Market Comment

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Overview

The third quarter ended last Tuesday with equity markets in nervous mood following some negative US economic releases and a slide in the dollar. By the end of the week, though, further releases were painting a more positive picture, particularly on the jobs front, which brought buyers back into equities and helped get the fourth quarter off to a buoyant start. The shift in economic sentiment had the reverse impact on bonds and prices fell back sharply.

The Conference Board's Index of US consumer confidence, released on Tuesday, dropped to 76.8, from 81.3 the previous month, and was well below expectations, largely due to employment fears. The Chicago Purchasing Managers' index of manufacturing activity, released on the same day, was also surprisingly weak.

However, Wednesday brought more upbeat economic news on both sides of the Atlantic, as well as in the Pacific Rim. In the US, the Institute of Supply Management's survey of manufacturing activity, while slightly below expectations, was at an expansionary level and confirmed that the US economy remains on a recovery path. Meanwhile, in Europe, the Reuters purchasing managers' index showed that eurozone manufacturing activity had returned to an expansionary level for the first time since before the war with Iraq. The increase in activity was particularly notable in Germany, which has been a key factor in European economic weakness. The outlook for Asian economies also brightened with an upbeat survey of Japanese business confidence which helped reinforce confidence in the durability of Japan's muted cyclical recovery.

Investors' optimism was further strengthened with the release on Friday of positive news on the US jobs front. Non-farm payroll figures jumped by 57,000 in September, defeating expectations of a 25,000 drop. The previous month's figure of 93,000 fewer employed was also revised upwards to a slide of 41,000. The jobs news is particularly important as many commentators have been warning of a "jobless" US economic recovery which would jeopardise consumer confidence and, given that consumer spending accounts for 70% of US GDP, put the recovery at risk.

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

Movements in the main markets since last week's comment

Market	Index	% Return 26/09/2003 to 03/10/2003	
		Local Currency	Euro
US	S&P 500	3.3	2.5
US	NASDAQ	4.9	4.1
Europe	FT/S&P Europe Ex. UK	2.1	2.1
Ireland	ISEQ	-0.7	-0.7
UK	FTSE 100	2.8	2.2
Japan	Topix	4.5	4.6
Hong Kong	Hang Seng	2.8	2.6
Australia	S&P/ASX 200	1.0	0.8
Bonds	Merrill Lynch Euro over 5 year	-1.2	-1.2

Equities

Equity markets across the globe were heartened by the trend in US employment, as well as better European and Asian economic news, and most registered strong gains on the week. Japan was particularly buoyant, the Topix index gaining 4.5% in response to signs of growing business confidence and Bank of Japan intervention to stop the yen rising against the dollar. Hong Kong and Singapore also rose to their best levels in over a year on hopes of economic recovery. Eagle Star funds are overweight the Asian markets on the grounds that the region will benefit most from a global economic upturn.

There was little activity on the corporate front in advance of announcements on Q3 earnings. In the European airline sector, KLM shares shot up on Tuesday on confirmation that Air France is taking over the group, which will create Europe's largest airline.

Bonds

The rally in bond markets ran out of steam in the middle of the week as better economic news overtook the impact of the dollar's slide and shifted sentiment back towards equity markets. In Europe, the ECB announced on Thursday that interest rates would remain unchanged and this counter-balanced the previous day's warning by its chief economist that money supply growth could trigger a rise in rates. However, by the end of the week, sentiment was dominated by the news on German manufacturing and US employment, both of which caused a sharp drop in eurozone bond prices and left the over 5 year index down 1.2% on the week.

Outlook

- Economic activity has strengthened in the US and investors have begun to anticipate a synchronised global recovery; inflation pressures remain low.
- Central banks have stated that interest rates are likely to stay low for a considerable period of time.
- Equity markets have risen sharply since mid-March; increased growth optimism could extend this rally further although valuations are a constraint in

certain sectors and markets. Additionally, investors still have some concerns about the sustainability of growth improvements.
- Bond markets have reversed some of their "growth-optimism" losses; central banks have re-stated their commitment to keeping interest rates low and recent inflation data has been bond friendly.
- Ultimately, however, a successful reflationary effort by global policymakers would mean a negative environment for bond markets and a more positive one for equities.
- Our current overall portfolio stance is broadly neutral bonds and overweight equities versus the manager average. The funds are underweight in the UK equity market due to its defensive characteristics and overweight Asia and Latin America due to more attractive valuations and better economic growth potential.