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So much for the security blanket.

One of the few constants in this sluggish, stop-and-go recovery has been the power of the Federal Reserve Bank to reassure investors by making the right moves and saying the right things. But that clout seemingly came to a halt this past week when the Fed’s actions and words proved to be cold comfort and the stock market stumbled, with all three major indexes falling back into the red for 2010.

	Key Market Data		
	Week ending...		
	8/13/10	8/6/10	Change
Dow Jones Industrial Average Index	10,303.15	10,653.56	-3.29%
S&P 500 Index	1,079.25	1,121.64	-3.78%
NASDAQ Composite Index	2,173.48	2,288.47	-5.02%
10-Year Treasury Note Rate	2.690%	2.826%	-0.136 pct. pts.
NYMEX Crude Future (Barrel)	\$75.39	\$80.70	-6.58%
Euro/U.S. Dollar	\$1.2753	\$1.3293	-\$0.0540

On Tuesday, the Federal Open Market Committee had a one-day meeting in Washington, D.C. after which it stated what many investors already knew: the recovery was in a near stall. In its last statement in June, the FOMC had used some pretty positive phrasing about the recovery “proceeding” while the labor market was “improving gradually” and household spending was “increasing.” This time there was no gilding the lily, as the statement said “the pace of recovery in output and employment has slowed in recent months” and “is likely to be more modest in the near term than had been anticipated.” To no one’s surprise, the Fed did not raise its benchmark overnight lending rate, but it did act, saying it would reinvest principal payments on the huge \$2.3 trillion portfolio it accumulated during the recovery, mostly by buying mortgage-backed securities, to purchase long-term government debt in an attempt to lower interest rates and thus boost borrowing. This move is a significant turnaround, as only a month or so ago the Fed was speculating as to how it might start to sell off those assets. Further, the Fed

indicated that it will “employ its policy tools as necessary to promote economic recovery and price stability.”

The reaction to the statement was, at best, lukewarm – *The Wall Street Journal* described it as “a statement of the obvious heard round the world” – and the response to the policy step was even more tepid with the paper saying the step was “largely symbolic and unlikely to stimulate the economy significantly.” Had the Fed finally run out of silver bullets? What can it do next other than print more money and run up more debt? Investors were unsure, and on the day of the release the Dow plummeted 265.42 points with all thirty of its listed companies falling.

The one dissenting voice on the FOMC continued to be Thomas Hoenig, president of the Federal Reserve Bank of Kansas City and the longest serving of the Fed’s presidents, on the job since 1991. Mr. Hoenig, who has been the only one to have voted against the Fed’s rate-setting policy since January, said the Fed’s latest step to invest the proceeds from its investments

could trigger a new “boom-and-bust cycle.” Speaking in Nebraska on Friday, he said, “Monetary policy is a useful tool, but it cannot solve every problem faced by the United States. In trying to use policy as a cure all, we will repeat the cycle of severe recession and unemployment in a few short years by keeping rates too low for too long.” Regarding the Fed’s benchmark rate, still at a record low, he said, “I advocate dropping the ‘extended period’ language from the FOMC’s statement and removing its guarantee of low rates. This tells the market that it must again accept risks and lend if it wishes to earn a return.”

Most of the rest of the subsequent economic news only served to underscore the somber tone of the FOMC’s release, with the exception of an unexpectedly positive report from the euro zone at week’s end.

The Commerce Department said that the trade balance grew 18.8% in June to \$49.9 billion, the largest gap since October 2008, as imports rose 3% and exports were down 1.3%. The trade gap with China was up 17% to \$26.2 billion. Worst of all, the news indicates that American manufacturers can’t rely on foreign buyers to step in and help them out while American consumers remain on the sidelines. Based on this and other recent releases, some analysts now say that the recently reported, and already disappointing, figure of 2.4% gross domestic product (GDP) growth for the second quarter may be revised downward as far as 1%.

The Labor Department reported that nonfarm productivity fell in the second quarter for the first time since the last quarter of 2008, off 0.9% after rising 3.9% in the first quarter, and labor costs were flat. The one bright spot was that the number of hours worked improved at an annual rate of 3.6%, the biggest jump since the first quarter of 2006, which would normally indicate that hiring would happen soon as workers were being squeezed to their limit. The Labor

Department also announced that first time jobless claims rose by 2,000 to 484,000 (the consensus had been a drop to 469,000).

The Commerce Department also said that wholesale inventories inched up 0.1% in June to \$399.2 billion, but sales fell 0.7%, and business inventories increased 0.3%. If nothing else, inflation is still not a concern, with the Labor Department reporting that the consumer price index climbed only 0.3% in July and just 1.2% during the previous year. Excluding the volatile food and energy categories, the index was up 0.1% for July and 0.9% over the last twelve months. The news continued to take its toll on the psyche of the American consumer, according to the latest *Wall Street Journal*/NBC News poll, which showed that 66% of Americans believe the economy has yet to hit rock bottom, compared to 53% in January.

Meanwhile, despite its pledges in mid-June, China’s currency has barely risen against the dollar and was actually adjusted downward by China’s central bank last week. Add to that the recent news about the trade gap and politicians are sure to start howling soon about what to do to force China’s hand economically.

At the close of the week, there was a glimmer of good news from Europe as the 16-nation euro zone saw GDP growth of 1% in the second quarter compared to just 0.2% in the previous quarter, its best result in four years. Germany led the way with quarter-to-quarter growth of 2.2% (an annualized rate of 9%), its best showing since reunification and enough to carry the zone’s laggards, notably Spain (+0.2%), Italy (+0.4%) and Greece (-1.5%).

### **The broader view**

From an investment standpoint, one of the most evident results of the recent uncertainty has been the rush to “safe havens,” notably U.S. Treasuries, a trend that may accelerate now that the Fed has pledged to buy our

debt. Indeed, despite the fact that high demand has driven yields to, or near to, record lows, there's been no shortage of takers at recent bond auctions – an auction of 10-year notes last week was the most heavily bid since 1993. That's good news for anyone borrowing money, if not for those with cash in savings accounts or money market funds.

So with stocks struggling at break-even for the year and Treasuries offering little other than a modest, if guaranteed, return, where are investors who are willing to take a risk looking for profits? According to Dealogic, the answer is “junk” or high-yield bonds from corporate borrowers with less than investment grade ratings. In fact, U.S. companies issued a record amount of junk bonds last week at \$15.4 billion, giving some investors a place to, in effect, roll the dice during the downturn. The month-to-date total for August was already \$21.1 billion, whereas the August average for the past decade is only \$6.5 billion. And year to date, the junk bond volume is now over \$155 billion, up 80% from a year ago and already well within striking distance of the record of \$163.6 billion set in 2009.

However, while it may make sense for investors to have modest exposure to high-yield bonds in their portfolio, we caution



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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

against chasing yield or having too much exposure to any one asset class, especially this one; after all, there's a reason they're called “junk” – they're risky instruments.

### **A look ahead**

This stands to be a quiet week of releases during what is usually one of the year's slowest months as politicians and business people take their vacations and trading volumes diminish. According to Bespoke, the Dow on average has fallen in August over the last 20 years, but the index has actually been up in 12 of those years, including the last four – even in 2008. However, any dip can be magnified by the low volumes, as was the case in 1990 when the market dropped 10% after Iraq invaded Kuwait or in 1998 when it fell 15% after Russia defaulted. That said, this week there will be updates on the producer price index, housing starts and building permits, industrial production and capacity utilization, as well as the latest on the Conference Board's leading indicators.

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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<sup>®</sup> 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<sup>®</sup> (S&P 500<sup>®</sup>) 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<sup>®</sup>). 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<sup>®</sup> 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 Federal Open Market Committee (FOMC) consists of twelve members--the seven members of the Board of Governors of the Federal Reserve System; the president of the Federal Reserve Bank of New York; and four of the remaining eleven Reserve Bank presidents, who serve one-year terms on a rotating basis. The FOMC holds eight regularly scheduled meetings per year at which the Committee reviews economic and financial conditions, determines the appropriate stance of monetary policy, and assesses the risks to its long-run goals of price stability and sustainable economic growth.

The consumer price index (CPI) is produced by the U.S. Department of Labor to report monthly changes in the prices paid by urban consumers for a representative basket of goods and services.

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