

## Economic Growth Slowing

Favorable resolutions to major uncertainties needed to end bear market

### INVESTMENT STRATEGY

#### What Has Changed

- ▶ Treasury bonds rallied and stocks weakened on downbeat economic data and the ratcheting up of war concerns.
- ▶ Federal Reserve Chairman Greenspan gave President Bush's \$670 billion stimulus plan a mixed review.
- ▶ Higher energy prices caused headline inflation to surge, although core inflation remains low and stable.
- ▶ The U.S. Treasury expanded its debt auctions amid forecasts of multi-\$100 billion budget deficits far into the future.

**G**EOPOLITICAL CONCERNS CONTINUE to dominate consumer, business, and investor behavior. Economic growth has slowed, if not actually stalled. Businesses remain quick to lay off workers but slow to rehire. The psychological impact fear can have on global flows of money and information is apparent in financial and commodity markets.

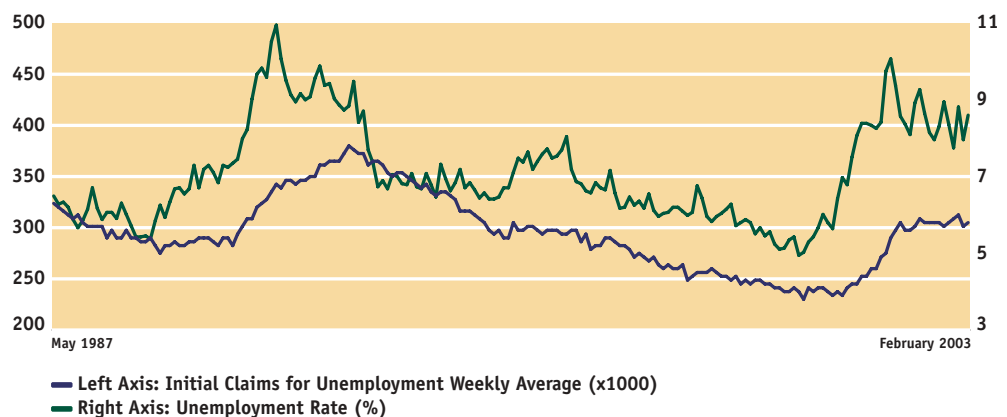
The economy, in effect, hit a wall of worry in February and early March. Virtually every major indicator — manufacturing surveys, consumer spending, confidence indexes, and unemployment — proved weaker than expected. Estimates for first-quarter and full-year gross domestic product (GDP) growth have been reduced, in some cases by up to 100 basis points. The consensus forecast is now for the economy to grow 2.5% in 2003.

Particularly troublesome was the Bureau of Labor's February employment report,

which indicated hours worked declined, the unemployment rate rose, and the economy lost 308,000 jobs. Severe winter weather throughout much of the country, reservists called for duty, and a terrorist alert undoubtedly depressed payrolls. Nonetheless, some of the weakness was fundamental, and therefore alarming. Job creation is at the heart of household spending. The persistent absence of hiring and the lengthening of individual periods of unemployment indicate an economy operating well below potential.

Federal Reserve policy will remain highly stimulative given the struggling economy. This policy, importantly, will not be constrained by the low level of Fed Funds (currently 1.25%), the Fed's main policy instrument. During the past six months, the bank has been highlighting its range of stimulus options even if the Funds rate were to hit zero. The Fed is not bound by any

#### EMPLOYMENT PICTURE WEAK



Source: Bureau of Labor Statistics

## Economic Headwinds to Keep

### 2003 Growth Moderate

- ▶ Aggregate demand will be restrained by rising personal savings, excess factory capacity, restrictive state and local government fiscal policies, and weak foreign economies.
- ▶ Crude oil prices could remain higher than earlier expected due to low global inventories and production impairments.

### Near-Term Outlook for Municipals

#### Clouded by Technical Factors

- ▶ Seasonal issuance surge likely to outstrip demand.
- ▶ Valuations temporarily depressed by Bush's tax and savings proposals.
- ▶ Ratings downgrades reinforce focus on high-quality issues.

### Clarity on Iraq and Moderate Economic Growth Should Favor Equities

- ▶ Resolution of the Iraqi conflict should bolster corporate confidence and mitigate investor concern.
- ▶ Earnings growth, currently slowing, should improve with the economy.
- ▶ We favor large-cap, financially strong companies whose scale economies help drive better profit gains in a moderate-growth environment.

### International Markets Continue to Underperform

- ▶ European earnings outlook has weakened, and corporate balance sheets must be strengthened.

### Conclusion

- ▶ Yields from cash and government bonds are near post-World War II lows, arguing for exposure to equities for long-term investors despite more volatility.
- ▶ Diversification and risk management remain critical.

## Economic Growth Slowing

CONTINUED

budget constraint and can expand its balance sheet at will. The assets it might purchase could include long-term bonds (perhaps to manage the yield curve) or non-treasury securities (perhaps to reduce private borrowing rates).

The unprecedented amount of monetary stimulus underway and contemplated is being accompanied by an equally extraordinary amount of fiscal stimulus. The federal budget has already swung from surplus to deficit only two years into the Bush administration's original \$1.3 trillion tax cut. Without new proposals, this existing legislation will incrementally add \$100 billion of stimulus per year for the next nine years. However, given the precariousness of the current economy, new legislation is likely. Significantly, the costs of geopolitical conflicts also must be added. Deficits probably will soon exceed \$300 billion annually.

Aggressive monetary and fiscal policies ultimately must translate into increased spending by consumers and businesses. Lower interest rates, for example, have clearly supported record strength in housing markets. This, in turn, has allowed consumers — through refinancing, equity loans, and capital gains — to “extract” a huge amount of money (nearly \$700 billion) to strengthen their balance sheets and support consumption.

The “missing” participant in this cycle has been business. Corporations remain reluctant to add employees, build inventories, or expand capacity.

Some encouraging signs indicate this may be changing: Business investment in plant and equipment rose 2.5% in the fourth quarter of last year. Spending on equipment and software increased 6.6% during this period — the third consecutive quarterly gain.

Business appears to be changing from balance sheet improvement and cost reduction toward growth as cash flows and profitability improve. Importantly, operating earnings grew only about 1% in 2002 but are now expected to improve as 2003 unfolds, possibly expanding nearly 10%.

Financial markets have been digesting this interplay of geopolitical risks, slowing economy, policy responses, and business behavior. The accompanying uncertainties have produced risk aversion and a flight to quality (with the notable exception of the high-yield bond market). The bear market in equities has persisted.

The consensus imbedded in stock prices today remains anxious, whether the topic is war, GDP, or earnings growth. Surprises, therefore, could be positive and produce strong short-term rallies. Beyond this, favorable resolution of the major uncertainties — which appears increasingly possible — is necessary to end the bear market.

*Orie L. Dudley, Jr.*  
*Chief Investment Officer*

The current income bonds provide helps offset market fluctuations.

## TOPICS IN INVESTING

# Tax-Smart Investing

Municipal bonds offer investors tax-advantaged income

**By Jane McCart**  
Director of Municipal  
Fixed Income Management

INVESTORS TRADITIONALLY HAVE looked to the safety of bonds during stock-market down periods. But with interest rates — the price driver for bonds — at near 40-year lows, it's only a matter of time before they rise and push down the price of bonds.

Does this mean the bond market no longer offers good potential returns for investors? While bond prices may be poised to come down, bonds still can play an important role in a well-balanced portfolio. One segment of the bond market in particular — municipal bonds — may be worth investing in for its tax-advantaged income.

### What Are Municipal Bonds?

Municipal bonds (or munis) are debt obligations issued by state, city, and county governments to raise money for projects such as building schools, roads, and hospitals. Like other types of bonds, municipal bonds earn money in two ways — from fixed interest payments and from principal repaid to you on a specific maturity date.

The current income bonds provide helps offset market fluctuations. The lower price volatility and low default rate they historically have offered can help investors ride out periods of stock market uncertainty. In addition, most municipal bonds offer income that is free from federal income taxes (and possibly from state taxes as well).

### Understanding Bond Investment Risks

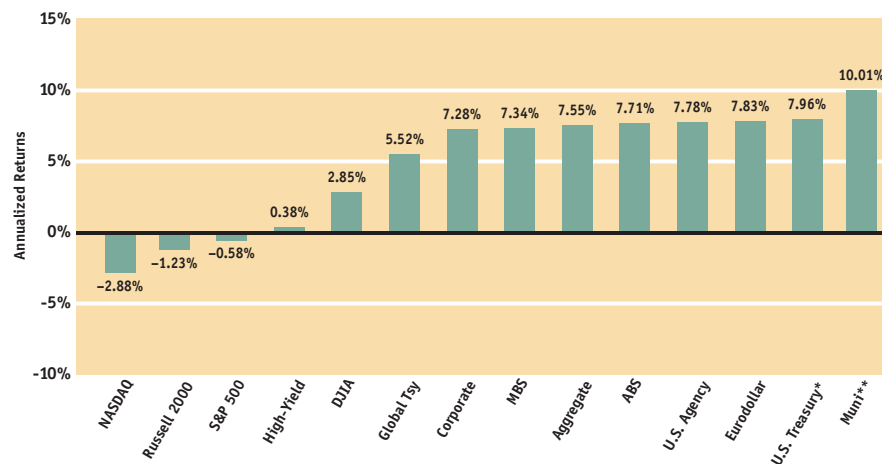
Bonds face two types of risk — credit and interest-rate risk. It is important to understand the role each plays to help determine how bonds should fit into your portfolio.

Because a municipal bond essentially is an IOU from the issuer, the issuer's underlying financial strength and its ability to repay the bond holder are important factors in a bond's credit-risk level. Rating agencies such as Moody's, Standard & Poor's, and Fitch rate bonds based on the issuer's underlying financial strength — bonds rated BBB or above are considered investment grade, those rated below BBB are high-yield bonds.

Interest-rate risk affects a bond's market price. As interest rates rise, the price of existing bonds typically decreases because the lower rate they offer is less appealing to investors. Conversely, as rates fall, the price of existing bonds typically go up.

### ASSET CLASS TOTAL RETURNS: JAN. 1, 1998 – DEC. 31, 2002

During the past five years, the taxable equivalent total returns for the Municipal Bond Index have outperformed all other asset classes.



\* U.S. Treasury income returns are exempt from state income taxes and adjusted (3.25% in 2002, 3.23% in 2001, and 3.18% prior) using a national state average (top bracket), net of federal income tax.

\*\* Based on an equally weighted national average federal and state (top bracket) income tax rate (41.85% for 2002, 42.33% for 2001, and 42.78% prior).

Source: Lehman Brothers

### Tax Advantages of Municipal Bonds

The exemption from federal income tax for municipal bond income can provide investors a significant advantage compared to a comparable taxable investment. For example, assume you are in the 38.6% tax bracket and have \$100,000 to invest in bonds. You could invest the \$100,000 in a taxable corporate bond earning 6% or a tax-exempt municipal

PLEASE TURN TO THE NEXT PAGE

## Tax-Smart Investing

CONTINUED

bond earning 4.5%. After taxes, you would earn \$3,684 on the corporate bond (\$6,000 interest – \$2,316 taxes). But the municipal bond would pay \$4,500 in tax-free interest, making its taxable equivalent yield 7.3%. (See the chart, *Comparing Tax-Exempt and Fully Taxable Bond Yields*.)

Municipal bonds historically have offered a higher total return for people in the top income tax brackets. In fact, over the past five years, municipal bond total returns were higher than total returns for any other asset class. (See the graph, *Asset Class Total Returns*.)

### Part of a Well-Balanced Portfolio

As market and economic events of the past three years have proven, keeping all of your money invested in one type of asset (such as stocks) is not normally a prudent strategy. By diversifying your investments between a variety of asset classes, you protect yourself against a downturn in one area.

The current income stream bonds generate is attractive to many investors.

Plus, municipal bonds' relatively low volatility in price due to their low default risk helps offset market fluctuations for money invested in stocks.

If interest rates begin to rise again — which they must do eventually — does this increased interest-rate risk make bonds less attractive? Rising interest rates will affect investors differently, depending on their investment goals and strategy. For investors who purchase bonds for current income and hold them to maturity, rising interest rates should not affect their strategy.

Investors who are more focused on total return may face some loss due to the declining value on the market of the bonds they are trading. For these investors, having their money in a professionally managed account — either an individual account or

### COMPARING TAX-EXEMPT AND FULLY TAXABLE BOND YIELDS

$\frac{\text{Tax-Exempt Yield}}{(1 - \text{Tax Bracket})}$	=	<b>Taxable Equivalent Yield</b>
$\frac{4.5\%}{(1 - 38.6\%)}$	=	<b>7.3%</b>

through a municipal bond fund — can help mitigate these risks.

### Experienced Guidance Important

No matter which investment strategy you follow, municipal bonds offer current income and tax advantages that aren't provided by other investments, as well as providing important diversification between asset classes in your portfolio.

Because of the inverse relationship between interest rates and price, many investors prefer to work with a knowledgeable portfolio manager. If you wish to learn more about the role municipal bonds could play in your portfolio, please call us.

### WILL BUSH'S TAX PROPOSALS AFFECT MUNICIPAL BONDS?

The Bush administration recently proposed several tax-law changes designed to make tax laws more favorable to investors, including the elimination of tax on dividends and the creation of tax-free savings accounts. Although many investors have expressed concern about how these proposals might affect the municipal bond market, they are unlikely to have a major effect because:

- Municipal bonds already give investors a relatively high yield compared to their taxable counterparts. While the municipal bond market may adjust to remain attractive to investors, it is unlikely to undergo a radical shift.
- Municipal bonds will remain attractive as an investment for protecting the safety of principal and for providing reliable fixed income streams and stated final maturities.

## TOPICS IN TAX PLANNING

# What to Invest Where

Consider how different types of investment income are taxed before allocating your investments

**By John D. Skjervem**  
Chief Investment Officer,  
Western Region – California

**D**IFFERENT TYPES OF investments result in different tax consequences. The type of account these investments are held in also affects how they are taxed. That's why it's important to consider both when planning your overall asset allocation.

### The Type of Investment

Investments in stocks and taxable bonds are taxed in two ways. First, any interest or dividend income is taxed at your ordinary income tax rate — which in 2003 can be as high as 38.6%. Second, when you sell the investment, you will pay tax on any gain you realize on the sale. If you have held the investment for one year or less, this gain will be taxed at your ordinary income tax rate. If you have held it for more than one year, the gain will be taxed at the long-term capital gains rate of 20%. If you purchased the investment after Dec. 31, 2000, and hold it more

than five years, the long-term capital gains rate drops to 18%.

Mutual fund investments may result in three types of “distributions” you must report on your federal income tax return, even if they were reinvested in the fund. Distributions of dividends, interest, and other income on securities in which a mutual fund invests are taxed as ordinary income. Distributions of profits the mutual fund makes on the sale of its investments are taxed as capital gains. Distributions of interest a mutual fund earns on tax-exempt bonds are tax-free.

Interest earned on savings accounts, money market accounts, and certificates of deposit (CDs) is taxed at ordinary income tax rates.

How a particular type of investment will be taxed isn't the only factor to consider. Also evaluate when the investment will generate ordinary income or capital gains, and how much the income or gain may be. Many stocks pay no dividends, so the only time you'll owe tax is when you

sell them at a gain. However, if you hold the stock a long time, the gain could be very large. In contrast, CDs pay interest, but never generate capital gains. Also consider the rate of return of an investment.

### The Type of Account

The types of accounts used to hold investment assets generally fall into one of three categories, each with different tax implications:

1. **Tax-free (Roth IRAs, Coverdell Education Savings Accounts [ESAs]).** You never pay tax on interest, dividends, or gains that investments in these accounts generate. In addition, you will pay no tax on distributions from these accounts as long as you follow the applicable rules, which limit the timing and amount of distributions.
2. **Tax-deferred (employer-sponsored retirement plans, traditional IRAs).** As long as you hold an investment in this type of account, you will incur no current taxes on any interest, dividends, or capital

## HOW A DIVIDEND TAX BREAK COULD AFFECT ASSET ALLOCATION CHOICES

Investors are paying close attention to the tax package President Bush announced in January, which includes a proposal to eliminate income tax on dividends. The rationale supporting this proposal is corporate income already is taxed at the corporate level, so a tax on dividends at the investor level is a double tax on the income.

Although Congress is unlikely to abolish the tax on dividends this year, it may lower the tax rate on them or create a tax exemption for a limited amount. If a tax break for dividends is passed, you may want to consult your tax and investment advisors and consider putting more dividend-producing stocks into taxable accounts, and fewer in tax-free and tax-deferred accounts.

PLEASE TURN TO THE NEXT PAGE

## What to Invest Where

CONTINUED

gains generated. However, when you make withdrawals, you will owe tax at your ordinary income tax rate — even if the income is attributable to long-term gains.

**3. Currently taxable (savings accounts, investment accounts, regular brokerage accounts, CDs).** Income and capital gains from investments held outside tax-deferred or tax-free accounts generally is taxable in the year received.

### Allocating Your Investments

All else being equal, it generally makes sense to put investments with the greatest potential for significant long-term growth — typically stocks and mutual funds invested in stocks — into tax-free accounts. Putting investments with less growth potential into tax-free accounts may waste a tax break. However, due to the differences in tax treatment discussed above, you should consult your tax and investment advisors before developing your overall investment allocation plan.

You also generally should put other high-yield investments into tax-deferred accounts to take advantage of tax-deferred compounding. You will lose the benefit

of the long-term capital gains rate, but if you have many years until you withdraw the funds, the benefits of tax-deferred compounding usually are greater.

Contributions you can make to tax-free and tax-deferred accounts are limited, but generally should be maximized before allocating the remainder of your portfolio to taxable accounts. Taxable accounts are an advantageous place for cash equivalents because the income generated will be relatively low. They also are a good repository for investments paying no interest or dividends that you plan to hold at least one year, because you can benefit from the lower long-term capital gains rate when you sell them.

### After-Tax Return Isn't Everything

With smart asset allocation, you can increase your after-tax return. Of course, tax consequences should be only one consideration. Also look at factors such as time horizon, risk tolerance, and overall investment objectives. If you would like to review your asset allocation strategy, call us. We would be happy to help you determine the best allocation for your personal financial goals.

RECEIVE MARKET SIGNALS BY E-MAIL

Please Contact Us at [pfsmarketing@ntrs.com](mailto:pfsmarketing@ntrs.com)

In the message, be sure to include your name, address, and e-mail address. Northern Trust will only use the e-mail addresses provided to us for *Market Signals* delivery.

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

The information contained in this newsletter is general in nature and is intended for informational purposes only. It has been obtained from sources believed to be reliable, but its accuracy and completeness are not guaranteed. Any opinions expressed herein are subject to change at any time without notice. Any person relying on this information shall be solely responsible for the consequences of such reliance. Because the facts and circumstances surrounding each situation differ, you should consult your investment advisor, tax advisor, and estate planning professional before taking any action based on these articles.

This newsletter is provided for informational purposes only and does not constitute an offer or solicitation to purchase or sell any security or commodity. © 2003



Northern Trust

Arizona | California | Colorado | Florida | Georgia | Illinois  
Michigan | Missouri | Nevada | Ohio | Texas | Washington | Wisconsin

[www.northerntrust.com](http://www.northerntrust.com)