Market Comment

Issued on 14th July 2003

Overview

Most equity markets enjoyed a strong start to the week on Monday, particularly the technology sector. With the exception of Japan, equity markets then drifted off in the middle of the week ahead of upcoming Q2 earnings reports. In Japan, the Nikkei Index broke briefly through the 10,000 mark for the first time since last August, investors still buoyed by last week's Tankan survey. Friday saw a sharp reversal of this trend in Japan as the market fell sharply. Some analysts suggested that the two and a half month rally had simply lifted share values too high. Elsewhere, equities rose on Friday to leave most indices up 1-2.5% on the week.

On the economic news front, the biggest stories of the week came in the UK and US. The Bank of England's Monetary Policy Committee, meeting under its new chairman, Mervyn King, cut UK interest rates on Thursday by 0.25% to 3.5%, their lowest level in 48 years. The accompanying statement spoke of a "hesitant" global recovery. On the same day in the US, unemployment claims were quite a bit higher than expected, and this was followed up on Friday by a weaker than expected core producer price index. These factors helped to put a halt to the recent downleg in bond markets.

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

Table 1

Market	Index	% Return 04/07/2003 to 11/07/2003	
		Local Currency	Euro
US	S&P 500	1.3	3.0
US	NASDAQ	4.2	6.0
Europe	FT/S&P Europe Ex. UK	2.4	2.4
Ireland	ISEQ	2.4	2.4
UK	FTSE 100	0.9	0.5
Japan	Topix	-0.3	1.6
Hong Kong	Hang Seng	2.9	4.6
Australia	S&P/ASX 200	0.5	-0.5
Bonds	Merrill Lynch Euro over 5 year	0.1	0.1

Equities

There was a distinct absence of headline grabbing corporate news during the week, as investors seemed more interested in looking to upcoming earnings reports, which really kick off this week. Investors seem to have been banking on a strong and swift business recovery in recent weeks. If this does not materialise, stocks may be vulnerable. Yahoo, the internet portal stock, which has enjoyed an excellent run in recent months, met expectations with its results on Wednesday and was marked down, as it had not exceeded the market's hopes. This led to a sell-off in technology shares. General Electric, the second largest US stock, reported in line results on Friday without dramatic response from the market.

Bonds

Government bond markets calmed somewhat this week, after a disappointing run. They started the week poorly as equities enjoyed a strong Monday but, as the week wore on, economic releases pointed to weakness on both sides of the Atlantic and helped bonds rebound. UK bonds bounced sharply in the wake of the Bank of England's interest rate cut on Thursday. The European Central Bank left eurozone interest rates unchanged after its meeting last week. This was not unexpected as Wim Duisenberg, the ECB President, had previously let it be known that he feels the ECB has done its bit for European recovery and that national governments must do more in the area of structural reform.

Outlook

- Global economic activity remains well below trend and looks likely to remain so for the next six months at least. Inflation pressures are low and could easily fall further.
- US growth is tepid despite massive policy stimulus. Investors, however, are already discounting a swifter pace of activity in H2 of 2003. Eurozone growth is very weak and forward indicators suggest no near term improvement is on the horizon.
- Further rate cuts are likely in the eurozone and US interest rates - at 1% - are likely to

stay low for a considerable time. While policymakers in the major economies view the chances of negative inflation, or deflation, as quite low, the Fed has partly justified its last cut as insurance against such an eventuality.

- Given current valuations in equities, and the sharp rally in markets since March, a continuous rise in equities will need a more robust economic and earnings environment.
- Bond yields are low in all major markets but have been underpinned by low inflation expectations and a supportive short rate background. From here yields are vulnerable - in both directions - to changes in perceptions regarding growth and short rate directions. 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 overweight bonds - given the ongoing disinflationary backdrop - and slightly overweight equities versus the manager average. The funds are underweight in Europe due to weak economic fundamentals and a strong currency and overweight Asia (ex-Japan) due to more attractive valuations and currency considerations