Market Comment *Economic Highlights for the week ended August 12, 2011*

Economic Week In Review: Worry Jolts Markets As Economy Plods On

Vanguard 8/12 – Market tensions overflowed this past week as economic prospects appeared to dim, doubts about European solvency deepened, and policymakers struggled to forge remedies. The volatility added to signs suggesting a higher risk of another U.S. recession, though the consensus view remains that the economy will continue its slow and fitful recovery.

"Market volatility is always high when investors' expectations about the economy take a sudden turn," said Vanguard senior economist Roger Aliaga-Díaz, who noted that economists now expect slower growth in the second half of the year and that consumer and business confidence has slipped amid heightened uncertainty over economic and fiscal policy. For the week ended August 12, the S&P 500 Index fell 1.7% to 1,178.81 (for a year-to-date total return of about –5.1%). The yield on the 10-year U.S. Treasury note fell 34 basis points to 2.24% (for a year-to-date decrease of 106 basis points).

AFP 8/15 - As if there were a contest to see if each week's economic news could outdo the previous week, the Federal Open Market Committee voted last Tuesday to not only keep the fed funds target rate at near-zero but stated that it was likely remain there for at least another two years. The committee's decision came just days after the historic downgrade of Standard & Poors' sovereign credit rating on the United States. An AFP survey released last week suggested that S&P's downgrade could detrimentally impact businesses' perception of the U.S. as an investment destination. But the news was not all bad: retail sales grew 0.5% in July while jobless claims continued their recent descent.

Federal Reserve Open Market Committee (FOMC) Rate Decision - August

AFP 8/15 - While not voting for a 3rd round of quantitative easing, the FOMC reaffirmed its extraordinary accommodative stance. The statement noted that the fed funds rate would likely remain at "exceptionally low levels" until "at least mid-2013." In addition, the committee maintained its policy of reinvesting principal payments made on the vast holdings of securities the Fed had built up in recent years. The statement acknowledged that economic growth has been considerably slower than expected with the slowdown not as "temporary" as previously hoped. The committee expects a "somewhat slower pace of recovery" with increased downside risks. Three FOMC committee members dissented with the majority vote as they did not support the explicit statement of keeping the target rate near-zero until 2013.

Should the committee carry out its intention to keep the fed funds target rate at "exceptionally low levels" through at least mid-2013, it would mean the target rate would have stayed at near-zero% for nearly five years (December 2008). As expected, there was no announcement of a third round of quantitative easing, although the committee did say it was prepared to adjust its securities holdings "as appropriate."

The statement also noted that the slowdown in the U.S. economy during the first half of the year was not just the result of "temporary" factors (e.g., higher commodity prices and the earthquake and tsunami in Japan). As a result, the committee anticipates the economy will grow at "somewhat slower pace" than had previously believed and that it was facing greater downside risks. The FOMC vote was subject to three dissenting votes— from Richard Fisher, Narayana Kocherlakota and Charles Plosser—all who had preferred that the announcement had not explicitly stated that the near-zero fed funds target rate likely would remain near zero for another two years. Instead, they preferred keeping the previously used "extended period" time horizon definition in the FOMC's statement.

Vanguard 8/12 – The Fed acknowledged a dimmer economic outlook while also trying to reassure nervous markets that it will keep monetary policy extraordinarily loose for at least 2 more years.

Concern about possible future inflation was evident in Tuesday's divided vote. Though the Fed traditionally takes pains to project unity, 3 of 10 members of its policymaking committee dissented in favor of continuing to commit to low rates only "for an extended period"—Fedspeak for 6 months or so.

At least for now, the Fed didn't embark on a third round of large-scale bond purchases to keep down interest rates. Though low rates can fuel inflation when an economy is growing, during slowdowns they can help employers by reducing bond yields to lower borrowing costs.

Econoday 8/9 - The Fed appears to have carefully chosen to not directly address the recent plunge in stock prices. Indirectly, the Fed takes all factors into account and states that downside risks to the outlook have increased. While recovery has been downgraded, it is important to note that there is no mention of recession. The expectation of a slow decline in unemployment indicates disappointment in the pace of recovery, but it also indicates that growth is expected to be strong enough to tug down on the unemployment rate. The expected decline in inflation gives the Fed latitude to keep rates low.

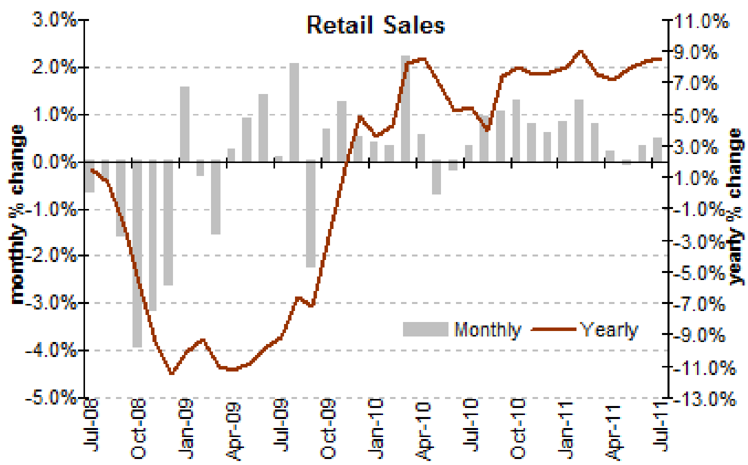
GS 8/9 - Despite three dissents--the largest number since 1992--the committee adopted an even easier policy stance than expected. The committee effectively signaled <u>an easing bias</u> saying that it discussed "the range of policy tools necessary to promote a stronger economic recovery" and that it "is prepared to employ these tools as appropriate." In our view, this leaves open the possibility of further asset purchases ("QE3") should the economic outlook deteriorate further from here.

Barclays 8/9 - We also suggest these dissents may be a pre-emptive dissent against the resumption of asset purchases.

Retail Sales – July: Solid Start to Q3 For US Retail Sales

AFP 8/15 - This was the largest increase in retail sales since March, thanks to 1.6% growth in sales at gas stations. Net of sales at gas stations and car dealers (+0.4%), core sales grew 0.3%. Sales grew 1.4% at electronic stores and 0.5% at furniture stores, grocery stores and apparel retailers. Sales declined at sporting goods stores (-1.5%) and building materials retailers (-0.4%). Retail sales were up 8.5% over the past year with core sales up 6.5%.

Retail sales grew at their fastest pace since early Spring in July, although a part of the gain is tied to an 1.6% jump in sales at gas stations. Net out the typically volatile data from gas stations and car dealers (+0.4%) and you get core retail sales increasing a more modest 0.3%. Retail sales have grown 8.5% since July 2011—this was not only the best 12-month comparable since February, it was only the third time since before the recession that had a comparable as large.

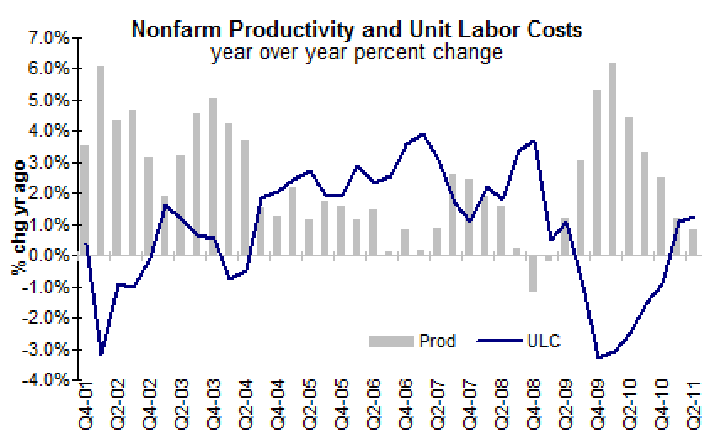


Vanguard 8/12 - Despite the various constraints consumers face, retail sales have been slowly picking up from a slowdown this spring, and July sales picked up even more. Gasoline and autos accounted for most of the increase. Since consumers account for more than two-thirds of the U.S. economy, even modest continued spending could add to evidence that the economy will keep recovering.

Econoday 8/12 - Overall, the consumer is still spending, although the pace is hardly gangbusters. Despite difficulties in the financial markets, the consumer has not withdrawn to the sidelines.

Productivity And Unit Labor Costs – Q2: Productivity Declines As Unit Labor Costs Rise

AFP 8/15 - The struggles of the U.S. economy during the first half of the year have manifested itself in the form of declining productivity. Output per hour worked decrease 0.3% during the months of April, May and June and followed a 0.6% decline during the first quarter. This was the first time in three years with <u>consecutive quarters of declining productivity</u>. The Bureau of Labor Statistics estimates output grew 1.8% during the quarter while the number of hours worked increased 2.0%. Productivity has grown a modest 0.8% over the past year. Unit labor costs grew 2.2% during the second quarter, less than half the 4.8% increase experienced during the first three months of 2011.



Vanguard 8/12 – After rising significantly over the past few years, productivity dropped slightly in the 2nd quarter—a sign that the <u>big gains in productivity achieved during the recession and recovery could be fading</u>. And the Labor Department revised earlier figures to show productivity had dropped in the 1st quarter as well, while labor costs were revised to show a larger rise than initially reported.

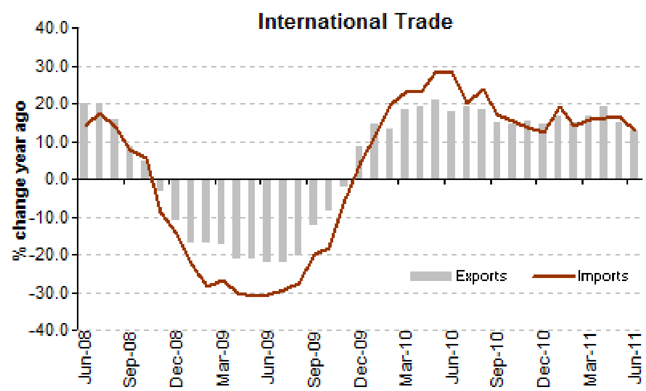
Many companies have been able to stay profitable despite tight credit and less demand by cutting workers and wages more than production. But slipping productivity could mean companies have extracted about all they can out of their current workforces, in which case they may find they need to hire more employees.

Barclays 8/9 - The tepid pace of productivity growth also suggest that firms will likely need to rely more heavily on increasing hours worked or hiring additional employees to continue increasing output.

Unit labor costs increased 2.2%, reflecting a 1.9% increase in compensation per hour. The increase was below our expectations (3.0%) and consensus (2.4%). Revisions, however, showed a much sharper rise in Q1 than previously estimated, with unit labor costs rising 4.8% (previous: 0.7%). Compensation per hour increased 4.2% in Q1, versus the initial estimate of 2.5%. In our view, the rise in unit labor costs could reflect a labor market that has less spare capacity than may be commonly perceived, in which case, rising labor costs are likely to continue.

Trade Balance – June: US Trade Balance Widens Further In June

Barclays 8/11 - The US trade balance moved wider to $53.1bn in June from a revised $50.8bn in May (initial estimate: $50.2bn). We had expected a modest narrowing ($48.4bn), as had consensus ($48bn). The softness was primarily in exports, which fell 2.3% m/m and were driven by declines in semiconductors (-5.1%), computer equipment (-4.5%) and industries supplies (-4.8%). However, exports for civilian aircraft (13.6%), consumer goods (5.2%) and autos (0.4%) increased. Imports posted a modest decline, falling 0.8%, with relatively broad-based declines across sectors, although increases did occur in pharmaceuticals (13.2%), semiconductors (1.3%) and civilian aircraft (12.6%). Imports of motor vehicles and parts from Japan were up by about 36%, indicating the supply-chain disruptions stemming from the earthquake began unwinding in June.



Wholesale Inventories – June: Weaker-Than-Expected US Wholesale Inventory Accumulation

Vanguard 8/12 – Firms watched their stockpiles grow a bit faster than sales this spring, but new figures for June show businesses took steps to slow the accumulation. Though inventories still rose, their growth was slower than expected as companies strived to keep them more closely in line with sluggish consumer spending in the spring.

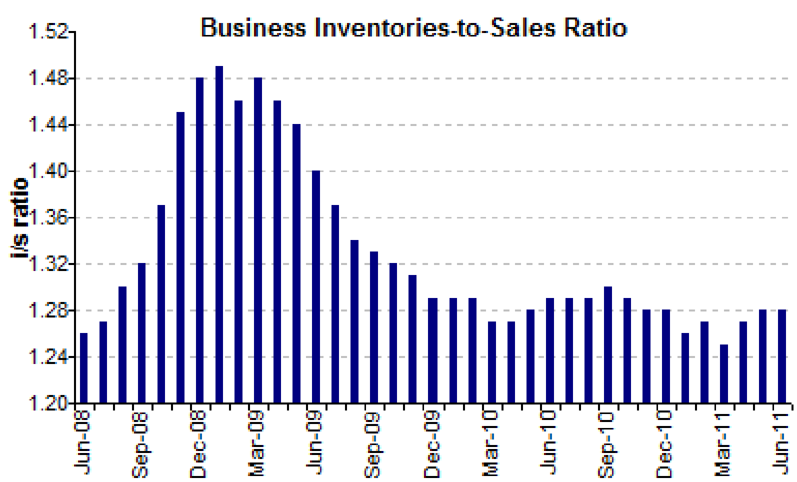
Back when the economy started emerging from recession, the buildup of inventories in anticipation of higher demand was a welcome jump start for growth. But with gross domestic production having slowed to a crawl in the first half of the year, firms may need to cut output to keep unsold inventories from accumulating.

Econoday 8/10 - Inventory growth in the wholesale sector slowed in June to 0.6% for the lowest rate of the year.

Business Inventories – June: US Retail Inventories As Expected In June

Econoday 8/12 – The nation's businesses are managing their inventories well, paring accumulation back slightly in reaction to slightly lower growth in sales. Business inventories rose 0.3% in June against a 0.4% rise in business sales to keep the stock-to-sales ratio unchanged at 1.28. A quarter-to-quarter look shows a 2.8% gain in second-quarter business inventories vs. quarterly gains of 2.8% and 2.7% in the prior two quarters.

Successful management of inventories reduces the risk of excess inventory growth during a slowdown, one that could lead to a step backward for the jobs market.



NFIB Small Business Optimism Index – July: US Small Business Optimism Edges Lower In July

Barclays 8/9 - The National Federation of Independent Business (NFIB) small business optimism index declined to 89.9 in July from 90.8 in June, in line with expectations and the fifth consecutive monthly decline. The NFIB survey has taken a soft tone relative to broader surveys of activity for some time, remaining well below pre-recession highs, and continues to suggest that small businesses are struggling more than most.

U. Of Mich. Consumer Sentiment –Lowest Level Since 1980 On Economic Policy Concerns

AFP 8/15 - The preliminary August reading of the University of Michigan Consumer Sentiment Survey fell to a seasonally adjusted reading of 54.9. Should this hold when updated at the end of the month, it would represent an 8.8 point drop from the final July reading, a 22.6 point decline from its recent peak in February and the worst reading since 1980.

Barclays 8/12 - The University of Michigan's index of consumer sentiment fell to 54.9 - its lowest point since 1980 - in the August preliminary survey from 63.7 in the final July release. The decline in the headline index was driven by another sharp drop in the expectations component, which fell from 56.0 to 45.7, also the lowest reading for this component since 1980. The current conditions component also declined, but remains above the lows it reached during the last recession. The majority of respondents reported deterioration in their personal finances and have expectations of little or no income growth. Households are apparently also concerned about the prospects of another near-term recession, as the majority of households anticipate an increase in the unemployment rate in the year ahead. Somewhat surprisingly, the University of Michigan indicated that the declines occurred prior to the S&P announcement that it was downgrading the US sovereign debt rating and that otherwise, sentiment readings this week were mostly flat. The report suggests that households are concerned about how the debt-ceiling agreement was concluded and the ability of policymakers to implement effective economic policy, as elements of the survey continue to suggest that consumers view economic policies unfavorably.

Overall, the report raises concerns about the outlook for the consumer, but with the retracing of oil prices recently, gasoline prices will likely continue to decline. Given that higher gas prices were a key factor in slowing the pace of spending in Q2, we see the potential for lower gasoline prices offering support to consumer spending in the second half of this year.

Econoday 8/12 –The debt-ceiling crisis and wild movements in the financial markets are very clearly not helping the consumer's faith in the economic outlook. One positive is that inflation is not a risk to the outlook with one-year expectations steady for the last month at 3.4% with the five-year even more firmly steady at 2.9%.

Unemployment Insurance Weekly Claims Report (Initial Jobless Claims) – Week of Aug 6

Press Release 8/11 (excerpts) – In the week ending August 6, the advance figure for seasonally adjusted **initial claims** was 395,000, a decrease of 7,000 from the previous week's revised figure of 402,000. The 4-week moving average was 405,000, a decrease of 3,250 from the previous week's revised average of 408,250.

The advance seasonally adjusted **insured unemployment rate** was 2.9% for the week ending July 30, a 0.1 percentage point decrease from the prior week's unrevised rate of 3.0%.

The advance number for seasonally adjusted **insured unemployment** during the week ending July 30 was 3,688,000, a decrease of 60,000 from the preceding week's revised level of 3,748,000. The 4-week moving average was 3,718,750, a decrease of 15,250 from the preceding week's revised average of 3,734,000.

WEEK ENDING	Aug 6	July 30	Change	July 23	Prior Year
Initial Claims (SA)	395,000	402,000	-7,000	401,000	478,000
4-Wk Moving Average (SA)	405,000	408,250	-3,250	414,500	468,750

Econoday 8/11 - Initial jobless claims, for the first time since early April, are under 400,000, at 395,000 in the August 6 week in what is a positive indication of job market improvement. The government is not citing any special factors in the data which is a positive surprise given possible distortions tied to summer retooling in the auto sector and to the temporary shutdown of the Federal Aviation Administration.

The Economic Week Ahead: Aug 15 – Aug 19, 2010

Vanguard 8/12- Reports include residential construction and industrial production on Tuesday; the Producer Price Index on Wednesday; and the Consumer Price Index, existing-home sales, and the Conference Board's index of leading indicators on Thursday.

This Week's U.S. Economic Calendar *Source: Market Watch*

DATE	TIME (ET)	REPORT	PERIOD	ACTUAL	FORECAST	PREVIOUS
Monday, Aug. 15	8:30 am	Empire State index	Aug.	-7.7	0.0	-3.8
Tuesday, Aug. 16	8:30 am	Housing starts	July		600,000	629,000
	8:30 am	Single-family permits	July		--	407,000
	8:30 am	Import price index	July		-0.1%	-0.5%
	9:15 am	Industrial production	July		0.9%	0.2%
	9:15 am	Capacity utilization	July		77.1%	76.7%
Wed., Aug. 17	8:30 am	Producer pride index	July		0.1%	-0.4%
	8:30 am	Core PPI	July		0.2%	0.3%
Thursday, Aug. 18	8:30 am	Jobless claims	8/13		400,000	395,000
	8:30 am	Consumer price index	July		0.4%	-0.2%
	8:30 am	Core CPI	July		0.2%	0.3%
	10 am	Existing home sales	July		4.99 mln	4.77 mln
	10 am	Leading indicators	July		0.4%	0.3%
	10 am	Philly Fed	July		0.5	3.2
Friday, Aug. 19		None scheduled				

Appendix: FOMC Press Release Link

www.federalreserve.gov/newsevents/press/monetary/20110809a.htm