EAGLE STAR

Market Comment

Issued on 14th October 2002

Overview

After a further weak start, there was some recovery in equity market confidence last week and most markets ended in positive territory while bonds moved sideways until falling back on Friday.

The main spur to the turnaround in equity market sentiment was on the corporate side as the economic fundamentals continued to give generally negative signals. In the US, figures released on Friday revealed a large drop in the University of Michigan consumer confidence index from 86.1 last month to 80.4, well below an expected level of 85.5. The long term average level for this index is 88 so the low October figure is a definite concern. This news came the day after decisions by the ECB and by the UK monetary authorities to leave interest rates unchanged, which will make it more difficult for the European economies to provide a growth stimulus. Nonetheless, reasonable corporate earnings news, particularly from General Electric in the US brought buyers back into equities and fuelled a two-day rally on Thursday and Friday.

The emergence of the rally after the downbeat economic news was surprising as more positive economic releases earlier in the week had no impact on sentiment. US unemployment numbers dropped by 40,000 and were well below expectations, while in Europe, German industrial orders were higher and industrial output bounced by 1.8%, compared to an expected rise of 0.2%.

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

Table 1

Market	Index	% Return 04.10.02 to 11.10.02	
		Local Currency	Euro
US	S&P 500	4.3	3.6
US	NASDAQ	6.2	5.4
Europe	FT/S&P Europe Ex. UK	3.9	3.9
Ireland	ISEQ	-0.5	-0.5
UK	FTSE 100	3.7	2.6
Japan	Topix	-4.8	-6.1
Hong Kong	Hang Seng	-1.0	-1.7
Bonds	Merrill Lynch Euro over 5 year	-0.3	-0.3

Equities

Equities staged a recovery in the latter part of the week following positive earnings reports from the internet company, Yahoo, and the giant US industrial conglomerate, General Electric. An analyst's upgrade on IBM combined with the Yahoo numbers resulted in a rally in technology stocks which left the NASDAQ up over 6% on the week. The US rally extended to Europe where technology and telecom stocks made strong gains. The battered financial sector, which had fallen sharply early in the week on fears of a liquidity crisis, also rallied as bargain hunters sought out undervalued stocks.

The main event of the week for Irish investors was a surprise announcement by Bank of Ireland on Monday of a bid for the UK bank, Abbey National. The news was not well received and the Bank share price fell on Wednesday before recovering along with the general rally in European financials to end the week down 5.5%.

Bonds

Bond markets remained in favour in the first part of the week, but suffered subsequently from a shift into equities on better corporate news. The decision of the ECB to leave interest rates at 3.25%, even though it was anticipated, had some negative impact on eurozone bond prices, as did the better economic news from Germany.

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 sectors and underweight technology stocks. Healthcare and telecoms have been moved from underweight to neutral on valuation grounds.
- While strong bear market rallies are possible over coming months, an end to the fall in equities will come about when the markets are convinced that the excesses of the 1990s, and especially the TMT bubble, have been fully worked off. This will take more time and more policy stimulus than previously thought.