



Economic News Mixed

Economy still has much slack, but with opportunity for positive surprises

INVESTMENT STRATEGY

What Has Changed

- ▶ Investors' risk aversion rose as the United States declared Iraq in "material breach" of the U.N. resolution on weapons disclosure.
- ▶ Stocks and the dollar weakened while Treasuries and gold rallied on concerns about international conflicts and weak job growth.
- ▶ Oil prices rose above \$30 per barrel despite assurances from OPEC that it would meet shortfalls caused by event-related production halts.
- ▶ A new White House economic team and new Senate leadership strengthened the Bush administration's ability to advance its fiscal stimulus plan.
- ▶ The major brokerage firms paid \$1.4 billion in an attempt to defuse conflict of interest concerns.

THE RECENT FLOW of news for investors has been schizophrenic:

- ▶ Speaking in New York, Alan Greenspan lauded the economy's resilience and its ability to work through the current "soft patch." On another occasion, fellow Federal Reserve governor Ben Bernanke forcefully maintained that the Fed would use *unprecedented* measures to prevent deflation in the United States and, by implication, to promote faster growth if need be. Investors could, justifiably, conclude that business-cycle risks were diminishing.
- ▶ Meanwhile, Secretary Powell was aggressively declaring Iraq in "material breach" of the U.N. resolution on weapons disclosure — a finding that could lead to war. More recently, Defense Secretary Rumsfeld, responding to North Korea's apparent breaches of its

accord not to build nuclear weapons, warned that the U.S. military was capable of fighting on two fronts. Investors, not surprisingly, concluded that geopolitical risks were increasing.

Initially, markets have focused more on the increased geopolitical uncertainties rather than diminished business-cycle risks: gold, oil, and Treasuries rose; equities and the dollar fell.

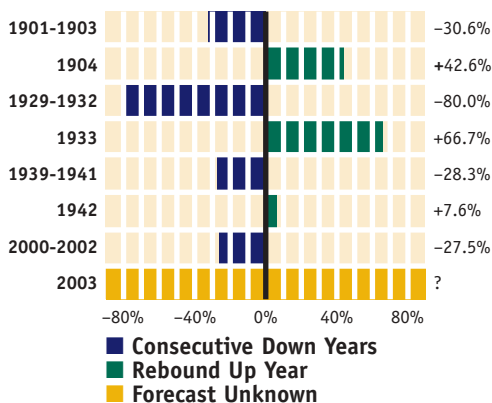
The weight of evidence, while still mixed overall, supports Greenspan's view of a gradually mending economy. For example, consumer spending, income, and sentiment improved in November, and leading economic indicators increased for a second consecutive month. In addition, in December, the Institute for Supply Management's manufacturing index surged.

Nevertheless, the base case for 2003, in our view, is for real gross domestic product (GDP) to grow slightly more than 2%. If correct, this represents an economy that possesses considerable "slack" — unemployment will remain high, capacity underutilized, and profits below potential. Still, there will be no "double dip" recession, and earnings, overall, could increase 8% to 10%.

The base case may prove conservative: monetary policy remains highly stimulative, as we emphasized last month, and the Fed appears ready to do more, if necessary. Money drives economic activity and financial markets — and money will be plentiful.

At the same time, the largest shift in federal fiscal policy since World War II

MARKET REBOUNDS
Recovery for DJIA following consecutive down years



INVESTMENT STRATEGY

Moderate Expansion Expected to Continue in 2003

- Growth will benefit from very accommodative federal fiscal policies.
- Aggregate demand will be restrained by a rising personal savings rate, restrictive state and local government fiscal policies, and weak foreign economies.
- Energy prices remain a major wildcard.

Municipal Bonds Are Attractive on a Tax-Adjusted Basis

- Maintain neutral duration.
- Five-year and longer maturities offer best relative value.
- Focus on high-quality issues given growing financial pressures on state and local governments.

Equity Rally Can Continue as Earnings Recover and if Geopolitical Problems Ease

- Earnings growth should continue with an economic recovery.
- A positive resolution to the Iraqi conflict would encourage business spending and improve investor confidence.
- Continue to focus on high-quality companies with an ability to generate strong earnings gains in a moderate growth environment.

International Markets Continue to Lag the United States Despite Attractive Valuations

- Few signs of economic improvement in the Euro area and Japan are once again disappointing.
- The European Central Bank may change its operating procedures, but policy responses overall are still timid.

Conclusion

- Equities are the asset of choice, but portfolio diversification and risk management remain crucial. We recommend slightly overweighting equities both tactically and strategically.

Economic News Mixed

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continues. The government's annual fiscal balance since 2000 has swung from surplus to deficit (-\$400 billion), and proposals under discussion would enlarge this amount by an additional \$50 to \$100 billion in 2003 and again in 2004. New stimulus could add 1% to 2% to GDP.

The most widely mentioned proposals include accelerating the 2001 tax cuts, removing the double taxation of dividends, accelerating depreciation again, and extending unemployment benefits. Federal spending, meanwhile, will increase for homeland security and defense. War would make fiscal policy even more stimulative.

The odds of military conflict, most immediately with Iraq, are increasing, as suggested by the quotes from Secretaries Powell and Rumsfeld. Such outcomes would not initially derail the economy, particularly because of the additional fiscal stimulus. However, a long, drawn out conflict — particularly where success is uncertain — could harm both the economy and financial markets. Economic risks would include potentially higher oil prices and lower consumer and business confidence. Financial markets would likely demand larger risk premiums. The impact of war on the markets, however, depends on length and probabilities of success — the equity market performed well during World War II, the Korean War, and the first Gulf War.

Investor confidence remains nervous and despondent, as 2002 proved to be a third consecutive down year for equity markets. This occurred in only

two other periods in the Dow Jones Industrial Average history: 1901–1903 and 1939–1941. In only one instance have four consecutive down years occurred: 1929–1932.

Current bearish psychology might suggest the possibility of a fourth down year, however extraordinary. Nonetheless, bear markets end when psychology is most pessimistic and fundamental improvements are ignored. As the economy mends, aggressive monetary and fiscal policies engage, and geopolitical uncertainties clarify, surprises could be quite positive. This is particularly true for factors that favor higher equity returns looking forward — growing profits, increased stability of the overall economy, and more favorable taxes.

Tactically we want to be positioned to benefit from such positive surprises, and advise that equities play a key role in asset allocation. That said, we still recognize the importance of risk control, diversification, and capital preservation, so the role of equities should be managed (slight overweight vs. benchmarks) and individual holdings should be concentrated in high-quality companies.

Strategically, equities clearly remain the asset of choice. Corporate profitability will recover, driven by productivity, expense control, unit growth, and, eventually, pricing. This prospect will produce higher equity returns and limit the odds of an extraordinary fourth consecutive annual decline in equity prices actually occurring.

Orie L. Dudley Jr.
Chief Investment Officer

Over time, tax-deferred growth can be significant.

TOPICS IN RETIREMENT PLANNING

Tax-Advantaged Retirement Savings

Making the most of your options

NO MATTER WHAT your net worth or annual income is, contributing as much as you can afford to tax-advantaged savings vehicles is most likely a smart strategy for you.

Although you sacrifice some control over how your money is invested and when you can access it, usually the current-year income tax savings and tax-deferred growth opportunities

Tax law changes have increased your savings opportunities.

more than compensate for these limitations. Tax law changes that began going into effect last year have increased your savings opportunities, and Congress may pass more beneficial changes this year. So if you aren't maximizing your retirement savings efforts, now is a great time to start.

The Power of Tax-Deferred Saving

Because contributions to most retirement plans reduce your taxable income dollar-for-dollar, you can invest more at the same cost. Say you're in the top income tax bracket of 38.6% and want to invest \$1,000 a month in mutual funds for the long term. If you invest directly in the funds, it will cost you \$1,000 a month or \$12,000 a year (not including fees). But if you invest through your 401(k) plan, it will cost you only \$614 a month, because you will save \$386 in taxes by making the contribution. This adds up to

an annual cost of only \$7,368, and an annual tax savings of \$4,632. In addition, the 401(k) plan fees are covered by the plan and are not a direct cost to you.

Perhaps even more important, your money grows tax deferred. Over time, this tax-deferred growth can be significant. For example, if you make the 2003 maximum IRA annual contribution of just \$3,000 each year for the next 20 years, in 2023 you will have \$200,000 (assuming an 8% average annual rate of return) from your investment of only \$60,000.

Three Potential Downsides to Consider

Most tax-advantaged retirement plans — including 401(k)s, most other employer-sponsored plans, and traditional IRAs — have potential downsides.

- When you take withdrawals, you have to pay tax at your individual income tax rate rather than at the lower long-term capital gains tax rate. But, by that time you probably will be retired and may be in a lower income tax bracket.
- With limited exceptions, you won't have access to your funds until you reach age 59½ without paying a 10% early withdrawal penalty in addition to income tax on your withdrawals. But unless your financial circumstances change, this isn't likely to be a problem.

- Your investment choices are limited to those offered by the plan. And, the times you can adjust your asset allocation also may be limited. Most employer-sponsored plans offer a variety of mutual funds so you may be able to create a well-diversified portfolio. For IRAs, you can shop around until you find an account that offers a selection of funds or individual securities that meets your needs.

Maximizing Contributions to Employer-Sponsored Plans

Your employer likely sponsors some sort of retirement plan, such as a 401(k) — or 403(b) or 457 plan if you work for a nonprofit or the government. If you work for a smaller company, you may have a Savings Incentive Match Plan for Employees (SIMPLE) or a salary reduction Simplified Employee Pension (SEP). Because of the tax advantages, it probably makes sense for you to contribute as close to the upper limit allowed by the plan as possible. Plan maximums are set by law (see the chart, *2003 Retirement Plan Contribution Limits*), but your personal contribution limit also will depend on your income, the type of plan, and whether you are contributing to other plans.

Another advantage of contributing to an employer-sponsored plan is most employers match at least a portion of your contribution and the matching contribution doesn't affect how much

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If you are a business owner or are self-employed, more powerful options are available to you.

Tax-Advantaged

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you are allowed to contribute. Not only do you receive additional compensation above and beyond your salary and bonuses, but, like your own contributions to your employer-sponsored plan, the matching contributions are not included in your current taxable income.

Special Options for Business Owners, Self-Employed

If you are a business owner or are self-employed, you have additional, more powerful, options available to you. You can establish a Keogh defined-contribution plan or defined-benefit plan or a single-employee SEP. The contribution limits are much higher for these plans than for employer-sponsored plans. (See the chart, *2003 Retirement Plan Contribution Limits*.) The contribution deadlines

for these plans also are later than those for employer-sponsored plans, giving you more time to make contributions. (See *It's Not Too Late to Make 2002 Contributions to Some Plans*.)

Here is a closer look at these three types of plans.

➤ **Keogh defined-contribution plan.** This can be a profit-sharing plan, a money-purchase plan, or both. Until last year, you needed to have both a profit-sharing and a money-purchase plan in place to make the maximum contribution. But now you need only the profit-sharing plan, which is generally better because it doesn't have mandatory contribution or separate annual filing requirements of a money-purchase plan. If you

currently have both plans in place, consider terminating the money-purchase plan or merging it into your profit-sharing plan to avoid continuing to be subject to these restrictions.

- **Keogh defined-benefit plan.** For this plan, contribution limits are determined actuarially based on a set future benefit and your age. As a result, older taxpayers may be able to contribute much more than the \$40,000 maximum allowed for Keogh defined-contribution plans and single-employee SEPs.
- **Single-employee SEP.** Before 2002, this plan was less attractive than its counterpart — the Keogh defined-contribution plan — because it allowed a significantly

WORTH NOTING

It's Not Too Late to Make 2002 Contributions to Some Plans

Just because we've rung in the new year doesn't mean you can't still make 2002 tax year contributions to your retirement plan — provided you have a plan with a post-Dec. 31 contribution deadline.

Traditional or Roth IRA. Your 2002 contribution deadline is April 15, 2003, and you still can deduct your traditional IRA contribution on your 2002 tax return.

Defined-contribution money-purchase or defined-benefit Keogh plan. You must have had the plan in place on Dec. 31, 2002, but you can make 2002 deductible contributions as late as Sept. 15, 2003.

Defined-contribution profit-sharing Keogh plan. You must have had the plan in place on Dec. 31, 2002, but you can make 2002 deductible contributions as late as the due date of your 2002 return, including extensions. This could be as late as Oct. 15, 2003.

Single-Employee Simplified Employee Pension (SEP). You can create a SEP in 2003 and still make 2002 deductible contributions as late as the due date of your 2002 return, including extensions.

smaller annual contribution. But now both plans share the same contribution limit, and the SEP has the added advantage of simpler documentation requirements and no Form 5500 annual filing.

**The Roth IRA:
A Unique Savings Vehicle**

Available only since 1998, the Roth IRA is a great vehicle for taxpayers who already are contributing the maximum to their employer-sponsored plans but would like to save even more. Contributions are not tax-deductible, but account funds grow tax free — if you take distributions only after the IRA has been open at least five years and you have reached age 59½ (with a few exceptions). This means that with proper planning, you'll never owe tax on growth in the account.

You can still take tax- and penalty-free distributions before age 59½, as long as they don't exceed your contributions. So a Roth IRA also can be a good choice if you think you may need access to your money before you reach retirement age.

The Roth IRA can be a useful tool for building wealth to pass along to the next generation. Unlike employer-sponsored plans and traditional IRAs, you don't have to start taking required minimum distributions beginning at age 70½, and you can continue to contribute after that age if you have sufficient earned income.

Beginning this year, employers can amend retirement plans they sponsor to allow participants to designate a portion of their contributions as going to a separate Roth IRA. If your employer offers this option, be sure to consider whether it could help you better achieve your retirement and wealth management goals.

2003 RETIREMENT PLAN CONTRIBUTION LIMITS

Type of Plan	Regular Contribution Limit	Catch-up Contribution Limit ¹
401(k), 403(b), or 457 employer-sponsored plan, or salary-reduction Simplified Employee Pension (SEP) plan	\$12,000	\$2,000
Savings Incentive Match Plan for Employees (SIMPLE)	\$8,000	\$1,000
Single-employee SEP or defined-contribution Keogh plan	\$40,000	\$0
Defined-benefit Keogh plan	\$160,000 ²	\$0
Traditional and Roth IRA	\$3,000	\$500

¹ For taxpayers age 50 and older.
² This is the maximum annual benefit the plan can provide. An individual taxpayer's maximum contribution is calculated actuarially based on his or her age.

Rolling Over Your Traditional IRA to a Roth

As you can see, a Roth IRA offers many advantages. But what if you already have a traditional IRA? You could be better off rolling over your traditional IRA into a Roth IRA.

However, you can make such a rollover only if your adjusted gross income (AGI) is less than \$100,000 (before the rollover). Just remember, you will have to pay income taxes on the amount you rolled over. If your

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Tax-Advantaged

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IRA has shrunk due to stock market volatility, now may be a good time to make such a move because you will owe less tax than you would have when the account was larger. Of course, the main benefit is future growth will be tax free.

Supplement Retirement Accounts With an Annuity

What if you are already contributing up to the limits to your employer-sponsored retirement plan and a Roth IRA, but would like to save even more for retirement at a tax advantage? Then consider an annuity. Your money grows tax deferred because you pay tax only when you receive payments.

You can choose from two basic types of annuities: traditional and variable. Traditional annuities offer less

control over your investments, but pay a fixed rate of interest and a fixed annuity payout. Variable annuities allow you to invest in “subaccounts,” which are similar to mutual funds but which could provide greater return over time, with more volatility. Both traditional and variable annuities also may offer a death benefit.

Are You Making the Most of Your Savings Opportunities?

Determining the best strategy for your particular situation is complex, because there are many considerations beyond what we’ve discussed here. Be sure to seek professional advice as you develop and revise your retirement savings plan.

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With an annuity, your money grows tax deferred because you pay tax only when you receive payments.

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