

Market Comment

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Overview

September ended on a downbeat note last Monday as weak economic data, corporate profit warnings and fears of war with Iraq sent equity markets into a tailspin, which left many at their lowest level for five years. By the end of the week, the mood had lifted somewhat as further economic releases painted a more positive picture, and there was some rebound in equities, but it was not sufficient to pull markets out of negative territory for the week.

The US economic outlook deteriorated with the release of the Chicago Purchasing Manager's Index on Monday which fell from 54.9 to 48.1, whereas analysts had been expecting only a slight decline. The important Institute of Supply Managers Manufacturing Index also fell to 49.5. This led investors to fear that the US manufacturing sector was contracting again. Subsequent releases of economic data painted a more positive picture, however, with better than expected factory orders and unemployment figures.

It is crucial to the maintenance of consumer confidence that the employment outlook and other indicators of consumer activity, such as auto sales and housing starts, do not deteriorate significantly.

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

Table 1

| Market | Index | % Return 27.09.02 to 04.10.02 | |
|-----------|--------------------------------|-------------------------------|------|
| | | Local Currency | Euro |
| US | S&P 500 | -3.2 | -3.3 |
| US | NASDAQ | -4.9 | -5.0 |
| Europe | FT/S&P Europe Ex. UK | -4.8 | -4.8 |
| Ireland | ISEQ | -3.8 | -3.8 |
| UK | FTSE 100 | -2.4 | -2.0 |
| Japan | Topix | -4.8 | -5.2 |
| Hong Kong | Hang Seng | -2.6 | -2.7 |
| Bonds | Merrill Lynch Euro over 5 year | 0.1 | 0.1 |

Equities

The news of declining manufacturing activity had a profoundly negative impact on already fragile equity markets and values fell sharply early in the week, as confidence was further eroded by a slower revenue growth forecast from the US retail giant, Wal-Mart, which is a barometer of strength in consumer spending. Europe was particularly weak, the financial sector tumbling on fears over credit ratings and capital raising exercises. As in previous periods, defensive stocks such as oils, utilities and consumer staples, held up reasonably well.

Bonds

Bond markets retained their safe haven status over the week, despite a slight waver as US economic indicators picked up a little. Eurozone bond prices marked time, as there were some conflicting influences on the market. The flight to quality effect was tempered by increased supply of stock as both France and Germany issued new long dated maturities. Equally, weak manufacturing data were countered by slightly higher inflation figures, which raised doubts on the ECB's ability to cut interest rates.

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 basic materials and financials 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.

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