



February 22, 2010

In a holiday shortened week, the debt woes of Greece took a backseat to the policymaking of the Federal Reserve, which raised the interest rate on its emergency loans to banks – the first time it has raised any rate since the recession began – and then embarked on a furious public relations campaign to convince investors that it had not advanced its timetable for increasing its signature overnight lending rate as well. The Fed succeeded, and as a result, the Dow was up on every trading day for the first time in 2010 and had its best overall week since early November of 2009, up 3%.

As the week began, the fate of Greece was still center stage and, despite having pledged to do so, the European finance ministers meeting in Brussels were still resisting giving any details as to just how Greece would be rescued. There were three very good reasons for their reticence. First, they were still reluctant to send a sign that they would step in to save profligate spenders who would then have less incentive to curb their poor spending habits. Secondly, Germany, the European Union’s strongest economy, was not yet on board with the bailout, and a survey showed that two-thirds of Germans were against any financial aid for Greece. Lastly, Greece was still vague about how it was going to reduce its spending – its fellow European Union members wanted Greece to cut its debt as a percentage of gross domestic product (GDP) by four percentage points, all the way from 12.7% in 2009 to 8.7% this year on the way to 3% by 2012, the limit for EU members. The EU gave Greece until March 16 to show a plan for debt reduction or it will demand “steep

	Key Market Data		
	Week ending		
	2/19/10	2/12/10	Change
Dow Jones Industrial Average Index	10,402.35	10,099.14	+3.00%
S&P 500 Index	1,109.17	1,075.51	+3.13%
NASDAQ Composite Index	2,243.87	2,183.53	+2.76%
10-Year Treasury Note Rate	3.782%	3.691%	+0.091 pct. pts.
NYMEX Crude Future (Barrel)	\$79.81	\$74.13	+7.66%
Euro/U.S. Dollar	\$1.3595	\$1.3618	-\$0.0023

spending cuts and fresh taxes,” all against the backdrop of further strikes and walkouts by civil service employees in Greece.

On the home front, President Obama took a step to address our burgeoning federal debt, using an executive order to create a bipartisan commission to recommend ways to reduce the deficit after Congress rejected his plan for such a group, the Democrats loathe to cut entitlement programs and the Republicans not wanting to raise taxes. “Those who preach fiscal discipline have to be willing to take the hard steps necessary to achieve it,” the president said. The 18-member commission, which will deliver a report recommending ways to lower the deficit to 3% by 2015 in December, after the midterm elections, will be co-chaired by Alan K. Simpson, the former Senate leader from Wyoming, and Erskine B. Bowles, a Democrat from North Carolina who was President Clinton’s chief of staff. This move by the president came during the same week that a moderate Democrat, Evan Bayh of Indiana, said he would not seek reelection because of the partisanship and pre-election

posturing by both parties that has led to congressional paralysis on the deficit, among other issues. The worst-case scenario for the deficit is that the mostly foreign investors who have been buying our debt will demand higher interest rates, threatening our government's ability to finance its borrowing. Even some Fed members, not probe to weigh in on fiscal policy, did do last week, with Richard Fisher, the president of the Dallas Federal Bank, saying, "Fiscal profligacy in Washington today hinders our ability to address fiscal issues tomorrow." On a related note, China sold enough of the U.S. debt it holds in December to put Japan back on top as our number one lender for the first time since 2008, at \$768.8 billion compared to \$755.4 billion for China.

In the short term, as the president has indicated, the deficit is less of a priority than economic recovery, and last week there was plenty of bipartisan back-and-forth about the impact, or lack thereof, of stimulus spending on the one-year anniversary of the signing of the bill that created what is officially known as the American Recovery and Investment Act. Mr. Obama said the spending saved or created two million jobs, lowered taxes for 95% of Americans, and staved off a second Great Depression. The GOP countered that three million jobs had been lost since the bill became law, the unemployment rate had climbed to 10%, and the deficit for this fiscal year was a record \$1.6 trillion. It was up to the nonpartisan Congressional Budget Office to have the final word (for now, anyway), pointing out that while the economy did indeed shed those three million jobs, it could have been as high as five million without the stimulus spending.

The Fed reported that industrial production rose 0.9% from December to January, the seventh straight monthly increase, supporting the thinking that companies are beginning to ramp up to restock their shelves. Capacity utilization rose from

71.9% in December to 72.6% (the average over the last two decades is 80%).

The Labor Department said that consumer prices were all but flat in January, climbing just 0.2% and lowering concern that the Fed will have to address inflation (and raise its rate) anytime soon. Excluding the volatile food and energy costs – and gasoline prices jumped 11.5% last month – the rate fell 0.1%, the first drop since the recession of 1982. For all of 2009, consumer prices rose 2.6% while core inflation was up 1.6%. Producer prices were up 1.4% in January, higher than expected as a result of those same gasoline prices, but still not enough to set off any inflation alarms.

The Commerce Department reported that housing starts rose 2.8% in January from December to an annual rate of 591,000, the highest level in six months and a 21% gain year-to-year. Still, there was a 4.9% decline in the number of building permits and a 12.4% falloff in completed houses, illustrating just how fragile the housing market still is. The Mortgage Bankers Association said that fewer people fell behind on their mortgage payments in the fourth quarter, with 3.63% of borrowers 30-to-59 days late compared to 3.79% in the third quarter, good news as that figure typically rises in the last quarter because of higher heating bills and holiday spending.

The broader view

Then there was the Fed and its policy tweak, heavily telegraphed but still unexpected as the move came between meetings of the Federal Open Market Committee (FOMC). In raising its rate on the money it lends banks (a.k.a. "emergency loans"), the Fed was indicating that it believes that the extraordinary steps it took in 2008 to support the banking sector are no longer necessary (while also bringing an end perhaps to some of the out-sized profits for those banks that have been able to borrow money cheaply from the Fed and then lend it at a higher rate to take advantage of the

near-record high gap between short- and long-term interest rates). The move was the first hike since 2006 and, as noted by many, largely symbolic as the level of bank borrowing had tapered off and the rate, even when raised from 0.50% to 0.75%, is still low by historical standards (it's typically one full percentage point higher than the Fed's overnight lending rate, currently at 0.25%, and the .50% mark was the lowest since World War II).

Even though the Fed statement made clear that the rate change did not "signal any change in the outlook for the economy or for monetary policy," the stock market fell in after-hours trading, and the Fed then rallied its forces, hitting the airwaves to make it clear that the tweak was a mere "technical change" and the result of "further normalization," while maintaining that the idea that it was the first step toward broader policy changes was "overblown." In the end, the Fed seemed to have convinced leery investors that though it feels the crisis is past for America's banks, that is not the case for other businesses or for consumers, and it again pledged to keep its short-term rate "exceptionally low" for an "extended period." The fact that the market was up, if only just, on Friday, indicates that the Fed succeeded in its PR campaign.

This came in the same week that the minutes of the FOMC's January meeting were released which showed that while the short-term rate was a subject of discussion, the timing and sequencing – how soon and how



Emmett Wright, CFA
Chief Investment Officer
Northwestern Mutual Wealth Management Company

Emmett Wright is the Chief Investment Officer of The Northwestern Mutual Wealth Management Company. The opinions expressed are those of Emmett Wright as of the date stated on this report and are subject to change. There is no guarantee that the forecasts made will come to pass. This material does not constitute investment advice and is not intended as an endorsement of any specific investment or security. Information and opinions are derived from proprietary and non-proprietary sources.

Northwestern Mutual Wealth Management Company, Milwaukee, WI, is a subsidiary of The Northwestern Mutual Life Insurance Company, Milwaukee, WI (NM) and a limited purpose federal savings bank authorized to offer a range of financial planning, trust, fiduciary, investment

fast – was still dependent on a stronger economy and positive news about employment. The members discussed the relationship of that short-term rate and the \$1.1 trillion in excess reserves from banks that it currently holds, debating whether the reserves should be reduced before raising the rate, the reverse, or whether the two events should happen simultaneously. The FOMC also projected that the unemployment rate would remain at 9.5-to-9.7% for the rest of 2010 and that inflation-adjusted GDP for this year would come in between 2.8% and 3.5%.

A look ahead

This week, there will be further news from the housing front, including the S&P/Case Shiller home price index as well as the latest numbers on new and existing home sales. The Commerce Department, meanwhile, will report on durable goods orders and also revise its estimate of GDP growth for the fourth quarter, expected to be down modestly from the initially reported 5.7%. However, at home all eyes will once again be on Benjamin Bernanke, the Fed chairman, who will visit the House on Wednesday and then the Senate on Thursday to deliver his semiannual report. And abroad, investors will watch closely as Greece tries to sell a new € billion bond offering; should demand be low, its EU neighbors may have to start taking the possibility of a bailout even more seriously.

61-1200

advisory and investment management products and services. Securities are offered through **Northwestern Mutual Investment Services, LLC**, subsidiary of NM, broker-dealer, registered investment adviser, member FINRA and SIPC.

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 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.

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.