

Bear Market Over?

Financial conditions continue to improve, future indications positive

INVESTMENT STRATEGY

What Has Changed

- ▶ The \$350 billion U.S. tax cut boosts the effect and accelerates the timing of fiscal stimulus.
- ▶ The yield curve flattened and Treasury rates fell to a 45-year low amid deflation debates and weak global economic growth.
- ▶ The euro rallied past its launch level on indications the Bush administration is willing to let the dollar weaken.
- ▶ Terrorist attacks on soft targets suggested al Qaeda is regrouping.

The Economic Outlook Is Improving

- ▶ Scheduled tax cuts represent an estimated 1.5% of gross domestic product for the next 12 months.
- ▶ By signaling its intent not to raise interest rates anytime soon, the Federal Reserve effectively has eased policy.
- ▶ The dollar's depreciation should aid the depressed manufacturing sector.

FINANCIAL CONDITIONS IN the United States continue to improve: interest rates and spreads have declined, the dollar has weakened, and equity prices have risen. This is the policy trifecta long sought but only recently achieved by the Federal Reserve, with assistance from Congress and the Treasury.

Congress passed an investor-friendly Federal tax-cut package. The bill's centerpiece was a tax reduction on both stock dividends and capital gains, which significantly enhances prospective returns from equities during the longer term.

The bill also provides meaningful economic stimulus, certainly in the short term, and possibly much longer if various temporary provisions are ultimately extended. As written, the new legislation will supply nearly \$200 billion of stimulus during the next 18 months. And if these provisions are extended beyond their

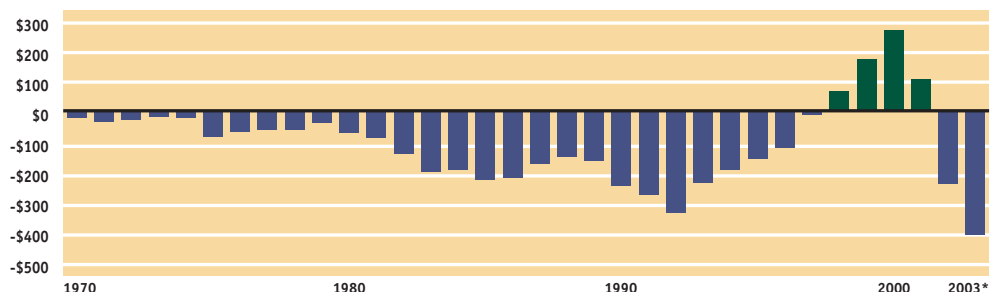
various sunset dates, it will *more than double* the law's official \$350 billion total cost. The near-term boost to the economy's growth rate could reach, if not exceed, 1.5%.

Treasury Secretary Snow, meanwhile, redefined the government's official strong-dollar policy at a May meeting of the Group of Eight. In the past, this policy meant the desire for a strong dollar versus other currencies. Snow defined "strong" to mean a measure of the currency's acceptability for commerce and how difficult it is to counterfeit. The Secretary didn't mention the dollar's market value against other currencies.

Currency markets correctly interpreted this new definition as a willingness to allow the dollar to fall against other currencies, without Treasury intervention in exchange markets. The Treasury's focus, it now appears, is to expand international dollar liquidity, in the process improving

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FEDERAL BUDGET DEFICIT SOARS



Left Axis: Federal surplus or deficit (x\$1 billion)
 *Estimate for 2003 fiscal year
 Source: Haver Analytics, Bloomberg

Narrow Trading Range Expected for Municipal Bonds

- ▶ President Bush's tax cuts likely to keep municipal after-tax ratios attractive.
- ▶ A typical seasonal surge in issuance should be met by strong demand.
- ▶ Focus on high-quality credits as budget deficits continue despite \$20 billion relief from the tax bill.

Prospects for Stocks Improving Along With Economic Outlook

- ▶ Low-yielding bond and cash alternatives, as well as tax reform, increase the attractiveness of equities.
- ▶ Acceleration in growth key for sustained equity performance.
- ▶ Favor large-cap stocks in the current environment.

International Outlook

- ▶ The European Central Bank cut its benchmark rate by 50 basis points as economies stalled and inflation fell.
- ▶ The euro reached its highest level versus the dollar since its introduction four-and-a-half years ago.

Conclusion

- ▶ Current yields and prospective returns justify an increased equity exposure where volatility and uncertainties can be tolerated. We would reduce cash holdings an additional 5%, investing the proceeds in high-quality, dividend-paying equities.

Bear Market Over?

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domestic manufacturing and countering deflation tendencies.

The Fed itself, meanwhile, continued shifting tactics to revive the economy — moves first suggested at the bank's May meeting. Chairman Greenspan and other board members have focused attention on the possibility of deflation and its corrosive effects and the need for pre-emptive action. For example, Greenspan recently suggested that the bank knows "so little" about fighting this problem that it was "inclined to be taking out insurance against economic weakness." The market had already priced in a high probability of another Fed easing prior to these comments. Since then, the futures market has fully discounted a Fed Funds Rate cut of at least 25 basis points in late June.

Beyond the likelihood of further stimulus in the short term, the Fed's new focus implies interest rates are likely to remain low longer than conventional analysis would suggest. Markets now expect the Fed to delay raising rates until the second half of 2004. Clearly both the Federal Reserve, and now the Treasury, have the same policy objective: expand global dollar liquidity to revive the economy and reverse any drift toward deflation.

The improvement in financial conditions (rates, currency, and equities), combined with record monetary and fiscal stimulus, appears poised to produce a much stronger economy. Indicators are only beginning to reveal a postwar bounce in current activity, but forward-looking indices are increasingly encouraging. The manufacturing and

nonmanufacturing Institute for Supply Management surveys, particularly the new order components, rose solidly in May.

Only solid gross domestic product (GDP) growth may prove insufficient from a policy perspective, given the current slack in the economy. GDP growth must exceed a 3% annual rate to begin absorbing unemployed resources (people and capacity) and to counter the acknowledged benefits of increased productivity. Very aggressive monetary and fiscal policies, at this stage, appear amply justified.

Fortunately the 3% growth threshold is likely to be exceeded, beginning in the second half of this year. Estimates for GDP growth and earnings going forward — for the first time in a long time — are increasing.

Improving financial condition, stimulative policies, and the prospect of strong economic growth suggest the equity bear market is finally over. This is confirmed technically: market averages have broken out of various resistances (bear market trendline, 200-day moving average, 10-month trading range), and, while over-bought on a short-term basis, still possess meaningful upside potential.

We would take advantage of this technical and more important fundamental opportunity by reducing cash holdings an additional 5% and investing the proceeds in high quality, dividend-paying equities.

Orie L. Dudley Jr.
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The new tax initiative is a reminder to refocus on long-term investment goals.

TOPICS IN TAX PLANNING

Tax-Wise Investing – Implications of the 2003 Tax Act

By Grace Allison & James P. Teufel
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NATIONAL OPINION IS split over whether this May's tax cut is a triumph of reason or an impressive exercise of political power. For investors, the Jobs and Growth Tax Relief Reconciliation Act of 2003 is important because it:

- reduces the four top income tax rates — effective Jan. 1, 2003 — for individuals, trusts, and estates:
- | from | to |
|-------|-----|
| 38.6% | 35% |
| 35% | 33% |
| 30% | 28% |
| 27% | 25% |
- reduces the top long-term capital gains rate for individuals, trusts, and estates from 20% to 15%, effective for sales on or after May 6, 2003; and
 - creates “qualified dividend income,” a new category of investment income taxed to individuals, trusts, and estates at 15%, effective Jan. 1, 2003.

New After-Tax Yields of Major Asset Classes

High-income investors are now focusing on new after-tax yields for major asset classes. The chart on the next page shows how the Act changes the after-tax yield of some familiar asset classes, favoring maximum growth portfolios over income portfolios by significantly increasing the after-tax yield of equities.

EXPLORING TRUSTS: A THREE-PART SERIES

In the April issue of *Market Signals*, we began this three-part series with a discussion of the many benefits trusts offer. Part two, in the May issue, looked at choosing the right trust to achieve your goals. The third part, discussing how to choose the trustees that will best meet your needs, has been postponed until the July issue so that we can bring you this article. (To read the first two articles, visit http://www.northerntrust.com/library/personal/mrkt_newsletters/index.html)

Reaction to the New Yield Dynamic

How will the marketplace react to this new yield dynamic? Some suggest a strong future demand by taxable investors for dividend-paying stocks, and perhaps a return by issuers to “traditional” preferred stock. With some important exceptions, dividends paid by domestic corporations and “qualified foreign corporations” (including stock/ADR traded on a U.S. exchange) are eligible for the new 15% rate. Not unexpectedly, the generally higher yielding “hybrid preferreds” do not qualify: these hybrids are equities in name only, with payments based on a stream of interest payments from the parent corporation.

Since traditional IRA and pension plan distributions (whether from interest, dividends, or capital gains) are taxed at ordinary income tax rates, investors may allocate taxable bonds to these portfolios — and equities to other personal accounts.

The potential for future appreciation may be more important to total investment return than current after-tax yield. Balanced against the desire for growth is the search for

safety — there will still be investors in high quality tax-exempt bonds.

Reaction to New Income Tax Uncertainties

As they assess a new yield dynamic, thoughtful investors must also face new extremes of income tax uncertainty. The Internal Revenue Code has always been subject to change — by legislation, regulations, administrative action, and court decisions. What is new is the extent to which basic income tax provisions are now riddled with scattershot effective dates, transitional rules, and sunset provisions, any one of which can be repealed, made permanent, or extended. In today's environment, future *inaction* by Congress — as well as future action — will affect future after-tax investment yield. This is a risk investors must consider.

For example, our new maximum 15% capital gains rate, effective for sales on or after May 6, 2003, currently terminates Dec. 31, 2008. This 2008 “sunset” might be extended — or it might be accelerated into 2005, 2006, or 2007. Investors wanting certainty may “capture” the current 15% rate by recognizing

Tax-Wise Investing – Implications of the 2003 Tax Act

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long-term gains now. What if an appreciated asset remains attractive from an investment perspective? Investors can “upcost” by selling and then repurchasing all or a portion of a position at the current market price. The wash sale rule (which prevents investors from recognizing losses if they repurchase a security within 30 days) does not apply to gains.

Other investors may not be able to take immediate advantage of the new 15% capital gains rate. Many have substantial capital loss carryforwards that will absorb any gains recognized in 2003. Today’s lower capital gains rates make existing capital loss carryforwards less valuable.

The New 15% Dividend Rate

Many investors are slowly realizing the new 15% dividend provisions are far less simple than they seem. Key to mastering these rules is recognizing that the new Act favors long-term investors and is much less kind to speculative traders who are “in and out” of the market.

This bias to long-term investors is evident in the capital gains provisions. Under prior law, the maximum long-term capital gains rate (at 20%) was 18.6 points lower than the highest marginal short-term capital gains rate (then 38.6%). Under the Act, short-term investors are even more severely penalized with a maximum short-term

capital gains rate (35%) more than twice the maximum 15% long-term capital gains rate.

The new 15% dividend rules also target investors seeking to avoid the risk of loss. To qualify for the 15% dividend rate, taxpayers (a) must have held the underlying stock for more than 60 days during the 120 day period that begins 60 days before the ex-dividend date and (b) must not be obliged to make “related payments with respect to similar or identical property,” such as in a short sale. Importantly, the required 60 day holding period does not include any day on which the investor diminishes the risk of loss on the underlying

	Maximum Growth Portfolio						Income Portfolio					
	Portfolio Makeup	Before-Tax % Yield	Tax Rate	After-Tax % Yield	Income Amount	Portfolio Percent	Portfolio Makeup	Before-Tax % Yield	Tax Rate	After-Tax % Yield	Income Amount	Portfolio Percent
Before the 2003 Tax Act												
Equities	850,000						300,000					
Recognized Capital Gain		7.00%	20.00%	5.60%	47,600	79.77%		7.00%	20.00%	5.60%	16,800	45.73%
Qualified Dividend Income (S&P 500 Avg.)		1.74%	38.60%	1.07%	9,081	15.22%		1.74%	38.60%	1.07%	3,205	8.73%
		8.74%		6.67%	56,681	94.99%		8.74%		6.67%	20,005	54.46%
Bonds (Interest)												
10-Year AAA Corporate	50,000	3.75%	38.60%	2.30%	1,151	1.93%	300,000	3.75%	38.60%	2.30%	6,908	18.80%
10-Year AAA Municipal	50,000	3.07%	0.00%	3.07%	1,535	2.57%	300,000	3.07%	0.00%	3.07%	9,210	25.07%
Cash												
Taxable Money Market	50,000	1.00%	38.60%	0.61%	307	0.51%	100,000	1.00%	38.60%	0.61%	614	1.67%
Totals	1,000,000				59,674	100.00%	1,000,000				36,737	100.00%
After the 2003 Tax Act												
Equities	850,000						300,000					
Recognized Capital Gain		7.00%	15.00%	5.95%	50,575	76.37%		7.00%	15.00%	5.95%	17,850	45.24%
Qualified Dividend Income (S&P 500 Avg.)		1.74%	15.00%	1.48%	12,572	18.98%		1.74%	15.00%	1.48%	4,437	11.24%
		8.74%		7.43%	63,147	95.35%		8.74%		7.43%	22,287	56.48%
Bonds (Interest)												
10-Year AAA Corporate	50,000	3.75%	35.00%	2.44%	1,219	1.84%	300,000	3.75%	35.00%	2.44%	7,313	18.53%
10-Year AAA Municipal	50,000	3.07%	0.00%	3.07%	1,535	2.32%	300,000	3.07%	0.00%	3.07%	9,210	23.34%
Cash												
Taxable Money Market	50,000	1.00%	35.00%	0.65%	325	0.49%	100,000	1.00%	35.00%	0.65%	650	1.65%
Totals	1,000,000				66,226	100.00%	1,000,000				39,460	100.00%

security. Translation: some hedging strategies will make the 15% dividend rate unavailable to investors. Strategies that apparently will not disturb the holding period include “qualified covered calls” and “significantly” out of the money options.

Mutual Fund Investing Under 2003 Act

In one sense, mutual funds present the ultimate test of how well we understand the new law. When, for example, will a dividend from a mutual fund be qualified dividend income? Will equity funds have qualified dividend income this year? What about money market funds? Do mutual fund dividends get the benefit of the new maximum capital gains rate? For answers, look to what has happened at the fund level.

Capital gains dividends from mutual funds are generally taxed at 15% only if gains at the fund level are attributable to sales on or after May 6, 2003. Equity mutual funds will have capital gains dividends in 2003 only if their capital gains in 2003 exceed their capital loss carryforwards. What about ordinary income dividends? If qualified dividend income has been received at the fund level, then that portion of the fund's ordinary income dividend attributable to qualified dividend income will be taxed at the 15% rate. Money market funds and bond funds will not generate qualified dividend income.

Dark Side of Rate Cuts: Deductions Are Worth Less

Because of the significant capital gains rate cut, capital losses are worth less. Similarly, because of income tax

rate cuts, there is a decline in the value of deductions that offset income — including investment interest, mortgage interest, and charitable contributions.

Investment interest. Under prior law, investors could deduct investment expense (including amounts paid in lieu of dividend by short sellers or participants in securities lending) to the extent of their investment income. Now, investors face an unpleasant choice: either excluding otherwise “qualified dividend income” from the investment income equation or losing the benefit of the 15% rate.

Mortgage interest. As the after-tax cost of borrowing rises, the desirability of incurring debt decreases.

Charitable deduction. Charities and charitable donors are seeing reduced tax benefits for current charitable contributions and existing charitable contribution carryforwards.

Things could be worse. As enacted, the tax cut reduces the four highest income tax rates and expands the brackets for the two lowest rates. It does not exclude an entire category of income from tax (as, for example, the exclusion proposal would have). This distinction is important because the individual income tax charitable deduction is limited by adjusted gross income (AGI). Exclusions reduce AGI; rate cuts and bracket expansions do not.

Recompute Estimated Income Tax Payments

With lower capital gains and dividend rates, individual investors may decide to reduce estimated income tax

payments due Sept. 15 and Jan. 15, giving them more cash in hand. The Treasury Department has already published new withholding tables for wage earners. These schedules are prospective only, increasing the possibility that many individuals will claim significant refunds in 2004. To avoid making an interest-free loan to the IRS (in the form of overpaid income tax), take the time to recompute third-quarter estimated income tax payments, remembering that each investor's estimated income tax situation is different.

To avoid penalties for underpayment of estimated income tax, trusts typically base their estimated income tax payments on last year's tax or on this year's annualized income. For trusts using an annualized income approach, the June 15, 2003, payment takes into consideration income or payments from January through April — a time period prior to the effective date of the 15% capital gains rate. Trusts, like individuals, should reconsider third-quarter estimates in 2003.

In estimated income tax planning, as in general income tax planning, involve income tax return preparers and run the numbers for alternate scenarios. Individuals and trusts can expect additional complexity on their 2003 income tax returns, with new lines on Forms 1099 and Schedule D for income and gains subject to different rates and recognized under different tax regimes.

AMT Forever

Dividends and capital gains taxed at 15% will not increase alternative minimum tax (AMT) liability. This

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tax-favored income is also subject to a 15% rate under the AMT. Other factors, however, such as lower ordinary income tax rates, a larger standard exemption for married couples, and increased state income tax will cause more individuals and trusts to pay AMT in 2003. A small increase in the AMT exemption, effective during 2003 and 2004, is a partial, short-term response.

The Big Question: What Will the Future Bring?

In a world where the paperback version of the Internal Revenue Code runs on for 14,000 pages, it is no surprise that income tax planning is heavily dependent on tax preparation software. Publishers have not yet created programs reflecting the 2003 Act. Virtually everyone is waiting for regulatory and administrative clarification from the IRS — and for advance versions of the 2003 Forms 1040 and 1041, typically released in the fall. It will be months before tax professionals are fully equipped to analyze specific income tax situations.

Meanwhile, the bare-majority passage of the Act and the desperate financial situation of state finances mean even more federal and state income tax changes may arrive shortly. For example, less than two weeks after President Bush signed the tax bill into law, Congress was considering

TAKING ADVANTAGE OF THE NEW RULES

To make the most of the 2003 Tax Act:

- Reconsider asset allocation.
- Know which of your securities and mutual funds produce qualified dividend income.
- Think about “capturing” the 15% maximum capital gains rate by reducing concentrations and recognizing long-term capital gains.
- Get expert tax advice before entering into hedging strategies and securities lending transactions.
- Tape the new holding period rules for qualified dividend income to your desk.

legislation to extend the child credit provisions to low-income (too poor to pay income tax) and middle-income (too wealthy to otherwise qualify for the credit) families. Meanwhile, states are tinkering with their tax laws to generate more revenue. California, for example, has passed new anti-Enron tax shelter legislation. Where all of this will end is unclear. By focusing on the current status of the tax law in 2003, investors and their advisors are doing the best they can in uncertain times.

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