

GDP on the Rebound

Economic Expansion Gaining Strength as Monetary and Fiscal Stimulus Unfolds

INVESTMENT STRATEGY

What Has Changed

- ▶ Signs of stronger economic growth became evident in the United States, Europe, and Japan.
- ▶ Bond yields spiked higher amid optimism about growth, the Federal Reserve's ability to engineer higher inflation, and heavy Treasury supply.
- ▶ Investors perceived the Fed might have backed away from earlier disinflation concerns.
- ▶ Second-quarter earnings were better than expected, with stocks advancing for the fifth straight month.

The Economy Has Transitioned to Faster Growth

- ▶ Capital spending is finally strengthening as profits improve.
- ▶ Low inventories imply future increases in industrial production.
- ▶ The Fed reaffirmed its willingness to accommodate strong economic growth.

ECONOMIC GROWTH IS gathering momentum and may finally reach a sustainable rate near the economy's potential. Since troughing in November 2001, this business cycle has been constrained by a unique combination of corporate governance, geopolitical, and post-bubble events. As a result, the expansion's pace has been below that of a normal recovery. This is changing for the better as the constraint adjustments progress, and massive monetary and fiscal policy stimulus unfolds.

Real gross domestic product (GDP) was stronger than expected in the second quarter, foreshadowing the growth improvement now underway. The surge in military spending, highlighted in the press, certainly

contributed, but shouldn't obscure the underlying strength in consumer spending (+3.3% seasonally adjusted annual rate) and business investment (+6.6%). Higher capital spending was particularly encouraging, suggesting adjustment to the overinvestment of the late '90s is nearing completion.

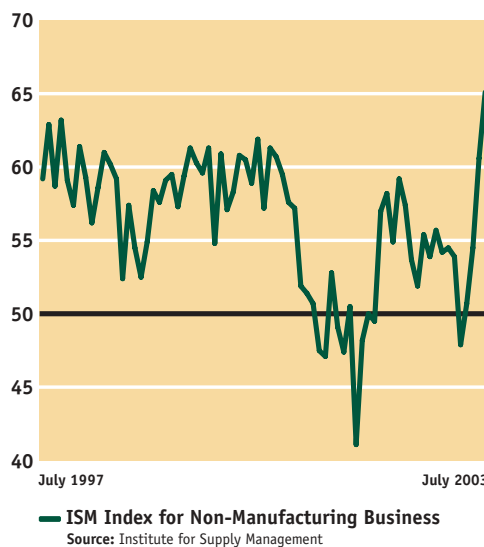
Second-quarter growth was restrained by lower state and local spending (-1.5%), net exports (-1.6%), and declining inventories (-0.8%). Together these components represented a significant economic drag, but each is expected to improve going forward — particularly inventory investment. Inventories actually declined \$18 billion during the quarter despite stronger final sales. As demand continues growing, inventories should increase, and could be a powerful positive second-half contributor.

The flow of economic data in the third quarter, in general, is more positive than the consensus forecasts. This includes auto sales, chain store reports, and factory orders. The Institute for Supply Management's Non-Manufacturing Index was especially strong — increasing for the fourth consecutive month in July and reaching its highest level since the survey was first conducted in July 1997.

The positive second-quarter surprises and favorable incoming data are raising future GDP forecasts. Second-half growth is now expected to exceed 3.5%, and the Federal Reserve released projections for 2004 whose mid-point was 4.25% (range 3.75 to 4.75%).

NON-MANUFACTURING SERVICES INDEX SOARS

An index level above 50 indicates expansion of U.S. service industries, and improving business conditions.



Municipal Bond Market to Remain Volatile Given Current Environment

- Municipal market faces less demand and expected increased supply.
- Maintain high-quality credit focus given continued state budget woes.

Outlook for Stocks Remains Constructive

- Stronger recovery should continue to favor economically sensitive stocks.
- While equities may consolidate recent gains, intermediate-term outlook remains positive.
- Large-cap, high-quality stocks are beginning to outperform as these companies deliver strong earnings reports.

International Outlook

- Early indicators of deflation are emerging in Japan.
- Strong earnings and low inflation lift European equities.
- China returns to high growth post-SARS.

Conclusion

- Prospective economic growth and earnings improvement suggest overweighting stocks where equity investing risks can be tolerated.
- Bond markets, in contrast, appear increasingly fragile given pressure from government deficits, a weak dollar, and the financing needs of an economy gathering momentum.

GDP on the Rebound

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Such growth will help address the economy's biggest remaining problem: unemployment. Payrolls declined for a sixth consecutive month in July. However, there are encouraging signs that labor markets are stabilizing — the four-week average for initial jobless claims is below 400,000, temporary employment has increased for three consecutive months, and small businesses (50% of the labor market) are more optimistic and profitable. An important key to self-sustaining economic growth, beyond the current acceleration, is increased hiring.

Economic growth, improved productivity, and slightly better pricing should produce higher corporate profits. Such was the case in the second quarter when S&P 500 operating earnings grew about 10%, and handily beat analysts' reduced expectations. Third-quarter and full-year estimates, counter to the normal pattern of Wall Street gamesmanship, are now holding, and in some instances, increasing. Positive operating leverage could produce surprisingly strong profits as the economy accelerates.

Financial markets are responding to improved economic prospects and stronger business performance in divergent ways. The attractiveness of equities continues to improve and also will be reflected in increased related activities such as mergers and acquisitions and initial public offerings. The environment for bonds, in contrast, is increasingly fragile.

The recent sell-off in the bond market was exacerbated by trading and portfolio strategies, such as hedging activities in the mortgage market. But the underpinnings of the secular bull market, which began in October 1981, are now being questioned. As the economy returns to a higher sustainable growth rate, interest rates will face growing pressures and the opportunities for capital appreciation in the bond market will diminish, if not evaporate. While not imminent, continued economic strength will cause investors to worry about higher inflation and eventual Fed tightening.

The stock market, in contrast, appears to be in the early stages of a cyclical bull market. After advancing five consecutive months, a near-term correction or consolidation would not be surprising or disconcerting. Underlying fundamentals — earnings and dividends — are strengthening, and prospective returns, looking forward, are increasingly attractive.

These prospective returns are not predicated on a return to the excess valuations of the late '90s. Rather, they assume corporate earnings growth of 6% to 8% during the business cycle and dividends of about 2% — providing a potential total return of 8% to 10% (without any multiple expansion from present levels). We would currently overweight stocks in portfolios where the risk of equity investing can be tolerated.

Orie L. Dudley Jr.
Chief Investment Officer

Different asset classes typically perform differently under the same market conditions.

TOPICS IN INVESTING

Asset Allocation Is Key to Success

Diversify Your Portfolio to Reach Investment Goals

By Bill Knapp

Managing Director — Personal Investment Management Group, Northern Trust Global Investments

WE'VE ALL HEARD the old saying “don't put all your eggs in one basket.” This is particularly sage advice when it comes to your investment portfolio. In fact, 91% of the variability in portfolio performance can be attributed to asset allocation, while only 2% is due to market timing. (See the chart, *Factors Contributing to Portfolio Returns*.)

Why Asset Allocation Is So Important

Asset allocation — how you distribute your investments among various asset classes — is important because it allows you to diversify risk, and thus more safely seek higher potential return. Why? Different asset classes typically perform differently under the same market conditions. So, for instance, when stocks become volatile, bonds often perform better. Diversifying your investments among the various asset classes allows you to soften the blow of losses, creating a smoother path to your ultimate financial goal.

But asset allocation goes beyond just allocating among stock, bonds, and cash. Assets can be further distributed across different sub-classes (large-cap vs. mid-cap vs. small-cap, domestic vs. international), sectors (technology, energy, health care, consumer goods, financial),

or styles (growth vs. value vs. alternative). The less concentrated your portfolio is in any one area, the more protection you have from market volatility. (See the chart, *The Case for Equity Diversification*, on the next page.)

Finding the Right Asset Allocation for You

There is no one-size-fits-all asset allocation solution. Such critical factors as your risk tolerance, time-frame, liquidity and income needs, return expectations, and tax situation are important in determining your asset allocation strategy.

Your risk tolerance is the amount of potential loss you are willing to accept in exchange for potential gain. It's important to be realistic when evaluating your risk tolerance, or you may face some unpleasant surprises.

Your timeframe also will affect your risk tolerance. Longer timeframes allow you greater opportunity

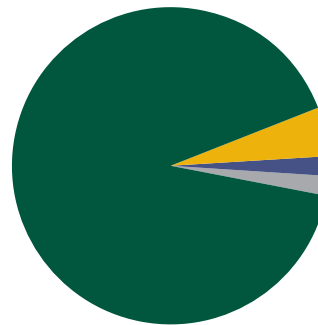
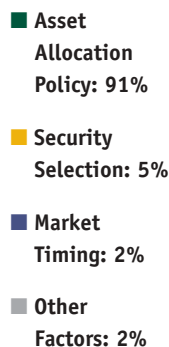
to make up for any losses. This may make you more comfortable investing in higher risk asset classes because you'll have more time to recover from any downturns.

Building an Efficient Portfolio

The ultimate goal of your asset allocation strategy should be to build an “efficient” portfolio — one that will provide you with the greatest possible return for the lowest risk based on your goals, timeframe, and comfort level with different investment strategies. You also should consider how the tax implications of various investments may affect your situation.

Determining your asset allocation strategy is challenging, and it's only the first step in developing an investment portfolio that will help you achieve your financial goals. After you've evaluated your priorities — looking at time horizon, risk tolerance, liquidity

FACTORS CONTRIBUTING TO PORTFOLIO RETURNS



Source: Brinson, Singer and Beebower, “Determination of Portfolio Performance II: An Update,” *Financial Analysts Journal*, May - June 1991. Based on U.S. pension fund data 1977-1987.

Asset Allocation Is Key to Success

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requirements, return expectations, and income needs — you need to structure your portfolio and select securities based on your asset allocation strategy and taking into account your tax situation.

In the September issue of *Market Signals*, we'll take a closer look at selecting securities and Northern Trust's equity investing approach. But if you would like to learn more now, please contact your Portfolio Manager. He or she would be happy to discuss your asset allocation strategy.

BENEFITING FROM NORTHERN ASSET DESIGN

When determining the asset allocation of your portfolio, your Portfolio Manager uses a proprietary software tool called Northern Asset Design. By using Northern Asset Design, your Portfolio Manager can help you establish appropriate investment objectives based on your return expectations, risk tolerance, and time horizon. This information, along with your responses to our Investor Profile Questionnaire, is used to generate information about the projected return for any given level of risk to ensure that your portfolio is operating efficiently. Using this data in conjunction with the broader guidelines set forth by Northern's Investment Policy Committee, Northern Asset Design provides asset allocation guidance that is used in the construction of your investment portfolio.

THE CASE FOR EQUITY DIVERSIFICATION: CHANGING MARKET LEADERSHIP

Leadership among market segments changes dramatically from year to year.

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Highest Performance	International 32.56%	International 7.78%	Large Cap Value 38.35%	Large Cap Growth 23.12%	Large Cap Value 35.18%	Large Cap Growth 38.71%	Large Cap Growth 33.16%	Mid Cap 8.25%	Small Cap 2.49%	Large Cap Value -15.52%
	Small Cap 18.88%	Large Cap Growth 2.66%	S&P 500 37.54%	S&P 500 22.95%	S&P 500 33.35%	S&P 500 28.58%	International 26.96%	Large Cap Value 7.01%	Large Cap Value -5.59%	International -15.66%
	Large Cap Value 18.12%	S&P 500 1.32%	Large Cap Growth 37.19%	Large Cap Value 21.64%	Large Cap Growth 30.49%	International 20.00%	Small Cap 21.26%	Small Cap -3.02%	Mid Cap -5.68%	Mid Cap -16.18%
	Mid Cap 14.30%	Small Cap -1.82%	Mid Cap 34.45%	Mid Cap 19.00%	Mid Cap 29.01%	Large Cap Value 15.63%	S&P 500 21.04%	S&P 500 -9.10%	S&P 500 -11.88%	Small Cap -20.48%
	S&P 500 10.06%	Large Cap Value -1.99%	Small Cap 28.45%	Small Cap 16.50%	Small Cap 22.36%	Mid Cap 10.09%	Mid Cap 18.23%	International -14.17%	Large Cap Growth -20.42%	S&P 500 -22.10%
Lowest Performance	Large Cap Growth 2.90%	Mid Cap -2.09%	International 11.21%	International 6.05%	International 1.78%	Small Cap -2.55%	Large Cap Value 7.35%	Large Cap Growth -22.42%	International -21.20%	Large Cap Growth -27.88%

The above table is presented for information purposes only and is not meant to depict past performance or predict future performance of any particular investment. Performance of all indexes is calculated on a total return basis with dividends reinvested. The indexes are unmanaged and should not be considered investments. Past performance is no guarantee of future results. Foreign securities involve risks in addition to those associated with domestic securities, including foreign currency risk and political instability. Investing in small and mid-size companies involves risks in addition to those associated with large-size companies.

Source: Northern Trust Investments

TOPICS IN RETIREMENT PLANNING

Want to Retire Early?

Some Things You Need to Consider

By Lee Woolley
Sr. Vice President

YOU'RE CLOSE TO reaching your financial goals. You've decided it soon will be time to turn the business over to your children. Or you want to take the time to travel or devote yourself to other pursuits while you're still young. Whatever the reason, you dream of retiring early. But turning that dream into reality involves more than just making sure you have enough money in your retirement accounts. In fact, if you retire early, you likely won't be able to take distributions from your retirement accounts for many years — unless you don't mind losing some of your hard-earned money to a 10% early withdrawal penalty.

Laying the Groundwork

When planning for retirement — especially if you're planning to retire early — it's important to ask yourself a few questions.

You need to consider realistically how long you think you'll live. This will help determine how much money you'll need to retire comfortably. And remember that you can't make retirement plan contributions unless you have earned income, so once you fully retire, you'll have to rely on the underlying investments for your plan to grow.

You also need to determine at what age you plan to stop working. Ensuring that you have liquid assets outside your retirement plans to last

until you can begin penalty-free withdrawals and are eligible for Social Security benefits is important.

Important Retirement-Related Dates

If you would like to retire early, you need to be aware of certain key dates and how they may affect your plan. With that in mind, consider these key ages:

59½. You can start taking penalty-free distributions from your qualified retirement plan. The 10% early withdrawal penalty is in addition to any income taxes. (You can start

Some types of retirement savings can generate income that will give you a huge tax hit in the year of your retirement unless you plan properly.

taking penalty-free distributions at age 55 from non-IRA accounts if you retired from the company running the plan on or after you turned 55.)

65. You won't be eligible for Medicare until you turn 65. This means you'll need to find and purchase basic health insurance to cover yourself until you turn 65. If you're married and your spouse doesn't work or if you have dependent children, you also may need to find insurance for them.

65-67. You can start receiving full Social Security payments when

you reach the normal retirement age, which is gradually increasing from 65 to 67. And this monthly check may be larger than you think. For someone retiring at full retirement age this year (age 65 and two months), the maximum monthly payment is \$1,721. If you retire earlier or later than the normal retirement age, your payments will be smaller or larger, respectively, within certain limits.

70½. If you are retired, you must start taking distributions from your qualified retirement plan or IRA (unless it is a Roth IRA) at age 70½ or face a 50% penalty on the amount you were required to withdraw but didn't.

Don't Forget to Plan for Taxes

As you approach retirement, especially if you're planning to retire early, it's important to consider the tax implications of your investments and retirement savings. The tax basis of your investments can be an important consideration at this point — the lower the basis in your investments the higher the tax hit when you sell them.

Some types of retirement savings also can generate income that will give you a huge tax hit in the year of your retirement unless you plan properly:

Nonqualified-deferred compensation. You can't roll funds in this type of plan over into an IRA, and you'll have to pay taxes on this income when you receive it. To extend the tax deferral, you can opt for an

Want to Retire Early?

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annuity rather than a lump-sum distribution. With an annuity, you'll pay taxes only on the amount you receive each year. Your payments can be spread over a fixed number of years, your lifetime, or the lifetimes of you and your spouse.

Ownership interests. If you have at least a partial ownership stake in your company or partnership, you must consider the tax implications of leaving that arrangement. The situation could create liability for a substantial long-term capital gains tax due in the current year. With proper planning, however, you can defer the tax. One way is through an installment sale. If your sale qualifies, you could receive payments over, say, five years, rather than in a lump sum. Your tax payments would then spread out and become lower during the same interval.

Certain income tax planning strategies also can help reduce your tax bite in the year you retire. For example,

you can increase your itemized deductions by making charitable contributions and pre-paying the next year's property and state income taxes in the year you retire. But also beware of the alternative minimum tax. Consulting your tax advisor is especially important when you retire early.

Where You Are Today

Retiring early may give you the freedom to pursue new interests, watch your children take over your business, and spend more time with your family. But early retirement also requires special consideration to make sure you can continue to live comfortably. Take the time now to work with your advisor to evaluate your current situation, your retirement goals, and your plan for achieving them. You may also want to consult with your attorney to ensure your estate plan is updated to reflect your new situation.

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