

Cyclical or Structural?

Cause of Economic Weakness Will Affect Future Performance

INVESTMENT STRATEGY

What Has Changed

- ▶ U.S. economic growth slowed during the buildup to the Iraqi war, suggesting possible further weakness ahead.
- ▶ Stocks soared and Treasuries sank as the war began, but quickly reversed course.
- ▶ Falling expectations of war-related disruptions to supply pushed oil prices down sharply.
- ▶ The Federal Reserve Open Market Committee held rates steady, but did not offer a risk assessment of the economy.
- ▶ Citing concerns about a rising budget deficit, the Senate sliced President Bush's \$726 billion stimulus plan in half.

The Economic Recovery

Is Losing Momentum

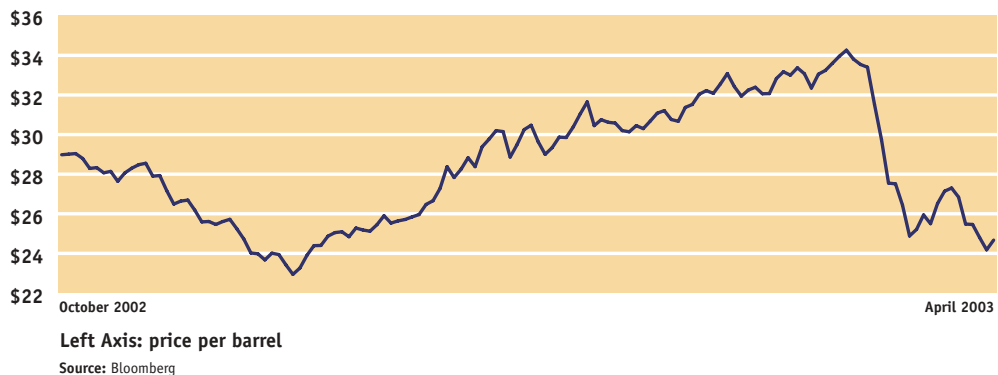
- ▶ Unprecedented post-World War II decline in household net worth, combined with high levels of debt, is restraining consumer spending.

IRAQ, NOT SURPRISINGLY, has dominated financial and commodity markets during the past month. As the conflict has evolved in favor of the United States and its coalition partners, initial volatility has been superseded by investors unwinding their safe-haven trades: selling oil, gold, and, to a lesser extent, government bonds, and

Only marginal expansion — 1% to 2% — is now expected.

Pressing questions for investors looking forward are: What is causing this economic weakness, and how will the economy perform as uncertainty about Iraq recedes? Is the current softness attributable to cyclical, and hopefully, singular causes (such as the war, psychology, poor weather,

THE RISE AND FALL OF OIL PRICES



purchasing equities and the dollar. In the process, oil and gold fell to four-month lows.

This behavior appeared almost uncorrelated with the flow of economic data, which has been uniformly weak. Most indicators — recently manufacturing, payrolls, and orders — have been disappointing and suggest the economy was weakening before the war began. Consensus forecasts for gross domestic product growth this year, particularly for the first half, have been reduced.

oil, or Severe Acute Respiratory Syndrome) or to more secular and perhaps structural problems (such as negative wealth effect or excess investment of the 1990s)?

The Federal Reserve, at least officially, is a proponent of the former: the cyclical case. Central bankers repeatedly have stressed that geopolitical uncertainties (and related premiums in oil prices) have restrained economic growth. The economic climate will improve significantly as these uncertainties lift.

ECONOMIC RECOVERY CONTINUED

- ▶ Additional monetary and fiscal stimuli are necessary to prevent economic growth from stalling.

Expect Continued Municipal Bond Market Volatility

- ▶ Slowing investor demand will pressure the market given anticipated increased supply of new issuance.
- ▶ Maintain neutral duration as valuations remain attractive vs. taxable alternatives.
- ▶ We prefer essential purpose and U.S. Treasury-backed municipal credits as fiscal stress continues.

Resolution in Iraq and Improvement in Economic Growth Needed

- ▶ Recent reductions in economic growth projections are hampering the outlook for stocks.
- ▶ We continue to favor large-cap, financially strong companies whose relative pricing power and purchasing economies help drive better profit gains.

International Markets Offer Value, but Face Slowing Economic Momentum

- ▶ Europe, particularly Germany, appears on the verge of economic contraction. Japan remains mired in policy paralysis and deflation.
- ▶ Valuations, including dividend yields, are historically attractive.

Conclusion

- ▶ Cash and government bond yields remain near post-World War II lows. Prospective returns therefore favor equities in portfolios that can tolerate heightened uncertainties and increased volatility.

Cyclical or Structural?

CONTINUED

The Fed appears prepared to cut rates further conditional on the war's progress and the related terrorism threat. The market now expects at least a 25-basis-point reduction by summer. The central bank also continues to discuss alternative stimulus options should its main policy instrument — the Fed Funds Rate — fail to produce the desired outcome.

One of the largest economic negatives before the war was the soaring price of oil. Its subsequent collapse now has become a positive. Many of the factors that disrupted oil supplies are dissipating (fear of Iraqi oil field destruction, the Venezuelan strike, and ethnic unrest in Nigeria), and there are signs that crude oil inventories are building. OPEC now is proposing an emergency meeting to reduce production to halt the recent price drop, which exceeds 30%.

Meanwhile, the rapid expansion of fiscal stimulus — both because of tax cuts and new spending — contributes to the Fed's confidence in its recovery outlook. Congress is debating additional stimulus in the new budget; the final figure probably will exceed the \$350 billion approved by the Senate but not reach the \$726 billion proposed by the Bush administration. Adding the costs of Iraq (both war and post-war), federal spending will increasingly be aggressively stimulative, and the annual deficit soon will exceed \$300 billion.

In this environment, business spending should grow, a necessary ingredient for cyclical recovery. Improvement in corporate profitability and cash flow will encourage this spending, and gradual improvement is already detectable in recent statistics — for example, profits in the National Income and Product Accounts. Profits will be supported by favorable operating leverage, greater pricing power, a weaker dollar, and lower interest rates. Operating earnings for the S&P 500, which grew only 1% in 2002, could reach \$52 per share this year (up 7.5%). Investors should begin discounting not only this possibility — which is widely disbelieved — but also the outlook for 2004, now less than nine months away.

While there are signs of increased risk taking in some markets (such as high yield and Nasdaq), investors, in general, remain risk averse — a position well understood given the level of uncertainties in the world. Those who can accept more volatility, however, should weigh carefully the return prospects offered by being an owner versus a lender going forward.

Orie L. Dudley, Jr.
Chief Investment Officer

Trusts can provide financial protection for you and your loved ones both now and after your death.

TOPICS IN ESTATE PLANNING

Controlling Your Financial Destiny

Trusts Make Flexible Financial Planning Tools

By Steve Lynch

Sr. Vice President, Chief Fiduciary Officer for Florida

TO ACHIEVE YOUR financial objectives, you need to effectively manage, invest, and eventually distribute your assets. Trusts are one of the best tools for accomplishing these goals because they offer many benefits.

What Is a Trust?

Basically, a trust is a legal relationship in which you as trust creator (the grantor) transfer property to a person or entity (the trustee) for the benefit of one or more current and future recipients (beneficiaries). Your attorney drafts the trust document spelling out your wishes for the trust's duration, the trustee's duties and powers, the distribution of trust income and principal, and the beneficiaries' rights. The trustee is legally bound to manage, invest, and distribute trust assets according to the terms of the trust document.

You can create a trust during your lifetime (commonly referred to as a living trust) or through your will (a testamentary trust). A living trust can be either revocable, meaning you can alter or terminate it — and have all the trust assets returned to you — or irrevocable, meaning you can't change it. You also can have any number of beneficiaries, including yourself. Finally, you have nearly unlimited discretion in establishing trust

provisions. As a result, a trust is an extremely flexible financial planning tool.

Protecting Financial Interests Now and After Your Death

Trusts can provide financial protection for you and your loved ones both now and after your death. During your life, you can use trusts to consolidate your assets and manage them more efficiently.

Some trusts also can protect your assets from future creditors. And, trusts provide management for your assets when you can't manage them yourself — whether you simply are on an extended vacation or you become physically or mentally incapacitated.

After your death, a trust can help ensure your spouse has someone to manage the money you put in trust. This can be especially useful if your spouse is inexperienced in managing financial matters. If you have children from a previous marriage, a trust can ensure your current spouse is provided for *and* your children ultimately receive an inheritance. You also can create trusts to provide for an elderly parent, disabled child, or other loved ones who depend on you financially

EXPLORING TRUSTS: A THREE-PART SERIES

Because trusts can play such a valuable role in helping you manage, invest, and distribute your assets, we will be taking a close look at them in this and the next two issues of *Market Signals*. In this issue, we'll focus on the many benefits they offer. In May, we'll examine several of the most useful trust types. And in June, we'll discuss how to choose the trustees that will best meet your needs.

but are unable to manage assets themselves. You can even use trust provisions as incentives for beneficiaries to achieve certain goals — such as graduate from college.

Saving Taxes

By transferring property to an irrevocable trust, you can remove it from your taxable estate — provided you follow the applicable rules. Generally, this means you can have no direct control over trust assets or distributions. Nevertheless, the terms you included in the trust agreement outline how trust assets will be managed and distributed, so you will have significant indirect control.

Transfers to irrevocable trusts are subject to gift or estate taxes, though you can apply your gift or estate tax exemption (\$1 million in 2003) to the transfer. But, because gifts to a trust are typically considered to be of “future interests,” you generally can't apply your annual gift tax exclusion (\$11,000 in 2003) to the gift unless

PLEASE TURN TO THE NEXT PAGE

Controlling Your Financial Destiny

CONTINUED

you include “Crummey” withdrawal right provisions in the trust agreement.

If you are married, you can use trusts to minimize or avoid paying estate taxes. You can allocate property equal in value to your estate tax exemption to a trust for the benefit of your spouse and your children. The trust will not be subject to estate tax at

If you have children from a previous marriage, a trust can ensure your current spouse is provided for and your children ultimately receive an inheritance.

your death or at your spouse’s death. In addition, you can allocate any assets in excess of your estate tax exemption to a trust for the benefit of your spouse that qualifies for the estate tax marital deduction. Your estate will pay no taxes on these assets at your death. The “marital trust” will be subject to estate

tax at your spouse’s death, and your spouse’s estate tax exemption could be used to offset any estate taxes. After your spouse’s death, your children could be named as the beneficiaries of both trusts.

Peace of Mind and More

As you can see, trusts can help guarantee financial security for you and your family. Not only can you be assured that your financial plan is in order and your commitments will continue to be honored — even if you are unable to manage them yourself — but you can save significant taxes. Northern Trust’s experience in asset management can help you create a plan to provide financial security for you and your loved ones. We welcome the opportunity to discuss how we can be of service.

NORTHERN TRUST NAMES WILLIAM KNAPP AS MANAGING DIRECTOR, PERSONAL INVESTMENT MANAGEMENT

Northern Trust has named William Knapp as Managing Director, Personal Investment Management. In this new position, Knapp will focus on investment strategy, asset allocation, and investment process.

“Bill brings significant experience and knowledge about asset allocation, quantitative tools, and portfolio management,” said Orie Dudley, Chief Investment Officer at Northern Trust. “His background in investment strategy along with his leadership skills will greatly enhance our ability to serve our clients in the investment arena.”

Knapp previously was Managing Director, head of global investment strategy for Citigroup Asset Management and Citigroup Private Bank. He also has taught economic and finance courses at the University of Wisconsin, University of Illinois and Northwestern University. Knapp holds a B.S. in economics from Drake University as well as an M.S. and a Ph.D. in economics and finance from the University of Wisconsin, Madison.

ACHIEVING ADDITIONAL GOALS

You also can use trusts to achieve a variety of other goals, such as:

- Maintaining privacy when assets are distributed after your death;
- Providing for charity as well as your loved ones while reducing your income and estate tax liabilities;
- Shielding life insurance proceeds from estate taxes;
- Transferring assets to minors without giving them control of the assets, yet still qualifying the transfers for the annual gift tax exclusion;
- Protecting assets from the generation-skipping transfer tax;
- Minimizing gift and estate tax on transfers of personal residences; and
- Preserving the marital deduction for transfers to a noncitizen spouse.

When you use Northern Trust to manage your investments, you benefit from our independent buy-side analysis.

TOPICS IN INVESTMENT PLANNING

Concerned About Research Bias?

Northern's Independent Research Is Free From Conflicts of Interest

By James D. McDonald
Sr. Vice President,
Director of Equity Research

WITH THE HISTORIC level of market volatility during the past three years, investors are more concerned than ever with having the information necessary to make wise investment decisions. Typically, investors access this research through their broker or investment professional, who receives it from their firm's equity research department. Yet some of this research may be biased. High-profile investigations have uncovered conflicts of interest, causing some investors to lose confidence in the objectivity of the information their broker provides. So what's an investor to do? By developing an understanding of the different types of research available, you can gauge the quality of research your investment professionals use to make decisions on your behalf.

Two Types of Research

There are two main types of equity research: buy side and sell side. In a nutshell, buy-side research is produced by analysts who work for "institutional" investors — firms that manage mutual funds, pension funds, trusts, or separately managed accounts. Sell-side research, on the other hand, typically is produced by analysts working exclusively for brokerage firms, which frequently handle both equity transactions for individual investors and investment banking for corporate clients.

Because the aims of institutional investment firms are different from those of brokerage firms, the type of research their analysts produce also is quite different. Intuitively, you may think that because individual investors are among brokerage firms' clients, sell-side research would be better suited to your needs. But this

seemingly logical conclusion is not necessarily an accurate one.

Buy-Side Research

Institutional investors' primary aim is to successfully manage investments entrusted to them by their clients. So, buy-side research analysts focus entirely on which equities will meet the investment objectives of their clients. Buy-side research can be helpful to individual investors because it identifies stocks with long-term appreciation potential — as well as identifying companies with poor outlooks. Because buy-side firms have only one type of client — investors — their research is generally independent and free from bias that might be caused trying to meet the needs of different types of clients.

Sell-Side Research

The aims of most brokerage firms are more complex, because their two

PLEASE TURN TO THE NEXT PAGE

NORTHERN TRUST'S INDEPENDENT RESEARCH CAPABILITIES

Northern Trust's nationally respected in-house staff of investment analysts provides unbiased research and recommendations on domestic and international equities. They combine their skills and experience with institutional strengths few others can match. In fact, our research is so highly regarded that more than 250 institutional money managers purchase it to guide their own investment decisions. Northern Trust analysts:

- Are assigned to specific industry groups and monitor 50 industries;
- Review 280 U.S. companies on our in-house stock guidance list;
- Perform fundamental and quantitative research;
- On average have an industry tenure of 11 years; and
- Are compensated based on accuracy of equity recommendations.

Our analysts provide critical support to our other investment professionals, who, in turn, can better help you achieve your financial goals.

Concerned About Research Bias?

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client bases — investors and investment banking clients — have conflicting interests. Basically, their investor clients want to buy stocks with long-term appreciation potential at the lowest possible price, but their investment banking clients want to raise capital by selling their stock at the highest possible price. In recent years, corporate clients have been much more profitable, and in many cases sell-side research has become more focused on the goals of corporate — rather than individual — clients, leading to a bias toward recommending the stocks of their corporate clients. This practice has led to highly publicized litigation as well as calls for reforms.

Even though individual investors are part of brokerage firms' client base and the audience for their research reports, it is important to understand the potential bias caused by the conflicting interests of their two types of clients.

The Northern Trust Advantage

The conundrum individual investors face is that the sell-side research they have relatively easy access to may not be objective, but the buy-side research that may better

suit their needs is unavailable to them. Northern Trust, however, provides a solution.

Even though you are an individual investor, when you use Northern Trust to manage your investments, you benefit from our independent buy-side analysis. If you have a trust or an individually directed investment account, your Portfolio Manager uses Northern Trust's buy-side equity research when helping you execute your investment plan. Northern Trust does not underwrite equity securities, so it has no investment banking conflicts of interest. We also use a tight control process to ensure stocks eligible for purchase have the proper research recommendations behind them. Northern also regularly reassesses the stocks it holds to ensure they still meet our investment criteria.

The Value of Independent Research

In today's volatile economic climate, independent equity research is critical to effective portfolio management. If you have questions about how Northern Trust's investment professionals use our independent research to help you achieve your financial goals, please call us.

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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.

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