EAGLE STAR

Market Comment

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Overview

Equity markets were quiet last week as the post-Iraq run of positive sentiment was tempered by more disappointing economic data. The key concern was that expressed by the Federal Reserve over a week ago, namely the undeniability of inflation falling further from its current low levels.

While weekend comments by the IMF, dismissed the possibility of global deflation (i.e. negative inflation), investors were unsettled last week by lower than expected US consumer and producer prices. The IMF acknowledged the probability of mild deflation taking hold in Germany and anticipated that in Japan prices would continue to decline at an annual rate of 0.5% to 1%. However, it stated that most central banks have room for cutting interest rates and called on governments to take "pre-emptive, forceful" measures to prevent a decline into a deflationary spiral. On the US, it regarded the deflation risk as minimal due to "relief provided by the recent depreciation of the dollar, the resilience in the financial sector, the availability of policy stimulus and the explicit willingness of policy makers to take pre-emptory action".

Comments by the US treasury secretary, John Snow, on currencies were interpreted as an endorsement of the recent weakness in the US dollar. This will intensify the pressure on the ECB for interest rate cuts.

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

Table 1

Market	Index	% Return 09/05/2003 to 16/05/2003	
		Local Currency	Euro
US	S&P 500	1.2	0.7
US	NASDAQ	1.2	0.7
Europe	FT/S&P Europe Ex. UK	1.4	1.4
Ireland	ISEQ	0.8	0.8
UK	FTSE 100	2.0	2.8
Japan	Topix	-0.5	0.1
Hong Kong	Hang Seng	0.1	-0.3
Australia	S&P / ASX 200	-0.2	0.3
Bonds	Merrill Lynch Euro over 5 year	1.1	1.1

Equities

Most markets made modest gains on the week helped by expectations that interest rates would eventually be cut to forestall the risks of inflation falling below current levels. The exception was Japan, where exporting stocks were hurt badly from the rise in the yen against the dollar.

In Europe, too, certain sectors suffered from dollar weakness, notably carmakers, many of which have a significant presence in the US market. The European auto sector fell 4.3% over the week. Strong performances were registered by european insurers, which continue to gain from the positive impact of the recent equity market rally on their reserves.

In the technology sector, Dell disappointed the market with a forecast that second-quarter revenues would fall short of analyst estimates. The world's second largest PC maker had seen its share price rise 20% this year, but its latest pronouncement caused a drop of over 3%. The largest chip-maker, Intel, announced on Friday that it is considering cutting capital expenditure.

In the UK, bid speculation amongst smaller market-cap stocks helped drive the FTSE 100 Index above the 4,000 level. The retail sector was active as Debenhams announced that it had received a bid approach from private equity group, Permira, which pushed the share price up 23% on the week. Meanwhile, Selfridges recommended that shareholders accept the takeover offer from Galen Weston, the Canadian millionaire and owner of the Brown Thomas Group, and the share rose 11%.

Bonds

The US bond market extended its rally of the previous week and ended the period with yields on 10 year maturities down 0.5% over two weeks. The sharp decline in inflation is a strong boost for bond prices as it increases the likelihood that interest rates will be cut further. The rise in the euro also helped bond prices in the eurozone area and the over 5 year index gained over 1% on the week.

In the currency markets, the Japanese monetary authorities bought dollars heavily and sold yen in an effort to limit the yen appreciation, which over the week saw it rise in value against both the euro and the dollar.

Outlook

- Forward indicators for the major economies suggest that growth will remain relatively subdued for the rest of 2003.
- Central banks were anticipating a recovery in confidence post an Iraq war. Now they will be monitoring developments closely to see if economic activity stages even a partial rebound. Our central scenario remains that further rate cuts will be necessary, especially in Europe.
- Given current valuation levels, a sustained rise in equities will need a more robust economic and earnings environment.
- Our current overall portfolio stance is overweight bonds and neutral equities versus the manager average. The funds are underweight in Europe due to deteriorating economic fundamentals and a strong currency.