Market Comment *Economic Highlights for the week ended May 20, 2011*

Economic Week in Review: No Alarms or Applause as Recovery Proceeds

Vanguard 5/20- While recent reports provided reasons to pause and ponder the condition of the U.S. economy, the gradual recovery doesn't seem to be in danger. Somewhat negative news came from the index of leading economic indicators, existing-home sales, and new residential construction. While economists expected better from all three, there were explanations rather than alarms. The Federal Reserve Board's release of meeting minutes indicated that care must be taken when it eventually weans the economy off its support. For the week ended May 20, the S&P 500 Index fell 0.3% to 1,333 (for a year-to-date total return of about 6.8%). The yield of the 10-year U.S. Treasury note fell 3 basis points to 3.15% (for a year-to-date decrease of 15 basis points).

Empire Manufacturing: May - Soft Start to Q2 for US Manufacturing

Econoday 5/16 – The first indication on this month's activity in the manufacturing sector points to a slowing in an otherwise still solid rate of growth. The Empire State index fell nearly 10 points.

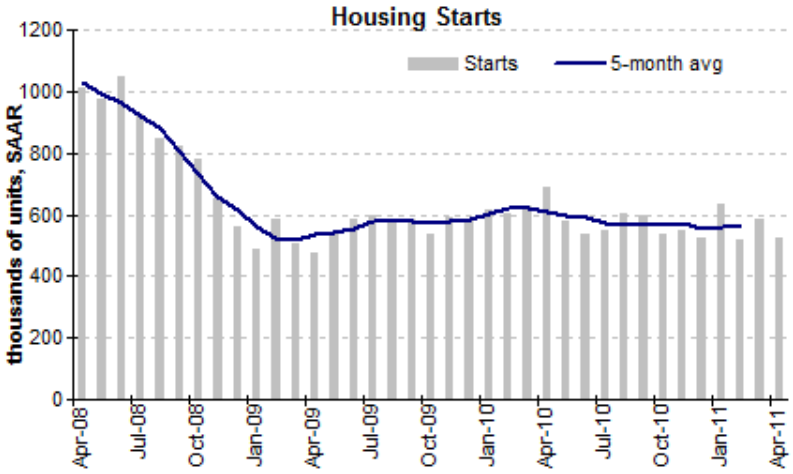
The news is definitely not that bad with new orders and shipments still strong, though showing slower rates of growth than April. Unfilled orders show an increasing rate of growth with inventories posting a sizable build. Job indications are special positives with the number of employees and the workweek on the rise. Price readings are a concern with inputs rising to their highest level since 2008 and output prices high and slightly accelerating.

A plus in the report is data on the six-month outlook where optimism across nearly all readings is on the rise.

Barclays 5/16 - While the headline index was weak, the details underlying this decline, coupled with the relatively strong performance in the component indices, point to more of a pause in the pace of expansion than a slowdown.

Housing Starts and Building Permits: April - Housing Starts Disappoint, But March Revised Up

Vanguard 5/20 - Relief remains elusive for residential construction. The start of construction on new U.S. homes dropped 10.6% in April to an annualized rate of 523,000, below analysts' expectations. Housing starts declined 23.9% compared with April 2010. Building permits, which indicate future construction, fell 4.0% from the previous month and 12.8% from April 2010. The April figures declined the most in the South, where tornadoes likely limited construction. Multifamily construction, primarily apartment buildings, retreated 24%, while single-family construction decreased 5.1%. In a bit of good news, March's housing starts were revised—up 7% to 585,000—and completions increased 4.1%.



Barclays 5/17 - This was a disappointing report overall. We believe that the recovery in housing starts will be gradual, as housing demand picks up with the general economy.

Econoday 5/17 – Housing activity is continuing to confound and is refusing to establish any kind of uptrend. Housing is flat and at anemic levels. Likely, we need to look to other sectors in the economy to keep the recovery moving forward.

Industrial Production and Capacity Utilization: April

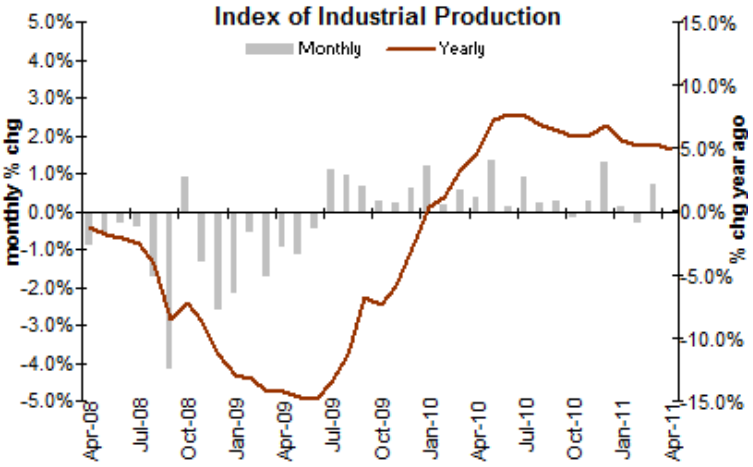
Vanguard 5/20 - Industrial production—the output of manufacturers, mines, and utilities in the United States—was flat in April as automobile production slowed resulting from a shortage in auto parts caused by Japan's earthquake. Not counting the 8.9% decrease in auto production, industrial production increased 0.2%. Industrial production was also revised downward for February and March. **Compared with April 2010, industrial production is up 5.0%**. Although manufacturing production fell, output for mining and utilities climbed 0.8% and 1.7%, respectively. Overall capacity dipped to 76.9% from 77.0%, a few percentage points below the long-term average.

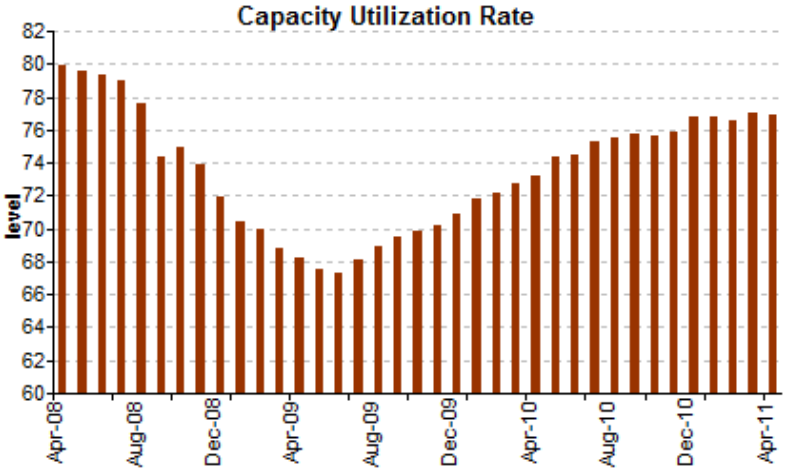
Barclays 5/17 - This report represents a soft start to Q2 for the manufacturing sector. More broadly, timely survey measures point to some easing in the pace of manufacturing growth but continue to suggest positive growth.

Market Comment *Economic Highlights for the week ended May 20, 2011*

Econoday 5/17 – Industrial production surprised on the downside for April with weakness led by a drop in auto assemblies. Auto assemblies likely were weighed down by supply disruptions for parts from Japan. But the auto industry is relatively healthy based on demand and recovery should be expected soon for auto assemblies.

Today's report is disappointing at the headline level and for total manufacturing. Non-auto manufacturing is mixed but still net positive.





FOMC Minutes: Major Decisions Await Fed Officials

Vanguard 5/20 - Federal Reserve officials discussed how to slowly end the monetary stimulus that's been in place since the financial crisis, according to the minutes of the Federal Open Market Committee's April 26–27 meeting. Because the economy is still on the mend, the Fed plans a gradual and flexible exit strategy. However, the talks don't mean the process "would necessarily begin soon." The minutes also revealed that the Fed expects the economic recovery to continue and inflation to stabilize. **There was full agreement among Fed officials that the target federal funds rate will remain between the record-low range of 0% and 0.25%**. Economic results will ultimately determine when the Fed will raise the rate, which has been in place since December 2008. The minutes also indicated that the Fed will complete its $600 billion purchase of longer-term Treasury securities by June. Shrinking its balance sheet of mortgage and Treasury securities will become a priority as the Fed hopes the economy will eventually be able to manage on its own.

Econoday 5/18 - The minutes of the Fed's April 26-27 policy meeting gave a little more detail about the internal debate over when and how to begin unwinding currently very accommodative policy. There was little dissention regarding the current status of policy although some indicated they saw little benefit from additional quantitative easing. **Regarding inflation, most saw the recent effects of recent oil price hikes as transitory**. Most within the FOMC see the fed funds rate as the preferred active tool for tightening but for now most see an end to reinvestment of pay down on mortgage-backed securities and agency debt as the first step in tightening. For the long-term, most are arguing for **a "corridor" system of fed interest rates** with interest on excess reserves at the bottom, the discount rate at the top, and the fed funds rate in the middle. For the long term, the FOMC wants to return the balance sheet to Treasuries only.

The FOMC agreed on several principles to guide normalization of policy. First, the pace and sequencing of the policy steps would be driven by the Committee's monetary policy objectives for maximum employment and price stability. Second, in the intermediate term, the balance sheet would be would be reduced so that implementation of monetary policy would be through management of the fed funds rate instead of size or balance sheet composition. Third, the balance sheet would be returned to Treasuries only. And fourth, asset sales would be communicated to the public in advance.

FOMC participants downgraded their forecast for GDP growth in 2011 while bumping up the 2011 inflation forecast. Nonetheless, members decided to indicate that the economic recovery was proceeding at a moderate pace and that overall conditions in the labor market were gradually improving.

Today's minutes primarily add depth to the debate over conduct of monetary policy over the next few years. While the Fed likely will raise interest rates not long into 2012 if not a little sooner, it will take years for the balance sheet to be returned to normal.

FOMC Meeting Continued – Details on the Exit Strategy

Goldman Sachs 5/18 – The committee also discussed exit strategy issues in detail at the meeting. A few points of uncertainty were clarified. First, the Fed will cease reinvestment of its securities portfolio as a first tightening step. Second, the committee will also stop reinvesting principal payments in its Treasury portfolio "soon after" stopping MBS reinvestment. Third, any sales of securities will come after rate hikes—as originally signaled by Chairman Bernanke in Congressional testimony last year.

Barclays 5/18 - The minutes of the April FOMC minutes contained extensive discussion of the sequencing of the exit strategy. After saying that the decision to discuss the appropriate strategy for normalizing the stance of policy now "did not mean that the move toward such normalization would necessarily begin soon," the committee enumerated its ultimate goals of returning to an environment in which the management of the federal funds rate is the primary instrument of policy and returning the SOMA to a Treasury-only portfolio **in about five years' time**. Most participants saw a long-run framework that was based on **a corridor system of interest rates** in which the federal funds rate was bound by interest on reserves from below and the discount rate from above. The minutes then went on to lay out a baseline sequencing of balance sheet run-off, followed by an increase in short-term interest rates and, ultimately, controlled asset sales. Modalities around this baseline were also discussed, including the possibility that asset sales will be introduced at an earlier stage.

In discussing the sequencing of the exit strategy, "nearly all" participants said that the first step toward normalization would be ceasing the reinvestment of principal payments on agency and Treasury securities. That "nearly all" participants held this view is consistent with the clarity of the chairman's statement during the press conference that the committee desires to keep the reinvestment policy in place into the second half of the year after concluding asset purchases. We felt at the time that the chairman would not have been that committal in his language without a firm belief that this represented a consensus view. The committee also maintained flexibility by saying that removing the reinvestment policy may be done for both agency and Treasury securities at the same time or sequentially – ceasing the agency reinvestment policy first, followed by Treasuries at a later date.

The "majority" of participants "preferred that sales of agency securities come after the first increase in the FOMC's target for short-term interest rates," and preferred that sales be conducted gradually on a "predetermined and preannounced path." We find two aspects of this statement interesting. First, the statement refers to sales of agency securities in the context of returning to an all-Treasury SOMA portfolio in about five years. The absence of a reference to sales of Treasury securities suggests that the majority of the committee believes **normalization of the size and composition of the balance sheet can be accomplished without resorting to sales of Treasuries**. Second, the statement refers to an increase in the "FOMC's target for short-term interests rates." While the goal of the committee is to return to an environment in which the federal funds rate is the primary instrument of monetary polity, we read the ambiguity about what short-term rate the committee will use as suggesting that the Fed may need to rely on the use of interest on reserves if it feels it does not have sufficient control over the funds rate.

Regarding control of the funds rate, the committee will likely use temporary reserve-draining facilities in advance of interest rate tightening.

We continue to look for the Fed to keep the reinvestment policy in place into the second half of the year and for the first increase in the federal funds rate to occur sometime around July 2012. Between, we expect the committee to begin immobilizing excess reserves to improve the control over the federal funds rate while making changes to the language on forward guidance in the statement.

Existing Home Sales: April- Surprise dip for existing-home sales

Vanguard 5/20 - Economists had forecast a modest rise, but buyers aren't stepping up in an economy where high unemployment and possible foreclosures are still a concern. Condominium sales retreated 3.1%, while single-family home sales backed off 0.5%.

Press Release 5/19 (excerpts) - Existing-home sales, which are completed transactions that include single-family, townhomes, condominiums and co-ops, eased 0.8% to a seasonally adjusted annual rate of 5.05 million in April from a downwardly revised 5.09 million in March, and are 12.9% below a 5.80 million pace in April 2010; sales surged in April and May of 2010 in response to the home buyer tax credit.

Lawrence Yun, National Assoc of Realtors chief economist, said the market is underperforming. "Given the great affordability conditions, job creation and pent-up demand, home sales should be stronger," he said. "Although

existing-home sales are expected to trend up unevenly through next year, unnecessarily tight credit is continuing to restrain the market, along with a steady level of low appraisals that result in contract cancellations."

"Although sales are clearly up from the cyclical lows of last summer, home sales are being held back 15 to 20% due to the very restrictive loan underwriting standards," Yun said.

The national median existing-home price for all housing types was $163,700 in April, which is 5.0% below April 2010. Distressed homes – typically sold at a discount of about 20% – accounted for 37% of sales in April, down from 40% in March; they were 33% in April 2010.

Total housing inventory at the end of April increased 9.9% to 3.87 million existing homes available for sale, which represents a 9.2-month supply at the current sales pace, up from an 8.3-month supply in March.

First-time buyers purchased 36% of homes in April, up from 33% in March; they were 49% in April 2010 when the tax credit was in place.

NAR President Ron Phipps, broker-president of Phipps Realty in Warwick, R.I., said that proposals and regulations are being considered in Washington that could further constrain the housing market. "One of the most damaging proposals would effectively raise downpayment requirements to 20%, which would slam the brakes on the housing market," he said. "What we need to do is simply return to the sound standards that were in place before the introduction of risky mortgage products."

"Our data shows only one out of five first-time buyers needing a mortgage could afford a 20% downpayment, and without first-time buyers the trade-up market would stall with very negative consequences for housing and the overall economy," Phipps said. "Ironically, low downpayment FHA and VA loans, which are so critical to this segment, have performed well and never needed a taxpayer bailout because those borrowers stayed well within their budgets." NAR consumer survey data shows 56% of entry level buyers in the past year financed with an FHA loan.

Philadelphia Fed Index: May

Econoday 5/19 – Like the Empire State report, the Philly Fed report points to slowing conditions in the manufacturing sector. The general business conditions index slowed to 3.9, to indicate a slower rate of month-to-month growth. New orders and shipments both show slowing while unfilled orders and inventories turned negative. Price pressures also eased which is consistent with slowing demand. Another negative in the report is an easing in the six-month outlook where optimism is fading. April didn't turn out to be a great month for the manufacturing sector and early indications on May are pointing to trouble.

Barclays 5/18 - The one bright spot in this otherwise dreary report was the employment index, which increased to 22.1 as a record 32.2% of firms reported expanding payrolls. This is an encouraging sign that despite an apparent pause in Philadelphia-area manufacturing activity growth in May, firms still have sufficient conviction in the durability of the expansion that they are continuing to invest in new hires.

Leading Indicators: April - Leading indicators take negative turn

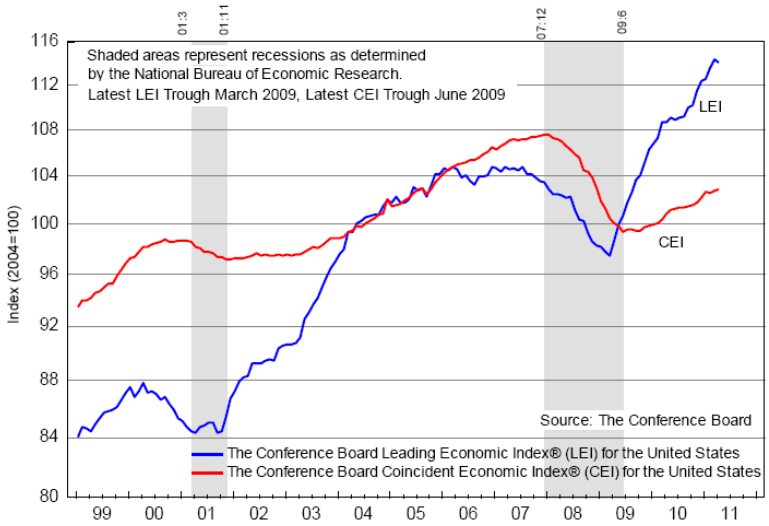
Vanguard 5/20 - The index of leading economic indicators fell in April for the first time in ten months. However, the shift is likely related to temporary factors and not expected to be the start of a downward trend. An increase in jobless claims triggered the unexpected 0.3% decline, but five of the nine other components were also negative. Interest rate spread was the index's leading positive contributor. The coincident indicator—a measure of current economic activity—edged up 0.1% in April behind a rise in all four of its components.

Econoday 5/19 – The economy appears to be hitting the pause button as leading indicators dipped 0.3% in April. The weakest factor is initial jobless claims which sliced off 0.33 percentage points from the index's growth.

Adding lift as always is the interest rate spread between the 10-yr T-note and fed funds (adding 0.35 percentage points) with positive contributions also from stock prices, money supply, and consumer expectations.

Press Release 5/19 - "Overall, the composite indexes still point to strengthening business conditions in the near term, **although the path may be uneven**."

The Conference Board Leading Economic Index® (LEI)



Unemployment Insurance Weekly Claims Report – week ended May 14

Press Release 5/19 (excerpt) - In the week ending May 14, the advance figure for seasonally adjusted initial claims was 409,000. The 4-week moving average was 439,000.

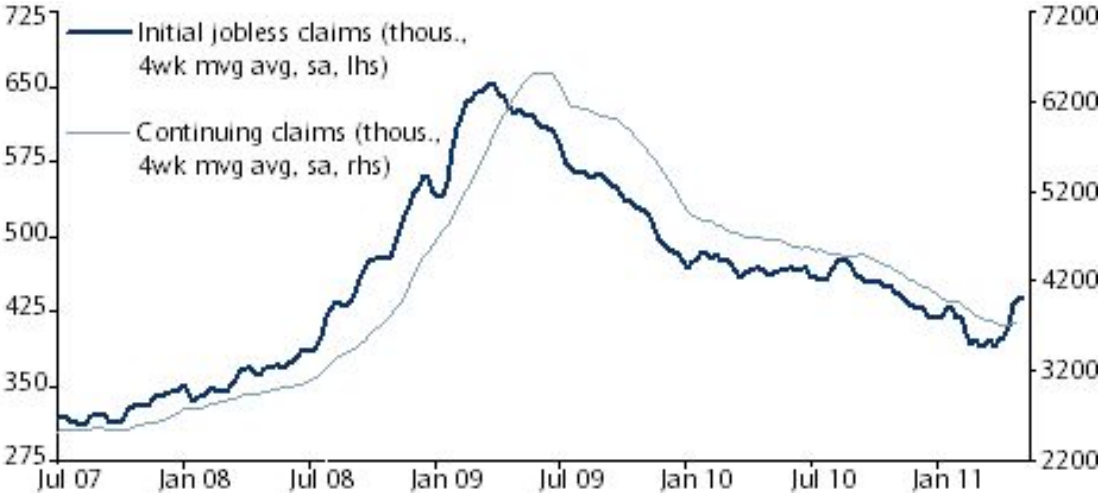
The advance seasonally adjusted insured unemployment rate was 3.0% for the week ending May 7.

The advance number for seasonally adjusted insured unemployment during the week ending May 7 was 3,711,000, a decrease of 81,000. The 4-week moving average was 3,728,250, an increase of 750.

WEEK ENDING	May 14	May 7	Change	April 30	Prior Year
Initial Claims (Seasonally Adj)	409,000	438,000	-29,000	478,000	477,000
4-Wk Moving Average (SA)	439,000	437,750	1,250	432,250	462,250

Econoday 5/19 – Auto and weather effects were no more than isolated in the week's data which sees the four-week average only very slightly higher. A decline in next week's data would push the four-week average down for the first time since early April.

Barclays 5/19 - Both Alabama and Michigan had reported increases in jobless claims for the week ending May 7, with Alabama attributing some increase in claims to the effect of severe storms during the previous week and Michigan reporting higher claims due to layoffs in autos and construction.



Economic Forecasts: More Dollar Depreciation

Goldman Sachs Economist 5/19 (excerpts) – *"The Dollar has now weakened well beyond our near-term forecasts and the driving forces of continued gradual depreciation are intact. There is still considerable downside potential in the USD. We have changed our forecasts to project more Dollar weakness."*

We are now projecting EUR/$ at 1.45, 1.50 and 1.55 in 3, 6 and 12 months.

One of the core reasons behind our Dollar view rests on a Fed that is more dovish than other central banks. Our official forecast for the first Fed hike is not until 2013, which is significantly below what the (futures) market is currently pricing. The second important factor behind our Dollar views is the growing current account deficit and the possible deterioration in funding inflows. Foreign flows into US assets other than US Treasuries have remained very weak, possibly affected by the negative returns following the 'tech bubble' until 2000 and the subsequent housing bubble in 2004/07.

The Economic Week Ahead: May 23 – May 27, 2011

Vanguard 5/20 – Thursday's report on real gross domestic product will provide a revised look on how quickly the U.S. economy is growing. Releases are also scheduled for new-home sales (Tuesday), durable goods (Wednesday), and personal income (Friday).

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

Date	ET	Release	For	Briefing.com	Consensus	Prior
May 24	10:00	**New Home Sales**	Apr	NA	NA	300K
May 25	08:30	**Durable Goods Orders**	Apr	NA	NA	2.9%
May 25	08:30	Durable Orders -ex Transportation	Apr	NA	NA	1.8%
May 25	10:00	FHFA Housing Price Index	Mar	NA	NA	-1.6%
May 26	08:30	**GDP - Second Estimate**	Q1	NA	NA	1.8%
May 26	08:30	GDP Deflator - Second Estimate	Q1	NA	NA	1.9%
May 26	08:30	Initial Claims	05/21	NA	NA	NA
May 26	08:30	Continuing Claims	05/14	NA	NA	NA
May 27	08:30	**Personal Income**	Apr	NA	NA	0.5%
May 27	08:30	Personal Spending	Apr	NA	NA	0.6%
May 27	08:30	PCE Prices - Core	Apr	NA	NA	0.1%
May 27	09:55	Michigan Consumer Sentiment - Final	May	NA	NA	72.4
May 27	10:00	Pending Home Sales	Mar	NA	NA	5.1%

FFCB Weekly Debt Issuance Activity

Week Ended Date	Discount Notes $million	New Bonds $millions	Issue Count	Called Bonds Par $millions	Issue Count
22-Apr	$ 3,440	$ 1,353	17	$ 812	5
29-Apr	4,945	1,725	18	739	8
6-May	4,315	2,942	16	2,425	16
13-May	4,320	1,968	19	1,110	7
20-May	5,250	623	15	157	2