

Geopolitical Risks Abound

For the markets the worst probably is over, but predicting the actual bottom is a “mug’s game.”

INVESTMENT STRATEGY

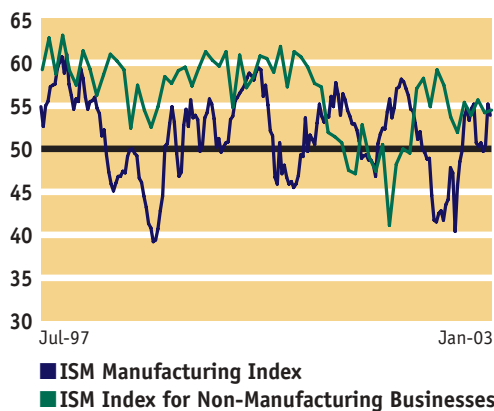
What Has Changed

- ▶ The likelihood of war with Iraq increased following weapons inspectors’ reports and Secretary Powell’s presentation to the United Nations.
- ▶ Preliminary fourth-quarter 2002 gross domestic product rose a tepid 0.7%, reflecting a modest increase in business investment and weak consumer spending.
- ▶ After an initial surge, stocks fell sharply on rising geopolitical tensions and disappointing earnings guidance.
- ▶ President Bush proposed a \$670 billion stimulus and structural tax-reform plan.
- ▶ The dollar came under pressure on mounting geopolitical tensions and a record U.S. current-account deficit.

FINANCIAL AND COMMODITY markets currently are monopolized by uncertainties: war with Iraq; the possibility of attempted terrorist attacks against Americans, here or abroad; and the reluctance of businesses to invest. Geopolitical risks permeate government, business, and market thinking and behavior. The Federal Reserve, for example, highlighted such risks as the major cause of restrained corporate hiring and spending. Discussions at the World Economic Forum in Davos were preoccupied by the prospect of war and the economic disruptions and weakened alliances that might ensue. Markets, meanwhile, are pricing a “war premium” into gold, oil, and government bonds. Equities and the dollar, in contrast, have been under pressure.

MANUFACTURING RECOVERY UNDERWAY

An index level above 50 indicates expansion of production and orders, and improving business conditions.



Source: Institute for Supply Management

The economic setting surrounding these uncertainties is fragile. The U.S. economy narrowly averted a fourth-quarter contraction; preliminary Commerce Department estimates are that gross domestic product (GDP) grew only 0.7%. Spending and investing decisions already reflect, to some degree, the heightened geopolitical risks: consumer spending slowed to a 1% annual growth rate and there was only a modest 1.5% rebound in business investment.

Recent economic news, however, is more encouraging. Manufacturing indicators, notably the Institute for Supply Management (ISM), and regional surveys suggest the elusive recovery in this economic sector finally could be under way. The ISM remained above 50 (indicating expansion) for the third straight month in January. The new-order index, which has a solid record predicting cyclical turns, was particularly strong. Elsewhere, employment and labor market indicators suggest the job market is stabilizing. Overall, GDP growth is now expected to exceed 2% in the first quarter, possibly gaining momentum as the year unfolds.

Such a scenario is supported by the Fed’s aggressive monetary policy and the accompanying improvement in financial conditions. Corporate bond spreads are narrowing, credit default swaps are improving, and the dollar is weakening. Importantly, liquidity is once again

INVESTMENT STRATEGY

Continue to Expect Moderate Expansion in 2003

- ▶ Growth will benefit from proposed fiscal policy changes.
- ▶ Rising personal savings, restrictive state and local government fiscal policies, and weak foreign economies will restrain demand.

Municipal Bonds Remain Attractive on a Tax-Adjusted Basis

- ▶ Valuations temporarily lowered by Bush's tax and savings proposals.
- ▶ Maintain neutral duration.
- ▶ Focus on high-quality issues given continued financial pressures on state and local governments.

Outlook for Equities Will Improve as Uncertainties Are Resolved

- ▶ Earnings growth, currently slowing, should improve with an economic recovery.
- ▶ Resolution of the Iraqi conflict should bolster corporate confidence and improve investor sentiment.

International Markets

Continue to Underperform

- ▶ Europe's economy is losing momentum with Germany on the brink of recession and the euro strengthening. Japan is slowing once again.
- ▶ Valuations are attractive but lack positive catalysts.

Conclusion

- ▶ Recommended asset allocation: underweight bonds, overweight cash, and slightly overweight equities. Diversification and risk management remain critical.

Geopolitical Risks Abound

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growing rapidly; M2, a measure of money supply, is expanding faster than economic activity.

Dollar weakness, in the current economic context, is positive: it strengthens the global competitive position of the United States, enhances S&P 500 earnings through transactions gains, and improves domestic pricing power.

Improvement in credit markets, meanwhile, is equally heartening. Borrowers, including issuers with lower ratings, are gaining renewed access, and many are taking advantage of lower capital costs.

Record monetary stimulus is being accompanied by an aggressive shift in fiscal policy. The federal budget already has swung from surplus to deficit. The Bush administration's new \$674 billion proposal will be partially approved by Congress — less than requested, but more than the \$300 billion package offered by Democrats — creating an even larger deficit, probably exceeding \$300 billion. The final version of new legislation likely will include acceleration of tax cuts already passed, some dividend-tax reduction, and higher depreciation allowances and tax cuts for small businesses.

After deducting the negative impact of state and local government fiscal problems, additional federal stimulus could add more than 1% to GDP during the next 18 months. The base case for 2003, therefore, is for real GDP growth to approach a 3% annual rate. While solid, this still is below

potential and implies continuation of a challenging operating environment for businesses. Exposure to exogenous shocks remains high.

After an initial surge, equity markets are testing October lows, prolonging the bear market. The pattern of persistent price declines, punctured by occasional failed rallies, is exhausting and demoralizing. The worst probably is over, but predicting the actual bottom, as the British say, is a "mug's game." Many traditional signs of a bear market low are in place: economic fundamentals are improving; investor psychology is horrible; and valuations are attractive, but there are few buyers. On the other hand, the uncertainties, as noted, remain significant and probably necessitate some resolution before a major rally can be maintained.

From a longer-term perspective, equities offer better returns than cash or bonds. The bear market has erased the excess returns of the preceding bull market to the degree that equity annual returns during the past decade are now 6.7% — right in line with their 101-year average. Looking forward, the factors that produce positive equity returns — growing profits, stability of the overall economy, lower taxes, and transaction costs — are coming together. This is the basis of our asset allocation strategy.

Orie L. Dudley, Jr.
Chief Investment Officer

Your risk tolerance may need to change to achieve new short-term financial goals.

TOPICS IN INVESTING

Has Your Risk Tolerance Changed?

By **James R. Grinney**
Senior Vice President
Chief Investment Officer of Florida

TODAY, MANY INVESTORS would answer “yes” to this question because they are much more concerned about risk than they were a few years ago. Market volatility and a slow economy are two sources of these increased concerns about risk.

Yet educated investors change their risk tolerance only when their personal circumstances or financial goals change, not when the market or the economy changes. In fact, accurately identifying your risk tolerance, applying it to your asset allocation strategy, and sticking

to a long-term plan are key to achieving your financial goals.

Determining Your True Risk Tolerance

All investments involve a tradeoff between risk and return, and generally the greater the risk, the greater the potential return. How much risk you’re willing to bear for the opportunity to enjoy a greater return is your risk tolerance. But determining your true risk tolerance can be difficult.

For example, when there’s a strong bull market, many investors may think they have a high risk tolerance because they focus on the large potential gains they could reap and generally discount potential losses. But these same investors may see only the large losses when the market turns into a bear. Such investors haven’t determined their true risk tolerance because they aren’t looking at potential gains and losses in tandem. Instead, they simply are reacting to market conditions.

No one likes to lose money, but knowledgeable investors realize they periodically may have to see the dollar-value of their portfolios shrink to recognize larger long-term gains. The higher an investor’s risk tolerance, the more losses he or she will accept in exchange for the possibility of significantly greater return later.

Smart investors also look at their various financial goals and realize more secure investments may be in order for short-term goals to ensure the

money is available when they need it. And they consider such factors as their age, current financial situation (net worth and income vs. debts and expenses), and personality.

Hidden Risk Factors

When many investors hear the term “risk,” they think about a stock that loses value because the share price decreases or a bond that becomes worthless because the issuer defaults. But other types of risk can affect whether and to what extent you achieve your financial goals.

➤ **Inflation.** This may be both the most common and most overlooked risk. Investments that on the surface seem the most secure because you can’t lose your principal and return may be guaranteed — such as savings accounts and CDs — often have inflation risk. In exchange for security, you receive a much lower return than you might on other types of investments. If the return is less than the inflation rate, you may be protecting your principal, but over time you can lose significant buying power.

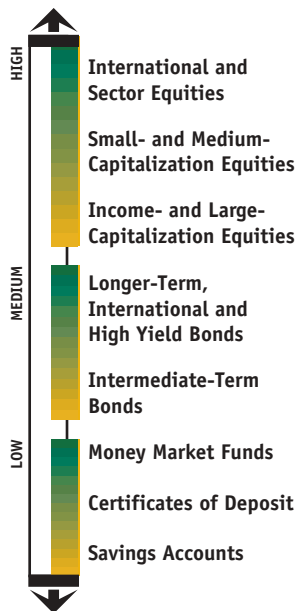
➤ **Liquidity.** This is a twofold risk that reflects your ability to turn an investment into cash when you need it. First, it’s the ability to quickly sell the investment. Real estate, artwork, and collectibles have a higher liquidity risk, because it may take time to find a buyer. Second, it’s the ability to get the amount of money out of the investment you find

INVESTMENT RISK-REWARD POTENTIAL
This risk-reward spectrum illustrates that risk and potential reward usually go hand-in-hand.

Growth
Offers you opportunities for capital appreciation and long-term growth.

Income
Provides you with the potential for current income.

Cash Equivalent
Helps you meet your cash management and short-term investment needs.



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Risk Tolerance

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acceptable. Real and personal property also have this risk, as do stocks, bonds, and mutual funds.

Allocating Assets Based on Risk Tolerance

Once you've determined your true risk tolerance and considered all possible risks, begin reviewing your asset allocation and whether you need to make adjustments so you can feel comfortable while pursuing your financial goals. The higher your risk tolerance, the larger the portion of your portfolio can be allocated to riskier investments. (See the chart, *Investment Risk-Reward Potential*.)

Nevertheless, for most investors it makes sense to spread out investments among the asset classes.

This diversification can make higher-risk investments more bearable because they are balanced with more secure investments.

When Your Risk Tolerance May Need to Change

There are times when your risk tolerance may need to change. For example, if you lose your job, your risk tolerance probably will decrease because protecting what you have becomes more important. On the other hand, if you receive a large bonus or an inheritance, your risk tolerance may increase. Either way, you'll want to adjust your asset allocation accordingly.

Your risk tolerance may also need to change to achieve new short-term financial goals. For instance, perhaps

you've been focusing on saving for retirement, but now decide you'd like to buy a vacation home within the next five years rather than waiting until you retire. Your risk tolerance for the portion of your investments going toward that home purchase may go down, because you want to access the funds sooner.

Financial Success and Peace of Mind

Knowing your true risk tolerance and allocating your assets accordingly can both help you achieve your goals on your chosen timeline and provide you peace of mind. Make certain to consult a professional financial advisor to assist you.

FIVE QUESTIONS TO HELP YOU ASSESS YOUR RISK TOLERANCE

More-detailed risk tolerance "quizzes" are available on the Internet, but answering these five questions can give you a rough idea of your risk tolerance. Of course, you most accurately can assess your risk tolerance by working with a professional financial advisor.

- 1 Do you consider yourself knowledgeable about investing?
- 2 Do you have enough liquidity so that you won't have to use the money you're investing within the next 10 years?
- 3 Are you more concerned about the effects of inflation on your ability to achieve your financial goals than about realizing an occasional loss?
- 4 If today you bought 1,000 shares of stock at \$25 a share, and tomorrow the stock price went down to \$20 a share due to market conditions, would you hold on to your shares?
- 5 In the same scenario as No. 4, would you buy more shares when the price went down?

If you answer most of the questions with a resounding "yes," you likely have a relatively high risk tolerance. If you answer most of the questions "no," you likely are a more conservative investor. And if you have a mix of answers, or your answers are less emphatic, you have a moderate risk tolerance. Keep in mind that many people find their risk tolerance increases as they educate themselves about investing, closely examine their financial goals, and develop or refine their plan for achieving them.

If you overpaid your 2002 taxes, consider crediting your 2002 overpayment to your 2003 estimated tax payments.

TOPICS IN TAX PLANNING

Reduce Estimated Tax Payments and Stay Penalty-Free

By Theresa A. Portis
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Personal Tax Services

DO YOU HAVE income, such as dividends, capital gains, interest, and alimony in addition to your annual salary? Do you have earnings from a sole proprietorship or are you self-employed? If so, you may have to pay quarterly estimated taxes. Why? Because withholding from your salary may not be sufficient to ensure you avoid underpayment penalties. Let's take a closer look at estimated tax payment rules and how to avoid penalties and reduce your quarterly payments.

Avoiding a Penalty

Even though you don't have to file a 2003 income tax return until April 15, 2004 (or as late as Oct. 15, 2004, if you are on a second extension), the IRS wants to receive most of your tax payment in 2003. So it requires that income taxes be withheld from your paycheck. If you have significant income not

subject to withholding, the IRS also requires you to make quarterly estimated tax payments. You don't have to pay 100% of your 2003 tax liability in withholding and quarterly payments, but you'll want to pay enough to avoid underpayment penalties. To do this, you have two options:

1. Pay 90% of your 2003 income tax, or
2. Pay 110% of your 2002 income tax (100% of your 2002 income tax if your adjusted gross income is \$150,000 or less — \$75,000 or less if you're married filing separately).

You can make these payments through withholding, timely filed quarterly estimated tax payments, or both. If you don't meet these requirements, the IRS will assess a penalty based on any underpayment — the difference between the lowest amount you must pay each quarter and the actual amount you have paid by that date.

Determining How Much to Pay

You could easily avoid any penalties by significantly increasing your withholding or making quarterly estimated tax payments so large that there would be no doubt you covered any liability. But if you raise your payments too high, this would amount to an interest-free loan to the federal government. For most taxpayers, the goal is to keep overpayment to a minimum while still avoiding penalties. To accomplish this, you need to estimate your 2003 tax liability, calculate required payments based on your 2002 actual and your 2003 estimated tax liability, and make timely estimated tax payments of the lower amount.

If you expect your 2003 tax liability to be less than 110% of your 2002 liability, basing your payments on your 2003 liability may be advantageous. Of course, this is more complicated because you must either accurately project your 2003 liability or measure and annualize your year-to-date liability each quarter. Under the first method, your quarterly payments will be equal. Under the second, they will vary.

This variable option can be beneficial if your income includes capital gains and bonuses because, generally, you don't realize or earn these types of income evenly

CUMULATIVE ESTIMATED TAX DUE BY QUARTERLY DEADLINES

Tax Payment Based on:	April 15 2003	June 16 2003	Sept. 15 2003	Jan. 15 2004
2003 tax (including annualized income method)	22.5%	45.0%	67.5%	90.0%
2002 tax (for AGI of \$150,000 or less)	25.0%	50.0%	75.0%	100.0%
2002 tax (for AGI more than \$150,000)	27.5%	55.0%	82.5%	110.0%

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Reduce Estimated Tax Payments

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during the year. Using this technique, you likely can reduce earlier quarterly estimates.

How do you determine the payments? Begin by computing your year-to-date tax — after withholding — and pay the net amount. You will not incur a penalty even if this amount is significantly lower than the amount due based on your prior-year's income tax. As the year progresses and your income increases, your quarterly payments will increase.

If you expect your 2003 tax liability to be 110% or more of your 2002 liability, basing your 2003 quarterly estimated tax payments on 110% of your 2002 liability will likely be the better option. It's easy to calculate, and you'll avoid overpaying. Payments are made in four equal installments. (See *Cumulative Estimated Tax Due by Quarterly Deadlines*.)

Avoid incurring a penalty by keeping track of year-to-date income and increasing withholding as the year progresses if necessary.

Another way to avoid incurring a penalty is to keep track of your year-to-date income and increase your withholding as the year progresses if necessary. The IRS treats withholding as if you paid tax evenly throughout the year. Also, keep a record of what you

pay in estimated tax and when. This is important because, when it's time to file your tax return, you can easily check to make sure the IRS has given you credit for your payments.

Minimizing Your 2003 Tax Bill

The steps you take today to reduce your 2003 tax bill also can reduce your quarterly 2003 estimated tax payments. Please consult a professional tax advisor if you would like assistance in determining the amount of estimated tax payments you may need to pay in 2003.

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