

Economy Strengthening

Are We on the Cusp of a Growth Rebound?

INVESTMENT STRATEGY

What Has Changed

- ▶ Optimism that the U.S. economy will strengthen and spark a global recovery fueled a strong second-quarter stock rally.
- ▶ Both the Federal Reserve and the European Central Bank cut interest rates to 40+ year lows.
- ▶ President Bush and Congress endorsed more fiscal stimulus in the form of a \$400 billion Medicare drug benefit.
- ▶ Escalating violence by Iraqi resistance forces slowed rebuilding efforts and pressured oil prices.

Indications of Faster Economic Growth Emerging

- ▶ Household demand has strengthened.
- ▶ Inflation pressures are expected to remain well-behaved.
- ▶ The manufacturing sector appears to be stabilizing.
- ▶ Economic conditions are expected to continue improving due to newly initiated fiscal and monetary policy stimuli.

THE BEHAVIOR OF bond and stock markets, viewed elementally, is determined by the interplay of money and belief. Money has been more and more plentiful following months of monetary stimulus, increased credit availability and income growth. What is now changing are investor beliefs, particularly expectations about economic prospects and business performance.

Stock markets rebounded strongly in the second quarter. The S&P 500 Index, for example, rose 15%, the biggest gain since the fourth quarter of 1998. Investors, particularly in the United States, are increasingly anticipating a solid economic recovery, accompanied by higher profits.

Meanwhile, bond markets extended their three-year bull run, again generating positive returns — though less than equities. The 10-year Treasury yield fell 28 basis points to close at an annual yield of 3.51%. Bond investors appear to believe the Federal Reserve will not raise interest rates for the foreseeable future; increased debt issuance, particularly as the federal government finances record budget deficits, can be successfully absorbed by the markets; and an economic recovery, however strong, will not be accompanied by excessive inflation, despite the Fed's stated desire for modestly more inflation.

The U.S. economy has been strengthening during the past month and appears to be on the cusp of a solid rebound in growth. This is being fueled by the most

potent combination of monetary and fiscal stimulus since the beginning of World War II. The Fed, for example, now has cut interest rates 13 times since early 2001, dropping the Fed Funds Rate to 1% — a level not seen since 1958. The federal government's fiscal position, meanwhile, has moved from a surplus of 1.4% of the gross domestic product (GDP) to a deficit forecast to approach 5% this year. The recently passed tax-cut package, including lower withholding taxes, is currently being implemented.

The full force of this policy stimulus is coming as signs of economic improvement are already multiplying. Forward-looking indicators have recently been encouraging. The Conference Board's index of leading indicators rose a solid 1% in May, with eight of 10 indicators that compose the index rising. Factory orders also unexpectedly rose in May, and last month's Institute for Supply Management's index of new orders at factories increased to 52.2. (Readings above 50 signal expansion.)

This data, combined with renewed and surprising firmness in household spending, has led most forecasters to predict an acceleration of economic growth — which is probably already underway. Consensus estimates for GDP growth in the second half have been increasing and now exceed 3.5%.

Importantly, earnings estimates, undoubtedly supported by the improving economic outlook, are not being trimmed

Volatility Within a Range-Bound Municipal Bond Market Expected

- ▶ Seasonal surge in demand to diminish with an uncertain supply picture unfolding.
- ▶ Continue to focus on high-quality credits as headline news regarding state and local budget and credit events will negatively impact spreads.
- ▶ Municipal after-tax ratios remain attractive versus taxable alternatives.

Stocks Remain Most Attractive

Asset Class

- ▶ Second-half economic rebound, evidenced by increasing economic and earnings forecasts, is key to sustained equity performance.
- ▶ While stocks may consolidate recent gains, the intermediate-term outlook remains constructive.
- ▶ Large-cap, high-quality stocks, which have lagged so far this year, should regain favor.

International Outlook

- ▶ Indicators suggest flat to negative gross domestic product growth rates for the Euro area, Canada, and Asia outside of China.
- ▶ Equity valuations are relatively attractive as yields in some instances exceed bond rates.

Conclusion

- ▶ High-quality, dividend-paying stocks offer attractive prospective returns and should be emphasized in portfolios that can tolerate the risks of equity investing.
- ▶ Cash and government bonds, in contrast, offer the lowest returns in decades, and should be de-emphasized.

Economy Strengthening

CONTINUED

as much as normal and negative pre-announcements from corporations have declined. The consensus now estimates that S&P 500 operating profits will grow more than 12% in the third quarter and more than 15% in the fourth quarter. As first quarter reported results suggested, profits may continue to be surprisingly strong and could exceed such forecasts as the recovery unfolds.

The stock market optimism about economic growth and earnings therefore appears justified. Is bond market optimism regarding future Fed policy, issuance, and inflation equally justified or somewhat contradictory?

The Fed has been forcefully “marketing” the idea that it will aggressively combat deflationary risks that might exist in an economy operating well below potential. Its policy announcement following the June Federal Open Market Committee meeting reconfirmed this idea: The committee noted that, while the risk of deflation was minor, it’s likely to be the predominant concern “for the foreseeable future.” The implication is the Fed will not be raising interest rates any time soon. The market is currently expecting an increase no sooner than the second half of 2004.

The Fed clearly wants low interest rates to help businesses fund their activities and to help consumers purchase products, particularly houses and autos. It also must deal with the prospect of increasing government financing requirements. The federal government will issue substantial debt

to fund deficits that will soon exceed \$400 billion annually. In a stronger economy, this financing requirement will clearly pressure rates. An alarming example of this problem recently occurred in Europe and Japan, where concern about deteriorating public finances and hopes for an economic recovery negatively impacted bond auctions and pushed interest rates higher.

As the economy gathers momentum, will inflation become a problem? This question might appear preposterous given the current focus on deflation. Indeed, core inflation appears to be running only about 1%. However, this rate is already too low given the Fed’s desire to minimize the risk of deflation occurring. The Bank simply wants a higher inflation safety margin and is actively pursuing this goal. Over time, this attempt to increase inflation should alarm bond investors, particularly because it’s occurring in the context of a growing economy, a falling dollar, and rising government financing needs.

Our asset allocation recommendations reflect our assessment of the validity of beliefs currently being priced into stock and bond markets. Prospective economic growth and earning improvement suggest overweighting stocks where the risks of equity investing can be tolerated. Bond markets, in contrast, look increasingly fragile, particularly if the Fed is successful in engineering an additional “bit” of inflation. We would underweight this asset class.

Orie L. Dudley Jr.
Chief Investment Officer

TOPICS IN INVESTING

Where Are We Going From Here?

Excerpts from Northern Trust's June "Focus on Investments" Forum

ON JUNE 12, 2003, a panel of Northern Trust's senior economic consultants convened to consider the subject "Investment Climate — Looking Toward Recovery." The panel featured Paul Kasriel, Director of Economic Research, The Northern Trust Company; Jim McDonald, Director of Equity Research, Northern Trust Global Investments; Glenn Migliozzi, Managing Director of Fixed Income, Northern Trust Global Investments; and Bill Knapp, Managing Director of the Personal Investment Group, Northern Trust Global Investments. Their discussion (excerpted here) will provide you with a variety of perspectives on what future market movements may look like.

Paul Kasriel

We're dealing with significant economic challenges. We've seen an unprecedented decline in household net worth. From 1952 to 1999, there was never a year where it fell. But since 2000, we have had three consecutive years of declining household net worth. It looks as though that decline is slowing and, if things continue in the second quarter, we're probably going to see an increase in net worth.

But this has really damaged the balance sheet of Americans. And it's going to force us to rebuild that retirement nest egg. And for a while we are going to see slower growth in household spending.

Another challenge is households have taken on a tremendous amount of debt. Although interest rates are at 40- or 45-year lows, we made it up

in volume of borrowing. So our required monthly payments in relation to our incomes are high, which will also limit our spending.

What factors will help boost our economy? One of the most important is the tax cut that was just passed. This tax cut will represent about \$150 billion in stimulus during the next four quarters. I feel it will boost the economy in the second half.

Another factor is the Fed. It has eased monetary policy in the last month or so. It has encouraged longer-term interest rates to come down. And that has encouraged new life in the mortgage and housing sectors. People are refinancing, which is helping their balance sheets.

Left to its own devices, the economy wants to grow. The reason it doesn't grow usually is because of speed bumps such as higher taxation, regulation, and tighter Fed policies. None of those speed bumps are out there right now. So we believe we're going to see improved economic conditions in the second half of this year and, barring any unforeseen shock, even better growth in 2004.

JOIN US AUGUST 7 AT 10:00 AM CENTRAL TIME

We invite you to join us for the next Market Update Webcast with **Orie L. Dudley Jr.**, Chief Investment Officer for The Northern Trust Company. Orie 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 Thursday, August 7, at 10:00 AM central time by logging into www.northerntrust.com/library/multimedia/audio/index.html.**

Jim McDonald

Looking at the market today, clearly, we've had a robust rally — a 25% move in equities since March 11. Investors are becoming comfortable that the economic picture is improving; the Iraq situation appeared to be resolved more quickly and cleanly than anyone imagined; first quarter S&P 500 earnings were better than expected. We came into the quarter with people expecting earnings growth in the 8% to 9% range. We actually exited the quarter with growth in the 12% range.

The other important thing is, in the first quarter, that GAAP reported earnings — the most conservative earnings measurement — were only 2% below the operating reporting's number that analysts typically focus on as the best measure of the ongoing profitability of corporate America. The fact that the write-off cycle has materially slowed also gave people confidence that corporate America's profitability was starting to improve.

The most important factor in the outlook for equities is the earnings

Where Are We Going From Here?

CONTINUED

growth picture. We're expecting this year to see 8% to 10% growth.

I would caution that we have had a really strong run in the stock market. It would only be natural to expect the market to pause and potentially even, on a short-term basis, retreat. But on a risk-reward basis, especially compared to cash and bonds, our views are that equities have a better performance outlook.

Glenn Migliozzi

In this day and age, buying bonds and expecting to get back your principal and interest certainly is a challenge. One thing we found about bonds is the good coupons they had are not always assured. We thought they had nice 5.5% coupons, and then we get these redemption notices that they've been called. It's like the reverse of refinancing our mortgages. Buying bonds with good call protection is important because we don't want these nice coupons getting called away.

Often, people want a laddered portfolio — buying out the yield curve. Right now the curve is steep. You have very low short-term rates and 10-year Treasuries at maybe 2% to 2.5% higher. One thought we have is to be barbelled — meaning owning really short- (almost cash) and longer-term bonds because, if we do get into a deflationary environment, you're going to want to own some long-term bonds that will be locking in the high coupons and going up in value. If growth and interest rates pick up and the Fed raises rates in the short term, we expect the steep yield curve to

flatten. And if the yield curve is going to flatten, you want to be more barbelled than laddered to have a chance to invest in higher rates.

Another attractive area that provides diversification is TIPs — Treasury Inflation Protection Notes. Think of these as U.S. Treasuries. They're liquid, there is no credit risk, and you get the return of a taxable coupon Treasury, but half of it comes in the form of the coupon and the other half comes from Consumer Price Index increases. So *if* inflation picks up, TIPs are much more attractive than they were. But we are not necessarily predicting a significant pick-up in inflation.

Bill Knapp

We've been in a bear market the last three years but in a bull market for bonds. We've reached the lows in the equity market last October. We tested those again in March of this year, but we're up 25% for the broader market from that low in March. Bond yields have also fallen substantially. Interest rates have fallen 25% in two months, while the stock market has been up 25%. Treasuries over the last year have given a total return of 20% and we're approaching even on equities. Cash is around 1% and going lower.

What does that mean for the future? Our expectation for longer-term returns is we are going to more normalized markets reflecting underlying economic growth.

The 10-year average return of the S&P 500 is now at about 9%. That's probably on the high side of what we

can expect for the next three to five years. The building blocks of equity return are real economic growth — we can expect 3% to 3.5% — plus inflation expectations — 1% to 2%. So let's be generous and add another 2% inflation to that 3% real earnings growth and you get a 5% nominal expectation for GDP. Add in a normal risk premium for holding a risky asset like equity — 3% to 4% — and you get a return expectation for equities that is 7% to maybe 9% in a good year. We're already up 15% for the year. The easy money has probably been made in the equity market this year.

What does that mean for other asset classes? Bond yields are low right now. You can't presume that because you hold the bonds to maturity you're getting a reasonable rate of return. You have to think about the opportunity cost of where you can invest that money when you hold that bond.

Cash is extremely low and will go lower in the next few weeks. This means the opportunity cost of putting money in riskier assets is low. The yield on the S&P 500 is about 1.7%, which is equal to the two-year bond rate. You can actually get a 3% dividend on a fair number of higher-dividend paying stocks now, and that's equal to a 10-year Treasury.

If you have any questions about our panelists' comments on the direction the economy and the markets seem to be moving, or about whether your portfolio is positioned to take advantage of these changes, please call us.

A professional trustee has the experience and expertise to carry out the trust terms.

TOPICS IN ESTATE PLANNING

What to Consider When Selecting a Trustee

By Frank Nejd
Executive Vice President

BECAUSE A TRUSTEE is responsible for carrying out the trust provisions, and thus ensuring the trust works as you intended, it is critical you choose the best person — or institution — for the job.

Trustee Responsibilities

First you must understand the trustee's responsibilities. Here are some of the most important duties, which will vary based on the trust's terms and holdings:

Legal. Seeking counsel as needed, the trustee assumes legal responsibility for proper trust administration.

Accounting and administrative. The trustee establishes recordkeeping procedures, performs ongoing accounting, submits records for review if needed, takes inventory, changes titles of assets received, and pays bills.

Investment management. This includes both strategic and administrative duties. For instance, the trustee will choose an asset allocation strategy

that will serve the beneficiaries' best interests based on the trust's terms, purposes, and distribution requirements. In addition, the trustee must collect assets and related income and maintain detailed records of all transactions. Each type must be managed appropriately:

➤ **Conventional financial assets.**

These are common assets such as cash, securities, options, commodities, insurance and employee benefit proceeds, and deferred compensation. Management responsibilities may include tracking dividend notices, bond calls, and maturities, and acting on stock warrants and subscription rights.

➤ **Real estate.** The trustee must arrange for the property's security, insurance, and maintenance;

investigate the status of taxes, assessments, and liabilities against it; and obtain appraisals, titles, deeds, and abstracts.

➤ **Business interest.** The trustee must retain management, valuation, and consulting services, and, if the business will be sold, also see that the sale is carried out under the most favorable terms possible.

➤ **Unique financial assets.** These may include copyrights, patent rights, mineral rights, oil and gas interests — all of which require specialized management.

➤ **Personal property.** The trustee must have the value appraised and preserve the security of assets such as family heirlooms, household furnishings, vehicles, collectibles, and jewelry until distribution or sale.

EXPLORING TRUSTS: A THREE-PART SERIES

This concludes our series on the valuable role trusts can play in helping you manage, invest, and distribute your assets. (To read the April and May articles on trust benefits and trust types, visit http://www.northerntrust.com/library/personal/mrkt_newsletters.)

THE NORTHERN TRUST FIDUCIARY ADVANTAGE

Northern Trust can provide you with all the benefits of a professional fiduciary and more:

- We have been a leading provider of personal trust services for more than 100 years, assuring you continuous, uninterrupted management of your assets.
- We provide in-house account administration, investment management, securities custody, tax preparation, and related fiduciary services.
- Our dedicated trust administrators and portfolio managers average 17 and 19 years of experience, respectively.
- Our staff includes specialists in handling unique assets, including real estate, family businesses, oil and gas holdings, mineral rights, collectibles, and farm and ranch holdings.
- We meet federal and applicable state law requiring fiduciaries to isolate trust assets from those of the institution; trust assets are never lent, pledged, or used as collateral by Northern Trust to secure its own obligations.

What to Consider When Selecting a Trustee

CONTINUED

Tax. The trustee must manage investments with tax considerations in mind, and track asset acquisition dates, cost, and adjustments; keep records of taxable income; file annual trust tax returns; and provide information to beneficiaries for their tax returns.

Beneficiary and estate settlement. The trustee must communicate regularly with beneficiaries, distribute income and principal to them as outlined in the trust terms, and provide detailed account statements. For living trusts, the trustee must settle the estate by preparing tax returns, discharging creditor obligations, determining final distributions, and arranging final asset transfers.

Individual, Institution, or Both?

You need a trustee with discretion, good judgment, commitment, and integrity. You likely have family members or close friends with these qualities. But the trustee's job is complex, often involving years of detailed research and recordkeeping, and informed decision-making. That's why many grantors choose a professional trustee or co-trustee such as Northern Trust. A professional trustee has the necessary experience and expertise, access to resources, and time to carry out the trust terms.

Individuals can obtain professional advice when needed, but an institution has additional advantages over an individual trustee:

NORTHERN TRUST OPENS IN NEW YORK

Northern Trust has opened a new office in New York City. Located in Manhattan at 65 E. 55th Street in the Park Avenue Tower, this office will offer high-net-worth individuals, families, and private foundations the full spectrum of private client and wealth management products and services. Visit www.northerntrust.com for more information or contact the office directly at 212-339-7414.

- 1. Continuity.** An individual can be limited by health, longevity, or even a busy schedule. An institution can ensure continuous management.
- 2. Impartiality.** A professional trustee isn't swayed by self-interest in the interpretation of trust provisions or management and distribution of assets. Even if family members or other individual trustees would be impartial, others may perceive their actions as self-serving.

Making the Right Choice

If your financial and estate plan includes trusts, it is essential to select a trustee who can carry out the trust terms — and help you achieve your objectives. Northern Trust would be glad to answer your questions about trustee responsibilities.

RECEIVE MARKET SIGNALS BY E-MAIL Please E-Mail Us at 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.

The information contained in this newsletter is general in nature and is intended for informational purposes only. It has been obtained from sources believed to be reliable, but its accuracy and completeness are not guaranteed. Any opinions expressed herein are subject to change at any time without notice. Any person relying on this information shall be solely responsible for the consequences of such reliance. Because the facts and circumstances surrounding each situation differ, you should consult your investment advisor, tax advisor, and estate planning professional before taking any action based on these articles.

This newsletter is provided for informational purposes only and does not constitute an offer or solicitation to purchase or sell any security or commodity. © 2003



Northern Trust

Arizona | California | Colorado | Florida | Georgia | Illinois
Michigan | Missouri | Nevada | New York | Ohio | Texas | Washington | Wisconsin

www.northerntrust.com