

WEEKLY ECONOMIC COMMENTARY – AUGUST 23, 2010

| FINANCIAL INDICATORS | | | | |
|---|-----------|--------------------|----------------------|--------------------------------|
| INTEREST RATES | August 20 | Week Ago | Month Ago | Year Ago |
| 3-month Treasury bill | 0.15% | 0.15% | 0.15% | 0.16% |
| 6-month Treasury bill | 0.18 | 0.18 | 0.19 | 0.25 |
| 3-month LIBOR | 0.33 | 0.37 | 0.49 | 0.39 |
| 2-year Treasury note | 0.49 | 0.53 | 0.58 | 1.09 |
| 5-year Treasury note | 1.44 | 1.45 | 1.72 | 2.56 |
| 10-year Treasury note | 2.61 | 2.68 | 2.99 | 3.57 |
| 30-year Treasury bond | 3.65 | 3.86 | 4.01 | 4.37 |
| Tax-Exempt Revenue Bonds (Triple-A) | | | | |
| 5-Year | 1.22 | 1.27 | 1.40 | 1.79 |
| 10-Year | 2.55 | 2.69 | 2.81 | 3.24 |
| 30-Year | 4.31 | 4.32 | 4.37 | 4.82 |
| 30-year fixed mortgage rate | | | | |
| | 4.42 | 4.44 | 4.56 | 5.12 |
| 15-year fixed mortgage rate | | | | |
| | 3.90 | 3.92 | 4.03 | 4.56 |
| 1-year adjustable rate | | | | |
| | 3.53 | 3.53 | 3.70 | 4.69 |
| STOCK MARKET | | | | |
| Dow Jones Industrials | 10213.62 | 10303.15 | 10424.62 | 9505.96 |
| S&P 500 | 1071.69 | 1079.25 | 1102.66 | 1026.13 |
| NASDAQ | 2179.76 | 2173.48 | 2269.47 | 2020.90 |
| Commodities | | | | |
| Gold (\$ per troy ounce) | 1229.10 | 1216.70 | 1186.50 | 955.50 |
| Oil (\$ per barrel) - Crude Futures (Nymex) | 73.46 | 75.37 | 79.97 | 73.86 |
| ECONOMIC INDICATOR (Latest Month/Quarter) | | | | |
| | | Previous Month/Qtr | Two-Months/ Qtrs Ago | Average-Past 6 Months or Qtrs. |
| Industrial Production (July) - % change | 1.0 | -0.1 | 1.3 | 0.5 |
| Capacity Utilization (July) - Percent | 74.8 | 74.1 | 74.1 | 73.5 |
| Housing Starts (July) - 000s of units | 546 | 537 | 588 | 598 |
| Building Permits (July) - 000s of units | 565 | 583 | 574 | 611 |
| Producer Price Index (July) - % change | 0.2 | -0.5 | -0.3 | -0.1 |

Prime Rate: 3.25%

1-Month LIBOR: 0.26375%

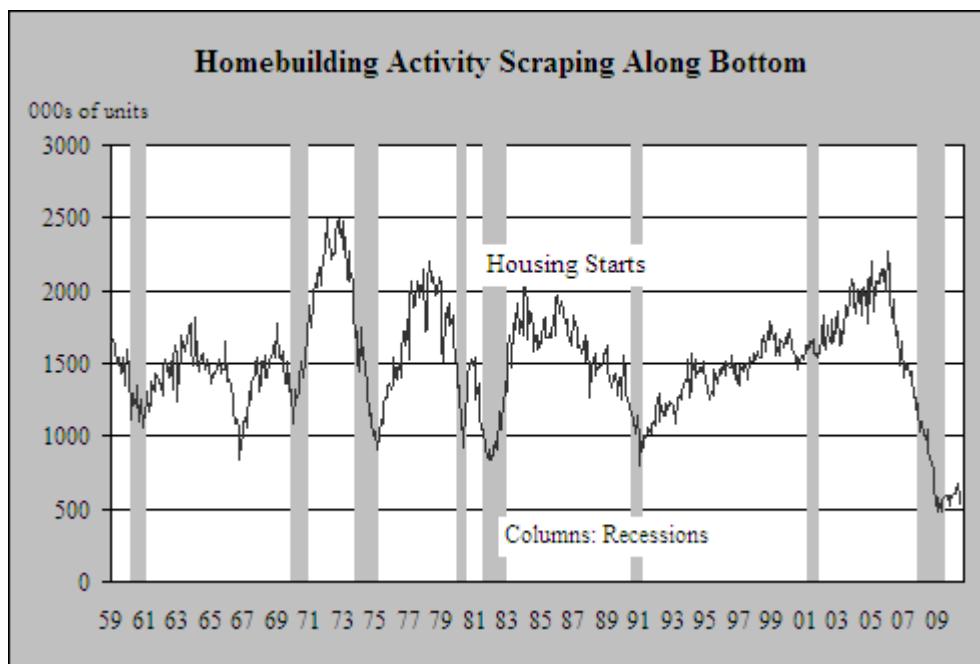
At first blush, a look at last week's economic data would belie the headline-grabbing fears of a double-dip recession, much less the scourge of deflation. Yes, first-time claims for unemployment benefits rose more than expected in the latest week; but a one-week spike bloated by Census workers going back on to the unemployment rolls does not make a trend. Nor should it undercut other data that portray an improving job

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market, albeit one that is painfully slow to unfold. When you adjust weekly jobless claims for the current size of the US workforce, they are exactly where they were at the same point of recovery following the recessions in 1991 and 2001. Likewise, the latest housing data paint an ongoing grim picture of the residential market, as single-family home construction in July fell by 4.2% to the lowest level in more than a year. Only a jump in multi-family starts, the noisy component of the housing mix, gave a slight lift to the overall number.

But the frail housing market is nothing new, and some of the recent weakness can be viewed as a payback from earlier strength spurred by the homebuyer's tax credit. What's more, homebuilders are responding to the poor sales market with understandable restraint that will strengthen their hand going forward. If nothing else, by holding down the pace of new construction they are preventing inventories of unsold homes from piling up. Indeed, inventories in the new-home market are at historical lows. It is in the existing home market, where about 2 million foreclosed homes are clogging the market (annually), that an oversupply condition exists. Even there, the foreclosed properties are being absorbed – keeping the supply of housing for sale relatively stable - and prices (as measured by Case-Shiller) are holding and, in many cities, creeping higher.



The initial claims and housing data provided the news on the economic front last week, which was enough to send stock prices into a tailspin. That's not surprising, given the negative psychology that has taken root in the markets over the past several weeks. With economic growth downshifting abruptly in the second quarter and the job market still not showing any vigor, there are few compelling reasons to feel encouraged over the near term outlook. When perceptions are exceptionally grim, as they currently are, it is easy to overlook, or at least downplay, the positive events that may surface. From our lens, at least two developments last week were worthy of note, which supports our long-standing view that the struggling recovery is not poised to double-dip into another recession.

The first is the Federal Reserve's release of its latest survey of senior bank lending officers. It is no secret that one of the biggest headwinds facing the U.S. economy is the difficulty that creditworthy borrowers face in obtaining loans. This credit restriction, of course, does not apply to large corporations that have access to the capital markets. Yield-hungry investors have been gobbling up record amounts of new bond issues in recent months, including those from companies with less than investment-grade ratings. More

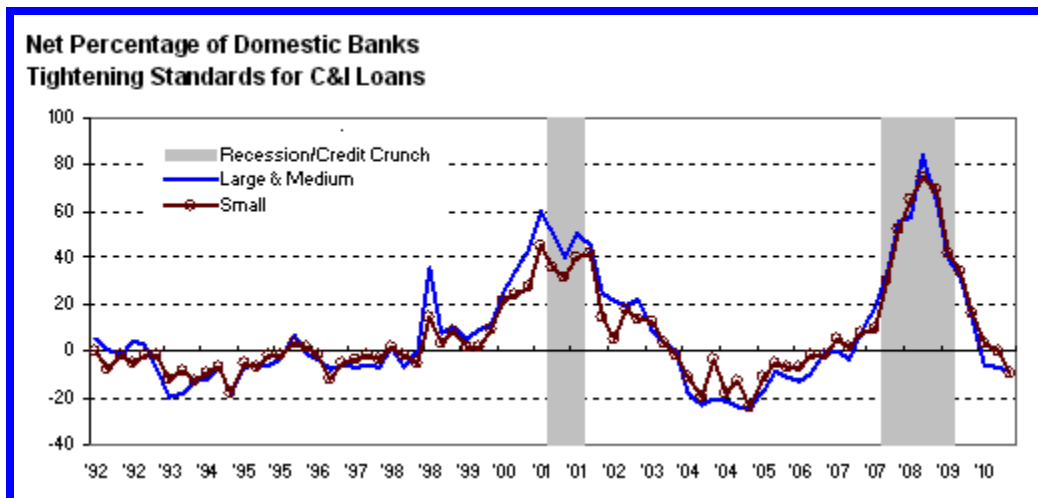
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than anything, the reopened floodgates in the capital markets confirm that the financial crisis, which ignited and intensified the Great Recession, is now a chapter for the history books.

While the restoration of a functioning capital market has played a pivotal role in jump-starting the recovery, its contribution to growth has not been as powerful as it should be. Much of the issuing activity has been for refinancing purposes or to generally repair ailing balance sheets that were damaged during the recession and financial crisis. Indeed, large companies have built up a cash hoard that, as a percent of total assets, is the highest since the mid 1960s. It's not entirely clear what's behind this huge appetite for liquidity. To some extent, it may simply reflect a lack of investment opportunities, as the uncertain economic climate and slackening demand for goods and services have undercut the potential rewards that such investments might provide. But another influence, cited by a number of corporate treasurers, is the fear that a financial crisis may erupt again; hence a larger cushion of liquidity is a rational defensive measure to guard against such a contingency.

However, smaller companies that rely on banks for financing do not have the luxury of deciding what to do with excess cash raised in the public markets. They need these funds to sustain operations, acquire working capital and to meet payroll. More to the point, small firms are a major source of job creation, and their inability to obtain funds has been one of the powerful headwinds keeping the job market in the doldrums. But the Fed's latest survey of banks, taken over the last two weeks of July, may be a sign that the tide is turning for the better. For the first time since late 2006, the Fed reported that banks were easing lending standards for small businesses. The survey did not specify why banks turned more hospitable to small and medium sized companies, but there are several possible reasons.



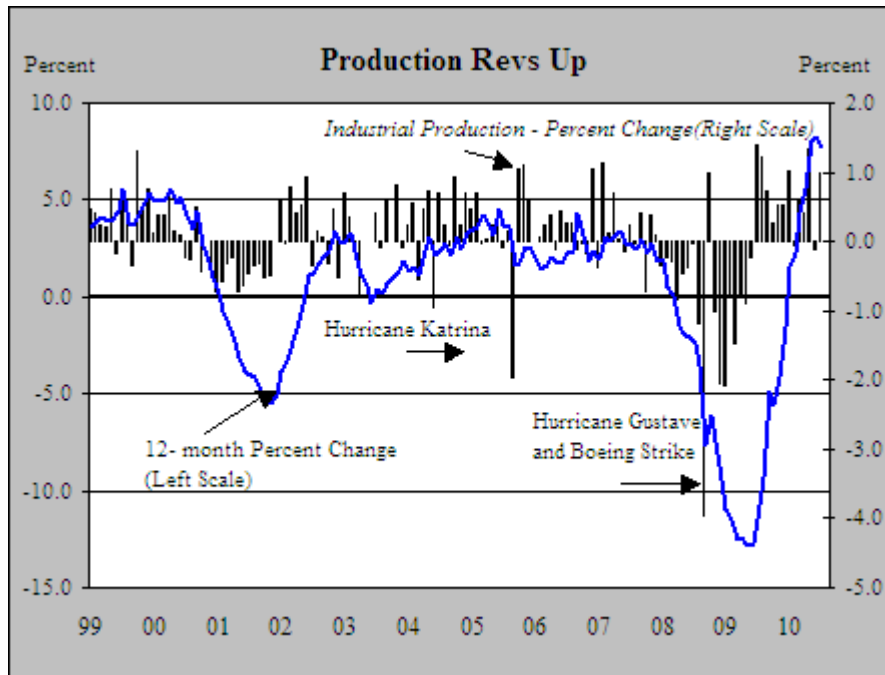
Topping the list may simply be that the year-old recovery itself has made lending officers more confident in the ability of these borrowers to repay their loans. True, the recovery has lost momentum in recent months, which would seem to make lenders rethink that more optimistic attitude. However, proprietor's income has posted solid increases in twelve of the past thirteen months, and stands 4.6% above the level of a year ago. That may not rival the outsized profit gains experienced by their larger corporate brethren, but those companies are not coming to banks for funds, turning instead to the capital markets. What's more, banks are sitting on a huge amount of excess reserves, which are earning little or no interest at the Federal Reserve. While risk aversion has not faded entirely, the improving income and revenue stream at small companies does shift the risk/reward equation, making small-business loans a more attractive alternative for banks.

In addition to the encouraging bank lending survey, the markets seemed to overlook another positive report last week. While economic growth has hit the skids in recent months, the downdraft has not yet engulfed

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industrial companies, which continue to ramp up activity. Industrial production in July rose by a sharp 1 percent, more than reversing a slight 0.1% dip in June. Over the past three months, output at factories, mines and utilities has increased by a hefty 8.4% annual rate. Like most other yardsticks, industrial production has its volatile component that can obscure a trend, most notably wide gyrations in automobile output. In July, auto production did spike higher, thanks to the decision of GM to keep 9 of 11 plants open during the usual retooling month. Even so, industrial output, excluding autos, registered a respectable 0.6% percent increase in July. In other words, the gains were broadly based, with the majority of major industry groups ramping up production.



To be sure, the economy may turn in a bi-polar performance for a while, but sustained hefty increases in the industrial sector may not persist if the rest of the economy is weakening. For the most part, the strength in manufacturing benefited from impressive increases in exports and the restocking of inventories that were greatly depleted during the last recession. We are not too concerned that export demand will wither, as are some, as global economic activity should hold up better than seemed likely a few months ago, when the European debt crisis hit.

For one, the Euro-zone just turned in a solid performance in the second quarter, growing at about twice the pace as the U.S., with Germany doing most of the heavy lifting. That surprising strength will probably fade as the fiscal austerity imposed on several deficit-ridden countries in southern Europe drags down the region's growth rate. But the slowdown may be less severe than thought a while ago. And, while the Chinese authorities are leaning against the wind to dampen speculative excesses, that nation's huge economy – now the second largest in the world – is still cruising at a remarkable growth rate of around 9 percent, only slightly below last year's 11 percent pace. Meanwhile, other emerging market nations in Latin America and Asia remain on a fast growth track, accounting for ever-larger shares of global output. Demand for American made goods, especially heavy machinery and other equipment used to build infrastructure in developing countries should remain strong, underpinning exports.

For another, while most of the inventory restocking has been completed among domestic firms, the lift from this source may not have run out entirely. At last look, inventory levels were barely keeping up with demand; the ratio of stocks to sales stood at 1.26 in June, up from a historic low of 1.23 in April, but well below the 1.48 cyclical peak reached early last year. What's more, the increase over the past two months

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stems primarily from the fall-off in retail sales. Unless the economy slips into the dreaded double-dip recession, that relapse should be reversed in coming months. It will not take much of a sales rebound to ignite more inventory restocking by companies, given the slim volume of merchandise sitting on shelves.

Simply put, there was little in last week's batch of economic data to suggest the economy's current "soft patch" is getting softer. But with the scaled down expectations of growth still the dominant theme, it will take a string of upbeat news to alter market psychology. That's not likely to happen anytime soon. Next up will be the second reading of last quarter's GDP, which is widely expected to be revised down sharply from the original estimate of a 2.4% growth rate, due to the widening of the trade deficit. The consensus is that Washington's revised numbers will bring the growth rate down to about 1.5%. That is still a positive pace, but close enough to the zero threshold to leave the economy highly vulnerable to an external shock. The most important yardstick of the economy's health, of course, is the headline-grabbing employment report, which is due Friday, September 3. It may not be as ugly as recent reports, but with another 140,000 Census workers falling off of payrolls during the month, it may not be particularly pretty either. Stay tuned.

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