

Insights

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

STOCK MARKET STAND-OFF

The year 2011 experienced unusually high volatility in stock prices for much of the time, with the market traveling up and down by several thousand points. However, the direction shifted on several occasions so that when all was said and done, there was very little net change for the year as a whole.

This stand-off came about as the product of several differing periods of investor sentiment. Early in the year, equity investors were moderately optimistic and stocks continued in the advance that had started in March 2009, producing a near 10% return by spring.

The advance then stalled out during the early summer, followed by a sharp decline occurring in August and September as sentiment shifted, thus carrying the market down by nearly 20%. Then, another shift produced a strong rally during October –which was the best single month for the stock market in many years.

Adding all of this action together, 2011 ended with a total return of just 2%. While this was clearly disappointing relative to general expectations at the beginning of the year, the outlook as we enter 2012 looks better than one would have expected just a couple of months earlier.

ECONOMIC SHIFT

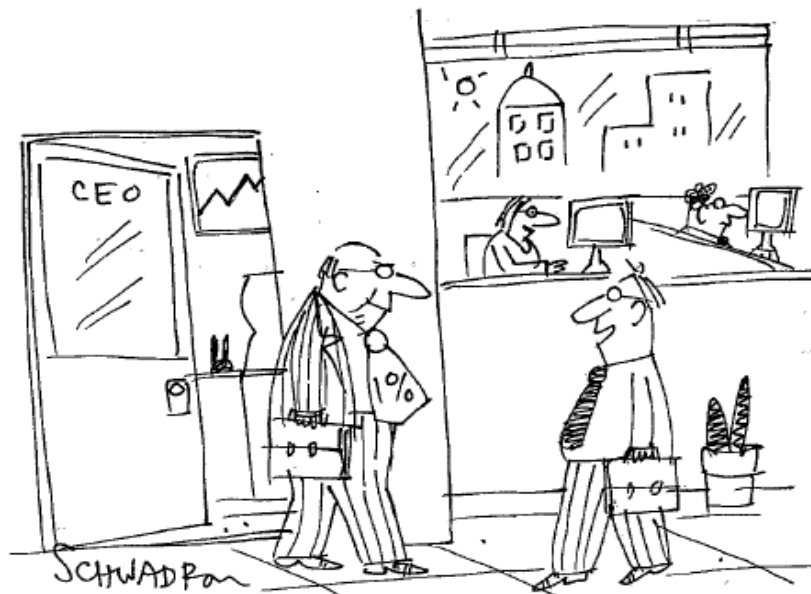
Early last year, the consensus view was that the economy would grow moderately, i.e. probably at an annual rate of about 3% in the first half of 2011, with some slowing likely in the second half. However, what actually happened was pretty much of a mirror image. In fact, first quarter growth was the weakest of the year and the fourth quarter the strongest.

The first change in sentiment came in July when first quarter real GDP was revised down from what had been reported at nearly a 2% rate to just 0.4% or almost flat. Moreover, it appeared that the second quarter wasn't much better (reported at 1.3%).

Bearish forecasters opined that the economy could fall into a double dip recession later in the year, thus frightening investors and producing the summer sell-off.

Sentiment shifted again at the end of September when it became apparent that the economy was not weakening further but actually reaccelerating in the second half. This view was confirmed when growth in the third quarter was reported at a 1.8% rate and expectations for the fourth quarter moved up, mostly to 3% or better.

This more optimistic expectation then triggered the sharp October rally that brought stock prices back up to the level at which they began the year. With some undulations, this level was essentially maintained for the balance of the year.



"NICE POWER TIE, J. B."

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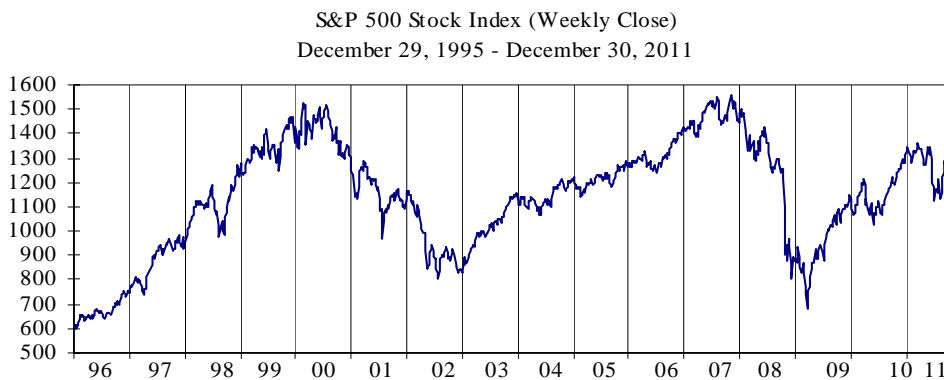
HEADWINDS

It is difficult to explain why real GDP increased by less than a 1% rate in the first half. While certainly not buoyant, activity didn't feel that sluggish at the time and it is clear that corporate profits actually exceeded expectations.

However, there were several developments which Chairman Bernanke of the Federal Reserve called "transitory" factors that acted as headwinds, thus holding down the rate of growth. These included the impact of the earthquake and tsunami in Japan, which sent that country into a sharp recession and caused a disruption in supplies of Japanese components for manufacturers here. A second candidate was the political turmoil in some of the Arab countries, especially the insurrection in Libya which caused a disruption in oil supplies. In addition, there was adverse weather, including blizzards and an unusually cold winter during the first quarter, followed by tornadoes and floods in the second quarter.

These events combined with an upward spike in commodity prices, especially for energy and foodstuffs but also for industrial metals and minerals. This caused an upsurge in headline inflation, which acted as a substantial tax increase on consumers and businesses, thus dampening the demand for other goods and services. For example, crude oil prices ran up to a peak of \$114 per barrel at the end of May, causing a sharp rise in the cost of gasoline to an average of over \$4.00 per gallon at the pump.

The good news is that these negatives subsequently turned and basically reverted to normal, which turned the headwinds into moderate tailwinds, thus permitting the economy to grow faster in the second half of the year and start 2012 with decent momentum.



Source: Federal Reserve Board

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MODERATING INFLATION

As suggested above, there was 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.

Fortunately, relative to inflation, the pace of activity in many of the economies around the world has been slower than forecast, and an increase in supplies of grain has eased the concerns about shortages. As a result, near-term inflation has calmed and the U.S. Consumer Price Index has actually been flat to down modestly. Certainly, the ebbing of inflation fears has been a positive factor for investors as the rate of prospective price increases has returned to a more normal level.

FISCAL STUMBLING BLOCK

One of the key uncertainties in the U.S. – the federal fiscal situation – will be carried over into 2012. President Obama and the Congress recently agreed to a temporary two-month extension of the reduced payroll tax rate, unemployment benefits and doctor reimbursements under Medicare. However, this problem will be back on the agenda during February and a new agreement will be required. The federal budget deficit appears likely to exceed \$1 trillion again in fiscal 2012 and, in spite of a lot of negotiations, the parties do not appear to be anywhere near a more permanent resolution. Thus, the situation continues to represent a significant uncertainty for investors.

A number of significant changes will likely be required to bring the budget under control, including a reduction in discretionary spending, reforms to the entitlement programs, and tax reforms. These would likely include a broadening of the tax base – including elimination or restriction of many exemptions and deductions – accompanied by a reduction in tax rates as a stimulus to faster economic growth. Whether such a package can be enacted remains to be seen; it may need to await the outcome of the elections in November.

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