Market Comment

Issued on 21st October 2002

Overview

There was some further respite last week from the seemingly relentless fall in equity values as markets enjoyed a bear market rally from oversold positions. The main spur to the rally came from slightly better than expected third quarter reports on corporate earnings, which caused investors who were short equities to cover their positions. It is indicative of the extent to which equities are oversold that the rally was sustained despite continuing concerns on the economic front, high valuations (in the US) and downbeat guidance on earnings for Q4 and 2003.

Economic signals were mixed, with figures in the US on housing starts and building permits rising, while industrial production weakened. The US consumer price index remained stable with a month-on-month rise of 0.2%, with limited impact on the markets. A cause for concern was a leap in the US trade deficit from $35.1bn in July to a record $38.5bn in August. Figures on leading economic indicators due out today should give some further guidance on the underlying economic trend.

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

Table 1

Market	Index	% Return 11.10.02 to 18.10.02	
		Local Currency	Euro
US	S&P 500	5.9	7.4
US	NASDAQ	6.4	7.9
Europe	FT/S&P Europe Ex. UK	6.7	6.7
Ireland	ISEQ	5.7	5.7
UK	FTSE 100	4.5	5.1
Japan	Topix	5.4	5.7
Hong Kong	Hang Seng	7.2	8.8
Bonds	Merrill Lynch Euro over 5 year	-1.3	-1.3

Equities

A swathe of slightly better than anticipated third quarter earnings reports by US corporations underpinned a strong rally on the S&P 500 and the NASDAQ, which was mirrored across the globe. Technology stocks were the main beneficiaries, thanks to positive results from giants Microsoft and IBM, which outweighed a more downbeat report from Intel. Financials also advanced strongly, helped by positive results from Citigroup, Merrill Lynch, JP Morgan Chase and Bank of America. In Ireland, the financial sector also gained from an announcement by Bank of Ireland that it had abandoned its proposed take-over of Abbey National, which had hit the share price in the previous week.

Bonds

Bond prices fell back as liquidity drained from the markets to finance new equity purchases. The rebound in equities also reduced expectations of a US interest rate cut in November with a cut by the end of the year now seen as only 50% likely. In the Eurozone, bond prices also came under pressure on fears that economic weakness would cause members of the European Union stability pact to change the rules on budget deficits and increase government indebtedness. By contrast, bond markets in those East European countries which will join the EU in 2004, such as Poland and the Czech Republic, enjoyed strong price rises on expectations that they will eventually join EMU.

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 and rising oil prices.
- 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.