



May 24, 2010

The story for the stock market was the same last week, as largely positive news about the American economy was more than offset by uncertainty about the European debt crisis, which refuses to be solved no matter how much rhetoric and money – in this case nearly \$1 trillion – is put against it. As a result, the euro fell to a four-year low before rebounding somewhat, and all three major U.S. indexes tumbled by at least 4%. The Dow briefly dipped below 10,000 during intraday trading on Friday and suffered a correction by dropping 10% from its high of the year before gaining back 125.38 points on Friday. More importantly, the leaders of the European Union have not only failed to come up with a coordinated strategy that reassures investors, but spooked them anew when Germany acted independently to curb speculative trading. Chancellor Angela Merkel, who has developed a gift for stating the ominous, said, “The euro is in danger. If we don’t deal with this danger, then the consequences for us in Europe are incalculable.” Meanwhile, the repercussions are becoming more and more widespread, with American investors now fearing that the “contagion” may cross the Atlantic. Speaking to a House subcommittee, Federal Reserve Governor Daniel K. Tarullo said the crisis in Europe could add up to a “significant external shock” for our economy, “stalling the global recovery.” He added, “In the worst case, such turmoil could lead to a replay of the freezing up of financial markets that we witnessed in 2008.” And China announced that it will not adjust its currency until the situation in Europe has been resolved as its exports have become

	Key Market Data		
	Week ending		
	5/21/10	5/14/10	Change
Dow Jones Industrial Average Index	10,193.39	10,620.16	-4.02%
S&P 500 Index	1,087.69	1,135.68	-4.23%
NASDAQ Composite Index	2,229.04	2,346.85	-5.02%
10-Year Treasury Note Rate	3.202%	3.444%	-0.242 pct. pts.
NYMEX Crude Future (Barrel)	\$70.04	\$71.61	-7.15%
Euro/U.S. Dollar	\$1.2574	\$1.2381	+\$0.0193

less competitive in the face of the fading euro.

Not surprisingly, given the turmoil in Europe, investors are looking for safe havens and are thus snapping up U.S. Treasuries. In fact, in March China was a net buyer of our debt for the first time since last September and it now holds \$895.2 billion in Treasuries. But the Chinese stock markets have been stumbling of late as a result of the situation in Europe coupled with the concern that its government is going to put the brakes on the country’s overheated economy which would mean higher interest rates (China’s economy grew 11.9% in the first quarter). As of last week, the Shanghai index, which was the best performer in the world last year, up 80%, was down 21% this year, and Hong Kong’s Hang Seng was off about 9% in 2010. One cultural note: Last week in Shanghai the city unveiled a huge bronze sculpture in the financial center that is an exact replica of the one that’s been a landmark on Wall Street for so many years.

As noted, the economic news in the United States was mostly positive. With the first quarter earnings reports all but in, last week saw more excellent returns, this time from Dell, HP, Home Depot, and even GM, which posted its first quarterly profit since 2007.

Bolstered by the recently expired homebuyers' tax credit, home building rose 5.8% in April from March, a 40.9% gain from April a year ago, with the Commerce Department reporting that work started on 672,000 new homes, the highest total since October of 2008.

The Labor Department said that producer prices fell 0.1% in April thanks to lower food and energy costs. The core producer price index, without the volatile food and energy figures, rose 0.2%. Later in the week, the Labor Department reported that inflation in April was actually down 0.1%, mostly because of lower energy costs. The core price index, less food and energy, was flat, and over the 12-month period it was up only 0.9%, its lowest growth rate since the 1960s (the consumer price index increased 2.2% over the same period).

The rate of inflation was addressed in the minutes of the Federal Open Market Committee's late April meeting that were released last week in which the FOMC slightly lowered its estimates for inflation this year. The FOMC also discussed how to begin to sell the assets it acquired during the financial crisis – the Fed more than doubled its balance sheet to \$2.3 trillion during that time – but indicated it would not start doing so until after it had raised the federal funds rate, which has been unchanged since December of 2008. On another positive note, the FOMC revised its forecast for gross domestic product (GDP) growth in 2010 to 3.2-to-3.7% from 2.8-to-3.5% in January.

The week was not without its glitches on the home front, however. The Labor Department also said that first-time

unemployment claims jumped unexpectedly last week, rising 25,000 to 471,000, the first increase in five weeks. Even so, the jobless rate fell in 34 states in April with only six states seeing upticks and 10 remaining unchanged. And the Conference Board's Leading Economic Index declined for the first time in more than a year, down 0.1% (after rising 1.3% in March) as six of the 10 indicators in its index fell. Ken Goldstein, an economist at the Conference Board, said, "These latest results suggest a recovery that will continue through the summer, although it could lose a little steam."

The broader view

At long last, the Senate passed the financial overhaul package that has been its main focus since the health care bill, with enough Republicans crossing the aisle to all but assure it will become law after being reconciled with the House version, passed in December – President Obama is hoping to sign the bill into law by July 4th. Hailed as the most comprehensive such bill since the Great Depression, it was created to prevent a repeat of the 2008 crisis, recast the role of various federal agencies, and empower the Fed to predict and address future crises.

The main differences between the House and Senate versions relate to derivatives (the Senate's version is tougher and the administration favors the House version), the proposed consumer financial protection agency (the Senate version grants it less autonomy), the question of whether banks should be banned from making market bets with their own money (the so-called "Volcker Rule"), and the way that the government could take over, and perhaps take apart, large financial firms or banks that were seen as a threat to economic stability. Even so, Christopher Dodd (D, Connecticut), the chairman of the Senate Banking Committee, said, "This is one of those rare occasions when the two bills are really very close together."

That said, the road to reconciliation will not be smooth, based on the upcoming midterm elections and comments by the Senate minority leader Mitch McConnell (R, Kentucky), who said the bill amounted to a government takeover of Wall Street. He characterized it as a “massive government overreach,” and added, “The marching orders are coming from downtown: push the bill as far to the political left as possible.”

The stock market seemed to respond positively to the bill’s passage in the Senate, mainly because it reduced the uncertainty about the bill. However, a Goldman Sachs research report released last week said the bill could cut earnings at the nation’s 28 largest banks by more than 20%.

A look ahead

This week, the horse-trading over the two versions of the financial overhaul will begin in earnest and the lobbyists for the financial



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All index references and performance calculations are based on information provided through Bloomberg. Bloomberg is a provider of real-time and archived financial and market data, pricing, trading, analytics, and news.

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-

industry will be deployed in force. There will also be several updates on the state of the housing market – mortgage applications, new and existing home sales, and the S&P/Case Shiller Home Price Index, as well as reports on personal income and spending, personal consumption, and the sale of durable goods. Also, Treasury Secretary Timothy Geithner, who is heading to China this week, has added Europe to his itinerary. He will meet with EU leaders and is expected to lobby them to be more sensitive to the market when taking policy steps and also to pick up the pace for stabilizing out Greece, Portugal, and Spain.

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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.

NASDAQ - National Association of Security Dealers Automated Quotations. The NASDAQ is a computer operated system owned by FINRA that provides dealers with price quotations for over the counter stocks.

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

Shanghai Composite - An index of all stocks that are traded at the Shanghai Stock Exchange.

The Hang Seng Index offers a comprehensive Hong Kong market benchmark that covers about 95% of the total market capitalization of companies listed on the Main Board of the Stock Exchange of Hong Kong.

The Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output. The prices included in the PPI are from the first commercial transaction for many products and some services.

The Consumer Price Indexes (CPI) program produces monthly data on changes in the prices paid by urban consumers for a representative basket of goods and services.

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.

The S&P/Case-Shiller Home Price Indices are designed to be a reliable and consistent benchmark of housing prices in the United States. Their purpose is to measure the average change in home prices in a particular geographic market. They are calculated monthly and cover 20 major metropolitan areas (Metropolitan Statistical Areas or MSAs), which are also aggregated to form two composites – one comprising 10 of the metro areas, the other comprising all 20.