



WEEKLY ECONOMIC COMMENTARY – WEEK OF JUNE 21, 2010

FINANCIAL INDICATORS				
INTEREST RATES	June 18	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.09%	0.07%	0.15%	0.16%
6-month Treasury bill	0.16	0.15	0.21	0.31
3-month LIBOR	0.54	0.54	0.50	0.61
2-year Treasury note	0.71	0.73	0.75	1.20
5-year Treasury note	2.01	2.02	2.00	2.80
10-year Treasury note	3.22	3.23	3.21	3.77
30-year Treasury bond	4.15	4.15	4.08	4.51
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	1.77	1.68	1.75	2.31
10-Year	3.23	3.04	3.09	3.57
30-Year	4.47	4.41	4.39	4.89
30-year fixed mortgage rate	4.75	4.72	4.84	5.38
15-year fixed mortgage rate	4.20	4.17	4.24	4.89
1-year adjustable rate	3.82	3.91	4.00	4.97
STOCK MARKET				
Dow Jones Industrials	10450.64	10211.07	10193.39	8539.73
S&P 500	1117.51	1091.60	1087.69	921.23
NASDAQ	2309.80	2243.60	2229.04	1827.47
Commodities				
Gold (\$ per troy ounce)	1258.50	1227.90	1177.30	935.20
Oil (\$ per barrel) - Crude Futures (NYMerc)	77.34	74.18	70.19	69.60
ECONOMIC INDICATOR (Latest Month/Quarter)				
		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Housing Starts (May) - 000s	593	659	634	613
Consumer Price Index (May) - % change	-0.2	-0.1	0.1	0.0
Core CPI (Ex. Food & Energy) - % change	0.1	0.0	0.0	0.0
Producer Price Index (May) - % change	-0.3	-0.1	0.7	0.3
Industrial Production (May) - % change	1.2	0.7	0.3	0.7
Capacity Utilization (May) - Percent	74.7	73.7	73.1	73.2

Prime Rate: 3.25%

1-Month LIBOR: 0.34719%

Last week's batch of economic data provides further evidence that a two-tiered recovery is unfolding, one that features both weakness and strength. By itself, such a dichotomy is not all that unusual. When an economy exits a recession, some sectors tend to be left behind while others forge ahead and lead the way to a full-fledged expansion. What makes the current situation unique is that the lagging sector, housing, has

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flipped positions with its usual role of being a prime growth catalyst during the early stage of the recovery. Similarly, factory production tends to rev up either concurrently or with a slight lag as a recovery gets underway. That's because new orders for capital goods and other industrial supplies usually don't pick up until customers are sure that a revival in domestic demand and exports is here to stay.

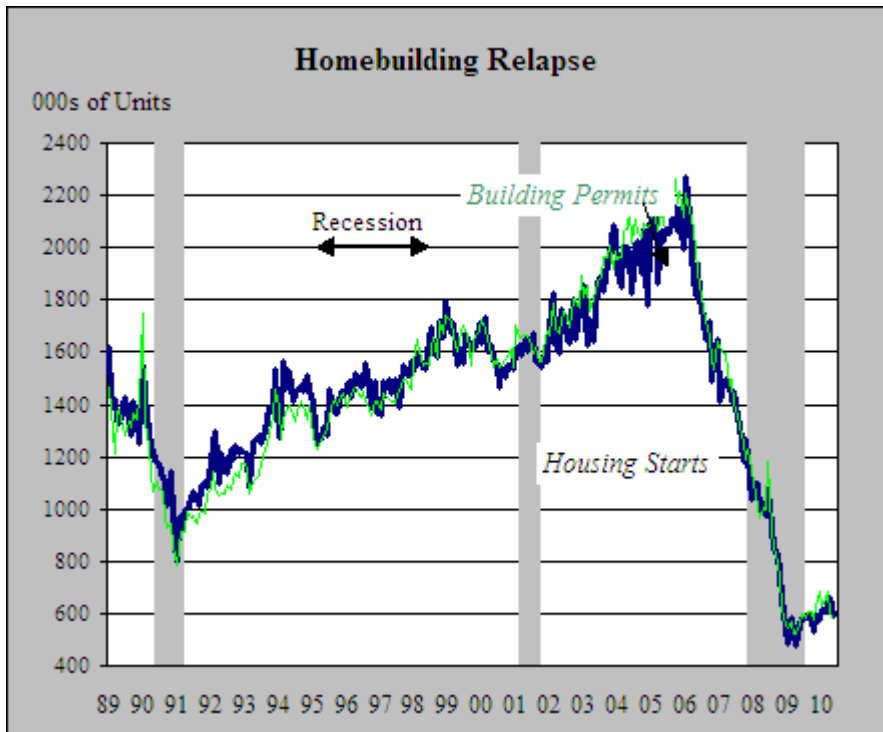
However, since exiting the recession last summer, housing has been anything but a sparkplug of growth, while manufacturing has been one of the brightest stars of the recovery. To be sure, the pernicious housing meltdown that played such a vital role in bringing the economy to its knees in 2007 and 2008 has largely run its course. Thanks to the government's unprecedented efforts to sustain mortgage flows and stimulate the demand for homes through tax credits, the freefall in home sales and construction has been arrested. Indeed, residential investment even made a modest contribution to economic growth over the second half of last year. However, that positive contribution was largely built on artificial steroids, whose pump-priming influence on housing activity is waning.

The question is, how much of a setback can be expected as the government withdraws its support for the industry. The most visible fiscal thrust has come from the homebuyers' tax credit, which has clearly lifted home sales beyond where they otherwise would be. But these gains have undoubtedly borrowed from future sales. With the expiration of the credit at the end of April, there is little question that some payback will occur. Anecdotal reports from real estate brokers already reveal a significant drop-off in home sales linked to the expiration of the credit. Although corroborating sales data from the industry will not be available until later this week, some sense of the looming drop-off can be gleaned from lending data. Since early April, mortgage applications for home purchases have fallen by more than 30 percent, notwithstanding a slight uptick in the latest week.

What's more, builders are already preparing for the sales letdown that is sure to come. In May, housing starts slumped by a whopping 10 percent from April, a decline that would have been even larger if not for a 33 percent increase in the volatile multi-family component. Even so, the overall decline to 593,000 units wiped out most of the increase made since the beginning of the year, leaving the level of starts just a tad above the 583,000 November/December average. Just as significant is the dim near-term outlook for construction activity, as building permits fell for the second consecutive month in May to 574,000 units. The latest drop of 5.9% follows a 10.9% plunge in April, and lowers the volume of building permits to the lowest level since May 2009, when it stood at 550,000 units.

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Hence, unlike past recoveries when sustained and powerful housing rebounds helped launch the economy out of recessions and served as key conduit leading to a full-fledged expansion, the initial thrust from this sector has already expired. Following the modest contribution to growth in the second half of last year, residential construction subtracted more than a quarter of a percentage point from GDP in the first quarter. That negative contribution will likely be reversed in the second quarter owing to the renewal of the homebuyers' tax credit through April, which gave a temporary boost to residential construction, brokers' fees (which are included in the residential spending data) and home renovations linked to higher sales. But that should be the last bump-up for a while, as the payback from the withdrawal of fiscal steroids will diminish, if not eliminate, housing's role as a time-honored tailwind supporting the recovery for the balance of the year.

That said, the looming housing drag on the economy may not be as severe as feared a few months ago, when the expected expiration of the tax credit was scheduled to coincide with the withdrawal of the Federal Reserve's mortgage purchase program at the end of March. Many industry analysts believed that would be a double-whammy hammering housing demand, with the removal of the tax credit reinforcing the impact of rising mortgage rates stemming from the absence of Fed mortgage purchases. But while the tax incentive has been removed, the rise in mortgage rates has not occurred. Indeed, since the Fed terminated its \$1.3 trillion mortgage and housing agency-related mortgage securities purchase program, the fixed rate on 30-year conventional mortgages has defied predictions and actually declined. This week, the rate stands at 4.75%, nearly half-percentage point less than the 5.21% nearby high reached in the second week of April.

To be sure, the slide in mortgage rates may well be a temporary aberration related to some unusual events in recent months. Keep in mind that these rates are linked to Treasury yields, which have been pushed lower by a resurgence in investor demand for safe assets spawned by a sovereign debt crisis and renewed concerns over the health of the global economy. An upsurge in risk aversion always drives down yields on Treasury securities, bringing mortgage rates along for the ride. By the same token, a resolution of the European debt crisis would spur a reversal of this safety bid and push up Treasury yields as quickly as they fell. For the moment, investors remain skeptical about such a resolution, so no sudden climb is in the cards. In fact, concerns over the contagion effect of the crisis are currently more pronounced than are hopes for a

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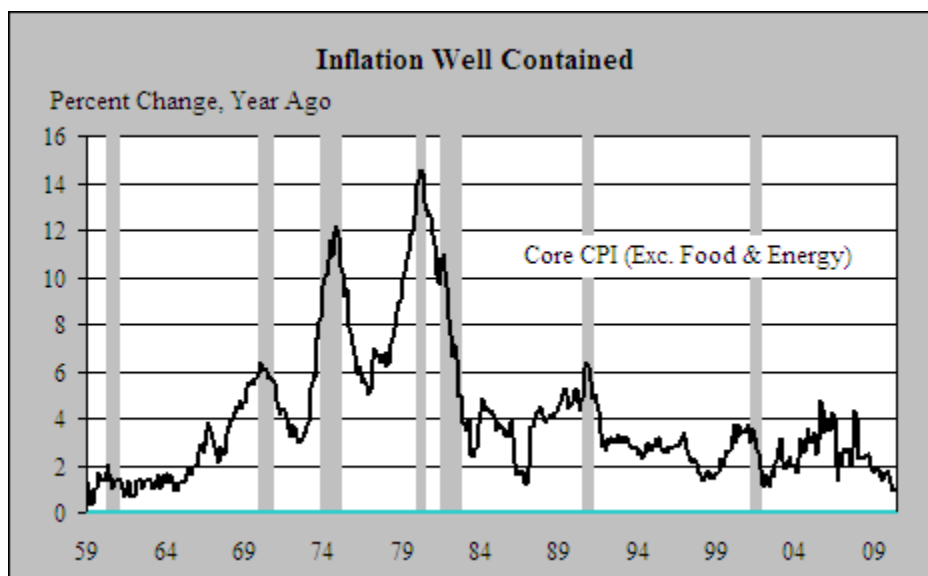
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solution. Hence, the prospective setback in housing demand should be cushioned by low mortgage rates for a while longer, softening the housing drag on economic growth at least for a quarter or so.

But even if the flight to safety subsides more quickly than expected, any prospective rebound in Treasury yields will be facing some strong offsetting forces. Recall that in early April, when the 10-year Treasury yield was pushing towards 4.00% (and lifting mortgage rates to their nearby peak), perceptions about the economy was much different than is currently the case. Then, forecasters were lifting their growth outlooks almost daily, as the economy had been performing consistently better than expected. The job market turned much stronger, consumer spending was rising briskly and the global economy prior to the sovereign debt crisis appeared to be booming, lifting American exports. With more and more of the economy's cylinders kicking in, the prevailing discussion revolved around when the Fed would start rescinding its easy monetary policy to short-circuit an inflation flare up.

That was then. Over the past month, dark clouds have formed over the economic landscape, bringing on a major shift in perceptions that facilitated a decline in Treasury yields closer to 3 percent than 4 percent. The Greek-inspired debt crisis took center stage, of course, prompting a wave of fiscal austerity measures that many believe will throttle European growth. Then the domestic house of cards began to waver, undercut by a much weaker than expected jobs report for May and a surprising downturn in retail sales, raising questions about whether consumers were poised to retrench. Suddenly, a more cautious outlook was usurping upward revisions of growth. Inflation concerns faded into the woodworks, replaced by heightened discussions over the prospects of deflation.

That shift in inflation perceptions has been further nourished by incoming data on prices, which continue to recede further below the Fed preferred inflation target of around 2 percent. Certainly, last week's reports on consumer and wholesale prices did little to dispel the notion that the forces of disinflation remain firmly intact. In May, the consumer price index fell for the second consecutive month, slipping by 0.2% following a 0.1% drop in April. Over the past three months, the headline inflation rate has fallen by an annual rate of 0.7%, hardly a reading that would inspire the inflation hawks. True, the CPI has been dragged down by falling energy quotes over the last two months. But excluding volatile energy and food prices does not alter the exceptionally benign inflation picture. The so-called core CPI edged up by 0.1% in May after showing no change in each of the previous two months. On a year-over-year basis, the core inflation rate is running at a paltry 0.9%, a rate not seen since the early 1960s.

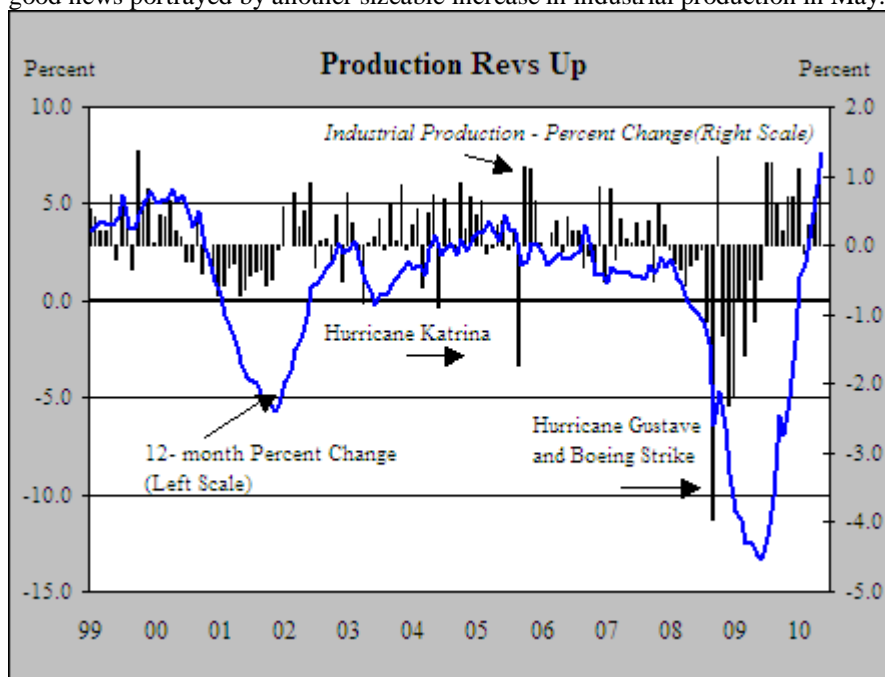


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Needless to say, a low inflation environment coupled with high unemployment and excess capacity gives the Federal Reserve considerable leeway to retain its highly accommodative monetary policy over the foreseeable future. Even the Federal Reserve Bank of San Francisco surprisingly indicated in a report last week that an increase in interest rates is not likely before 2012. Not surprisingly, private economists have been falling all over each other to push back their timetable for an expected rate increase; earlier this year, the consensus was looking for an increase this fall, with some expecting a rate increase as early as the summer. Now, the prevailing view is for no action at least until next year. We will have more to say about Fed policy this week, following the scheduled FOMC meeting on June 22-23.

But if the newfound caution on the part of forecasters tells us anything, it is that perceptions can change rapidly. Hence, just as the upward revisions that were so rampant earlier in the year overstated the fundamental strengths of the economy, the emerging pessimism may be extrapolating more bad news into the future than is warranted. As we noted in the outset, this is a bipolar recovery, consisting of weak and stronger elements of the economy that naturally generates a lot of ambivalence about the outlook. Recently, the weak sisters, including last week's housing data, have dominated the headlines, overshadowing the good news portrayed by another sizeable increase in industrial production in May.



U.S. industrial production has risen at an 8.8% annualized pace since hitting bottom in June 2009. At this pace industrial production will have completely recovered to its former highs in 12 months. If that plays out, it will be a much faster recovery than the period following the 2001 recession, when it took industrial production almost 4-and-a-half years to recover from the June 2000 high of 104.25. It wasn't until October 2004, 52 months later, that factory output exceeded 104.25. The performance of factories may not grab as much attention as housing developments, but it does reflect ongoing gains in capital spending, exports and inventory rebuilding, all of which will give the recovery a solid base going forward.

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