INVESTMENTS

2011

INFLATION EXPECTATIONS

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Contrary to what many were predicting in early 2009, Atlantic Trust issued the opinion that, despite U.S. Government actions, rising commodity prices and early signs of an economic recovery, inflation would be slow to materialize. Two years later, this has proven to be the case. While we believe U.S. inflation rates troughed in mid-2010, the necessary requirements for inflation to rise to such an extent that the Federal Reserve is prodded into raising interest rates is not imminent.

While the U.S. and many other developed nations are experiencing muted levels of inflation, rapid economic growth in emerging economies has created the need to stave off high inflation rates. In the discussion below, we explain our views on global inflation in the context of an unbalanced global economy, and contend that above trend inflation will not appear in the U.S. in the near future.

Current Inflation Enviromment and Outlook

Central Banks Unite To Revive Global Economy

During 2008 and 2009, global central banks engaged in an historic coordinated effort to resolve the financial crisis through massive fiscal and monetary levers. This precipitous action largely staved off further meltdown of global economies and a longer period of deflation similar to what Japan has experienced for almost 20 years. The intent was to stabilize credit conditions and reflate the economy.

U.S. Currently at Trough Inflation Levels

The U.S. "core" Consumer Price Index (CPI) notched a reading of 0.8% for 2010, well below the targeted 2.0% rate desired by the U.S. Federal Reserve. Core inflation excludes volatile food and energy inputs. The 0.8% rise represents the smallest calendar year increase in the history of the index. The Fed deemed this unacceptably close to deflation, and embarked on its second round of quantitative easing (QE2) and is now in the midst of purchasing $600 billion of Treasury securities by midyear. QE2 comes on the back of a variety of government rescue and fiscal stimulus plans since 2008, as well as several other monetary initiatives by the Fed. Through these mechanisms, policymakers believe that creating money and encouraging the flow of credit will restore confidence in the economy and create a self-sustaining economic expansion. At the same time, these highly stimulative measures have led many investors to worry about a money supply-induced surge in inflation.

Is Inflation About to Become a Problem in the U.S.?

Despite aggressive measures by the Fed, U.S. economic growth has been well below historical norms for typical recoveries. Growth strengthened as we exited 2010, but several ingredients in the recipe for inflation are not yet in evidence. This should provide an impediment to a sharp upward move in inflation over the next 12 to 18 months.

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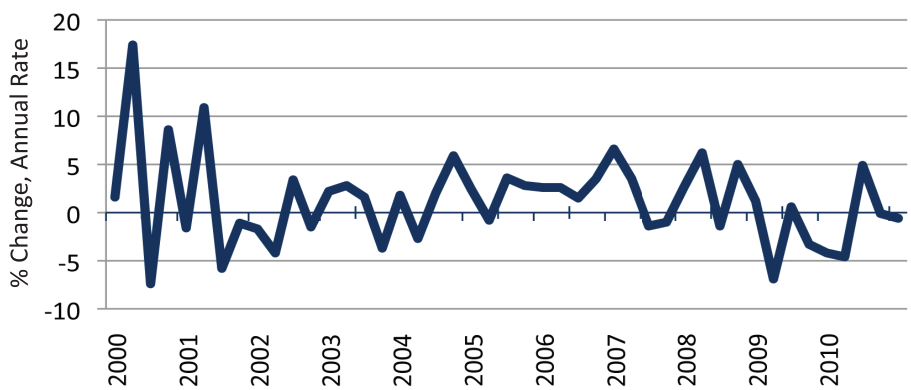
First, labor productivity is solid as illustrated by the flat reading for unit labor cost growth. The significant rise in unemployment during the recession has been followed by very grudging re-hiring in the recovery. Companies are doing more with less – a key ingredient in the strong profits recovery. The downside, however, is a lack of consumer income growth. Without income growth, consumers are reluctant to spend. Additionally, with high unemployment, employees are not in a good position to demand higher wages. While we expect the unemployment rate to come down gradually in coming years, the U.S. economy is a long way away from full employment and any sort of wage/price spiral.

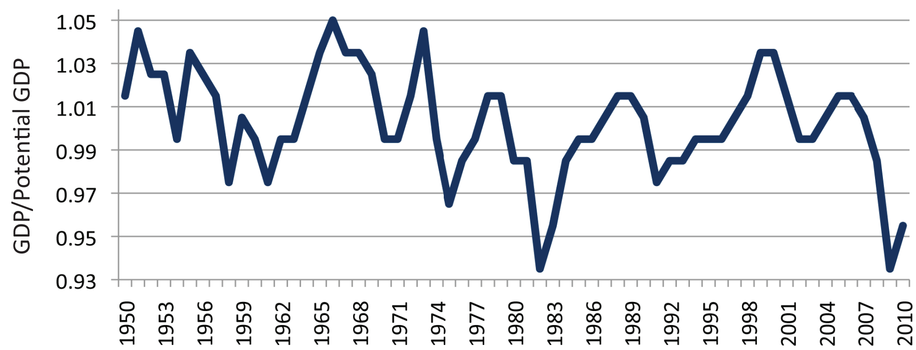
Nonfarm Business Sector Labor Costs



Source: Strategas, December 31, 2010

Secondly, excess capacity remains in the U.S. economy as a residual effect of the deep recession. This exists in numerous sectors but predominantly in real estate, and commercial and residential construction. The significant issues faced by these sectors, as well as the general unemployment problem, is keeping a lid on inflation. This can be seen in the GDP output gap shown at the top of page 3, which is defined as the deficit between the economy's current operating rate and its potential capacity. The current low reading is indicative of slack in the economy or, as economists call it, low resource utilization. Whatever the terminology, it is difficult to attain pricing power in such an environment.

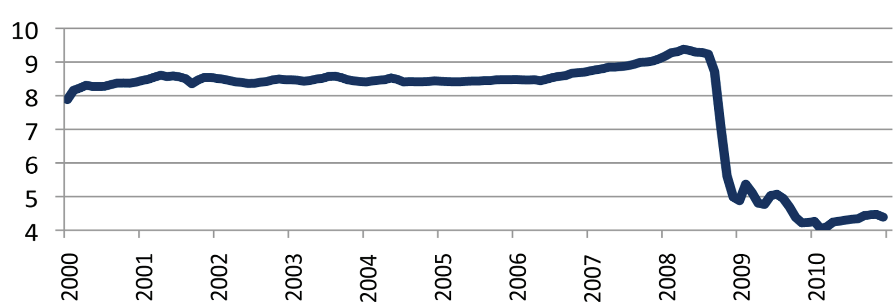
GDP Output Gap



Source: Strategas, December 31, 2010

Lastly, while the Fed and U.S. fiscal authorities have added liquidity to the economic system, the velocity of money - the rate at which money is recycled through the system - has not meaningfully improved. This can be seen on several fronts, including dormant bank lending and the rise in the personal savings rate. Thus, while there is more Fed-induced liquidity in the system, the explosion in the money supply that could spur inflation has not materialized. The chart below illustrates the low level of the "money multiplier" effect.

Low Level "Money Multiplier" Effect*



*Source: Strategas, December 31, 2010. *Change in Money Supply/Change in Bank Reserves.*

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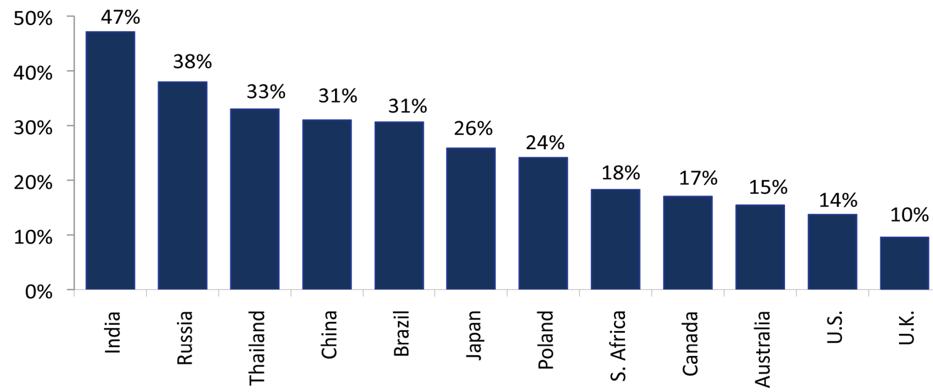
Inflation Is an Issue Now in Many Emerging Economies

U.S. GDP growth and inflation have been muted in the latest recovery. Meanwhile, emerging markets are moving in the opposite direction, with economic growth and inflation readings above policymakers' comfort zones. Countries including China, Indonesia, Korea and Thailand recently tightened policy through higher interest rates. Likewise, Brazil has raised its key interest rate above 11%. Because these emerging market economies are now significantly larger than they were 10 years ago (China is now the world's second largest economy), the demand for natural resources is strong and supply constraints have emerged. Commodity prices from cotton to oil to copper to coal have risen on the higher demand pull from these economies. Food is another group that has experienced precipitous increases in prices, leading to riots in many developing countries. As seen in the chart at the top of page 4, food prices make up a far larger part of the inflation picture in emerging economies vs. the U.S.

Food Weighting in Country-Specific CPIs



Source: Strategas, March 2011

An awful lot of central bankers around the world will have to "get it right," and that means different things in different countries.

Inflation is defined as a general rise in prices across an economy, not solely commodities. Therefore, while emerging economies are experiencing broad-based price escalation (inflation), citizens of developed countries are witnessing price pressures in a few select areas such as commodities. Policymakers in emerging market economies exhibiting strong growth must focus on tapping the economic brakes without causing recession, while those in many developed economies are still focused on protecting fragile recoveries by retaining loose monetary policies. These divergent paths for inflation and monetary policy pose a risk to the global economic expansion. An awful lot of central bankers around the world will have to "get it right," and that means different things in different countries.

Rising Inflation in the U.S.: Delayed, Not Denied

For many reasons, we do not expect an imminent rise in inflationary pressures in the U.S. Higher energy prices are currently a concern. However, given the lack of broader inflationary conditions discussed earlier, rising consumer energy costs will act more like a tax rather than induce inflationary expectations. Having said that, we are concerned about the longer-term consequences of massive deficit spending and the potential for a government policy bias to allow inflation to reduce the real value of its accumulated liabilities. Currently, we are scraping along the bottom of a nearly 30-year era of declining inflation. Longer term, the odds for higher inflation increase as excess capacity is absorbed, the money multiplier normalizes and policy makers look for ways to minimize a heavy debt burden. This will have material implications for the direction and level of interest rates, fixed income strategy and asset allocation in general.

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