



May 3, 2010

Despite earnings reports that exceeded the high expectations of analysts, slightly more upbeat news from the Federal Reserve Board about the state of the economy, and the announcement on Friday that gross domestic product (GDP) rose a solid 3.2% in the first quarter, the week and month ended on a down note as it became clear that the dithering in Europe over Greece's fate had led to exactly what everyone was hoping to avoid – contagion – while the announcement of a second investigation against Goldman Sachs (this one criminal, not civil) sent the firm's stock in a one-day plummet that stripped away \$21 billion in market value, taking the equity markets down with it. In the end, the eight-week winning streaks for the Dow and NASDAQ were snapped, but all three major indexes did finish up for the month of April, with the Dow gaining 1.4%, the S&P 500 climbing 1.5% and the NASDAQ adding 2.6%.

For those who like overheated rhetoric and finger-pointing, the U.S. Senate was the place to be last week. As expected, the Democrats tried to move the financial overhaul bill to a debate in the Senate (the bill was passed by the House back in December), and, as expected, the Republicans voted to stall the debate for three days in a row (the Democrats are one vote short of being filibuster-proof in the Senate). The Democrats claimed that the GOP was stonewalling to protect its friends on Wall Street while the Republicans said the majority party was pushing them around to rush through a bill that was not ready for prime time, as had been the case with health care. In moving the bill to debate, Senator

	Key Market Data		
	Week ending		
	4/30/10	4/23/10	Change
Dow Jones Industrial Average Index	11,008.61	11,204.28	-1.75%
S&P 500 Index	1,186.69	1,217.28	-2.51%
NASDAQ Composite Index	2,461.19	2,530.15	-2.73%
10-Year Treasury Note Rate	3.663%	3.813%	-0.150 pct. pts.
NYMEX Crude Future (Barrel)	\$86.15	\$85.12	+1.21%
Euro/U.S. Dollar	\$1.3314	\$1.3375	-\$0.0061

Christopher Dodd (D, CT), chairman of the Senate Banking Committee, said, "We are as vulnerable as we are today in the waning days of April 2010 as we were in the fall of 2008. Nothing has changed. Except, of course, jobs have been lost, homes have gone into foreclosure, retirement incomes have evaporated, housing values have declined." The impasse was finally breached late on Wednesday, the day after executives from Goldman Sachs were taken to task by both parties during a Senate subcommittee session investigating the causes of the recession. There was no smoking gun – although some indelicate emails were aired – but it clearly became difficult for the GOP to excoriate Goldman Sachs in one ante-chamber and then be portrayed by their rivals as the defender of the financial industry on the floor of the Senate. When the majority leader Senator Harry Reid (D, Nevada) requested the unanimous vote of the Senate to move forward, and was not resisted, he said, "Now let's get to work. And let's do the utmost to make the American people proud of our efforts. Wall Street needs reforming." Both sides,

predictably, given the upcoming elections, claimed victory as the bill was opened for debate and amendments, with the expectation that it will be voted on in about two weeks. The issues dividing the parties, meanwhile, remain largely unchanged: the status and power of a new consumer agency, the regulation of derivatives, and the proposed bailout account funded by major financial firms.

Amidst all the back-and-forth, there were a number of new signs that the economy was still solidly on the mend. Two bellwether firms, Caterpillar and Ford, both came in with better-than-expected first quarter returns, and S&P 500 firms are currently on track for a record “surprise factor” – the number of companies beating analysts’ expectations (the average since 1994 is about 61%, according to Thomson Reuters).

As expected, the Federal Open Market Committee (FOMC) did not deviate from its ongoing pledge to keep the federal funds rate “exceptionally low” for an “extended period,” especially as inflation remains in check. Even so, the FOMC statement did contain some slightly more upbeat language, saying that the labor market was “beginning to improve” as opposed to merely “stabilizing” as it said after its previous meeting on March 16th. The FOMC also noted that household spending has “picked up recently” though it “remains constrained by high unemployment, modest income growth, lower housing wealth, and tight credit.” The news was enough to send the Dow up 53.28 points on Wednesday.

Housing continued to be stuck in low gear, however. The Standard & Poor’s Case-Shiller Home Price Index for 20 major metropolitan areas posted a slight annual increase of 0.6% in February but the monthly number was down 0.9%, the fifth straight drop, with 19 of 20 cities reporting declines. The index remains 30.3% off its peak in mid-2006.

Then on Friday, the Commerce Department reported that first-quarter GDP had come in just about as expected, up 3.2%. Though the reception was somewhat subdued given the stubbornly high unemployment rate – President Obama responded to the report by saying, “‘You’re hired’ is the only economic news many people are waiting to hear” – there were a number of positive signs beneath the number. For example, following the increase of 5.6% in the fourth quarter of 2009, it was the best six-month run since 2003. Further, consumer spending was up 3.6% compared to an increase of 1.6% in the previous quarter, led by purchases of durable goods such as cars. Business purchases of equipment and software grew at an annual rate of 13.4% (after 19% in Q4). And for the first time in two years, businesses began rebuilding inventories, which accounted for nearly half of the quarter’s growth.

Lastly, the president’s bipartisan debt commission, charged with coming up with a deficit reduction plan by December 1, had its first meeting last week. Mr. Obama said that “everything has to be on the table,” while the commission’s co-chairman, Alan Simpson, the former Republican Senator from Wyoming, warned that, “the extreme right and the extreme left will savage our final product.” At the same time, the idea of a European-style value-added tax that had been floated as a possible way to address the deficit by, among others, Paul Volcker, the former Fed chairman who is now one of Obama’s advisors, was taken off the table for “now or the indefinite future,” mainly because it had become the focal point for GOP opposition. In Japan, meanwhile, the government came up with a novel way to hold its bureaucrats responsible for what they spend: lawmakers taking them to task in public hearings that are streamed online.

A closer look

Greece has been on the front pages for many months now, and there has been a certain sameness to the drama that gives it a soap

opera quality. Greece has been profligate, threatening the euro. Its partners in the European Union (EU) shake their heads and tut-tut. The cost of Greece's debt increases. Greece pledges to behave more responsibly. France and Germany finally say they'll help in return for Greek belt-tightening. The Greeks take to the streets in protest of new austerity measures. The market settles. And then the story starts all over again. (Regarding Greece and its profligacy, *The New York Times* recently offered an irresistible stat. In one high-end suburb in Athens, the government was suspicious when taxpayers reported a total of only 324 swimming pools. Investigators used satellite photos and found that the actual number of pools was just a tad higher: 16,974.)

Last week, however, the stories took a definite turn for the worse and observers both inside Europe and elsewhere were quick to weigh in: If the EU had acted months ago, this crisis might well have been minimized. Or, as the former German foreign minister Joschka Fischer succinctly put it, "Why the fire department has been scratching its head for weeks instead of operating the pumps, I don't understand."

As a result, over the course of a few days, not only was the debt of Greece downgraded to junk, a first for an EU nation, but the debt of both Portugal and Spain were also lowered. (Greece and Portugal together account for less than 5% of the EU's GDP but Spain has its fourth largest economy, thus the concern about "contagion.") The yield on Greece's benchmark 10-year note closed in on a new high of 10% and the cost of insuring debt in Portugal and Spain also hit record levels. Suddenly, instead of the tab of €45 billion that was being discussed just a week or two ago, the new cost of saving Greece was put at €120 billion. The issue is further clouded by the fact that Germany and France, who stand to be the biggest contributors to any bailout, already hold billions in Greek bonds (Germany an estimated \$36 billion and France about \$54

billion), some of it now rated junk. Worse still, there's a growing concern that the money may be wasted, used not to rebuild Greece's economy, but simply to pay off debt. In other words, the market began to think the EU was all talk and no action.

Even as the crisis spiked last week, the German Chancellor Angela Merkel continued to dither, in large part because she was hoping to avoid acting before May 9 when there's a key regional election in Germany where public opposition against the bailout is very high. She made it clear that if Greece was going to get any money, it would have to accept "harsh measures" to get its economy under control.

It's an additional embarrassment for the EU that the International Monetary Fund (IMF), whose intervention was eschewed at the outset as an insult to the EU – we can handle our own economic affairs, thank you – is now playing the leading role. Meanwhile, as the IMF's chief Dominique Strauss-Kahn said, "Every day that is lost, the situation is growing worse and worse, not only in Greece, but in the European Union."

By week's end, Greece had agreed to still further austerity measures – and was preparing for a long weekend of strikes and demonstrations – with the goal of having enough money in hand by May 19th to cover an upcoming debt payment of some €10 billion.

The week ahead

This coming week there will be an enormous number of updates on the state of the economy, including personal income and spending, consumer credit, factory orders, vehicle sales, manufacturing, non-farm productivity, and home sales and mortgage applications (the last two expected to be up in the wake of the recently ended tax-credit program for home buyers). This will also be a big week for further earnings news for the first quarter, with 164 S&P 500 and 30 Dow companies reporting. The latest litmus test

for the economy will come on Friday when the Labor Department releases the latest unemployment rate; so far the one key indicator has not budged much. And finally the war of words will continue over the current headline stories at home – the debate over financial regulation in the Senate and the oil disaster in the Gulf of Mexico – and abroad – the effort to save Greece before it

does any more damage to the euro and the credibility of the European Union.

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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.

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.

International Monetary Fund (IMF) 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.