

Insights

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

THE RALLY ROLLS ON

There have been a few fits and starts, but the stock market advance continued during November, providing a 25% total return for the first eleven months of 2009. While this is an exemplary performance, one must consider that it is essentially a partial rebound from the 37% negative return booked in 2008. Nevertheless, after a poor start this year, stock prices have advanced very significantly from the low set back on March 9 when expectations were at their gloomiest, and the S&P 500 managed to close near 1,100 at the end of last month.

Moreover, we remain hopeful that the positive seasonality in the period that lies immediately ahead should provide some additional reward to investors. This is the traditional "year-end rally," which means that the market often performs relatively well from November until early in the New Year. What happens in the weeks ahead, of course, remains to be seen, but most of us would prefer to see this particular seasonal aspect live up to expectations.

As suggested, investor attitudes about the market have undergone a considerable upgrading in recent months. In fact, most participants now believe that the bear market ended in late winter and has been replaced by a strong upward trend in stock prices, which have risen by about 65% from the extreme low of 676 on the Standard & Poor's 500 Stock Index set back on March 9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 dire scenarios that had been set forth by some pundits and widely quoted by the media earlier in the year simply didn't occur. The downward momentum in the economy diminished sharply in the second quarter and then shifted into positive growth in the third. As a result, by late November stock prices had reached their highest level of 2009 with a total return of about 23% for the year to date even though the earlier pace of upward momentum has now slowed somewhat.

THE RECESSION ENDS

Our belief has been that the economy passed an important inflection point last summer and has now transitioned from a sharp recessionary environment to a moderate recovery. This shift 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 (averaging a -6% rate) in the fourth quarter of 2008 and the first quarter of 2009. There has clearly been improvement in a fairly broad swath of economic indicators, including consumer spending, industrial production, new unemployment claims and durable goods orders. Even in the troubled housing sector, there has been somewhat better news with respect to home sales, permits, inventories of unsold units and affordability, and it now appears that this key area will cease to be a drag on overall activity sometime in 2010.



"I SPEND THE WINTER IN SARASOTA NOW, SINCE I SOLD MY ENTIRE LIST TO TELEMARETERS."

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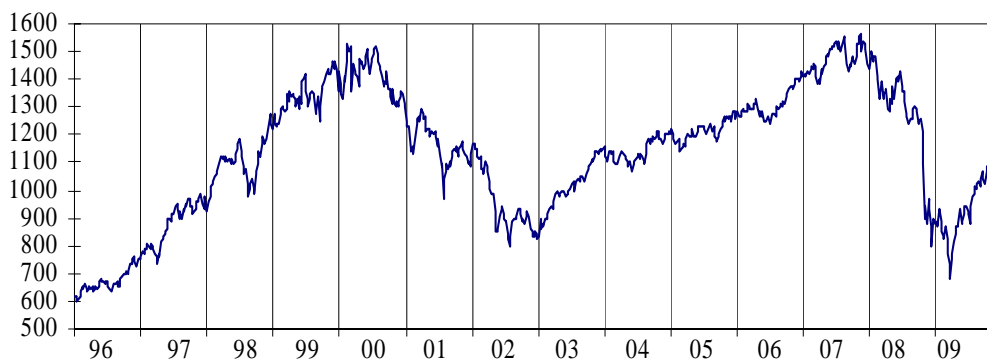
As a result of these more favorable developments, it now appears that the second quarter represented the tail end of the recession. In fact, based on the government's preliminary reading, the third quarter showed an increase in real GDP at an annual rate of 2.8%. Thus, the economy has now returned to a moderate growth mode, which should persist for the upcoming 12 months, if not beyond, with the bottom of the recession likely reached back in June. A reasonable guess at this point is that fourth quarter real GDP will also increase at about a 3% annual rate.

MASSIVE STIMULUS

To combat the adverse effects of the credit crisis and the global recession, the major governments around the globe put forward a massive series of fiscal and monetary stimulus actions in their determination to prevent another economic depression this time in spite of the malaise in the financial system. Here in the U.S., federal spending increased sharply, thus offsetting weak spending by consumers and the corporate sector.

Of course, this frenzy of activity was not particularly efficient, and it has clearly taken longer than the government expected for the fiscal stimulus to have an effect, but the magnitude of the actions was so large that it necessarily is having a significant positive impact on economic growth over the near to intermediate-term period. The federal budget deficit soared to \$1.4 trillion in fiscal 2009 or about 10% of GDP and seems likely to increase further in the current fiscal year to a relative level higher than ever seen before, except for the peak military spending period during World War II.

S&P 500 Stock Index (Weekly Close)
December 29, 1995 - November 27, 2009



Source: Federal Reserve Board

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December 2009
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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 direct action 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. As a result of these actions, 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 have been adversely affected by the recession. As a result, comparisons with a year ago have been quite weak in recent quarters, with especially poor readings in the fourth quarter of 2008 and first quarter of 2009 when there were massive write-downs of asset values in the financial sector of the economy as well as in a few other industries. However, we believe that the weakest comparisons are now behind and that better results lie ahead.

To some extent, the expected improvement in earnings is a two-edged sword. It is based largely on highly successful cost-reduction efforts as corporate managements purged excessive inventories, laid off many workers and cut spending on travel, entertainment and a large number of other categories, which all made the recession more severe than it otherwise would have been. However, the resulting jump in productivity has clearly cushioned earnings.

Companies have nearly completed reporting third quarter profits. Based on what we have seen, results are substantially better than originally expected, and while they are still down on a year-to-year basis, the shortfall was relatively minor. Now, we believe that earnings comparisons will be sharply higher in the fourth quarter reflecting fewer asset write-downs and better operating profits. Moreover, based on our expectations for economic recovery, we expect a considerable further rebound in earnings in 2010, possibly on the order of 25%. At some point, however, it will be important that profit growth shift from reflecting cost cutting to benefiting from growth in sales.

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