EAGLE STAR

Market Comment

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Overview

Following on the surprise 0.5% US interest rate cut on 6th November, US economic indicators released last week signalled resilience on the consumer side and helped to ease fears of a further weakening in the economy.

On Thursday, advance retail sales figures for October were flat overall, while sales less autos were up 0.7% on the previous month, ahead of an expected 0.3% rise. Initial jobless claims, while up on the previous week, were below expectations, as were import prices. Friday brought some negative indicators on the industrial side, however, with industrial production for October down 0.8%, worse than the expected decline of 0.3%. There was also a dip in capacity utilisation and a rise in business inventories, all serving to highlight the degree of weakness in the output side of the economy. Significantly, though, the University of Michigan confidence index, which is an important indicator of consumer sentiment, surprised commentators with a jump from 80.6 to 85.

In Europe, economic indicators were less positive as the German economy appeared to be heading for a double dip recession. The ZEW Institute's monthly index of German business expectations dropped 19 points to 4.2 in November, as sentiment declined on worries about the new government's economic policies, the ECB's interest rate stance and global geo-political uncertainty. The French economy also weakened with industrial production down 0.3% in September. Hopes of an early interest rate cut were raised on remarks by members of the ECB that a weak economy and stronger euro would help reduce eurozone inflation, which is the key factor deterring the ECB from cutting rates to date.

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

Table 1

Market	Index	% Return 08/11/2002 to 15/11/2002	
		Local Currency	Euro
US	S&P 500	1.7	2.1
US	NASDAQ	3.8	4.3
Europe	FT/S&P Europe Ex. UK	3.2	3.2
Ireland	ISEQ	1.4	1.4
UK	FTSE 100	1.4	1.3
Japan	Topix	-2.7	-2.7
Hong Kong	Hang Seng	1.0	1.4
Bonds	Merrill Lynch Euro over 5 year	0.3	0.3

Equities

Equity markets moved firmly ahead on some better US economic news and positive corporate results.

Technology and telecom stocks were particularly strong as there was continued rotation out of defensive areas such as basic materials and consumer staples into the growth-oriented sectors. European telecoms were boosted by better than expected results from Vodafone which reported a 41% rise in underlying interim profits. The share price rose 16% on the week.

Retailers also had a good week on both sides of the Atlantic, with Hennes & Mauritz in Europe reporting positive results, while in the US, the giant retailer Wal-Mart reported 16-17% revenue growth for the year.

In Asia, Japanese equities continued to be afflicted by the weak economy and concerns that the government would take a hard line on the banks' bad loans, many stocks hitting their lowest levels since 1983.

Bonds

The positive economic signals from the US were outweighed on Eurozone bond markets by a deteriorating economic outlook for Germany and growing expectations of an early ECB interest rate cut. Prices were further supported by a continued rise in the euro against the dollar and a statement by Ottmar Issing, the ECB's chief economist, that inflation expectations had declined.

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 slightly 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.

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