Market Comment *Economic Highlights for the week ended August 13, 2010*

Economic Week in Review: Signs point to softening economy

Vanguard 8/13 - The economy continued to show signs of weakness as the U.S. trade deficit widened at an unprecedented pace, the Federal Reserve announced it would continue its expansionary monetary policies, and deflationary fears continued even though consumer prices rose for the first time in three months. For the week ended August 13, the S&P 500 Index fell 3.8%, to 1,079 (for a year-to-date total return—including price change plus dividends—of about –2.0%).

FOMC Meeting Announcement

Barclays 8/10 - The FOMC announced earlier this afternoon that it plans to re-invest the prepayments on its MBS and agency debenture holdings into Treasury securities. In effect, the Fed has now created a new target – the size of its balance sheet – in addition to the traditional policy rate.

The Fed will seek to keep its securities portfolio locked at $2.054trn; MBS holdings will decline with a dollar-for-dollar increase in Treasuries. At prevailing mortgage interest rates, the Fed's MBS portfolio is expected to shrink by $275bn over the next year. But this is subject to how quickly the portfolio prepays in reaction to the Fed's efforts. Purchases of Treasuries will be concentrated in the 2yr -10yr sector and conducted like the Fed's pre-crisis coupon passes.

Given the concentration of purchases outside of the front end, it is difficult to say where short rates will settle. Our preliminary estimate is that OIS, repo, and Libor will all move 5 to 10bp lower. Of course, the Fed's intention is really more focused on bringing down longer-term consumer interest rates.

Econoday 8/10 – (Excerpts) As some had hoped, the Fed will engage in some new quantitative easing – to keep the level of the balance sheet constant rather than to further expand its assets. The Fed, of course, left the fed funds target unchanged at a range of zero to 0.25%. The somewhat controversial language that rates are expected to remain low for an "extended period" was retained. As in recent policy decisions, Kansas City Fed President Thomas Hoenig voted against this language. The FOMC did make a minor downgrade in its view of the recovery but emphasized that growth continues.

The Fed's balance sheet strategy has been adjusted a bit. The emphasis is on keeping the current size of the balance sheet by reinvesting payments on agency debt and mortgage-backed securities into longer-term Treasuries. This is consistent with many Fed officials' view that the Fed should not be tinkering with specific private portions of the credit markets (mortgages, for example). "To help support the economic recovery in a context of price stability, the Committee will keep constant the Federal Reserve's holdings of securities at their current level by reinvesting principal payments from agency debt and agency mortgage-backed securities in longer-term Treasury securities. The Committee will continue to roll over the Federal Reserve's holdings of Treasury securities as they mature."

A key question from this newly adjusted strategy is whether the Fed will end up monetizing the federal government debt. That will depend on whether the Fed unwinds its balance sheet prior to a buildup of inflation pressures. Currently, the Fed sees inflation as subdued and not an issue due to slack resource utilization.

On the status of the economy, the statement acknowledged "that the pace of recovery in output and employment has slowed in recent months." This is less positive than in the June statement "that the economic recovery is proceeding and that the labor market is improving gradually."

For this vote, Kansas City Fed President Hoenig expanded the reasons behind his dissent. "Voting against the policy was Thomas M. Hoenig, who judges that the economy is recovering modestly, as projected. Accordingly, he believed that continuing to express the expectation of exceptionally low levels of the federal funds rate for an extended period was no longer warranted and limits the Committee's ability to adjust policy when needed. In addition, given economic and financial conditions, Mr. Hoenig did not believe that keeping constant the size of the Federal Reserve's holdings of longer-term securities at their current level was required to support a return to the Committee's policy objectives."

Overall, today's decision was not earth shattering. It was well within the range of expectations but markets still were glad to see a little extra attention for the economy from the Fed. About half an hour after the FOMC statement, the New York Fed announced some of the specifics for the Fed purchases.

"On August 10, 2010, the Federal Open Market Committee directed the Open Market Trading Desk ("the Desk") at the

Federal Reserve Bank of New York to keep constant the Federal Reserve's holdings of securities at their current level by reinvesting principal payments from agency debt and agency mortgage-backed securities ("agency MBS") in longer-term Treasury securities. The most recent H.4.1 data release indicates that outright holdings of domestic securities in the System Open Market Account ("SOMA") totaled $2.054 trillion as of August 4, 2010. The Desk will seek to maintain the face value of outright holdings of domestic securities in the SOMA at approximately this level."

The New York Fed expects to begin these new purchases of Treasury securities on or around August 17 and will concentrate its purchases in the 2- to 10-year sector of the nominal Treasury curve. Yields on most Treasuries eased on the news.

Barclays 8/10 – (Excerpts) In response to the incoming data received since the last meeting, the FOMC indicated that "the pace of recovery in output and employment has slowed in recent months." The Committee continued to indicate that business spending remains robust, while household spending remains constrained by "high unemployment, modest income growth, lower housing wealth, and tight credit." The FOMC expressed its unease in the state of events by noting that "the pace of economic recovery is likely to be more modest in the near term than had been anticipated." In other words, the Fed does not appear to view the recent slowing of activity as simply a soft patch in the recovery.

On the inflation front, the statement removed the language suggesting that lower energy and commodity prices were pushing inflation lower in favor of past language stating that inflation is likely to remain subdued and with stable inflation expectations. The statement noted that the maturing principal and interest from agency debt and agency mortgage-backed securities will be reinvested into "longer-term" Treasuries.

Finally, if the Fed has indeed lost a measure of confidence in the strength of the recovery, the change in strategy towards keeping the balance sheet at an elevated level will likely lead to increased speculation about additional asset purchases at coming meetings.

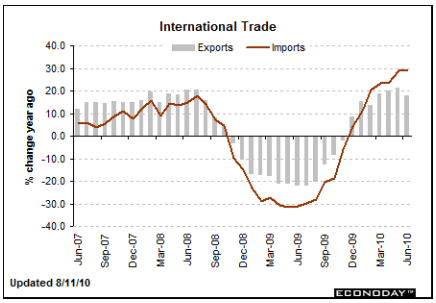
Productivity and Costs – 2Q2010

Econoday 8/10 - A 3.6% increase in hours worked outpaced a 2.6% increase in output, making for a 0.9% quarter-to-quarter decline in second quarter productivity and ending five straight quarters of strong growth. In a partial offset, first-quarter productivity was revised 1.1 percentage points higher to plus 3.9%.

The reversal in second-quarter productivity made for a 0.2% rise in labor costs to end three straight quarters of sequential decline. The rise in labor costs doesn't mean that workers are making more. Hourly compensation fell 0.7% following a flat reading in the first quarter. Weakening productivity is not surprising given the slowdown in growth, but today's results are further evidence that the recovery may be in jeopardy.

International Trade - June

Econoday 8/11 - The U.S. appetite for imported goods rose in June – but not overseas as U.S. exports fell. The overall U.S. trade deficit spiked to $49.9 billion from $42.0 billion in May. The June shortfall was much larger than the market forecast for a $42.5 billion gap. Exports fell 1.3%, following a 2.5% gain in May. Overall imports advanced 3.0% in June after rising 2.8% the month before. Nonoil imports gained a sharp 4.7%, following a 6.1% spike in May.



The widening of the trade gap was primarily in non-oil. The nonpetroleum deficit widened to $40.0 billion in June from $32.2 billion the prior month. The petroleum goods gap, however, narrowed to $21.2 billion from $21.5 billion in May.

By end-use categories, the drop in goods exports was led by a $1.4 billion decline in capital goods excluding autos. Also slipping were industrial supplies, down $1.0 billion, and foods, feeds & beverages, down $0.3 billion. Exports of consumer goods and autos posted modest gains. The advance in imports was widespread outside of oil. Consumer goods surged $3.1 billion; autos were up $1.3 billion; capital goods ex autos increased $0.5 billion; and foods, feeds & beverages rose marginally. Industrial supplies-which include oil-fell $0.2 billion.

US Q2 GDP growth tracking 0.3% following record trade deficit widening

Barclays 8/12 - The nominal US trade deficit widened to $49.9bn in June from $42.3bn in May, greater than we ($43.5bn) and the consensus ($42.1bn) had expected and the largest monthly widening in the deficit on record. In real terms, the trade deficit widened to $54.1bn from $46.0bn.
The deterioration in the trade balance in June was much sharper than had been assumed by the BEA in the advance Q2 GDP report. As such, **Q2 GDP growth is now tracking just 0.3% q/q (saar)**, relative to our previous tracking estimate of 1.6% and the initially reported 2.4%.

Jobless Claims

Econoday 8/12 - Initial jobless claims for the August 7 week came in at 484,000, far above expectations for 460,000 and the highest level since February. The four-week average, up a steep 14,250 to 473,500, is also the highest since February. There are no unusual factors affecting the results.

In a partial offset, continuing claims fell 118,000 in data for the July 31 week. The four-week average fell 64,000 to 4.519 million. The unemployment rate for insured workers came down one tenth to 3.5%. These numbers do look good but do reflect, to a degree, the expiration of benefits as the unemployed simply fall out of the insured labor pool.

Week Ending	Aug. 7	July 31	Change	July 24	Prior Year
Initial Claims	484,000	482,000	+2,000	460,000	557,000
4-Wk Moving Average	473,500	459,250	+14,250	453,250	564,500

Economic Week Ahead: August 16- 20

Vanguard 8/13 - Economists will be busy again next week as several key reports come out that will shed more light on the current state of the U.S. economy. On Tuesday, the Department of Commerce releases its latest data on new residential construction, the Department of Labor comes out with its July report on production prices, and the Federal Reserve releases its latest numbers on industrial production. On Thursday, the Conference Board will report on leading economic indicators for July.

Economic Calendar: Week of August 16- 20

Date	ET	Release	For	Briefing.com	Consensus	Prior
Aug 17	08:30	Housing Starts	Jul	550K	555K	549K
Aug 17	08:30	Building Permits	Jul	570K	573K	583K
Aug 17	08:30	PPI	Jul	0.1%	0.2%	-0.5%
Aug 17	08:30	Core PPI	Jul	0.1%	0.1%	0.1%
Aug 17	09:15	Industrial Production	Jul	0.8%	0.6%	0.1%
Aug 17	09:15	Capacity Utilization	Jul	74.8%	74.5%	74.1%
Aug 19	08:30	Initial Claims	08/14	470K	475K	484K
Aug 19	08:30	Continuing Claims	08/07	4500K	4500K	4452K
Aug 19	10:00	Leading Indicators	Jul	0.1%	0.2%	-0.2%