EAGLE STAR

Market Comment

Issued on 20th June 2002

Overview

Equity markets remained in bearish mood over the past week as economic signals remained mixed and corporate earnings news disappointed investors. Bonds gained from a shift of capital towards safer havens and from a lowering of interest rate expectations.

On Friday last, figures on the US consumer confidence index showed a decline from 97 to 91, worse than expected and reflecting consumers' caution at continued equity market weakness and terrorist scares. Retail sales figures the previous day were also below expectations, showing a decline of almost 1%, compared to a rise of 1.2% a month earlier. This deterioration in consumer sentiment, which heretofore had been the main source of resilience in the US economy, is a concern for the Federal Reserve in its efforts to engineer a durable recovery. Inflation data meanwhile continue to show a low and stable trend. Against this background, it is not surprising that interest rate expectations are coming down. On the US interest rate futures market, the expected year end Fed funds rate has moved from 3.4% in March to 2.1%, not much higher than the current rate of 1.75%. The negative trend in consumer sentiment was balanced somewhat by the release on Tuesday of housing data which revealed an increase of 12% on the previous month, and 8% on the same period last year. This rebound was above expectations and gave some comfort that the economy continues to improve.

Table 1 below shows the movements in the main markets since last week's comment.

Table 1

Market	Index	% Return 12.06.2002 to 19.06.2002	
		Local Currency	Euro
US	S&P 500	0.0	-1.0
US	NASDAQ	-1.5	-2.4
Europe	FT/S&P Europe Ex. UK	-2.0	-2.0
Ireland	ISEQ	-3.5	-3.5
UK	FTSE 100	-4.1	-3.9
Japan	Topix	-7.5	-7.2
Hong Kong	Hang Seng	-4.3	-5.2
Bonds	Merrill Lynch Euro over 5 year	1.3	1.3

Equities

The dominant theme on equity markets was earnings concerns, fuelled by profit warnings and a lack of confidence in the strength of economic recovery. In the technology sector, positive news from Oracle was offset by profits warnings from Apple and AMD, and the NASDAQ recorded a fall on the week, although the broader S&P 500 Index remained unchanged. Financials also came under pressure on earnings fears, particularly the European insurance sector, which fell on concerns that falling equity markets would reduce returns on their reserves. The sector was also hit by Deutsche Bank selling off a large holding of Munich Re. Pharmaceutical stocks remained out of favour, while sectors such as basic materials, consumer staples and utilities made some relative gains.

Bonds

Bond markets made strong gains on the week, fuelled by a lowering of interest rate expectations and a continued switch of portfolio holdings to a safer haven than equities. The Eurozone bond market was also helped by a further rise in the euro against the dollar, to just under 96 cents. This outweighed concerns expressed by the ECB chief economist Ottmar Issing, at the level of Eurozone inflation. Expectations of year- end interest rates in Europe have reduced from 4.4% in December last to 3.8% currently, which is just 0.5% above current rates.

Outlook

- An ongoing improvement in global economies remains the central scenario, although there are some doubts about the durability of the US consumer, given high personal debt levels, and we are still awaiting a pick up in capital spending.
- While the current monetary background is supportive of growth, investors had begun to anticipate US rates increases from the artificially low levels of post September, but pressures for rate increases have eased in the past number of weeks.
- In any event, interest rate increases globally are likely to be modest given the continued benign outlook for inflation. Many companies continue to report a lack of pricing power.
- Overall, the environment supports a neutral stance on equities, as markets await the earnings recovery. Geographically we prefer markets in Asia and Europe while we remain biased towards cyclical and financial stocks while underweight technology stocks.