

Insights

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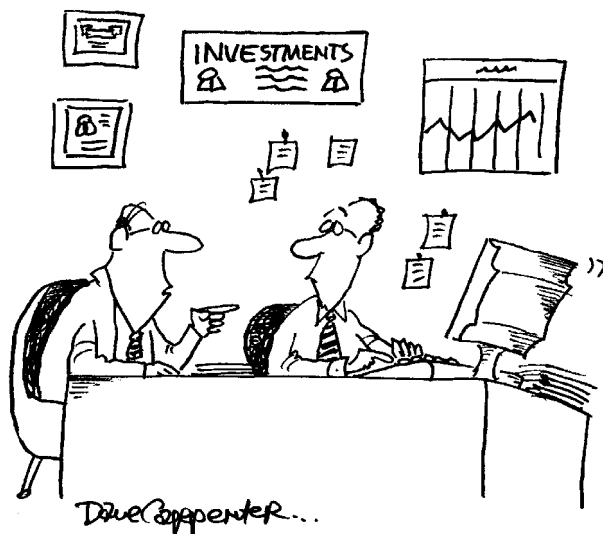
Commentary on the economy and financial markets from Atlantic Trust's chief investment strategist.

A GOOD START

The first month of 2012 provided a positive experience for equity investors. The stock market started out on an upward path on the first trading day and pretty much stuck to that trend through most of January, ending up with a 4½% gain for the entire month.

Many times, the first month is a harbinger of what lies ahead for the year as a whole. However, it doesn't always work that way as turned out to be the case in 2011, which started out well but was a disappointment as it ended up with zero appreciation.

Volatility in stock prices and trading volume were much lower during January than was the case for most of last year. However, corporate earnings and reports on the economy during the early weeks were pretty much in line with expectations, and there were no new fiscal or political crises to alarm investors. In fact, there was only one day last month in which the Dow moved as much as a hundred points.



"HOW MUCH FOR THE GENERIC EQUIVALENT OF THOSE BLUE CHIPS?"

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RETROSPECTIVE

Looking back at last year, there was no clear market trend but, in fact, several changes in direction reflecting sharp shifts in investor sentiment. An initial market upturn of about 10% lasted well into spring. However, the advance stalled out during the early summer when it was reported that GDP growth in the first half of the year had been revised down significantly.

This bad news was accompanied by forecasts by bearish economists that we could fall back into a double-digit recession, causing a reversal in sentiment. This shift in sentiment then triggered a sharp decline in stock prices during August and September, carrying the market down by nearly 20%.

However, once it became clear that the economy was actually gaining momentum in the second half rather than losing it, there was a strong rally during October –which was the best single month for the stock market in many years. In the end, the ups and downs cancelled each other out so that 2011 turned out flat for appreciation, while providing a total return of 2.1%.

ECONOMIC UPTURN

Early last year, the consensus view was that the economy would grow moderately, i.e. probably at an annual rate of about 3% in the first half of 2011, with some slowing likely in the second half.

However, what actually happened was pretty much of a mirror image. In fact, first quarter growth was the weakest of the year and the fourth quarter the strongest.

It is difficult to explain why the economy turned out to be so much weaker than expected in the early quarters of last year, i.e. by less than a 1% annual rate in the first half, as activity didn't feel that sluggish at the time and corporate profits actually exceeded expectations.

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There were, however, several transitory factors that acted as headwinds holding down the rate of growth. These included the impact of the earthquake and tsunami in Japan, which sent that country into a sharp recession and caused a disruption in supplies of Japanese components for manufacturers here.

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. 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.

The good news is that these negatives subsequently shifted and essentially reverted to normal, which turned the headwinds into moderate tailwinds, thus permitting the economy to grow faster in the second half of the year.

However, growth in the final quarter of 2011 turned out to be a bit disappointing. Although the 2.8% rate of increase in real GDP was close to the consensus expectation, a substantial portion of this was due to inventory accumulation rather than final demand. On the other side of the equation, a surprisingly large decline in government spending acted as a substantial drag on growth. As a result, economic momentum as we entered 2012 was slower than one would have expected.

MODERATING INFLATION

In early 2011 there had been concern that a surge in commodity prices would lead to a significant acceleration in over-

all 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, this upward movement encompassed nearly all types of commodities, including agricultural products, industrial raw materials and energy.

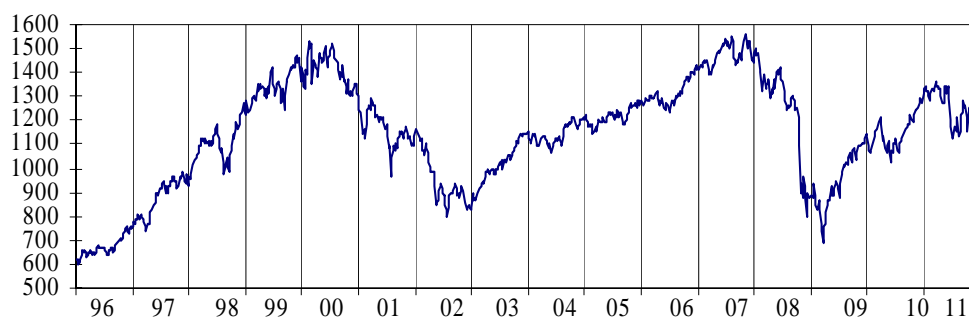
Fortunately, relative to inflation, the pace of activity in many of the economies around the world has been slower than forecast, and an increase in supplies of grain has eased the concerns about shortages. As a result, near-term inflation has calmed and in the latest readings, at least, the U.S. Consumer Price Index has actually been flat to down modestly. Certainly, the ebbing of inflation fears has been a positive factor for investors as the rate of prospective price increases has returned to a more normal level.

FISCAL STUMBLING BLOCK

One of the key uncertainties in the U.S. – the federal fiscal situation -- has been carried over into 2012. President Obama and the Congress recently agreed to a temporary two-month extension of the reduced payroll tax rate, unemployment benefits and doctor reimbursements under Medicare. However, this problem will be back on the agenda during February and a new agreement will be required. The federal budget deficit appears likely to exceed \$1 trillion again in fiscal 2012 and, in spite of off and on negotiations, the parties do not appear to be anywhere near a more permanent resolution. Thus, the situation continues to represent a significant uncertainty for investors.

Most students of the budget are in general agreement that a number of significant changes will be required to bring the budget under control, including a reduction in discretionary spending, reforms to the entitlement programs, and tax reforms, which would likely include a broadening of the tax base – including elimination or restriction of many exemptions and deductions – accompanied by a reduction in tax rates as a stimulus to faster economic growth. Whether such a package can be enacted remains to be seen, but it may not happen until 2013, and the outcome may well depend on the results of the elections this November.

S&P 500 Stock Index (Weekly Close)
December 29, 1995 - January 27, 2011



Source: Federal Reserve Board

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