

Insights

Alfred F. Kugel
Senior Vice President

Commentary on the economy and financial markets from Atlantic Trust's chief investment strategist.

SEASONAL CONFUSION

There are several old adages or items of folklore in the investment business having to do with seasonality that get quite a bit of comment at the appropriate times of the year. One of them that investors hear every spring is "Sell in May and Go Away." This is meant to suggest that the stock market often does not perform all that well between Memorial Day and Columbus Day, so that it has often been a good time to be in a cautious investment posture with regard to equities. However, the 2009 market rally has been so persistent that this would not have been a good strategy this time.

A second seasonal aspect is the fact that on average over a long period, September has been the least rewarding month for stock owners. However, this year, it has been one of the best months in a long time, thus disappointing many of those who have been underweighted in equities this year and hoping for a significant correction in which to make some advantageous buys.

A seasonal aspect to the markets that lies ahead is on the other side of the ledger. This is the so-called year-end rally, which means that the market often performs well from mid-October until New Year's. What happens in the fourth quarter of 2009, of course, remains to be seen, but most of us would prefer not to see this particular seasonal aspect to turn out as a disappointment.

As suggested, investor attitudes about the market have undergone a considerable upgrading in recent months. In fact, most now believe that the bear market actually ended in late winter, and stock prices have been in a strong upward trend, rising by nearly 60% from the extreme low of 676 on the Standard & Poor's 500 Stock Index set back on March 9 to the recent recovery high.

What happened was that the "black hole" scenarios that had been set forth by some pundits and widely quoted by the media earlier in the year, including comparisons with the Great Depression of 1929-1933, were simply overcome by a run of more favorable than expected economic reports. As a result, by late September stock prices had reached their highest level in 2009 with nearly a 20% total return for the year to date.

It wasn't that the news was all that good, but it was clearly less bad than consensus expectations. As a result, once investors concluded that stocks were considerably undervalued, they began to increase their equity positions. In any event, the more positive economic situation proved out in that the decline in real GDP during the second quarter was at a minor 0.7% annual rate as compared to the plunge of 6.4% in the first quarter. Moreover, while still well below their year ago level, corporate earnings in the second quarter were substantially better than analysts' forecasts.



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RECESSION ENDS

As we have noted in recent months, we believe that the economy passed an important inflection point and has transitioned from a sharp recessionary environment to a moderate recovery. This started in the second quarter when the rate of decline in real GDP slowed sharply to a nominal rate of less than 1% from the shockingly bad numbers in the fourth quarter of 2008 and the first quarter of 2009. There was clearly improvement in a fairly broad swath of economic indicators, including consumer incomes, new unemployment claims, international trade and durable goods orders. Even in the troubled housing sector, there has been better news with respect to home sales, permits, inventories of unsold units, consumer attitudes and affordability, and it now appears that this key area will cease to be a drag on overall activity by early 2010.

As a result of these more favorable developments, it now appears that the second quarter represented the tail end of the recession. In fact, based on our latest expectations, we believe that the economy has now returned to a growth mode, which should persist for the upcoming 12 months, if not beyond, with the bottom of the recession actually reached back in June or July. A reasonable guess at this point is that third quarter real GDP will increase at about a 3% annual rate.

MASSIVE STIMULUS

In order to combat the adverse effects of the credit crisis and the global recession, the major governments put forward

a massive series of fiscal and monetary stimulus actions in their determination not to permit another economic depression this time in spite of the malaise in the financial system. Here in the U.S., federal spending increased sharply, thus improving sentiment and stimulating consumer incomes, while trying to reduce the amount of so-called "toxic paper" on the balance sheets of the banks so that they can lend more actively.

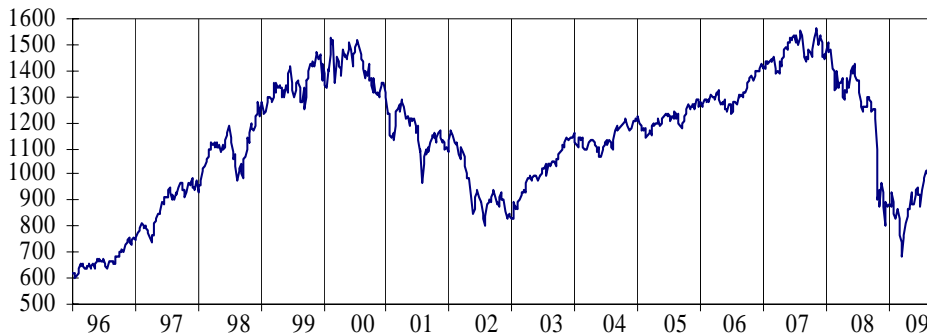
Of course, this frenzy of activity may not be particularly efficient, and it clearly took longer than the government expected for the fiscal stimulus to have an effect, but the magnitude of the actions is so large that it will necessarily have a significant positive impact on economic growth over the near to intermediate-term period. The federal budget deficit seems likely to soar to something like \$1.6 trillion in fiscal 2010, which will be 13% of GDP – far higher than ever seen before, except for the peak military spending period during World War II.

At the same time, the Federal Reserve stepped on the accelerator with regard to monetary stimulus, reducing short-term interest rates to nominal levels. The Fed has also undertaken new programs to purchase large amounts of Treasury, Agency and asset-backed paper in order to reduce intermediate and longer-term interest rates, which has helped to bring down mortgage rates and make housing more affordable. Moreover, the yield curve on Treasury paper is now unusually steep, which is normally a harbinger of an acceleration in economic activity.

EARNINGS SET TO IMPROVE

Certainly, corporate profits were adversely affected by the recession. As a result, comparisons with a year ago have been quite weak in recent quarters. However, we believe that results are about to improve, based largely on successful cost-reduction efforts. Thus, while third quarter profits may still be down on a year-to-year basis, the shortfall should be relatively minor. Moreover, we believe that earnings comparisons will be sharply higher in the fourth quarter reflecting fewer asset write-downs and better operating profits. In addition, based on our expectations for economic recovery, we expect a considerable further rebound in earnings in 2010.

S&P 500 Stock Index (Weekly Close)
December 29, 1995 - September 25, 2009



Source: Federal Reserve Board

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