

Market Comment *Economic Highlights for the week ended June 03, 2011*

Economic Week In Review: Japan's Aftershocks Ripple Through U.S. Economy

Vanguard 6/3- Consumers and investors looking for good news this week were largely disappointed as the effects of the tragic natural disasters in Japan reverberated through the global economy. The U.S. unemployment rate ticked up, job creation was weak, manufacturing growth slowed, and consumer confidence slid—even before the latest releases. For the week ended June 3, the S&P 500 Index fell 2.3% to 1300 (for a year-to-date total return of about 4.2%). The yield of the 10-year U.S. Treasury note fell 8 basis points to 2.99% (for a year-to-date decrease of 31 basis points).

Case-Shiller 20-City Index – March: Home Prices Decline Broadly

Barclays 5/31 - The S&P/Case-Shiller composite 20-city home price index fell 0.2% m/m sa in March. The decline was broad-based, with thirteen of twenty cities showing a decrease. On a y/y basis, prices fell 3.6%. We believe this largely reflects persistent downward pressure as foreclosures continue to enter the housing market, but expect an increase in non-distressed sales in the spring to largely offset this downward pressure.

Econoday 5/31 –The S&P Case-Shiller report says its latest data confirm a double dip for still falling home prices. Year-on-year rates are showing deterioration, at minus 2.8 percent for the 10 city index and minus 3.5 percent for the 20 city index.

The breadth of decline is a big negative in the report with 18 of 20 cities showing unadjusted month-to-month declines. The national quarterly reading is at minus 4.2% in the first quarter, a new low for the cycle.



Chicago PMI – May

Barclays 5/31 - The Chicago PMI dropped to 56.6 in May. The decline was driven by production, which plummeted to 56.0, and new orders, which fell to 53.5. The supplier deliveries index decreased to 63.8. Of the five weighted components of the headline index, only the inventories index increased, rising to 61.6. The order backlog index fell to 51.7, and the prices paid index moderated to 78.6.

The headline Chicago PMI for May was at its lowest level since November 2009, but is still indicative of a healthy pace of expansion historically consistent with periods of solid overall economic growth. The relative resilience of the employment index is an encouraging sign that Chicago-area businesses are continuing to hire, signaling that they have confidence in the durability of the expansion.

Econoday 5/31 –Growth in backlog orders almost entirely evaporated while inventories surged which may indicate an unwanted build tied to slowing activity.

Employment Situation – May: Non-Farm Payroll Unemployment Rate Creeps Up Again

Press release (excerpts) 6/3 - Nonfarm payroll employment changed little (+54,000) in May, and the unemployment rate was essentially unchanged at 9.1 percent, the U.S. Bureau of Labor Statistics reported today. Job gains continued in professional and business services, health care, and mining. Employment levels in other major private-sector industries were little changed, and local government employment continued to decline.

Vanguard 6/3 - The unemployment rate inched up to 9.1% in May from 9.0% in April, after falling below the 9.0% threshold in February and March. Confounding expectations for more significant growth, only 54,000 new nonfarm jobs were created in May. In the private sector, the increase in payrolls was the lowest since June 2010, while public-sector payrolls continued to shrink. As with many of the economic indicators released this week, some of the weakness in job creation likely resulted from the disruption to the manufacturing supply chain caused by the devastating earthquake and tsunami in Japan.

The unemployment report was surprisingly weak, even relative to the already marked-down expectations, noted Vanguard senior economist Roger Aliaga-Díaz. In particular, the softness in manufacturing could be troubling, since it has been a key private-sector driver of the U.S. economic recovery so far.

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Econoday 6/3 – Analysts had lowered their forecasts after an anemic ADP private payrolls report but they did not lower them enough as growth was very soft. Nonfarm payroll employment in May grew a modest 54,000. The March and April revisions were down net 39,000. Private nonfarm payrolls advanced 83,000.

Sluggishness in payroll jobs was broad based. Goods-producing jobs were basically flat while private service-providing rose moderately and government jobs declined moderately.

Turning to the household survey, the unemployment rate nudged up to 9.1%. Household employment actually rose 105,000 for the month but was outpaced by a 272,000 gain in the labor force.

Percent **Chart 1. Unemployment rate, seasonally adjusted, May 2009 – May 2011**

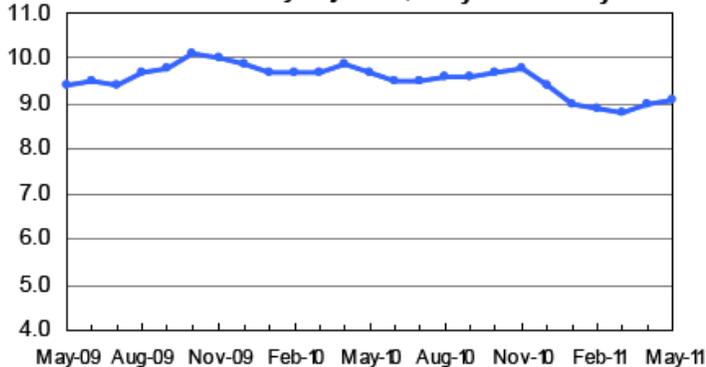
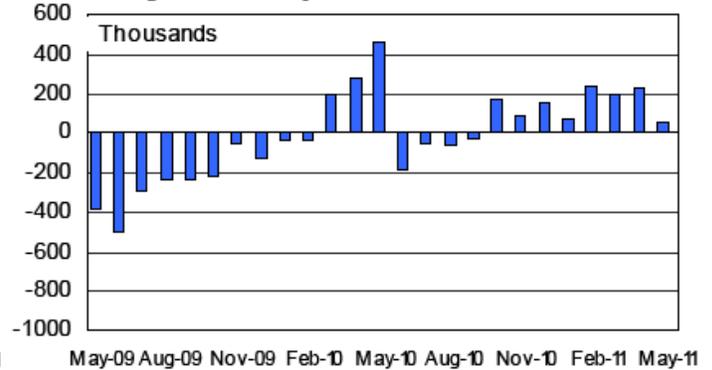


Chart 2. Nonfarm payroll employment over-the-month change, seasonally adjusted, May 2009 – May 2011



Goldman Sachs 6/3 - May employ report shows clear deceleration as payrolls +54k vs an average +220k jobs in the prior 3 mos. Mar-Apr net revision is -39k. Jobless rate +0.1pt to 9.1% in second gain in 2 months to a high since Dec'10. In May payrolls, +13.6k was food services (MacDonalds effect) and weakness was seen in -5k mfg, -8.5k retail, -1k info, -12.3k arts/sports, & -28k local govt. Gains were in construction +2k, finance +3k, accounting +17.8k, health +27.2k. Also, gains in hours and wages (private AHE +6c to +2.1% YOY) are somewhat stronger than the payroll data, suggesting a pause rather than panic at businesses. Still, a weak report overall.

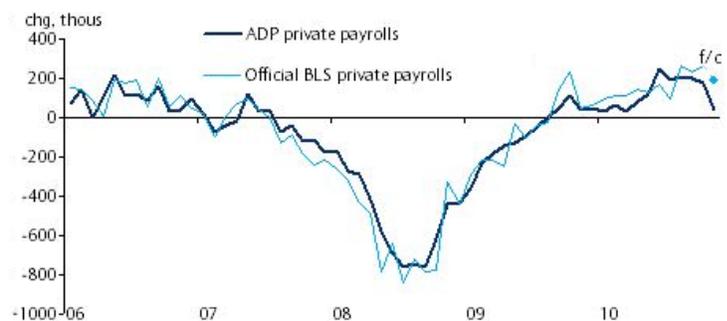
Barclays 6/3 - The 30k decline in state and local payrolls reflects the ongoing budgetary pressures at the state and local level. Elsewhere, and really the only bright spot in the employment surveys today, average hourly earnings were up 0.3%, and the work week held at 34.4 hours. Altogether, this is a very weak jobs report. The weakening in private sector job growth hints that the private sector may be turning a bit more cautious than we had thought.

ADP Employment Change - May

Barclays 6/1 - ADP private payrolls grew just 38k in May. Weakness was general across all categories: small business payroll growth fell to 27k, medium business payrolls dropped to 30k, and large business payrolls contracted 19k. Service-sector employment increased 48k, with financial activities falling 6k. Goods-producing industries lost 10k jobs.

Manufacturing employment fell 9k and construction declined 8k.

This was a dismal report, indicating a significant slowdown in job creation after 6 mths of solid gains.



Consumer Confidence – May: Consumer Confidence Disappoints

Vanguard 6/3 - Contrary to expectations, The Conference Board's May index of consumer confidence fell to 60.8 from 66.0 (revised) in April. The index now stands at its lowest level since November. Consumers are considerably more apprehensive about future business and labor market conditions. Consumers' outlook weakened in all three areas that make up the expectations component of the index: business conditions, jobs, and incomes. Inflation expectations also rose, despite the easing in gasoline prices at the pump in late May.

Econoday 5/31 – Easing of gas and food inflation had bolstered this report in April but a downturn in pump prices is not convincing consumers that inflation is on the downtrend. One-year inflation expectations rose to a very severe 6.6%. The assessment of the present situation weakened with more saying, at 43.9%, that jobs are hard

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to get. This report contrasts sharply with last week's consumer sentiment data that showed significant improvement during May.

ISM Index – May: Manufacturing Index Slumped To 53.5 In May

Vanguard 6/3 - The manufacturing index reported by the Institute for Supply Management (ISM) fell more than expected in May, to 53.5, its lowest level in almost two years. The slower pace of growth was especially evident in new orders and production, in part related to supply-chain problems originating in Japan. Still, any index reading above 50.0 signals expansion in the manufacturing sector. Many of the purchasing managers surveyed cited rising costs as a factor in their less optimistic outlook.

Barclays 6/1 - This is a disappointing report, signaling an abrupt slowdown in the manufacturing expansion in May, seemingly in response to the weakening demand precipitated by the energy price shock in the first quarter. We are optimistic that manufacturing growth will resume as energy prices stabilize and demand picks up again.

Goldman Sachs 6/1 - We continue to believe that supply chain disruptions in the auto sector resulting from the events in Japan are one factor behind the abrupt weakening in the manufacturing surveys. However, it cannot explain all of the weakness in the recent data, including that seen in measures of employment growth.

Construction Spending - April: Construction Spending Rebounded, Weakness Remains

Vanguard 6/3 - Construction spending rose in April for a second straight month, with a modest 0.4% increase. As overall spending has picked up across much of the economy, this has translated into more private construction spending, especially for home improvements. In the cash-strapped public sector, however, construction spending fell. Despite the recent uptick, total construction spending was nearly 10% below a year ago.

Auto Sales - May

Econoday 6/1 – Sharp declines for Japanese brands pulled down North American-made vehicle sales to an 8.8 million annual rate, down more than 10% from April's rate and pointing to big trouble for the motor vehicle component of the retail sales report. Lack of available Japanese brands pushed up related prices and pushed up prices overall in what evidently convinced shoppers to wait and see.

Productivity and Cost- Q1: Productivity Growth Revised Higher; Compensation Revised Lower

Vanguard 6/3 - The Labor Department's revised 1Q productivity and unit labor costs data showed modest improvement compared with the preliminary estimate released last month. Nonfarm business productivity—or output per hour worked—increased at a revised rate of 1.8%, up from the first estimate of 1.6%. Unit labor costs rose 0.7% (down from the 1.0% preliminary estimate).

Barclays 6/2 - On a y/y basis, unit labor costs were revised down to 0.7% and compensation per hour was revised down to 2.0% y/y, indicating less income growth than previously reported; the latter was due to the downward revisions to wage and salary income growth revealed in last week's GDP report.

Productivity growth remained at 1.3% on a y/y basis, indicating substantial moderation from the 2.0% rate recorded in Q4 10 and the peak of 6.7% y/y in the first quarter of last year. Our view remains that firms will find it increasingly difficult to wring further productivity gains from workers, leading to continued hiring in the coming months.

Factory Orders – April: Factory Orders Down 1.2% In April

Econoday 6/2 – Factory orders fell 1.2% in April as a price-fueled 0.6% rise for new orders of non-durable goods failed to offset a steep 3.6% retreat on the durable side where the monthly declines are wide and deep. Factory shipments fell 0.2% to end a recovery-long string of gains. And suddenly the build underway in inventories doesn't look so great, hinting at unwanted inventory that's building, not due to anticipation of future demand, but due to lack of current demand. Inventories rose 1.3% in the month, right in line with the prior two months. A plus in the report is a continued rise in backlog orders.

Vanguard 6/3 - Japan-related interruptions to production processes were responsible for much of the slippage. There has been no consistent trend in orders this year: January and March enjoyed increases of more than 3% but were each followed by a decline. Shipments of manufactured goods were down 0.2%, the first monthly decline this year.

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ISM Services - May

Barclays 6/3 - After dropping to 52.8 in April, the ISM non-manufacturing index rose to 54.6 in May. The business activity index ticked lower to 53.6. The export orders index rose to 57.0 while imports sank to 50.5. The prices index moderated to 69.6.

Following a slew of weak May data, this moderately positive ISM report is an encouraging sign that overall activity will pick up again from the recent slowdown. The resilience of the employment component is somewhat at odds with the slowing in private service sector payroll growth reported by the BLS.

Vanguard 6/3 - May's reading marked the 18th consecutive month of growth in this sector.

Econoday 6/3 - In a rare bit of good news, the ISM reports broad month-to-month acceleration in the non-manufacturing economy.

Unemployment Insurance Weekly Claims Report – Week Ended May 28

Press Release 6/2 (excerpt) - In the week ending May 28, the advance figure for seasonally adjusted initial claims was 422,000, a decrease of 6,000 from the previous week. The 4-week moving average was 425,500, a decrease of 14,000 from the previous week.

The advance seasonally adjusted insured unemployment rate was 3.0% for the week ending May 21, unchanged from the prior week.

The advance number for seasonally adjusted insured unemployment was 3,711,000, a decrease of 1,000 from the preceding week. The 4-week moving average was 3,737,750, a decrease of 10,000.

| WEEK ENDING | May 28 | May 21 | Change | May 14 | Prior Year |
|---------------------------------|---------|---------|---------|---------|------------|
| Initial Claims (Seasonally Adj) | 422,000 | 428,000 | -6,000 | 414,000 | 464,000 |
| 4-Wk Moving Average (SA) | 425,500 | 439,500 | -14,000 | 440,250 | 465,750 |

Barclays 6/2 - The four-week moving average in initial claims declined sharply and is further indication that the bulk of the upward move in claims in the previous weeks was related to special factors.

Moody's Warning on U.S. Sovereign Debt Credit Rating

Moody's 6/2 - Moody's Investors Service said today that if there is no progress on increasing the statutory debt limit in coming weeks, it expects to place the US government's rating under review for possible downgrade, due to the very small but rising risk of a short-lived default. If the debt limit is raised and default avoided, the Aaa rating will be maintained. However, the rating outlook will depend on the outcome of negotiations on deficit reduction. A credible agreement on substantial deficit reduction would support a continued stable outlook; lack of such an agreement could prompt Moody's to change its outlook to negative on the Aaa rating.

Although Moody's fully expected political wrangling prior to an increase in the statutory debt limit, the degree of entrenchment into conflicting positions has exceeded expectations. The heightened polarization over the debt limit has increased the odds of a short-lived default. If this situation remains unchanged in coming weeks, Moody's will place the rating under review.

Forecast: US real GDP growth forecast revised lower

Barclays 6/3 - We have revised down our US GDP forecast. We now look for Q2 11 growth of 2.0% and Q3 11 growth of 3.0%. The surge in headline inflation over the December-April period has clearly hurt consumer purchasing power and consumer spending, as seen by the slowdown in real consumer spending, now estimated to be 2.2% in Q1. Real consumer spending got off to a weak start in April, and we had been looking for some improvement in May and June as the rate of headline inflation eases, but the soft auto sales in May (in part due to supply chain disruptions from Japan) suggest consumption for the quarter will be more muted than expected. In addition, the weak May ISM Manufacturing report suggests that production is slowing abruptly, not only because of the consumption slowdown and supply chain disruptions but also because of a slowdown in export growth (which may be related to the effect of the surge in energy prices on demand elsewhere).

We continue to project that real income growth is going to reaccelerate in May and June, as the CPI looks set to be flat in May and down slightly in June and the pickup in hours worked so far in Q2 suggests nominal income growth is still solid. Thus, we look for real consumer spending to improve along with real income growth over the

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next few months, and this is the reason we still believe Q3 growth will be stronger than Q2. However, the weakening in private sector job growth hints that the private sector may be turning a bit more cautious, which leads us to slightly trim the Q3 forecast.

The Economic Week Ahead: June 6 – June 10, 2011

Vanguard 6/3 – A shorter menu of economic reports is set for release beginning on Tuesday with consumer credit, followed by the Federal Reserve's Beige Book nationwide survey of economic activity on Wednesday, and international trade on Thursday.

This Week's U.S. Economic Calendar

Source: *Briefing.com*

| Date | ET | Release | For | Briefing.com | Consensus | Prior |
|--------|-------|-------------------------|-------|--------------|-----------|-----------|
| Jun 07 | 15:00 | Consumer Credit | April | \$6.5B | \$6.0B | \$6.0B |
| Jun 08 | 14:00 | Fed's Beige Book | June | | | |
| Jun 09 | 08:30 | Initial Claims | 06/04 | 430K | 423K | NA |
| Jun 09 | 08:30 | Continuing Claims | 05/28 | 3700K | 3688K | NA |
| Jun 09 | 08:30 | Trade Balance | April | -\$47.5B | -\$48.7B | -\$48.2B |
| Jun 09 | 10:00 | Wholesale Inventories | April | 0.8% | 0.9% | 1.1% |
| Jun 10 | 08:30 | Export Prices ex-ag. | May | NA | NA | 1.0% |
| Jun 10 | 08:30 | Import Prices ex-oil | May | NA | NA | 0.6% |
| Jun 10 | 14:00 | Treasury Budget | May | NA | NA | -\$135.9B |

FFCB Weekly Debt Issuance Activity

| Week Ended Date | Discount Notes \$million | New Bonds \$millions | Issue Count | Called Bonds Par \$millions | Issue Count |
|-----------------|--------------------------|----------------------|-------------|-----------------------------|-------------|
| 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 |
| 27-May | 6,650 | 2,080 | 17 | 1,221 | 13 |
| 3-Jun | 5,831 | 2,793 | 20 | 1,962 | 13 |