

Profit Revival Underway

Stage is set for surprisingly good earnings reports

INVESTMENT STRATEGY

What Has Changed

- ▶ Global stock prices eased from 2003 highs and bonds rallied despite strengthening gross domestic product and earnings forecasts.
- ▶ G-7 nations pushed for more flexible exchange rates to help fix global trade imbalances, raising fears that foreigners might pull back from investing in U.S. assets.
- ▶ OPEC's surprise move to cut production reversed a welcome decline in oil prices.
- ▶ The collapse of Cancun's WTO talks and the United States' further push away from the United Nations highlighted a global drift toward protectionist and isolationist tendencies.
- ▶ Corporate governance concerns resurfaced with the SEC's investigation of the mutual fund industry and a compensation scandal at the NYSE.

THE ANTICIPATION OF profit is the fundamental driver of business investment and equity valuations. The strong revival in U.S. corporate profits — currently gaining momentum — is therefore very good news for the economy and the stock market.

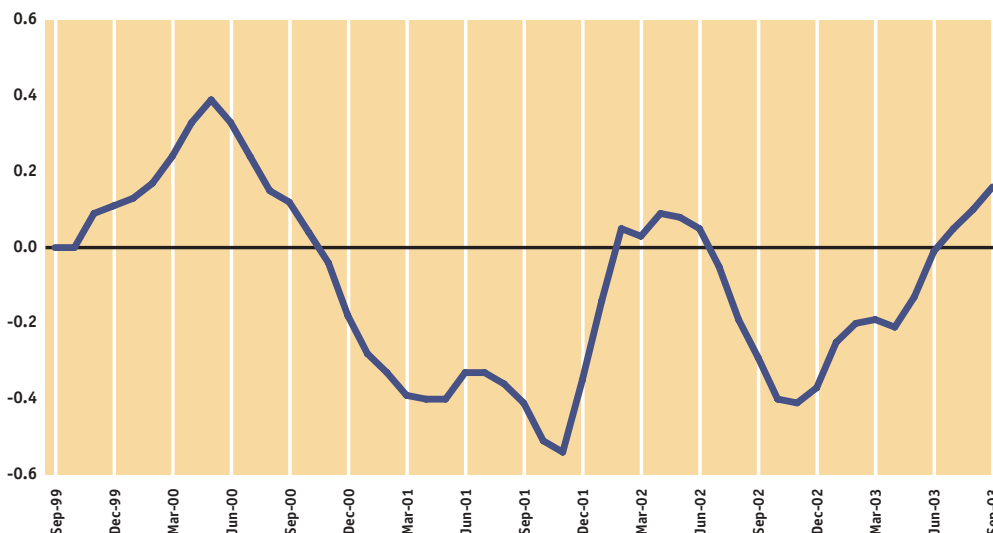
This profit revival has been increasingly visible and impressive as the year has progressed. In the second quarter, for example, after-tax profits for all corporations reached their highest share of gross domestic product (GDP) since the 1960s (excluding the remarkable surge in 1996-1997). This improvement is largely attributable to cost cutting and productivity gains as revenue increases were constrained by below-average economic growth.

With economic activity now accelerating, and indications that pricing power may be returning to some sectors, the stage is being set for surprisingly good earnings looking forward. The recently completed third quarter should provide an excellent base: corporate profits are expected to have been the best in three years. Negative pre-announcements and management confessions that profits will not reach market expectations were far fewer than normal. Instead, a high percentage of companies apparently will make their numbers — numbers that have, uncharacteristically, been raised as the quarter proceeded.

These results will influence business behavior going forward. Management is currently formulating next year's operating, staffing, and capital budgets. The revival in

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EARNINGS REVISIONS CONTINUE TO IMPROVE



— S&P 500 3-month moving average (3MMA)

Note: 3-month moving average of the following ratio: (Upward Revisions - Downward Revisions)/Total Revisions

Source: FactSet, I/B/E/S

Long-Run Trend Growth Is Expected Through 2004

- Tax cuts are buoying consumer spending.
- Low inventories, a weaker dollar, and strong corporate profits are aiding manufacturing.
- Employment growth is likely to resume soon.

Municipal Market Outperformance Expected to Temper

- Municipal versus U.S. Treasury yield ratios in 2-15 year maturities are close to one-year lows.
- Supply is expected to increase for the rest of the year.

Strong Profit Growth Expected to Support Stock Gains

- Strong cash flows are leading to increased dividends and should support hiring and capital expenditure gains.
- Cyclical stocks should continue to outpace the broad market.

International Outlook

- Yen and euro appreciation may constrain economic recovery in Japan and Europe.
- Koizumi's re-election is a positive sign for genuine economic reform in Japan.

Conclusion

- Strongly improving profitability argues for overweighting stocks where the risks of equity investing can be tolerated.
- Bond markets present limited opportunities for capital appreciation as the interest rate cycle turns unfavorable.

Profit Revival Underway

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profitability should increase confidence and encourage higher investment against this background of improving performance.

During this cycle, business has been reluctant to add employees, build inventories, or expand capacity. This hesitancy has recently been subsiding, if only gradually. For example, business investment increased 7.1% in the second quarter, and overall employment appears to have bottomed out in September as new hirings resumed. Inventories, nonetheless, have continued to contract, bringing the inventory-to-sales ratio to record lows. Inventory rebuilding, expected to begin shortly, will therefore be a powerful addition to GDP growth during the next six months.

Increased investment in operations, people, and capacity will be an important contributor to the business cycle going forward. The current cycle, until now, has been driven by consumption and housing, the direct beneficiaries of record monetary and fiscal stimulus. As consumer spending slows (probably back to trend), business investment should materialize to allow the economy to expand at a sustainable rate.

Many fear such a typical progression might not occur this cycle because of the aftermath of the late-1990s bubble, geopolitical risks, and imbalances in the economy. The revival of profits underway, and accompanying renewal of business confidence, should alleviate this concern. The economy, after an above-trend second half in 2003, should grow at a sustainable 3.5% through 2004, if not beyond.

Equity markets have been signaling improved fundamentals. The S&P 500, for example, has risen 34% from its low 12 months ago. Importantly, this recovery, while impressive, is actually below the median performance of the S&P after prior bear markets. Despite the rally, many investors remain skeptical — their perceptions “anchored,” as behavioral economists would say, in the problems that caused the preceding bear market.

This perception should change as fundamentals continue to improve, particularly if profits exceed expectations, which is likely given the earnings leverage now built into the system. Consensus estimates for 2003 (now \$54.00+ per share) and 2004 (\$61.00+ per share) have been gradually rising, but probably underestimate this leverage.

The stock market directly benefits from rapid growth and higher profits. The case is less clear, and often the opposite, for debt markets. Credit spreads may narrow and defaults should lessen, but pressure on interest rates will probably grow. This will be especially true if economic growth is accelerating at the same time government deficits are widening and central banks are attempting to reflate the system.

We would continue to overweight stocks in portfolios where the risk of equity investing can be tolerated.

Orie L. Dudley Jr.
Chief Investment Officer

For most people, rolling over funds from old retirement plans into an IRA is the best option.

TOPICS IN RETIREMENT PLANNING

Consolidate Your Retirement Plans

Consolidation Can Provide an Opportunity to Improve Performance

By Jerome B. Simon
Managing Executive

RETIREMENT PLANNING DOESN'T end once you've made your contributions; you need to continue to take steps to maximize your retirement funds. Whether you already have retired or simply have changed jobs, you probably are holding your retirement savings in multiple accounts. In turn, each account likely is invested in multiple funds. As a result, you may be suffering from limited investment options, redundant holdings, below-average returns, and unnecessary fees. For these reasons and more,

consolidating your plans into one rollover IRA provides an opportunity to improve the performance of these investments.

Why Alternatives to Consolidation Are Less Than Perfect

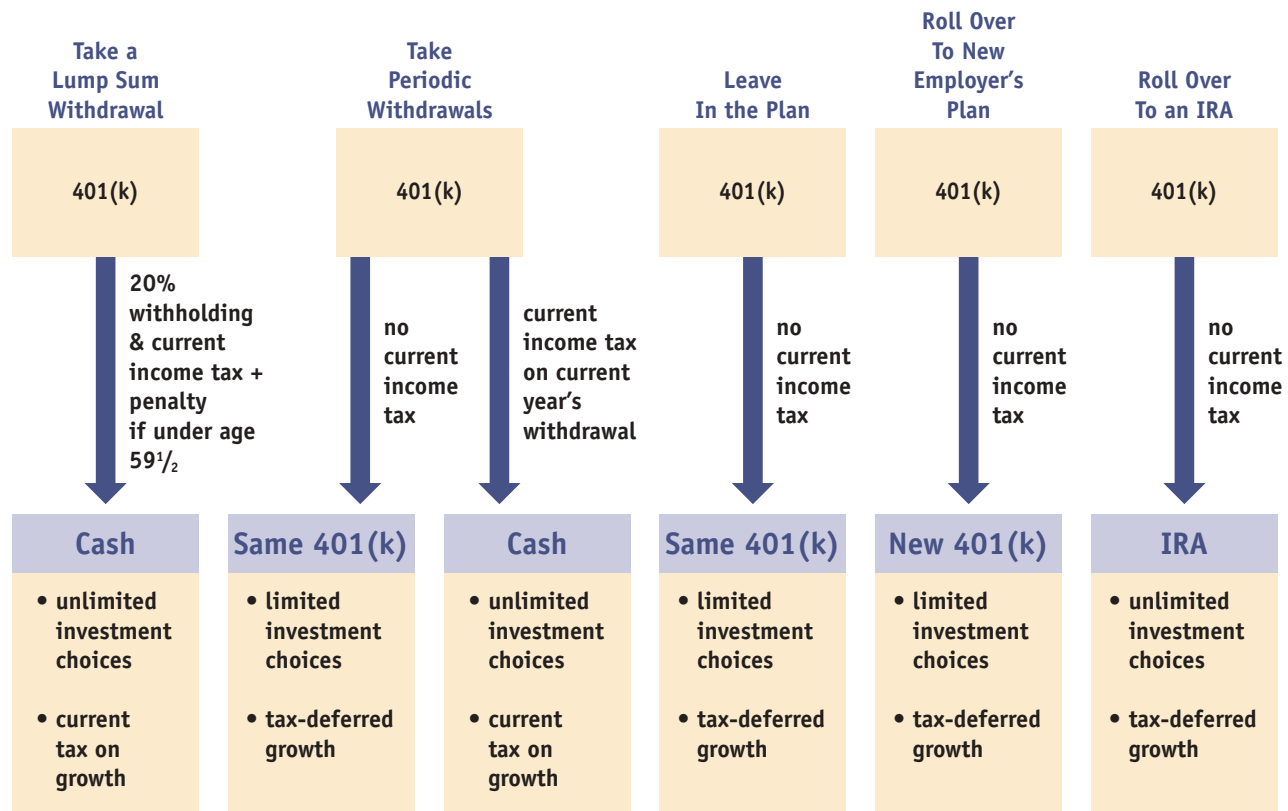
For employer-sponsored defined contribution plans, such as 401(k) and 403(b) plans, exiting and former employees typically have several options in addition to rolling over funds into an IRA, but all have downsides:

Take a lump sum. Although this allows you complete control over how to invest the plan assets, it generally is

not a good option because your money no longer will grow tax-deferred. In addition, there is a 20% mandatory withholding tax and current income tax liability on contributions and growth. In most cases if you're under age 59½, you also will owe a 10% early withdrawal penalty.

Take periodic withdrawals. If substantially equal payments are scheduled for a period of 10 years or more or your (or your and your beneficiary's) lifetime, the 20% withholding tax doesn't apply. You will owe income tax on the payments as you receive them. Nevertheless, the

COMPARING OPTIONS WHEN CONSIDERING RETIREMENT PLAN CONSOLIDATION



Consolidate Your Retirement Plans

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period of tax deferral may be more limited than under other options. Perhaps more critical, amounts that haven't been paid out are tied up in the retirement plan's investment choices. Finally, if you have a retirement plan from a previous or new employer (or an IRA), you will have multiple plans to monitor.

Leave assets in the plan. Although your assets can continue to grow tax-deferred until you are required to take distributions, your investment choices are limited to those offered by the plan. As with periodic withdrawals, this may leave you with multiple plans to deal with.

Roll over to the new employer's plan. If you are switching jobs rather than retiring, this option offers some benefits. Funds rolled over to a new employer's plan are not subject to the mandatory withholding tax or current income tax. You also won't have to worry about monitoring multiple plans (unless you also have an IRA), while continuing to enjoy tax deferral. But, the problem of being limited to the plan's investment options remains.

The Benefits of Consolidation

For most people, rolling over funds from old retirement plans into an IRA is the best option. (Generally, however, it is advantageous to continue to contribute to the plan sponsored by your current employer because contribution limits are higher than for IRAs and your employer likely matches a portion of your

contribution.) Consider these four benefits of consolidation.

Consolidation:

1. Avoids mandatory penalties for withholding and current income tax;
2. Provides continued tax-deferred growth;
3. Allows you to "simplify" the process, focusing on managing one retirement plan (two if you're still employed) via consolidated financial information and reporting;
4. Most importantly, gives you control over your investment options, allowing you to be better positioned to effectively manage risk and improve performance, taking into account your specific financial goals and objectives.

If you have multiple IRAs, consolidating them also can make sense. Not only does it make management easier, but it can reduce your fees in some cases.

Finding the Best Solution for You

If you decide to consolidate your retirement plans into one IRA, you can choose from a wide variety of investment options based on the size of your rollover IRA and your risk tolerance and financial goals. Here is a closer look at a few of these options:

Individually managed portfolios.

For large rollover IRAs, you have the additional benefit of being able to construct a portfolio of individual securities that is custom tailored to meet your specific needs and priorities

such as managing to specific time horizons, risk tolerances, liquidity needs, return expectations, income needs, etc.

Self-directed brokerage investment.

Most employer-sponsored plans don't give you the opportunity to invest directly in securities (except perhaps in the employer's stock). If your rollover IRA is moderately large, you may be able to hold — and trade — specific stocks and bonds, giving you even more control over how your money is invested. And because the securities are held in a tax-deferred account, you won't owe current income tax on any gains from your trades. (Of course, you also won't be able to take any losses against your current taxable income.)

Mutual funds. Employer-sponsored retirement plans usually offer several mutual fund options, however an IRA can provide even more choices so that you can select the funds that are best suited for your asset allocation strategy.

Certificates of deposit (CDs) and money market accounts. These FDIC-insured cash investments typically are not available in employer-sponsored plans (though money market funds may be). For CDs, you can select the timeframes that meet your needs.

Should You Consolidate?

By consolidating your retirement accounts, you can continue to enjoy the benefits of tax deferred investing while taking more control of how your money is invested and even

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If you have multiple IRAs,
consolidating them also can make sense.

Consolidate Your Retirement Plans

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reducing your fees. Your Northern Trust Relationship Manager would be pleased to discuss your particular

situation and how consolidating your retirement plans can help

you improve performance and achieve your financial objectives.

DON'T FORGET ABOUT THE ROTH IRA OPTION

Roth IRAs allow you to enjoy *tax-free* growth on your retirement savings. You can't, however, directly roll over funds from an employer-sponsored plan to a Roth IRA. But you can roll them into a traditional IRA and convert that to a Roth.

A conversion to a Roth IRA may be beneficial if you can leave the assets in the account for many years, because the tax-free growth could be significant. Because you aren't required to take any distributions during your lifetime, it also can be advantageous if you plan to bequeath the account assets to your children or other loved ones. That means a larger nest egg for your beneficiaries — one that can continue to grow tax-free as long as there are assets in the account. Finally, if you plan to work well beyond typical retirement age, you may want to consider a conversion. Why? Regardless of whether you're still working, you can't make contributions to a traditional IRA after age 70½, but you can make non-deductible contributions to a Roth IRA if you have earned income equal to the contribution amount and meet certain income requirements and other contribution limits.

The catch is that to qualify for the conversion, your adjusted gross income (AGI) for the year you want to convert your IRA (not including the conversion amount) must be less than \$100,000. If you're still working, keep in mind that even though your income may be too high for you to qualify now, it likely will go down after you retire, perhaps making you eligible then. Please note that you also cannot convert to a Roth IRA if you are married and you and your spouse file separate income tax returns.

You can take steps to reduce your AGI. Unfortunately, itemized deductions like property taxes and charitable contributions don't affect AGI. But "above-the-line" deductions do. Consider these AGI reduction strategies:

- If you're still working, pre-tax retirement plan contributions and contributions to a flexible spending account may reduce your AGI. You also may be able to defer bonuses.
- If you're self-employed, a portion of your self-employment tax and 100% of your health insurance cost is deductible. If you have a cash-basis business, you can reduce AGI by deferring billing for services already performed.
- If you're retired and under age 70½, you can defer retirement plan distributions without penalty.
- Working or retired, you may be able to time your capital gains and losses to reduce AGI in the year you want to make the conversion.

But converting from a traditional to a Roth IRA does have tax implications — you do have to pay income tax on the conversion amount. However, by reducing your AGI to less than \$100,000, you avoid the highest income tax rates. And other tax-saving strategies, including maximizing *itemized* deductions, can further reduce your liability. While distributions from Roth IRAs are tax free, you must meet certain requirements to take a qualified distribution, including a five-year holding period and reaching age 59½ or upon disability or death. You also may qualify for a distribution on account of first-time homebuyers' expenses or other special exceptions allowed by law. Talk to your financial advisor about whether converting your traditional IRA to a Roth IRA makes sense for you.

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In addition to our new Midtown Manhattan location in New York City, we've just opened a downtown Boston office as well. Plus, in November, we'll be opening the doors to our newest office in Stamford, Connecticut.

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10:00 AM CENTRAL TIME

We invite you to join us for the next Market Update Webcast with Orië L. Dudley Jr., Chief Investment Officer for The Northern Trust Company. Orië will share his perspective on the state of the economy and financial markets, as well as offer timely investment insights into what it all means for investors. Please join us Wednesday, October 29, at 10:00 AM central time by logging into www.northerntrust.com/library/multimedia/audio/index.html.

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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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