MEMBERS®
Trust Company

2014 Market & Economic Outlook

Inside this issue:

Equity Market Outlook	1
Geo-Political and Economic Update	2
Fixed Income Outlook	3
2014 Forecast	4

Equity Market Outlook - Jason Ritzenthaler, CFA, CTFA

Year in Review

US Equity

Wow, what a year! The S&P 500 logged its best gain at 32.39% since 1997 and recorded the ninth best year in the US index's history. Small companies led the pack with annual returns of 41.31%, while mid-sized companies also beat the overall average with gains of 33.5%. The best performing sector was Consumer Discretionary with a return of 40.96% while the dividend heavy Utility and Telecom sectors lagged at 8.75% and 6.49% respectively. Contributing to the equity market growth was improving corporate earnings, greater confidence in the corporate sector, and backing by the Federal Reserve.

Corporate profits reached all-time highs consecutively in each of the first three quarters of 2013. Expectations are fourth quarter earnings will again break records when companies begin reporting later this month. Higher consumer confidence in the recovery and increased corporate profit margins led to price-to-earnings (P/E) ratio multiple expansion—meaning investors were willing to pay a bit more for every dollar of earnings. The current forward looking P/E is 15.21, still well below the average since 1988 of 16.81. Even if earnings are flat, a return to the historical average of 16.81 could equate to a price gain of 10.5% for the S&P 500 index. The bottom line, valuations look realistic. The Federal Reserve has begun the initial stages of ending their Quantitative Easing 3 (QE3) program with purchases being tapered off their current $85 Billion per month pace. QE3 helped reduce overall volatility in the equity markets throughout 2013 with a maximum peak-to-trough decline of 6.8% for the year. A relatively calm figure considering 2012's 11% and 2011's 20% declines.

International Markets

Internationally, developed markets struggled to keep pace with their 2012 outperformance of the US, with an annual return of 22.78% as measured by the MSCI EAFE index. Within Europe, returns improved to 25.23%. Germany steamed along as the engine of growth while the Eurozone's second and third largest economies, France and Italy, sputtered under the stress of austerity. Progress will need to be made if the European Union is to bring a fiscal union to the monetary party. Negotiations surrounding European banking supervision and continued structural reforms will be a focus of 2014. The banking union is likely the largest policy response since the financial crisis ,but talks have stalled as Angela Merkel is concerned about opening Germany's purse strings without additional regulatory and fiscal control of Southern Europe.

Most Asia Pacific markets struggled through 2013 with a composite 5.49% return of the MSCI Pacific ex Japan index. Japan soared 57% higher on the back of one of 2013's most popular terms "Abenomics," coined from prime minister Shinzo Abe's three arrow plan to solve Japan's lost decades which includes monetary stimulus, fiscal stimulus, and structural reform. The Bank of Japan is injecting $1.4 Trillion into the economy through the end of 2014 and the government has announced $107 Billion in infrastructure spending to put an end to deflationary pressures and spur growth. Early indications are promising with the deflationary cycle halted, although still below the 2% inflation target and Japan's government raising their 2014 growth forecast, albeit to a paltry 1.3%. The short-term monetary and fiscal policies were enough to kick-start the economy and improve optimism, but the third arrow of structural reforms including labor market,

(continued on page 2)

Equity Market Outlook (from page 1)

healthcare, and broader business deregulation will be needed to achieve lasting improvement in the economy. Did you know the Japanese labor market is so rigid that corporations have resorted to creating what are called "banishment rooms"? Large numbers of unproductive employees are often housed, with little or nothing to do, instead of being fired or accepting retirement offers. In a global economy where competition is fierce, these types of inefficiencies can be devastating to an economy.

Emerging markets struggled throughout much of 2013 with a -2.6% return of the MSCI Emerging Market index. The over 30% in underperformance relative to the US was the largest gap we have seen since 2009 when Emerging markets *outperformed* the US by over 45%. Concerns included potential effects on inflation within emerging markets as the Fed looks to taper its QE3 program. In particular, concern surrounded current account deficit countries (those that rely on foreign investment capital flows) which prompted greater cooperation among the emerging world. The idea is to be less dependent on the developed world and create a combined currency pool linking current account surplus countries, those with capital to invest—mainly China and Russia—to those in deficit as a mechanism to internally manage global economic shocks.

The global economy is on the mend, a trend we expect to continue at a slow, but sustainable pace. The question we ask ourselves is, did global central bank policy and improving confidence in the recovery just shift equity market return away from 2014 into 2013? Similar to US demand shifting programs like "cash for clunkers" and the first time home buyer tax credit... We believe the answer to that question is yes. Our investment team expects US equity market returns to be a little below average in 2014 with the S&P 500 returning 7.2%. We believe international developed markets will keep pace and emerging markets lead the way with slight underperformance in 2014.

Jason Ritzenthaler CFA, CTFA

"Emerging markets struggled throughout much of 2013 with a -2.6% return of the MSCI Emerging Market index."

Geo-Political and Economic Update —Sheldon Reynolds, CFA

2013 in Review

While 2013 was a very good year for the U.S. equity markets and most of the major developed markets, it was not so pretty for the preponderance of the major emerging equity markets. The MSCI EAFE Index, which is representative of the major developed markets except for the U.S., had impressive results with a total return of 22.78% for the year. The MSCI Emerging Markets Index, which is representative of the major emerging markets, incurred a loss of 2.6% for the same period. The major central banks remained very accommodative throughout 2013 and we expect those policies to remain largely intact during 2014 and the near term. Much of the underperformance of many emerging equity markets has been blamed on the predicted and actual tapering by the U.S. Federal Reserve since emerging markets are viewed as being more interest rate sensitive than developed markets. Many emerging markets are also highly correlated with commodity prices, many of which have been falling in recent months.

2014 Forecast

The International Monetary Fund forecasts an uptick in global growth, as measured by world output, in 2014. They also forecast continued higher growth rates in the emerging markets as compared to the developed economies. Europe appears to be emerging from their recession while growth in China is expected to slow, but should remain considerably higher than the major developed markets.

While we have seen a recent uptick in intermediate and long-term U.S. interest rates as well as U.S. GDP, inflation is still not of much concern in the developed markets due to weak loan demand and slow wage growth. Inflation also remains at relatively low levels in most emerging markets, with Argentina being an exception. The IMF forecasts inflation of over 10% in 2014 for that country. As a result of expected inflation, Argentines have been rapidly buying cars, televisions and other durable goods as an inflation hedge.

(continued on page 3)

Sheldon Reynolds CFA

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Geo-Political and Economic Update (from page 2)

While valuations are attractive in most international developed and emerging markets, a potential continued strengthening of the U.S. dollar could reduce the international equity market returns on a dollar basis. Our forecast for 2014 is for the MSCI EAFE index to return 7.6% and for the MSCI Emerging Markets Index to return 5.6%. The primary international equity holdings in our exchange traded fund models (ETF Portfolio Advantage®) are currently iShares MSCI EAFE (EFA) and iShares Core MSCI Emerging Markets (IEMG) which are representative of the aforementioned indexes.

Potential risks

As always, potential geo-political risks that could adversely affect world markets do exist. The Syrian civil war could spill over into neighboring countries or alter existing political alliances. China has recently flexed their muscles at the United States and allies in the Pacific Rim region over disputed air defense zones. There are internal disputes in Ukraine as to whether to more closely align with the E.U. or long-time ally Russia. The recent terrorist attacks in Russia are also very concerning, but hopefully not an ongoing problem.

Fixed Income Outlook —Kate Braddock, CFA

The main focus in the bond market for all of 2013 has been the tapering of the Federal Reserve Bank's monthly purchases of $85 billion in bonds. The million dollar questions were "when?" and "how much?". Too much, too fast and both stocks and growth in the economy could crash. The Federal Reserve has finally begun their long awaited tapering. After their December meeting, it was announced that the monthly bond purchases would be reduced by $10 billion to $75 billion. The stock market rallied strongly, rising 2.5-3% on the announcement. The reduction was significantly less than forecast earlier in the year. It also took care of the uncertainty that had plagued the market, signaling to the markets that the Federal Reserve indeed saw the current recovery as sustainable. The Fed has suggested that this tapering will continue throughout the year. We will be watching economic trends carefully for movements towards the stated "line in the sand" of unemployment of 6.5% or inflation above 2%.

Overall in the bond market, we are at the tail end of a thirty year bull market. In late May, rates began to rise, taking the yield on ten year treasuries from 1.6% to 3% by Labor Day. Later, with the two week government shut down, concerns surfaced about the drag on the economy and its already sluggish recovery. In response, yields fell back to the mid 2% level. By Christmas week, we saw the rate on the ten year again move back above 3%, but this time it seems more reasonable as economic improvement is starting to be seen. Over the course of the year, using The Barclay's Aggregate Bond Index as a proxy, bonds dropped 2.02%. The S&P 500 over the same period rose 32.39%. Junk bonds returned 7.4% in 2013, which given the drastic increase in rates, was a stellar performance.

Going forward, we expect to see average annual bond returns closer to historical levels of 4-6%. There will continue to be increasing demand for fixed income due to the overall aging of the population. We were well positioned for the rise in interest rates in 2013 by staying on the short end of the yield curve. After the June rise in interest rates, we extended our positioning slightly and benefited again when rates retraced their path again from 3 to 2.5% around Halloween. We will continue to

(continued on page 4)

Kate Braddock CFA

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Fixed Income Outlook (from page 3)

analyze the market and execute tactical adjustments to benefit our client's portfolios. Expect to see continued volatility in the three to seven year sector as investors continue to debate interest rates next move. However, we don't expect another major move upward over the next 12 months. Another potential headwind that the market will face is the fact that the Fed now has a balance sheet of $4 trillion. As tapering ends, the next question will be how they handle selling these assets back into the open market. This has the potential to significantly raise interest rates. In the new head of the Federal Reserve Bank, Janet Yellen, we expect to see a more transparent Federal Reserve. Inflation does not look to be a concern at the current level of 1%. Wages remain low and global growth contained. In the end, it will be a continued balancing act between improving economic growth and the Fed trying to orchestrate a smooth exit from quantitative easing.

2014 Forecast — John Largent, CFA, CFP®, CAP

John Largent
CFA, CFP®, CAP

"Regarding inflation, many are concerned about an increase because of the great amount of quantitative easing. MTC expects inflation as measured by CPI of 1.65%, slightly below the FED's target of 2%. "

2013 closed as another great year in the history books as the stock market increase exceeded most forecasts.

Members Trust Company's Investment Team Forecast for 2014 is as follows: an increase of 7.6% for the Dow Jones Industrial Average, the S&P 500 up 7.20%, NASDAQ up 6.40%, developed international markets up 7.60%, and emerging markets at up 5.60%. We forecast fixed income as the 10 year treasury increasing to a 3.01% yield from the current 2.98%. We're forecasting that the Fed Funds Rate will maintain an average of about .25%. Fed Chairman Ben Bernanke has said multiple times that short term rates will stay low and we will be monitoring what Janet Yellen will be communicating going forward. MTC expects the year-over-year growth of the United States economy as measured by Gross Domestic Product (GDP) to be 2.77%. Regarding inflation, many are concerned about an increase because of the great amount of quantitative easing. MTC expects inflation as measured by CPI of 1.65%, slightly below the FED's target of 2%. As the economy continues to slowly grow, MTC sees oil at $94.90.

Everyone have a great New Year!

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