EAGLE STAR

Market Comment

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In this, our first investment comment of the new year, we are taking the opportunity to look back at 2003 as a whole. We would also like to wish all of our readers a very happy and prosperous New Year.

Overview

2003 was marked by a substantial recovery in equity markets, following three years of negative returns. Interest rates cuts to historically low levels and stronger corporate earnings on the back of cost cutting aided the revival in market sentiment, as did the conclusion of the conflict with Iraq. Bond markets made strong gains in the first half of the year, helped by low inflation and falling interest rates, but lost ground from June as economic growth picked up.

After a downbeat start to the year for equities due to war, economic and earnings fears, the outbreak of the Iraq war in March marked a turning point in sentiment and equity markets rallied strongly from oversold levels. They remained pretty much on an upward trend thereafter, helped by US interest rates at 40 year lows and better than expected Q2 and Q3 corporate earnings. Further cuts in interest rates in Europe, by 0.25% in March and 0.5% in June, and in the US, by 0.25% to 1% in late June, also helped sentiment. Exceptionally strong Q3 US GDP growth of over 8.0% annualised,strengthened prospects of strong global economic growth in 2004 and further underpinned equity markets.

On currency markets, the dollar depreciated sharply, falling by 20% against the euro, significantly reducing returns to eurozone investors from dollar based markets.

Movements in the main markets during 2003

Market	Index	% Return 31/12/2002 to 31/12/2003	
		Local Currency	Euro
US	S&P 500	26.4	5.7
US	NASDAQ	50.0	25.4
Europe	FT/S&P Europe Ex. UK	16.7	16.7
Ireland	ISEQ	23.2	23.2
UK	FTSE 100	13.6	5.2
Japan	Topix	23.8	14.3
Hong Kong	Hang Seng	34.9	13.3
Australia	S&P/ASX 200	9.7	23.3
Bonds	Merrill Lynch Euro over 5 year	4.4	4.4

Equities

The US S&P 500 Index started the year on a weak note, mainly on war fears, but also due to uncertainty regarding the economic outlook. From March the market rallied strongly, supported by better than expected earnings and post war optimism. A further interest rate cut and a rapidly improving economic outlook underpinned sentiment. Cyclical sectors made the strongest gains, with technology stocks leading the advance. Other sectors recording strong growth were consumer cyclicals and basic materials, supported by better earnings and, latterly, a better economic outlook. Consumer staples and pharmaceuticals suffered from a shift away from defensive stocks and underperformed the index.

Europe recovered from heavily oversold levels from March. Banking stocks gave the best returns, aided by merger speculation. Technology stocks also recovered well, helped by improved earnings and prospects of a stronger global economy. Defensive sectors such as food and beverages performed poorly, as did retailers which were hit by an accounting crisis in the Dutch giant, Ahold, in mid-year.

In the UK, the FTSE 100 index slightly under-performed other markets, reflecting its higher weighting of defensive stocks although many stocks made substantial gains. Cyclical sectors such as mining (+33%) led by BHP Billiton and construction (+46%) outperformed significantly and focus on the improving cash flow generation of telecommunication stocks (+22%) aided superior returns. The giant Vodafone also out-performed, with a rise of 22%.

In Ireland, smaller financials had an excellent year as Anglo Irish Bank rose 84% on strong results and First Active added 44% on the back of an agreed take-over by Royal Bank of Scotland. AIB (-1%) and Bank of Ireland (+11%) were weaker due to their perceived defensive attributes. Mid cap stocks such as Kingspan (+175%) and Grafton Group (+64%) significantly outperformed large caps over the year. Elan added 166% from an extremely low level on some resolution of its financial difficulties.

Japan suffered initially from a weak domestic economy, but from May it performed strongly, helped by improved economic data and some hope of a resolution to its long term structural problems after the government injected funds into one of the country's ailing banks.

Hong Kong and other Pacific markets were hit in late March and April by the outbreak of SARS but performed well thereafter, boosted by prospects of economic recovery, as well as attractive valuations. Australia out-performed initially, due to its defensive banking sector before it under-performed from March although resource stocks continued to benefit significantly from Chinese demand.

Bonds

Bond market prices rose strongly for the first half of the year, helped by low economic growth, US deflation concerns and falling interest rates, and their safe-haven status during the Iraq conflict. Stagnant growth in the main European economies led the ECB to cut interest rates by a total of 0.75%. This stance was helped by a sharp rise in the value of the euro against the US$, which offset the negative effects of higher oil prices on the eurozone inflation rate. Oil prices rose to a peak of $40 per barrel in April, falling back to end the year at $32.50.

Bond sentiment turned lower from June as improved economic data and stronger corporate earnings reports from the US and Europe caused downward pressure on prices. Interest rate expectations changed significantly in the second half as investors began to anticipate a turn in the interest rate cycle in 2004, with the UK and Australia having already raising rates in November. This underlined a negative outlook for bonds although prices remained supported to some degree by very low inflation and, in the eurozone, by a strengthening exchange rate. The Merrill Lynch > 5 year bond Index recorded a total return of 4.4% over 2003.

Outlook

- The global economy, led by the US should continue to expand fairly strongly during 2004.
- As confidence in the global economy has improved, investors have begun to anticipate the turn (upwards) in the US and Eurozone interest rate cycle, although the strength of the euro may keep the ECB on hold for longer.
- This environment is one in which bond markets will remain on the back foot, despite the relatively supportive inflationary background currently being experienced.
- The economic picture remains a more positive one for equity markets, although valuations are once more an issue in certain markets and sectors. Historically, equity markets have continued to be supported even in the initial stages of tighter monetary policy.
- Our current stance is overweight equities and underweight bonds versus the manager average. The funds continue to be overweight Asia and Latin America due to more attractive valuations and better economic growth potential and underweight in the UK equity market due to its defensive characteristics. The funds are also overweight Europe on valuation grounds. The funds continue to have a sectoral bias toward cyclical stocks although defensive sectors such as pharmaceuticals have been moved from underweight to neutral.