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Economic Outlook 2010 Challenges, Transition and Opportunity

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2010 is shaping up to be a period of transition for the economy and the markets. We continue to face a number of obstacles in our journey to a healthy and robust economy.

Economics is about confidence. Uncertainty breeds a lack of confidence. What is needed is a clear understanding of what outside forces will play on our economic lives. The biggest and most powerful influence is Federal Government.

We are currently looking at 10 percent unemployment, the Federal budget deficit is topping One Trillion dollars, consumer activity is sluggish, there are prospects of tax increases and the issue of nationalized healthcare and its impact on our lives is uncertain. Most of these issues will be made clearer by mid-year. This is when we should see some real positive signs of economic recovery.

The challenge for us is to make sense of the issues and develop a path beyond these obstacles and look for opportunities.

The issue that really hits hardest to all of us is the employment situation. The official unemployment rate, as captured in the Bureau of Labor Statistics measurement, U-3, is at 10 percent. U-3 measures the total unemployed as a percent of the

civilian labor force. U-3 is the top line rate reported and used by just about every commentator, analyst and government official. This number has been rising over the last year, but appears to have leveled off. This measure does not tell the full story about our current employment situation.

Challenges exist for state and local governments as they deal with high unemployment and crumbling infrastructure.

Commercial real estate may be the next big financial crisis we face. This will affect regional banks to a greater extent than larger banks, but no one will be immune. This will have an impact on the already tight credit markets.

Long-term debt and unfunded obligations of the Federal Government will begin to put pressure on our economy, politicians and our pockets. This is an issue that will need to be addressed now.

Unemployment

If we look closer and begin to expand our view into what is really happening on Main Street we need to look at U-6. U-6 measures the total unemployed, plus all marginally attached workers, plus total employed part time for economic reasons, as a percent of the civilian labor force plus all marginally attached workers. Marginally attached workers are persons, who currently are neither working nor looking for work, but indicate that they want and are available for a job and have looked for work sometime in the recent past. Discouraged workers, a



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subset of the marginally attached, have given a job-market related reason for not currently looking for a job. Persons employed part-time for economic reasons are those who want and are available for full-time work but have had to settle for a part-time schedule.

As of December 2009, the U-6 is at 17.3 percent. This number has been steadily rising over the last 18 months and has not slowed in pace.

Prospects for improvement in the employment situation this year are not promising. While we may see a slight decline in the U-3, the official number, the measure we need to focus on is the trend of U-6. The official number can mask those who have simply given up and at this time are not planning to return to the workforce. We will keep an eye on the U-6 number to see signs of real improvement in the employment picture.

The challenges to employment include continued slack in industrial production, reduced demand from consumers, a higher savings rate (we will look at this later) and uncertainty about taxes on businesses and the impact of national healthcare.

Unemployment will continue to put pressure on housing prices, foreclosures and delinquencies. New construction will not pick up until foreclosure inventory is worked off.

The bright spot in employment may be in manufacturing. One benefit of the recent decline in the dollar is that it makes our goods and services less expensive abroad. Should economies outside the U.S. show signs of stability and/or strengthening it could provide some stimulus to exports and increased demand for workers.

The Elephant in the Room

The record deficits we are accumulating at a rate of about \$1 Trillion a year or more is simply not sustainable. This is a rate of about 10 percent of our Gross Domestic Product (GDP). Historically, budget deficits run in the area of 2 percent of GDP. This is something we can all agree we can not continue. It is encouraging that people are starting to take notice and feel unease about such large numbers. The term ‘trillion’, when it comes to budgets, has suddenly made its way into everyday conversation. It was not long ago that a Billion dollars was a lot of money.

We may get into a situation where the Fed simply monetizes the debt by printing money. Monetization reduces the real value of the debt, essentially making debt less costly, in real terms, at the expense of wealth and wealth creation.

The real danger to our economy, in the long term, is the unfunded liabilities of the federal government. These include social security, Medicare and various other obligations for pensions.

Do not confuse unfunded liabilities with the federal deficit, which is currently topping \$12 Trillion dollars.



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There are several estimates that are used to quantify unfunded liabilities. We usually hear numbers in the area of \$56 Trillion, which includes off balance sheet IOU's to Social Security. It is hard for many of us to get our heads around how much that really is. In 2008, total global GDP was just over \$60 Trillion, according to the World Bank.

\$107,000,000,000,000. This is \$107 trillion, the estimated unfunded federal obligations as reported by the Federal Reserve in 2009.

The bottom line is that no one has a real handle on what our total obligations are at this point. Our obligations are going to have to be addressed or certainly it will bring on a collapse of our economic system.

Taxes

Addressing the budget and deficits is not going to be an easy task. Deficit spending is becoming very unpopular. This is going to translate into higher tax rates for everyone.

Continued trillion dollar deficits are not sustainable. The Congressional Budget Office (CBO) is indicating that there is no foreseeable reversal of this trend. Even if a reduction in spending occurs it will not be enough, unless there are dramatic cuts in social programs. This is unlikely.

Taxes will be going up for all Americans; whether it is in direct rate increases, taxes on businesses

that will be passed along to consumers or a new tax scheme.

Inflation

Continuing budget deficits place inflationary pressure on the economy and may ultimately place restraints on the Federal Reserve's ability to meet its mandates effectively.

While we continue to run these \$1 Trillion plus deficits the holders of our debt are becoming concerned with our ability to meet our obligations. China has expressed its concern quite loudly in the last several months. While they and others continue to buy our debt, there is going to come a point where they are going to require higher rates of return in order to continue to buy Treasuries or worse they may begin to reduce their exposure to US debt. Either of these scenarios will lead to higher interest rates. As these rates increase the percentage of the federal budget that goes into servicing debt will also increase.

The Fed has pumped a lot of liquidity into the market. It will be a challenge to extract it in a manner that does not kill off growth. Additional dollars in the system will end up chasing the same or fewer products/services.

Stagflation, a time of slow economic growth, high unemployment and rising prices, is something that few people are talking about at this time. Admittedly we see this as a remote possibility, but it is important to recognize the causes and assess our environment. Causes are identified as a combination of high unemployment, easy money and rising commodity prices. We do not anticipate this scenario unfolding and feel the Fed will be effective enough to avoid, but we need to remain aware.

Other Issues

Commercial real estate may be the next economic crisis we face. The trend is toward lower occupancy rates and increasing defaults on loans. This is likely to have an impact on the regional banks, which have not been as widely affected by the financial crisis. Many are working to increase loss reserve and the Treasury is working on the issue as well.

Household savings rates have increased dramatically over the last eighteen months. The Bureau of Economic Analysis defines savings as personal income less the sum of personal outlays and personal current taxes. It has risen from a recent low of about 1.2 percent in the third quarter of 2008 to about 4.5 percent in the third quarter of 2009. Long term this is a positive development to the overall health of US households. In the near term it will have a dampening effect on economic growth. Our economy is seventy percent consumer driven.

State Governments are hanging on by a thread at this point with some on the edge of financial crisis. California is the most widely reported, but others exist. Many states have balanced budget requirements. The debt market is being crowded out by Federal borrowing. Receipts to states are down dramatically. Crisis at the state level will likely translate into tax increases coupled with reductions in services. On top of this, increased

federal mandates for states will place even more pressure; many federally mandated programs are not funded by the federal government or provide initial funds that drop off over time and require states to maintain or increase funding. States are also facing increased costs for unemployment compensation and have to deal with deteriorating infrastructure. This will contribute to a sluggish recovery.

Double Dip

We are likely to see a double dip recession. The conventional wisdom is that it has never happened; all the more reason to expect it. Recent increase in economic activity have been spurred by inventory re-building, government spending and to some extent the cold winter causing increased energy production. Once these have passed, fuel for the economic engine will dry up and we could see GDP get near zero or go negative at mid year. It will be shallow and brief.

As the effects of stimulus packages begin to wane the engine that will drive activity remains in question. Job losses continue to mount, even as the unemployment rate stabilizes (see above for the explanation). Until this trend reverses the risks of a double dip will remain.

GDP growth will end the year in the two to three percent range, due to slow consumer spending.

We may see an additional stimulus package from the government, but that will be after the fact. The righting of the ship will require a boost in confidence among consumers. The current inflection point for this is employment. Consumers need to have some level of comfort that jobs will stabilize, until



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then they will continue to do those things that will prepare them for a lay-off or job loss. In the long-run this is a good thing, but in the short-run it will inhibit growth.

Risks to businesses include new taxes and increased regulation. These would lead to a wait and see attitude before businesses look to expand their workforce. In environments like this, businesses will tend to try to do more with less.

Conclusions

We are optimistic about 2010. Our Outlook has discussed many obstacles we will face this year. An understanding of the risks in the economy is necessary when managing your investments, your lifestyle and your future. Remember to look for opportunities in these obstacles and discuss them with your advisors.

A balanced approach to investing is going to be the winning approach for the foreseeable future. In the current environment we suggest being selective and focus on risk management is prudent. When investing in Municipal Bonds keep bonds shorter in anticipation of rising rates later this year and heading into next. Also, be aware of the fiscal health of the issuer. Good quality Corporate Bonds should be considered, question the ratings given by rating agencies and be in shorter maturities. Understand the company whose debt you are buying. Keep maturities and duration short in

anticipation of rising rates. Treasury Inflation Protected Securities (TIPS) should also be considered as inflation will become an issue. Discuss the tax characteristics of TIPS with your advisors.

On the equity side there are opportunities. Emerging Markets will be a bright spot in a sluggish global economy. Be aware of the inherent volatility and risks associated with Emerging Markets. Domestically, dividend paying companies and value should be preferred. On the growth side technology will be favored as businesses will look for to improve efficiency and make technology investments.

2010 will be a year of transition for the economy; beyond this we see a return to more normalized growth rates, both in the economy and the markets. We remain ever confident in American Entrepreneurs, Workers and Businesses to work through adversity and lead us out of this economic downturn. They did it before, they will do it again!



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