EAGLE STAR

Market Comment

Issued on 29th October 2002

Overview

The recent equity market rally faltered somewhat last week as softer economic data had a negative impact on investor sentiment. While most world markets fell back, the US equity market held up on the back of better then expected earnings reports from US corporations. However, many companies had previously lowered their earnings forecasts and were meeting these new lowered expectations. The decline in fixed interest markets came to a halt as the lack of strength in equity markets saw investors return to bonds.

Weak economic data emerged on both sides of the Atlantic last week. In the US, the Conference Board said its index of leading economic indicators fell 0.2% in September. This is the forth consecutive month that the index has fallen. The US Federal Reserve's Beige Book survey of US economic conditions was also less than optimistic. US durable goods orders fell prompting speculation regarding possible interest rate cuts. US housing data continue to offer respite to the market as sales of both new and second hand homes rose again in September. In France, consumer spending fell by 1.2%, while in Germany, the Ifo index of business sentiment fell to 87.7 in October from 88.2 in September.

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

Table 1

Market	Index	% Return 18.10.02 to 25.10.02	
		Local Currency	Euro
US	S&P 500	1.5	1.0
US	NASDAQ	3.4	2.9
Europe	FT/S&P Europe Ex. UK	-1.7	-1.7
Ireland	ISEQ	1.3	1.3
UK	FTSE 100	-1.9	-2.0
Japan	Topix	-2.5	-2.0
Hong Kong	Hang Seng	1.1	0.7
Bonds	Merrill Lynch Euro over 5 year	0.2	0.2

Equities

Following two weeks of strong gains many equity markets stalled this week. In Europe, the big story of the week came from ABB, the Swiss-Swedish engineering group. A profit warning and fears over the extent of its asbestos liabilities in the US caused the stock to collapse on Tuesday. The company stated that its US arm, Combustion Engineering could face asbestos liability costs that may exceed its assets. The announcement saw all the main investment houses downgrade the stock.

The UK market fell back, led by oil stocks which receded on more muted comments from the US president George Bush regarding Iraq. News that the Bank of England's monetary policy committee voted 6-3 to leave interest rates unchanged led to speculation regarding an interest rate cut in the UK. The committee had voted unanimously to leave rates unchanged in the previous two meetings.

The US market ended the week in positive territory as investors continued to enter the equity market from oversold positions. The Nasdaq index outperformed as technology stocks continued to make ground on positive earnings reports from companies in the sector.

The Irish market rose on strong performances by financial stocks. Unlike their European counterparts the Irish banks are considered to be defensive stocks and have held up well while the banking sector has been weak across the rest of Europe. The Bank of Ireland share price rose as rumours of a possible link up with National Australia Bank emerged.

Bonds

Bond prices rose marginally last week boosted by weaker economic data and investor uncertainty regarding equity markets. Weak durable goods orders in the US and a poor German Ifo business climate index helped bonds to regain their upward momentum following a sell off in recent weeks. The market was also dominated by speculation over interest cuts in the UK, US and in Europe. The Merrill Lynch over 5 Year government bond index rose 0.2% on the week.

Outlook

- Forward indicators of economic activity have turned down in the US and Europe in the past quarter; growth momentum is likely to weaken further. The immediate outlook is complicated by the recent rise in geo-political tensions.
- A sustained and robust global growth picture probably needs further policy stimulus by way of lower European interest rates and possibly a further reduction in already low US rates.
- While there has been some improvement in underlying US corporate profitability, earnings forecasts still appear to be overly optimistic.
- Our overall portfolio stance is overweight bonds, neutral/underweight equities. We remain underweight in the US on valuation grounds, marginally underweight Europe, which has failed so far to de-couple from the US and overweight Asian markets and the UK. At the sectoral level, we remain biased towards defensive and cyclical stocks and underweight technology stocks. Healthcare and telecoms have been moved from underweight to neutral on valuation grounds.
- A new bull phase in equities should only emerge when the markets are convinced that the excesses of the 1990s, and especially the TMT bubble, have been fully worked off. This will probably take more time and more policy stimulus than previously thought.