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A Look Back: Market Scorecard

2016: Started with a Correction, Ended with a Bang

Donald Trump’s pro-growth message spurred a post-election U.S. equity rally. Domestic stocks again outperformed most foreign markets, as the strong U.S. dollar suppressed overseas returns.

A post-election sell-off left investment-grade bond returns barely in positive territory for the year. The high-yield market rallied in sympathy with equities.

Commodities generally had a good comeback year, led by a rebound in energy markets. The rally in gold faded in the second half of the year.

Total Returns as of December 31, 2016

<table>
<thead>
<tr>
<th></th>
<th>Year-to-Date</th>
<th>Trailing 3-Year</th>
<th>Trailing 5-Year</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Stocks</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S.</td>
<td>12.0%</td>
<td>8.6%</td>
<td>14.6%</td>
</tr>
<tr>
<td>Developed International</td>
<td>1.6%</td>
<td>-1.0%</td>
<td>7.1%</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>11.3%</td>
<td>-2.3%</td>
<td>1.5%</td>
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<tr>
<td><strong>Bonds</strong></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Long-Term Treasuries</td>
<td>1.3%</td>
<td>7.8%</td>
<td>2.5%</td>
</tr>
<tr>
<td>Intermediate Govt/Corp</td>
<td>2.1%</td>
<td>2.1%</td>
<td>1.9%</td>
</tr>
<tr>
<td>Corporate High-Yield</td>
<td>17.1%</td>
<td>4.7%</td>
<td>7.4%</td>
</tr>
<tr>
<td><strong>Commodities</strong></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>CRB Commodity Index</td>
<td>11.4%</td>
<td>-11.4%</td>
<td>-9.0%</td>
</tr>
<tr>
<td>Oil (Brent)</td>
<td>25.4%</td>
<td>-29.0%</td>
<td>-16.2%</td>
</tr>
<tr>
<td>Gold</td>
<td>7.7%</td>
<td>-1.9%</td>
<td>-6.5%</td>
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2017 Investment Themes

- U.S. economic expansion is poised to improve in 2017/2018; overseas growth remains subdued.

- Low recession risk and a rebound in corporate earnings point toward continuation of the U.S. equity bull market.

- Donald Trump’s election victory has accentuated key inflection points:
  - Fiscal stimulus will be ascendant as the Fed’s monetary stimulus recedes.
  - U.S. deficit financing is likely to increase in the years ahead.
  - The bond bull market that began in the early 1980s is likely over; higher yields are expected in the future.

- Investors must be ready for bouts of volatility driven by unquantifiable uncertainties:
  - More “populism vs. the establishment” elections in Europe
  - Intentionally unpredictable nature of the Trump administration, both policies and messaging
  - China’s management of a slowing private sector, capital outflows and a potential increase in tensions with the U.S.
Inflation Watching Fashionable Again

- We rate recession risk as low in 2017 and expect a modest acceleration in GDP growth over 2016.

- Yet, post-election excitement about a jolt to the economy from fiscal stimulus needs to be tempered. We expect the ultimate size of a tax cut/infrastructure package will be smaller, and the timing later, than many currently perceive. The biggest impact on the economy will likely be in 2018, not 2017. Meanwhile, the stronger dollar, higher interest rates and tight labor markets should restrain growth in 2017.

- Inflation is set to garner more attention this year, as the rebound in energy prices raises headline figures for the CPI. Unit labor costs provide a more comprehensive look at the potential for inflation, as they combine wage pressures with productivity. ULCs are rising, nearing rates associated with more aggressive monetary policy tightening.

Source: Bloomberg, BLS. Data as of 09.30.2016.
Global Economy

Strong U.S. Dollar a Mixed Blessing

- Exports in Europe and Japan should benefit from double-digit weakening of the euro and yen vs. the dollar over the last two years. This, along with continued extraordinary monetary stimulus, should produce slightly stronger growth in the non-U.S. developed economies in 2017. However, both growth and inflation trends should lag the U.S.

- The strong dollar presents a major challenge for China and, therefore, the global economy. Weakness in the yuan has been greeted with accelerated capital outflows, and policymakers have reacted by deploying reserves to defend the currency. This cycle cannot go on forever, and the imposition of capital controls or a major yuan devaluation could be sources of market volatility in 2017.

- We expect geopolitics will influence business and economic confidence more than usual in 2017:
  - Trump economic and trade agenda unfolds.
  - Brexit negotiations are likely to begin in earnest.
  - Key elections are scheduled in France and Germany.

Source: Bloomberg LP. Data as of 10.31.2016
Monetary Policy

Upward Bias to Yields

- The Federal Reserve surprised no one when they voted unanimously to increase the federal funds rate by 0.25% in December. They did slightly increase projections for the path of short-term rates in future years, perhaps assuming they could more quickly normalize rates if expansionary fiscal policy is on the way.

- The big jump in bond yields occurred in response to the election rather than to the Fed’s decision. The immediate “go for growth” message from Donald Trump conjured concerns about a potential rise in inflationary pressures and budget deficits.

- The pace of rate increases will be a function of the administration’s tax reform/infrastructure spending legislation, and the impact of the strong dollar as an offset to that potential fiscal jolt. Our current operating assumption is three rate hikes of 0.25% each in 2017.
Rising financing needs, a less accommodative Fed and rising inflation expectations could push 10-year Treasury yields into the 3% - 4% range in 2017.

Post-election, bond investors quickly discounted a more favorable outlook for corporate bonds and a more challenging environment for municipal bonds.

To the extent that fiscal policy can encourage capital spending and growth, the end of the corporate credit cycle could be pushed further into the future and credit spreads could remain narrow.

Muni yields spiked relative to Treasuries right after the election on fears that tax cuts would reduce the value of the muni tax exclusion on interest. Spreads have since reverted to pre-election levels; however, the sector will likely face volatility as the tax plan takes shape in 2017.
After four quarters of decline, profit growth returned in the third quarter of 2016. We expect earnings to continue to improve in 2017.

Corporate tax reform has the potential to increase U.S. competitiveness while delivering higher profitability. For every 5% decrease in the corporate tax rate, S&P 500 earnings increase 4.2%.*

Though the timing and magnitude of a tax package are unknown at this time, they should deliver an additional degree of profit growth in 2017 and 2018. This is a factor in our continued favoring of U.S. equities.

A lower statutory tax rate would mostly favor mid- and small-cap companies that pay higher effective tax rates. A provision to repatriate foreign profits at a one-time lower tax rate would mostly benefit large multi-nationals.

Source: KPMG, Deutsche Bank, Data as of 12.31.2016.
*Source: Deutsche Bank, as of 12.05.2016.
Active Management: Better Times Ahead?

- While the late 2016 post-election rally may have “borrowed” some of 2017’s return potential, we believe the equity bull market will continue this year. We anticipate a higher degree of volatility, driven by the new political regime in Washington, D.C. and inevitable angst over the Fed’s higher interest rate agenda.

- For most of this nearly eight-year bull market, correlations between stocks have been very high. This often happens when the Fed is easing monetary policy and interest rates decline. As a result, generating excess returns through stock picking has been challenging.

- Now that the Fed has reversed course, bond yields are rising, and the new administration is scrambling perceptions of corporate winners and losers, correlations have collapsed. This bodes well for active management.
Global Equities

Tactical Overweight to U.S., But Not Forever

- The Asset Allocation Committee continues to favor U.S. stocks due to:
  - Greater visibility on economic and earnings growth
  - Stronger dollar a drag on international returns for U.S. investors

- The top chart shows that U.S. outperformance vs. non-U.S. stocks has been dramatic. The bottom chart indicates a wider than normal valuation premium (price/earnings ratio) for U.S. stocks vs. the rest of the world.

- We believe both of these relationships are mean reverting. In other words, while current conditions favor U.S. equities, we could well see an inflection point in this relationship later in the year.

Sources: FactSet, Yardeni Research, Inc.
Data as of 12.31.2016
## Portfolio Takeaways

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Fundamental Assessment</th>
<th>Asset Allocation View</th>
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</thead>
<tbody>
<tr>
<td><strong>U.S. Equities</strong></td>
<td>Stronger economic momentum in 2017/2018</td>
<td>Overweight U.S. equities vs. fixed income</td>
</tr>
<tr>
<td></td>
<td>Earnings growth to continue, with potential accelerant from fiscal policy</td>
<td>Post-election surge in bullishness overdone; expect moderate market returns and periods of elevated volatility</td>
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<tr>
<td></td>
<td>Improved outlook for smaller capitalization stocks given outlook for tax policy, economic growth rate and U.S. dollar strength</td>
<td>Retain favorable view of small-/mid-cap stocks</td>
</tr>
<tr>
<td><strong>International Equities</strong></td>
<td>Multiple eurozone elections in 2017 present risks; less visible growth catalysts in Europe and Japan despite desperate central bank efforts</td>
<td>Overweight U.S. vs. International equities; slight U.S. valuation premium warranted</td>
</tr>
<tr>
<td></td>
<td>Emerging market earnings nearing a bottom in some countries, but headwinds from strong U.S. dollar and downside economic risks in China</td>
<td>Emerging market equities do not yet present an above-average risk-adjusted outlook</td>
</tr>
<tr>
<td><strong>Fixed Income</strong></td>
<td>The Fed should be more aggressive raising short-term rates in 2017; three rate hikes expected</td>
<td>Underweight and below-average duration recommended as yields expected to rise</td>
</tr>
<tr>
<td></td>
<td>Outlook for corporates and munis will be impacted by details of fiscal stimulus package</td>
<td>Enhanced yield strategies focused on floating rates favored</td>
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