



February 1, 2010

It's a sign of just how fragile investor confidence is right now that in a week of what might easily be construed as mostly good news, the Dow fell 105.65 points and was only one more poor showing away from dropping back under the 10,000 point mark, a key psychological barrier. This came despite the fact that President Obama, in his State of the Union address, made it clear that it was too early in the recovery to end stimulus spending; that Benjamin Bernanke won a second term as Chairman of the Federal Reserve; that fourth-quarter earnings reports were largely better than expected; and that the U.S. economy grew at its fastest clip since 2003. So what happened? Simply stated, nervous investors accentuated the negative. Instead of being pleased that Mr. Obama said stimulus spending was crucial to job creation, deficit hawks saw further spending raising the already bloated deficit. Instead of relief that Mr. Bernanke held onto his job, pundits said he had been gored during the process and lost credibility. Rather than see Apple's soaring earnings, for example, as a good sign, demanding investors decided the new iPad just didn't pack enough "wow" and Apple's stock was punished. And instead of being delighted that gross domestic product (GDP) growth was well above expectations, analysts discounted the spike as the product of a one-time restocking of business inventories. As a result, the market has now fallen 6.1% from its 15-month high on January 19, and may be in the midst of a correction, broadly defined as a 10% drop.

Not only was it a bad week for the three indexes, but for the month, the Dow fell

	Key Market Data		
	Week ending...		
	1/29/10	1/22/10	Change
Dow Jones Industrial Average Index	10,067.33	10,172.98	-1.04%
S&P 500 Index	1,073.87	1,091.76	-1.64%
NASDAQ Composite Index	2,147.35	2,205.29	-2.63%
10-Year Treasury Note Rate	3.611%	3.597%	+0.014 pct. pts.
NYMEX Crude Future (Barrel)	\$72.89	\$74.54	-2.21%
Euro/U.S. Dollar	\$1.3863	\$1.4139	-\$0.0276

3.5%, the S&P 500 3.7%, and the NASDAQ 5.4%, the worst month since February of last year, just before the selloff began. And, as noted in my commentary on January 11, Ned Davis Research has said that, based on the market's performance from 1900 through 2009, the Dow will rise a median average of 10.4% for the rest of the year when it's up in January but improve only an average of 0.28% when it's down for the month. For those who believe in trends, at least the Super Bowl Index bodes well; when one of the original NFL teams (there for the merger in 1970) wins the big game, the stock market is up 79% of the time, and this year it's a sure thing as both the Saints and the Colts (then from Baltimore) were around in 1970. Talk about grasping at straws.

On Tuesday, the Congressional Budget Office called the U.S. budget outlook "bleak" and estimated that it would be \$1.35 trillion in fiscal 2010. In an effort to address the deficit, Mr. Obama proposed a three-year spending freeze on discretionary spending that accounts for one-sixth of the federal budget. The freeze, details of which are

expected to be announced today, is designed to save \$250 billion over the next decade while leaving untouched spending on the military, homeland security, Medicare, and Social Security.

In his State of the Union Address on Wednesday night, Mr. Obama reiterated his desire to see Congress revamp financial regulations, compared the bailout to a "root canal," and defended stimulus spending as a job creator, adding that right now jobs were more important than debt (additional programs are expected to take stimulus spending from \$787 billion to the \$1 trillion mark). He said he wanted to double U.S. exports in the next five years and planned to use repaid bailout money to fund job creation by, among other initiatives, offering tax credits to small businesses that hire. He also used his executive power to create a committee to study the deficit and ways to lower it, a proposal that had been rejected by the Senate earlier in the week.

The Commerce Department reported that GDP growth was a lofty 5.7% in the fourth quarter following a rise of 2.2% in the third. It was the biggest increase since the 6.9% in the third quarter of 2003, but naysayers noted that a total of 3.4 percentage points came from, in effect, businesses cutting into their inventories more slowly, which will level off, and that all-important consumer spending actually fell to 2.0% from 2.8% in the previous quarter. Further, as Commerce Secretary Gary Locke said, "Today's strong GDP showing represents important economic progress that must now be translated into new jobs." For all of 2009, GDP fell 2.4%, the largest yearly contraction since 1946. Looking to 2010, the International Monetary Fund raised its forecast for global economic growth from the 3.1% estimated last October to 3.9%, with U.S. GDP rising 2.7% and China's 10.0%.

The Federal Open Market Committee (FOMC) met on Tuesday and Wednesday, and again kept its rate at near zero, though it

wasn't a unanimous vote for the first time since January of last year, with Thomas Hoenig, president of the Federal Bank of Kansas City, voting to raise the rate. Overall, the FOMC was slightly more upbeat about the economy, saying, "economic activity has continued to strengthen" and "the deterioration in the labor market is abating." It also restated its intention to end its \$1.25-trillion program to purchase mortgage-backed securities in March.

Meanwhile, news from the housing front continued to be deflating. Sales of previously owned homes fell a whopping 16.7% in December, according to the National Association of Realtors (though some wrote it off, again, as a reaction to the home-buyers' tax credit; once it was extended into 2010, people put off purchasing). However, for the year, sales climbed 4.9% and the median price rose the same 4.9% from November to \$178,300 in December, the biggest monthly increase since 2005. The Commerce Department reported that sales of new homes fell 7.6% to a seasonally adjusted rate of 342,000 in December, the weakest figure since March of 2009 and well below the forecast of 370,000. Overall, the number of new homes sold fell 23% from 2008 to 2009, the worst year since record-keeping began in 1963. The Standard & Poor's Case Shiller Home Price Index rose 0.2% in November, again attributable to what was thought to be the tax credit's impending demise, but the index is down 5.3% from last year and off 29.2% from its high in 2006.

The Commerce Department also said that orders of durable goods (those built to last three years or more) rose a modest 0.3% in December (the expectation was 2%) to a seasonally adjusted \$167.9 billion after a 0.4% drop in November. For all of 2009, orders were down 20.2%, the biggest drop since 1992.

Across the Atlantic, the annual World Economic Forum was underway in Davos,

Switzerland, and, as *The Wall Street Journal* styled it, this year's theme was, "First, kill all bankers." The international backlash against banks continued, fueled by the perception that they precipitated the crisis, were saved by the bailout, and are now profiting because of it. Dominique Strauss-Kahn, head of the International Monetary Fund, spoke of the need for addressing bank regulation but urged a "multilateral solution," noting that "the strength of international cooperation" is what prevented a second worldwide Depression.

The broader view

Few events have been as revealing of the public's ill will toward Wall Street, and the calculated political response to it, than Mr. Bernanke's renomination as Fed chairman. As bonus season neared, and Americans began to howl, his job became the flashpoint. In the end, he won a second term by what one would think would be a comfortable margin in the Senate, 70-30 votes. In fact, that represents the lowest percentage of "yes" votes for a proposed chairman in the Fed's 96-year history (by comparison, only one Senator voted against Bernanke in 2005; perhaps that's the price one pays for serving under presidents from different parties). And it comes at a time when both the Senate and the House are considering bills that would weaken the Fed's oversight and power to set its rate, not to mention when critical decisions are going to have to be made as to when the Fed's rate will finally be raised and at what pace. In sum, the issue is that on the way to getting his job back, Mr. Bernanke was excoriated by his detractors and tepidly endorsed by his supporters (especially those facing reelection). The comment of Orrin Hatch (Utah, R), is illustrative of the sour mood: "This man

knows what he's doing. Can he improve? You bet your life. But I'm going to vote for him." Some see the result of the criticism and second-guessing as compromising Mr. Bernanke's ability to make those very tough decisions that lay ahead of him. As the editorial board of *The Wall Street Journal* said, while again coming out against his getting his job back, "The next Fed chairman is going to need the market credibility, and political support, to raise interest rates when much of Congress and Wall Street will be telling him to stay at zero." At least Mr. Bernanke did not suffer the same indignities as his counterpart in Argentina who was fired by his president, reinstated by a judge, and then barred from his office by police when he tried to sneak in last Sunday night.

A look ahead

This week there will be reports on manufacturing, construction spending, car sales, and productivity, all closely watched indicators of economic good health. But the number everyone will be waiting for is the unemployment rate for January, released by the Labor Department on Friday. A dip below the current jobless rate of 10% could ease the minds of investors, while a rise might provide enough momentum to complete the correction. That said, a correction is not shocking given the rebound of last year that was in part the result of investors returning to higher risk investments. There's no good reason, however, for thinking it's the start of a double-dip, especially given the slow but steady improvement in economic fundamentals since the recovery began; as of today, there's no sequel to Lehman Brothers on the horizon.

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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-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.

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.

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.