



March 15, 2010

The major indexes were up for the second week in a row after marking, on March 9th, the one-year anniversary of the stock market’s low point during the recession. Stocks have come a long way since then. And last week the S&P 500 reached its highest point since October 2008 after Citigroup, one of the financial firms hit hardest by the recession, announced it was back on track for “sustained profitability.” But the past week’s trading volumes were subdued and returns were held in check as investors weighed mixed reports about the state of the recovery – and bided their time waiting on this Tuesday’s meeting of the Federal Open Market Committee.

Most of the news from Greece was about the protests and strikes that have been called in the wake of the government’s new austerity measures. However, early in the week the EU floated the idea of a European Monetary Fund to bail out members of the euro zone (without having to rely on the International Monetary Fund) as the European Union’s treaty blocks its members from bailout each other out. Assuming any such body was created – and some member countries feel that it would only encourage fiscal irresponsibility if other members knew they would be bailed out – it would come along too late to help Greece which, though coming off a successful bond sale, has to raise another €23 billion by the end of May and stands to pay rates of return that may hinder the country’s efforts to cut its deficit by 4% this year, as promised. The Greek Prime Minister, George Papandreou, visited Paris and Washington last week, pushing for a crackdown on the use of financial tools

	Key Market Data		
	Week ending		
	3/12/10	3/5/10	Change
Dow Jones Industrial Average Index	10,624.69	10,566.20	+0.55%
S&P 500 Index	1,149.99	1,138.70	+0.99%
NASDAQ Composite Index	2,367.66	2,326.35	+1.78%
10-Year Treasury Note Rate	3.710%	3.682%	+0.029 pct. pts.
NYMEX Crude Future (Barrel)	\$81.24	\$81.50	-0.32%
Euro/U.S. Dollar	\$1.3762	\$1.3622	+\$0.0140

such as the credit default swaps that were used to hide Greece’s debts and ultimately drove up its borrowing costs.

Meanwhile, with the rancorous struggle over the health care bill as a backdrop, the two parties have made little progress overhauling financial regulation, one of the few issues that a majority of Americans of both parties seem to agree needs to be addressed (a recent poll showed that three-fifths of Americans supported tougher regulations for Wall Street). Negotiations between Senator Christopher Dodd (D, CT), the chairman of the Senate’s Financial Services Committee and the GOP broke down again last week, and Dodd said he was going to send the proposed bill to the Senate without Republican support, daring the GOP to risk the wrath of voters by thwarting the bill’s passage. Dodd said provisions of the bill would change the way Wall Street operates, bring an end to the “too big to fail” phenomenon, and protect consumers from questionable financial practices. Prior to the breakdown in negotiations, the two parties had apparently also agreed on the formation

of a new Office of Research and Analysis housed in the Treasury Department, an early warning system that would give federal regulators daily updates of the stability of financial firms and their trading partners. As Senator Jack Reed (D, RI) noted, “One of the problems we observed in the recent crisis is that nobody knew who had what.” The two parties had also agreed to give the Federal Reserve control over a new consumer protection agency while stripping that body of its power to supervise bank holding companies, except for those with assets of \$100 billion or more. At the same time, if any further evidence of the need for regulation was needed, the long-awaited report of the fall of Lehman Brothers, all 2,200 pages of it, was released last week, citing the “grossly negligent” and “actionable balance sheet manipulations” the firm used to cover up its bad investments.

The Commerce Department reported that wholesale inventories were down 0.2% in January and 9.7% from January of 2009, indicating that businesses are remaining cautious about restocking their shelves (a 0.2% increase was forecast). Month-to-month, retail inventories were off 0.1% and business inventories were unchanged. On a positive note, the ratio of wholesale inventories to sales, indicating how long it would take to clear the shelves, was a record low of 1.10 months. The Commerce Department also reported that the U.S. trade deficit fell 6.6% in January to \$37.3 billion, with imports off 1.7% and exports down 0.3%, the first decline since last April. Our trade deficit with China, the largest, climbed to \$18.3 billion.

A week after the Labor Department said that the nation’s jobless rate was unchanged at 9.7%, it reported that unemployment rose in 30 states in January, down from 43 in December, with five states hitting new highs, including California at 12.5% (Michigan continues to have the nation’s highest rate, 14.3%).

There was further evidence of a robust recovery in China – accompanied by rising concern that the Chinese government is going to put on the brakes because of inflation, which would slow the global rebound. In February, Chinese exports were up 46% year-to-year, signaling demand in Europe and the United States, while imports rose 45%.

China was on President Obama’s mind as he announced steps to follow through on his recent State of the Union pledge to double exports in the next five years while creating two million jobs, which would include a new Export Promotion Cabinet. Referring to China’s actions to link its currency to the dollar, he said, “China moving to a more market-oriented exchange rate will make an essential contribution to that global rebalancing effort.”

The broader view

To date, the missing ingredient in a full economic recovery has been consumer spending – and little wonder given the high unemployment rate and the woeful housing market. By most estimates, consumer spending now accounts for 70% of gross domestic product (GDP), and while the government’s stimulus and emergency spending programs can boost GDP in the near term, sooner or later consumers will have to open their wallets to sustain long-term growth.

Last week, there was some encouraging news on this front. For instance, despite the snowstorms that walloped the East Coast, retail sales rose 0.3% in January, the fourth increase in the last five months (though sales in December were revised downward to 0.1% from the original 0.5%). And if auto sales, hurt by Toyota’s woes, were removed, sales were up 0.8%, rising in almost every other category. At the same time, according to Thomson Reuters, sales in stores open for at least a year, “same store sales,” a key yardstick, were up 4%, and consumer borrowing rose in January for the first time

in a year. As a result, real consumer spending is on track to improve by 3.5% in the current quarter and 5.8% for all of 2010.

The Federal Reserve also reported that total U.S. household debt fell 1.7% in 2009 to \$13.5 trillion – that's \$43,874 for every resident – the largest drop since reporting began in 1943. But while the fact that mortgages and credit cards have become harder to get during the recession played a role in the lower figure, four-fifths of the debt reduction came from defaults on mortgages and other obligations. Total household debt represented 122.5% of annual disposable income at year's end, down from 130.6% at the close of 2008, but still well above the 100% thought to be "sustainable."

On a related note, as of April 5th, there will be a new federal program designed to help underwater homeowners execute "short sales" – where their property is sold for less than the balance of their mortgage. Lenders would have to accept the agreement, forgiving the difference between the sale price and what they are owed while the seller would get \$1,500 in "relocation assistance." The idea is that lenders would get more money than they would if the home was foreclosed; there would be fewer foreclosed houses on the market, improving overall sale prices; and the borrower's credit rating would not suffer as much as it would through default.



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Taken together, these data would seem to bode well for a gradual resurgence in consumer spending and a more robust recovery. Even so, if judged by consumer sentiment polls, consumers remain wary: the Reuters/University of Michigan index fell to 72.5 in March from 73.6 in February, well below the historical average of 86.5 but far above the recession low of 55.3 in November of 2008.

A look ahead

This week, there will be updates on housing, industrial production and capacity, and both producer and consumer price indexes. That said, all eyes will be turned toward Congress to see what, if anything, gets done before the March 26th recess begins, and, of course, the Fed, which meets on Tuesday. No one is expecting the Fed to raise its rate – in fact, the futures markets are not looking for a hike until November or December – but, as always, investors and analysts will be parsing every word from the Fed for any clues, however veiled, about its thinking and its timetable. At the same time, the White House is in the process of vetting three new members to the Fed's board of governors, which would let the Obama administration put its stamp on the board's thinking as it continues to wrestle with the timing and frequency of rate hikes.

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The Dow Jones Industrial Average Index[®] is a price-weighted average of 30 blue-chip stocks that are generally the leaders in their industry. It has been a widely followed indicator of the stock market since October 1, 1928.

Standard and Poor's 500 Index[®] (S&P 500[®]) is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

Standard & Poor's offers sector indices on the S&P 500 based upon the Global Industry Classification Standard (GICS[®]). This standard is jointly maintained by Standard & Poor's and MSCI. Each stock is classified into one of 10 sectors, 24 industry groups, 67 industries and 147 sub-industries according to their largest source of revenue. Standard & Poor's and MSCI jointly determine all classifications. The 10 sectors are Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, Information Technology, Materials, Telecommunication Services, and Utilities.

The NASDAQ Composite Index[®]. Stocks traded on the NASDAQ stock market are usually the smaller, more volatile corporations and include many start up companies.

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Bear market calculations and interpretations are derived from data supplied by Ned Davis Research, Inc.

Federal Open Market Committee (FOMC) is the branch of the Federal Reserve that sets monetary policy through controlling open market operations, the discount rate, and reserve requirements.

International Monetary Fund is an organization set up in 1944 to lower trade barriers between countries and to stabilize currencies by monitoring the foreign exchange systems of member countries, and lending money to developing nations.

The Reuters/University of Michigan Surveys of Consumers are monthly surveys of consumer attitudes and expectations about the U.S. economy. They provide a gauge of consumer anticipation of changes in the economic environment.