

## WEEKLY ECONOMIC COMMENTARY – WEEK OF JULY 12, 2010

FINANCIAL INDICATORS				
INTEREST RATES	July 9	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.15%	0.16%	0.07%	0.17%
6-month Treasury bill	0.19	0.21	0.15	0.24
3-month LIBOR	0.53	0.53	0.54	0.50
2-year Treasury note	0.62	0.62	0.73	0.89
5-year Treasury note	1.84	1.81	2.02	2.21
10-year Treasury note	3.06	2.97	3.23	3.29
30-year Treasury bond	4.04	3.94	4.15	4.19
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	1.56	1.67	1.68	2.04
10-Year	2.95	3.05	3.04	3.44
30-Year	4.38	4.43	4.41	4.83
30-year fixed mortgage rate	4.57	4.58	4.72	5.20
15-year fixed mortgage rate	4.07	4.04	4.17	4.69
1-year adjustable rate	3.75	3.80	3.91	4.82
STOCK MARKET				
Dow Jones Industrials	10197.72	9686.48	10211.07	8146.52
S&P 500	1077.93	1022.58	1091.60	879.13
NASDAQ	2196.45	2091.79	2243.60	1756.03
Commodities				
Gold (\$ per troy ounce)	1210.00	1211.90	1227.90	912.20
Oil (\$ per barrel) - Crude Futures (Nymex)	76.25	72.27	74.18	59.94
ECONOMIC INDICATOR (Latest Month/Quarter)		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Nonmanufacturing Index (June)		53.8	55.4	53.9
Consumer Credit (May) - mlns of \$s		-9148.0	-14860.0	-5150.0

Prime Rate: 3.25%

1-Month LIBOR: 0.34094%

It may be nothing more than a brief interlude, but it was still nice to see the financial markets accentuate the positive last week, shifting away from the constant drumbeat of negativity that had prevailed for the better part of the past three months. To be sure, investor psychology remains in a fragile state, and it probably would not take much in the way of bad news to produce another shift in sentiment to the dark side. Keep in mind that the solid rebound in stock prices occurred in a holiday-shortened week that was virtually devoid of meaningful economic data. Hence, the absence of bad news may have been the primary catalyst behind last week's rally.

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Still, it would be a mistake to downplay the influence of what may shape up to be another banner season for corporate profits in the second quarter. Much attention was focused on the robust earnings expected for banks during the period, but that should come as no surprise given the very steep yield curve that is underpinning bank profitability. After all, just reinvesting depositors' funds at near zero cost into safe Treasury securities yielding 3 percent or so guarantees a nice rate of return, even after subtracting the hit from loan defaults and markdowns of other assets. From our lens, the more significant influence on the overall health of the economy is the prospect of another muscular increase in non-financial corporate earnings.

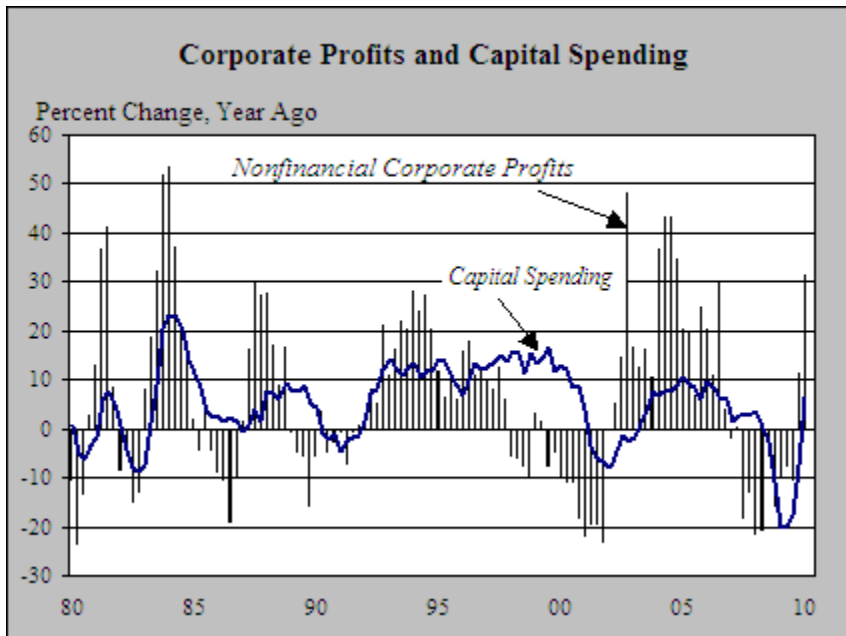
In the first quarter, economic profits of these companies surged by 10.7% following an 8.7% gain in the fourth quarter of last year. Those were the strongest back-to-back quarterly gains since the first and second quarters of 2004. It also marked the fourth consecutive quarter of rising profits, lifting the annual gain by an astonishing 31.3%, the strongest year-over-year advance in more than five years. With an economy that is still struggling to emerge from the deepest recession in the postwar era, the increase in corporate profits matches up favorably with the strongest cyclical rebounds observed over the past fifty years. What's particularly impressive is that the strength in profitability has occurred in an environment of very weak pricing power. Simply put, companies have managed to replenish their cash coffers by increasing productivity and keeping their costs down, particularly labor costs.

The question now, however, is whether the rebound in earnings can be sustained as companies have gone as far as they can in cutting costs and raising productivity. Indeed, skeptics claim that the strenuous cost-cutting measures that widened profit margins are undermining the prospects for stronger revenue growth going forward. That's because workers are bearing the brunt of the cost savings, and without expanding paychecks in coming months the demand for goods and services will wither, thus undercutting the top-line growth in revenues. Even worse is that the prospect of weaker demand could provoke companies into even bigger labor cutbacks, which would set in motion a vicious cycle that brings on the feared double-dip recession, hardly a friendly environment for profits.

However, that negative spin on future prospects is not the most likely outcome, in our view. Yes, the profits rebound has been primarily driven by greater efficiencies and cost reductions. But the history of business cycles strongly suggests that, whatever the catalyst is, a revival in profits invariably leads to positive events for the economy. For example, within a quarter or two of a profit rebound, companies step up hiring and capital spending. The lag may be longer or shorter for a variety of reasons, but that response has never failed to materialize. To be sure, the current propensity of corporations to build a hoard of cash – equaling a record \$1.6 trillion in the first quarter – would seem to belie that tendency. But despite the huge cash pile accumulated over the past year, that did not short-circuit a pick-up in corporate spending. As the chart shows, capital outlays have rebounded nicely in recent quarters, consistent with the time-honored script following past cyclical increases in profits.

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No doubt, the mountain of cash being held by corporations reflect, in good part, a high degree of uncertainty on the part of CEOs, as well as the ongoing huge amount of excess capacity that still prevails. But much of the buildup has also occurred in response to the financial crisis that froze credit availability in 2008 and early 2009, leaving corporate treasurers unsure if they could obtain enough funds to cover operating costs, much less capital expenditures. A related worry was the enormous amount of debt on corporate balance sheets, a legacy of the borrowing binge during the expansion, which needed to be either serviced or refinanced as they came due. If the capital markets were not hospitable to refinancing maturing debt, corporations would have to tap into their cash reserves to pay off the bondholders.

But those reasons for holding on to cash have become far less potent, and are not likely to restrain spending going forward. For one, the credit markets are functioning again, and corporations are having little trouble refinancing debt. What's more, borrowing costs remain exceptionally low, reflecting strong demand from investors who are eagerly gobbling up new issues to replace maturing ones held in portfolios. The euro debt crisis does raise questions about the continued functioning of the credit markets, particularly if risk aversion towards euro-denominated assets spreads to the U.S. At this juncture, however, fears of the so-called contagion effect appear to be overblown, and the European monetary and fiscal authorities seem to be getting a handle on the debt crisis in their back yard.

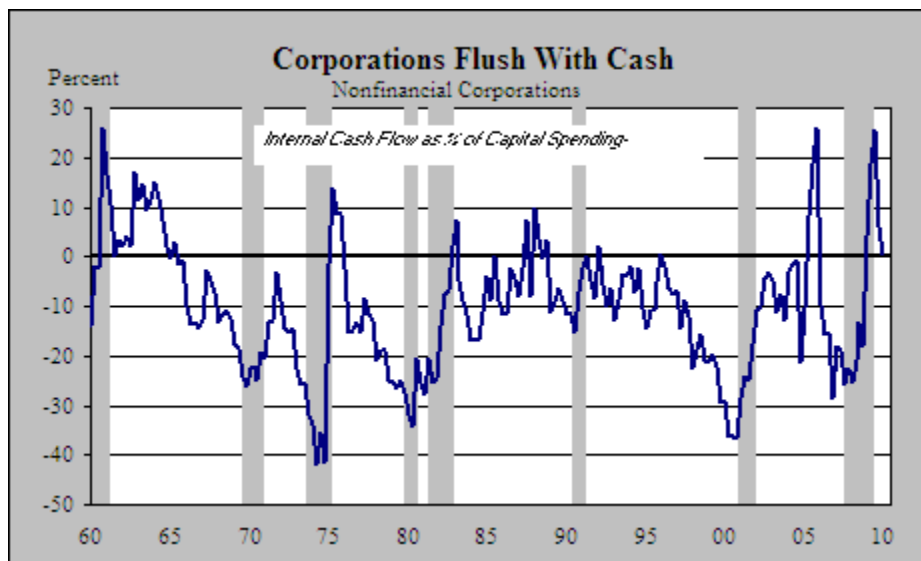
Hence, a more likely scenario is that firms will be less motivated to hoard their cash and more inclined to draw on these resources to aid the broader economic recovery. As noted, capital spending has already turned the corner, rebounding by a 15 percent annual rate over the last two quarters ending in March. Monthly data on durable goods shipments and orders suggest that another solid increase took place in the second quarter. While the gain over the second half of the year will probably moderate somewhat, there is every reason to believe that companies will continue to increase their capital budgets and provide key support for the recovery.

For one, thanks to the strong profits rebound and the buildup of liquid assets, corporations have the financial resources to spend more and, hence, further aid the recovery process. As the chart shows, internal funds of non-financial corporations have exceeded capital spending for five consecutive quarters, the longest stretch of positive cash flow in at least the past fifty years. For another, while excess capacity remains high by historical norms, it is rapidly being used up as production is growing strongly. Reinforcing the narrowing of the output gap is the fact that capacity has been cut back in recent years, reflecting the

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steepest decline in capital spending during the recession than any time in the post war period. Indeed, despite the rebound in outlays over the past two quarters, business investment as a share of GDP is the lowest on record.



That said, there is no denying the still fragile sentiment on the part of corporate CEOs that may well dampen their incentive to spend on capital goods, as well as step up the hiring of workers. It is a trite but true axiom that uncertainty is the enemy of growth, and there are enough uncertain elements clouding the outlook to keep business leaders on the fence. Chief among them, of course, is the extent by which consumer demand will hold up, providing the top line revenue growth that would motivate firms to add capacity and staff. On this score, the evidence is mixed, at best, justifying the heightened caution reflected in recent business surveys. Consumers scaled back spending in May, following healthy increases in prior months, and early indications by department stores as well as auto dealers do not suggest a snapback in June.

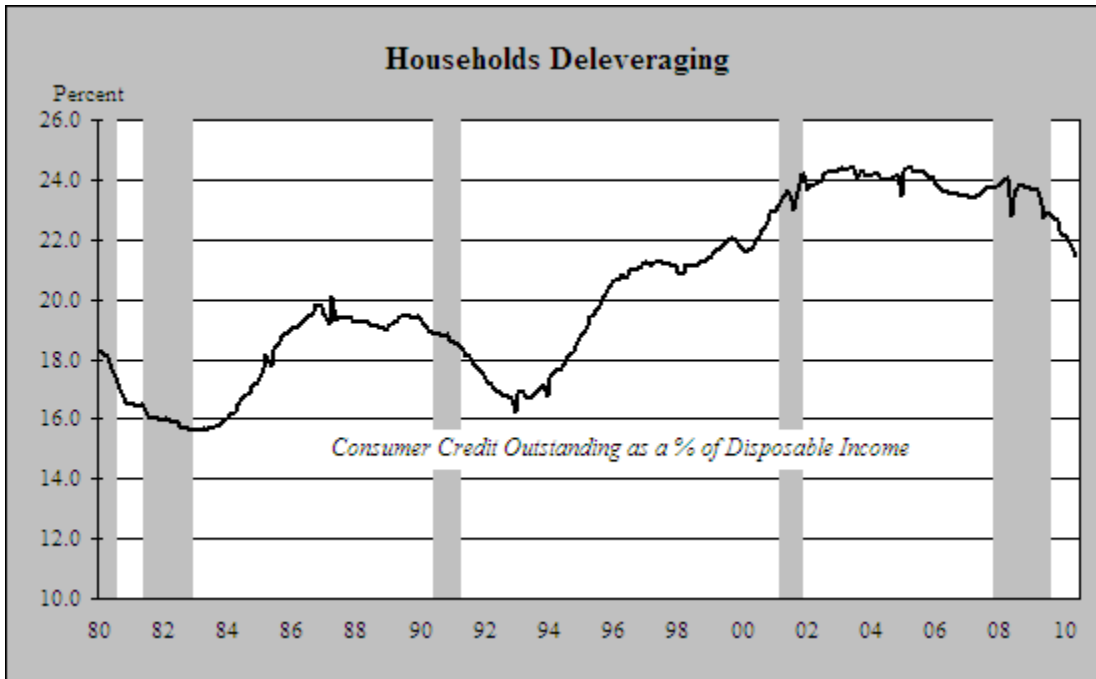
Indeed, the newfound caution on the part of households - together with the disappointing jobs reports in the last two months - have been largely responsible for the revival of double-dip fears and the pervasive negativity that has buffeted the stock market. We agree that the consumer pullback is a potential source of concern; if it intensifies in coming months, the case for a double-dip recession would certainly strengthen. However, we believe that households are more than likely taking a breather from their earlier spending spree rather than zipping up their wallets and purses for an extended period of time. Keep in mind that a major priority of households following the huge wealth destruction associated with the collapse in housing and stock prices during the Great Recession was to rebuild savings and pay down debt in an effort to restore a semblance of financial security. The spending binge late last year and early this year derailed that effort somewhat, and consumers may now be backtracking a bit to compensate for their errant ways.

But households have made considerable progress towards repairing their balance sheets, helped by the strong yearlong rally in stock portfolios as well as an astonishing reduction in debt. Indeed, according to the latest Federal Reserve figures, released last week, consumers have paid down installment debt in 18 of the past 20 months. The \$9.1 billion reduction in May lowered the total outstanding to slightly over \$2.4 trillion, which equals 21.5% of disposable incomes. As the chart shows, that's the lowest fraction in more than a decade, which greatly eases the debt-servicing squeeze on household budgets. The consumer credit figures do not include mortgage debt, but there too the trend is improving thanks to a surge in refinancings at ever-declining mortgage rates. Keep in mind also that income growth is picking up as workers are putting in longer hours. If, as we expect, the job market breaks out of its slumber in coming months, that

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improving income trend should continue and provide a solid floor under consumer spending. More than anything, that would give companies an even bigger incentive to draw down their cash hoards and step up both investment spending as well as payrolls. Stay tuned.



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