EAGLE STAR

# Market Comment

**Issued on 20th January 2003**

## *Overview*

Equity markets lost some ground last week in response to disappointing economic data and downbeat corporate statements. Heightening fears of an imminent war with Iraq, which pushed the oil price to a two year high, was a further negative factor. The pessimistic mood proved positive for bonds, which gained on the week.

The earnings reporting season for Q4 2002 got underway with major technology companies such as Intel, Microsoft, IBM reporting results slightly better than analysts' much reduced expectations. However, they all signalled a cautious outlook, leaving investors wary that future earnings may not warrant the high levels of valuations on many technology stocks. These concerns were compounded by the economic data, which indicated that US industry is struggling. While retail sales data released on Tuesday showed an increase on the previous month, this was entirely due to strong growth in auto sales, helped by zero interest financing deals. Apart from autos, sales were flat relative to the previous month. Industrial production figures also disappointed, recording a decline of 0.2% on the previous month, whereas a rise of 0.2% had been anticipated. While economists generally expect that productivity gains, low interest rates and possible tax cuts will ultimately generate a recovery in profits, the degree of recovery and its timing remains uncertain and hence investors are cautious.

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

**Table 1**

| Market | Index | % Return 10/01/2003 to 17/01/2003 | |
|---|---|---|---|
| | | Local Currency | Euro |
| US | S&P 500 | -2.8 | -3.7 |
| US | NASDAQ | -4.9 | -5.8 |
| Europe | FT/S&P Europe Ex. UK | -2.9 | -2.9 |
| Ireland | ISEQ | -3.8 | -3.8 |
| UK | FTSE 100 | -3.9 | -4.2 |
| Japan | Topix | 2.6 | 2.9 |
| Hong Kong | Hang Seng | -1.1 | -2.0 |
| Bonds | Merrill Lynch Euro over 5 year | 0.8 | 0.8 |

## *Equities*

Equities started the week in positive territory, with technology and telecom stocks rising on a positive statement from Alcatel, the French telecoms equipment maker. Subsequently, however, Intel's announcement that it would cut back on capital expenditure, despite results ahead of expectations, renewed pessimism on the sector. This was followed by warnings from Microsoft of lower sales and revenue growth this year. Defensive stocks held up reasonably well, while technology and telecoms were weakest, as indicated by a fall of almost 5% in the NASDAQ Index.

In the UK, the retail sector was taken aback by a surprise announcement by Wm. Morrison of a £2.65bn. bid for the supermarket group, Safeway. This was quickly followed by a counter offer of £3.15bn. from Sainsbury, then by expressions of interest by the US giant, Wal-Mart, which already owns the Asda supermarket group, and the US venture capital group, Kohlberg Kravis Roberts. The news led to considerable activity in the retail sector.

## *Bonds*

Bond prices moved firmly ahead as announcements by US weapons inspectors that they had found empty warheads capable of carrying of chemical weapons in Iraq brought the prospect of war closer. Weak economic data from the US also helped sentiment, as did the downbeat statements from the corporate sector on prospects for this year. Continued strength in the euro against the dollar boosted eurozone bonds and the over 5 year index gained 0.75% on the week.

## *Outlook*

- Forward indicators for the major economies suggest that growth will remain relatively subdued, particularly in the first half of 2003.
- Renewed geo-political tensions have seen oil prices rise by 35% since the low of last November. If sustained at these levels, economic growth forecasts could be reduced further.
- With growth below trend in all the major economies, interest rates are likely to stay low in the US and could fall further in the Eurozone and possibly even the UK.

- The US dollar will remain under scrutiny in 2003 with further downward pressure likely.
- For sustained rises in equities we need to see a more robust economic and earnings environment.
- However, shifting war fears will continue to have an impact on the economic and market outlook in the short term.
- Our current overall portfolio stance is overweight bonds and neutral equities versus the manager average. On a geographic basis, we are underweight equities in the UK, Europe and Japan. We are broadly neutral in Ireland and have recently moved to overweight in the US. We continue to have a preference for the Pacific region on a valuation basis and as a low cost producer.