EAGLE STAR

Market Comment

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Overview

Equity markets moved forward last week as speculation grew that the Federal Reserve would cut interest rates beyond their current forty-year lows when the board meets on August 13th. As the week progressed, hopes of an interest rate cut waned somewhat but most markets held their ground, to end the week in positive territory. On the economic front, data released showed a fall in the producer price index in the US. The fact that inflation remains benign gives the Federal Reserve room to move on interest rates, if they choose to do so. A decline in weekly jobless claims in the US also supported equity markets although not all economic data was positive.

The International Monetary Fund announced a €30 billion loan package for Brazil's ailing economy on Thursday. This is the largest loan in the IMF's history and it has helped to allay fears about companies with a heavy exposure to the Latin American country. European markets rose strongly on the news, in particular the Spanish financial sector, which is heavily connected with Brazil.

News of a reshuffle in the Dax index in Frankfurt caused volatility on the German market last week. Altana, Germany's third largest drugs company by market value gained 4.9% when it was suggested that it might replace Epcos, an electronic components maker, on the index. Epcos has been under pressure since it announced a profit warning last month.

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

Table 1

Market	Index	% Return 02.08.2002 to 09.08.2002	
		Local Currency	Euro
US	S&P 500	5.1	7.0
US	NASDAQ	4.7	6.5
Europe	FT/S&P Europe Ex. UK	5.5	5.5
Ireland	ISEQ	1.5	1.5
UK	FTSE 100	6.1	4.6
Japan	Topix	2.6	3.4
Hong Kong	Hang Seng	0.2	2.0
Bonds	Merrill Lynch Euro over 5 year	0.7	0.7

Equities

It was a better week for equity markets worldwide as speculation over interest rates helped lift markets. Cisco Systems reported on Tuesday that sales has risen by 12 per cent, with operating earnings coming in above analyst expectations. The stock rose over 5% on the announcement. Qwest Communications, the US telecoms company, which is under investigation by the Securities and Exchange Commission said that it was in discussions with banks to restructure its €3.4bn credit facility. Investors welcomed the revelation and the stock jumped 12%.

There was unsettling news from Worldcom , the US telecommunications group, when it announced that it had uncovered a further €3.3 billion in earnings that had not been properly accounted for. This is in addition to the €3.9 billion fraud that resulted in bankruptcy for the company in June.

There was a rally in the Spanish banking sector, in reaction to the bailout for Brazil, by the IMF. Santander Central Hispano, which owns Brazils third largest private bank, rose over 8%. Other stocks connected with Brazil also responded positively including Telefonica, the Spanish telecom company and Portugal Telecom, which controls Brazil's biggest mobile carrier, TCP.

Bonds

Fixed interest markets rose this week despite the improvement in equity markets. While equity markets rallied, investors failed to flee from the safe haven environment of bonds. The European Central Bank's monthly bulletin appeared to confirm expectations that interest would remain on hold for the rest of the year. However, towards the end of the week, there was less of a consensus among investors that interest rates would be cut sooner rather then later and short-dated debt fell back as a result. Long-dated bonds stayed firm on news of weaker German manufacturing figures. The Merrill Lynch over 5 Year Government Bond Index rose 0.7% on the week. The Eagle Star Active Fixed Interest Fund is up 6.9%, year to date.

Outlook

- Economic recovery remains the central scenario, supported by generally accommodative monetary policies.
- Current investor sentiment remains negative, with concerns stemming from relatively high US valuations and a series of investigations into US corporate accounting this year.
- These events have obscured the underlying improvement in US profitability, which has occurred over the past few months. However, we remain underweight in the US on valuation grounds, underweight Europe, which has failed so far to de-couple from the US and overweight Asian markets. 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.
- Overall, our stance remains overweight bonds, underweight equities although a bear market rally in equities is not unlikely given the technically oversold level of many share prices. An end to the two and a half year fall in equities will come about when the markets are convinced that the excesses of the 1990's, and especially the TMT bubble, have been expunged.