

U.S. Equity Investment Outlook



Market review

The U.S. equity market rebounded sharply in late July from year-to-date lows reached earlier in the month amid lingering concerns over the strength of the global economic recovery. Expectations of a strong earnings season, along with removal of pressure from the passage of financial reform, drove investors' appetite for risk. The successful stress tests of European banks contributed to the positive market sentiment and led to a significant rise in the euro versus the U.S. dollar during the month. Nevertheless, the broad-market S&P 500® Index remains slightly negative for the year to date.

On the positive side, according to Standard and Poor's, nearly two-thirds of the S&P 500 Index companies reporting second-quarter results as of the end of July exceeded consensus expectations. S&P estimates that, while overall EPS may decline modestly in the second half of the year, they still should show considerable improvement over fourth-quarter 2009 levels. However, economic statistics released during the month provide evidence of a marked decrease in the pace of U.S. GDP growth during the second quarter. While still indicating modest levels of expansion in industrial production, the Institute for Supply Management's Purchasing Managers Index has declined for two consecutive months after reaching its recent peak in April. Inventories continue to be reduced, while the pace of new orders and backlogs slowed.

Economic and market outlook

While we believe that a more growth-supportive policy environment from Asia, namely mainland China, will contribute marginally to global economic improvement, we feel that nothing yet indicates acceleration from the current, unimpressive rate of growth. Consequently, we think that the stock market will experience similar apathy without significant changes of this view, particularly in the likelihood of further government stimulus. It is interesting to note that not all industries should experience sluggish fundamentals. We feel that the broad technology sector outlook remains robust in the short term even as companies in other sectors and economists temper their outlooks. As a result of both pent-up demand and new product introductions, consumers and institutions are making room in their budgets. However, as this demand has exhibited high cyclicality, investors are not willing to place a high valuation on what appears to be peak-level earnings. Therefore, the group appears inexpensive compared to other less cyclical businesses but we do not necessarily believe they make good investment opportunities currently.

Shares of healthcare services companies also appear to be inexpensive, and they are traded in a similar depressed range as those in the technology sector as we noted above. However, we believe these shares may present attractive long-term investment opportunities at current levels. In addition, the natural U.S. demographic shifts also provide strong and growing demand. On the other hand, the U.S. government is looking to these companies to help pay for the massive healthcare reform being implemented over the next decade. As Medicare is the single-largest payer for these providers and holds unilateral power on pricing, the profitability of these companies will be affected even as they see higher business volumes as insurance coverages expand as a result of the reform. For services providers, the state-run Medicaid system also is experiencing sharply reduced budgets due to lower state-level tax receipts. Although there are federal initiatives being implemented to help these state-run programs, the overall impact is difficult to forecast. Despite these uncertainties, we believe there are healthcare services companies which can more than offset pressures from pricing with volume and can grow their earnings. We also feel that there will be significant consolidation as smaller and operationally less efficient firms are folded into larger firms with better economies of scale.

U.S. stock prices rose significantly in the second half of July, erasing earlier losses.

Almost two-thirds of S&P 500 companies have exceeded second-quarter earnings estimates.

We believe that the U.S. equity market's near-term performance may reflect the current sluggishness in the economy.

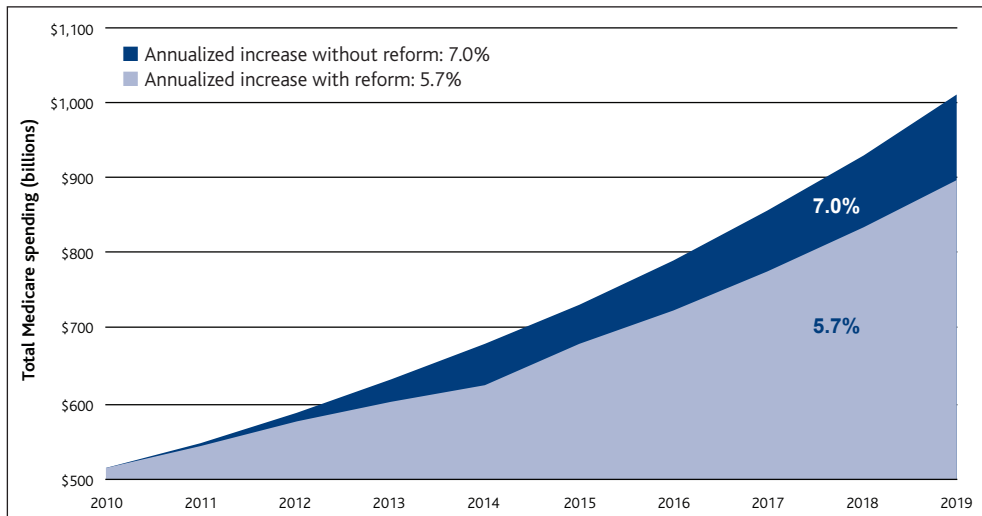
We are focusing on healthcare services companies that we feel can increase earnings by offsetting pricing pressures with higher business volumes.

U.S. Equity Investment Outlook

Healthcare reform: No overnight success, but long-term possibilities

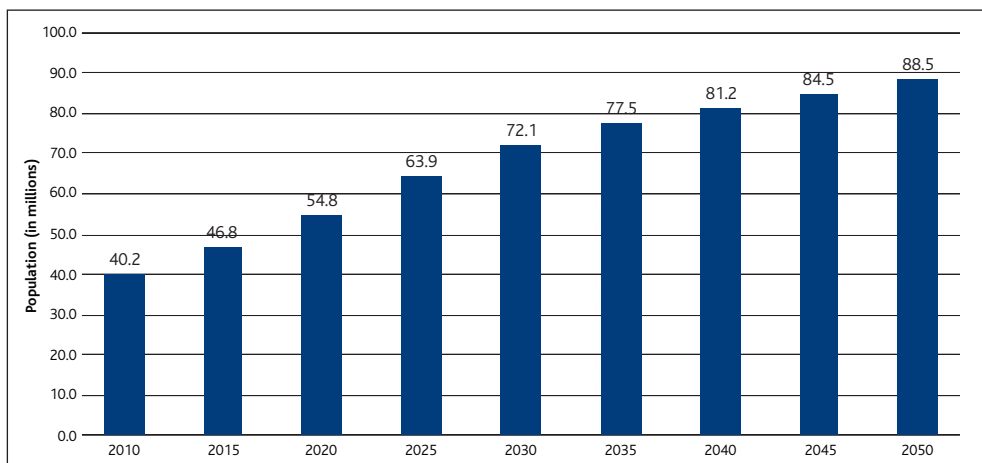
The implementation of healthcare reform will take much of the next decade to complete. Although the estimated overall annualized rate of savings is 1.5% between 2010 and 2019, it is projected to reduce Medicare spending by as much as \$850 billion cumulatively during this period and lengthen the duration of Medicare Trust solvency by another 12 years to 2029. It is anticipated that roughly 17% of the savings will come from health insurers' future profitability as payments for Medicare Advantage programs are reduced. Approximately 24% of the savings is projected to come from pricing adjustments to healthcare providers such as doctors, hospitals, nursing homes, and home-based healthcare providers. The U.S. Census Bureau estimates that the population aged 65 and over will rise by more than 14 million over the next 10 years, an annualized growth rate of 3.1%, while Medicare spending under healthcare reform will rise 5.7% annually as projected by the Centers for Medicare and Medicaid Services. These rates do not directly correlate with each other considering factors such as the expected rise in the number and costs of medications, labor and treatment frequency and intensity. Nonetheless, in our view, these numbers still provide an environment in which well-run healthcare companies that can provide quality patient care and are able to achieve economies of scale will continue to thrive, despite some of the near-term uncertainties caused by the reform.

Projected Medicare Spending With and Without Healthcare Reform



Source: Centers for Medicare and Medicaid Services, April 2010

Projected Population Aged 65 and Over (2010 to 2050)



Source: U.S. Census Bureau, 2008

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