Insights

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

A Cascade Of Fears

August was one of the worst months for equity investors in a long time. The S&P 500 Stock Index fell by 5%, giving up all of the earlier gains for the year and then some, and by most measures the deterioration in many foreign markets was even worse.

What happened was a series of events that frightened investors like waves coming 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 requirement of a full-scale market correction.

At the beginning of the month, the initial concern was that the United States might default on interest or principal repayment of its Treasury debt. Although this seemed highly unlikely and was eventually resolved by an increase in the debt ceiling agreed to by President Obama and the Congress, it frightened investors.

This was followed by a surge of fears about a possible double-dip recession in the economy based on some particularly weak data for June, which were subsequently confirmed by the fact that real GDP grew at a rate of only 1% during the second quarter, following an increase of only 0.4% in the first quarter.

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. This did happen, but it doesn't seem to be of particular consequence to bond investors. In fact, the prices for Treasury securities actually rose subsequently, with the fallout being on stocks instead.

On this basis, at this point one could say that the Treasury default didn't happen, that a resumption of the recession remains unproven (as the July economic data showed improvement as compared to June) and that the rating downgrade wasn't very significant.

The question remains whether the economy is going to enjoy a rebound in the second half of 2011 following the disappointing shortfall in growth during the first half. In fact, the increase in real GDP was only 0.7% 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" that acted as headwinds, holding down the rate of growth in activity. It remains to be seen if these adverse developments, having had a temporary negative effect, will now fade away.

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Inflection Point Ahead?

In theory at least, we may be on the verge of a watershed in the economic news, which may have already turned more positive. The evidence is that supplies from Japan are being restored to more normal levels, which is providing a bounce in industrial production as assembly rates get cranked up and inventories are replenished. Hopefully, this will lead to at least some modest improvement in employment. The commodity spike appears to have peaked around the beginning of May, and many of the sharpest advances 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 effects noted above wear off. Of course, there may have been some more fundamental negatives involved in the recent slowdown, but time will tell.

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 shortages. As a result, near-term inflation has calmed and in the latest readings 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

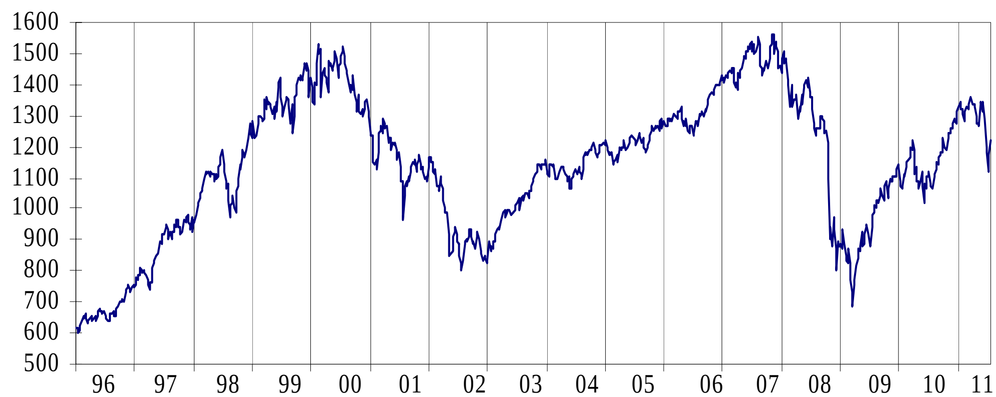
A key question at the beginning of the month was how the federal debt ceiling issue would be resolved. After a delay right up to the last minute, an agreement was finally reached between President Obama and the Congress for an $900 billion increase in the debt limit. This was offset by a deal to reduce federal spending in the out years by $917 billion or approximately the same amount over the next 10 years. Nevertheless, the close call with respect to the government being able to pay all its bills was worrisome to investors.

Federal Budget Negotiations

As part of the debt ceiling agreement between the President and Congress, a new 12-member bipartisan super-committee of Senators and Representatives has been created to study other actions that would reduce future deficits by another $1.5 trillion. Recognizing that the public wants action to reduce the magnitude of future deficits, 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, there would be automatic cuts in spending totaling $1.2 trillion starting in January 2013.

S&P 500 Stock Index (Weekly Close)
December 29, 1995 - August 31, 2011



Source: Federal Reserve Board

Atlanta
404 881 3400

Chicago
312 368 7700

Newport Beach
949 660 0080

Austin
512 651 7800

Denver
720 221 5000

San Francisco
415 433 5844

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410 539 4660

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