

Insights

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

SERIOUS BUSINESS

It turned out that August was one of the worst months for equity investors in a long time, and we can now report that September provided more of the same. Stock prices continued to decline last month and the market has now given up all of its gains of earlier this year and then some, and by most measures the deterioration in foreign markets was even worse.

What happened was that a series of events frightened investors like waves crashing in at high tide. While the recent market setback didn't reach the 20% decline from a high that would qualify it as a true bear market, it certainly met the qualifications of a full-scale market correction.

The *crisis du jour* in early August was that the United States might default on interest or principal repayment of Treasury debt. Al-

though this seemed highly unlikely and was eventually resolved by an increase in the debt ceiling agreed to by President Obama and the Congress, it upset investors.

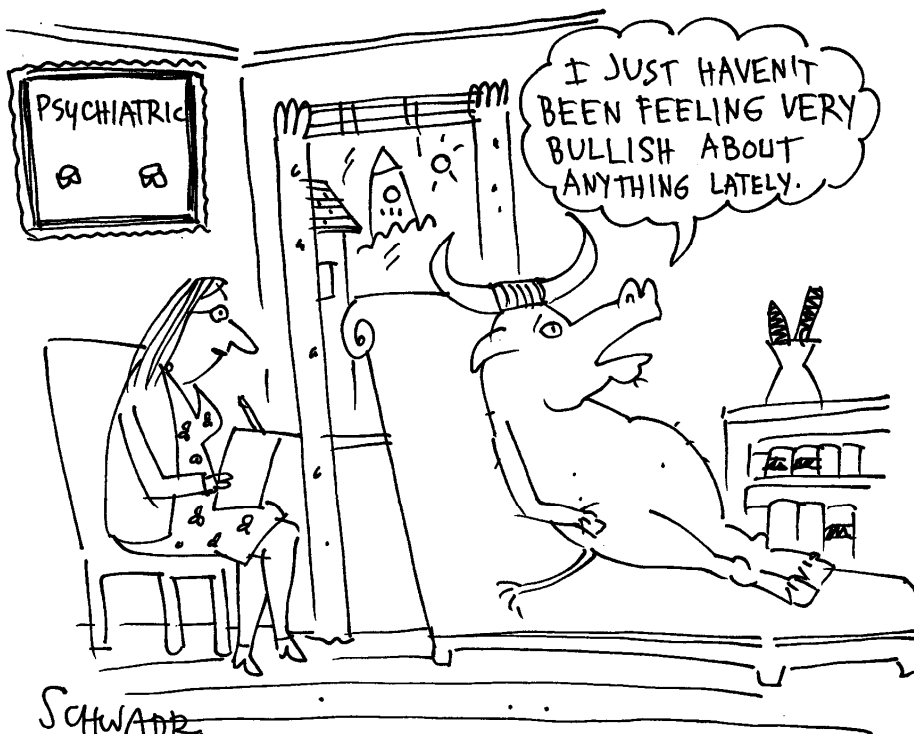
This was followed by a surge of fears about a possible double-dip recession in the economy based on some particularly weak data, especially with regard to employment, which failed to grow at all during August. Overall, real GDP grew at a rate of just under 1% during the first half of 2011.

The third event was a downgrading of the rating on U.S. Treasury debt from AAA to AA+ by one of the major financial agencies. While this did happen, it hasn't seemed to be of particular consequence to bond investors. In fact, the prices for Treasury securities have actually been rising in the subsequent period, with the fallout being on stocks instead.

In Europe, the concerns about the quality of the sovereign debt of some of the weaker members of the euro bloc have continued unabated. Various proposals to relieve the pressure have been put forward by the European Central Bank and International Monetary Fund, but the situation remains unresolved.

Of course, the current question is whether the economy is going to enjoy a measurable uptick in growth in the second half of 2011 following the disappointing shortfall during the first half. In fact, the increase in real GDP was only 0.9% during the first six months of the year, which was far below any of the early forecasts that had been made by economists.

To some extent, this reflected 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.



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It remains to be seen if these adverse developments, having had a temporary negative effect, will now fade away. Nevertheless, there are clearly some fundamental negatives in the picture, which make forecasts for the next several quarters increasingly uncertain.

INFLECTION POINT AHEAD?

In theory at least, the economic news may be about to turn more positive. The evidence is that supplies from Japan are being restored to more normal levels, which is providing something of a bounce in industrial production as assembly rates get cranked up and inventories are replenished. Moreover, the commodity spike that raised questions about a possible upsurge in inflation this spring has run its course, and many of the earlier increases have now been partially reversed, including those for oil products.

At this point, we believe that there will be some reacceleration of activity in the second half as the factors noted above wear off. Nevertheless, there is little momentum in the economy and it seems unlikely that the lack of job growth is going to be reversed any time soon.

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.

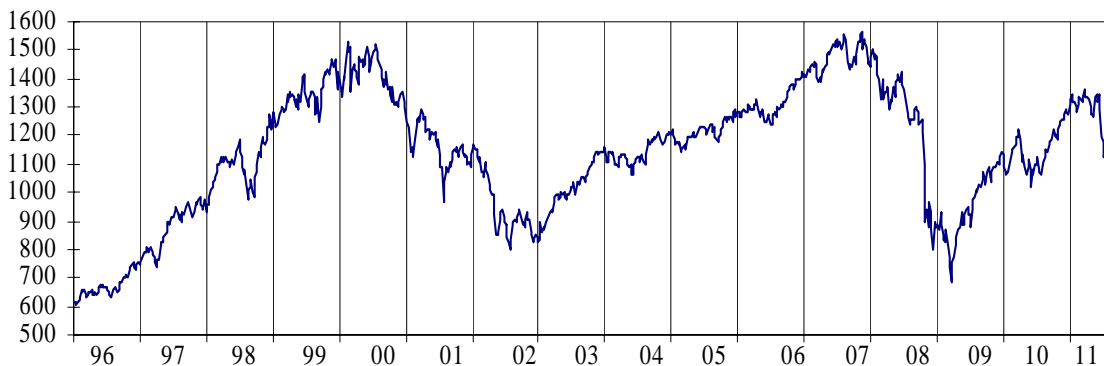
DEBT CEILING LIFTED

A key question relates to the federal fiscal problem, with a current budget deficit running near \$1.4 trillion annually. An agreement was reached between President Obama and the Congress for a \$900 billion increase in the debt limit. This was offset by a deal to reduce federal spending in the out years by \$917 billion over the next 10 years and to establish a new 12-member bipartisan super-committee of Senators and Representatives to work toward reducing future deficits by another \$1.5 trillion. Recognizing that the public wants action on this front, this group is scheduled to report back by late November.

If the members can agree on a set of specific actions, the program would then be sent to Congress as a whole, where it would

be voted up or down without amendment prior to Christmas. No one can be sure exactly what will happen, but if the "Gang of 12" doesn't agree or if their plan is turned down, automatic cuts in spending totaling \$1.2 trillion would go into effect starting in January 2013.

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



Source: Federal Reserve Board

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