

WEEKLY ECONOMIC COMMENTARY – WEEK OF AUGUST 30, 2010

FINANCIAL INDICATORS				
INTEREST RATES	August 27	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.14%	0.15%	0.14%	0.13%
6-month Treasury bill	0.18	0.18	0.19	0.24
3-month LIBOR	0.30	0.33	0.45	0.35
2-year Treasury note	0.56	0.49	0.55	1.01
5-year Treasury note	1.49	1.44	1.60	2.45
10-year Treasury note	2.64	2.61	2.91	3.44
30-year Treasury bond	3.69	3.65	3.99	4.19
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	1.15	1.22	1.33	1.87
10-Year	2.48	2.55	2.76	3.25
30-Year	4.20	4.31	4.37	4.78
30-year fixed mortgage rate	4.36	4.42	4.54	5.14
15-year fixed mortgage rate	3.86	3.90	4.00	4.58
1-year adjustable rate	3.52	3.53	3.64	4.69
STOCK MARKET				
Dow Jones Industrials	10150.65	10213.62	10465.94	9544.20
S&P 500	1064.59	1071.69	1101.60	1028.93
NASDAQ	2153.63	2179.76	2254.70	2028.77
Commodities				
Gold (\$ per troy ounce)	1239.80	1229.10	1183.70	957.20
Oil (\$ per barrel) - Crude Futures (Nymex)	75.38	73.46	78.93	72.77
ECONOMIC INDICATOR (Latest Month/Quarter)				
		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
New Home Sales (July) - 000s of units	276.0	315.0	281.0	336.0
Home Resales (July) - 000s of units	3830.0	5260.0	5660.0	5152.0
Durable Goods Orders (July) - % change	0.3	-0.1	-0.7	0.5
Revised GDP (Q2) - % change at Saar	1.6	3.7	5.0	1.1

Prime Rate: 3.25%

1-Month LIBOR: 0.25938%

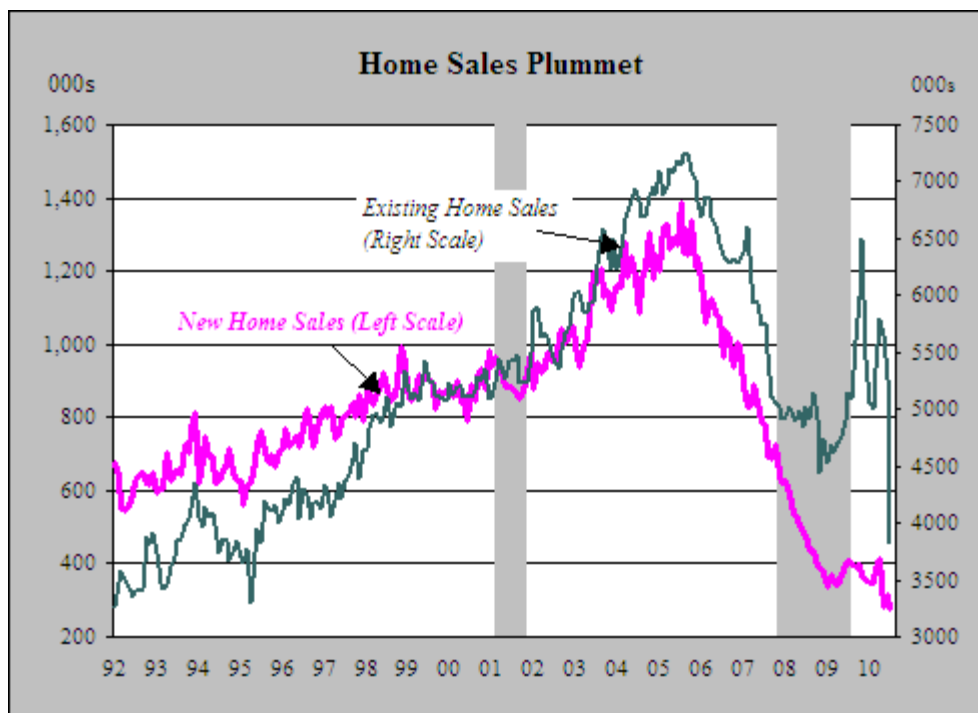
In next week's commentary, which will be shortened due to the Labor Day holiday weekend, we will update the statistical table and provide an analysis of the all-important jobs report scheduled for release on Friday, September 3. The next full commentary will be delivered on September 13.

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The dog days of August continue to churn out grim economic news. On the bright side, the month is mercifully nearing an end. On the dark side, it's ending with a thud. Worse, things may not look much better in September, starting with the much-anticipated jobs report to be released this Friday. Certainly, the economic news last week did not provide any cause for cheer.

The week opened with the ailing housing market showing deeper wounds than could have been imagined a few weeks ago. Sales of new homes plunged to an all-time low of 276,000 units in July, a hefty 12.4% fall-off from June, which was itself revised lower than what was originally reported. As weak as new homes sales were, conditions in the much-larger existing housing market were even worse. There, home re-sales plummeted by 27.2% during the month, from 5.26 million units to 3.83 million units. That was the steepest one-month drop on record - both in absolute and percentage terms.



With the expiration of the homebuyer's tax credit, a drop in sales should have come as no surprise. After all, it was widely recognized that the tax-related spur to sales during the spring was simply pushing forward transactions that would otherwise have occurred at a later date. But if the July plunge is any indication, the payback has been more severe than anticipated. In the end, one has to wonder if the ultimate result of the tax credit was to reshuffle the deck chairs around a sinking ship, merely postponing the inevitable. Historians will provide the answer some day, but for now the positive ramifications from the housing incentive is hard to see.

One thing is clear: This was not the script the tax credit was meant to write. While the authors of the bill may have been overly optimistic, their plan would have made sense if a more normal recovery had taken place. When the tax credit was originally conceived, the expectation was that it would pull forward sales and, hence, lead to some payback after it expired. However, it was hoped that the payback would be softened by an improving economy, including a revival in job growth that would enable the housing market to function more normally without the artificial support of the tax credit. Sadly, that scenario has not played out according to plan.

The job market did, of course, snap back in the spring, as private-sector employment posted impressive monthly gains of 158,000 and 241,000 in March and April respectively. But those increases came on the heels of what seemed to be a momentum-building economic upturn. Real GDP expanded by a surprisingly

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strong 5.0% annual rate in the fourth quarter of last year, followed by a slower, but still solid, 3.7% pace in this year's first quarter. Economists, and even the Fed, lifted their growth forecasts for the year, injecting a wave of optimism into business psychology that spurred a greater willingness to expand payrolls. But that sense of optimism faded abruptly, as incoming data showed more weakness than expected, ushering in a "soft patch" that has been intensified by a sovereign debt crisis and its unsettling effects on the financial markets.

As a result, the nascent revival in job growth fizzled as private companies ramped down hiring in the face of growing uncertainty. From May through July, job growth in the private sector receded to a monthly average of 51,000. Instead of the expected improvement in housing fundamentals, the environment for home sales took a turn for the worse. True, mortgage rates continued to fall, reaching the lowest level in decades, which, combined with sliding home prices, sharply increased home affordability. But while affordability is clearly a positive force for home sales during normal times, it is overwhelmed by the negative impact of a weak job market and poor income prospects that potential home buyers are currently dealing with. Until the job market improves significantly, a major pillar supporting home sales will be missing, and the sales pulled forward by the tax credit will leave a deep void in the housing market.

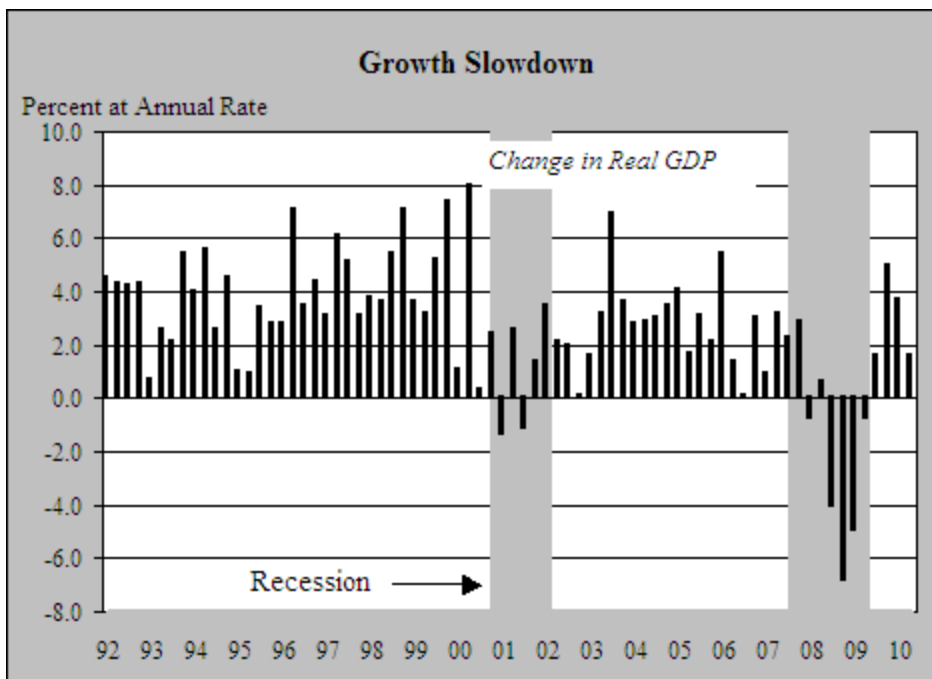
What's more, there is a growing sense that the moribund housing market is reinforcing the weakness in the job market. With home prices continuing to slide, more households are seeing the equity in their homes evaporate, leaving them with mortgage debt that exceeds the value of their homes. According to the best estimates, more than 20 percent of households with mortgage debt find themselves in such a negative equity position, and another 5 to 10 percent have only a slim equity cushion of about 5 percent. While this has spurred a rash of so-called strategic defaults, involving people who choose not to meet their mortgage payments even though they are able to, the majority of homeowners strive to tough it out. Unfortunately, many of them are unemployed and because they are tied to their homes cannot move to areas where there may be better job opportunities. Economists describe this lack of mobility as structural unemployment, a condition that makes it more difficult to lower the jobless rate.

Needless to say, the weak housing market remains one of the most intractable headwinds impeding the recovery's progress and is poised to be a drag on growth over the balance of the year. That alone should not choke off the recovery, as the influence of housing on the overall economy has diminished considerably in recent years - accounting for only 2.7% of GDP compared to over 6% before the housing bust. But housing's impact on economic activity extends beyond the direct spending on construction and even the indirect effects on ancillary industries and the workers involved. For the majority of households, their homes are the most important asset and, hence, falling property values can take a big bite out of net worth. Indeed, between the fourth quarter of 2006 and the first quarter of this year, households suffered a \$6.4 trillion loss in home values, something that clearly diminished their sense of financial well-being.

Hence, instead of seeing their homes as a vital part of retirement nest eggs, households had to rebuild wealth the old-fashioned way - by putting aside a higher fraction of their paychecks. As much as anything, that balance sheet rebuilding effort has kept the growth in household spending far below what usually occurs in the first year of a recovery. Since personal consumption accounts for two-thirds of overall economic activity, the recovery is clearly missing a vital spark that would provide it with much needed momentum. As the Commerce Department reported on Friday, the economy registered an even weaker growth rate in the second quarter than the tepid 2.4% pace initially estimated a month ago. The revised figures lowered the growth rate for the period to 1.6%, less than half the 3.7% first-quarter pace and even further behind the 5 percent rate in the fourth quarter of last year. The second-quarter gain equals the third quarter of last year, when the economy just emerged from the recession.

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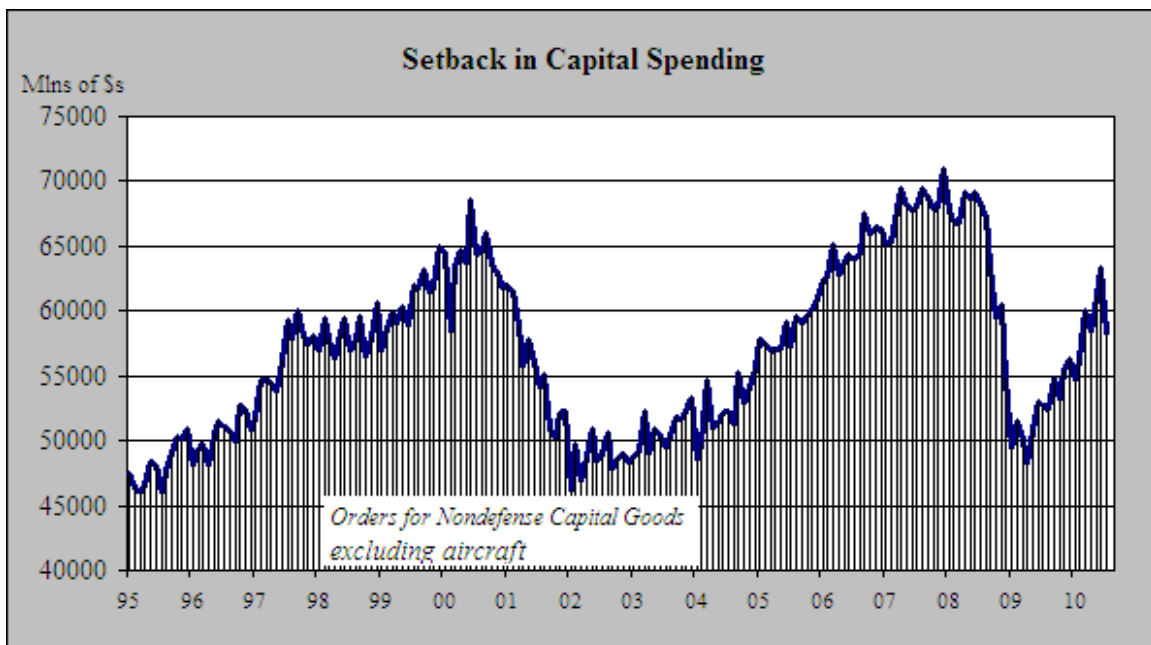
Small wonder that a vocal chorus of economists believe the nation is perilously close to dipping back into a recession. Clearly, the trend is in their favor and it would not take much of an external shock to push the economy over the edge. However, we have maintained that a double-dip recession will probably be avoided, and continue to hold that belief, despite the latest downward revision in the economy's performance. Paradoxically, the revisions to the second quarter's numbers did not cut into the initial estimate of final demand. Instead, a wider trade deficit, owing to a bigger surge in imports, and a reduced level of inventories accounted for the lower growth rate. Final domestic demand for all goods and services, from wherever produced, actually increased at a faster pace than thought, rising 4.4% versus 4.2%.

We suspect that the downward revision to the second quarter's GDP at least partly reflects a one-time surge in imports from China in response to expectations of an imminent upward revaluation of the Chinese currency, the Yuan, which would make such imports more expensive. That influence should be reversed in the third quarter. Likewise, the lower inventory levels may portend more inventory restocking in the future than otherwise if demand holds up. That's a potential boost to economic growth. Significantly, consumer spending was not revised down, but was actually adjusted upward from an original estimate of a 1.6% increase to a slightly stronger 2.0% gain. While still well below the increase needed to put the recovery on solid ground, the upward revision suggests that consumer demand may be holding up better than anticipated. Simply put, households have made great strides in repairing their balance sheets – reducing debt and increasing savings, which had been revised significantly higher last month – leaving them in a better financial position to step up spending when the job market turns stronger.

That may not happen quickly, but even a sign of steady spending should prevent a major pullback in business investment, which has been a key source of strength driving the recovery so far. What makes this so critical is that capital-spending prospects took a significant turn for the worse in July, as orders for non-defense capital goods plunged by 8 percent, reversing all of the gains over the previous two months. This series tends to be notoriously volatile from month to month, so the latest plunge may be more noise than substance. Even with the nosedive, the volume of new capital goods orders still stands more than 10.5% above the same month of a year earlier. But the suddenness of the July drop is nerve-racking and punctuates a string of disappointing numbers over the past month. While we are not expecting a favorable report on jobs this week, we are hopeful that it will not come in below the already subdued expectations, which would kick off September on an ominous note.

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Before we head into the last big summer weekend (of what was a glorious summer – weather-wise), with our heads in our hands, we want to leave you with a David Letterman-like list of reasons why we believe we have hit a “soft-patch,” as opposed to the start of another serious downturn:

- 1) **Corporate profits are strong:** In the 1.6% revision to Q2 GDP, we received the first estimate of corporate profits for the quarter. Profits rose 3% from the first quarter, and are up 25% in the past year.
- 2) **Capital spending is increasing:** Capital spending has grown at an impressive rate since the end of the recession, with no signs of a slowdown. Strong cap-ex reflects at least some positive degree of confidence on the part of businesses, and that is a leading indicator of future growth in the economy
- 3) **Industrial production:** US Industrial production is increasing at a very fast rate, and most global economies also are experiencing a rapid recovery in industrial production. The cutback in production that occurred in the wake of the financial crisis was sufficient to allow a substantial inventory drawdown. Now, with demand and confidence slowly returning, production must ramp up to avoid continued inventory depletion.
- 4) **Commodity prices:** are up across the board. This reflects strong growth in global demand and/or accommodative monetary policies worldwide. No matter the reason, rising commodity prices all but preclude the deflation that so many are worried about and may rule out the possibility of a double-dip.
- 5) **Shipping:** The amount of freight being transported by truck, rail, and ship has been growing at double-digit rates over the past year, and reflect burgeoning global trade.

To round out the “top 10,” US trade is bouncing back as exports boost GDP and rising imports reflect stronger consumer demand than they are given credit for. Automobile sales underscore this as they have rebounded strongly in 2010. Corporate layoffs have all but disappeared and temporary hiring is steadily increasing, laying the groundwork for a new wave of hiring once companies feel more certain of the regulatory and tax landscape. China and most developing nations are growing like crazy and global trade is the beneficiary. The more they produce will translate into more purchases from (and investment in) the US.

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Lastly, the ISM manufacturing index (released this Wednesday), has been strong all year and correlates pretty well with US GDP. US manufacturing has been the hidden news in the recovery and, barring a collapse, points to GDP growth of 3% to 4% in the third quarter.

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