

Market Comment

Issued on 7th July 2003

Overview

Equity markets ended the second quarter of 2003 last Monday with many recording their highest quarterly gains for five years. Equities rebounded in March from heavily oversold levels on optimism that the war with Iraq would be short-lived. The rally was subsequently sustained by better than expected Q1 earnings reports and further interest rate cuts in Europe and the US.

The month of July has commenced with valuations significantly higher and slightly more optimism about global economic growth prospects, but still a considerable degree of uncertainty as to the strength of that growth. This, combined with the July 4th bank holiday in the US, resulted in a relatively quiet week for markets.

The notable exception was Japan, where the stock market gained over 5% on a wave of optimism about a recovery in the economy. The Tankan survey of Japanese business confidence, released on Tuesday, surprised investors with a sharp increase in sentiment and triggered both domestic and overseas buying of stock.

On the broader economic front, there were some contradictory indicators; US employment statistics were downbeat with the unemployment rate rising to 6.4% and new jobless claims higher than expected. The Institute of Supply Managers manufacturing index was lower than expected and at 49.8 remained below the level which indicates growth. However, the Institute's index of services sector activity registered an unexpectedly large increase to 60.6, from 54.5 the previous month. There was also some positive news in the manufacturing sector, an increase in prices paid reducing fears of deflation, and May factory orders rising marginally, compared to a decline of 2.9% the previous month. In Europe, German industrial orders for May were lower than expected, affected by the strong euro.

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

Market	Index	% Return 27/06/2003 to 04/07/2003	
		Local Currency	Euro
US	S&P 500	1.0	0.3
US	NASDAQ	2.4	1.6
Europe	FT/S&P Europe Ex. UK	-1.1	-1.1
Ireland	ISEQ	0.5	0.5
UK	FTSE 100	-1.1	-0.6
Japan	Topix	5.1	5.8
Hong Kong	Hang Seng	-0.2	-0.9
Australia	S&P/ASX 200	-0.7	0.7
Bonds	Merrill Lynch Euro over 5 year	-0.2	-0.2

Equities

Technology stocks had a good week, helped by the more positive news on the US manufacturing sector. Earnings of technology companies tend to rise more sharply than others when the economy is growing, hence their definition as growth or 'high beta' stocks. Thus, any positive economic signal would tend to have a greater impact on this sector. The largest gains were on semiconductors and chip equipment stocks, which have seen an improvement in chip prices in the last quarter. In the US, Intel added 6% on the week, but stronger gains were made among Japanese semi-conductors, which were buoyed by the general rise in sentiment on the Japanese market. NEC rose 33% on the week and Fujitsu gained over 22%.

Bonds

The poor US unemployment figures gave a slight boost to bond markets early in the week, but this dissipated after the better than expected news on the US services sector. In Europe, there was disappointment at an announcement by the ECB president, Wim Duisenberg, that further interest rate cuts were unlikely in the immediate future, although weak German industrial figures gave some support to eurozone bond prices despite an increase in supply of stock with new bond issues from Germany, France and Spain.

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 neutral to marginally 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.

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