

Business Sector Engages

Increased business investment crucial for sustained recovery

INVESTMENT STRATEGY

What Has Changed

- ▶ Equity markets exhibited resilience as investors looked past geopolitical risks and protectionist sentiments and focused on strong economic fundamentals, including improving labor markets.
- ▶ Treasuries rallied on safe haven investing and a Federal Reserve statement that the potential U.S. growth rate had increased to 4.5% from 3.5%, implying preemptive tightening was unnecessary.
- ▶ Chairman Greenspan warned that the combination of protectionism and the need to fund the U.S. current-account deficit could fuel future inflationary pressures.
- ▶ In response to mounting attacks on American forces, the United States agreed to return power to an Iraqi provisional government in advance of writing a constitution or holding national elections.

FOR THE FIRST time since 2000, the business sector has become a driver of growth in the economy. This cycle, business has been preoccupied with cost control, governance issues, and balance sheet improvement — in part caused by a lack of confidence and in part by a failure of nerve. This is changing. Business is now investing, spending, and increasingly hiring. Risk taking, in other words, is returning, and financial markets are again rewarding expansion strategies.

The upward revision in third-quarter gross domestic product (GDP) growth (to an annualized rate of 8.2% from an initial estimate of 7.2%) reflected this change. Business investment in the third quarter increased 14%, double the second-quarter rate, and spending on equipment and software rose an outstanding 18.4%.

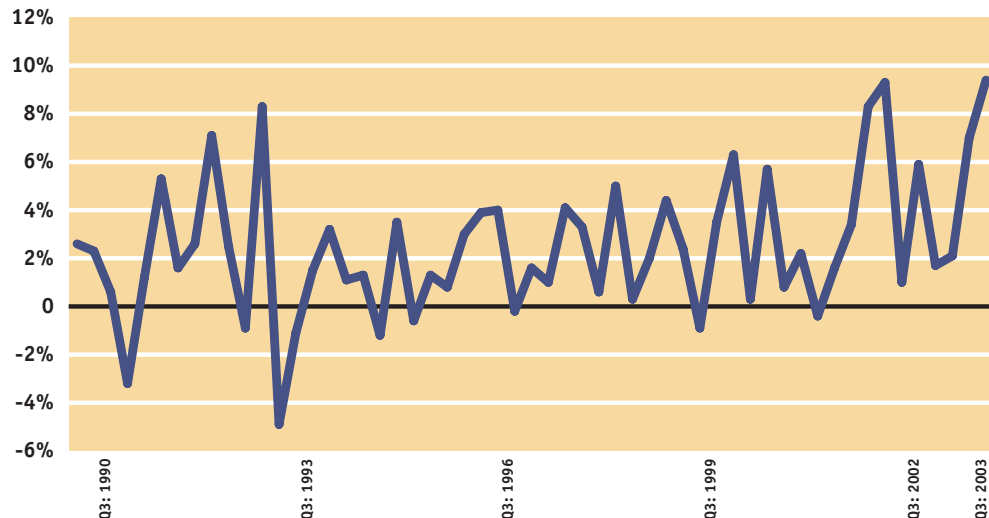
Incoming data and forward-looking indicators, moreover, suggest businesses are continuing to invest at double-digit growth rates. Importantly, these expenditures are no longer just for the replacement of existing capabilities, but represent discretionary investment for future growth.

At the same time, profitability and cash flow continue to be stronger than expected, supporting this renewal of business confidence and risk taking. The Bureau of Economic Analysis (BEA) estimates that third-quarter profits rose 30% compared with last year's third quarter, and almost 12% sequentially. BEA figures, which adjust statements for the change in the value of inventories and capital equipment, are the broadest measure of profits in the economy and often provide the best picture of trends. Other profitability and cash flow measures,

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WORKER OUTPUT CONTINUES TO RISE

Productivity growth is the most important measure of economic performance.



Left Axis: Percentage change of worker output per hour

Source: Bureau of Labor Statistics

Longevity of Economic Expansion Enhanced by More Balanced Growth

- ▶ Capital spending and exports will offset the moderation in consumer spending.
- ▶ Inventories are expected to rise due to improved business sentiment and rising wholesale prices.
- ▶ The Fed is likely to remain on hold through the first half of 2004.

Municipal Bonds Expected to Continue to Trade in a Narrow Range

- ▶ Light issuance is anticipated through year-end.
- ▶ Maintain high-quality focus as several states remain on credit watch.

Cyclical Stocks Should Outperform as Economy Expands

- ▶ Corporate earnings are benefiting from increased capital expenditures, inventory, and trade.
- ▶ A moderation in the earnings growth rate should favor higher-quality companies.

International Equities

- ▶ Equity valuations remain attractive as economies still show early signs of recovery.

Conclusion

- ▶ Solid growth and improving profitability argue 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.

Business Sector Engages

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including S&P 500 operating earnings, are equally positive. Estimates for S&P 500 operating profits in the fourth quarter and next year continue to rise; for 2004, they are now approaching a record \$62 per share.

Business has been achieving these results, to a significant degree, through expense reduction and productivity gains. The improvement in productivity — the most important longer term measure of an economy's performance and prospects — has, in the words of the Federal Reserve, been "remarkable." U.S. worker productivity grew in the third quarter at a 9.4% annual rate, the fastest rate in two decades. More importantly, the secular growth rate of productivity has clearly increased, perhaps approaching the 3.5% annual rate as suggested by William Poole, president of the Federal Reserve Bank of St. Louis.

Faster productivity growth does have a downside in the short run: businesses are able to meet demand without hiring workers. This is a key reason employment growth has lagged so severely this cycle. However, with the continued strength in final demand and the revival of business confidence, the economy is now creating jobs faster than at any time since the end of the recession in November 2001. While not yet robust, the trend in payrolls has risen from negative to increases near 100,000 per month during the past three months. Moreover, labor market indicators, from weekly jobless claims to small business hiring plans, point to significant payroll gains going forward.

Increased business investment and improvement in labor markets are the final pieces in the sustainable recovery jigsaw puzzle. The economy is now positioned

to grow in a more broadly based and balanced way. GDP could expand above a 4% annual rate through 2004, if not beyond.

Nonetheless, because of productivity gains, this growth might not entirely eliminate the large number of unemployed workers and underutilized resources in the economy. This possibility, and the current lack of inflation problems, led the Federal Reserve to keep the Fed Funds rate at 1% at its December meeting. Moreover, the central bank reaffirmed its belief that "policy accommodation can be maintained for a considerable period."

A stimulative monetary policy will therefore continue to anchor the short end of the yield curve, probably through spring. Eventually, however, this policy must tighten, particularly because the real Fed Funds rate is currently negative. Market-driven interest rates, meanwhile, face increased pressure from private and public financing needs and a weak dollar. We continue to expect yields on the 10-year Treasury bond to rise 50 to 100 basis points during the next 12 months.

Solid growth, improved profitability, and a steep yield curve are very advantageous for equities. Despite the significant price appreciation during the past year, equities should continue to be overweighted in portfolios where greater volatility can be tolerated. This position becomes even more compelling if the economy's longer-term sustainable rate of growth, once the current slack is eliminated, has risen because of productivity advancements.

Orie L. Dudley Jr.
Chief Investment Officer

A carefully worded will or living trust gives you the peace of mind that your wishes will be carried out.

TOPICS IN ESTATE PLANNING

Lifetime Estate Planning Strategies

Taking action during your lifetime works to your benefit

With input from Gary Gehm

Vice President, Financial Consultant,
Personal Financial Planning

CREATING A SOUND estate plan is essential to ensure your estate is disposed as you wish and to reduce estate tax liability. And even if you have already created a plan, you should review it periodically to determine whether it still meets your needs. Here are some key strategies that may help achieve these goals.

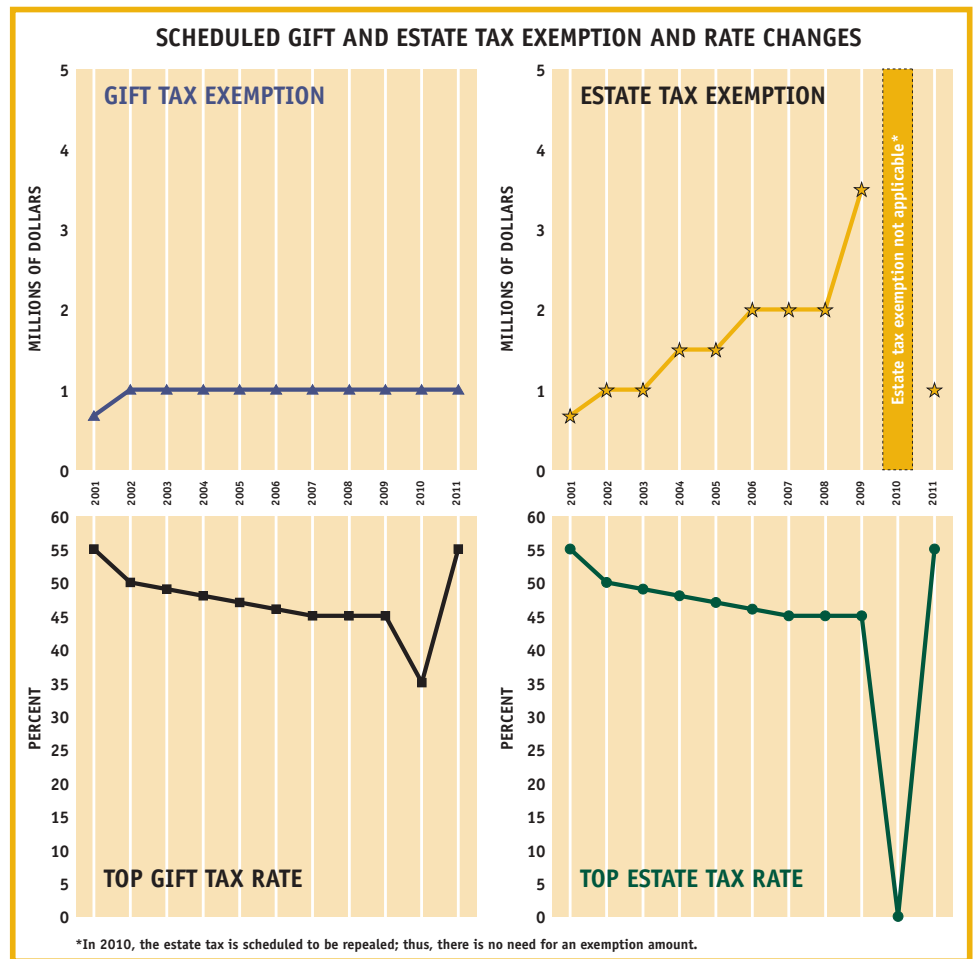
Put It in Writing

You've worked hard to build your estate and, understandably, you want to be sure your assets are transferred according to your wishes. A carefully worded will or living trust gives you the peace of mind that your wishes will be carried out.

If you already have a will or living trust, remember to review and update it regularly. As your circumstances change, you may wish to alter your beneficiary designations — add new family members, such as grandchildren or great-grandchildren, or remove beneficiaries who are no longer part of the family.

Scrutinize Executor and Trustee Appointments

The role of executor or trustee carries a fiduciary duty to your beneficiaries and requires a high standard of care. For this reason, you should consider carefully the person or institution you choose in



this role. Bear in mind the significant time and expertise necessary to effectively manage your estate or trust, as well as the need for independence and objectivity this role demands. Then choose your executor or trustee accordingly.

Use a Power of Appointment

A power of appointment is a right you give during your lifetime or through your will or living trust to a holder, such as your spouse,

adult child, or trusted friend, that allows him or her to decide how to distribute assets.

You may grant a general power of appointment to a holder by creating a trust that gives him or her the right to distribute the trust's property. Keep in mind the holder can exercise this power in favor of himself or herself or his or her own estate; therefore, property subject to a general power of appointment will be included in the holder's estate for estate tax purposes.

Lifetime Estate Planning Strategies

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You also may grant a special (or limited) power of appointment to a holder by creating a trust that gives him or her the right to distribute the trust's property among a limited group of people (such as your descendants) or charities. Because this type of power gives the holder limited control over trust assets, the property isn't includable in his or her estate.

Estimate and Reduce Your Potential Estate Taxes

Before taking steps to ensure your assets are distributed as you wish, consider the effects of estate taxes. If your projected taxable estate exceeds the exemption of \$1.5 million (for 2004 and 2005), the excess will be subject to federal estate tax. And with the 2004 minimum federal estate tax rate at 45%, it's prudent to take advantage of all the appropriate estate tax savings devices.

Your estate may also be subject to state estate tax. The federal credit for state estate taxes is gradually being eliminated and eventually will be replaced with a deduction. The states are reacting in different ways to this change. Some have "decoupled" from the federal credit to keep their estate tax in force. Others appear to be letting their state estate taxes die with the federal credit. Still others are creating new taxes to help boost sagging state revenues. Your estate tax professional can help you determine the potential effect of a state-level estate tax.

You can reduce your estate tax exposure by taking advantage of the

annual gift tax exclusion. It allows you to make tax-free gifts up to \$11,000 per individual (\$22,000 if you're married and use a gift-splitting election) without using any of your \$1.5 million gift and estate tax exemption. You may apply this exclusion to gifts made to an unlimited number of people.

Remember that unlimited gifts to your spouse (provided he or she is a U.S. citizen) and qualified charities are gift- and estate-tax free. But, depending on your tax situation, transfers to qualified charities may be limited from an income tax standpoint. Also consider the additional benefits for the recipient of giving appreciating property. The recipient will benefit from the gift's future appreciation and income, which will be excluded from your estate.

Beware of Ownership Issues

If you and your spouse have a combined joint estate exceeding \$1.5 million and you don't live in a community property state, assess the ownership of your assets. If most are in your name and your spouse dies before you, you may incur more federal estate tax than

necessary. Generally, it's wise for both spouses to own assets at least equal to the estate tax exemption.

Joint tenancy is another important ownership issue to consider. It occurs when two or more co-owners simultaneously hold an undivided interest in property with a right of survivorship. When one joint tenant dies, the joint property automatically passes to the surviving joint tenant or tenants. Because of the rights of survivorship, a will cannot control the distribution of the joint tenancy assets. Thus, placing assets in joint tenancy may not achieve your estate planning goals.

Get Started Today

Don't procrastinate on reviewing and revising your estate plan just because of the scheduled one-year repeal of the estate tax in 2010. Work with your advisors to be sure your estate plan takes advantage of all the techniques available to help you minimize your estate tax burden and meet your goals. The January issue of *Market Signals* will examine the use of estate planning documents such as wills, living trusts, and powers of attorney.

NORTHERN TRUST OPENS IN CONNECTICUT

Northern Trust has opened a new office in Stamford, Connecticut. Located at 300 Atlantic Street, our newest office will offer high-net-worth individuals, families, and private foundations our full complement of trust, investment management, and private banking products and services. Visit www.northerntrust.com for more information or contact the office directly at 203-351-8700.

TOPICS IN INVESTING

Three Rs of Successful Investing

Rethink, refocus, and refresh your investment strategy today

By **Charlie Mueller**

National Sales Manager, Personal Financial Services

DESPITE THE DOWN MARKETS of 2000-2002, it's important to remember the market's one constant: long-term participation gives you the best potential for investment rewards. And while your financial focus today may be on implementing last-minute strategies to reduce your 2003 taxes, with the new year rapidly approaching, it's also the perfect time to follow the three Rs of a successful financial strategy — rethink your market outlook, refocus on your long-term investment goals, and refresh your portfolio allocations — to stay on track toward achieving your goals.

Rethink

Markets rise and fall, but basic investing principles endure. Considering how the market has changed recently and its effect on your viewpoint can be worthwhile. The following five reasons can put market fluctuations in perspective:

1. More than three down years in a row have been rare.

Three years of consecutive negative returns, as we saw in 2000, 2001, and 2002, last occurred more than 60 years ago. Since 1939, the average duration of down markets has not been more than two years.

2. Market upswings following bear markets have been substantial.

The 1929 crash, for example, was followed by a total cumulative market gain of more than 1,028% until the next bear market in 1956.

3. The market is resilient during times of crises.

For instance, the 1962 Cuban Missile Crisis was followed by a nearly 25% rise within approximately four months.

4. Missing the best single-day gains can be costly.

Timing the market doesn't work. Missing even 10 days of the best single-day gains can significantly reduce your portfolio's long-term performance. (See the chart, *The Effect of Missing Days When the Best Returns Occur.*)

5. Cash sitting on the sidelines doesn't provide enough growth.

Unless your long-term investments' rate of return exceeds the inflation rate, the value of your money may actually shrink.

Refocus

In uncertain times, your short-term outlook may change, but not necessarily your long-term goals. It's important to separate the two when considering your investment strategy. Keep your eyes on the long term, making certain your investment decisions are wise for tomorrow as well as today. These five ideas can help:

1. Consider stocks for their long-term growth potential.

Over 10- and 20-year periods, stocks typically have outperformed asset classes such as bonds and cash.

2. Consider at least some risk to meet your goals.

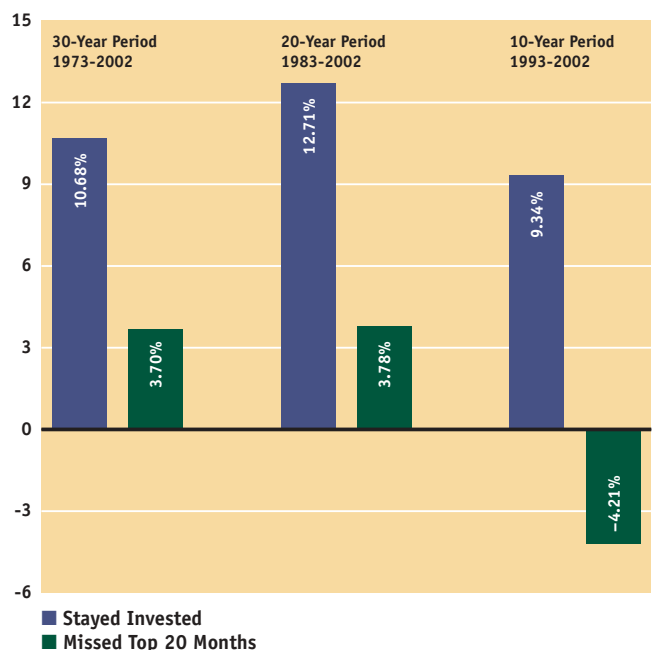
If you take too little investment risk, you face a different kind of risk: not having enough money when you need it.

3. Don't wait to tackle the rising cost of a college education.

According to the College Board, if your child or grandchild is an infant or toddler today, the projected future cost of a four-year private college

THE EFFECT OF MISSING DAYS WHEN THE BEST RETURNS OCCUR
This chart shows how returns would have been affected by missing the 20 top-performing months of the S&P 500 during 30-, 20-, and 10-year periods.

S&P 500 Compounded Total Annualized Return



Source: Standard & Poor's. Stocks are represented by Standard & Poor's Composite Index of 500 stocks, an unmanaged index that is generally considered representative of the U.S. stock market. Past performance is no guarantee of future performance.

Three Rs of Successful Investing

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education is more than \$60,000 per year — not including books, supplies, and other related expenses.

4. **Give your retirement more days to grow.** Neglecting your 401(k) or other retirement plan during volatile markets can be costly because your account will lose not only the money you would have invested, but also the potential for that money to compound and grow over time.
5. **Create a legacy.** In both bear and bull markets, careful estate planning can preserve your assets for your heirs while guarding against hefty federal estate taxes.

Refresh

As circumstances in your life change, it's important to adjust your investment strategies accordingly. Consider the following five strategies:

1. **Asset allocation can help you achieve the return you need.** Research shows that as much as 92% of a portfolio's performance depends on asset allocation among the three major asset classes — stocks, bonds, and cash.*
2. **Rebalancing your holdings can get you back on track.** As certain portions of your portfolio perform better than others, the relative percentage of one investment class can grow while others shrink, leaving your holdings out of sync with your long-term strategy.

3. **Diversification can serve to lessen your risk.** From year to year, the best- and worst-performing investment styles frequently change, and it's difficult to predict which style will be in favor in any particular year.
4. **With mutual funds, a buy-and-hold strategy can be wise.** When you increase your holding period, you can correspondingly decrease your returns' variability — plus the capital gain may be treated as long-term, lowering your tax liability.
5. **Dollar cost averaging can help you stay in the market.** By continually investing the same amount regardless of price fluctuations, you essentially purchase more shares when prices are low and fewer when prices are high.

React Now

The three Rs of investing — rethink, refocus, and refresh — are investment strategies that hold true in any market. So don't delay. Learn more about how they can help you move forward with confidence and achieve your long-term goals. Call your Relationship Manager today to get started reviewing your investment portfolio and overall strategy.

* Source: Brinson, Hood, and Beebower, "Determinants of Portfolio Performance II," *Financial Analysts Journal*, May-June 1991.

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