Market Comment *Economic Highlights for the week ended July 29, 2011*

Economic Week in Review: Debt drama continues, new data disappoint

Vanguard 7/29 - With the federal debt ceiling debate serving as a shadowy backdrop, the latest economic reports continued to paint a picture of an economy struggling to sustain a recovery. The first estimate of second-quarter gross domestic product was lower than hoped, but the figure for the previous quarter was revised downward so much that the latest number represented an uptick. The Federal Reserve's latest survey confirmed a slowing economy, while new-home sales and durable-goods orders also retreated a bit. For the week ended July 29, the S&P 500 Index fell 3.9% to 1,292 (for a year-to-date total return of about 3.9%). The yield on the 10-year U.S. Treasury note fell 17 basis points to 2.82% (for a year-to-date decrease of 48 basis points).

AFP 8/1 - The U.S. economy grew a disappointing 1.3% on an annualized basis during the second quarter of 2011. The awful second quarter figure was outdone however by a revision to first quarter growth, which the Bureau of Economic Analysis now estimates was at now only 0.4%. Two other reports on business activity show the economy at best has been crawling along thus far this summer, while two reports on consumer sentiment provided conflicting readings. All of this occurred in the backdrop of continuing drama of the debt ceiling showdown.

2nd Quarter 2011 GDP: GDP Data Surprise to The Downside

Press Release 7/29 (excerpt) - Real gross domestic product -- the output of goods and services produced by labor and property located in the United States -- increased at an annual rate of 1.3% in the second quarter of 2011, (that is, from the first quarter to the second quarter), according to the "advance" estimate released by the Bureau of Economic Analysis. In the first quarter, real GDP increased 0.4%.

Vanguard 7/29 - U.S. economic activity grew more slowly than expected in the second quarter, at an annual rate of 1.3%, based on the first estimate of gross domestic product (GDP). But that sluggish figure actually represented a pickup from the first quarter because annualized GDP for the first three months of the year was revised dramatically downward, from 1.9% to 0.4%. (All figures are adjusted for inflation.)

Behind the disappointing headline numbers, however, some data indicated that growth may be poised to pick up later this year. Consumer spending, the biggest GDP component, was soft (+0.1%) but was dragged down mainly by sales of motor vehicles and parts (–0.7%), which were affected by short-term supply disruptions following Japan's March 11 disaster. Those problems are expected to ease. Meanwhile, fixed nonresidential investment (including structures, equipment, and software) showed strength, rising an annualized 6.3% and making up about half of GDP's net growth. And homebuilding also contributed to growth in the second quarter, after subtracting from it in the first. The trade deficit shrank, as exports, helped by a weaker U.S. dollar, grew much more strongly than imports. Government spending was a hindrance, falling at a 1.1% annualized rate, as a slight gain in federal spending was more than offset by state and local cutbacks.

AFP 8/1 - It was not a surprise that the BEA had reported that gross domestic product had grown at a slow pace during the Spring, but the 1.3% annualized growth rate was at least a half percentage point below consensus expectations. **Most noticeable in the data was the disappearance of the consumer**. Real personal consumer expenditures were up a mere 0.1% on an annualized basis, versus a 2.1% increase during the first three months of the year. Spending on durable goods plummeted 4.4%, which was counterbalanced (barely) by increases in spending on non-durable goods (+0.1%) and services (+0.8%). Still, the only major component of GDP that dragged down growth was government spending. Thanks to a 3.4% decline in state/local government spending, total government spending made a 23-basis point negative contribution to GDP growth. Look for two revisions in the second quarter GDP data over the next two months.

The July GDP report also featured the regular annual revisions to the data series. This round of revisions indicates that economic activity has been slower than previously estimated (with a few exceptions). BEA changed its estimate of GDP growth by -3/10ths of a percentage point for 2008, by -9/10ths of a percentage point for 2009, and a +1/10th of a percentage point for 2010. The most striking (and perhaps disturbing) revision was the sharp downward revision to first quarter 2011 growth—from +1.9% to +0.4%. This means that the U.S. economy barely expanded during the first three months of the year, a far cry from the optimism expressed by (hoped for) by some during the first days of January. Tie that news with the weak second quarter report and one becomes increasingly concerned about the viability of the two-year old economic recovery.

Econoday 7/29 - Most of the anemia in the second quarter came from the consumer sector which came to a screeching halt with a 0.1 annualized percent uptick in the first quarter, following a 2.1% rise the prior quarter. Government purchases declined modestly while gains were seen in net exports, business investment in structures and equipment, and even residential investment. Inventories nudged up.

Economy-wide inflation according to the GDP price index showed only incremental change in momentum, rising 2.3%, following an increase of 2.5% in the first quarter. Analysts expected a 2.0% gain.

The recent recession was worse than earlier believed. When the contraction is not annualized, but rather reported as the actual decline over the six quarter period, GDP fell a cumulative 5.1% -larger than the 4.1% as previously estimated. This was the largest recession since World War II.

WSJ 7/29 Economists React: 2Q2011 GDP

–Anemic consumption, still declining state and local government spending, tepid business investment, and soft housing activity all combined to offset some strength in exports. Concerns about the weak labor market and rising food and energy prices continue to weigh on consumer confidence. Business sentiment is not more optimistic than consumers, in general, and likely to result in no more than moderate expansion of business investment. The more bullish forecasters that believe we are only experiencing a cyclical soft patch are likely to be disappointed when growth struggles to get above 2% in the second half of the year. –Kathy Bostjancic, The Conference Board

– Recovery? What recovery? Economic growth has largely stalled led by a depressed consumer and budget cutting state and local governments. Household spending came to a screeching halt as vehicle sales tanked in the spring. That created a sharp decline in durable goods spending. Businesses continued to invest but the demand for equipment and software grew at the slowest pace in two years. And then there were state and local governments, where budget cutting has become de rigueur. The slicing and dicing reduced economic growth by over 0.4 percent point. That is not chump change and shows that my comment that there is no such thing as a free budget cut was not just a cute phrase. Thankfully, the trade deficit narrowed on solid increases in exports and weak imports. That kept growth above one percent. –Naroff Economic Advisors

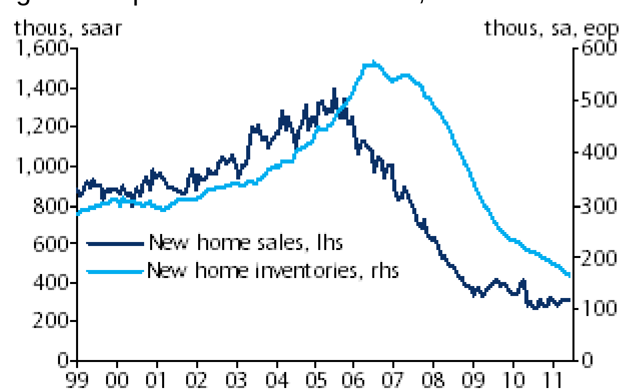
Beige Book: Fed Says Economy Is Growing More Slowly

Vanguard 7/29 - The economy's growth slowed a bit in June and early July, according to the Federal Reserve's latest Beige Book survey of nationwide conditions. Reports from all of the Fed's 12 districts showed that economic activity moderated, particularly in the six districts in the eastern United States. However, consumer spending was higher in virtually every district, as consumers were helped by falling gasoline prices, although auto sales slowed a bit as inventories remain affected by Japanese supply-chain disruptions. The Fed's report noted that "the summer tourism season has started off stronger than last year in most areas unaffected by severe weather." Also, most districts reported slightly improved labor market conditions. Real estate activity remained weak, "although construction and activity in the residential rental market continued to improve since the previous Beige Book."

AFP 8/1 - Manufacturing activity grew, with several markets seeing activity pick up as supply chain issues emanating from Japan dissipated. While commodity costs continued to squeeze a number of companies, only “some” were able to pass on some of the increased costs to their customers. Credit conditions were unchanged from the previous report, while loan demand was “more mixed,” with growth reported in the New York, Richmond and Chicago Districts.

New Home Sales - June

Vanguard 7/29 - Sales of new homes fell 1.0% in June to an annualized pace of 312,000 units. Sales dropped sharply in the Northeast (–16%) and the West (–13%), but rose in the Midwest (+10%) and South (+3%). The data confirm that the housing market continues to bounce along a bottom. Builders have slimmed down their inventories to very lean levels. Also, the median price of new homes rose 6% to $235,200, but that measure has been more volatile lately because of the lower number of sales.



Barclays 7/26 - In Q2 as a whole, new home sales averaged 315k, up from 299k in Q1. The months supply stood at 6.3 in June, a tenth lower than May, and the level of inventory reached a new low of 164k.

Consumer Confidence Indicator Ticks Upward - June

Vanguard 7/29 - The Conference Board's index of consumer confidence bounced off its lowest level since late last year and ticked up to 59.5 in July. The index had fallen to 57.6 in June (revised downward from 58.5). The rise was the first since April, when the index stood at 66.0, and still well below the recent peak of 72.0 in February.

"Consumer confidence posted a modest gain in July, the result of an improvement in consumers' short-term outlook," said Lynn Franco, director of the Conference Board Consumer Research Center. "Consumers' appraisal of current business and employment conditions, however, was less favorable as concerns about the labor market continue to weigh on consumers' attitudes. <u>Overall, consumers remain apprehensive about the future, but some of the concern expressed last month has abated</u>."

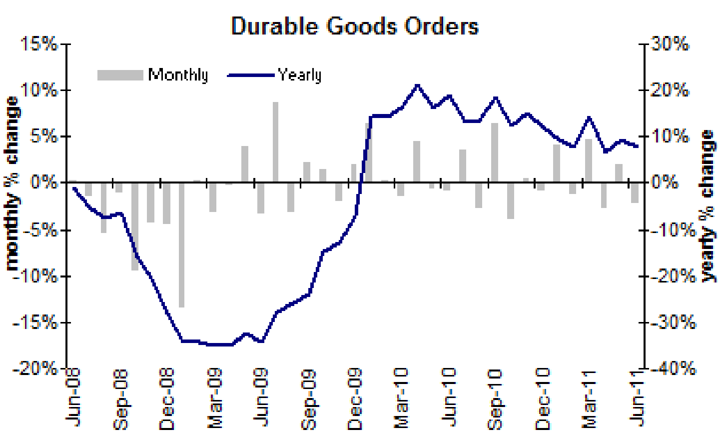
Univ. of Michigan Consumer Sentiment – July Final

Moody's 7/29 - The University of Michigan consumer sentiment index dropped precipitously in July. The index was revised down a minimal 0.1 point from the preliminary report, but the total 7.8 decline was substantial. <u>The stalemate surrounding deficit-ceiling negotiations appears to be adversely affecting consumer sentiment</u>, because most of the fundamentals that usually support this index are positive. Sentiment was generally down across the board, but the largest drop occurred within consumer expectations. <u>However, inflation expectations fell, which normally boosts confidence</u>.

The University of Michigan Consumer Sentiment Survey went in the opposite direction as the headline index fell to levels not experienced since the depths of the recession in early 2009. The Index of Consumer Sentiment plummeted 7.8 points to a seasonally adjusted 63.7 (1966 Q1 = 100), as the indices for current and future conditions each experienced sharp declines (-7.6 percent and 13.6 percent, respectively). The press release notes that twice as many respondents reported that their finances had worsened rather than improved over the past year, with "<u>eight-in-ten respondents anticipate no financial improvement during the year ahead</u>" and a solid majority also <u>pessimistic about prospects for the next five years</u>. The press release also ties the decline in the index to the debt ceiling debate, noting that while everyone may not understand what the debate is about, "they do understand the meaning of the oft repeated warnings of "dire economic consequences."

Durable-Goods Data Continue To See-Saw

Press Release 7/27 (excerpts) – New orders for manufactured durable goods in June decreased $4.0 billion or 2.1% to $192.0 billion, the U.S. Census Bureau announced today. This decrease, down two of the last three months, followed a 1.9% May increase. Excluding transportation, new orders increased 0.1%. Excluding defense, new orders decreased 1.8%.



Transportation equipment, also down two of the last three months, had the largest decrease, $4.2 billion or 8.5% to $45.4 billion. This was due to nondefense aircraft and parts which decreased $2.8 billion.

Vanguard 7/29 - New orders for U.S. durable goods—those expected to last at least 3 years—dropped 2.1% in June, more than offsetting May's increase of 1.9%. The latest dip continued a 12-month trend with this indicator—rising one month, falling the next. Transportation goods—including aircraft and autos—accounted for most of the decrease, reflecting some lingering effects of supply-chain problems in the wake of the Japanese tsunami. Excluding that category, orders were up slightly (0.1%). Orders of core capital goods—which exclude aircraft and defense orders—retreated 0.4%, but shipments rose 1.0%.

Employment Cost Index: Q2 - Compensation Costs For Employers Rise

Vanguard 7/29 - Employment costs climbed 0.7% in the second quarter, led by a 1.3% boost in benefits. Growth in wages and salaries remained steady at 0.4%. Compared with a year ago, total compensation has increased 2.2%, wages and salaries 1.6%, and benefits 3.6%. Wages grew faster in the second quarter for employees in the private sector compared with those in state and local governments, which continue to face budget constraints. Overall, compensation is growing slowly, which many analysts expect will continue to restrain consumers from ramping up their spending anytime soon.

Unemployment Insurance Weekly Claims Report (Initial Jobless Claims) – week of July 23

Press Release 7/28 (excerpts) – In the week ending July 23, the advance figure for seasonally adjusted initial claims was 398,000, a decrease of 24,000 from the previous week's revised figure of 422,000. The 4-week moving average was 413,750, a decrease of 8,500 from the previous week's revised average of 422,250.

The advance seasonally adjusted insured unemployment rate was 2.9% for the week ending July 16, a 0.1 percentage point decrease from the prior week's revised rate of 3.0%.

The advance number for seasonally adjusted insured unemployment during the week ending July 16 was 3,703,000, a decrease of 17,000 from the preceding week's revised level of 3,720,000. The 4-week moving average was 3,721,000, a decrease of 5,250 from the preceding week's revised average of 3,726,250.

WEEK ENDING	July 23	July 16	Change	July 9	Prior Year
Initial Claims (SA)	398,000	422,000	-24,000	408,000	457,000
4-Wk Moving Average (SA)	413,750	422,250	-8,500	424,000	455,750

Econoday 7/28 - Initial jobless claims dropped a very sharp 24,000 in the July 23 week to 398,000 for the first sub-400,000 reading since early April. One factor that may cloud today's report is uncertainty about retooling in the auto sector, uncertainty is even greater this year due to ongoing production cutbacks tied to Japan. Minnesota, where the government remained shut down for most of the week, is also a special factor though the state did not provide any related details this week. Yet given that the Labor Department isn't citing any special factors, today's report offers badly needed good news for the stock market.

The Economic Week Ahead: August 1 – August 5, 2011

Vanguard 7/29 - Next week brings a slew of reports, including construction spending and the ISM Manufacturing Index on Monday, personal income on Tuesday, factory orders and the ISM Non-Manufacturing Index on Wednesday, and consumer credit and the Labor Department's closely watched update on the employment situation on Friday. Meanwhile, the federal debt debate could continue into next week.

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

Date	Time (ET)	Statistic	For	Actual	Briefing Forecast	Market Expects	Prior
Aug 1	10:00 AM	ISM Index	July	50.9	51.0	54.0	55.3
Aug 1	10:00 AM	Construction Spending	June	0.2%	0.2%	0.0%	0.3%
Aug 2	8:30 AM	**Personal Income**	June	0.1%	0.0%	0.1%	0.2%
Aug 2	8:30 AM	**Personal Spending**	June	-0.2%	-0.2%	0.1%	0.1%
Aug 2	8:30 AM	PCE Prices - Core	June	0.1%	0.3%	0.2%	0.2%
Aug 3	8:15 AM	ADP Employment Change	July	-	100K	100K	157K
Aug 3	10:00 AM	Factory Orders	June	-	-1.0%	-1.0%	0.8%
Aug 3	10:00 AM	ISM Services Index	July	-	52.0	53.7	53.3
Aug 4	8:30 AM	Initial Claims for Unempl.	07/30	-	420K	405K	398K
Aug 4	8:30 AM	Continuing Claims	07/23	-	3700K	3700K	3703K
Aug 5	8:30 AM	**Nonfarm Payrolls**	July	-	50K	84K	18K
Aug 5	8:30 AM	**Nonfarm Private Payrolls**	July	-	75K	100K	57K
Aug 5	8:30 AM	**Unemployment Rate**	July	-	9.3%	9.2%	9.2%
Aug 5	3:00 PM	Consumer Credit	June	-	$5.0B	$5.0B	$5.076B