Market Comment *Economic Highlights for the week ended January 7, 2011*

Economic Week In Review: Employment Numbers Are Mildly Encouraging

Vanguard 1/7 - The overall trend in employment continues to be somewhat positive. The U.S. unemployment rate fell from 9.8% to 9.4%. But the government's monthly jobs report included a mixed bag of other data indicating the economy's job creation engine is still not operating at full throttle. Construction spending and factory orders rose a bit more than expected, and manufacturing and service activity continued to expand at a healthy clip. For the week ended January 7, the S&P 500 Index rose 1.1%, to 1,272. The yield of the 10-year U.S. Treasury note ended the week up 4 basis points at 3.34%.

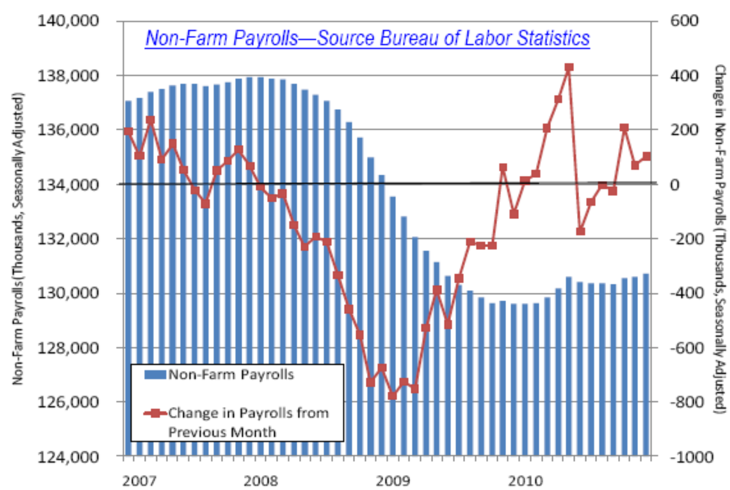
Nonfarm Payrolls – December: Employment Gains Are Modest

Vanguard 1/7 - The U.S. jobless rate fell more than expected, from 9.8% in November to 9.4% in December, according to the U.S. Department of Labor. **Payrolls grew by 103,000** for the month. This figure was below expectations, which had risen earlier in the week after the widely followed report from payroll services firm ADP indicated private employers added nearly 300,000 jobs, a number far higher than expected. On a positive note, the unexpectedly low payroll number from November's Labor Department report was revised upward to 71,000, from 39,000.

Looking back over 2010, the employment trend has been mildly positive. For 2010, the economy created an average of 94,000 jobs each month overall, 112,000 per month in the private sector. The fourth-quarter average was 92,000 total and 135,000 private per month—numbers that are still below what is needed to keep pace with the growing population and also absorb unemployed workers.

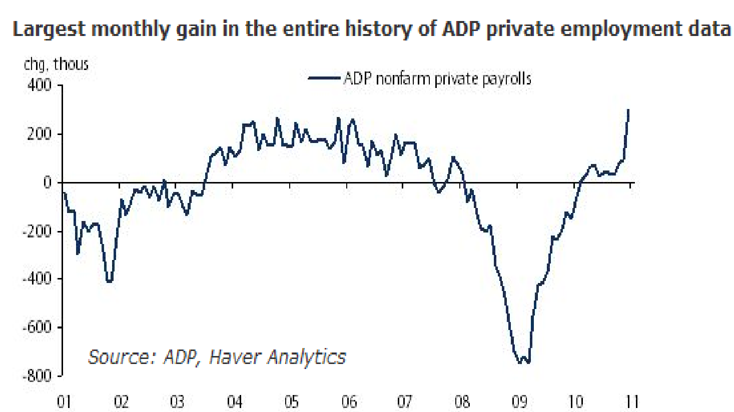
"On the one hand, the drop in the unemployment rate is probably overstated because about half of the decline is simply because of people leaving the workforce," said Vanguard economist Roger Aliaga-Díaz. "On the other hand, in spite of the still-weak reading for monthly payroll growth in December, there's a clear positive trend in the more reliable three-month trailing average. In fact, our own analysis is showing that, for the first time since the beginning of the recession, there's a significant tilt in our projections toward faster-than-expected job growth—specifically 200,000 jobs or more created per month—for the second half of the year."

Barclays 1/7 - Altogether, this is a moderately encouraging report in light of the upward revisions to the prior two months of data and the drop in the unemployment rate. Broad trends in the labor market continue to suggest moderate job growth. We continue to expect that job growth will strengthen gradually over the course of 2011.



AFP 1/10 - The U.S. economy added 103,000 jobs during the final month of 2010, capping off a year where the economy expanded but the labor market lagged behind. December expansion in payrolls was improvement from the upwardly revised estimate for November of +71,000, but paled from the 210,000 jobs added in October. While both manufacturing and retail activity gained strength during the final months of the year, neither sector added a particularly large number of new workers in December.

US ADP Private Payrolls Surge



Barclays 1/5 - The ADP private employment report posted a jump of 297,000 in December following a 92,000 rise in November. This was significantly above consensus estimates of a 100k increase and the biggest monthly gain in the history of the series. The vast majority of the increase was concentrated in the service-providing industries (270k), while the goods-providing industries contributed 27k, with manufacturing up 23k. The surge in services employment is encouraging since this sector consists of roughly 86% of total employment. However, the ADP data often do not predict well the changes in nonfarm payrolls within the same period, so we are not revising our payroll forecast in response to this report.

Unemployment Insurance Weekly Claims Report (Initial Jobless Claims) – week ended Jan. 1

Press Release 1/6 (excerpts) – In the week ending Jan. 1, the advance figure for seasonally adjusted initial claims was 409,000, an increase of 18,000 from the previous week's revised figure of 391,000. The 4-week moving average was 410,750, a decrease of 3,500 from the previous week's revised average of 414,250.

The advance seasonally adjusted insured unemployment rate was 3.3% for the week ending Dec. 25, unchanged from the prior week's unrevised rate of 3.3%.

The advance number for seasonally adjusted insured unemployment during the week ending Dec. 25 was 4,103,000, a decrease of 47,000 from the preceding week's revised level of 4,150,000. The 4-week moving average was 4,122,500, a decrease of 2,750 from the preceding week's revised average of 4,125,250.

WEEK ENDING	Jan. 1	Dec. 25	Change	Dec. 18	Prior Year
Initial Claims (Seasonally Adj)	409,000	391,000	+18,000	420,000	456,000
4-Wk Moving Average (SA)	410,750	414,250	-3,500	426,000	467,250

AFP 1/10 - The number of initial claims for unemployment insurance benefits increased from the previous week, but remained near recent lows. The 4-week moving average shrank by 3,500 to 410,750. A year earlier, the 4-week moving average was 467,250. 8.77 million people were receiving unemployment benefits (including extended benefits) during the week ending December 18th versus 10.67 million during the comparable week a year earlier.

While the data series tends to be very volatile during the holiday season, it is notable that the four-week moving average of 410,750 was more than 15% below levels of late summer.

Construction Spending Rises - November

AFP 1/10 - Construction spending in November was $810.2 billion (SAAR). Spending on private construction totaled $491.8 billion, up 0.3% from October. Residential private construction increased 0.7% while non-residential private construction fell 0.1%. Public construction spending grew 0.7% in November to $318.5 billion. Educational construction was up 1.0% while highway construction slipped 1.0% from October.

Econoday 1/3 - Construction outlays in November provided some good news for the New Year, gaining 0.4%, following a 0.7% boost the prior month. The November figure came in above analysts' forecast for a 0.1 uptick. Strength was in private residential and public outlays.

The gain in November was led by a 0.7% increase in private residential outlays, following a 3.9% surge in October. For the latest month, the multifamily component increased 3.0% while the single-family component rebounded 0.6%. Also, public outlays rose 0.7% after a 0.3% dip in October. Meanwhile, private nonresidential spending declined 0.1% in November, following a 0.7% drop the previous month.

On a year-ago basis, overall construction outlays rose to minus 6.0% in November from down 8.8% in October.

The bottom line is that this is <u>one more sign that overall construction has hit bottom</u> with some modest-repeat, modest-strength in multifamily housing and possibly public outlays (from stimulus). Overall activity, however, is still soft.

ISM Manufacturing and Services Indices - December

Vanguard 1/7 - U.S. manufacturing continued to expand, as the Institute for Supply Management (ISM) manufacturing index registered 57.0 for December, up from 56.6 in November and its highest level since May. (Numbers over 50 indicate expansion of activity.) New orders rose by 4.3 points to 60.9, according to the ISM survey. There was one noticeable disappointment: The employment index fell from 57.5 in November to 55.7 in December.

Meanwhile, the ISM nonmanufacturing index, which measures activity in the services sector, showed growing momentum. The December reading of 57.1 was higher than expected, up from November's 55. The number marks the fourth consecutive gain and puts the index at its highest level since mid-2006. But as with the manufacturing data, the employment index went in the opposite direction, falling from 52.7 in November to 50.5 for December.

Overall, the two surveys indicate the economy is regaining the momentum it lost in the summer.

Econoday 1/5 - The non-manufacturing economy, with the unfortunate exception of employment, is really picking up steam. The ISM's index rose to 57.1, up more than two points from November for a new recovery best. New orders show a rare plus 60 reading, at 63.0 for a more than five point jump and also a recovery best. Business activity, which includes quoting activity, jumped 6-1/2 points to a recovery-best 63.5.

Now the bad news: Job gains are minimal according to the ISM's sample. The ISM non-manufacturing employment index slowed by more than two points to a 50.5 level that indicates very little month-to-month improvement.

Factory Orders - November: Factory Orders Bounce Back

Econoday 1/4 - Factory orders proved better than expected in November, up a sizable 0.7% vs. expectations for no change. Behind the gain is a big upward revision to the durable goods component, now at minus 0.3% vs. last week's initial estimate of minus 1.3%. Durables show special strength for metals and related machinery as well as electronics. Orders for civilian aircraft, always the report's most volatile factor, swung steeply lower in the month. Nondurable goods, which is the component included in this report, jumped 1.7% in November on price increases for petroleum and coal.

Vanguard 1/7 - The dip in October was also revised upward. The data in the report indicates the manufacturing recovery remains solidly in place.

Consumer Credit – November: Consumer Borrowing Rises Modestly

Vanguard 1/7 - Consumer borrowing rose $1.3 billion in November, according to the Federal Reserve. The increase, representing an annualized rise of 0.7%, was only the second uptick in total credit for 2010. Revisions shifted all of September's gains to October. Nonrevolving credit, such as car loans and student loans, rose $5.6 billion. On the other side of the scale and continuing a trend that dates back to autumn 2008, revolving credit card debt declined $4.2 billion in November, an annualized rate of –6.1%, the mildest decline since June. The consumer credit report is considered a gauge of consumer activity even though it doesn't include real estate-secured loans such as home mortgages.

FOMC Minutes – December 14 Meeting

Econoday 1/4 - Participants at the December 14 FOMC meeting apparently were more optimistic than indicated in the meeting statement.

"In their discussion of the economic situation and outlook, meeting participants saw the information received during the intermeeting period as pointing to some improvement in the near-term outlook, and they expected that economic growth, which had been moderate, would pick up somewhat going forward."

"A number of participants noted that their business contacts had become more optimistic about the outlook for sales and production. Nonetheless, many contacts remained cautious about hiring and investment, with some reportedly concerned about the potential effects of government policies."

Basically, the incoming data increased the FOMC's confidence in the recovery but left progress slow.

But the bottom line was that the recently improved data were seen as not strong enough to change earlier announced plans for Quantitative Easing (QE)2-meaning the Fed chose to go forward with implementation.

Also, the Board's staff economists raised their forecast for real GDP in the near term due to improved numbers for production and spending.

Participants noted both upside and downside risks to economic growth. On the up side is the very accommodative stance of monetary policy currently in place. On the down side, housing was seen as possibly weakening again due to considerable actual or pending supply. Also, there was concern over ongoing deterioration in the fiscal position of U.S. states and localities.

The inflation outlook was little changed-subdued and too low at the core consumer level.

"Regarding the outlook for inflation, participants generally anticipated that inflation would remain for some time below levels judged to be most consistent, over the longer run, with maximum employment and price stability. In particular, most participants expected that underlying measures of inflation would bottom out around current levels and then move gradually higher as the recovery progresses."

However, some participants saw upside risks to inflation from further balance sheet expansion leading to a rise in inflation expectations. Others saw downside risks from persistent underutilization of resources (high unemployment and low capacity utilization).

The staff's comments regarding the impact of QE2 on interest rates were interesting as providing possible explanation for the rise in rates despite the additional balance sheet expansion. Basically, not only was $600 billion expected initially in QE2 but markets expected further expansion beyond that. Initially lower rates assumed more than $600 billion for QE2. When it became apparent that QE2 would likely be only the additional $600 billion, then rates rose. The explanation in the minutes follows.

"The decision to expand its holdings of longer-term securities by $600 billion by the end of the second quarter of 2011 was also roughly in line with market expectations, although market participants appeared to expect the purchase program would be increased over time. In the weeks following the November meeting, yields on nominal Treasury securities increased significantly, as investors reportedly revised down their estimates of the ultimate size of the FOMC's new asset-purchase program."

Also, year-end positioning was also seen as a possible contributor to the bump up in rates.

Overall, the minutes show the Fed officials were quite aware of the improvement in economic news. But the final consideration was that risks remain and that the Fed prefers to take out an insurance policy to ensure a recovery.

Bernanke Testimony – Senate Committee on the Budget

Barclays 1/7 - In his appearance before the US Senate's budget committee, Fed Chairman Ben Bernanke indicated that he sees evidence of a self-sustaining recovery and an accelerated pace of activity in the coming year. However, despite the improved outlook, he suggested that progress on the Fed's dual mandate of maximum employment and price stability "is expected to remain slow" and that "it could take four to five more years for the job market to normalize fully." We see the chairman as having a cautiously optimistic view of the recovery and we continue to believe that the Fed will complete its intention to purchase $600bn in Treasury securities by the end of the second quarter.

AFP 1/10 - It is the uneven recovery of the labor market that led the Federal Reserve to resume its quantitative easing program last November. In testimony to the Senate Committee on the Budget on Friday, Fed Chairman Ben Bernanke stated that “a self-sustaining recovery in consumer and business spending may be taking hold” but that “conditions in the labor market have improved only modestly at best.” He pointed out in particular the fact the private sector was adding only a 100,000 jobs per month, “a pace barely enough to accommodate the normal increase in the labor force and, therefore, insufficient to materially reduce the unemployment rate.” He noted that at the current pace of job creation, “it could take four to five more years for the job market to normalize fully.” Yikes.

Chairman Bernanke also expressed concern about the **“unsustainable fiscal path”** of the Federal government. In calling for a “credible program” to lower the deficit, he also sought out reforms that would “enhance the long-term growth potential of our economy—for example, by encouraging investment in physical and human capital, by promoting research and development, by providing necessary public infrastructure, and by reducing disincentives to work and to save.”

The Economic Week Ahead: Jan. 10 – Jan 14, 2011

Vanguard 1/7 - Next week will feature the Federal Reserve's **Beige Book report** on Wednesday, followed on Thursday with the **Producer Price Index** and a trade deficit reading. A busy Friday brings updates on the **Consumer Price Index**, industrial production, retail sales, business inventories, and consumer sentiment.

This Week’s U.S. Economic Calendar Source: Briefing.com

Date	ET	Release	For	Briefing.com	Consensus	Prior
Jan 11	10:00	Wholesale Inventories	Nov	1.0%	0.9%	1.9%
Jan 12	08:30	Import & Export Prices	Dec	NA	NA	0.8%
Jan 12	14:00	Treasury Budget	Dec	-$80.0B	-$80.0B	-$91.4B
Jan 12	14:00	**Fed's Beige Book**	Jan			

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Date	ET	Release	For	Briefing.com	Consensus	Prior
Jan 13	08:30	Initial Claims for Uneml.	01/08	415K	415K	409K
Jan 13	08:30	**Producer Price Index PPI**	Dec	0.8%	0.8%	0.8%
Jan 13	08:30	Trade Balance	Nov	-$39.5B	-$41.2B	-$38.7B
Jan 14	08:30	**Consumer Price Index CPI**	Dec	0.3%	0.4%	0.1%
Jan 14	08:30	Retail Sales	Dec	1.0%	0.7%	0.8%
Jan 14	09:15	Industrial Production	Dec	0.4%	0.4%	0.4%
Jan 14	09:15	Capacity Utilization	Dec	75.3%	75.5%	75.2%
Jan 14	09:55	U of Mich Consumer Sentiment	Jan	75.5	75.4	74.5
Jan 14	10:00	Business Inventories	Nov	0.9%	0.8%	0.7%

FFCB Weekly Debt Issuance Activity

Week Ended Date	Discount Notes $million	New Bonds $millions	Issue Count	Called Bonds Par $millions	Issue Count
10-Dec	$ 6,180	$ 1,876	27	$ 461	9
17-Dec	6,140	2,167	21	647	6
24-Dec	6,520	667	8	-	-
31-Dec	12,345	563	7	-	-
7-Jan	12,732	2,550	12	260	3

Selected Forecasts: Goldman Sachs 1/10 - US Views: Stronger Growth, But a Very Long Way to Go

1. The December employment report was a bit weaker than market expectations, as the worse-than-expected establishment survey outweighed the slightly better-than-expected household survey (only "slightly" because more than half of the outsized 0.35-point decline in the unemployment rate was due to a drop in labor force participation). But it does not alter our expectation that US GDP growth will reach 4% by the spring and monthly payroll growth will climb to 200,000 by the fall.

2. This judgment is partly based on the impressive recent run of economic data, other than payrolls. Most importantly, the ISM indexes and the jobless claims figures have shown further significant improvement. In addition, demand growth remains firm, with another month of decent consumer spending gains in the holiday month of December judging from the auto and same-store retail sales figures released this week.

3. But while the economy is on track for genuine improvement, it's hard to overstate how far we have to go before conditions are again close to normal. And it's also hard to overstate how wrong, once again, the consensus forecast that rate hikes will commence within 6-12 months seems to us.

4. Key Fed officials seem to have a fairly similar view, although they would of course never voice it with such specificity. Chairman Bernanke's testimony to the Senate Budget Committee on Friday: the chairman implied that even a significant fiscal tightening was premature for now: *"In their planning for the near term, fiscal policymakers will need to continue to take into account the low level of economic activity and the still-fragile nature of the economic recovery."* This is not the statement of someone who is planning to raise interest rates on anything like the schedule that most forecasters have in mind.

5. The upshot? Above-trend growth, a large amount of slack, easy monetary policy and only a modest updrift in longer-term bond yields in 2011-2012. That is a very positive environment for the equity and credit markets because it is likely to involve double-digit profit growth, low discount rates, and shrinking risk premiums to boot.

6. Of course there will still be concerns, including the poor fiscal outlook. Much of the commentary about impending fiscal doom looks simplistic. Yes, federal debt held by the public may rise to around 90% of GDP over the next decade, a relatively high level by historical standards. But the ratio stood at 110% at the end of World War II and fell consistently in subsequent decades, without a default or a real risk of one. There are also plenty

of historical examples outside the United States of countries that managed to unwind much larger debt burdens without a default, as well as of countries with relatively small debt burdens that did experience fiscal crises. The government debt issue is more complex than often portrayed, and we expect to do more work on it in coming months.