

Business Confidence Up

Economy entering a self-sustaining cycle of spending, investment, and hiring

INVESTMENT STRATEGY

What Has Changed

- ▶ The advance report of gross domestic product indicated that the U.S. economy expanded at an annualized rate of 7.2% in the third quarter, significantly exceeding expectations.
- ▶ Fears rose that global monetary authorities might move to increase interest rates sooner than expected.
- ▶ Equity market sentiment improved after the release of better employment news and strong earnings results.
- ▶ More frequent and deadly attacks by Iraqi resistance forces weighed on U.S. public support for the occupation and highlighted the possible need for additional troops and spending.

Economic Expansion to Continue on Firmer Foundations

- ▶ The global economic recovery and the weaker dollar are buttressing the factory sector.
- ▶ Business inventories are likely to be built in the face of rising commodity prices.

AN OWNERSHIP POSITION, over time, should deliver higher returns than a creditor position. This basic truth of a capitalist system is being reaffirmed as stock markets recover from their 2000-2002 bear market. Equities, as an asset class, will outperform most debt securities this year and will probably continue to do so until the current business cycle is completed.

In other words, the case for owning equities, despite significant price appreciation during the past year, remains compelling. The advance report of third-quarter gross domestic product (GDP), for example, registered the fastest growth (+7.2%) in almost two decades. Strength was broad-based and exceeded expectations. The 11% increase in business investment, the fastest rate since early 2000, was particularly encouraging, and the composition of growth — final sales up 7.8% and inventories down

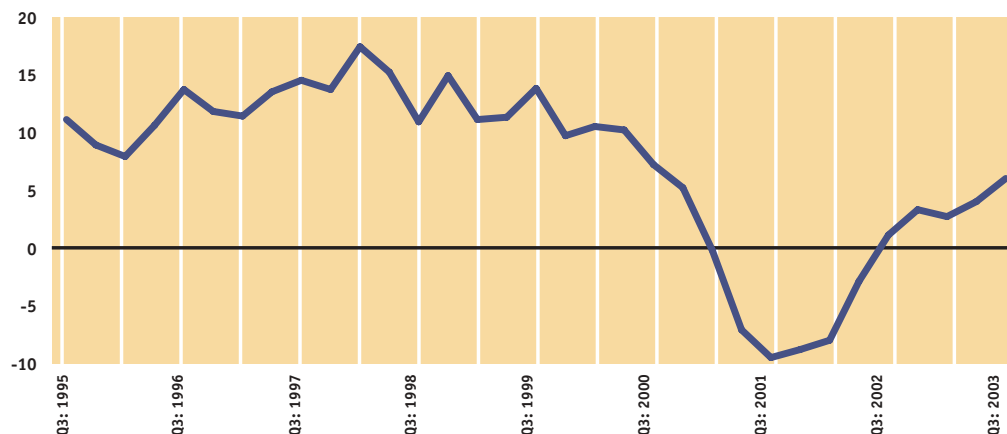
\$36 billion — leaves the economy well positioned for growth going forward.

Corporate profitability, meanwhile, continues to improve. S&P operating earnings increased almost 20% year-over-year in the third quarter, helping overall profits climb above an estimated 7% of GDP — near post-1960s record highs. This performance, in a challenging business environment, is not only heartening investors but business executives as well. Business confidence, a largely missing ingredient this business cycle, is finally recovering.

Economic growth, strong profitability, and business confidence are now beginning to translate into a self-sustaining cycle of spending, investment, and hiring. The recent improvement in labor markets is important confirmatory evidence of this. Payroll growth of 126,000 jobs in October was almost double the consensus forecasts and, just as significant, prior employment gains in August and September were

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BUSINESS INVESTMENT STEADILY IMPROVING



Left Axis: Year-over-year percentage gain or loss

Source: Bureau of Economic Analysis

ECONOMIC EXPANSION CONTINUED

- ▶ Although economic growth will slow from its blistering third-quarter pace, it is expected to remain at or above its long-term trend rate of 3½%.

Municipal Bonds to Be Range-Bound

- ▶ The supply picture has changed dramatically with a lighter calendar developing through the balance of the year, with the exception of a few mega-deals.
- ▶ Municipals remain expensive versus U.S. Treasury yields, especially in the one-to-five year maturity range, as investors continue to reach for higher yields versus cash.

Quality Stocks Should Gain Favor as Expansion Continues

- ▶ Corporate earnings continue to exceed analysts' expectations.
- ▶ Strength in earnings and cash flow will lead to improved capital expenditures and hiring.

International Equity Relatively Attractive

- ▶ Earnings revisions have turned positive.
- ▶ Potential for upside economic growth surprise exists.

Conclusion

- ▶ Solid growth and improving profitability argues for overweighting equities in portfolios where equity investing risks can be tolerated.
- ▶ Debt markets, in contrast, must contend with the prospects of an increasingly unfavorable interest rate cycle.

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revised up a combined 144,000 jobs. In other words, employment has expanded for three consecutive months and indicators (claims, temporary employment, and surveys) suggest the trend is gaining momentum.

The return of confidence and improved business performance is producing a renewed management focus on growth strategies. Business once again not only is investing in operations, but also is acquiring other businesses. October, for example, represented the biggest month for U.S. mergers and acquisitions in more than two years. This focus on growth is very timely, being a vital prerequisite for a sustainable economic expansion.

Third-quarter consumption spending benefited from the summer tax cuts and record mortgage refinancing. As a result, spending on autos and housing increased at unsustainable rates, and will slow in the fourth quarter. This deceleration now will be partially offset by business spending, particularly if inventory investment rises and the economy can enter a cycle of self-sustaining growth going forward in which demand leads to increased output and jobs, producing income and profits, leading to more demand. The likely outcome is GDP growth approaching 4% in the fourth quarter and a similar pace through 2004.

In this environment, operating profits should improve further, particularly because productivity remains excellent and earnings leverage is high. The profit upturn this cycle, in short, is far from exhausted. Current estimates for 2004 presume operating earnings

will increase 12% to 14%. These estimates are viewed quite skeptically and investors would be pleasantly surprised were they to be achieved. The odds are improving that this will occur.

These favorable fundamentals should support current market valuations. Moreover, investors are increasingly rewarding companies that possess high expected growth rates and maintain high levels of investment (R&D and capital spending). This will reinforce business's renewed "animal spirits" to invest and grow.

While the stock market will directly benefit from the evolving virtuous economic cycle and improved profitability, debt markets must contend with an increasingly unfavorable interest rate cycle. The Federal Reserve continues to maintain that its policy can be "more patient" than in prior recoveries, but its next policy move will be to begin tightening, possibly by next spring.

Meanwhile, market-driven interest rates will face increased pressure from the financing needs of the economic cycle, government deficits, a soft dollar, and incipient inflation. Yields on the 10-year Treasury note, for example, could rise 50 to 100 basis points during the next 12 months. These pressures will limit opportunities for capital appreciation in bond markets.

In short, we continue to recommend overweighting equities in portfolios where greater volatility can be tolerated.

Orie L. Dudley Jr.
Chief Investment Officer

Time spent talking with your tax advisors this November and December may save you substantial time and money.

TOPICS IN TAX PLANNING

Year-End Planning Guide

Take advantage of tax planning strategies now to maximize savings

By Grace Allison
Tax Counsel

WITH 2004 FAST approaching, time is short, and it is tempting to leave year-end financial planning to your financial professionals. What you may not realize is that, unlike mistletoe, tax planners do not do well in the dark. Communication from you is key — and communication before December 15 is just good common sense.

Given this year's massive tax changes, your biggest challenge may be sharpening your tax-planning focus. To help you get started, we've compiled a list of 10 year-end income tax planning strategies and seven transfer tax planning strategies.

Year-End Income Tax Planning Tips

1. Review your capital gains and losses. Look closely with your investment advisors at prior-year loss carryforwards and at year-to-date gains and losses. Earlier losses may allow you to sell all or part of a stock concentration with minimal tax effect. Remember: The new maximum capital gains rate is 15% for sales on or after May 6, 2003.

2. Ask your accountant to compute tax cost on older securities. It may be higher than you think. Many investors, for example, forget that shares in a dividend reinvestment plan, whether from corporate stock or mutual funds, are treated for tax purposes

as additional purchases, increasing tax cost for the aggregate holding.

After taking dividend reinvestment into account, your tax cost in the mutual fund you purchased in 1957 may be many times greater than your original \$10,000 investment, making sale much less expensive from a capital gains perspective. Likely sources of information? Mutual funds will generally provide you with average tax cost, which may be used for income tax purposes when selling mutual fund shares.

For individual securities, the tax law rules are stricter: you must keep records for each lot of securities you purchase. Good record keepers — or those who have others keep good records for them — have a real advantage here. Why? It's likely that the tax cost of shares purchased five years ago is higher than that of older shares. By knowing your tax cost, you can identify the shares sold as the high-cost shares and minimize capital gains tax.

Good sources of information? Transfer agents for dividend reinvestment plans, or death and gift tax returns for inherited or gifted assets. Be sure to ask about stock splits, corporate reorganizations, and spin-offs. Your accountant can use all this information to complete the tax cost computations.

3. Remember that not all dividend income is taxed at 15%. If you have hedged a stock position with options or invested in foreign stock, ask your

tax return preparer about the effect of those investments on your eligibility for the new 15% qualified dividend income tax rate.

4. Make charitable contributions to offset income. Think about making year-end charitable contributions to offset a surge of income and reduce taxes. Give appreciated low-basis stock instead of cash when possible. If you need the deduction but want time to decide where to give, consider a donor advised fund.

5. Take another look at your estimated taxes. With top rates reduced and belt-tightening at many employers, you may find yourself in a lower tax bracket than last year. Reducing your withholding at work — or omitting your final estimated income tax payment for 2003 — may improve current cash flow. The IRS is currently highlighting this tax tip on its website, www.irs.gov.

6. Check your retirement plan contributions and distributions. Are further contributions or distributions required or prudent? If you haven't contributed the maximum allowable amount to your plan, doing so before the end of the year will reduce your taxable income for 2003.

7. Contribute to a Coverdell Education Savings Account. If your income is within the limit (\$220,000 in 2003 for married couples filing jointly), you are

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permitted to make contributions to a tax-exempt education savings account for a designated beneficiary under age 18. Although total annual contributions to such plans (from you or others) cannot exceed \$2,000 per beneficiary, Coverdell monies can be used for elementary and high school expenses, such as books and tutoring, as well as for college.

8. Submit expense claims promptly.

If you have medical insurance or a cafeteria plan at work, be sure to submit all your expenses promptly for reimbursement. Although most plans have a March 31 deadline, it's best not to push the envelope.

9. When doing 2003 tax planning, do your homework. Your accountant can only work with the information you provide. Whether you forget to tell your accountant about your new \$3 million charitable remainder trust or the birth of your eighth child, you may miss substantial tax savings. Do what the professionals do: take out your 2002 tax return, go through it line by line and ask yourself what has changed.

10. Be aware that tax law changes in 2003 may translate into tax preparation delays in 2004. Massive changes to the income tax code this year put a premium on getting as much tax information to your income tax preparer as you can by the end of January. Especially if you receive income from a flow-through

entity — such as a partnership, mutual fund, or trust — be prepared for delays.

Time spent talking with your tax advisors this November and December will likely save you substantial time and money in the new year. Think of it as a special present to yourself this holiday season.

Transfer Tax Planning Tips

Unless you plan carefully, wealth transfers can result in burdensome taxes, either during life, at death, or both. Thoughtful planning will help to minimize the effect of the gift, estate, and generation-skipping taxes, also known as the transfer taxes.

Maximizing Annual Exclusion Gifts

In 2003, your annual gift tax exclusion is \$11,000 per recipient.

However, with some planning, you may be able to increase the amount you can give annually without incurring a gift tax liability.

1. Take advantage of gift splitting with your spouse. If you are helping out an unemployed adult child with a family, a timely gift-splitting election on your 2003 gift tax return can raise the amount excluded to \$22,000. Combining gift splitting with making gifts to both your son and daughter-in-law raises the amount excluded to \$44,000.

2. Make direct payments on the recipient's behalf. If you would like to give more than the gift-splitting option will allow, consider making payments on behalf of your child (or other recipient). Payments of

Estate and GST Tax Rates and Exemptions

Year	Top Tax Rates	Exemptions	
	Estate And GST	Estate	GST
2001	55%*	\$675,000	\$1,060,000
2002	50%	\$1,000,000	\$1,100,000
2003	49%	\$1,000,000	\$1,120,000
2004	48%	\$1,500,000	\$1,500,000
2005	47%	\$1,500,000	\$1,500,000
2006	46%	\$2,000,000	\$2,000,000
2007	45%	\$2,000,000	\$2,000,000
2008	45%	\$2,000,000	\$2,000,000
2009	45%	\$3,500,000	\$3,500,000
2010	Repealed	Repealed	Repealed
2011	55%*	\$1,000,000	Indexed

* Excluding 5% surtax.

Source: U.S. Internal Revenue Code

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medical expenses (including medical insurance premiums) and tuition made directly to the doctor, hospital, or school on behalf of a third party are not subject to federal gift tax.

3. Use your annual gift tax exclusion to fund college education. Consider contributing to a tax-exempt Section 529 college savings plan for a child, grandchild, niece, or nephew. No matter what your income tax bracket, you can, if you so elect, contribute as much as \$55,000 to a 529 plan in a single year without gift tax liability. Although each plan account can have only a single beneficiary, the tax law allows rollovers to accounts benefiting another family member (broadly defined to include parents, spouses, and cousins) if the final account balance exceeds qualified education expenses.

Use the Generation-Skipping Transfer Exemption

Since 1986, a generation-skipping tax has been imposed on transfers from older givers to younger generations. “Skip persons” include relatives at the “grand,” “great-grand,” or younger levels as well as unrelated individuals who are 37½ years younger than the donor. An \$11,000 annual exclusion applies to certain direct transfers — and to direct payments of medical and tuition expenses that qualify for the gift tax exclusion described above.

4. Maximize your use of the generation-skipping transfer exemption. In 2003, a \$1.12 million generation-skipping transfer tax

exemption allows you to make certain transfers — either during your life or at death — without paying the generation-skipping transfer tax. If you have already used your entire \$1.12 million generation-skipping tax exemption making lifetime transfers, be aware that you will have an additional \$380,000 of exemption available for allocation beginning January 1, 2004. Talk with your financial planners now to understand how — or if — this extra exemption will be used under your existing estate plan.

Minimize Your Estate Tax Liability

Even though the estate tax currently is being phased out, it’s not dead yet. There is no guarantee that this repeal will actually occur in 2010, so it pays to be prudent in your planning. The December issue of *Market Signals* will explore more ways to minimize your estate tax liability, but here are some ideas to get you started.

5. Ensure your estate plan is up-to-date. It’s important to make sure your estate plan is updated to take tax law changes — both current and potential future changes — into account. With both the generation-skipping and estate tax exemptions increasing in 2004, now is a good time to revisit your plan with your advisors. And don’t forget to take into account state-level taxes. Many states, hungry for revenues, have enacted their own estate and gift tax laws, resulting in estate tax increases of hundreds of thousands of dollars for some taxpayers.

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6. Double-check retirement plan beneficiaries. The single most common estate-planning mistake is inattention to significant retirement assets. The wrong beneficiary designation can be very costly. Be aware too that, with institutional mergers and reduced staff, transfers from one plan manager to another may result in inadequate records: check to see if the beneficiary designations you want are still on file with the new plan manager.

7. Consider charitable contributions. If you would like to keep transfer taxes low by making transfers in trust for family members or friends, consider charitable alternatives that can reduce your estate tax significantly. Some, like charitable remainder or lead trusts, can provide for both you or your beneficiaries and charity. Others, like donor advised funds or private foundations, could provide loved ones with the wherewithal to contribute financially to

the wider community, whether for the arts, for education, or for human welfare. Giving charity a contingent interest in an IRA or retirement plan allows individual beneficiaries to disclaim and avoid significant income tax at your death.

Plan Early to Maximize Savings

Being aware of transfer taxes and the effect they may have on your estate can help you create and implement a plan to minimize these taxes. Likewise, spending time before the end of the year reviewing your income tax situation may allow you to take advantage of year-end strategies to reduce your taxable income and lower your income tax burden.

If you have questions about how any of these strategies may apply to your situation, talk to your tax advisors or call us.

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