



**ATLANTIC TRUST**

PRIVATE WEALTH MANAGEMENT

**Economic and Investment Overview**

Second Quarter 2011

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### U.S. Economy

- Expansion finally supported by job growth
- Growth potential restrained by end of stimulus, housing woes and de-leveraging
- Geopolitical risks abound: Japan, Middle East, euro debt
- D.C. focus: Budget fireworks ahead

### Equities

- Stocks rise in face of global turmoil
- Good news on the economy, earnings and tax rates extend the two-year bull market
- 2011 outlook: Moderate gain achievable, driven by EPS growth and reasonable valuations
- Profit margins are near historical peaks; earnings growth likely to slow later this year and in 2012

### Bonds

- Inflation is not a near-term threat
- QE2 has inflated equity and commodity prices but bank lending still flat
- Munis: Q1 recovery after rough Q4
- Munis: State tax receipts on the rise

### Asset Allocation Themes

- U.S. Equities: Favored areas are **large caps** and **long/short hedge funds**
- Embrace **emerging markets** : equities, local currency debt, commodities and U.S. stocks with high EM sales component
- Favor **enhanced yield** alternatives to bonds: EM and senior bank debt, energy MLPs and diversified equity income
- Private equity: Distressed and turnaround situations most attractive

### “The economy is on firmer footing....”<sup>1</sup>

- The U.S. economy has successfully transitioned from recovery to expansion. It took 3 years, but the level of economic activity has surpassed the prior peak of late 2007.
- A notable pickup in the job market is finally taking hold in 2011. Private sector hiring has accelerated, more than making up for layoffs of government employees. Employment has risen 1.3 million in the last twelve months, but is still down more than 7 million versus 3 years ago.<sup>2</sup>
- While the expansion has begun, we continue to expect subpar growth as fiscal stimulus wanes, QE2 ends, the housing market withers and consumers deleverage. The consensus on real GDP is for readings above 3% each quarter through mid-2012.<sup>3</sup> Our expectation is for slower growth and more volatility.
- Headline inflation rates have risen and will likely continue increasing in the months ahead. This is due to acceleration in food and energy price increases. Overall inflation has accelerated in the last six months, but the core rate excluding food and energy is essentially unchanged. Higher food and energy prices act as a tax on consumers, a factor in our below-consensus growth forecast.

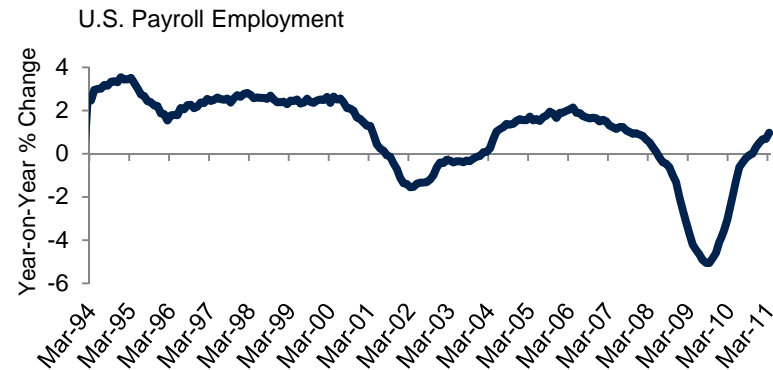
<sup>1</sup> Federal Reserve statement, March 15, 2011

<sup>2</sup> Bloomberg LP, March 31, 2011

<sup>3</sup> Blue Chip Financial Forecasts, April 1, 2011

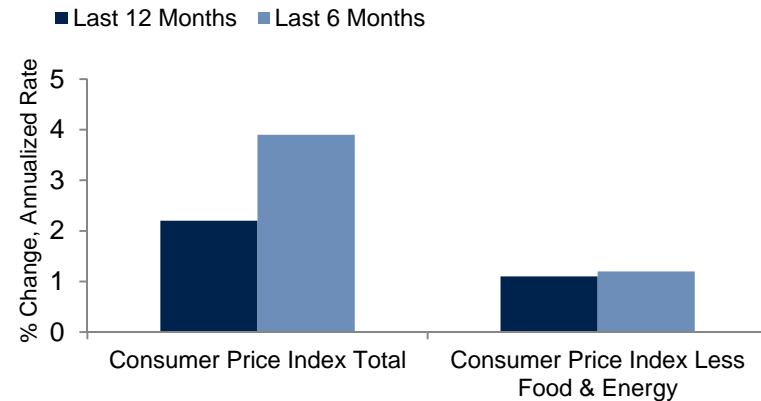
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#### Improving Job Market



Source: Bloomberg LP, data as of March 31, 2011

#### Commodity Prices Hit the CPI

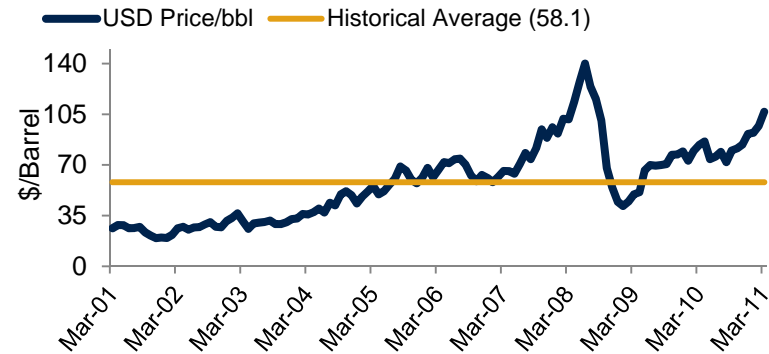


Source: Bureau of Labor Statistics, data as of February 28, 2011

## Geopolitical risks all over the world...and at home

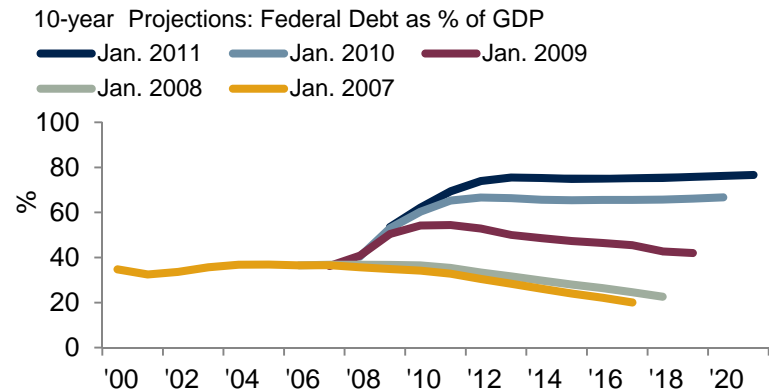
- The Japanese earthquake was a horrible tragedy, and the resultant nuclear crisis may change the outlook for that industry. Japan will likely experience a short period of paralysis followed by a rebuilding boomlet extending into 2012. It is not a “game changer” for the U.S. or global economy.
- The rolling wave of rebellion in North Africa and the Middle East has clearly impacted the price of oil. While Libya garners much attention, internal strife in Saudi Arabia or Iran would be far more critical to the global economic and markets outlook.
- The eurozone sovereign debt drama continues, with Portugal now facing potential default. It is critical for the eurozone economy and global markets that Spain not meet the same fate. Spain’s economy is nearly twice the size of Greece, Ireland and Portugal combined.
- Washington will be dominated by budget drama in the second quarter. Intense debate over the size and scope of spending restraint will dominate headlines. Investors would likely embrace an outcome favoring aggressive deficit reduction. The chart shows the progressively worsening expectations for the accumulating federal debt.

### Oil Rises on Middle East Supply Worries



Source: Bloomberg LP, data through April 4, 2011

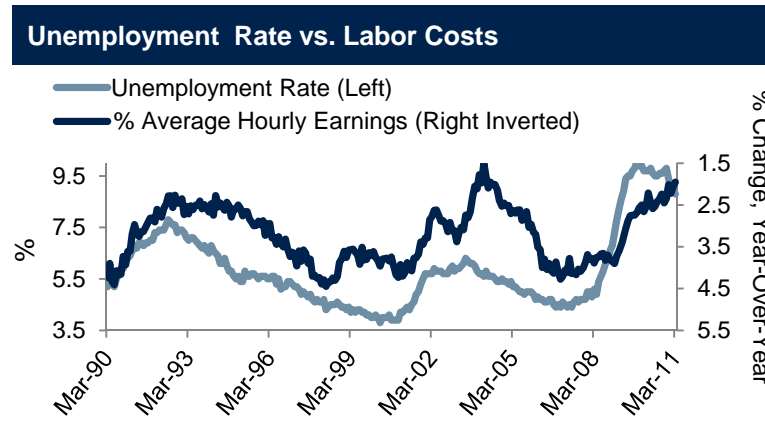
### Getting Worse Every Year



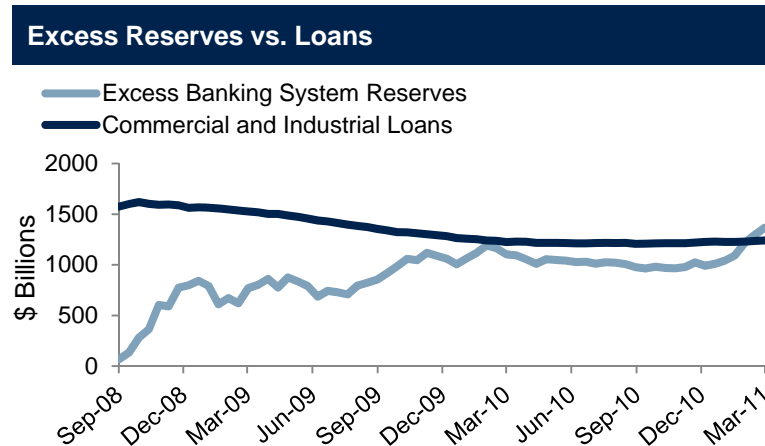
Source: Congressional Budget Office and Strategas, data as of February 2011. Data after January 2011 is estimated.

## Inflation factors

- With the Federal Reserve pumping money into an expanding economy through Quantitative Easing (QE2) and commodity price increases so severe as to spark uprisings in the Middle East and North Africa, shouldn't the U.S. expect a wave of inflation? Not yet.
- There is still plenty of slack in labor and product markets. Commodity inflation is not passing through to final goods and is therefore more likely to constrain profit margins than lead to inflation.
- QE2 has been blamed for dollar depreciation and the subsequent commodity spike, but it has had little direct economic impact. Monetarists see the expansion of the Fed's balance sheet as leading to inflation, but the monetary link of velocity is still missing from the equation. Even though liquidity has been added to the economy, bank lending has remained flat.
- Treasury Inflation Protected Securities imply higher inflation in the future, but no more than what they have predicted during the early stages of other recent economic recoveries.



Source: Bureau of Labor Statistics, Federal Reserve, April 2011

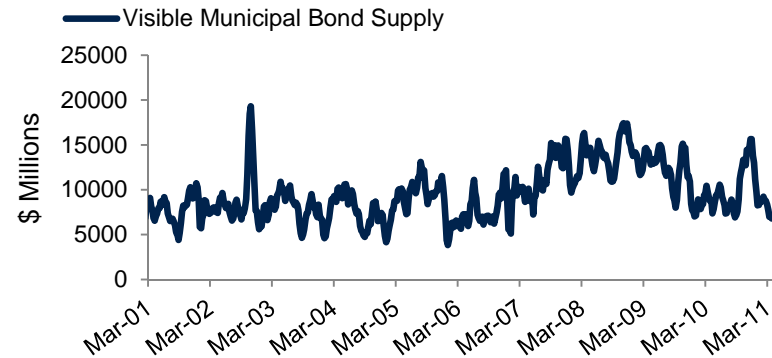


Source: Bureau of Labor Statistics, Federal Reserve, April 2011

## Muni recovery

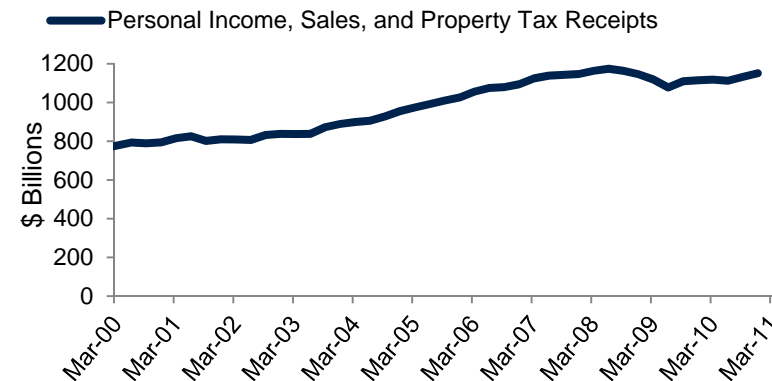
- Muni returns turned positive for most categories of debt in the first quarter. This followed a wave of selling by individual investors, a dramatic drop in bond prices in the fourth quarter and a chorus of default predictions.
- With tax receipts on the rise, thanks to improving labor and retail sales data and pressure on public sector union benefits, are we out of the woods? Not yet.
- In some ways, the first quarter rebound was a normal response to the overreaction of the fourth quarter downturn. Markets started to buckle in the fourth quarter due to an excess of supply over demand. The accompanying increase in yield made new supply unappealing for municipalities, and the scarcity of debt issuance in the first quarter contributed to stability.
- The underlying economic trends are certainly encouraging, but the state budget processes for fiscal 2012 are far from complete, and we anticipate further rounds of political posturing. The combination of headline risk and an eventual increase in supply should increase near-term volatility in municipal bonds.

### Sharp Drop in Supply



Source: Municipal Market Data, Bureau of Economic Analysis, April 2011

### Tax Revenue Growth Continues

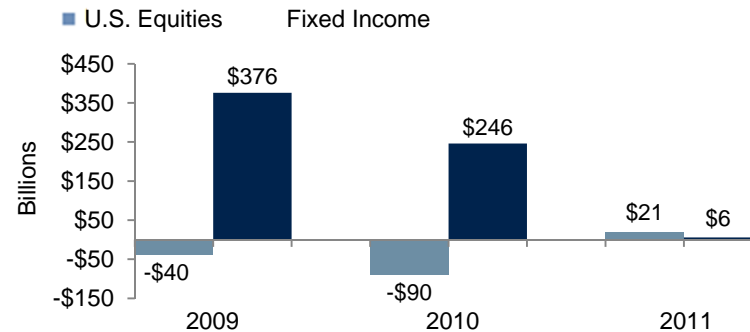


Source: Municipal Market Data, Bureau of Economic Analysis, April 2011

## Resilience

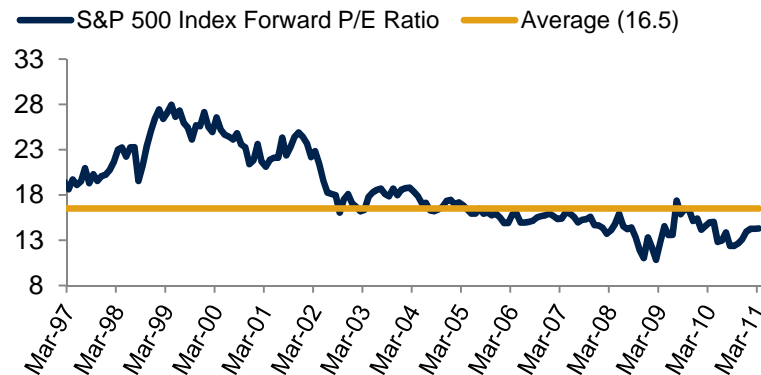
- Considering the various worries that needed to be overcome in recent months, investors in domestic equities can look back on the first quarter with considerable satisfaction. The S&P 500 posted a total return of about 6%.
- The positive first quarter was achieved in spite of several significant negative factors, including the insurrection in Libya – a significant oil exporting country, the effects of the earthquake and related tsunami in Japan, and a jump in domestic inflation caused primarily by a surge in commodity prices.
- Recent strong equity performance can be attributed primarily to four positive fundamental aspects: better than forecasted economic activity and earnings, the mid-term election results and the tax rates deal in Washington for 2011 and 2012. These developments encouraged investors and brought some of the money previously on the sidelines into the equity market.
- In spite of rising stock prices, valuations are moderate. In fact, earnings estimates have been revised up sharply so that multiples on expected profits have remained below their long-term average.

### Just Starting: Money Flowing to Equities



Source: Strategas, data as of March 2011

### Valuations Attractive in Strong Earnings Environment

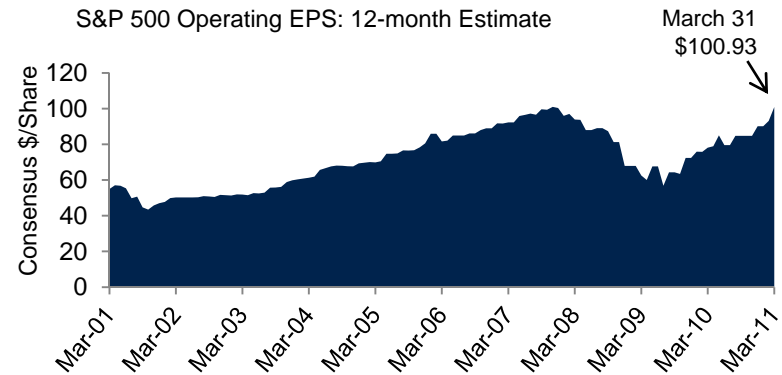


Source: Thomson Financial, data as of March 2011

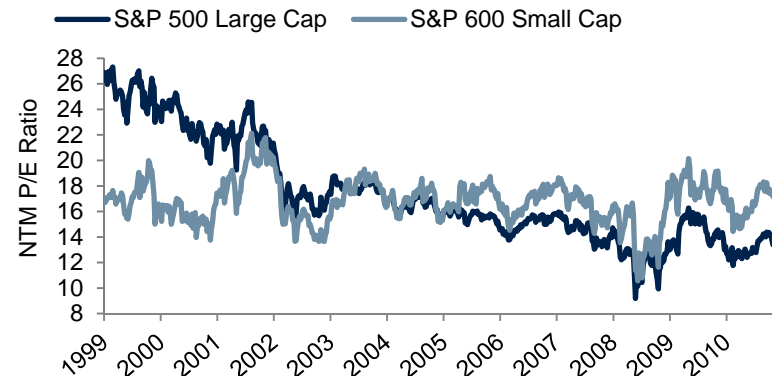
## Major earnings recovery

- As to profits, up until mid-2009, they were depressed by both the negative effects of the recession and a major wave of asset write-downs. This activity has come to an end, so that strong operating profits are now being reflected in the earnings reports.
- The best news is that with the recovery in the economy and the cessation of asset write-downs, earnings showed a strong rebound of more than 40% in 2010 and, based on our current estimates, earnings for 2011 will finally exceed those in 2006, which was the best previous year on record.
- Profit margins have soared – a testament to the recovery and acumen of U.S. corporate management. However, they are already close to all-time highs. Future earnings gains will need to rely more on stronger revenue growth or share buybacks. We expect slower earnings growth in 2011 and 2012.
- We continue to emphasize large-cap multi-national companies as the best combination of quality and value in the stock market. Large caps are historically undervalued versus small caps.

### A Bull Market Driven by Profits



### Large Cap Inexpensive vs. Small Cap



### Emerging markets remain compelling despite inflation headlines

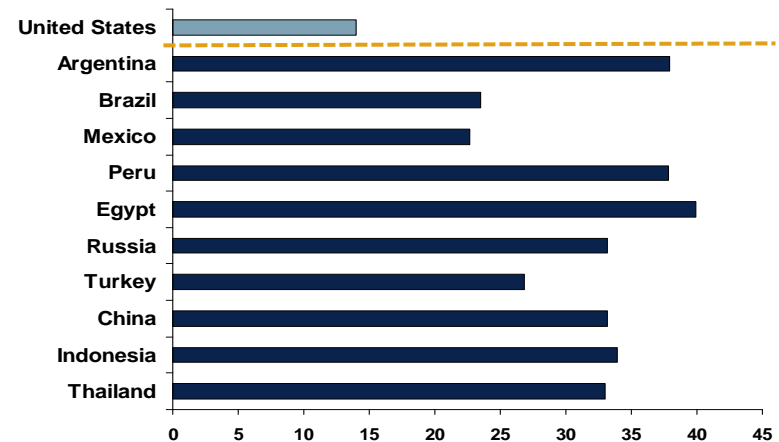
- During Q1, emerging market (EM) equities returned 2.1%, lagging the S&P 500 by 3.8% and the MSCI EAFE by 1.3%. Since November 2010, emerging markets have underperformed the S&P 500 by 6.6%.<sup>1</sup>
- For the past six months, EM have been in the crosshairs of monetary policy tightening. Central banks have not only raised rates in a number of countries, but they have also targeted the funding and investment flows that contribute heavily to these countries' economic engines.
- As a result of tightening measures, some economies have already exhibited signs of moderating growth. Two of the larger EM engaged in tightening cycles, Brazil and India, have both seen industrial production growth drop from nearly 20% year-over-year to the low single digits.
- Tightening measures have not gone unnoticed by investors. In a significant reversal from 2009 – 2010 trends, during Q1 developed markets received inflows of \$36 billion versus redemptions of \$18 billion from EM equity funds.<sup>2</sup>
- EM currencies remained fairly stable during the recent period of equity volatility. Atlantic Trust has been recommending the use of EM debt – denominated in local currencies – to clients for over a year. EM fundamentals support currency appreciation over the medium and long-term.
- The good news is that EM equities began a spirited recovery during the last few weeks of Q1 as global grain prices fell sharply – food prices have a large influence on EM inflation as the weight of food in EM CPI baskets is much larger than in developed markets.

- The growth outlook for emerging markets has stabilized, inflationary pressures are easing and sentiment is improving, all at the same time that a prolonged period of low interest rates in developed markets is likely coming to an end. Our expectation for long-term, EM outperformance remains intact.
- Further downside risk exists if output gaps continue narrowing as demand remains strong. In this scenario, central banks may be forced to slow growth more drastically and quickly than expected.

<sup>1</sup> Bloomberg, March 31, 2011

<sup>2</sup> Bank of America Merrill Lynch

#### Weight of Food in CPI Baskets (%)



Source: Bloomberg, Bank of America Merrill Lynch, Credit Suisse, January 2011

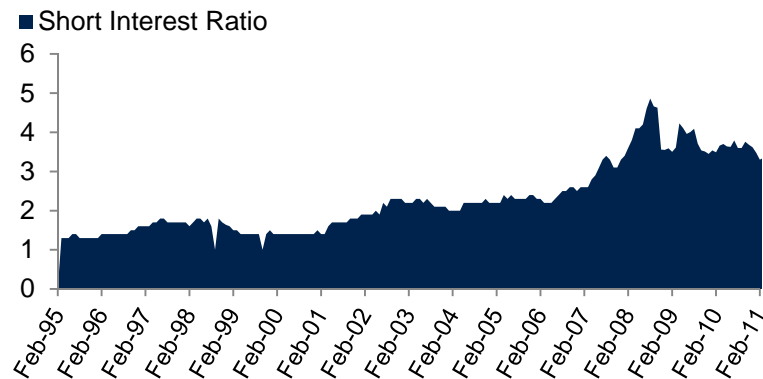
### Record inflows and attractive opportunities...

- Hedge funds raised \$56B in 2010, the largest annual increase in flows since 1990. About 80% of public pension funds made their first hedge fund investment in 2011. New hedge fund launches totaled 935 in 2010, completing the best year for launches since 2007.<sup>1</sup>
- Global hedge funds weathered Japan's earthquake well. While the Nikkei and MSCI World dropped 16.1% and 3.0%, respectively, equity-focused funds only dropped an estimated 1.5%.<sup>2</sup>
- Equity hedge funds are in "re-risking" mode and continue to increase gross and net exposures as valuations remain compelling. However, hedge funds remain cautious and tactical in managing portfolios as macro events and resultant volatility spikes may continue. The short ratio continues to decline in response to takeover risk.
- Credit managers have shifted to more relative value and middle market opportunities as the distressed opportunity winds down. U.S. corporate default rates have dropped to historically low levels, and spreads have tightened, resulting in U.S.-focused distressed managers holding high levels of cash. The distressed opportunity in Europe continues to remain fertile in light of the sovereign debt issues.
- Event-driven managers continue to benefit as record-high corporate cash is being used to acquire attractively valued companies. Eight out of the 10 largest global deals this year are U.S.-focused, with oil and gas and telecommunication being the leading target industries.<sup>2</sup>
- We remain bullish on the fundamental equity long/short strategy as we expect managers to benefit from long term trends in sectors such as technology, consumer and energy. We also expect markets to differentiate between individual stocks on a fundamental basis as equity correlation and volatility continue their decline.

<sup>1</sup> Prequin, March 31, 2011

<sup>2</sup> Bloomberg and HFRI, March 31, 2011

### Short Sellers More Cautious



Source: Bloomberg LP, data as of March 31, 2011