

## Financial Climate Clearing

Whether a second-half economic acceleration transpires remains cloudy

### INVESTMENT STRATEGY

#### What Has Changed

- ▶ None of investors' worst fears were realized as Iraq was defeated handily.
- ▶ Equities and credit spreads rallied amid rebounding consumer confidence and favorable first-quarter earnings.
- ▶ The Federal Open Market Committee identified slow growth as the primary risk to the economy and called further declines in inflation "unhelpful."
- ▶ The dollar hit a four-year low vs. the euro in response to disappointing U.S. growth and low interest rates.

**T**HE OVERALL U.S. financial climate has improved meaningfully during the past six weeks.

This can be seen in important financial variables and asset prices (often labeled a country's "financial conditions").

- ▶ Interest rates, particularly for government and investment-grade debt, remain near 40-year lows. Credit spreads, meanwhile, also have continued to narrow. The spread rally in investment-grade corporate bonds has now set a new record, declining more than 45% since peaking in late October of last year. This improvement in credit markets has allowed broader access and increased issuance. Recently, General Motors Acceptance Corporation, for example, sold \$1 billion of five-year unsecured notes with relative ease despite a Moody's review for possible downgrade.
- ▶ The U.S. dollar has continued to weaken, particularly against the euro.

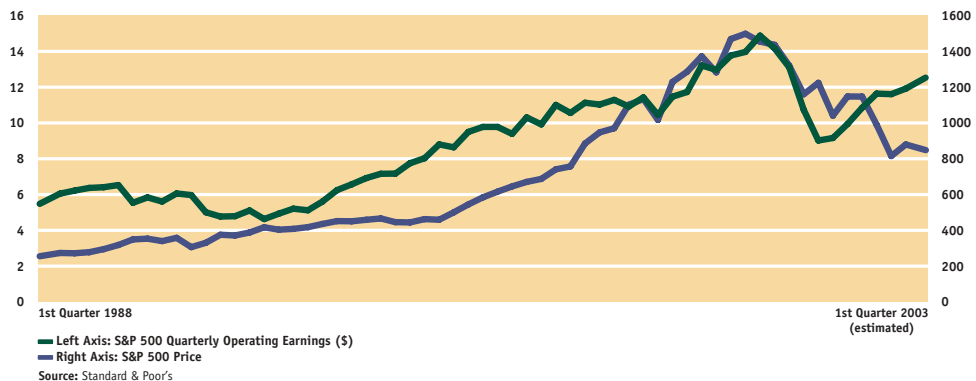
Over time, a weak currency is problematic. However, in the current economic context, it is a distinct positive because dollar weakness strengthens the U.S. global competitive position, increases reported profits through transaction gains, and enhances domestic pricing power. It is inflationary.

- ▶ Equity markets have rallied strongly off their March lows. Equity prices affect economic growth through several channels: for example, household wealth (influences consumption); the market value of capital stock relative to its replacement value (influences investment); and confidence (influences spending and investing). The stock market is one of the best leading indicators of future economic activity.

Improvement in financial conditions, to a meaningful degree, reflects the Federal Reserve's ongoing stimulative monetary policy. This policy was reaffirmed at the

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### CORPORATE PROFITABILITY SHOWS IMPROVEMENT



## Downside Risks to Forecast of Second-Half Economic Pickup

- Cyclical recovery remains below trend.
- Nature and timing of fiscal stimulus remain uncertain.
- Stimulus from currently low Fed Funds Rate is eroding.

## Demand for Municipal Bonds Expected to Improve in Coming Months

- Record new-issue supply should be absorbed easily.
- Reduced prospects for dividend tax cut likely to boost relative attractiveness of tax-exempts.
- Maintain neutral portfolio duration.

## Strength of Second-Half Recovery Key to Outlook for Stocks

- Better-than-expected first-quarter earnings have boosted investor confidence.
- Improved corporate confidence needed to accelerate second-half growth.
- We favor large-cap stocks that can generate stronger earnings growth through economies of scale and relative pricing power.

## Valuations Attractive Even if Economies Are Not

- Asian equity markets remain weak on SARS-induced economic slowdown.
- Europe, particularly Germany and France, exhibits even weaker employment and manufacturing than the United States.

## Conclusion

- Cash and government bond yields remain relatively unattractive. Prospective returns therefore continue to favor equities where volatility and uncertainties can be tolerated.

## Financial Climate Clearing

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central bank's May meeting. Although it did not again lower the Fed Funds Rate, the bank changed its risk bias toward economic weakness and, unexpectedly, signaled that higher economic growth, in the absence of inflationary pressures, would not necessarily force it to raise interest rates. An implicit change in tactical approach (targeting both inflation and deflation) suggests the Fed is a long way from raising interest rates this cycle. Markets responded positively. Bond yields and the dollar fell, while equities rose.

Meanwhile, proposals for additional fiscal stimulus are moving through Congress. All plans include tax cuts for individuals, families, and small businesses; major differences concern the treatment of dividends and capital gains. In other words, there is close agreement on the more short-term stimulative issues, but disagreement on longer-term policy and tax code issues. Additional stimulus approaching \$80 billion this year appears to be the likely outcome of the debate. When added to federal government spending, including security-related outlays and the costs of our involvement in Iraq, overall fiscal stimulus will be massive. The annual federal deficit shortly could exceed \$400 billion.

Current economic growth, however, remains sluggish. First-quarter gross domestic product (preliminary estimate) increased a lackluster 1.6%, and activity indicators, particularly for production and employment, remain weak. The central question looking forward is: What kind will the post-war recovery be? Will there

be a strong second-half acceleration or continued below-trend growth?

There are encouraging indicators, notably confidence surveys and durable goods orders. Moreover, many constraining factors have become more positive. For example, oil prices have declined more than 30% and geopolitical concerns have lessened.

Particularly heartening, both for financial markets and the economy, has been the improvement in corporate profitability and cash flow achieved in the first quarter. Year-over-year growth in S&P 500 operating earnings exceeded 12% — well above expectations. Cost cutting and productivity were major contributors, but revenues also grew (up 9% including the energy sector; up 4% excluding energy). These results have increased the probability that S&P 500 operating earnings for the full year will reach, if not exceed, \$52 per share. This outcome was viewed with considerable skepticism before recent reports.

Investor psychology and behavior increasingly have been influenced by the improvement in financial conditions, continued monetary and fiscal stimuli, and economic prospects for the second half and beyond. Risk-taking has expanded, and the search for returns has broadened. This can be seen in the performance of the NASDAQ and particularly in the performance of the high-yield bond market. A definitive end to the equity bear market — while not yet certain — appears increasingly possible.

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

TOPICS IN INVESTING

## Seeking More Diversity?

Alternative Investments Can Reduce Risk, Increase Return

**By Lori Runquist**

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**E**XPERIENCED INVESTORS KNOW a diverse portfolio is a proven strategy for reducing risk and increasing return over the long term. You likely have spread your investments across the traditional asset classes of stocks, bonds, and cash and cash equivalents and have further diversified by owning a home and perhaps a vacation home, artwork, or other collectibles. Nevertheless, if you are looking for other investment opportunities that could improve your portfolio's performance even if the market remains volatile, you may want to consider "alternative investments."

Two of the most popular alternative investment types are hedge funds and private equity. Both have a low correlation with traditional investments, which means they perform differently under the same market conditions.

But these alternatives aren't right for everyone. They are complex, so a high degree of financial sophistication is necessary to understand how they work and if they belong in your portfolio.

### Hedge Funds

Funds using techniques such as short selling, leveraged purchases, and arbitrage for hedging their exposure to down markets are known as "hedge funds." In the past 10 years, hedge funds have grown in number and size — from a few firms managing less than \$30 billion to more than 5,000 firms managing in excess of \$500 billion — providing investors with access to instruments, markets, trading styles, and hedging techniques not available in traditional portfolios. Here are three of the most important benefits hedge funds offer:

1. Hedge funds can provide downside protection to investors because managers have the ability to generate profits regardless of market direction.

2. Volatile markets may offer investment opportunities for hedge fund managers, so investing in these funds can enhance returns and reduce the overall risk of your portfolio.
3. Hedge funds use a wide array of strategies and instruments to generate returns.

### Private Equity

Since the mid-1990s, investments in privately held companies have grown in popularity among high-net-worth individuals. Because private equities aren't traded on a public exchange, there is no ready market for them and they're considered relatively illiquid. But for some investors, this is an acceptable trade-off for the potential long-term return advantages. Generally over periods of 5 to 10 years, private equity returns have exceeded the S&P 500 Index by as much as 5%.\*

Four factors contribute to private equity's success:

1. Managers of private equity funds — those that pool investor assets to buy private equity interests — often can exploit market opportunities more easily than mutual fund managers can.
2. Managers have more investment choices: There are approximately 1.3 million privately held U.S. companies with annual sales greater than \$1 million, compared to approximately 10,000 public companies.

### NORTHERN TRUST EXPANDS INTO NEW YORK

Northern Trust announced that it is expanding its private client and wealth management networks with a new office in New York City — serving clients in the Northeastern corridor. In July 2003, Northern Trust plans to open the Manhattan office at 65 East 55th Street — providing current and potential clients with a full spectrum of services, including private banking, trust, investment management, financial consulting, wealth advisory, and wealth management.

The opening of the New York office will bring Northern's personal financial services network to 84 offices in 14 states.

## Seeking More Diversity?

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3. Private equity firms often have voting control on the private companies' boards, allowing them to influence strategic and management decisions that affect investment value.
4. Private companies aren't compelled to meet quarterly forecasts, which means they can pursue long-term value more easily.

An added benefit of private equity's long-term focus is tax efficiency. Because these investments are held long-term and typically exhibit very low turnover, most — if not all — taxes you pay will be at the lower long-term capital gains rate.

### Fund-of-Funds

A fund-of-fund's portfolio offers broader diversification than a single manager or fund could achieve, without the high cost and extensive research required to invest in individual private equity or hedge funds.

A fund-of-funds combines the diverse styles and talents of multiple

private equity or hedge fund managers. The manager:

- provides thorough due diligence (disciplined investment selection);
- researches strategies and managers;
- determines asset allocation;
- monitors portfolio positions;
- manages correlation among fund managers;
- oversees risk management; and
- furnishes consolidated performance reporting and tax information to investors.

Risk essentially is spread over many underlying companies or investments with relatively low correlation to one another. In addition, the individual funds have varying investment strategies, which further disperses risk.

A fund-of-funds allows individual investors to make investments they might not be able to make on their own. For example, a fund-of-funds may have a minimum investment significantly lower than many individual funds require. A fund-of-funds also

may provide access to top funds that are closed to new individual investors.

Finally, a fund-of-funds provides administrative efficiency. The fund-of-funds manager conducts all manager research and provides professional risk management oversight. In addition, information administration and reporting is consolidated for investor convenience.

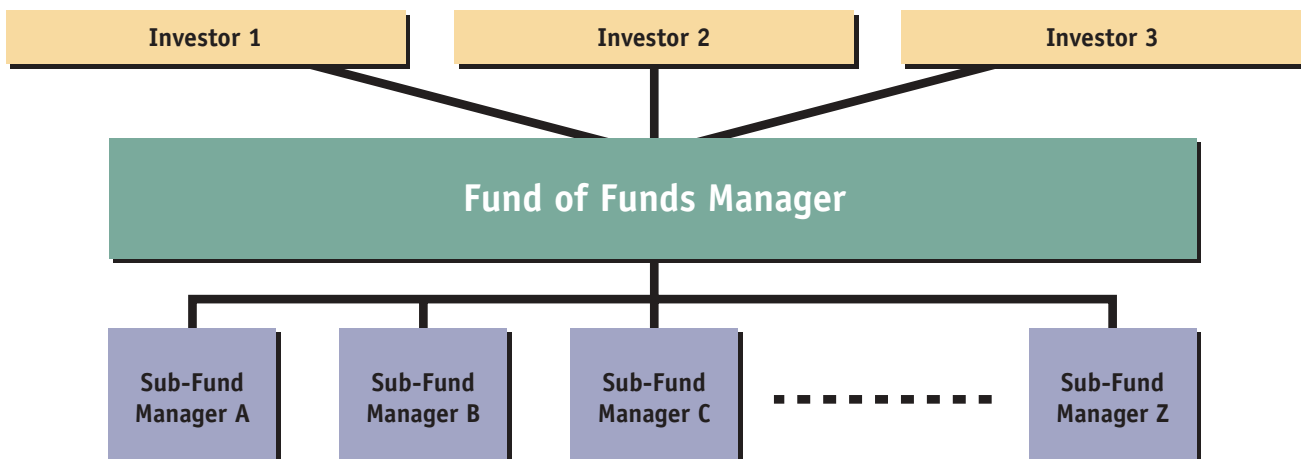
### Should Alternative Investments Be in Your Portfolio?

Alternative investments can further diversify your portfolio, reducing risk and increasing return. But the specialized nature of hedge funds and private equity makes them suitable only in specific circumstances for sophisticated investors with substantial portfolios. Northern Trust would be pleased to discuss whether and how these alternative investments might complement your portfolio.

\*Source: Salomon Smith Barney, "Private Equity Investing: Past, Present and Future," March 2001.

### FUND-OF-FUNDS INVESTING

*A fund-of-funds combines the diverse styles and talents of multiple fund managers, consolidated into a single fund for investor convenience.*



Certain trusts allow you to control the disposition of property after your death.

## TOPICS IN ESTATE PLANNING

# Trusts of Many Shapes and Sizes

How to Choose the Right Trusts to Achieve Your Goals

By Vivian K. Fleet  
Wealth Advisor

WHETHER YOU WANT to maintain privacy, protect financial interests, or save taxes, a trust may help you achieve that goal. Becoming familiar with some of the most common trusts can help you determine which ones will work best in your situation.

### Living Trusts

A living trust allows you to streamline asset management during your life, and continuing after your death. Some of the advantages of a living trust are:

- Ensuring your assets continue to be managed according to your wishes and avoiding guardianship (which can be cumbersome) if you become physically or mentally incapacitated;
- Providing privacy by avoiding court proceedings associated with either probate or guardianship; and
- Establishing an asset or investment management vehicle that can continue after your death.

### EXPLORING TRUSTS: A THREE-PART SERIES

This is the second in a three-part series discussing the valuable role trusts can play in helping you manage, invest, and distribute your assets. In April, we focused on the many benefits trusts offer. (To read the article visit [http://web1t04.ntrs.com/library/personal/mrkt\\_newsletters](http://web1t04.ntrs.com/library/personal/mrkt_newsletters)). Here we examine several of the most useful trust types. In June, we'll discuss how to choose the trustees that will best meet your needs.

How does a living trust work? You transfer assets into a trust benefiting yourself during your lifetime and your heirs after your death. You can name yourself or someone else (a loved one, professional advisor, or institution such as Northern Trust) as trustee.

A living trust is typically revocable and, regardless of whom you choose as trustee, you basically retain the same control over the trust assets as you had before you transferred them to the trust. You pay tax on the trust income as if the trust didn't exist. To be effective, the trust needs to hold all your assets. You will also need a short "pour-over" will to transfer any remaining assets to the trust when you die.

### Marital Trusts and Family Trusts

Certain trusts are not only tax-efficient ways to benefit your family, but also allow you to control the disposition of the property after your death. Two frequently used vehicles are:

1. **Qualified terminable interest property (QTIP) trust.** A QTIP trust allows you to benefit first your surviving spouse, and then your children or other heirs. With the marital deduction, no estate tax is due when the trust is funded at your death, but the entire value of the QTIP trust is subject to estate tax when your spouse dies.

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### IMPORTANT TRUST TERMS

- **Effective date.** When your trust goes into effect — either during your life (funded through gifting), or at your death (a testamentary trust, funded by bequests in your will).
- **Fiduciary.** An individual or institution responsible for acting in the best interests of another party. A fiduciary is bound by law and duty to put aside personal interests and act in good faith when making decisions for the benefit of another.
- **Guardianship.** The management by an individual or institution named by the court of the property of another person who is judged incapable of handling his or her own affairs.
- **Revocability.** The ability to alter or terminate a revocable trust and have all the trust assets returned to you. Although testamentary trusts are inherently irrevocable, lifetime trusts can be revocable or irrevocable. As a result, assets in revocable trusts are included in your estate.

## Trusts of Many Shapes and Sizes

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**2. Credit shelter or family trust.** This trust allows you to take advantage of your estate tax exemption (should you die first) while still transferring at your death assets up to the exemption amount (\$1 million in 2003) to a trust to benefit your surviving spouse and other family members. Typically, your spouse may receive trust income and, if needed, principal distributions. No estate taxes are due when the trust is funded and none are due on your spouse's death.

### Charitable Trusts

Charitable trusts provide a tax-efficient way to benefit one or more charities as well as yourself and your family. The two main types of charitable trusts are:

- 1. Charitable remainder trust (CRT).** You transfer assets to the CRT, you or your chosen beneficiary receives payments for the trust's term, and the charity receives what remains at the term's end. While you will take a charitable income tax deduction for the present value of what is scheduled to remain in the trust, you may also owe gift or estate tax on the present value of the payments from the trust if you name someone other than yourself as beneficiary.
- 2. Charitable lead trust.** This essentially is the reverse of a CRT. The charity receives payments for the trust's

term, and the beneficiary you choose receives what remains at the term's end. Typically you don't receive an income tax deduction; however, you are subject to gift or estate tax only on the present value of what remains when the trust ends.

### Dynasty Trusts

A dynasty trust allows you to take maximum advantage of the \$1.12 million generation-skipping transfer (GST) tax exemption. It can be lifetime or testamentary trust (funded by your will), and you can transfer funds to it up to the GST tax exemption amount. The beneficiaries have restricted access to the trust assets, which protects the assets from estate taxes at the beneficiaries' deaths. Thereafter, the trust continues to exist generation after generation — estate- and GST-tax free. Only 15 states, including Illinois, do not limit dynasty trusts' duration. If the trustee is located there you may establish trusts in these states without being a resident.

### Many Different Trusts, Many Different Benefits

These are only a handful of the many trust types and we've only touched on some of their specific benefits. To learn more about how different trusts can help you achieve your goals, please contact us. Northern Trust's experienced professionals would be happy to help you find the trust that can best meet your needs.

**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.

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