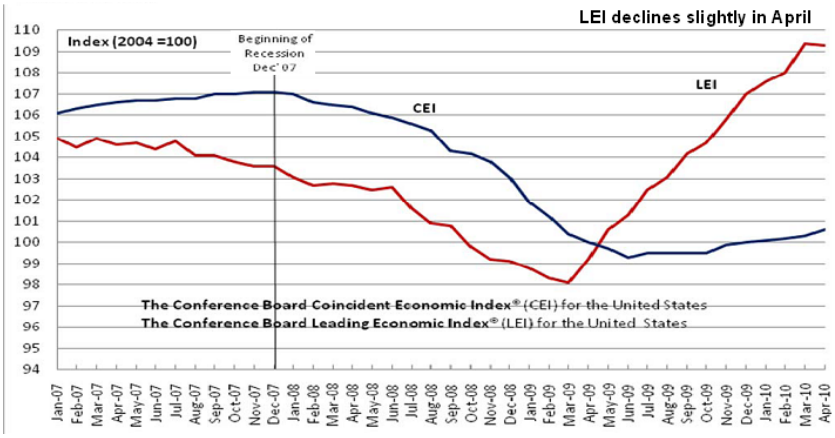
Market Comment *Economic Highlights for the week ended May 21, 2010*

Economic Week In Review: Recovery Downshifts But Keeps Moving Forward

Vanguard 5/21 - The nation's economic growth, which wasn't rising at record pace to begin with, appears to be slowing down. For the first time in more than a year, the Conference Board's index of leading indicators fell. But the news wasn't all negative. Minutes from the last Federal Open Market Committee meeting revealed confidence in the economy's recovery. According to reports on the latest wholesale and consumer prices, inflation shouldn't be a problem for the foreseeable future. There was good and bad news on the housing front as housing starts were up and building permits were down. The U.S. stock market continued to struggle. For the week, the S&P 500 Index fell 4.2% to about 1,088 (for a year-to-date total return—including price change plus dividends—of about –1.7%). The yield of the 10-year U.S. Treasury note fell 24 basis points to 3.20% (for a year-to-date decrease of 65 basis points).

Leading Indicators - April

Vanguard 5/21 - The Conference Board's index of leading indicators dropped 0.1% in April, a performance that was below expectations and the first drop since March of 2009. Since December, the index's six-month growth rate "has moderated," according to the Board. Six of the index's ten leading components were negative. On the downside, the money supply shrank and new building permits dwindled; on the upside, stock prices went higher *[BW note: May's stock decline won't help.]* and the manufacturing workweek increased.



The coincident index, a measure of the current economy, rose 0.3% in April and is now positive on a year-ago basis for the first time in almost two years. Overall, the reports indicate the economy's recovery is slowing.

Press Release 5/20 - Says Ken Goldstein, economist at The Conference Board: "These latest results suggest a recovery that will continue through the summer, although it could lose a little steam."

FOMC Minutes: Fed Appears Confident About Recovery

Vanguard 5/21 - According to minutes released this week from the Federal Open Market Committee meeting on **April 27 and 28**, members are more optimistic about the economy's recovery. Noting that inflation remains stable, the Fed declined to raise interest rates. Since mid-December 2008, the federal funds rate—the interest rate banks charge one another for lending and the benchmark for the market's short-term rates—has remained at 0% to 0.25%. Members also said they would eventually like to rid the Fed's balance sheet of all assets but Treasuries. The timing and strategy of the plan remain in question, however; the majority of members would rather wait until the Fed begins raising interest rates to begin selling the agency and mortgage-backed securities the Fed has purchased in recent years.

Press Release 5/19 (excerpts) - *Staff Review of the Economic Situation:* The information reviewed at the meeting suggested that, on balance, the economic recovery was proceeding at a moderate pace and that the deterioration in the labor market was likely coming to an end. Consumer spending continued to post solid gains in the first three months of the year, and business investment in equipment and software appeared to have increased significantly further in the first quarter. Growth of manufacturing output remained brisk. However, residential construction, while having edged up, was still depressed, construction of nonresidential buildings remained on a steep downward trajectory, and state and local governments continued to retrench. Consumer price inflation remained low.

Inflation: Participants' assessments of the risks to the inflation outlook were mixed. Some participants saw the risks to inflation as tilted to the downside in the near term, reflecting the quite elevated level of economic slack and the possibility that inflation expectations could begin to decline in response to the low level of actual inflation. Others, however, saw the balance of risks as pointing to potentially higher inflation and cited pressures on

commodity and energy prices associated with expanding global economic activity as an upside inflation risk; some also noted the possibility that inflation expectations could rise as a result of the **public's concerns about the extraordinary size of the Federal Reserve's balance sheet** in a period of very large federal budget deficits. While survey measures of longer-term inflation expectations had been fairly stable, some market-based measures of inflation expectations and inflation risk suggested increased concern among market participants about higher inflation.

Econoday 5/19 - The Fed's minutes of the April 27-28 FOMC meeting included its **quarterly forecast**. The Fed upgraded its forecast for GDP for 2010 while nudging down their numbers for unemployment and inflation. The central tendency forecast range for 2010 GDP is now 3.2 to 3.7% Q4/Q4, up from a range of 2.8 to 3.5% for the January projection. The forecast range for 2010 PCE inflation is 1.2 to 1.5% Q4/Q4, down from a range of 1.4 to 1.7% for the January projection. The Fed now has the 2010 Q4 unemployment rate coming in at a range of 9.1 to 9.5% versus April's forecast for 9.5 to 9.7%.

Producer Price Index (PPI): Wholesale Prices Drop

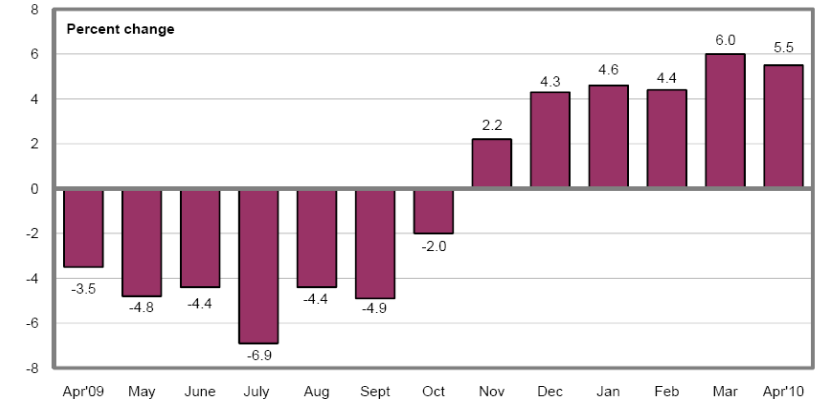
Vanguard 5/21 - The Producer Price Index fell for the second time in three months in April, a sign that inflation isn't an immediate threat. The decline of 0.1% was a surprise, as economists expected an increase of 0.1%. Most of the retreat was due to drops in the prices of energy (–0.8%) and food (–0.2%), which were unusually high in March. Core prices for finished goods, which exclude food and energy, advanced 0.2%. A major reason for that rise was an increase of 0.6% in car prices. At the earlier stages of production, prices for intermediate goods rose 0.8% and prices for crude goods fell 1.2%.

Barclays 5/18 - All in all, recent PPI data suggest that pipeline price pressures are gradually building across most sectors. While this is unlikely to feed through to CPI inflation one-for-one in the near term, it does limit the chances of sustained disinflation at the consumer level, in our view.

Econoday 5/18 - Gasoline dropped 2.7% in the latest period after gaining 2.1% the month before. As expected, food prices slipped 0.2% on lower prices for fruits and vegetables as the impact of severe winter weather fades. Egg prices also fell significantly.

For the overall PPI, the year-on-year rate decreased to 5.4% from 6.1% in March (seasonally adjusted). The core rate firmed to 1.0% from 0.8% the month before. On a not seasonally adjusted basis for April, the year-ago increase for the headline PPI was up 5.5% while the core was up 1.0%.

Chart 2. 12-month percent changes in the Producer Price Index for Finished Goods, not seasonally adjusted: April 2009 – April 2010



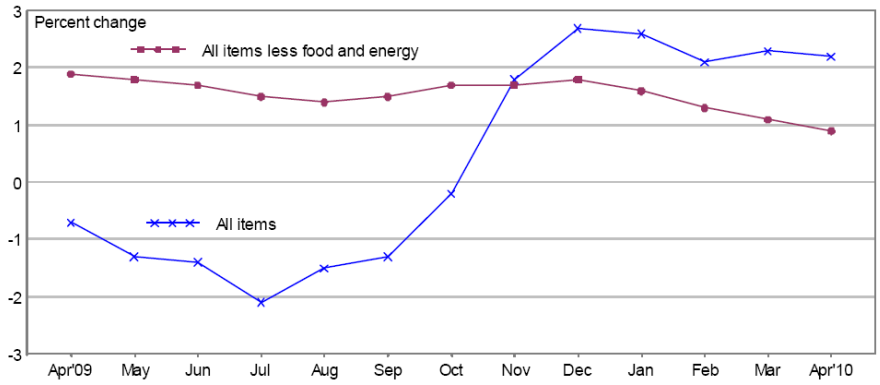
Consumer Price Index (CPI): Cost Of Living Drops, Weaker-Than-Expected - April

Press Release 5/19 (excerpts) - On a seasonally adjusted basis, the Consumer Price Index for All Urban Consumers (CPI-U) declined 0.1% in April, the U.S. Bureau of Labor Statistics reported today. Over the last 12 months, the index increased 2.2% before seasonal adjustment.

The index for energy decreased 1.4% in April and accounted for the seasonally adjusted decline in the all items index. The indexes for gasoline and natural gas both decreased significantly, outweighing increases in the indexes for fuel oil and electricity.

The food index increased 0.2% in April, while the index for all items less food and energy was unchanged. The index for meats, poultry, fish, and eggs rose sharply in April and accounted for the food increase; other grocery store food groups were mixed and the index for food away from home rose slightly. Within all items less food and energy, the indexes for

Chart 2. 12-month percent change in CPI for All Urban Consumers (CPI-U), not seasonally adjusted, Apr. 2009 - Apr. 2010



recreation, airline fares, and medical care all rose in April. Offsetting these increases were declines in the indexes for apparel and for household furnishings and operations. The continuing stability of the index for all items less food and energy has resulted in an increase over the last 12 months of 0.9%, the smallest 12-month increase since January 1966.

Econoday 5/19 - Inflation is hardly a problem for the Fed. In April, overall CPI inflation dipped 0.1% after edging up to 0.1% the month before. Consumer prices inflation remains extremely low-giving the Fed plenty of leeway in its timing of unwinding its balance sheet expansion.

Barclays 5/19 - On a y/y basis the CPI fell to 2.2% from 2.4% and the core to 0.9% from 1.0%. All in all, this is a softer-than-expected report and the fourth consecutive flat reading on the core CPI. However, we do not expect this trend to persist.

Vanguard 5/21 - "In addition to the deflationary forces from stagnant wages and weak consumer spending we've been experiencing for months, the recent strength of the dollar is making the imported items of the CPI basket cheaper, thus pushing average price levels lower," said Vanguard economist Roger Aliaga-Díaz. "This is a direct result of Europe's debt crisis and investors' flight to safety, back into U.S. dollars."

Housing Starts & Building Permits: New Construction Numbers Mixed - April

Vanguard 5/21 - Data on new residential construction was both promising and disappointing in April. Housing starts increased to an annual rate of 672,000, the highest since October 2008 and an increase of 5.8% over the previous month. Building permits, a sign of future construction, tumbled 11.5% to an annual rate of 606,000, the lowest in six months. The prime reason for the disparity was the imminent expiration of the federal tax credit for home buyers, who were required to sign a contract by April 30 and close on sale by June 30. Construction was highest in the Northeast; the West was the only region that posted a decline.

Gain In US Housing Starts Driven By Single-Family Construction

Barclays 5/18 - Housing starts increased a solid 5.8% in April, to 672,000, above our and consensus estimates of 650,000. This was accompanied by an upward revision in March to 635,000 from 626,000 previously. The positive surprise in today's report was driven by single-family starts, which jumped 10.2% (last: 2.1%). Multi-family housing starts continued to be volatile, falling 18.6% in April after a 24.4% gain in March.

Today's report is consistent with the recent pickup in homebuilders' sentiment, but the positive surprise was tempered somewhat by the choppy pattern in building permits.

US Empire State Manufacturing Index Disappoints

Barclays 5/17 - The Empire State manufacturing index fell to 19.11 in May from 31.86 in April, below March's level of 22.86 and well below our (32.0) and consensus (30.0) expectations. The move lower in today's report was broad-based. The index of new orders fell to 14.30 from 29.49, the index of shipments also dropped to 11.29 from 32.10, and the inventories index fell 1.32 from 11.39.

Although the release did reflect expansion in the current number of employees and in expected capital expenditures, today's report was disappointing as the move lower in most major components was the dominant theme.

Unemployment Insurance Weekly Claims Report (Initial Jobless Claims)

Press Release 5/20 (excerpts) – In the week ending May 15, the advance figure for seasonally adjusted initial claims was 471,000, an increase of 25,000 from the previous week's revised figure of 446,000. The 4-week moving average was 453,500, an increase of 3,000 from the previous week's unrevised average of 450,500.

The advance seasonally adjusted insured unemployment rate was 3.6% for the week ending May 8, unchanged from the prior week's unrevised rate of 3.6%.

The advance number for seasonally adjusted insured unemployment during the week ending May 8 was 4,625,000, a decrease of 40,000 from the preceding week's revised level of 4,665,000. The 4-week moving average was 4,642,500, a decrease of 9,500 from the preceding week's revised average of 4,652,000.

WEEK ENDING	May 15	May 8	Change	May 1	Prior Year
Initial Claims (SA)	471,000	446,000 rev	+25,000	446,000	625,000
4-Wk Moving Average (SA)	453,500	450,500	+3,000	459,000	619,250

Econoday 5/20 - In a setback for the May payroll outlook, initial jobless claims jumped 25,000 in the May 15 week to 471,000. The disappointment includes a 2,000 upward revision to the prior week. There are no special factors to explain the latest week's jump.

Initial claims have been stubbornly high with expectations hoping for a big move lower -- not a big move higher. If next week's report doesn't show a reversal, estimates for May payrolls will be very conservative.

Farm Credit Designated Bond: $1 billion, 3-year Maturity, Non-callable

May 20 – Three System Banks participated in a new, $1 billion, 3-year, non-callable Designated Bond. The fixed coupon rate was set at 1.375% with a price to investors of 99.688% of par to yield 1.479%, a +31 bps spread to Treasury. The all-in cost was 1.504%. The Banks swapped most of the issue to pay floating indexed to 1-month and 3-month LIBOR. The lead underwriters were Bank of America Securities, J.P. Morgan Securities, and UBS Securities.

Bond Market Vigilantes

Alan S. Blinder 5/20 WSJ Opinion (excerpts) - From a long-run perspective, the bond market vigilantes have it right. Greece, Europe, the U.S. and other countries must take serious steps to get their budget deficits under better control. And the long-run budget problems of many nations are too large to be solved exclusively on either the tax side or the expenditure side.

The U.S. is a case in point. Under continuation of current policies, our budget deficit and national debt would soar to impossible heights. (Ask the oracle: the Congressional Budget Office.) The amount of deficit reduction needed to stop this incipient explosion is so large that no serious person should believe we can do it without both spending cuts and higher taxes.

The Economic Week Ahead: May 24 – May 28

Vanguard 5/21 - A variety of economic reports are set to be released next week. Existing-home sales will be available Monday, followed by consumer confidence on Tuesday, durable-goods and new-home sales on Wednesday, gross domestic product on Thursday, and personal income and spending on Friday.

U.S. Economic Calendar

Source: Briefing.com

Date	ET	Release	For	Briefing.com	Consensus	Prior
May 24	10:00	Existing Home Sales	April	5.7M	5.65M	5.4M
May 25	09:00	Case-Shiller 20-city Home Price Index	March	3.0%	2.8%	0.6%
May 25	10:00	**Consumer Confidence**	May	58.1	58.3	57.9
May 26	08:30	Durable Goods Orders	April	1.3%	1.4%	-0.3%
May 26	10:00	New Home Sales	April	430	425	411
May 27	08:30	**GDP - Second Estimate**	Q1	3.3%	3.3%	3.2%
May 27	08:30	Initial Claims for Unemployment Benefits	05/22	450K	455K	NA
May 27	08:30	Continuing Claims	05/22	4600K	4600K	NA
May 28	08:30	**Personal Income**	April	0.4%	0.4%	0.3%
May 28	08:30	**Personal Spending**	April	0.0%	0.3%	0.6%
May 28	08:30	PCE Prices - Core	April	0.0%	0.1%	0.1%
May 28	09:45	Chicago Purchasing Managers Index	May	60.0	60.0	63.8
May 28	09:55	U. Michigan Consumer Sentiment	May	73.8	73.7	73.3