Market Comment *Economic Highlights for the week ended July 15, 2011*

Economic Week In Review: Prices drop, but economy's soft patch continues

Vanguard 7/15 – Producer and consumer prices both fell substantially in June while sales output and inventory reports continue to point to an economic soft patch. For the week ended July 15, the S&P 500 Index declined 2.1% to 1,316.14 (for a year-to-date total return of about 5.7%). The yield on the 10-year U.S. Treasury note fell 9 basis points to 2.94% (for a year-to-date decrease of 36 basis points).

International Trade: May - US trade balance widened in May on stronger imports

Vanugard 7/15 - The trade deficit widened sharply in May as imports rose and exports fell. The $50.2 billion deficit was the highest since October 2008. The reduction in exports reflected lower sales of industrial supplies and materials; consumer goods; and foods, feeds, and beverages. The higher imports reflected an increase in purchases of industrial supplies and materials; capital goods; and automotive vehicles, parts, and engines.

Barclays 7/12 - Automobile imports increased by 3.0%, but are still well below their Q1 levels. Total imports directly from Japan declined, suggesting the supply chain and manufacturing disruptions continued to hamper the auto sector in May. We expect imports from Japan over the next few months to recover and for the overall trade deficit to modestly widen later this year before leveling off in 2012.

NFIB Small Business Optimism Index: June - US small business optimism edges lower in June

Barclays 7/12 - The NFIB small business optimism index declined to 90.8 in June, the fourth consecutive monthly decline. The details of the report struck a more mixed tone, with improvements in measures of hiring intentions and capital spending but declines in measures of sales expectations and the economic outlook.

Econoday 7/12 –The weakest readings concern the outlook for the economy and the outlook for sales. Interestingly, strength appears in employment plans. Also there's evidence of pricing power with a net 10 percent raising their selling prices over the last three months. It also notes that access to credit is only a limited problem.

FOMC Minutes

Econoday 7/13 - Even with the post-FOMC statement press conference and plenty of FedSpeak, there actually was new information in today's minutes. For the first time, some FOMC participants argued that QE3 might be appropriate if the recovery remains too slow. The argument appeared to be very tentative and by a small number of participants. However, others at the meeting countered that QE3 would do little to help the economy. All saw the likelihood of a pickup in growth in coming quarters. The rest of the new news was largely regarding settling on principles for the Fed's exit strategy from an expanded balance sheet and a return to a normal monetary policy.

Import and Export Prices: June - Drop in food prices pushes core US import prices lower

Barclays 7/13 - Import prices fell 0.5% in June. Petroleum prices fell only 1.6% and ex-petroleum prices fell 0.2%. The ex-fuels core measure fell 0.1%. This report suggests that the easing in market energy and commodity price inflation is beginning to be reflected in imported goods. That said, pipeline pressures at the core level are likely to continue to build, reflecting the effects of a weaker dollar and building inflationary pressures in foreign markets.

Econoday 7/13 – Declines are broad through nearly all input components with output components, including capital goods and consumer goods, showing moderating pressure from already incremental rates. Yet the monthly decline didn't hold down the year-on-year increase which at 13.6 percent is the largest since August 2008.

The export side shows a mild 0.1 percent increase though the year-on-year rate is extremely elevated, at 9.9 percent with the non-agricultural rate at a record 7.8 percent. The monthly rate was held down by the drop in oil prices which offset a sharp 0.7 percent rise in agricultural products.

Unemployment Insurance Weekly Claims Report (Initial Jobless Claims) – week of July 9

Press Release 7/14 (excerpts) – In the week ending July 9, the advance figure for seasonally adjusted initial claims was 405,000, a decrease of 22,000 from the previous week. The 4-week moving average was 423,250.

The advance seasonally adjusted insured unemployment rate remained at 3.0 percent for the week ending July 2.

The advance number for seasonally adjusted insured unemployment during the week ending July 2 was 3,727,000, an increase of 15,000 from the preceding week. The 4-week moving average was 3,719,250, an increase of 6,250.

WEEK ENDING	July 9	July 2	Change	June 25	Prior Year
Initial Claims (SA)	405,000	427,000	-22,000	432,000	440,000
4-Wk Moving Average (SA)	423,250	427,000	-3,750	427,750	485,750

Econoday 7/14 - The headline decline in jobless claims is good news though there are special factors at play that cloud the July 9 week, a shortened period that includes the July 4 holiday. Another factor is the timing of shutdowns for retooling in the manufacturing sector, a seasonal factor that lowers claims after adjustment and always makes for uncertain readings at this time of year. One factor that is clearly inflating claims is the government shutdown in Minnesota which added 11,500 to the week's total.

Retail Sales: June

Vanguard 7/15 - U.S. retail sales increased 0.1% in June, reversing May's similar decline. While department store, building supply store, and apparel sales all rose, sales figures from furniture, sporting goods, and hobby stores showed the biggest declines.

Econoday 7/14 -Retail sales edged up in June despite a price related drop in gasoline sales. A rebound in auto sales helped lift overall sales. Motor vehicle sales made a partial 0.8 percent rebound. Both months' sales were constrained by shortages of models dependent upon parts from Japan. Excluding autos, sales were flat. Gasoline dropped 1.3 percent. Sales excluding autos and gasoline in June posted a modest 0.2 percent rise.

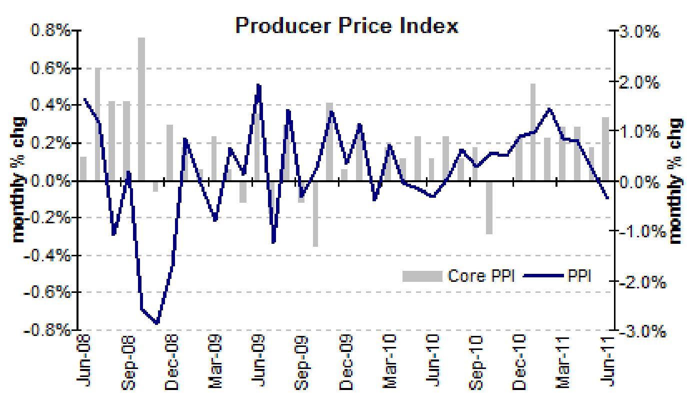
Retail sales on a year-ago basis in June posted at 8.1 percent, excluding motor vehicles up 7.9 percent.

Essentially, overall retail sales in June were soft and mixed. However, today's drop in initial jobless claims may be encouraging for future sales along with supply constraints in the auto sector being resolved.

PPI: June

Vanguard 7/15 – Producer prices fell 0.4% in June, their steepest decline since February 2010, as energy prices eased. Prior to June, overall prices had risen for 12 straight months.

Barclays 7/14 - On a y/y basis, headline PPI fell to 7.0% but the core rose to 2.4%. Energy, food and vehicle prices (partly related to supply constraints in Japan) are likely to cause volatility in the PPI in the coming months, but beyond these components there is continued evidence of building pipeline price pressures.



Business Inventories: May

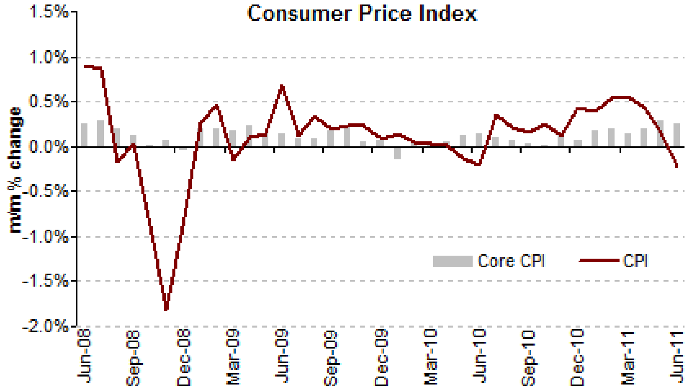
Vanguard 7/15 – U.S. business inventories rose to $1.51 trillion in May. Inventories are at their highest level since October 2008 and 11.6% higher than a year ago. Wholesale inventories alone are up 15.5% over last year's level.

Econoday 7/14 - Inventories are on the high side right now, the result of the economic soft patch that has put supply-chain professionals on the defensive. Business inventories rose 1.0 percent in May in contrast to a 0.1 percent decline for sales, a mismatch that puts the stock-to-sales ratio at 1.28.

The new component that rounds out May's report is retail where inventories rose 0.4 percent vs a 0.2 percent contraction for sales. The ratio between factory inventories and sales and wholesale inventories and sales show even greater mismatches. Businesses are trying to pull back their inventories, evidenced by what looks to be a slight quarter-to-quarter slowing in accumulation, a negative for second-quarter GDP.

CPI: June

Econoday 7/15 –The CPI in June dipped 0.2 percent. Turning to major components, energy dropped 4.4 percent. Gasoline fell 6.8 percent. Food price inflation slowed with a 0.2 percent gain.



Within the core new vehicles increased 0.6 percent, used cars and trucks jumped 1.6 percent, and apparel increased 1.4 percent in June. Owners' equivalent rent rose 0.2 percent.

Year-on-year, overall CPI inflation held steady at 3.4 percent (seasonally adjusted) in June. In contrast, the core rate firmed to 1.6 percent. The headline is good news but the strong core will give Fed officials pause on taking on more quantitative easing. However, the motor vehicle prices gains are likely temporarily hot.

Industrial Production and Capacity Utilization: June

Econoday 7/15 – Industrial production in June rose moderately, but mainly due to a rebound in the utilities component. Overall industrial production in June advanced a modest 0.2 percent.

Manufacturing was soft with no change. The auto component has pulled down on production with three consecutive declines, down 2.0 percent in June. Excluding motor vehicles, manufacturing rose 0.2 percent. Utilities rebounded 0.9 percent. Mining output grew 0.5 percent. Year-on-year, overall industrial production improved to 3.4 percent. Overall capacity utilization in June held steady at 76.7 percent.

Barclays 7/15 - Taken alongside downward revisions to April and May this rounded out a very soft quarter, with production up just 0.8% q/q (saar). All in all, a soft report, particularly given the downward revisions earlier in the quarter too. However, we continue to expect a solid rebound in manufacturing output in Q3, led by the auto sector.

Mich Sentiment: July - Consumer sentiment drops on concerns over debt ceiling negotiations

Econoday 7/15 – Consumer spirits have weakened sharply from already low levels this month according to the consumer sentiment index which fell to a two-year low of 63.8. Expectations fell nine points to a 55.8 level that indicates wide pessimism over the economic outlook. Current conditions fell nearly six points to 76.3.

Barclays 7/15 - The expectations component appeared to be weighed down by the uncertainty surrounding the debt ceiling negotiations. The question that asks about consumer judgments of economy policy registered a reading comparable with some of the lowest levels over the past several decades. Consumer expectations were also weighed down by personal income concerns.

In sum, the report was softer than expected and reflected several factors weighing on consumers, including the recent slowing in the labor market and fiscal policy uncertainty. A continued decline in high gas prices, along with a resolution of the debt ceiling, could help support higher consumer sentiment in the coming months.

Moody's downgrade watch - Not really a surprise

Barclays 7/13 - A few hours ago, Moody's placed the Aaa rating of the US government on review for possible downgrade, given the rising possibility of a default on debt obligations. This should not be much of a surprise to the market. On June 2, 2011, Moody's had warned that if by mid-July there was no evident progress in debt limit negotiations, a rating review would be likely. The only surprise was in the timing - we had thought that July 22 was a more likely date for any such action, since it was flagged by President Obama as the date by which an agreement must be reached for the law to be written and passed before August 2, 2011. Moody's now says that it considers the probability of a default on interest payments low, but no longer de-minimis. Since it expects such an event to be shortlived, the rating would most likely be downgraded to somewhere in the Aa range. More importantly, while the rating would be affirmed if a default is avoided, the outlook would likely be negative unless a substantial/credible plan is achieved that includes long-term deficit reduction; resulting in first stabilization and then a decline in the debt/GDP ratio and debt/revenue ratio within the next few years.

We view a missed coupon payment as an extremely unlikely event. While Treasury has said that it does not want to pick and choose which payments to make and which not to (if the debt ceiling is not raised), we continue to believe that if absolutely necessary, the US will prioritize coupon payments over other outlays. But a credible deficit reduction plan, along the lines of what Moody's seems to want, is a different issue, at least over the next few weeks. CBO recently forecast that its 'alternative scenario' (where most tax cuts include the Bush era cuts are extended, war spending falls as troops deployed decline and other discretionary spending rises at the rate of nominal GDP), the debt/GDP ratio would rise to 100% by 2021 (we are only talking about marketable debt/GDP, which is currently around 69%). If the debt ceiling plan being agreed upon cuts $2.5trn (without any future triggers), then the debt/GDP ratio would likely be 90% by 2021. Hence, the likelihood of such a plan being perceived as credible and substantial is probably low. In our view, the rating agencies' outlook on the US will be negative, even if the debt limit is raised through any such plan.

In terms of positioning, we believe the 5s30s/10s30s Treasury curves should continue to steepen. If a $2.5trn deal is reached without significant entitlement reform (as seems increasingly likely), it will be composed largely of spending cuts. This would create a drag on growth in coming years without addressing long-term fiscal issues - a recipe for steepening.

The Economic Week Ahead: July 18 –July 22, 2010

Vanguard 7/15- Two real estate reports are set for release: new-home sales on Tuesday and existing-home sales on Wednesday. The June report on leading economic indicators is scheduled for Thursday.

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

Date	ET	Release	For	Briefing.com	Consensus	Prior
Jul 18	09:00	Net Long-Term TIC Flows	May	NA	NA	$30.6B
Jul 18	10:00	NAHB Housing Market Index	Jul	NA	NA	13
Jul 19	08:30	Housing Starts	Jun	570K	570K	560K
Jul 19	08:30	Building Permits	Jun	600K	605K	609K
Jul 20	07:00	MBA Mortgage Purchase Index	07/16	NA	NA	-5.1%
Jul 20	10:00	Existing Home Sales	Jun	4.90M	4.95M	4.81M
Jul 20	10:30	Crude Inventories	07/16	NA	NA	-3.124M
Jul 21	08:30	Initial Claims	07/16	390K	411K	405K
Jul 21	08:30	Continuing Claims	07/9	3700K	3700K	3727K
Jul 21	10:00	Philadelphia Fed	Jul	0.0	0.0	-7.70
Jul 21	10:00	Leading Indicators	Jun	0.3%	0.3%	0.8%
Jul 21	10:00	FHFA Housing Price Index	May	NA	NA	0.8%