

Record Profit Cycle

New year begins with many economic indicators pointing up

INVESTMENT STRATEGY

What Has Changed

- ▶ Global equities closed 2003 at yearly highs, posting their best performance since 1986.
- ▶ The Blue Chip Survey forecasts 2004 gross domestic product (GDP) growth of 4.4%.
- ▶ Investors' risk appetites strengthened despite a host of unsettling headlines.
- ▶ The European Central Bank voiced increasing concern that a weak dollar will undermine the eurozone recovery, while Japan's Ministry of Finance authorized record spending to keep the yen from strengthening.

Global Economic Growth Set to Accelerate in 2004

- ▶ China's shrinking overall trade surplus is stimulating Asian and Latin American economic activity.
- ▶ The Fed has indicated that strong U.S. economic growth alone will not trigger rate hikes.

THIS YEAR HAS begun with mounting evidence that the business cycle is vigorous and expanding. Examples include:

- ▶ Consumer confidence and spending are exceeding expectations, and will soon benefit from higher employment and tax refunds.
- ▶ The Institute for Supply Management manufacturing survey, one of the most reliable trend indicators, reached a 20-year high in January. This strength was echoed in recent regional manufacturing surveys. These reports revealed strong new order trends that will soon be reflected in higher production and employment.
- ▶ The combination of higher foreign demand and a weaker dollar is producing welcome strength in export markets.

The trade deficit surprisingly narrowed in November, as exports of goods rose 26% (annualized rate).

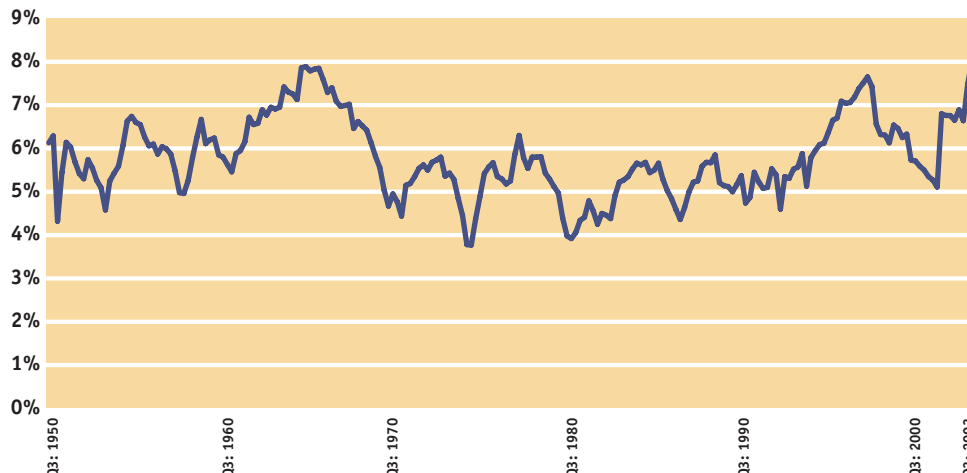
In response to such evidence, economists are increasing their estimates of economic growth in the fourth quarter of 2003 and the first half of 2004. The consensus for both periods now exceeds an annual rate of above 4%, but probably remains too conservative.

A key element in the strength of this business cycle — with favorable implications for financial markets — is the remarkable improvement in corporate profitability. Since the recession ended in late 2001, after-tax corporate profits (adjusted for inventory and depreciation distortions) have increased at the fastest pace for a comparable period in more than 60 years. Aggregate profit margins have reached their highest level

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CORPORATE PROFITS SOAR TO RECORD HIGH

After-tax corporate profits reach post-war record high in the third quarter of 2003.



Left Axis: After-tax corporate profits as a percentage of gross domestic product

Source: Haver Analytics, Bureau of Economic Analysis

Use Caution Toward Municipal Bonds Heading Into 2004

- ▶ We recommend less-than-benchmark duration ahead of increased supply.
- ▶ The yield curve is expected to flatten, with shorter maturities rising the most.
- ▶ Maintain high credit quality as states continue to struggle with deficits and downgrades.

Stocks to Benefit From Strong Earnings Growth and Moderate Inflation

- ▶ Strong industrial momentum favors cyclical exposure.
- ▶ Higher-quality stocks should regain favor as the economic expansion broadens.

International Equities Remain Attractive

- ▶ The Parmalat scandal dominates corporate news but equity markets are relatively unaffected.
- ▶ Further euro and yen strength has not yet derailed export growth in Japan and Europe.

Conclusion

- ▶ Positive economic fundamentals and resilience argue for overweighting equities in portfolios where equity investing risks can be tolerated.
- ▶ Debt markets, in contrast, must contend with the prospects of an increasingly unfavorable interest rate cycle.

Record Profit Cycle

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in post-war history. As a result, the profit share of gross domestic product, as measured by the Bureau of Economic Analysis, is now at its highest level since the series began in 1947.

This outstanding performance is attributable to the following five factors in ascending order of importance: a weaker dollar, lower taxes, lower interest rates, revenue growth and, most important, the gap between productivity and real wage growth.* More than half of the improvement can be ascribed to the decline in labor costs per dollar of output (productivity/real wage gap). This improvement has been a result of productivity growth — expanding at an annual rate of more than 5% during the past two years — and a slowdown in real compensation growth — from 4% to 2%.

Improved profitability — with a concomitant surge in free cash flow — explains the strength of higher risk bonds and equity markets in 2003. However, the positive implications of these trends are not yet fully reflected in asset prices, particularly in the stock market.

Record profits and free cash flow provide management with a variety of options that can enhance shareholders' values. Management may:

Use cash flow to strengthen the company's financial position through improved liquidity and debt reduction. This behavior is typical in the early stages of a cyclical recovery. Today, cash and short-term investments, as a share of balance sheet assets, are near post-war records and debt to equity ratios are declining. This increases operating strength and lowers risk for creditors and owners.

Increase investment for future growth.

This may be focused internally (capital spending) or externally (mergers and acquisitions). Capital spending is now rising at double-digit rates, particularly for efficiency- and productivity-enhancing technology. At the same time, merger and acquisition activity is also beginning to stir. The attractiveness of this capital allocation will be measured by the returns generated. The strength of the business cycle and improved operating efficiencies suggest executives (and investors) can anticipate attractive future returns from these decisions.

Improve current returns for shareholders by declaring higher dividends or repurchasing shares. In 2003, 229 S&P 500 companies boosted their dividends by an average of 26% and 21 businesses started paying dividends for the first time. This renewed focus on dividends can be attributed to changes in the tax code and record corporate liquidity. Dividends are a major contributor to long-term returns achieved by shareholders.

In short, record profits and free cash flow provide management with the resources to lower risks (improved liquidity and balance sheet strength), to reward current shareholders (higher dividends and share repurchases) and to invest for the future (capital spending and mergers and acquisitions). The strength of the business cycle, moreover, suggests these resources will continue to grow rapidly and could exceed expectations. This attractive prospect is not fully discounted in equity markets.

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Chief Investment Officer

* Goldman Sachs' U.S. Economics Analyst; Issue No. 04-02, January 9, 2004

In 2003, business investment started increasing and growth once again became the strategic priority.

TOPICS IN INVESTING

Looking Back and Peering Forward

2003 economic performance provides a strong foundation for 2004

By Orie L. Dudley Jr.
Chief Investment Officer

THE BEGINNING OF a new year is a natural time to sum up the year just ended and assess the outlook going forward. Despite many uncertainties and well-known worries, such reflections this year are ultimately very encouraging:

- The business cycle gained strength throughout 2003, and the economy entered the new year expanding at a much higher, sustainable rate.
- After a successful test in March of the October 2002 low, the worst bear market since the 1930s ended, and equities proceeded to record one of their best recoveries of the past two decades.
- Despite a unique combination of shocks (terrorism, scandals, the Iraq war, etc.), the U.S. economy continued to demonstrate remarkable resilience and productivity — suggesting the intriguing possibility of a higher secular growth potential beyond the current cycle.

Sea Change Begins in Second Quarter

Emerging out of a brief recession that officially ended in late 2001, the U.S. economy grew hesitantly and below its potential. Driven primarily by consumer spending and supported by massive policy stimuli, the recovery was perceived as too narrowly based and vulnerable to a “double-dip” retrenchment. Businesses were dealing with the aftermath of the 1990s

investment bubble and its associated scandals and governance issues. Executives focused on correcting prior errors, shrinking operations back to core activities and improving balance sheets. Risk taking and investing for growth were largely shunned.

This behavior began changing in the second quarter of 2003. Business investment started increasing and growth once again became the strategic priority. The reasons for this change — reasons that are extant today — include:

- Current profits and cash flows were recovering strongly, reaching record levels by the third quarter. Cash flows were actually exceeding ongoing investment.
- Financial conditions (interest rates, credit availability, equity prices and currencies) were extraordinarily supportive for growth.
- The expected returns from investment were rising. The market value of assets relative to their replacement cost, productivity

and longer-term earnings prospects were all increasing.

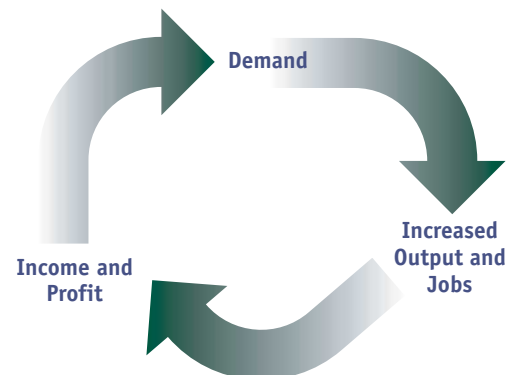
Business, in short, had the resources, opportunity and motive to invest. This reality, in turn, had positive implications for financial assets and for the business cycle.

Expansion Broadens, Financial Markets Respond

With the re-engagement of business, the economic expansion broadened. In addition, the economy appears to have entered a virtuous cycle of self-sustaining growth in which demand leads to increased output and jobs, thus producing income and profits and creating more demand. Monetary and fiscal policies, meanwhile, continue to be highly stimulative and financial conditions, particularly with the dollar falling, remain markedly supportive. In 2004, gross domestic product (GDP) will therefore probably grow at an above average rate, possibly at or even above the upper end of the Federal Reserve’s forecast range (3.75% – 4.75%).

THREE KEY COMPONENTS OF A SELF-SUSTAINING ECONOMIC GROWTH CYCLE

With business having re-engaged in 2003, the economy appears to have entered a cycle of self-sustaining growth, in which demand leads to increased output and jobs, which produces more income and profit, which leads to more demand.



Looking Back and Peering Forward

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Financial markets have increasingly anticipated a more vigorous business cycle. This was clearly reflected in the strong performance of stocks, higher-risk bonds and emerging market debt in 2003. In contrast, U.S. Treasury investors experienced very modest gains, and, for the first time since 1999, yields on the benchmark 10-year government bond rose during the year — from 3.82% to 4.26%.

This divergent performance is likely to persist this year. Government bonds have been deriving support from accommodative central banks, negligible inflation and those who were skeptical about the sustainability of the business cycle. Each of these supports for bond prices will be challenged going forward. There is the particular risk that a declining dollar will be inflationary and might force central banks to change their supportive policies.

The anticipated rise in 10-year bond yields (+50 to 125 basis points) should not be severe enough to unsettle equity markets. Stocks unmistakably benefit from more rapid growth and higher profits; the 40% increase in the S&P 500 since the March lows clearly discounts significant improvement in both. Nonetheless, this recovery from the preceding severe bear market is still slightly less than the median recovery of the last century. Moreover, improvement in business performance this cycle, especially corporate profitability, should support further, if more modest,

gains this year. S&P 500 operating earnings appear set to reach a record \$62 per share, an increase of about 13% compared with 2003 results.

“Dynamic” Economy Generates Productivity Gains

As the United States returns to trend growth (probably higher in 2004) the bigger economic story is the remarkable dynamism of the economy and its ability to generate productivity gains. Since the peak of the prior boom in 2000, productivity growth has actually speeded up when it was expected to slow. Advocates of

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a “new economy” — at least the idea that secular productivity growth has shifted up to a higher trend rate — appear vindicated. During the period from 1995 (boom, bust, recovery), productivity growth has averaged about 3% per year, twice the rate seen during the previous two decades.

This performance, if it persists, increases the economy’s noninflationary growth potential and its ability to generate income and profits. This, in turn, has very positive implications for expected returns from financial assets, particularly stocks. Companies can achieve more rapid real earnings gains and pay higher dividends — which are now taxed at lower rates.

A Happy New Year for Equity Investors?

A stronger cyclical recovery and a potential higher secular growth rate are not yet fully priced into equity markets, despite recent strength. Unquestionably risk exists, particularly exogenous threats like terrorism, but markets adjust and require new and undiscounted things to happen to alter well-developed trends. The state of the business cycle, the end of the bear market, and the economy’s remarkable resilience and productivity argue 2004 will be a favorable year for equity investors.

At a minimum, consider naming a professional as a successor executor because your initial executor may become unable to serve.

TOPICS IN ESTATE PLANNING

Put Pen to Paper

Build your estate plan around four key documents

By Brett Rees

Senior Vice President, Director of Sales and Marketing,
Southeast Region

FOUR DOCUMENTS FORM the foundation of a sound estate plan: a will, a living trust and two powers of attorney. Whether you are just developing your plan with your attorney or updating it, understanding the basics of each document can help you achieve your goals.

Wills

A will helps ensure on your death that your assets will be transferred according to your wishes. If you die without one, your assets will pass to heirs according to state intestacy laws. When drawing up a will:

- ❑ **Understand that your estate will be subject to probate.** This is a court process to ensure payment of your debts and an orderly transfer of your assets. Some assets can pass outside of probate: annuities, insurance policies, qualified retirement plans, property held in a living trust and property held in joint tenancy.
- ❑ **Select an executor (also known as a personal representative) to administer your estate.** This may be a family member, a trusted friend, or a professional executor such as a bank's trust department or a trust company. At minimum, consider naming a professional executor as a successor executor because your initial executor may become ill or die and be unable to serve.
- ❑ **Store your will in a secure location.** Place the original, signed document in a bank's safe deposit box, in safekeeping with your professional executor or have your attorney keep it on file. In addition, keep a duplicate — there should only be one signed original — to periodically review.

Living Trusts

A living trust is revocable. Thus, you may revise or cancel it — including changing the trustees and beneficiaries during your lifetime. As its name implies, it's effective during your lifetime, meaning you may transfer assets into the trust for your own benefit during your lifetime (including while you are incapacitated), and after your death those

assets are transferred to your beneficiaries. When developing a living trust:

- ❑ **Choose a trustee.** A trustee manages the trust per your instructions. You may appoint yourself as trustee or name an individual, professional or corporate trustee. Also be sure to name a successor trustee.
- ❑ **Transfer probate-type assets into the trust.** Typically this requires only a letter of instruction. Probate-type assets include securities, certificates of deposit, and bank and mutual fund accounts. Transferring other asset types — for instance business interests, tangible personal property or real property — is complex and requires legal guidance.
- ❑ **Create a pour over will.** If your goal is to avoid probate, using a living trust will work only if all assets are in trust when you die. Use a pour over will to cover any assets you didn't fund your living trust with. This provides that these assets will “pour over” into your living trust when you die.

Powers of Attorney

A power of attorney gives another person (typically called an agent) the legal authority to act on your behalf. You may rescind a power of attorney whenever you wish for whatever reason. If you do so, alert family members and third parties. With a “durable” power of attorney, the agent can act on your behalf when you are incapacitated. There are two kinds of powers of attorney:

- ❑ **A healthcare power of attorney permits the agent to make medical or mental health decisions for you.** This power provides an agent the ability to reject or stop any medical service, including, importantly, life-sustaining procedures.
- ❑ **A financial power of attorney permits the agent to make financial, investment and tax decisions for you.** This power provides an agent the ability to manage your investments, write checks, sell real estate, file tax returns and generally handle your financial affairs.

Write It Down (With Legal Guidance)

Wills, living trusts and powers of attorney are complex documents. Whether you are beginning to build your estate plan or are revising your current plan, seek competent legal advice for your personal situation.

Northern Trust Honored for Generosity and Security

NORTHERN TRUST HAS always been dedicated to philanthropy. This culture of caring and commitment to investing in our communities was recognized in 2003 by *BusinessWeek* magazine, which ranked Northern Trust ninth on its “Most Generous Cash Givers” list. Northern Trust also was recently honored by *Global Finance* magazine, which named it as one of the “World’s Most Socially Responsible Companies.”

Northern Trust’s corporate philanthropy program awarded numerous nonprofit organizations worldwide nearly \$10 million in cash contributions in 2003. The majority of funds were directed to human service organizations that provide critical services to low- and moderate-income families striving to build better lives and provide people in need with critical services, including housing, food, child care and health care.

“Since its founding in 1889, Northern Trust has advanced a culture of caring and a commitment to invest in the communities it serves,” said William A. Osborn, Northern Trust Chairman and Chief Executive Officer.

“Deeply rooted in our community commitment is volunteerism, and we’re proud of the many Northern employees who contribute in a variety of ways to local communities and charitable efforts around the world.” In 2003, 2,500 Northern Trust employees volunteered more than 180,000 hours to nonprofit organizations.

In addition to its commitment to community, Northern Trust also is committed to ensuring the safety of the funds our clients entrust us with. Once again, we are proud to announce that Northern Trust was selected by *Global Finance* magazine as one of the world’s 50 safest banks.

Northern Trust is one of only five U.S. financial institutions to be included among this select group. These global rankings take into account asset size as well as long-term foreign currency ratings from several prominent international rating agencies including Fitch IBCA, Moody’s and Standard & Poor’s. This ranking recognizes Northern’s excellent asset quality and sound risk management practices.

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Questions about this issue? Please call us at 800-622-4922.

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