U.S. Equity Investment Outlook

Aberdeen

Market review

The U.S. equity market posted another gain in April. The S&P 500 Index closed above 1,200 for five consecutive days late in the month—the first time it had reached that level since September 2008. However, stocks retreated somewhat near month-end due to growing concerns about Greece's ongoing credit problems. Shares of financial companies led the market upturn amid increasing expectations for improving credit conditions.

Economic data during the month provided more glimmers of improvement. The U.S. Census Bureau reported that new home sales in March were significantly higher than economists' forecasts as good weather and a pending tax credit deadline spurred buying. The majority of U.S. retailers reported better-than-expected sales for the month of March due to leaner inventory levels and the favorable comparison to the weak results from the same period a year earlier. The U.S. dollar strengthened during the month, most notably against the euro.

U.S. stocks rose to 19-month highs in April before giving back some gains late in the month amid continuing worries regarding Greece's credit problems.

Economic and market outlook

Broad evidence of continued economic recovery accompanied earnings reports for the first quarter, but companies have generally appeared slightly more cautious in their description of the environment and around their expectations for revenue growth than they were at the end of the fourth quarter of 2009. A majority of companies beat estimates for earnings during the first quarter, but many of them merely "glossed over" the factors contributing to their positive results and did not significantly increase their forecasts for the rest of the year. This more conservative tone has raised concerns among many investors who previously believed that the general V-shaped economic recovery would continue to show improvement at least through the rest of this year. These concerns, along with ongoing worries about sovereign credit quality in Europe, high budget deficits in the U.S., and seemingly successful attempts by the Chinese government to slow economic growth, caused equity prices to stagnate during the second half of April, only to begin to rise sharply in early May.

While the first-quarter earnings season began on a positive note, companies appear to be taking a more cautious outlook.

From our perspective, however, these elements are just data points along the progression of the economic recovery; that is, they say less about the sustainability of earnings growth through 2010 than they do about how much the marketplace has already come to believe the recovery is firmly in place. Clearly, expectations of continued growth and the ability of companies to leverage newfound productivity have risen considerably.

Financial firms have seen significant improvements in their balance sheets over the past year primarily because of the rising values of the fixed income assets on their balance sheets and as they began to rebuild capital organically. Now that the financial crisis appears to have ended, Congress is pursuing a financial services reform package aimed at reducing risks in the financial system. Proposals range from forcing companies to improve their disclosure to their customers to controlling the types of risk-taking activities in which they can engage. The most vocal constituents of the pro-regulation community have focused on Depression-era legislation such as the Glass-Steagall Act of 1933, which expressly separated banking from other financial services activities.

The balance sheets of financial companies have improved significantly, but they now face uncertainty because of more stringent financial services reforms proposed in Congress.

While the financial services reform measures have been proposed and are currently in the amendment process, we feel that it is too early to identify all the potential risks and opportunities from changes to existing legislation. We do anticipate a general trend toward more transparency of balance sheets, centralized clearing of derivatives transactions, and a general reduction in proprietary risk-taking at larger banks. Consequently, we believe that these moves could reduce the profitability of larger banks and may be intertwined with tighter capital standards over time. While our portfolios hold a selection of financial services companies which we feel will be relatively less affected by the core legislation that has been proposed, we continue to monitor the issues carefully for items which may have a negative impact on our holdings or provide opportunities to purchase at discounted prices other companies that we do not currently hold.

We feel that some of the proposed reform measures may have a negative impact on the profitability of some larger banks.

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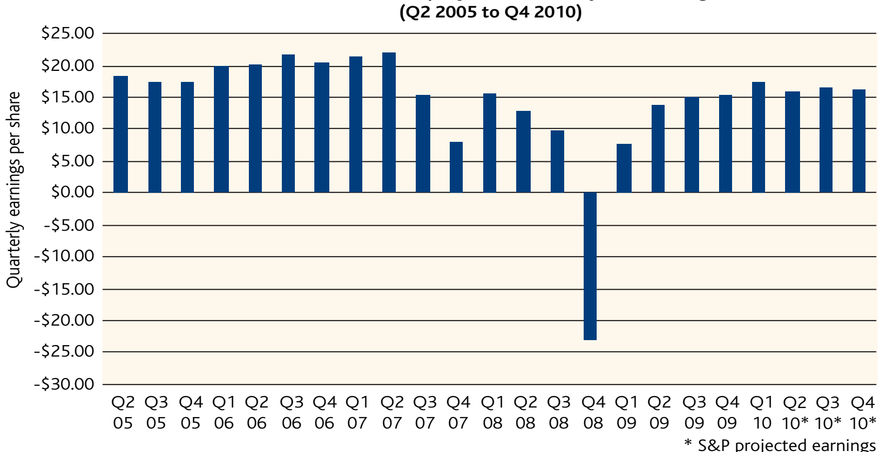
Corporate profits rise with economic outlook

Corporate profit growth historically has been an effective indicator of economic recovery following a recession. According to Standard and Poor's, more than three-fourths of the 410 S&P 500 Index constituent companies reporting first-quarter results through the first week in May exceeded consensus earnings expectations. We believe that the steady rise in earnings over the past five quarters provides evidence that the current economic recovery is sustainable. As companies continue to report strong earnings, they generally are still benefiting from efficiency measures put in place over the past year. As a result, we feel that corporate earnings are likely to continue to remain on a positive trajectory–beating expectations–over the next few quarters. Additionally, while S&P projects a modest drop in profit growth through the remainder of 2010, corporate earnings are expected to remain above their relatively low levels of 2008 and early 2009.

S&P 500 Index Company Actual and Projected Earnings (Q2 2005 to Q4 2010)



Source: Standard and Poor's, May 2010

For more information please visit

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Important information