

## WEEKLY ECONOMIC COMMENTARY – WEEK OF AUGUST 2, 2010

FINANCIAL INDICATORS				
INTEREST RATES	July 30	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.14%	0.15%	0.16%	0.18%
6-month Treasury bill	0.19	0.19	0.21	0.25
3-month LIBOR	0.45	0.49	0.53	0.48
2-year Treasury note	0.55	0.58	0.62	1.10
5-year Treasury note	1.60	1.72	1.81	2.51
10-year Treasury note	2.91	2.99	2.97	3.48
30-year Treasury bond	3.99	4.01	3.94	4.29
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	1.33	1.40	1.67	1.84
10-Year	2.76	2.81	3.05	3.32
30-Year	4.37	4.37	4.43	4.84
30-year fixed mortgage rate	4.54	4.56	4.58	5.25
15-year fixed mortgage rate	4.00	4.03	4.04	4.69
1-year adjustable rate	3.64	3.70	3.80	4.80
STOCK MARKET				
Dow Jones Industrials	10465.94	10424.62	9686.48	9171.61
S&P 500	1101.60	1102.66	1022.58	987.48
NASDAQ	2254.70	2269.47	2091.79	1978.50
Commodities				
Gold (\$ per troy ounce)	1183.70	1186.50	1211.90	954.50
Oil (\$ per barrel) - Crude Futures (Nymex)	78.93	79.97	72.27	69.17
ECONOMIC INDICATOR (Latest Month/Quarter)				
		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Consumer Confidence (July) - Index	50.4	54.3	62.7	54.0
Durable Goods Orders (June) - % change	-1.0	-0.8	2.9	1.1
New Home Sales (June) - 000s of units	330	267	422	350
Real GDP (Q2) - % change, Saar	2.4	3.7	5.0	1.2

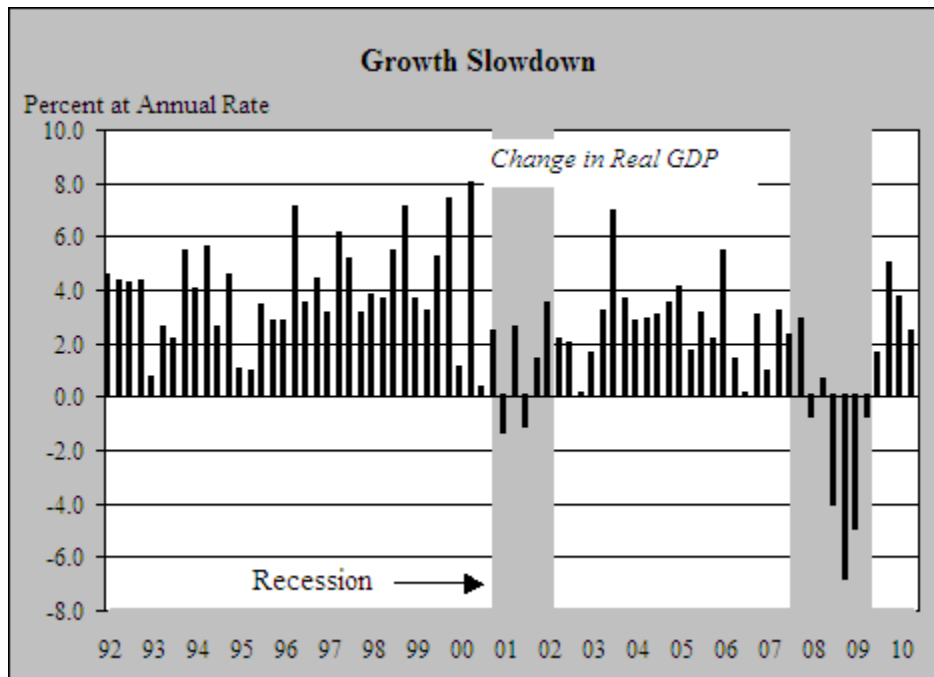
**Prime Rate: 3.25%****1-Month LIBOR: 0.30281%**

The release of the second-quarter GDP figures on Friday added more fuel to the debate over whether the economy is vulnerable to a double-dip recession. On the surface, growth slowed significantly in the April-June period, to an annual rate of 2.4% from a 3.7% (revised) pace in the first quarter. What's more, benchmark revisions to the figures going back three years show that the recession was deeper (and the recovery weaker) than had been originally estimated. From our lens, however, the internal dynamics of the

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business cycle actually shows more fundamental strength than before, as households seem to be in much better financial shape than had previously been thought, which is good news.



Despite all the debate and dialogue it has garnered of late, it should be pointed out that there is no clear definition as to what constitutes a “double-dip recession.” The closest the nation has even come to one was in the early 1980s when there were two recessions separated by only a year of recovery. But, by the time the second downturn occurred in July 1981, the economy had regained all of the ground lost during the 1980 recession, as real GDP had surpassed its previous peak. As a result, the National Bureau of Economic Research, the official arbiter of business cycles, declared that the 1981-82 downturn had indeed qualified a new, separate, recession. By other metrics, that conclusion made sense. For example, not only had the economy regained all of its lost output, but workers had also regained all of the jobs lost during the 1980 recession.

Measured against those yardsticks, if the economy were to suddenly contract again, an argument could be made that it never really exited the recession, but had indeed suffered a double-dip recession. That’s because even with four consecutive quarters of output growth, real GDP at the end of the second quarter still remained \$147 billion (more than 1 percent) below the peak level reached in the fourth quarter of 2007. Hence, the economy has not yet recovered all of the ground lost during the recession. An even more dramatic shortfall is evident on the employment front, where 8.5 million jobs were extinguished during the recession. So far, only about 900,000 of those positions have been recovered. More than anything, that shortfall gives workers plenty of reason to believe the economy has never really left the recession.

It’s hard to argue with the notion that, were the economy to contract over the next quarter or two, the episode would qualify as a double-dip recession. But the real issue is, how likely is that to happen? From our lens, such a relapse remains a distant possibility. As we have noted in the past, rarely does a recovery simply run out of steam on its own accord. In the case of the 1981 setback, only the strenuous anti-inflationary credit restraint imposed by the Federal Reserve to combat double-digit inflation (which sent short-term interest rates up to nearly 20 percent) short-circuited the recovery that was then underway. No such stranglehold on growth exists today, nor are any on the near term horizon. True, the possibility of a policy mistake that would snuff out the recovery cannot be entirely dismissed. But such a mishap is more likely to come from the fiscal side, not from the Fed - reflecting the bitter partisan divisions over how big a

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role Washington should play in furthering the recovery. Even so, the biggest danger is not that fiscal policy will turn overly restrictive but that fiscal stimulus will fade more quickly than required.

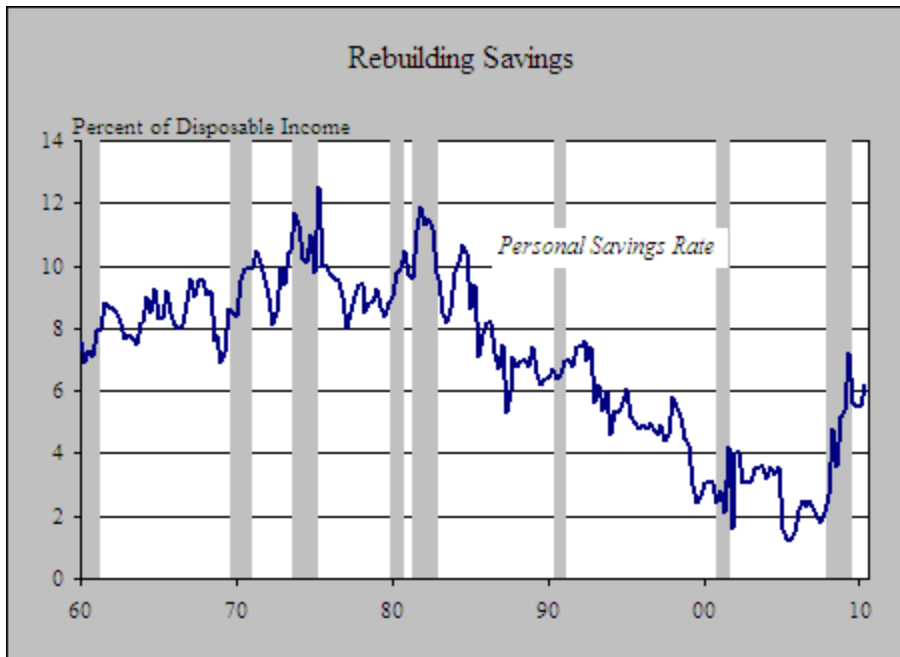
On the surface, the most worrisome development contained in the GDP data is the weakness in consumer spending. Prior to the revisions, real consumption outlays increased at a solid 3 percent annual rate in the first quarter, up from 1.6% in the previous quarter and 2.8% in the third quarter of last year. But the revisions show that consumers were actually much more cautious throughout the period, increasing spending by only 1.9% in the first quarter, following smaller increases of 0.9% and 2.0% in each of the two preceding quarters. What's more, they retrenched even more in the second quarter of this year, as the preliminary estimates show that real consumer spending only edged up by a 1.6% annual rate in the April-June period. Needless to say, with consumer spending accounting for about two-thirds of economic activity, should households continue to zip up their wallets and purses in coming quarters, the recovery would have a good chance of fizzling out.

But the cloud cast by the weaker pattern of consumer spending has a silver lining. Yes, it dragged down the overall growth rate, making the recovery seem much shallower than initially perceived. At the same time, however, the more cautious behavior of consumers can also be viewed as a rational response to the devastation imposed by the Great Recession – which revised figures show was even greater than thought – and they opted to repair the damage as quickly as possible. Simply put, households chose to rebuild savings and pay down debt to a far greater extent than had previously been thought. What's more, the government revisions show that personal incomes increased faster over the past three years than previously estimated. The combination of stronger incomes and weaker spending meant that households were able to sock away far more of their paychecks than thought.

Instead of the personal savings rate peaking out at a quarterly average of 5.4%, the new figures show that households had actually put aside 7.2% of after-tax incomes in the second half of last year. What's more, the savings rate remained at a healthy level throughout the first half of this year, climbing from 5.5% at the end of last year to 6.2% in the second quarter. Simply put, the perception that households have not compensated for the dramatic reduction in asset values in recent years by rebuilding wealth the old fashioned way – through higher savings – does not hold up under scrutiny. As the chart shows, the personal savings rate is as high as its been at any time over the past twenty five years. This suggests that households are not in as dire financial straits as is generally perceived, and actually have the firepower to sustain spending in coming quarters.

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Remarkably, the pickup in the savings rate has been accomplished with interest rates at historically low levels. While this may seem like a contradiction, there is some logic behind this development. Keep in mind that the savings rate is influenced not only by boosting liquid assets but also by paying down debt. By all accounts, households have been deleveraging at a hectic pace, something that shows up in the longest stretch of debt reductions ever recorded. Freddie Mac provided further evidence of that trend last week in its latest quarterly tally of refinancing activity. In the past, the emphasis of the quarterly reports was on how much cash homeowners were pulling out of their housing equity when they refinanced their mortgages. But with the bursting of the housing bubble that vaporized home values, such cash-outs have shriveled considerably.

Instead, households are now taking advantage of low mortgage rates to both refinance their outstanding debt and reduce principal as well. According to Freddie Mac's latest estimates, 22 percent of homeowners who refinanced their mortgages over the last four quarters actually *reduced* outstanding principal, nearly double the 12 percent share that did so since these estimates began in 1985. In other words, homeowners are bringing more money to the table than they are taken away; instead of cashing out equity, they are "cashing in." To be sure, some of this behavior is being forced on them, as lenders are requiring more equity from borrowers who want to refinance. But the end result is the same. Households are left with lower debt burdens, and monthly payments are reduced because of the lower rates on their refinanced loans.

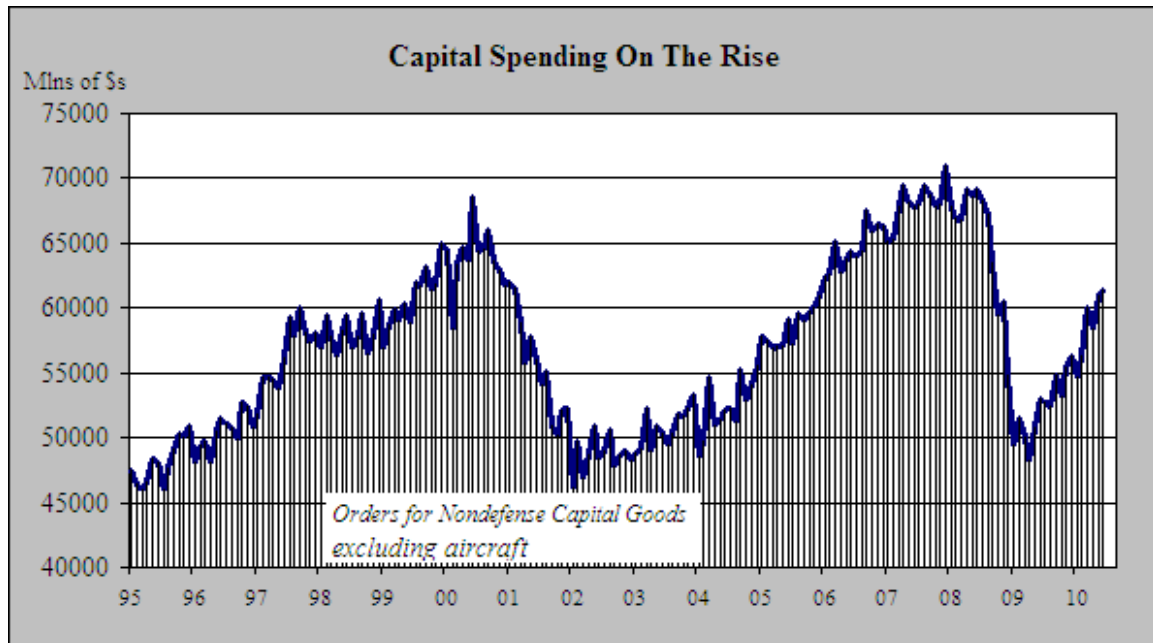
Clearly, the combination of higher savings and lower debt burdens represents a plus for consumer spending going forward. No doubt, households are far from embarking on a consumption binge. Indeed, until the job market turns much stronger, they are likely to retain their frugal ways. The latest surveys of consumer confidence support that notion, as household are pulling back on their plans to spend on big-ticket items over the next six months, citing uncertain job and income prospects as the major reason. But should consumption continue on a modest growth path of, say, 2 percent or so over the second half of the year, the recovery will have more than enough firepower to stay on track.

One reason is that businesses are taking up the slack, thanks in large part to booming profits. Unlike the slowdown in consumer spending over the first half of the year, business investment spending is revving up. In the second quarter, capital goods outlays surged by a 21.9% annual rate, following a sturdy 20.4%

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increase in the first quarter that, in turn, was revised up from an original estimate of 11.4%. These were the strongest back-to-back quarterly gains since the fourth quarter of 1994 and the first quarter of 1995 - during the height of the most torrid capital-spending boom of the post war period. It's unclear just what is propelling businesses to open up their capital spending budgets so aggressively, even as a good deal of spare capacity exists. But this source of strength is not expected to diminish in the near future. According to last week's report on durable goods, new orders for non-defense capital goods less aircraft are continuing to march significantly higher. In June, such bookings stood 15.8% above the level of a year ago.



If, as the numbers suggest, investment spending remains strong over the next quarter or two, businesses will need to hire more workers to run the additional equipment and software put in place. Indeed, there is a time-honored correlation between capital spending and job growth, which leads us to believe that the current slowdown in overall economic activity represents more of a temporary pause than a portent of a double-dip recession. Given the astonishing rebuilding of household balance sheets that seems to be firmly underway, our sense is that the slowdown – induced mainly by a pullback in consumer spending – will turn out to be the pause that refreshes.

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