

WEEKLY ECONOMIC COMMENTARY – WEEK OF AUGUST 16, 2010

FINANCIAL INDICATORS				
INTEREST RATES	August 13	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.15%	0.14%	0.15%	0.17%
6-month Treasury bill	0.18	0.18	0.18	0.25
3-month LIBOR	0.37	0.41	0.52	0.43
2-year Treasury note	0.53	0.50	0.58	1.06
5-year Treasury note	1.45	1.50	1.68	2.51
10-year Treasury note	2.68	2.82	2.93	3.57
30-year Treasury bond	3.86	3.99	3.94	4.42
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	1.27	1.33	1.48	1.76
10-Year	2.69	2.75	2.87	3.28
30-Year	4.32	4.37	4.38	4.85
30-year fixed mortgage rate	4.44	4.49	4.57	5.29
15-year fixed mortgage rate	3.92	3.95	4.06	4.68
1-year adjustable rate	3.53	3.55	3.74	4.72
STOCK MARKET				
Dow Jones Industrials	10303.15	10653.56	10098.35	9321.40
S&P 500	1079.25	1121.64	1065.09	1004.09
NASDAQ	2173.48	2288.47	2179.68	1988.52
Commodities				
Gold (\$ per troy ounce)	1216.70	1206.80	1190.90	950.40
Oil (\$ per barrel) - Crude Futures (Nymex)	75.37	80.92	75.82	67.69
ECONOMIC INDICATOR (Latest Month/Quarter)		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Trade Deficit (June) - mlns of \$\$	49895.0	41984.0	40320.0	41243.0
Nonfarm Productivity ((Q2) - % change	-0.9	3.9	6.0	4.6
Consumer Price Index (July) - % change	0.3	-0.1	-0.2	0.0
Core CPI (ex. Food & Energy) - % change	0.1	0.2	0.1	0.1
Retail Sales (July) - % change	0.4	-0.3	-0.1	0.4

Prime Rate: 3.25%

1-Month LIBOR: 0.26656%

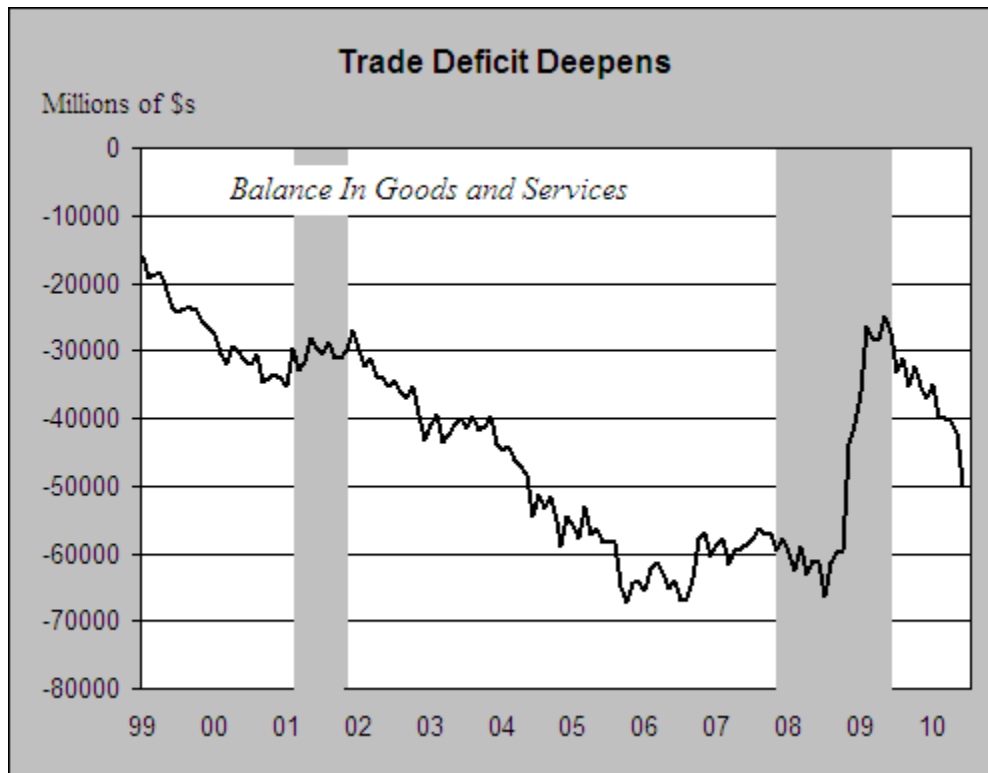
The Federal Reserve tried to strike a delicate balance this past week, taking modest steps to help stimulate the economy while providing assurances that it has everything under control. In essence, the Fed is signaling that it is concerned about recent economic developments but believes there is no cause for alarm.

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That approach seems eminently sensible to us, as the last thing Wall Street and Main Street needs right now is a whiff of panic coming from policy makers. Still, it is hard to deny that households, businesses and investors are becoming increasingly concerned over whether the Fed has the tools to prevent the economy from slipping into a double-dip recession or, more ominously, keep the scourge of deflation at bay.

To its credit, the Fed didn't just stay pat, as many had expected, in its policy-setting meeting this week. Doing so might have signaled a sense of complacency that is simply not warranted by an economy that has clearly slowed quite dramatically in recent months. Indeed, the preliminary reading of second quarter-GDP released by Washington at the end of last month now seems overly optimistic, based on data that have since become available. For example, the nation suffered a much larger trade deficit in June than assumed in the GDP figures – the gap widened to \$49.9 billion from \$42.2 billion the previous month – which, along with a downward revision in business inventories, could slice the 2.4% original estimate of GDP growth by as much as half.



Needless to say, an economy that grew at a pace barely exceeding 1 percent last quarter makes it exceedingly vulnerable to an external shock. Indeed, the Fed acknowledged in last week's policy statement that economic growth has slowed considerably since its last meeting in June. While it avoided mentioning the dreaded D word that would give credibility to the deflation worriers, the Fed did reaffirm its tame inflation outlook, noting that the slowdown coupled with the considerable slack in the labor and product markets should temper price increases. At the same time, the statement sounded a mildly upbeat note, asserting that the recovery should not be derailed by the ongoing formidable headwinds.

In summary, the Fed affirmed what just about everyone knew: the economy is struggling mightily and the Fed needs to be vigilant and flexible in its policy approach going forward. The earlier debate over how and when an "exit" strategy should be implemented has faded as quickly as Tiger Woods' golfing skills of late. That debate flared up when the economy was posting growth rates of between 3% and 5%, depicting solid

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strength early in the recovery. That was then. With the recovery flagging since the spring, and showing every sign of wilting under the blaze of summer, this is no time to withdraw policy stimulus already in the system. While that conclusion is widely accepted, however, there is no consensus over how the Fed should proceed from here.

With the Fed's short-term interest rate target already lowered to just over zero percent, the major option still available to stimulate the economy is through an expansion of the quantitative easing (QE) strategy put into effect during the height of the financial crisis in late 2008 and early 2009. Essentially, this involves expanding the quantity of money in the financial system by directly purchasing bonds and securities. From late 2008 through early this year, the Fed's balance sheet more than doubled to slightly over \$2 trillion. An integral part of the QE strategy was the central bank's decision to purchase about \$1.4 trillion of mortgage-backed securities and housing agency debt, and another \$300 billion or so of Treasury issues. The Fed's plan was to end the purchase program by this March, and then gradually allow its balance sheet to shrink as the underlying mortgage assets either matured or were prepaid. Part 1 of the plan was carried out, as the mortgage-purchase program ended in March, as scheduled.

However, part two, which in effect would constitute a gradual withdrawal of policy stimulus if the Fed's balance sheet were allowed to shrink, has been put on hold. In its statement following last week's FOMC meeting, the Fed indicated that it would reinvest the proceeds of its vast holdings of mortgage securities into Treasury securities. Simply put, policy has been put on cruise control, staying the course until the economy's direction comes into clearer focus. While the Fed's decision did not come as a shock to the financial markets, it did come as a mild surprise. Many expected the Fed to wait until its next meeting to change any nuance in policy strategy, but the abrupt deterioration in economic conditions seems to have forced its hand.

Perhaps the biggest surprise in the announcement was the decision to reinvest the proceeds from mortgage holdings into longer-term Treasuries instead of short-term issues. Under normal circumstances, the Fed's balance sheet is primarily composed of short-term Treasury securities, mainly bills. No doubt, the objective behind this strategy is to lower long-term interest rates, or at least prevent them from rising. The yield on Treasury notes and bonds, particularly the 10-year issue, serves as the benchmark for a broad array of loans made to the private sector, including mortgages. Not coincidentally, the 30-year fixed mortgage rate slid to another historic low this week, hitting 4.44%. That's a decline of more than half-percent over the past three months and more than a percentage point below the peak level of last summer.

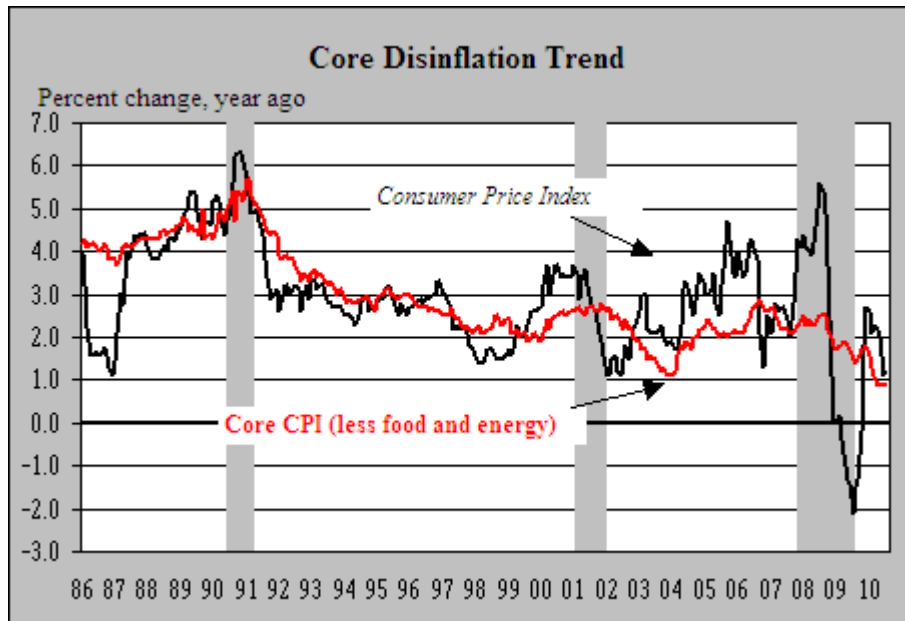
There remains a good deal of disagreement over whether the Fed is doing much good by lengthening the maturity of its balance sheet. Critics assert that it is not high long-term interest rates that are stifling the recovery, but the lack of jobs and tougher lending standards imposed by banks on households and small businesses. Proponents of the move claim that at the very least, lower mortgage rates will spur a new wave of re-financings, which puts extra cash into the pockets of homeowners for spending. While that has clearly been a spending booster when housing conditions were booming, it's doubtful such would be as potent a force in today's housing environment. With home values sliding and a sizeable fraction of homeowners owing more than their homes are worth, the ability of households to refinance outstanding debt has been greatly reduced.

That said, the commitment to keep interest rates low should provide some modest support for the economy, if only by muting fears of deflation that are clearly looming larger with each passing month. It seems that every commentator appearing on TV or writing in the press is comparing the current U.S. experience with that of Japan, which has grappled with a deflationary environment since the early 1990s. If a deflationary psychology gains more traction, households will delay spending, waiting for still lower prices, which would intensify the slowdown and heighten the odds of a double-dip recession that would morph into a long and painful period of subpar performance for the U.S. economy. Recent data on inflation have done little to alleviate these concerns. As reported last week, the consumer price index (CPI) rose by 0.3% in July - the

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first increase in four months. But the increase was driven primarily by energy prices, which are highly volatile and have already reversed the climb in August. Likewise, food prices, which slipped in July, are another volatile influence on the CPI that can distort the underlying inflation trend. Hence, economists like to strip out food and energy prices to arrive at a so-called “core” inflation rate, which presumably gives a more accurate picture of inflation



Last month, the core CPI edged up by 0.1%. The good news is that this index has stayed mildly positive for six consecutive months, after falling last January. The bad news is that the trend is decidedly downward, with the year-over-year increase sliding to 0.9%. That equals the slowest rise in core inflation since the mid-1960s. However, as the chart shows, we were not far from that rate in late 2003, when the economy was also struggling to climb out of the 2001 recession. But after hitting a low of 1.1% in November of that year, the core inflation rate moved steadily higher as the recovery gained traction. To be fair, that comparison is not strictly valid, as the latest recession was much more severe than in 2001, leaving the economy with considerably more economic slack than was the case then.

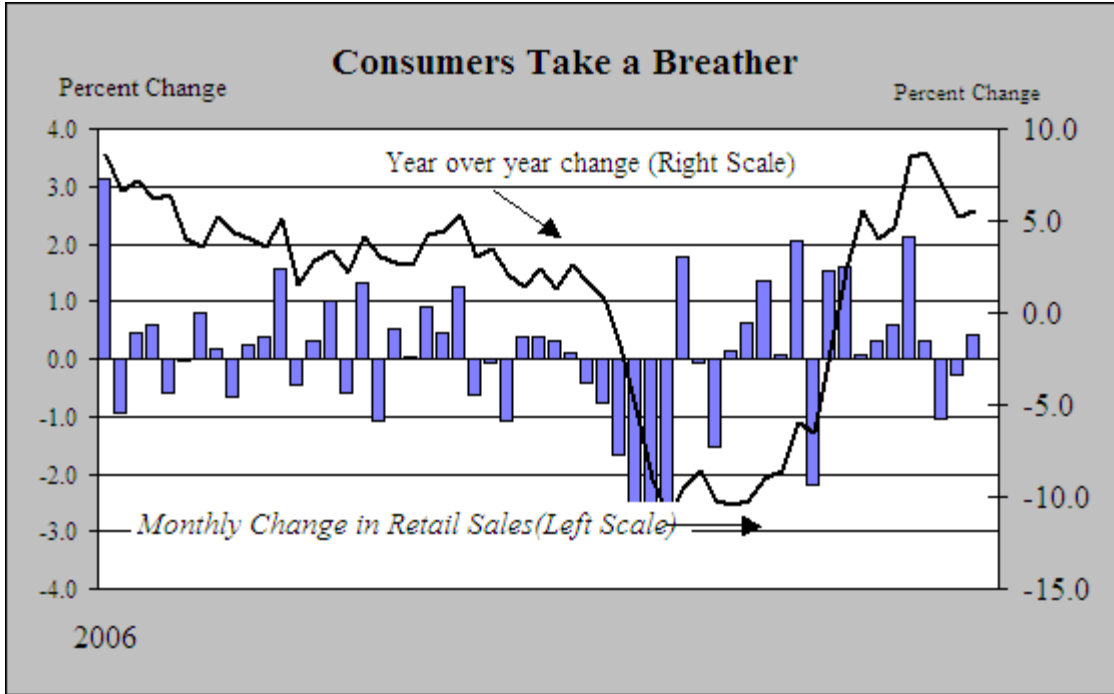
However, there are compelling reasons to believe the bottom of the disinflationary cycle is close at hand, if not already here, and will stop short of turning into a deflationary spiral. Most important is that the biggest drag on core inflation, housing costs, appears to have turned the corner. Residential rents rose for the second consecutive month in July, reflecting the steep drop in homeownership rates over the past two years that has spurred an increase in demand for rental properties. The recession also caused a good deal of “doubling up” among financially-strapped households, which is gradually unwinding and bringing people back into the rental market. This trend should continue and put a floor under prices as the recovery progresses in the months ahead.

Of course, this is where the rubber meets the road, as recovery prospects have taken a big hit in recent months. Certainly, the latest batch of economic indicators does not hold out the promise of a quick rebound. Last week’s report on retail sales for July – showing an increase of 0.4% – portrays a consumer that remains cautious and wary about the job market. We suspect that attitude will not improve until companies step up hiring on a sustainable basis. Even if, as we expect, that becomes more of a reality than a hope by the fall, it may take time for consumers to acquire enough confidence to visit the malls and shop more vigorously than they are now. Accordingly, the tepid growth of the economy should extend through

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the third quarter, keeping alive worries that the flagging recovery may run out of steam. That will also keep the Federal Reserve in play, including the possibility that it will expand its policy of quantitative easing by resuming purchases of mortgage bonds and other securities. Our sense is, however, that the recovery will gain a second wind by the fall, and consumer spending, supported by a pickup in job creation, will play a key role in the revival. We'll see.



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