

Fundamentals Improving

Second-half growth forecasts revised upwards as expansion gathers strength

INVESTMENT STRATEGY

What Has Changed

- ▶ Global stock prices revisited 2003 highs on brightening profit and economic outlooks.
- ▶ Financial conditions (interest rates and the dollar) turned less accommodative despite assurances by the Federal Reserve that it wouldn't tighten rates preemptively.
- ▶ The euro weakened against the dollar and yen amid evidence Europe's recovery is lagging behind the United States and Japan.
- ▶ A new wave of international terrorist incidents raised the prospect of additional fiscal and monetary stimulus, which investors could view negatively.

Long-Run Potential Growth Is Expected Through Mid-2004

- ▶ Tax cuts appear to be stimulating consumer spending.
- ▶ While the manufacturing sector is rebounding, housing probably is peaking.
- ▶ Employment growth is a key to a sustained economic expansion.

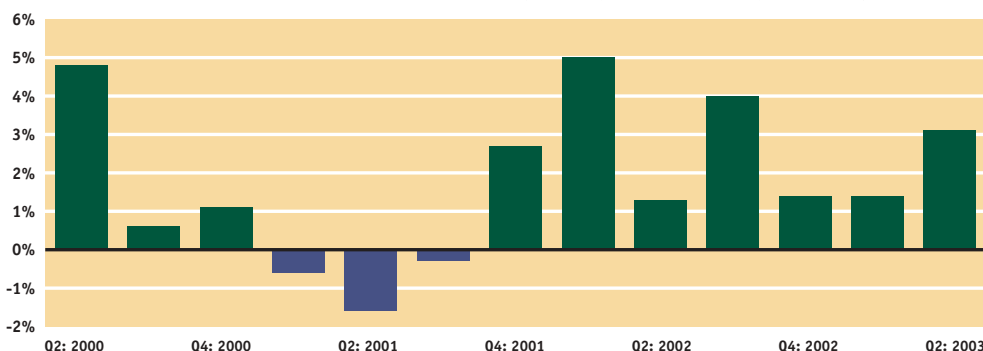
ECONOMIC GROWTH IS accelerating and business performance is improving. Expectations, nonetheless, remain guarded, and many investors continue to be doubtful and apprehensive. Such a dichotomy — fundamentals vs. psychology — isn't unusual in the initial stages of new bull markets. The demoralization caused by the preceding bear market fades gradually — especially if

the most important change — was revised to an 8.2% growth rate, the fastest in three years. Momentum going into the second half, given this strength in both consumption and investment, was therefore higher and broader than anticipated.

- ▶ Activity indicators paint an even stronger picture unfolding in the second half. The August Institute of Supply Management (ISM) Manufacturing Index rose to 54.7,

ECONOMIC GROWTH IS ACCELERATING

Since the recession's end in Nov. 2001, the U.S. economy has experienced seven quarters of growth.



Source: Bloomberg, Bureau of Economic Analysis

investors have experienced the third largest decline in S&P 500 history, as they did from 2000 to 2002. If fundamentals continue to strengthen, however, investor confidence will eventually be restored. This scenario appears to be unfolding.

Recent evidence clearly justifies the conclusion of strengthening fundamentals:

- ▶ Growth was much stronger in the second quarter than first reported (gross domestic product [GDP] +3.1% vs. 2.4%). Consumer spending was revised up to a 3.8% growth rate, and business investment in equipment and software —

its highest reading this year, and the August ISM Non-Manufacturing Index held at its highest level in its six-year history (65.1). Consumer spending now appears to be growing about 5%, with autos, housing, and general retail all better than expected in August. Durable goods and factory orders (the main sources of information on capital goods demand) suggest that business investment — consistent with rising profits, productivity gains, and improved confidence — is now rebounding firmly.

Municipal Market Outperformance Expected to Continue

- Issuance is less than expected.
- Seven- to 10-year maturities are most attractive.
- Higher-quality credits continue to offer best relative value.

Cyclical Recovery Playing Out In Stock Market

- Better-than-expected earnings reports are leading to rising earnings estimates.
- Expect the recent outperformance of cyclical stocks to continue.
- The intermediate-term outlook for the broad market remains constructive.

International Outlook

- Japanese government bond yields rose significantly on expectations of improving domestic economic growth and price reflation.
- Consumer prices increased and imports reached all-time highs in China, suggesting improved domestic consumption and mitigating deflation risk.

Conclusion

- Stronger economic growth and improved profitability argue for overweighting stocks where the risks of equity investing can be tolerated.
- Bond markets, in contrast, present limited opportunities for capital appreciation and face growing pressures on interest rates.

Fundamentals Improving

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- The surge in consumption and investment has been depleting inventories, possibly involuntarily. Investment in inventories is estimated to have fallen \$21 billion in the second quarter, and thus far in the third has failed to keep pace with orders, despite rising production. For example, the manufacturing inventory-to-sales ratio fell to a record low 1.31 in July. Inventory rebuilding will be a powerful contributor to second-half growth.

Economists and strategists are now rushing to increase their second-half growth forecasts. Before the second-quarter revisions and recent indicators, median estimates for GDP growth were 3.6% for the third quarter and 3.7% for the fourth. The consensus for both now is moving above 4%, but is still probably low given where we are in the inventory cycle and the possibility of rising export demand. The economy is positioned for at least two *consecutive* quarters of above-trend growth for the first time during this expansion, which is now 22 months old. It will be the strongest second half since 1999.

As the expansion has gathered strength, employment has remained surprisingly weak. Payrolls fell for a seventh consecutive month in August, declining an estimated 93,000. The labor market is traditionally a lagging indicator, but not since World War II has employment failed to grow so long after the economy began recovering. The reasons for this weak performance appear to be productivity growth and structural changes in declining industries. Several jobs lost during this cycle may be permanent. Nonetheless, small businesses are expanding (50% of the employment) and the pickup in temporary and part-time employment is encouraging. The labor market should improve this fall.

Productivity, while problematic for employment growth, is good news for corporate profitability. Earnings from current production rose almost 16% in the second quarter and recovered to 8.4% of the GDP. Estimates for the third quarter and full year, moreover, are now being increased, though they still appear conservative given the strengthening economy. Positive operating leverage could produce surprising strong profits in the second half.

Improving fundamentals present contrasting implications for bonds vs. stocks. The bond market faces growing pressures from the credit needs associated with an accelerating economy, accompanied by a massive swing in fiscal policy (the Federal deficit will soon exceed \$500 billion). Moreover, as global economic growth recovers, as current indicators suggest, demand for U.S. debt outside the United States may diminish. Finally, inflationary pressures will increase as “economic slack” diminishes. The Federal Reserve would like modest reflation, but will find it difficult to contain the inflationary process once it’s underway.

The stock market, in contrast, benefits from higher growth and improved profitability. The market’s performance since March (six consecutive monthly gains) reflects increased confidence in the expansion and a decline in risk aversion. Nonetheless, this recovery from the preceding bear market is actually well below normal* and possesses considerable upside potential, given the improvement in fundamentals.

* See “Examining 100 Years of Stock Market Recoveries,” published by Leuthold Group, August 2003.

Orie L. Dudley Jr.
Chief Investment Officer

Using a donor advised fund is a simple, flexible way to support one or more charities.

TOPICS IN ESTATE PLANNING

Explore Your Options for Charitable Giving

By **Hugh Magill**

Senior Vice President

AMERICANS ARE KNOWN for their generosity. Last year in the United States, charitable donations equaled \$240 billion, improving an untold number of lives. And individuals accounted for more than 75% of all giving, with organizations contributing the rest.

Reasons for giving to charity are varied and personal — you may want to leave a legacy, promote social change, help find a cure for a disease, or simply give back to the community. Regardless of your reasons for giving, it makes sense to carefully consider *how* you plan to donate.

Donations and Bequests

Direct gifts to charity may be made either by donations during your lifetime or through a bequest in your will or a similar provision in your trust at death. Each method offers different advantages:

- **Lifetime donations** provide substantial income tax deductions — generally up to 50% of adjusted gross income (AGI) for cash gifts and 30% of AGI for long-term appreciated capital gain property, such as marketable securities. (See the chart, *Income Tax Deduction Limits for Charitable Contributions*.)
- **Outright bequests** are ideal if you want to retain the assets during your lifetime but wish to leave some or all of your estate to charity. This gift type carries an unlimited estate tax deduction, but provides no income tax benefits.

Choosing the Right Vehicle

Whether you choose to make gifts to charity during your lifetime or through your will or trust, you have a variety of philanthropic vehicles to choose from.

Income Tax Deduction Limits for Charitable Contributions

Contribution Recipient	AGI LIMITS	
	Cash and Ordinary Income Property	Appreciated Capital Gain Property FMV
Public Charities	50%	30%
Operating Private Foundations	50%	30%
Nonoperating Private Foundations	30%*	20%*

* You can increase the ceiling amount to the public charity and operating private foundation limit if the nonoperating foundation makes qualifying contributions out of its corpus within 2½ months after the end of its taxable year, equal to 100% of the contributions it received that year.

Source: U.S. Internal Revenue Code

Do you need a simple, flexible way to support one or more charities while streamlining your charitable giving? If yes, then consider a **donor advised fund**, which allows you or your designees to act as a “donor advisor” who recommends grants to tax-exempt organizations. A donor advised fund is especially appropriate if you need a current income tax deduction but wish to allocate the gifts to multiple charities over time.

With a **charitable remainder trust (CRT)**, you transfer assets to a trust for a specific term. You or your chosen beneficiary receives payments for the trust’s term (typically, for the beneficiary’s lifetime); the charity receives the remainder at the end of the term. A CRT can help you increase

Explore Your Options for Charitable Giving

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cash flow and defer capital gain recognition on highly appreciated assets.

A **charitable lead trust** is more or less the reverse of a CRT. Here, the charity receives payments during the trust's term, while the beneficiary you choose receives what remains at the expiration of the term.

You can also set up a **private or a nonprivate foundation** for charitable purposes. Generally, a private foundation works better if you prefer giving to a number of charities and want to involve family members in the decision making process. A nonprivate foundation typically will suit you if you have a strong commitment to one institution, but you don't want to make an outright gift to it.

Each of these vehicles offers different advantages and disadvantages. It's important to consider your individual circumstances when choosing which method will best help you meet your philanthropic goals and achieve the best tax outcome.

Charitable Giving in Action

Here are examples of how two charitable giving options work:

Supporting charities with less administrative work. Steve is a 45-year-old who recently sold his closely held company to invest in another business. Now, he wants to donate \$150,000 for leukemia research. He wonders which would best suit his goals — a donor advised fund or a private foundation.

REVIEW YOUR CHARITABLE GIVING PLAN NOW

Third-quarter estimated tax payments are due soon, and because of recent tax law changes to withholding rules, you may want to revisit your charitable giving plan. Why? Because reduced withholding may leave you with extra discretionary cash, meaning you can adjust your contributions accordingly. But remember, less than four months remain before the end of the year. If you want to create a new charitable vehicle, now is the ideal time to begin the discussion and planning process so your plans can be implemented before the end of the year.

The foundation option is attractive, but Steve learns that it will entail substantial administrative costs and time at this level of funding. Instead, he chooses to transfer the money to the Northern Trust Charitable Giving Program, a donor advised fund. This option will require less administrative work on his part and, at the same time, give him a larger current income tax break: 50% of his AGI for the cash gift he made. By comparison, a foundation would have involved more legal and administrative work and produced a smaller (30% of AGI) income tax deduction.

Lifetime income and supporting a charity. A retirement-age couple, Charlie and Helen, own a vacation home they no longer use. They want to sell the home to provide themselves with a steady income. They also want to leave a substantial gift to their local art museum.

Their financial advisor suggests that they establish a charitable remainder trust. They agree, transfer the home to the CRT, and the trustee sells the home to an unrelated third

party. Capital gains taxes on the sale are deferred, and the proceeds are invested in a diversified investment portfolio. Beginning with the first year after the sale, the trustee pays out 5%* of the trust's current market value to Charlie and Helen annually. After their deaths, the remaining trust assets will go to the art museum.

How Northern Can Help You

Your reasons for being philanthropic reflect your personal goals and values, and achieving those goals in a tax-effective manner can be complicated. Northern Trust offers a breadth of knowledge and experience to help you put your goals into action to benefit yourself and charities that are important to you.

** Percentages can vary depending on the CRT holder's income needs.*

Portfolios are built using quality stocks, chosen because they have the best potential for price appreciation.

TOPICS IN INVESTING

Selecting Stocks to Beat the Market

Northern Trust's Core Equity Approach

By **Bill Knapp**

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

IN THE AUGUST issue of *Market Signals*, we discussed the importance of finding the right asset allocation strategy for you. But this is only the first step in developing an investment portfolio that will help you achieve your financial goals. That's why Northern Trust brings a personalized, risk-sensitive view to asset management. After helping you evaluate your priorities — looking at time horizon, risk tolerance, liquidity requirements, return expectations, and income needs — we build your portfolio based on your asset allocation strategy. We select individual securities by taking into account your tax situation while striving to beat the market.

Your overall asset allocation will cover a variety of asset classes, including equities (divided among investments in the large cap, mid cap, small cap, and international stocks), fixed income, cash, and possibly even alternative investments. Of course, stocks are likely an integral part of your portfolio. And for that reason, this article focuses on the equity portion of your asset allocation.

Style Differences: Growth vs. Value

Many investment firms or managers follow a specific equity style of investing, typically either focusing on growth — looking for stocks with strong earnings and/or revenue growth potential — or value — seeking good stocks at great prices, rather than great stocks at good prices. Like various asset classes and market sectors, investing styles rise and fall in

popularity, with investors favoring value one year and growth the next.

Growth and value stocks perform differently. In any given year, growth may outperform value or vice versa. (See the chart, *Growth vs. Value in Equity Investing*.) Obviously, having a portfolio tilted toward the winning style can provide great rewards. But having a portfolio heavily weighted in a style that is underperforming can be costly. Unfortunately, no one can predict which style — growth or value — will perform best in any given year.

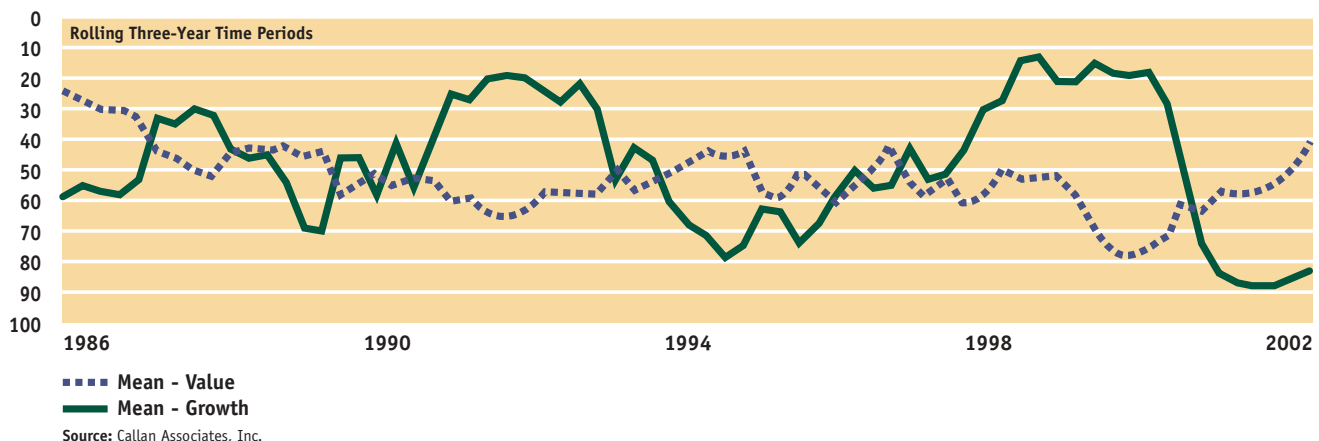
Northern Trust's Core Approach

Rather than focusing on either a value or a growth approach, at Northern Trust we use a “core” approach to investing. Each investor's large-cap equity portfolio includes a combination of growth and value equities. Portfolios are built using

GROWTH VS. VALUE IN EQUITY INVESTING

This graph illustrates the relative over- or under-performance of the average Value and Growth managers versus the Total Equity Database. In general, when Value is “in,” Growth is “out” and vice versa.

Percentile Ranking



Selecting Stocks to Beat the Market

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quality stocks, chosen because they have the best potential for price appreciation, regardless of their style distinction. Following a core approach, rather than implementing a value or growth style, helps your portfolio even out the ups and downs of style volatility, providing you with more consistent returns. Our goal is to outperform the market, but to do so in a more consistent manner than portfolios biased toward growth or value styles.

How We Select the Best Stocks

We select stocks based on rigorous criteria, including strong financial condition and consistent, profitable growth. Our equity research analysts (with average industry tenure of 11 years) evaluate 290 U.S. companies in 50 industries on our in-house stock guidance list. They examine three-to-five-year histories of consistency in earnings per share, revenue and earnings growth, return on shareholder equity, and debt to total capital ratios. Our analysts forecast future earnings and profitability and which stocks are most likely to outperform the market.

Each week, our experienced portfolio managers meet to review the analysts' research and to provide their own

insight on stocks of interest. Working together they select their top stock ideas. Then, each manager uses this shared knowledge to develop customized portfolio solutions for individual investors.

Unbiased and Objective Analysis

Northern Trust doesn't underwrite equity securities, so it has no investment banking conflicts of interest. Our analysts are compensated based on the accuracy of their equity recommendations. As a result, the analysts' and the investors' interests are aligned, and investors receive unbiased, objective analysis.

Achieving Your Investment Objectives

Selecting the equities right for you is vital to creating an investment portfolio that will help you meet your goals. Northern Trust's core approach and experienced portfolio managers not only can help protect your portfolio from market fluctuations, but also can make your portfolio more efficient — earning the highest returns possible with the amount of risk you are comfortable with.

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