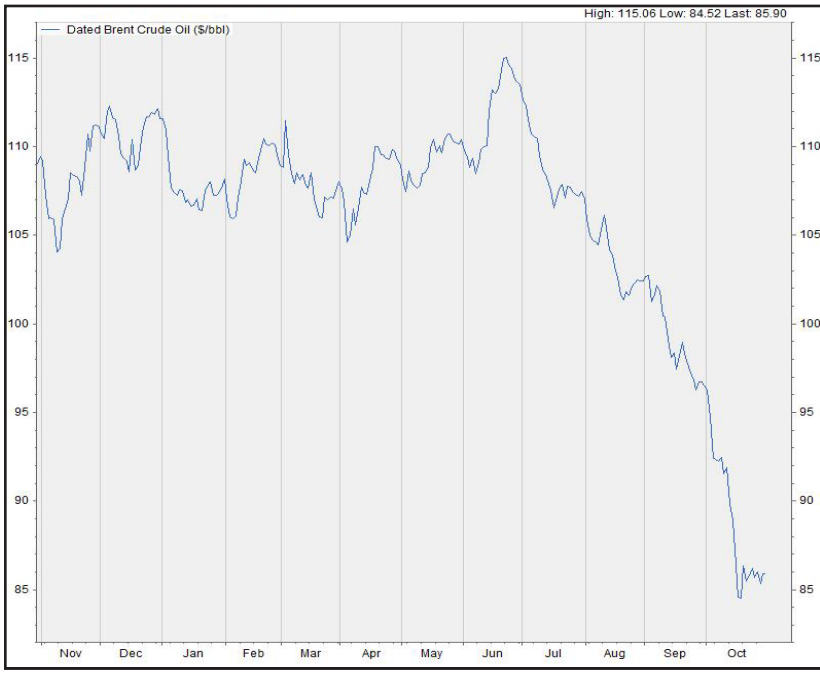

Consumer Spending for the full year of 2014 is expected to increase by 2.8% based on gradually increasing consumer confidence, increased employment levels and easing credit standards. Business Fixed Investment Spending, following weakness in the first quarter, has also shown significant improvement beginning in the second quarter and should record growth of over 6% for the full year 2014. Residential construction trends that were extremely choppy during the first half of the year are now showing signs of improvement as we move through the fall. Reflected in the third quarter GDP release, Government Spending has started to show renewed growth this year, after being a relative head wind against economic growth over the past four years and should be a modestly positive contributor for the full year.

The slow but steady overall growth of the domestic economy to date over the last five and a half years, since the depth of the recession in 2009, has resulted in continuing slack in the economy that has prevented any significant pick-up in inflation or inflationary expectations. For example, the domestic economy is currently operating at around 80% of capacity utilization, little changed versus a year ago.

Non-farm payroll employment has shown steady improvement, while the unemployment declined to 5.9% in September.

The Federal Reserve has been concerned with the underutilization of labor resources but noted recent improvement. The FOMC stated (October 29 statement) that "on balance, a range of labor market indicators suggests that underutilization of labor resources is gradually diminishing."

### Graph II: Brent Crude Oil Price




*Source: FactSet, Inc.*

Inflation rates remain subdued and the Federal Reserve continues to communicate the view that the Fed Funds rate will likely remain at current historically low levels at least in to the first half of 2015. Inflation, as measured by the CPI, is expected to remain below 2% for the full year 2014 and has been aided by a significant decline in global prices for commodities and, most predominantly, oil. As the Graph II illustrates, the price per barrel of crude oil (Brent) declined from $115 to about $86.

The growth discussion becomes more muddled, as one looks outside the U.S. Many of the emerging market economies in Asia and more selectively in Latin America are growing at reasonably good clips. The International Monetary Fund (IMF) forecasts that growth in emerging markets generally will moderate to 4.4% in 2014 before accelerating to 5.0% in 2015. For example, the IMF expects China to grow 7.4% this year moderating to 7.1% in 2015. Conversely, the IMF sees growth in India accelerating from 5.6% this year to 6.4% next year.

However, international developed economies in the Eurozone are experiencing significant headwinds. Economic growth in the Eurozone is well below forecasts that were released earlier in the year.

In the IMF's October 2014 publication of the World Economic Outlook (WEO), real GDP growth is expected to come in at less than 1.0%; at 0.8% this year and rising only gradually to 1.3% in 2015. The European Central Bank (ECB) has launched a quasi "Fed-like QE" in buying asset backed securities rather than government debt.

Over the next 12 to 18 months continuing improvement in consumer and private investment spending as well as further improvement in the housing market should result in sustainable economic growth of slightly over 3% in the U.S. As the recovery continues to broaden, the positive economic trends that are driving the domestic markets currently could be expected to continue over the next one to two years, barring any significant unforeseen geopolitical shocks. Growth in many emerging nations will be rapid, even if lower by historical standards, while the road upward in the Eurozone will be gradual given the political environment and the cultural differences within this region.

### The Capital Markets

Since the stock market lows recorded in 2009, the general market averages have been on a relatively stable recovery track over the last five years that has resulted in new market highs for the major averages this past summer. While the stock market has recorded dramatic gains over the past five years, valuation levels do not appear to be overly extended. The current price earnings ratio of the market, based on the S&P 500 Index, is 16 times estimated forward twelve month earnings of $124. This multiple valuation is in line with the market's longer term average valuation level. While current valuation levels are no longer historically inexpensive, they are by no means excessive given the current interest rate environment and corporate earnings growth improvement.

The magnitude of the 180% appreciation and five year longevity of the current bull market is creating investor nervousness currently, while earnings have expanded in line with the markets to date and valuation levels remain in line with the longer term averages. Given the continuing slack in the economy as measured by capacity utilization, low inflation trends and unemployment, coupled with the improved balance sheets of both the consumer and corporate sectors, the economic outlook for the next 12 to 18 months remains positive and earnings growth should continue to aid future valuation levels. Stock market valuation levels, while not viewed as excessive, should not be expected to expand materially from current levels, but the market itself can appreciate further as underlying earnings growth continues in response to the broadening economic recovery.

Recently, volatility has spiked upward relative to the rather tranquil markets of 2013 and most of 2014. Between September 19 (S&P 500 peak) and October 15 (S&P 500 low), the VIX (a measure of market volatility) more than doubled. We have been of the view for quite some time that the transition from a market, primarily driven by the liquidity created by the Fed, to one that derives more support from fundamentals would result in some acceleration of volatility. The likelihood is that the markets will be punctuated with more bouts of volatility, connected to economic concerns in international markets such as the Eurozone, as well as the Ebola virus concerns, among others.

Stock market valuation levels are also viewed as relatively attractive in relation to the fixed income markets. The equity market, as measured by the S&P 500 Index is currently providing a current dividend yield of close to 2%. This level of dividend payout represents less than 30% of the market index's current estimated earnings per share. This current payout is historically depressed when compared with the longer term earnings payout ratio of 45%. With corporate cash flows having shown a substantial rebound from depressed recession levels over the past five years, the number of dividend increases has expanded dramatically and the upward trend is expected to continue over the next 12 to 18 months. This equity dividend yield compares with a ten year U.S. Treasury Bond yield of around 2.3%. Graph III indicates the effects on total return of 3 and 10-year Treasury bonds relative to a 1% change in interest rates over different time periods.

**Graph III: Price Effects of a 1% Change in Interest Rates**

| 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 | -6.88% | -2.08% |
| 1 Year | -5.55% | -1.2% |
| 3 Years | +0.09% | +0.67% |

*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 process to charges in interest rates and not at an interest rate forecast. Updated as of 10/20/14.*

As the Federal Reserve begins to increase rates over the next 12 to 18 months and the bond markets weaken, the attractiveness of a current stock market dividend income stream that is derived from an increasing share of growing corporate earnings will likely look increasingly attractive. Investors should remember that dividend income, unlike a bond's declared interest rate, will grow over time along with the company's earnings and will therefore offer a degree of longer term inflation protection.

**Executive Vice President**
Harry R. Madeira, Jr. "Gary"
610-581-4791
gmadeira@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

**BMT Asset Management & Retirement Services**
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