

Insights

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

ENDING ON A HIGH

Considering how badly things started off a year ago, the stock market performed well enough over the remaining months that it turned out to be quite satisfactory for equity investors. Although there were a few fits and starts, the market advance that got underway last March essentially continued for the balance of the year, with stocks closing at their high for the year and providing a 26% total return. While this can be considered as an exemplary performance, it is necessary to consider that it is essentially a partial rebound from the 37% negative return booked in 2008. Nevertheless, prices advanced very significantly from the low set in the first quarter when expectations were at their gloomiest, with the S&P 500 closing at 1,115 at the end of last month.

Moreover, the final push for the year that occurred in November and December was accompanied by a substantial upgrading of economic expectations. In fact, in the most recent months there was a run of better than

expected economic data that caused most economists to increase their forecasts for growth in the final quarter of 2009 and for 2010. This was then reflected in a considerable upgrading in investor attitudes about the market. Thus, earlier fears about an extended recession and possible deflation have essentially disappeared. In fact, most participants now believe that the bear market ended in late winter and has been replaced by a strong upward trend in stock prices, which have risen by more than 65% from the extreme low of 676 on the S & P 500 Stock Index set back on March 9 to the recent 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, stock prices continued on their upward path through December, reaching their highest level of 2009 by year end.

RECOVERY UNDERWAY

Our belief has been that the economy passed an important inflection point last summer and that it has successfully transitioned from a sharp recessionary environment in the fourth quarter of 2008 and first quarter of 2009 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) of the two previous quarters. 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 better news with respect to home sales, permits, inventories of unsold units and affor-



"THE MARKET IS BACK. WHEN ARE YOU COMING BACK?"

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bility, and it now appears that this key area will cease to be a drag on overall activity in the coming year.

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, albeit a modest one at an annual rate of 2.2%. Thus, it appears that the economy has now returned to a moderate growth mode, which should persist for the upcoming 12 months, if not beyond. A reasonable guess at this point is that real GDP will be growing at least through mid-2010 at an annual rate likely to be between 3 and 4%.

MASSIVE STIMULUS

In order to combat the adverse effects of the credit crisis and the global recession, nearly all of the 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.

While 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, 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 even 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.

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.

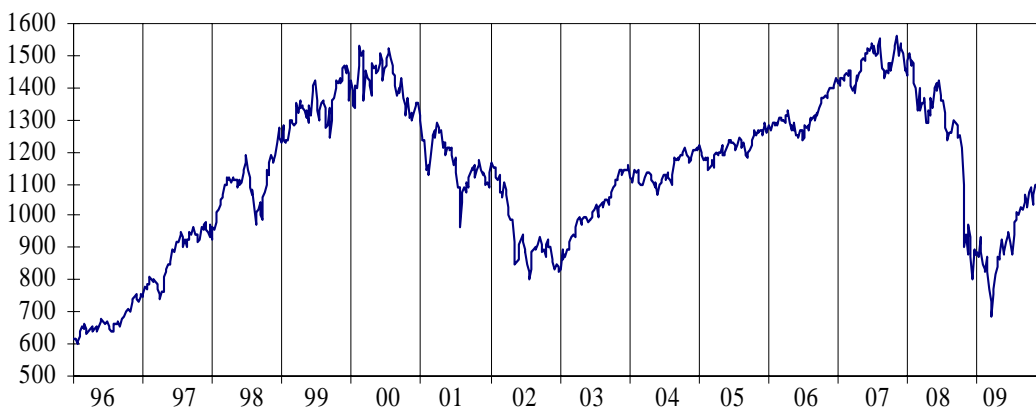
EARNINGS SET TO IMPROVE

Obviously, corporate profits were adversely affected by the recession, and comparisons with a year ago have been quite weak, 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.

In fact, while third quarter results were still down year/year, the shortfall was relatively minor. 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 rebound in earnings in 2010, possibly on the order of 25% versus 2009.

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



Source: Federal Reserve Board

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