



“After enjoying a healthy rebound from mid-March lows, financial stocks came under renewed pressure in May as more banks announced rights issues. Continuing credit quality concerns, and reduced economic growth forecasts, resulted in some paring of profit forecasts.”

Joe Lawlor — Financials Research Team

Stock markets gain, but inflation threatens...

- Many of the world's stock markets built on the rebound seen in April as it emerged that economic growth in the first quarter was stronger than previously estimated. However, inflation worries grew, and this resulted in some erosion of gains as central banks dampened interest-rate cut hopes.
- Such inflation concerns were fuelled by ever-rising oil prices, which hit a record high of US\$135 per barrel with forecasts of up to US\$200 oil capturing the headlines.

Energy and technology stocks outperform...

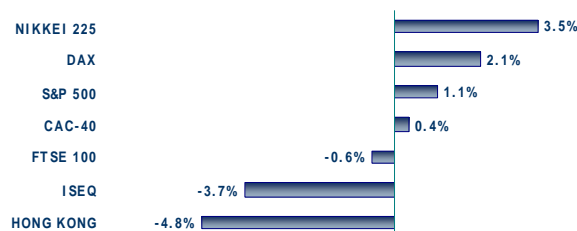
Asia-Pacific indices recorded mixed returns in May. Hong Kong's Hang Seng Index and China's Shanghai Composite Index recorded losses of 4.8% and 7%, respectively, as high oil prices and a devastating earthquake in mainland China dampened sentiment. More positively, the Japanese market rallied on news that the economy grew by 3.3% in the first quarter, as demand from Asian and developing markets offset pressure on exports to the US.

Given the ascending oil price, it's no surprise that energy stocks tended to perform well. The oil price hit US\$135 per barrel, despite Saudi Arabian plans to increase production by 300,000 barrels per day. The high oil price is making it more economical to produce oil from less accessible areas, and companies that provide drilling equipment and services also enjoyed strong support in the month.

Concerns that information technology (IT) spending would be an early victim of corporate budget cutbacks appeared overdone, as companies such as Dell announced better than forecast profit. Indeed, after energy, the US IT sector generated the best earnings growth in the first quarter, and the sector performed well in May.

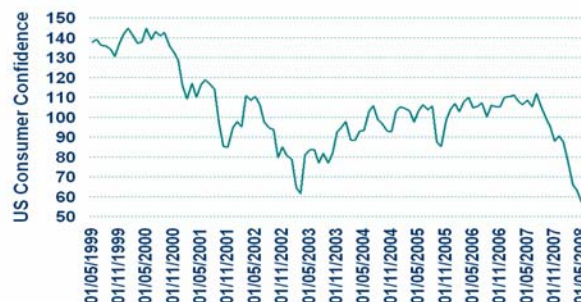
Ongoing Irish property market concerns contributed to a negative ISEQ return for the tenth month out of the last twelve. Even as Bank of Ireland announced a 6% increase in annual profit, the market focused more on its lower earnings guidance. Although Irish banks outperformed European financials, they represent a higher share of the Irish market and thus have a bigger impact. UK and European banks weakened, as speculation of further rights issues mounted.

Equity market returns – May 2008



Source: Bloomberg. Capital returns in local currency.

Housing and job worries drag US consumer confidence lower...



Source: Bloomberg, US Conference Board.

Irish retail sales slump...



Source: Bloomberg, CSO.

Bonds record negative returns...

Bond markets sold off during May as inflation worries rose. Widely documented increases in food and energy prices dampened expectations of further rate cuts as central bankers became more vocal on the topic. European Central Bank President Jean-Claude Trichet stated that inflation is expected to “remain high for a rather protracted period of time”. Meanwhile, the minutes of the last Federal Reserve (Fed) meeting revealed that the decision to cut rates to 2% was a “close call”, increasing speculation that the Fed has no near-term rate cuts planned. The Fed also cut its 2008 GDP growth forecast and increased its inflation estimate.

Although investors are attracted to fixed interest instruments during uncertain times, inflation erodes the value of future income streams. Government bond yields rose right across the curve.

10-year bond yields

	31-Dec-07	30-Apr-08	31-May-08
US	4.03	3.73	4.06
UK	4.51	4.67	4.99
Germany	4.31	4.12	4.41
Japan	1.51	1.58	1.76

Source: Bloomberg.



BIAM Outlook

- While there are indications that the subprime crisis may well be abating, other issues on the horizon raise concerns about the macroeconomic and financial market outlook. Volatile commodity prices have been a recent feature of markets, with oil prices reaching new highs. If oil prices are sustained at current levels, that would have a negative impact on world economic output and lead us to reassess our views.
- The sharp recovery in financial stocks — particularly in the US, but also in Europe — since mid-March has subsided, as the market’s attention has moved from the subprime issue to conventional loan losses in a slowing economic environment. Attention has also focused on inflation as higher food and energy prices are visible in higher headline inflation rates, crimping consumer spending plans. It should be noted that higher inflation rates have not yet been accompanied by wage-price inflation, except in parts of Asia.
- The Irish economy faces a number of challenges relating to a slowdown in domestic consumption and an over-extended property market. These challenges are compounded by Ireland’s close trade links with the UK economy where the outlook remains difficult — specifically for the domestic economy — and the weakness of sterling poses further problems for certain Irish companies. Looking further ahead, the Economic and Social Research Institute (ESRI) predicted that economic growth will rebound in 2009 and will average close to 4% through 2015.