Market Comment *Economic Highlights for the week ended March 18, 2011*

Economic Week in Review: Fed's outlook brighter but stocks shaky

Vanguard 3/18 – Gradual improvements in the labor market helped lift the Federal Reserve's outlook for economic recovery, though construction remains a drag. Food and energy prices jumped, with core inflation still modest. But investors were perhaps more distracted by declines in stock prices during the week in the wake of Japan's earthquake-tsunami-nuclear woes. For the week ended March 18, the S&P 500 Index fell 1.9% to 1,279 (for a year-to-date total return—including price change plus dividends—of about 2.2%). The yield of the 10-year U.S. Treasury note fell 12 basis points to 3.28% (for a year-to-date decrease of 2 basis points).

US: Empire State manufacturing index continues to rise in March

Barclays 3/15 - The Empire State manufacturing index increased to 17.50 in March from 15.43 in February. The components, which do not directly contribute to the headline index, were mixed. New orders slipped to 5.81 from 11.80, and shipments fell to 1.62 from 11.31. The employment index showed significant improvement, however, rising to 9.09 from 3.61. The average workweek index also rose, to 15.58 from 6.02 - the highest level since October 2009 and the second-highest since the start of the recession. All in all, this is a fairly encouraging report, showing that despite some volatility in certain components, New York-area manufacturers are still seeing a pickup in the pace of improvement in general business conditions.

Import and Export Prices - February

Econoday 3/15 - Import & export prices showed extending inflationary pressures in what before the ongoing Japanese crisis would have raised further concern over the price outlook. In data for February, import prices jumped 1.4% to extend a long string of similar outsized gains. Excluding another big monthly surge in petroleum, this time 3.7%, import prices rose 0.6% to also extend a trend of sizable gains. There were also indications that some of this pressure was making it to final goods as consumer goods and capital goods both show 0.2% gains in the month, still tame but above trend.

Export prices showed similar pressure, up 1.2% in the month. Here agricultural prices were the big factor, up a very high 4.4% in the month and excluding which prices rose a very high 0.9%.

Year-on-year rates were also on the climb, at plus 6.9% for import prices and at plus 8.6% on the export side. But the still unfolding Japanese catastrophe is now bringing commodity prices down including oil and food prices which point to a much different report for March.

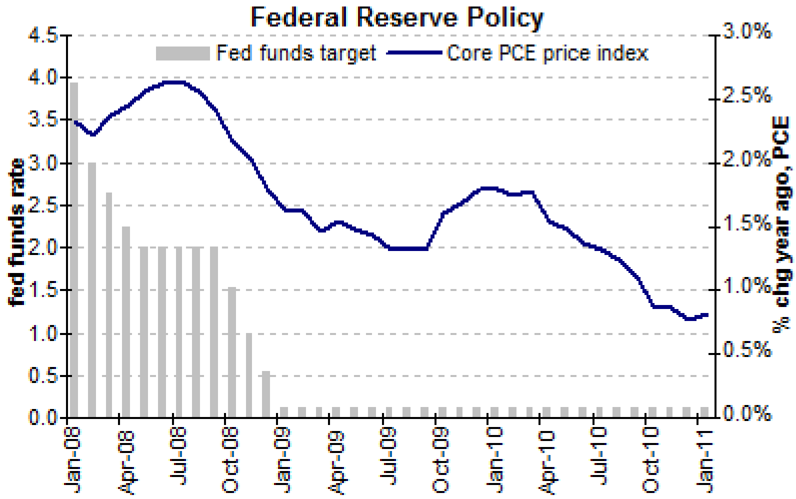
NAHB Housing Market Index

Barclays 3/15 - The National Association of Home Builders housing index edged up to 17 in March after holding constant at 16 for four consecutive months. Home builder sentiment remains broadly steady at low levels observed since the middle of 2009; we only expect sentiment to improve modestly this year as housing demand gradually improves and inventories of new single family homes subside.

FOMC Rate Decision – March: On a firmer footing

Vanguard 3/18 - The Fed upgraded its economic outlook, according to the Federal Open Market Committee's monetary policy statement released this week. The economic recovery "is on a firmer footing, and overall conditions in the labor market appear to be improving gradually," the Fed stated. The central bank's earlier view was that the rate of recovery wasn't fast enough "to bring about a significant improvement in labor market conditions." Although the prices of oil and other commodities have been rising sharply, the committee observed that "longer-term inflation expectations have remained stable, and measures of underlying inflation have been subdued." The committee didn't change its 0% to 0.25% target for the federal funds rate—in place since December 2008—nor its plan to purchase $600 billion in Treasury bonds through June of this year ("QEII"), which is designed to support the economy's recovery.

Barclays 3/15 - The FOMC moved to a more upbeat tone in characterizing the recovery but left the asset purchase program unchanged. However, the shift in tone was larger than we had expected, stating that the recovery "is on a firmer footing" and that conditions in the labor market "appear to be improving gradually." The FOMC dropped several phrases that had been used in recent statements to cast a cautious tone on the pace and durability of the recovery. In particular, it dropped the statement that employers are reluctant to add to payrolls and removed the four factors that had been constraining growth in household spending: high unemployment, modest income growth, lower housing wealth, and tight credit. Finally, the FOMC removed the statement that "progress toward its objectives has been "disappointingly slow."



On the inflation front, it also acknowledged developments in commodity markets, saying that "concerns about global supplies of crude oil have" have led to a "sharp run-up of oil prices in recent weeks" and that "the recent increases in the prices of energy and other commodities are currently putting upward pressure on inflation." Although the committee interprets these pressures to be transitory, it said it will nevertheless "pay close attention to the evolution of inflation and inflation expectations."

The upbeat tone of the report reinforces our view that the FOMC will conclude its asset purchases in June, with the next significant issue being whether the committee maintains its policy of reinvesting principal payments from its securities holdings. We believe the committee will decide to do so, keeping the size of the balance sheet constant in order to avoid a passive tightening.

Econoday 3/15 – Once again, the Fed left its fed funds target rate at a range of zero to 0.25% and retained the "extended period" language on retaining a low target rate. The Fed is keeping QE2 on schedule for completion by the end of June. The Fed gave a marginal upgrade to the recovery, noting that it "is on firmer footing" with the labor market "improving gradually." The FOMC sees the recent impact of higher oil prices on inflation as likely transitory.

Economists React: If Worst Happens in Japan, All Bets Are Off

Wall Street Journal 3/15 -

–At this stage, it's too early to come up with meaningful estimates of the overall impact of the terrible events in Japan. And, in economic and financial terms, the effects may be dominated by other challenges facing the global economy, including still elevated oil prices and rising interest rates. And much still hinges on the radioactive threat to Japan's more urbanised areas: if that threat fails to transpire, the [1995] Kobe quake provides a useful framework but if the worst happens, all bets are off. –Stephen King, HSBC

–The near-term impact on Japanese growth is likely to be negative and potentially quite large. However, by the end of this year the reconstruction effort is likely to get underway and provide a substantial boost to growth. The big uncertainty about this disaster (and what sets it apart from other such disasters) is that roughly 10% of electricity generation capacity (both nuclear and coal) may be off line for a few months, until oil- and gas-fired plants can ramp up.. In the near-term, this could have major negative ramifications for the Japanese industrial sectors; some steel and automotive factories have already been closed. –Nariman Behravesh, IHS Global Insight

–Economic output from the affected region plus its connections to the rest of the economy have darkened the outlook. The cost of rebuilding collides with low levels of insurance coverage, and may require tax increases or much higher government deficit spending. In addition, power supplies will be limited, affecting the broader economy, with transportation services disrupted to the north of Tokyo, and tourism likely to be drastically affected for months. –Ron Napier, SBC Global

Housing Starts and Building Permits - February

Vanguard 3/18 – Construction activity in the housing market dropped off, remaining at historically low levels. Housing starts declined 22.5% in February to an annual rate of 479,000 new homes. The construction of single-family homes fell 11.8% for the period, while the multifamily home sector plunged 47.0%. The multifamily home sector, which consists of buildings with five units or more, tends to be volatile. Last month's drop was preceded by an 87.4% increase in January.

Building permits, considered a good indicator for future housing starts, also fell in February. Permits dropped 8.2% from January, reaching their lowest level since 1959 when the government first began tracking building permits.

Barclays 3/16 - US housing starts fell 22.5% m/m in February to 479k units. The decline in the headline number was driven by declines in multi-family starts (-89k to 104k, -46.1% m/m) and single-family starts (-50k to 375k, -11.9% m/m). The drop in starts was widespread geographically as well, with starts in the Midwest falling the most on a percentage basis (-48.6%), followed by the Northeast (-37.5%), West (-28.0%), and the South (-6.3%).

Econoday 3/16 – Several factors likely affected the latest starts number which is extremely low. First, January's jump was way above trend and some reversal should be expected. Second, winter months are notoriously volatile and starts may have been hampered by severe weather. Finally, housing demand is still soft and inventories of single-family houses are still high. The bottom line is that housing is still anemic but maybe not as bad as suggested by today's numbers.

Producer Price Index (PPI) – February: Surge in food prices boosts US PPI

Vanguard 3/18 - Climbing energy and food prices bloated the level of inflation in February. But, if energy and food prices are excluded—a gauge known as "core inflation"—a tamer picture emerges. The core rate of increase was 0.2% for both producer prices and consumer prices. Producer prices for finished goods, including energy and food prices, surged 1.6%, double the prior month's rate.

Econoday 3/16 - Producer price inflation remains red hot at the headline level while the core eased from January's spike. Energy and food, of course, jacked up the headline number. The overall PPI inflation rate for February posted at a strong 1.6% increase, following the January jump of 0.8%. Both food and energy components were exceptionally strong. By components, food prices surged 3.9%, after a 0.3% rise in January. The energy component remained under strong upward pressure, gaining 3.3% after jumping 1.8% in January. At the core level, the PPI slowed to a 0.2% rise after jumping 0.5% in January.

For the overall PPI, the year-on-year rate jumped to 5.8% from 3.7% in January (seasonally adjusted). The core rate rose to 1.9% from 1.6 the month before.

Barclays 3/16 - This was a very strong report, providing clear indications that recent gains in oil and commodity prices are beginning to feed through the production line and put upward pressure on a range of goods beyond energy and food.

Consumer Price Index (CPI) – February: Economists Debate Inflation

Econoday 3/17 - Prices pressures are rising at the headline level while the core remains on the warm side. The CPI in February jumped 0.5%, following a 0.4% boost in January. Excluding food and energy, CPI inflation increased 0.2%, matching the rise in the prior.

Although the overall CPI was led upward by energy, food also played a major role. Energy surged 3.4% in February after increasing 2.1% in January. Gasoline jumped 4.7%, after increasing 3.5% the previous month. Food price inflation remained strong with a 0.6% increase, following a 0.5% gain in January.

WSJ 3/17 - A Little Point-Counterpoint On The CPI Numbers This Morning.

First, High Frequency Economics U.S. Economist Ian Shepherdson says there's not much to worry about, inflation-wise, in the CPI report.

"The February CPI rose 0.5%, with the core up 0.2%; both readings were a tenth above the consensus. The headline index was boosted by energy and food prices. Expect similar in March then Apr/May decline due to seasonals, if oil stays at $100. Food prices rose 0.6%, much less than in the PPI, thanks to the layers of stable distribution costs between PPI and CPI. Core was lifted by a surprise 1.0% jump in new car prices, which have been slipping in recent months. We suspect retailers have pushed up sticker prices under cover of cheap financing incentives, not included in the CPI calculation. We doubt this can last. Elsewhere medical and recreation rebounded slightly but rents were up only 0.1%; apparel -0.9%. No sustained core pressure here."

Next, a different take from Harm Bandholz, Chief U.S. Economist at UniCredit Research.

"In mid-January, our warnings that the tide for inflation in the US has turned, raised a smile among many market participants. Back then, Fed Chairman Bernanke and other high-ranking FOMC members were still concerned about deflation. Merely two months later, the smiles are gone and the Fed is not talking about deflation

anymore…This is the fastest increase in the headline CPI over a three-month period since mid-2008, i.e. when the oil price approached USD 150 per barrel…The press release after this week's FOMC meeting revealed that the Fed is more concerned about inflation than is has been over the last two to three years…quite remarkable for a central bank that only a few months ago was still concerned about deflation…The Fed [adds] "longer-term inflation expectations have remained stable, and measures of underlying inflation have been subdued." We remain more concerned about inflation than the Fed and now think that even our above-consensus forecast was too low."

Unemployment Insurance Weekly Claims Report – week ended March 12

Press Release 3/17 (excerpt) –. In the week ending March 12, the advance figure for seasonally adjusted initial claims was 385,000, a decrease of 16,000 from the previous week's revised figure of 401,000. The 4-week moving average was 386,250, a decrease of 7,000 from the previous week's revised average of 393,250.

The advance seasonally adjusted insured unemployment rate was 3.0% for the week ending March 5, unchanged from the prior week's unrevised rate of 3.0%.

The advance number for seasonally adjusted insured unemployment during the week ending March 5 was 3,706,000, a decrease of 80,000 from the preceding week's revised level of 3,786,000. The 4-week moving average was 3,779,000, a decrease of 58,000 from the preceding week's revised average of 3,837,000.

WEEK ENDING	March 12	March 5	Change	Feb. 26	Prior Year
Initial Claims (Seasonally Adj)	385,000	401,000	-16,000	371,000	454,000
4-Wk Moving Average (SA)	386, 250	393,250	-7,000	389,250	464,250

Econoday 3/17 - Jobless claims confirmed their improving trend, reversing half of the prior week's rise with a 16,000 decline in the March 12 week to an as-expected 385,000 (prior week revised to 401,000). The four-week average is down 7,000 to 386,250 for its best reading of the recovery. A month-to-month comparison shows a 20,000 improvement.

Initial claims now appear to have moved below the 400,000 level in what will raise talk of further gains for payroll growth.

Industrial Production and Capacity Utilization – February: Industrial output slips

Vanguard 3/18 – Industrial production fell 0.1% in February largely because warmer weather slowed production at utility companies—output dropped 4.5% as demand for heating declined following two months of unseasonably cold temperatures. Manufacturing production rose 0.4%, boosted by ramped-up production at motor vehicle and parts factories. Industrials used 76.3% of total capacity, slightly below a month earlier and 4.2 percentage points under the long-term average.

Econoday 3/17 - One sector of the economy clearly is gaining momentum as manufacturing posted another healthy gain - but one masked at the headline level for industrial production by a drop in utilities output. Overall industrial production in February slipped 0.1%, following a revised 0.3% gain the prior month. The latest fell far short of the consensus forecast for a 0.6% boost. The dip in February was led by a 4.2% drop in utilities output, following a 4.5% decrease the month before. Utilities were down on atypically warm weather for the month. In contrast, manufacturing output posted 0.4% gain after a 0.9% surge in January. Mining output rebounded 0.8%, following a 0.7% decline in January.

Overall, the headline numbers continues to be whipsawed by atypical changes in weather. But manufacturing continues a healthy uptrend.

US: Philadelphia Fed manufacturing index highest since 1984

Barclays 3/17 - The Philadelphia Fed manufacturing index surged in March to 43.4 from 35.9 in February, the highest level since January 1984. The component indices, which do not directly contribute to the headline, were also generally quite strong. The new orders index jumped to 40.3 from 23.7, shipments edged slightly lower to 34.9 from 35.2, and the inventories index rose to 12.0 from 2.1.

Overall, this is a very strong report which signals continued improvement in manufacturing sector growth.

Leading Indicators - Index of leading indicators shows gains

Vanguard 3/18 - The Conference Board's index of leading indicators rose 0.8% in February, its eighth consecutive gain. Eight of the survey's 10 components increased, led by a widening yield spread—largely reflective of the Fed's policy to keep interest rates near zero—and fewer jobless claims. The two weakest components of the index reflected declines in building permits and new orders for manufactured goods. While some of the gains last month may have resulted from weather and other temporary distortions a month earlier, economists said they are more confident in the recovery.

Econoday 3/17 - A decline in unemployment claims helped give a big lift to the index of leading economic indicators which rose 0.8% in February, well up from the prior month's 0.1% gain. The yield spread, reflecting the Fed's near zero policy rate at the short end, remains the index's leading strength. Building permits, data released yesterday, were the report's biggest negative.

Barclays 3/17 - After slowing in mid-2010, leading indicators picked up late in the year and are now once again trending higher at an encouraging pace, supporting our outlook for sustained above-trend economic growth.

The Economic Week Ahead: March 21 – March 25, 2011

Vanguard 3/18 - The highlight of next week's economic reports will be Friday's release of its final estimate of gross domestic product figures for the fourth quarter of 2010. Other reports expected next week include: existing-home sales (Monday), new-home sales (Wednesday), and durable goods orders (Thursday).

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

Date	ET	Release	For	Briefing.com	Consensus	Prior
Mar 21	10:00	Existing Home Sales	Feb	4.80M	5.05M	5.36M
Mar 22	10:00	FHFA Housing Price Index	Jan	NA	NA	-0.3%
Mar 23	07:00	MBA Mortgage Index	03/18	NA	NA	-0.7%
Mar 23	10:00	New Home Sales	Feb	275K	288K	284K
Mar 23	10:30	Crude Inventories	03/19	NA	NA	1.745M
Mar 24	08:30	Initial Claims	03/19	370K	384K	385K
Mar 24	08:30	Continuing Claims	03/19	3700K	3700K	3706K
Mar 24	08:30	Durable Orders	Feb	0.2%	0.9%	3.2%
Mar 24	08:30	Durable Orders ex Transportation	Feb	0.5%	1.8%	-3.0%
Mar 25	08:30	GDP - Third Estimate	Q4	2.9%	2.9%	2.8%
Mar 25	08:30	GDP Deflator - Third Estimate	Q4	0.4%	0.4%	0.4%
Mar 25	09:55	Michigan Sentiment - Final	Mar	69.0	68.0	68.2