

Insights

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

ROLE REVERSALS

For most of the second half of 2011, investors were destined to deal with three overriding risk aspects that were not of particular concern at the beginning of the year. First was a sharp slowdown in the rate of growth in the U.S. economy that raised fears of a possible double-dip back into recession.

Second was a deepening and broadening of the sovereign debt crisis in Europe, which began with Greece and then spread to Italy and several other members of the euro currency bloc.

Third, was the risk involved in the fiscal imbalance in the federal budget in the U.S., where spending had soared from 21% of GDP to 25% during the first three years of the Obama administration and seemed to be out of control.

During August and September, the market began to focus heavily on these risks and experienced a sharp sell-off, which culmi-

nated in a full-scale correction of some 19% as compared to the high that had been reached in late spring.

This was followed by a strong reversal during October as the stock market advanced sharply based on an upturn in economic data here in the U.S., hope that a new plan for dealing with the sovereign debt problem in Europe would be implemented and an attempt to resolve the fiscal situation in the U.S. by the appointment of a new Supercommittee that was charged with producing a plan to reduce federal spending by \$1.2 trillion in the years ahead. Investors responded quite favorably to these developments. In fact, October was the best month for stock prices in the past 25 years.

Unfortunately, this situation was destined to be short lived. The European problems didn't get resolved but, instead, seemed to go from bad to worse, and the Supercommittee came up empty handed in terms of creating a set of steps to be taken to improve the fiscal situation here at home. As a result, there was yet another reversal, with stock prices giving back part of the October gains during November.

During this particularly volatile period, the cumulative effects of the market declines meant that stocks ended up giving back essentially all of their gains of earlier in the year, ending November with a slight 1% positive return for the year to date.

ECONOMIC PROGRESS

The best news is that, for the short run at least, the economic news here at home has clearly turned more positive. Among the factors was that supplies of components from Japan, which had been disrupted by the earthquake and tsunami, were restored to more normal levels. This provided something of a bounce in industrial production in the U.S. as assembly rates got cranked up.



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Moreover, the commodity spike that had raised questions about a possible upsurge in inflation this spring, ran its course, and many of the earlier increases have now been partially reversed. This included a big jump in oil products, for which the surge in prices had been a drag on consumers.

Many of the economic reports for September and October – especially for retail sales, employment, industrial production 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. As a result, the latest official reading shows that economic activity increased at a 2% pace in the third quarter as compared to a bit less than 1% in the first half, and the current expectation for the fourth quarter is that growth may increase further to a rate near 3%. Of course, the question today is whether the economy is going to sustain the uptick in growth shown in the third and fourth quarters into 2012.

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 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, 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.

FISCAL PROBLEMS PERSIST

The federal budget problem became of significance 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.

A related event was concern about a downgrading of the rating on U.S. Treasury debt from AAA to AA+ by a major financial agency. Although 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, with the fallout being felt by stocks instead.

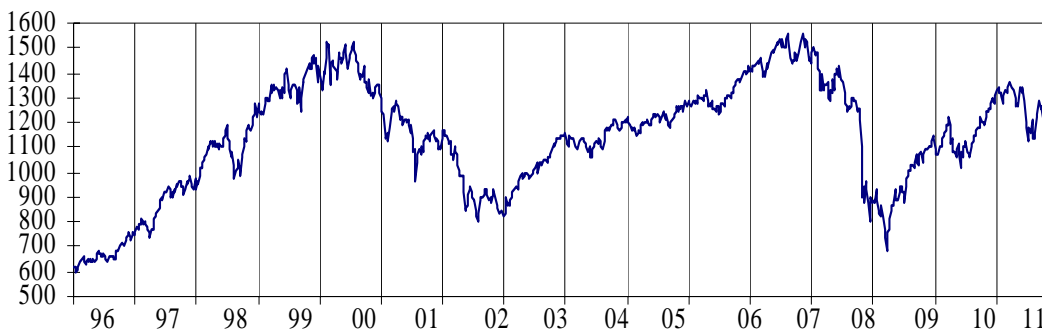
SUPERCOMMITTEE FAILS

The appointment of a 12 member Supercommittee with equal numbers from both parties and both houses of Congress was an interesting plan to inject some discipline into the federal budget. Pretty much everyone knows that spending must be reduced, that entitlements need to be reformed, and that the tax system needs to be overhauled. However, there is great reluctance to take the risks of actually doing something about the situation.

Reflecting the high level of partisanship among the members, it turned out that the group was simply unable to fashion a program that would accomplish the objective of reducing the out year deficits by \$1.2 trillion – which was in fact probably the minimum amount that is necessary.

Next year, Congress will have to readdress the longer-term budget problem, although it remains unclear just what sort of a deal can be enacted.

S&P 500 Stock Index (Weekly Close)
December 29, 1995 - November 30, 2011



Source: Federal Reserve Board

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