



July 19, 2010

Even though solid earnings announcements flowed throughout the week, the equity markets were unable to keep the prior week's rally going. Despite strong news from the likes of Intel and JP Morgan earlier in the week, sellers on Friday found the glass half full when companies such as Bank of America, Citigroup and General Electric announced their quarterly results and outlooks. Adding fuel to the fire was a much worse than expected report on consumer sentiment that helped take the Dow down 2.5% on Friday, the largest one-day decline this month.

On Thursday, the U.S. Senate approved the most far-reaching piece of financial legislation since the 1930's, aimed at overhauling the nation's financial regulatory framework. The sweeping reform – all 1,616 pages of the bill – establishes a new consumer protection bureau aimed at preventing deceptive and abusive practices in the marketing of financial products to consumers, permanently increases the FDIC coverage limit to \$250,000 on bank deposits, mandates income qualifications mortgage lenders need to employ on borrowers, establishes a new Federal Insurance Office to oversee the insurance industry, and provides greater transparency in derivatives trading. These are just a few of the changes President Obama will likely soon sign into law.

Economic releases last week generally confirmed that the economy more than likely has hit a soft patch. Retail sales declined 0.5% in June, mainly driven by a 2.3% decline in vehicle sales for the month.

	Key Market Data		
	Week ending...		
	7/16/10	7/9/10	Change
Dow Jones Industrial Average Index	10,097.90	10,198.03	-0.98%
S&P 500 Index	1,064.88	1,077.96	-1.21%
NASDAQ Composite Index	2,179.05	2,196.45	-0.79%
10-Year Treasury Note Rate	2.93%	3.056%	-0.126 pct. pts.
NYMEX Crude Future (Barrel)	\$76.01	\$76.09	-0.01%
Euro/U.S. Dollar	\$1.2927	\$1.2640	+\$0.0287

On Thursday, the Labor Department reported that wholesales prices dropped 0.5% in June, the fourth decline in the last five months, and more than the -0.1% consensus estimate supplied by Bloomberg. Food prices dropped 2.2%, the most since 2002, which accounted for over 80% of the decline in the Producer Price Index (PPI). Deflationary pressures continued to slow price increases with the year-over-year PPI measurement dropping to 2.8% from 5.3%. June consumer prices dipped down 0.1% as expected, putting the year-over-year increase in the Consumer Price Index (CPI) at a modest 1.1%. Some counter-deflationary trends could be detected in the core CPI, which excludes food and energy, rising 0.2%. This was the largest increase since October 2009. The most concerning news came on Friday, when the University of Michigan reported that consumer sentiment plunged to 66.5 in the first half of July from a 75.5 reading in the second half of June. From a numbers perspective, it appears that both current conditions and expectations call for a clear slowdown in consumer activity.

On Wednesday, the minutes of the June 22-23 Federal Open Market Committee (FOMC) meeting revealed that Committee members had revised down modestly their forecast for economic growth in the next eighteen months. Concerns about increased volatility in the financial markets, largely driven by the sovereign debt concerns emanating from the Euro zone, were cited as adversely impacting investor confidence and prompting a strengthening in the U.S. dollar and a corresponding drop in equity prices. These factors were expected to dampen domestic demand, resulting in a lower real gross domestic product (GDP) growth forecast. Prospects for improvement in the labor market are expected to unfold gradually, which is consistent with the FOMC's outlook for slower economic recovery.

The broader view

Over the next three weeks, we'll take advantage of the usual summer lull in the stock market to look more closely at three issues that are always of importance to our clients as well as the ways we at Northwestern Mutual go about addressing those issues. We'll begin this week with an update on how we shape and implement our forward-looking capital market expectations; continue the week of July 26 with a look at our strategy for investing in global and emerging markets; and finish up on August 2 with an overview of our approach to rebalancing.

Let's start with the basics. Asset allocation is the first and most important decision that must be made when creating an investor's portfolio, explaining more than 90% of the variation in a portfolio's total plan return. There are three crucial, and highly complex, data points that relate to effective allocation: 1) the performance returns for each asset class – we typically recommend eight – which are based on historical performance, pretty easy to determine, and projected future returns, not so easy to determine; 2) the volatility for returns within each asset

class; and 3) the correlations between the various asset classes and performance returns. Taken together, this information allows us to create a portfolio based on the "efficient frontier," the best way to invest into a variety of asset classes based on the relative risk and return.

The key variable in all of this is, of course, the quality of the information plugged in, and the information that's the most difficult to determine is naturally that related to future performance, a.k.a., forward-looking capital market assumptions, or, more simply, the projected return of each asset class over the course of time. And whatever claims firms or fund managers may make, no one can predict the future, but the more educated and informed the guess, the more effective an investor's asset allocation will be.

So how do we go about it? We've developed a proprietary process to generate capital market assumptions by combining the expertise of a number of areas across our enterprise, including the Northwestern Mutual Wealth Management Company, Mason Street Advisors, Advanced Financial Security Planning, Northwestern Mutual Investment Services, our Treasury and Investment Operations team, Corporate Planning and our Actuary team. Phew. We've done so because we firmly believe that an enterprise-wide approach will help us establish a framework for setting consistent capital market assumptions. Those assumptions, designed to produce annualized returns for a variety of asset classes over a ten-year time horizon, will in turn enable us to develop rational investment expectations that are objective, repeatable and transparent, precisely what our clients should expect of us. Importantly, the forward-looking assumptions we generate can also help us develop strategic asset allocation policies and guide our investment decision-making.

To be more specific, here's what we do. We use a building block methodology that's

anchored by such macroeconomic variables as real gross domestic product (GDP) and inflation, obtained from the Livingston Survey that's produced semi-annually by the Federal Reserve Bank of Philadelphia. We also use forward yield curves to forecast cash and U.S. Treasury returns. For riskier assets, such as corporate bonds and equities, we add additional risk premium that produces an excess return component. In the case of real or hard assets, such as commodities, our return projections are centered on expected global GDP growth and adjusted for the weightings of developed and developing countries' contributions.

And, since the world's economy is far from static, we update our capital market assumptions twice a year and review any changes to our strategic asset allocation policies as necessary. At present, our long-term forecast is for slightly lower nominal rates of return across asset classes. This is a result of the impact the ongoing global de-leveraging process will have on the capital markets. In addition, we see that over the next decade, emerging economies will play a more dominant role in driving world GDP. Finally, we track expected returns against actual returns over time to make sure we're on target.

It's a combination of art and science, but we believe we've come up with the next best thing for forecasting the future of various



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asset classes: a carefully constructed, data-driven model that puts the collective expertise of Northwestern Mutual to work on behalf of our clients. Moreover, over the coming months we'll be introducing specific recommendations on how clients' portfolios may be positioned to take advantage of our long-term investment views. Please consult with your financial advisor if you have any questions.

A look ahead

This week will be fairly light with respect to economic releases with reports on existing home sales, housing starts and leading indicators the most visible. Federal Reserve Chairman Benjamin Bernanke will provide some insight into the current state of the economic recovery in his semi-annual report to Congress. Second quarter earnings reports from the likes of Ford, IBM, Apple, Goldman Sachs, Johnson & Johnson and Morgan Stanley will provide a busy week for analysts and hopefully bring more optimism with respect to economic growth prospects.

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Please remember that all investments carry some level of risk, including the potential loss of principal invested. Indexes and/or benchmarks are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment. Diversification and strategic asset allocation do not assure profit or protect against loss. Although stocks have historically outperformed bonds, they also have historically been more volatile. Investors should carefully consider their ability to invest during volatile periods in the market. The securities of small capitalization companies are subject to higher volatility than larger, more established companies and may be less liquid. Bond investors should carefully consider risks such as interest rate risk, credit risk, securities lending, repurchase and reverse repurchase transaction risk. Greater risk is inherent in investing primarily in high yield bonds. They are subject to additional risks, such as limited liquidity and increased volatility. There is an inverse relationship between interest rates and bond prices. Investing in foreign securities is subject to certain risks not associated with domestic investing such as currency fluctuations and changes in political and economic conditions.

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-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 the NASD 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.

The Livingston Survey, which began in 1946, is the oldest continuous survey of economists' expectations. It summarizes the forecasts of economists from industry, government, banking and academia. The Federal Reserve Bank of Philadelphia took responsibility for the survey in 1990.