

Insights

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

REACCELERATION?

One of the key questions in the mind of investors today is whether the economy is going to enjoy a rebound in the second half of 2011 following a disappointing shortfall in growth during the first half. In fact, the increase in real GDP was less than 1% during the first six months of the year, which was well below any of the early forecasts that had been made by economists.

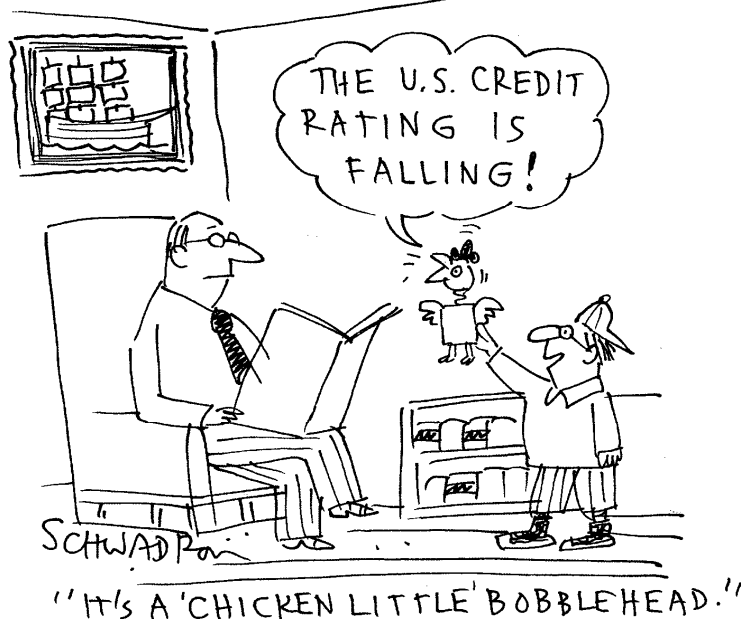
There were, of course, several developments which Chairman Bernanke of the Federal Reserve has called "transitory" factors that acted as headwinds, holding down the rate of growth in activity. The current expectation is that these adverse developments, having had a temporary negative effect, will then fade away.

Heading the list of unexpected negative events, of course, was the impact of the earthquake and tsunami in Japan, which sent that country into a sharp recession and caused a disruption in supply lines of Japanese components for manufacturers in the U.S. and elsewhere.

A second candidate was the political turmoil in some of the Arab countries, especially the insurrection in Libya which caused a disruption in oil supplies from this OPEC member country. In addition, there was adverse weather, including blizzards and an unusually cold winter during the first quarter, followed by tornadoes and floods in the second quarter.

These events were combined with an upward spike in commodity prices, especially for energy and foodstuffs but also for industrial metals and minerals. This caused an upsurge in headline inflation, which acted as a substantial tax increase on consumers and businesses, thus dampening the demand for other goods and services. For example, crude oil prices ran up to a peak of \$114 per barrel, causing a sharp rise in the cost of gasoline at the pump to an average of over \$4.00 per gallon in the U.S.

The good news is that these negatives have already turned or seem about to revert to normal, which promises to turn the headwinds into at least moderate tailwinds, thus permitting the economy to grow faster in the second half of the year.



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INFLECTION POINT AHEAD?

As indicated, we may right now be on the edge of a watershed in the economic news, which may be about to turn more positive. The weather has turned more seasonal, and there are indications that supplies from Japan will be restored to more normal levels in the next few months. This will provide a bounce in industrial production as assembly rates get cranked up and inventories are replenished, and probably some improvement in employment. The commodity spike now appears to have peaked around the beginning of May, and many of the sharpest advances have now been partially reversed, including those for oil products.

At this point, it is difficult to estimate just how

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much of a drag on the economy was caused by the transitory factors. However, it doesn't seem unreasonable to think that they could have accounted for most of a shortfall of about a percentage point and a half (at an annual rate) or even two percentage points. If so, it appears reasonable to expect a reacceleration in the second half as these effects wear off. Of course, there may have been some more fundamental negatives involved in the recent slowdown, but time will tell.

Unfortunately, housing remains the most depressed sector of the economy, and that hasn't changed in the recent past. Indeed, reflecting the large number of homes for which the mortgage debt is as high or higher than the current value of the property, along with continuing weakness in home prices and reluctance on the part of potential buyers, this doesn't seem all that surprising. Thus, we are likely to be still some considerable period of months away from seeing a more favorable scenario for housing.

MODERATING INFLATION

For a while earlier this year, there was concern that the surge in commodity prices would lead to a significant acceleration in overall inflation. 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, it affected all types of commodities, including agricultural products, industrial raw materials and energy.

Fortunately, relative to inflation, the pace of activity in many of the economies around the world has been slower than forecast, and an expected increase in supplies of grains has eased the concerns about shortages. As a result, inflation

has calmed and in the latest reading, at least, the U.S. Consumer Price Index has actually shown a decline.

MONETARY STIMULATION

In an effort to help the economic recovery, the Federal Reserve has carried out several phases of stimulation through monetary policy. Interest rates on short-term borrowing have been set at rock-bottom levels for the past two years and seem likely to be maintained there until well into 2012, if not longer. In addition, The Fed has carried out two rounds of "quantitative easing" through which it has sharply expanded its balance sheet by large purchases of Treasury debt in order to lower borrowing costs and provide more attractive mortgage rates. The latest of such efforts was completed on June 30.

DEBT CEILING NEGOTIATIONS

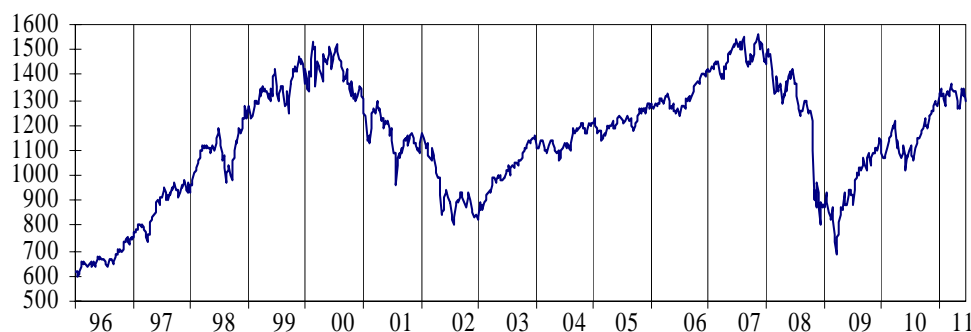
At the very end of July, as the earlier authorization for the national government to borrow money was about to expire, a deal was reached between President Obama and the leadership of both houses of Congress to provide an immediate \$400 billion increase in the debt ceiling and give the President authority for another \$500 billion increase in September. This would be accompanied by a reduction of \$917 billion in spending versus the current benchmark over the next ten years. On this basis, the threat of any near-term default in government securities has been averted.

In addition, a special committee of members of Congress will be appointed to identify an additional \$1.5 trillion of savings to be achieved (also over a 10-year period). Their recommendation will be reported back to Congress before Thanksgiving and is to

be acted on before Christmas in an up-or-down vote. In the event that these recommendations are not approved, a sequestration mechanism would go into effect, automatically reducing spending by a further \$1.2 trillion.

On the whole, this isn't a magic package that will solve all of the fiscal problems at the federal level. However, considering that we have a divided government, it is probably the best that could be done under the circumstances.

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



Source: Federal Reserve Board

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