EAGLE STAR

Market Comment

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Overview

Interest rates were the dominant focus of investor interest last week as the US Federal Reserve made a larger than expected cut of 0.5% in its key Fed funds rate on Wednesday, while on this side of the Atlantic, the ECB and UK monetary authority decided to leave rates unchanged.

A reduction in US rates was widely anticipated and equity markets had risen in anticipation of the move. However, the size of the cut was double most forecasters' estimates and indicated concern among the policy makers at the state of the US economy. This consideration drove many investors to take profits and equities gave up some of their gains on Thursday and Friday, even though there were some positive economic signals, notably a jump in US productivity growth. Manufacturing productivity in Q3 was 5.9% higher than a year ago, and unit labour costs were down 1.9%. These trends should provide a badly needed boost to profits against a background of severe pricing constraints.

In Europe, the ECB decision to leave rates on hold was a disappointment, even though it indicated that a cut was likely in December. The delay in cutting Eurozone rates will prolong the weakness of economic growth in Europe and make it more difficult to achieve a global economic recovery. Ironically, the day after the rate decision, the German economics ministry released industrial output figures which indicated a fall of over 1% between August and September. This followed on earlier bad news for the Eurozone's largest economy including a decline in manufacturing orders, weaker retail sales and higher than expected unemployment.

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

Table 1

Market	Index	% Return 01/11/2002 to 08/11/2002	
		Local Currency	Euro
US	S&P 500	-0.7	-2.2
US	NASDAQ	-0.1	-1.7
Europe	FT/S&P Europe Ex. UK	-1.2	-1.2
Ireland	ISEQ	-0.1	-0.1
UK	FTSE 100	0.9	0.9
Japan	Topix	-0.5	-0.1
Hong Kong	Hang Seng	3.9	2.2
Bonds	Merrill Lynch Euro over 5 year	0.6	0.6

Equities

Equity markets moved ahead at the start of the week in anticipation of the US rate cut but succumbed to profit-taking thereafter amid renewed economic concerns, some disappointing corporate news and a move closer to confrontation with Iraq.

In the US, the rate cut initially bolstered the market, but this was followed by profit-taking as investors realised that, while the size of the rate cut should benefit the economy in the longer term, it signalled concerns about the short term economic outlook. On the corporate side, Cisco, the world's largest manufacturer of networking equipment, reported earnings ahead of expectations, but forecast that sales would be lower in the current quarter in a difficult operating environment, and this pushed technology stocks lower. Sentiment was also hit by a profit warning from McDonalds and a negative analyst comment on GE Capital, the financial arm of General Electric.

European markets were pushed lower by the lack of movement on interest rates and German economic concerns. Financial stocks, which moved ahead strongly in previous weeks, succumbed to profit taking, as did many technology stocks after heavier than expected losses at Infineon, which makes microchips.

Bonds

Bond prices moved ahead on the week, buoyed by a favourable interest rate environment and weak economic numbers. Eurozone bond prices rose in anticipation of an eventual interest rate cut in December and on concerns at the weak state of the German economy. A move in the euro to just above parity with the dollar also lent support as as a sustained rise in the euro is likely to help eurozone inflation come within the ECB target range.

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 continuation of geo-political tensions.
- A sustained and robust global growth picture probably needs further policy stimulus, particularly by way of lower European interest rates.
- While there has been some improvement in underlying US corporate profitability, earnings forecasts still appear to be overly optimistic. Earnings expectations for 2003 may be revised downwards for Continental Europe due to lower growth forecasts.
- 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 require stimulative policy measures for longer than previously thought.
- 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 financials and some defensive areas and neutral technology stocks. Healthcare and telecoms have been moved from neutral to overweight, while cyclical stocks have been downgraded to neutral.