EAGLE STAR

Market Comment

Issued on 6th January 2003

In this, our first investment comment of the new year, we are taking the opportunity to look back at 2002 as a whole. We would also like to wish all of our readers a very happy and prosperous new year.

Overview

For investors, 2002 was another year of disappointment as equity markets registered their third successive year of negative returns. While bond markets performed strongly, with double-digit price rises, this was insufficient to offset the losses of over 20% on many of the world's major stock markets. A number of factors combined to extend the equity bear market into a third year, foremost among them being the spectacular collapse of Enron, the energy trading company, early in the year in the US. The subsequent revelations of accounting irregularities in many major companies badly undermined confidence in equity investment for most of the year.

As the year progressed, the consumer side of the US economy remained robust, aided by tax cuts and mortgage refinancing at historically low interest rates. However, capital spending by corporate America failed to pick up and unemployment rose to 6%, an eight-year high. This uncertain environment was exacerbated by geo-political concerns as the threat of global terrorism refused to go away and the US drifted closer to war with Iraq. In the fourth quarter, the Federal Reserve (the US Central Bank) reduced US interest rates again to a forty-year low of 1.25% and this calmed nerves somewhat, although by that stage Europe had become the focus of concern as the German economy stagnated.

The year ended with hopes that the US business sector could recover in 2003, aided by deep cost-cutting and the expectation of a new set of US tax cuts, such as a reduction in taxes on dividends received by individuals and new incentives to spur business investment. While the ECB cut European interest rates by 0.5% in December to stave off recession, economies ended the year with minimal growth levels and with major concerns that a confrontation with Iraq could de-stabilise any fragile recovery.

Bond markets had a very good year, recording their highest returns since 1998, supported by low economic growth, low inflation, weak equity markets and their safe-haven status against a tense geo-political background. The Merrill Lynch EMU Government >5 year Bond Index was up 12.2% on the year as the main European economies weakened, leading the ECB to eventually cut rates by 0.5% in December. Continuing economic weakness raised market expectations of a further interest rate cut early in 2003 and this helped bond prices to move strongly ahead towards year end. Bonds were also assisted by a rise of 18% in the euro against the dollar, to end the year at $1.05, as this countered some of the negative effect of rising oil prices on the eurozone inflation rate, which had been consistently higher than the ECB target of 2%

Table 1 below shows the movements in the main markets during 2002 as a whole and during the last quarter of the year.

Table 1

Market	Index	% Return 31/12/2001 to 31/12/2002		% Return 03/09/2002 to 31/12/2002	
		Local Currency	Euro	Local Currency	Euro
US	S&P 500	-23.4	-35.1	7.9	1.5
US	NASDAQ	-31.5	-42.0	14.0	7.2
Europe	FT/S&P Europe Ex. UK	-33.1	-33.1	6.1	6.1
Ireland	ISEQ	-29.8	-29.8	4.4	4.4
UK	FTSE 100	-24.5	-29.1	5.9	2.2
Japan	Topix	-18.3	-23.3	-8.4	-11.7
Hong Kong	Hang Seng	-18.2	-30.7	2.8	-3.4
Bonds	Merrill Lynch Euro over 5 year	12.2	12.2	2.4	2.4

Outlook

- Forward indicators for the major economies suggest that growth will remain relatively subdued, particularly in the first half of 2003.

- Renewed geo-political tensions have seen oil prices rise by 25% since the low of last November. If sustained at these levels, economic growth forecasts could likely be reduced further.
- With growth below trend in all the major economies, interest rates are likely to stay low in the US and could fall further in the Eurozone, while the UK may be reluctant to change rates despite the strength of the housing market.
- The US dollar will remain under scrutiny in 2003 with further downward pressure likely.
- For sustained rises in equities we need to see a more robust economic and earnings environment.
- However, shifting war fears will continue to have an impact on the economic and market outlook in the short term.
- Our current overall portfolio stance is overweight bonds and neutral equities versus the manager average. On a geographic basis, we are underweight equities in the UK, Europe and Japan. We are broadly neutral in Ireland and marginally overweight in the US. We continue to have a preference for the Pacific region on a valuation basis and as a low cost producer.