

Market Comment

Issued on 27th May 2003

Overview

Equity markets in the western world were in negative territory last week, with the biggest falls coming in Europe. The Euro continued its strong, upward trend against the dollar, breaking through its January 1999 launch level, but leading to further concerns for the health of European, blue-chip exporters, who find themselves in a significantly less competitive world. This factor partly explains the underperformance of European equity markets on the week.

In the US, comments by the Treasury Secretary, John Snow, in which he described the movements of the dollar against the euro as "really fairly modest", gave further fuel to the fire of analysts who have detected a shift away from the strong dollar policy of previous years. Later in the week, Alan Greenspan, Chairman of the Federal Reserve, in testimony to Congress, said that it was too soon to make a firm judgement about the strength of the US economy after the Iraq war, but expectations for a pick-up were not unreasonable. He did, however, acknowledge the deflationary threat, saying that the Fed had done a lot of work on the subject, but still regarded the risk as minor.

Geo-political tensions have been heightened also, with the recent spate of suicide bombings leading the White House and Downing Street to upgrade the risk of terrorist action.

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

Table 1			
Market	Index	% Return 16/05/2003 to 23/05/2003	
		Local Currency	Euro
US	S&P 500	-1.2	-3.4
US	NASDAQ	-1.9	-4.1
Europe	FT/S&P Europe Ex. UK	-3.3	-3.3
Ireland	ISEQ	-1.3	-1.3
UK	FTSE 100	-1.7	-3.1
Japan	Topix	0.9	-2.2
Hong Kong	Hang Seng	2.3	0.0
Australia	S&P / ASX 200	1.6	0.4
Bonds	Merrill Lynch Euro over 5 year	1.4	1.4

Equities

The performance of equity markets in the western world this week suggested that the "Baghdad bounce" had run out of steam, though Pacific Region markets were boosted by the apparent fading of the SARS threat.

One of the big stories of the week came on Wednesday as a Florida appeals court overturned a \$145 billion punitive judgement against major US tobacco companies. This was seen as a major positive for the tobacco industry world-wide, with tobacco stocks surging in response.

Another of the giants of the technology sector, Hewlett Packard, reported this week. The company revealed better than expected earnings and revenues, driving its share price up 5.5% on Wednesday.

In Europe, the insurance sector, which had risen on the back of rising equity markets in recent weeks, went into reverse. A report from one large, US investment bank highlighted the negative effects the weaker dollar would have on earnings, with a fall of 2-4% on the cards. Shares in Aegon, ING, Axa and Allianz all dropped in subsequent trade.

Bonds

The Eurozone over 5 year bond index gained 1.4% over the week, supported by continuing talk of deflation and rising speculation about interest rate cuts in the major economies. Many interpreted Alan Greenspan's comments to mean that the Fed will continue to use every weapon at its disposal in the fight against possible deflation, including further cuts in rates. In the UK, publication of the minutes of the last Bank of England Monetary Policy Committee meeting, showed a 5 to 4 vote in favour of keeping rates unchanged. The narrow margin was interpreted as making a cut at the next meeting on June 5th more likely. Finally, rates are widely expected to be cut in Europe at the next meeting of the ECB, also on June 5th. The ongoing poor economic performance of the Eurozone, combined with the rising pressures from a fast-increasing currency, are likely to lead to action on the interest rate front, though the ECB has shown itself to be

remarkably independent on this issue in the past. UK and US bonds were also strong performers on the week.

Outlook

- ▶ Forward indicators for the major economies suggest that growth will remain relatively subdued for the rest of 2003.
- ▶ Central banks were anticipating a recovery in confidence post an Iraq war. Now they will be monitoring developments closely to see if economic activity stages even a partial rebound. Our central scenario remains that further rate cuts will be necessary, especially in Europe.
- ▶ Given current valuation levels, a sustained rise in equities will need a more robust economic and earnings environment.
- ▶ Our current overall portfolio stance is overweight bonds and neutral equities versus the manager average. The funds are underweight in Europe due to deteriorating economic fundamentals and a strong currency.

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