

Insights

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

CORRECTION TIME?

Once the market hit its bear market low last March 9, the subsequent advance was remarkably consistent and free of any unnerving interruption in spite of periodic calls by some pundits for a correction that would give back a substantial portion of the upswing. In any event, this didn't happen and stock prices essentially closed 2009 at their recovery high, posting a 26% total return for last year and up nearly 70% from the March bottom. However, a moderate uptick in the first half of January was followed by a sell-off in the latter part of the month so that the market closed with a modest loss for the first month of the new year. This obviously poses the question as to whether the long-awaited correction is now upon us.

Considering how badly things started off in early 2009 and how favorably they went

subsequently, it is hard to say that early developments provide much of an indication about what lies ahead for the year as a whole. Certainly, the stock market performed well enough over the remaining months of last year that it turned out to be a very satisfactory year for equity investors.

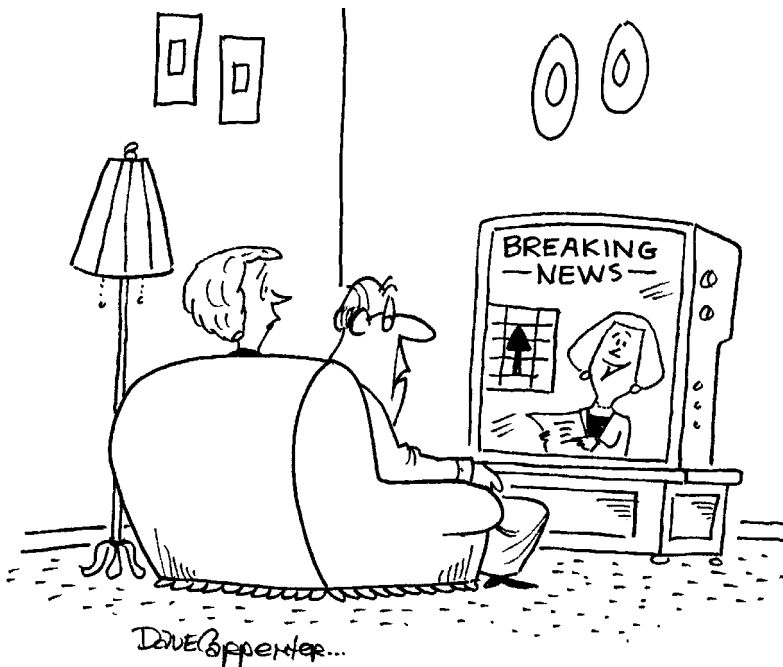
It should be noted that the final push for the year that occurred in November and December was accompanied by a substantial upgrading of economic expectations. In fact, in the most recent months there was a run of better than expected economic data that caused most economists to increase their forecasts 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 recent months. In fact, most participants now believe that the bear market ended in early 2009 and has been replaced by an upward trend in stock prices for at least the intermediate term.

THE RECOVERY QUICKENS

Looking back, the evidence suggests that an important inflection point was reached in July 2009 when the economy transitioned from recession to recovery. It wasn't all that vigorous of an upturn at the beginning, as suggested by the fact that real output grew at only a 2.2% annual rate in the third quarter, but it was a lot better than the deep recession that gripped us during the fourth quarter of 2008 and first quarter of 2009 when overall activity contracted at a rate that averaged 6%.

The good news is that activity accelerated toward the end of 2009, resulting in growth at a 5.7% rate in the fourth quarter. The bad



"IT ISN'T GOOD WHEN AN UP-MARKET IS CONSIDERED
BREAKING NEWS."

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news is that more than half of this pace was accounted for by a sharp reduction in the rate of inventory liquidation, which is only a “one shot” event and doesn’t have any positive carry into subsequent periods. As a result, we believe that it is more appropriate to think of the economy growing at a moderate 3% pace, which is essentially what we are forecasting for 2010 as a whole.

There has clearly been improvement in a broad swath of economic indicators, including industrial production, new unemployment claims and durable goods orders. Even in the troubled housing sector, there has been better news with respect to existing home sales, permits, inventories of unsold units and affordability. As a result, it now appears that this key area will cease to be a drag on the economy as a whole sometime in the coming year.

MASSIVE STIMULUS EFFORT

In order to combat the adverse effects of the credit crisis and the global recession and to prevent another economic depression in spite of the malaise in the financial system, nearly all of the governments around the globe put forward a massive series of fiscal and monetary stimulus actions during late 2008 and in 2009. Here in the U.S., federal spending increased sharply, which provided an offset to weak spending on the part of consumers and the corporate sector.

Although 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 is necessarily having a sig-

nificant positive impact on economic growth over the near to intermediate-term period. In fact, the federal budget deficit soared to \$1.4 trillion in fiscal 2009 or about 10% of GDP and we estimate that it will increase somewhat more in the current fiscal year to a relative level higher than ever seen before except during the peak military spending period in World War II.

Concurrently, the Federal Reserve stepped on the accelerator with regard to monetary stimulus, reducing short-term interest rates to nominal levels during all of 2009. 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 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.

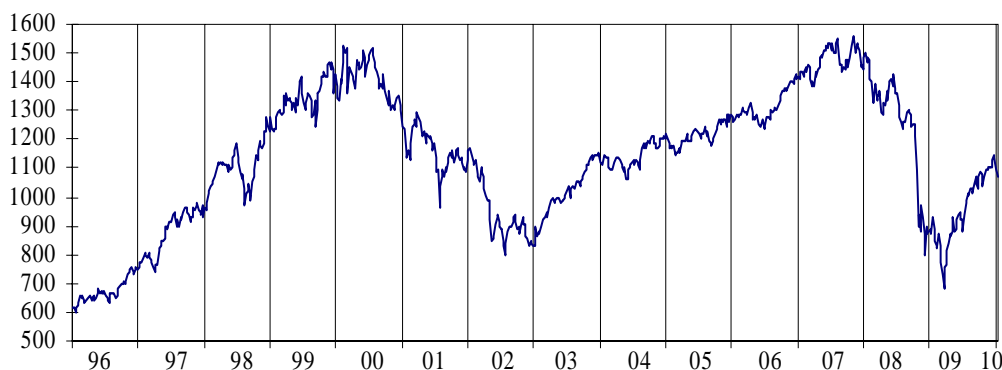
Sometime later in 2010, the government will need to start reducing the amount of fiscal stimulus being provided to the economy and the Fed will start to cut back the monetary stimulus. The trick will be to have this happening at the same time as the private sector starts growing more rapidly, in terms of more consumer spending and higher corporate outlays for capital equipment.

EARNINGS IMPROVE

Obviously, corporate profits were adversely affected by the recession, and comparisons with a year earlier were quite weak, especially 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, the weakest comparisons are now behind and better results started to show up in the fourth quarter of 2009.

Moreover, we expect that earnings comparisons will continue to be sharply higher in the first quarter of 2010, reflecting fewer asset write-downs and better operating profits. Overall, based on our expectations for the economic recovery, we expect a rebound in earnings in 2010, possibly on the order of 25% versus 2009.

S&P 500 Stock Index (Weekly Close)
December 29, 1995 - January 29, 2010



Source: Federal Reserve Board

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