

Market Comment

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Overview

Further downbeat economic data weighed heavily on investor sentiment last week and made it difficult for equities to extend their recent gains, although positive corporate news contributed to modest advances in some markets.

US economic data were generally negative. The release on Tuesday of the Conference Board's consumer confidence index gave real cause for concern, recording a dramatic drop from 93.3 last month to a nine year low of 79.4. A recording below 80 on this index is considered recession level, so the latest figure is a worry. The main source of consumer concern is weakness in the labour market and data later in the week confirmed that the employment trend is deteriorating.

A bright note was struck by confirmation that US GDP grew in Quarter 3 by just over 3% year on year, which follows a rate of just over 1% in the second quarter and 5.6% for quarter 1. The latest figure gave little cause for euphoria, however, as all the gains in the quarter were consumer related and the weakening in consumer sentiment means that this level of growth rate will be difficult to sustain.

The deterioration in the US economy has heightened expectations that the Fed will cut interest rates this week at its meeting on Wednesday. Among market participants there is an expectation of a 0.25% cut and some expect it could be higher. The ECB is also due to make rate decisions this week as is the Bank of England. Following a 3:6 split among the authority members on the need to cut at its previous meeting, there is increased speculation of a 0.25% reduction this week. The ECB, however, is less likely to make a move, as its priority concern continues to be the persistence of Eurozone inflation above the target level of 2%, although deteriorating European economic indicators should give cause for concern.

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

Table 1			
Market	Index	% Return 25/10/2002 to 01/11/2002	
		Local Currency	Euro
US	S&P 500	0.4	-1.7
US	NASDAQ	2.2	0.1
Europe	FT/S&P Europe Ex. UK	1.0	1.0
Ireland	ISEQ	3.7	3.7
UK	FTSE 100	-1.3	-2.6
Japan	Topix	-0.5	-0.9
Hong Kong	Hang Seng	-3.2	-5.3
Bonds	Merrill Lynch Euro over 5 year	0.6	0.6

Equities

While equity markets took a knock from the drop in US consumer confidence, investors took heart from a reasonably positive third quarter earnings season. More than half the US corporations which have reported so far have exceeded earnings expectations, albeit from a very low base. Additionally, a number of companies were optimistic about future prospects.

The technology sector was boosted by an upbeat statement from the chief executive of IBM. In Europe, Alcatel rebounded sharply from a heavily oversold position, rising 40% on Thursday on a statement by its chief executive that it was getting its debts under control and would return to profit next year.

Consumer stocks also made gains following positive results from Proctor & Gamble in the US and Unilever in Europe.

On the negative side, European engineering companies fell sharply on fears of asbestos liabilities and these fears extended to the insurance sector.

Bonds

Bonds had a better week, supported by lower interest rate expectations and weak economic figures. While eurozone interest rates are less likely to be cut this week, eurozone bond prices strengthened on conviction that economic weakness will ultimately force the ECB to act. Exchange rate movements also helped eurozone bond prices as dollar weakness pushed the euro above parity. A sustained rise in the euro would help inflation to come down and encourage the ECB to implement a rate cut.

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 by way of lower European interest rates and 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. Earnings expectations for 2003 may be revised downwards for Continental Europe due to lower growth forecasts.
- ▶ 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 stocks and neutral technology stocks. Healthcare and telecoms have been moved from neutral to overweight, while cyclical stocks have been downgraded to neutral.
- ▶ 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.

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