

Insights

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

AN AUTUMN RALLY

Equity investors certainly didn't get the usual summer rally this year as August and September turned out to be two of the worst consecutive months in some considerable time. Here at home, the Standard & Poor's 500 index fell by 14% during the third quarter as investors became concerned about a possible double-dip into a new economic recession. Moreover, there was a sharp increase in concerns about sovereign debt problems in Europe and a lack of a meaningful policy response to the fiscal problems in the U.S.

However, when the data for September began to be reported during early October, it was clear that the economy was actually accelerating rather than falling into an even more sluggish pattern or an actual decline. In addition, an agreement has just been announced by the Europeans on a plan to address the sovereign debt problem, including a 50% write-down of Greek debt, a boost in the rescue fund to €1 trillion and additional capital being raised by the banks.



"IT WAS A DARK AND STORMY MARKET, THEN THE DOW RALLIED AND BLUE CHIPS ROSE..."

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As a result, there has been a significant autumn rally in stocks, which thus far has amounted to a 15% advance from the recent low. Whether this is an early start to a more significant year-end rally – which often occurs – or merely a temporary bounce after a sharp drop, remains to be seen. However, it is at least encouraging to see stocks actually going up following the rough summer.

During the downturn, U.S. stock prices declined for a number of weeks, giving up all of their gains of earlier in the year and then some, and by most measures the deterioration in most foreign markets was even worse. What happened was a series of events that has frightened investors like waves crashing in at high tide. Although the market setback didn't quite reach the 20% decline from a high that would qualify it as a true bear market, it certainly met the qualifications of a full-scale market correction.

SCARY EVENTS

The problems started in early August with concern that the United States might default on interest or principal repayment of its Treasury debt. Although this seemed highly unlikely and was resolved for the time being by an increase in the debt ceiling agreed to by President Obama and the Congress, it frightened investors. This was followed by a surge of fears about a possible double-dip recession in the economy based on some particularly weak data, especially with regard to employment, which increased substantially less than expected during August. In fact, real GDP grew at a rate of only 1.3% during the second quarter.

The third event was a downgrading of the rating on U.S. Treasury debt from AAA to AA+ by one of the major financial agencies. While this did happen, it hasn't seemed to be of particular consequence to bond investors. In fact, the prices for Treasury securities actually rose in the subsequent period,

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with the fallout being on stocks instead. Of course, the current question is whether the economy is going to sustain the uptick in growth shown in the third quarter for the remainder of the year and into 2012.

INFLECTION POINT AT HAND?

For the short run at least, the economic news has turned more positive. Supplies of components from Japan, especially for the auto industry, have been restored to more normal levels, providing something of a bounce in industrial production as assembly rates got cranked up. Moreover, the commodity spike that raised questions about a possible upsurge in inflation this spring, ran its course and many of the earlier increases have now been partially reversed, including those for oil products.

A number of the economic reports for September – especially for retail sales, employment and durable goods orders – were substantially better than the consensus forecasts of economists, who have subsequently been busily raising their forecasts for the balance of the year. It is unclear whether the 2½% growth in GDP for the third quarter was mostly a reversal of the drags felt earlier in the year, so it remains to be seen whether the better momentum can be extended to the quarters ahead.

MODERATING INFLATION

One of the most unnerving aspects of the circumstances earlier this year was the concern that the surge in commodity prices would lead to a significant acceleration in overall infla-

tion. This situation was generally attributed to faster than expected growth in demand for these materials in the Emerging Market economies, especially China and India. In fact, this upward movement encompassed nearly all types of commodities, including agricultural products, industrial raw materials, precious metals and energy.

Fortunately, with regard to inflation fundamentals, the pace of activity in many of the economies around the world has been slower than forecast, and an expected increase in the supply of grains has eased the concerns about food shortages. As a result, near-term inflation has calmed and the latest readings for consumer prices have been flat or lower. Certainly, the ebbing of inflation fears can be viewed as a positive factor for investors, with the rate of prospective price increases returning to a more normal level.

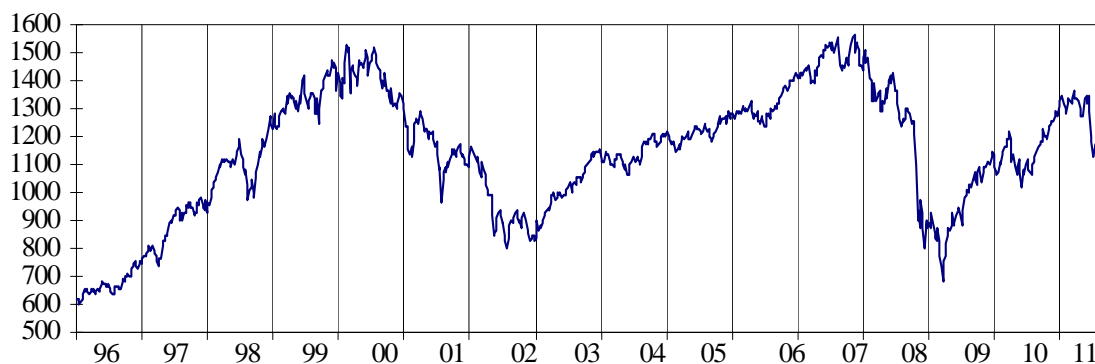
DEBT CEILING LIFTED

A key question relates to the federal fiscal problem, with a current budget deficit running around \$1.3 trillion annually. Although an agreement was reached between President Obama and the Congress for a \$900 billion increase in the debt limit, this was offset by a deal to reduce federal spending in the out years by \$917 billion over the next 10 years and to establish a new 12-member bipartisan super-committee of Senators and Representatives to work toward reducing future deficits by another \$1.5 trillion. Recognizing that the public wants action on this front, this group is scheduled to report back by late November.

If the members can agree on a set of specific actions, the program would then be sent to Congress as a whole, where it would

be voted up or down without amendment prior to Christmas. No one can be sure exactly what will happen, but if the “Gang of 12” doesn’t agree or if their plan is turned down, automatic cuts in spending totaling \$1.2 trillion would go into effect starting in January 2013. One other possibility would be an extension of the time period for making a deal.

S&P 500 Stock Index (Weekly Close)
December 29, 1995 - October 28, 2011



Source: Federal Reserve Board

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November 2011
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