EAGLE STAR

Market Comment

Issued on 30th September 2002

Overview

There was both good and bad news on the economic and corporate front last week, with the result that equity markets were volatile. While some markets managed to end the week with small gains, they were not nearly enough to offset the losses of previous weeks.

Economic news was initially downbeat with the release on Monday of the US Conference Board's Index of Leading Economic Indicators showing a decline for the third successive month, while at the same time oil prices broke through the $30 per barrel level to hit a high point for the year. The decision on Tuesday by the Federal Reserve to leave interest rates unchanged was widely expected, but the likelihood of a cut at its next monthly meeting increased as two members dissented from the no-change decision. The Fed's statement expressed concern at the weakness in the US economy and acknowledged that part of the uncertainty was due to "the emergence of heightened geo-political risks". These risks were very much to the fore in investors' minds as the UK Prime Minister, Tony Blair, gained increased support in Parliament for his stance on Iraq following the release of a dossier on Baghdad's weapons capability. Political factors also influenced investor sentiment in Europe where the German market fell sharply in reaction to the election result, which produced a reduced majority for the incumbent government.

A more positive note was struck by better than expected US consumer confidence figures and durable goods orders and a German Ifo business confidence index in line with expectations. However, by the end of the week, some downbeat corporate news, particularly in the technology sector, sent investors rushing for safety again.

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

Table 1

Market	Index	% Return 20.09.02 to 27.09.02	
		Local Currency	Euro
US	S&P 500	-2.1	-1.9
US	NASDAQ	-1.8	-1.6
Europe	FT/S&P Europe Ex. UK	0.5	0.5
Ireland	ISEQ	-2.7	-2.7
UK	FTSE 100	1.2	1.8
Japan	Topix	1.0	1.8
Hong Kong	Hang Seng	-0.4	-0.2
Bonds	Merrill Lynch Euro over 5 year	0.1	0.1

Equities

Equity markets continued their downward slide in the early part of the week, but enjoyed a brief two-day rally on Wednesday and Thursday in response to better corporate news, before coming under further pressure on Friday as economic and geo-political fears took hold once more. In Europe, the UK FTSE 100 Index enjoyed a strong 3 day run, buoyed by a firm domestic economy. Eagle Star funds are overweight UK stocks. The overall European index was held back, however, by a continued decline in the German market.

US stocks slid further as heightened fears of war with Iraq and concerns on the economy took precedence over a pick-up in corporate news. In Japan, the banking sector rallied on increased expectations that the Bank of Japan's call on the government to bail out the financial sector would be heeded.

Bonds

The general tone of bond markets remained positive in the light of continuing economic and political gloom and expectations that interest rates could move lower. US bonds rallied as dissent emerged among members of the Federal Reserve on the appropriate response to the economy and investors anticipated that rates were now more likely to be cut in November. Eurozone bonds gave up some of their gains early in the week following a better than expected German business confidence survey, but prices rose again towards the end of the week on lower interest rate expectations.

Outlook

- Economic recovery remains the central scenario, supported by generally accommodative monetary policies. However, risks of a double dip recession have re-emerged.
- Current investor sentiment remains negative, with concerns stemming from relatively high US valuations and geo-political tensions.
- These events have obscured some improvement in underlying US profitability, which has occurred over the past few months. However, 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.
- Overall, our stance is overweight bonds, neutral/underweight equities. 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 fully worked off. This may take further cuts in US and European interest rates and more expansive fiscal policy.