

Eagle Star Investments

Weekly News

13th October 2008

Global Overview

Following one of the worst ever weeks on markets worldwide, today we are going to look at some of the reasons behind the falls, measures being taken to help matters and, finally, our outlook for the coming weeks.

Index		Year to Date Return 31.12.07 to 10.10.08		1 Week Return 03.10.08 to 10.10.08	
		Local Currency %	Euro %	Local Currency %	Euro %
US	S&P 500	-38.8	-33.7	-18.2	-16.1
US	NASDAQ	-37.8	-32.6	-15.3	-13.2
Europe	FT/S&P Europe Ex. U.K.	-43.9	-43.9	-21.5	-21.5
Ireland	ISEQ	-58.6	-58.6	-27.2	-27.2
UK	FTSE 100	-39.1	-43.5	-21.1	-22.5
Japan	Topix	-43.0	-30.7	-19.8	-12.5
Hong Kong	Hang Seng	-46.8	-42.0	-16.3	-14.0
Australia	S&P/ASX 200	-37.5	-49.6	-15.7	-27.3
Bonds	Merrill Lynch Euro over 5 year Govt.	3.7	3.7	-0.6	-0.6

What was behind the falls and what measures are being taken to tackle the crisis?

Banking concerns

There was fear of further banking failures as many European banks were rumoured to be struggling to raise capital. Causing this is the fact that banks have ceased lending to each other, amid fear of non-repayment. Any lending that took place between banks was at a record interest rate level over the base interest rate. This breakdown in the functioning of the banking system heightened fears that the world will be pushed towards a global recession.

Federal Reserve moved to buy commercial paper

Early in the week, the Fed announced that it would start buying commercial paper – effectively lending money directly to corporate borrowers – in order to ease frozen lending conditions. It was hoped that this would kick-start lending, as the commercial paper market is an important source of short term funding for companies.

Central banks inject liquidity

On Tuesday, central banks throughout the world continued to try and bring lending rates back to normal levels by injecting further dollar liquidity into money markets. This hope was short lived though, as concerns grew over eurozone banks, along with the UK and Iceland.

Interest rates

Central banks worldwide continued looking for measures to try and stop the financial crisis spiralling out of control and creating systemic problems. On Wednesday, there was a co-ordinated cut of 0.5% in interest rates by central banks in the US, the eurozone, UK, Canada, Switzerland and Sweden. This big move is thought to be the start of further interest rate cuts, with more expected by year-end, most notably in the UK and the eurozone.

Weekend developments

Discussions amongst European leaders took place over the weekend in Paris, while the G7 met in Washington to address the global financial crisis. Details are only emerging, but the initial reaction in equity markets has been quite positive.

One of the main action points was the move by eurozone countries agreeing a common set of rules to bail out their banking sectors, pledging to guarantee all loans between banks until the end of next year, while also agreeing to buy shares in struggling banks.

Secondly, the G7 group of nations approved a five-point plan over the weekend to unfreeze credit markets. One of these is that major central banks have pledged to pour unlimited amounts of dollars to unblock frozen credit markets. This follows on from the money injected early last week.

What impact did the worsening financial crisis have on equities, bonds, commodities and currencies?

Equity markets

Equity markets suffered huge losses last week, falling to levels not seen for many years, as credit concerns intensified and caused unprecedented panic amongst investors. Most markets finished each day in the red, losing roughly 20% of their value over the week.

Bonds

As equity markets fell and interest rates across the world were cut, bonds gained due to their safe-haven status. These gains were erased however, and bonds finished the week in negative territory as continued stress in money markets and concern over the amount of debt governments are having to take on, caused bonds to retreat by 0.6% over the week.

Commodities

Oil continued its recent slump over fears that the current financial crisis will drag the global economy into a deep recession. Having fallen from \$106 to \$91 per barrel a week prior, last week oil ended the week at \$77, its lowest in over a year. Following the financial developments over the weekend, it regained some of its losses to rise above \$80 in early trading.

Currencies

As risk aversion in markets grew over the week, investors fled to the dollar and the yen, as fears over the European banking system and economy became more pronounced. The €/£ rate finished the week at 1.35 – a fall of almost 2%. The dollar as a whole gained against major currencies, most notably by over 3% against sterling.

Global Outlook

- Last week policymakers finally grasped the incredible risks facing the global economy. As global equity and risk markets crashed and Iceland's banking system faced total collapse, panic-stricken governments and central banks sought to pull financial markets and the real economy back from complete implosion. It's now a given that US and European growth rates will be severely curtailed in the next year or so and that a global recession will have to be worked through. Policy action is intended to put a floor under economies and prevent a prolonged slump.
- Policy makers have committed to taking all measures necessary to kick-start the money markets - the lifeblood of the banking system and the real economy. As part of this process there will be further sharp falls in short term interest rates. At least a further 0.50% reduction is seen from ECB by the end of the year, but this could happen much faster, given the pace of recent events. US rates are seen falling by around the same amount over that period too.
- With equity markets and corporate bonds priced for the deepest slump since the Great Depression, government bonds have received strong safe haven flows. These may unwind somewhat over the next while as governments step-up their borrowings substantially and if investors' fear of risky assets recedes somewhat. Overall however, bonds should be supported by falling short rates and large drops in inflation rates.
- Global equity markets became dysfunctional last week, with a combination of panic and massive price falls meaning that investors were anticipating prolonged economic slump conditions. Co-ordinated policy action is intended to arrest that fear and set the stage for the return of some semblance of confidence into the banking system, the real economy and equity markets. While history suggests that powerful rallies can occur in the midst of severe bear markets such as we are experiencing now, this notion appeared a distant possibility last week. That may indicate just how weak sentiment had become and ironically this is often the time when rallies occur. At the moment the unfreezing of the money markets and the banking system is seen by equity investors as the acid test of whether policy action is working or not. Huge uncertainty will persist until those markets begin to return to normality.
- The funds are currently moving to a slight overweight position in equities and a neutral position in bonds, versus the manager average. Within equity sectors healthcare is an overweight and industrials are underweight. Geographically the funds have an underweight position in Ireland and Japan, are neutral in the Pacific Basin, and are overweight in the US, Europe and the UK.

This outlook does not constitute an offer and should not be taken as a recommendation from Eagle Star/Zurich. Advice should always be sought from an appropriately qualified professional.