



July 26, 2010

Investors looking at the glass half full won out this week. But it wasn't without some drama. The Dow dropped 109 points on Wednesday after Federal Reserve Chairman Benjamin Bernanke referenced the "unusually uncertain" outlook the central bank had with respect to the U.S. economic recovery. Yet, a day later, investors realized that Bernanke's comments were not radically different from the Federal Open Market Committee (FOMC) minutes released a week earlier and instead focused on strong earnings reports. Encouraging announcements and increased profit forecasts, along with signs of top-line revenue growth from the likes of UPS, General Electric, McDonald's, Verizon and Ford, lifted stocks prices at the end of the week and allowed the S&P 500 to close above the 1,100-point mark.

The housing market appears to be struggling since the expiration of the first-time homebuyer tax credit at the end of April. On Tuesday, the Commerce Department reported that housing starts declined in May by 5% to 549,000 units versus the consensus estimate of 577,000 units. Moreover, April figures were revised down an addition 5%. Also, existing home sales in June fell for the second consecutive month, down 5.1% to a 5.37 million unit annual rate. The one bright spot: economists had expected a larger decline of 9.9% to 5.10 million units. The Conference Board also provided some optimism for the markets on Thursday, announcing that the Leading Economic Index (LEI) fell 0.2% in June, declining for only the second time since March 2009. Expectations were for a larger drop of

	Key Market Data		
	Week ending...		
	7/23/10	7/16/10	Change
Dow Jones Industrial Average Index	10,424.62	10,097.90	+3.24%
S&P 500 Index	1,102.66	1,064.88	+3.55%
NASDAQ Composite Index	2,269.47	2,179.05	+4.15%
10-Year Treasury Note Rate	2.99%	2.93%	+0.06 pct. pts.
NYMEX Crude Future (Barrel)	\$78.98	\$76.01	+3.91%
Euro/U.S. Dollar	\$1.2917	\$1.2927	-\$0.0010

0.3%. Also, the prior month's gain was upwardly revised to 0.5% from 0.4%.

Bernanke's testimony before the Senate Finance Committee did not break much new ground with respect to what was said in the minutes of the June FOMC meeting, but it did confirm that the Fed is on hold for now. In terms of potential next steps, he suggested the possibility of further monetary policy easing, but that would be contingent on a severe threat to economic growth – not in the case of merely a slower growth environment. On Thursday, before the House Financial Services Committee, the Fed Chairman suggested that in the near-term extending the Bush-era tax cuts would strengthen the domestic economy. At the same time, he argued for a substantial reduction in the federal deficit from the period of 2013-2020.

The Senate ended a filibuster by Republicans, who opposed extending jobless-aid on the grounds it would increase the federal deficit, and is preparing to approve a \$34 billion benefit package. The

pending legislation was sent to the President on Thursday and would extend through November a program offering the long-term unemployed up to 99 weeks of assistance and provide aid retroactively to more than 2.5 million Americans. This would result in over \$130 billion in unemployment benefit spending this year, close to a 50 percent increase from last year, according to the Congressional Budget Office.

Finally, Europe took some steps last week to restore investor confidence. On Friday it was announced that only 7 out of 91 European banks failed the stress tests designed to identify if they would hold up if the economy deteriorated. This proved to be a much rosier outcome than what analysts and investors were expecting.

The broader view

This is the second of three reports on the way we go about investing at Northwestern Mutual. Last week, we talked about capital market expectations; this week we'll consider investing in global and emerging markets; and next week we'll finish up with a look at rebalancing.

People always like to root, root, root for the home team, as the song goes, and the same is true of investors. In fact, one of the most common characteristics of American investors is what the experts call “home country bias” – the inclination to invest in homegrown, rather than foreign, assets. Twenty-five years ago, a representative asset allocation for an individual investor likely diversified across three asset classes: bonds, stocks and cash. All, by the way, denominated in U.S. dollars. Twenty years ago, adding a small exposure to international developed equities of maybe 5% wasn't uncommon. And by the 2000s, advisors started to introduce a similar small exposure to “riskier” assets, such as emerging markets equities, to improve the expected risk/return payoff for investors. By way of example, the 2009 Capgemini Merrill Lynch World Wealth Report estimated that 81% of the

portfolios of North Americans were comprised of North American assets, whereas the allocation based on market capitalization, according to the MSCI All-Country World Index, would instead be 42% in U.S. equities, 40% in international developed markets such as Germany, France and Japan, and 18% in emerging markets, including China, India and Brazil.

So are we suggesting that American investors should overhaul their portfolios and invest 58% of them in non-American assets, in effect rooting for the road team? In a word – no. However, we would say there is a preferred middle ground between the current average of 19% of assets that is invested abroad, according to the *World Wealth Report*, and that 58%, and that most American investors would be wise to increase their exposure to foreign markets.

But investors may well ask, “Why go global?” given the recent sovereign debt crises in Greece, Spain and Portugal (with other profligate European countries perhaps waiting to join the list). First and foremost, there's the compelling argument of asset allocation: as positive as the long-term returns for American stocks have been, overexposure to any one nation's equities – or any one asset class – can cripple portfolios, as anyone who's seen the value of their investments tumble since 2007 can attest. Even after the bounce back year in 2009, investors who were too deeply weighted in American equities this year have suffered anew. And while certain overseas investments may dip at the same time as the Dow or NASDAQ, all of the world's exchanges do not rise or fall in lockstep – that's what asset allocation is all about, after all.

Further, there's no question that as the global recovery continues, however sluggish it may be at the moment, the American economy will be constrained over the next few years by our outsized budget deficits and relatively high costs of labor and capital,

which could lead to lower U.S. equity returns, higher domestic interest rates and a weaker dollar. (This view assumes, with the appropriate monetary and fiscal policies, we avoid a protracted deflationary environment similar to what Japan has experienced over the past decade.) And, even if we effectively address our deficit, which would call for a level of bipartisan cooperation that Congress has not exhibited of late, emerging markets are still expected to experience faster growth over the next few years than those of developed countries as those countries achieve in a matter of decades what took most developed countries centuries: transforming themselves from agrarian-based, subsistence economies into consumer-based economies. Moreover, the strong demographic trends in nations such as Brazil, India and China add even more fuel to this economic transformation. And, simply stated, that rapid economic growth should result in improved corporate earnings and, in turn, higher equity market returns for those markets. That adds up to an opportunity to potentially enhance returns and, at the same time, hopefully reduce risk through diversification, the twin goals of effective investment.

In sum, now's the time, not to abandon the home team's equities, which will still constitute the better part of the portfolios of most Americans, but to take advantage of the many other opportunities out there. Instead, we are recommending that many clients would be well served to alter their asset allocation to reflect less reliance on U.S.-focused investments and gain more



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

exposure to non-U.S. sources of returns. Think of it in terms of the recent World Cup. If you had staked everything on the American team, you would have made a small profit when they won their group. But had you spread your investment across the teams from, let's say, America, Germany, Ghana and Uruguay, you would have done even better. That's the idea behind global investment – and not rooting only for your home team.

As always, we suggest you work with your financial advisor to determine the appropriate level of risk your investment plan can withstand in helping to meet your financial security needs.

A look ahead

Aside from the barrage of second quarter earnings reports from companies such as DuPont, Boeing and Merck, market participants will have a busy week reviewing economic releases on the health of housing prices, manufacturing activity and consumer confidence. At week's end, the Bureau of Economic Analysis will give us its preliminary reading on the Gross Domestic Product index for the second quarter.

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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

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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 Conference Board is a global, independent business membership and research association working in the public interest. The Conference Board is a non-advocacy, not-for-profit entity holding 501 (c) (3) tax-exempt status in the United States.

The Leading Economic Index[®] for the U.S. is produced by The Conference Board. Its composite economic indexes are the key elements in an analytic system designed to signal peaks and troughs in the business cycle. The ten components of The Conference Board Leading Economic Index[®] for the U.S. include: average weekly hours (manufacturing), average weekly initial claims for unemployment insurance, manufacturers' new orders, consumer goods and materials, index of supplier deliveries – vendor performance, manufacturers' new orders, nondefense capital goods, building permits, new private housing units, stock prices (500 common stocks), money supply (M2), interest rate spread, 10-year Treasury bonds less federal funds, and index of consumer expectations.

The World Wealth Report is produced annually by Capgemini and Merrill Lynch. It was initiated as the two firms began collaborating to analyze the macroeconomic factors that drive wealth creation, and better understand the key trends that affect High Net Worth Individuals (HNWIs) around the globe.

The MSCI ACWI (All Country World Index) Index is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of developed and emerging markets. As of May 27, 2010 the MSCI ACWI consisted of 45 country indices comprising 24 developed and 21 emerging market country indices.