



WEEKLY ECONOMIC COMMENTARY – WEEK OF JUNE 14, 2010

FINANCIAL INDICATORS					
INTEREST RATES	June 11	Week Ago	Month Ago	Year Ago	
3-month Treasury bill	0.07%	0.12%	0.15%	0.06%	
6-month Treasury bill	0.15	0.21	0.21	0.28	
3-month LIBOR	0.54	0.54	0.45	0.62	
2-year Treasury note	0.73	0.73	0.78	1.27	
5-year Treasury note	2.02	1.98	2.16	2.78	
10-year Treasury note	3.23	3.20	3.46	3.79	
30-year Treasury bond	4.15	4.13	4.34	4.64	
Tax-Exempt Revenue Bonds (Triple-A)					
5-Year	1.68	1.65	1.81	2.19	
10-Year	3.04	3.02	3.14	3.42	
30-Year	4.41	4.41	4.40	4.88	
30-year fixed mortgage rate	4.72	4.79	4.93	5.59	
15-year fixed mortgage rate	4.17	4.20	4.30	5.06	
1-year adjustable rate	3.91	3.95	4.02	5.04	
STOCK MARKET					
Dow Jones Industrials	10211.07	9931.97	10620.16	8799.26	
S&P 500	1091.60	1064.88	1135.68	946.21	
NASDAQ	2243.60	2219.17	2346.85	1858.80	
Commodities					
Gold (\$ per troy ounce)	1227.90	1221.20	1231.10	940.40	
Oil (\$ per barrel) - Crude Futures (NYMerc)	74.18	70.98	71.91	72.16	
ECONOMIC INDICATOR (Latest Month/Quarter)		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.	
Consumer Credit (April) - Mlns of \$s		955	-5436	-7728	-6625
Trade Deficit (April) - Mlns of \$s		40285	40046	40147	37991
Retail Sales (May) - Percent Change		-1.2	0.8	2.1	0.4
Consumer Sentiment Index (early June)		75.5	73.6	72.2	73.8

Prime Rate: 3.25%**1-Month LIBOR: 0.34969%**

The U.S. recovery is taking a “two-steps forward, one step back” track that is confusing investors and heightening market volatility. Granted, a bevy of external forces highlighted by the European debt crisis has contributed to the bewildering mix of developments underpinning the turmoil in the financial markets. The proliferation of fiscal austerity measures and the renewed focus on reducing deficits have usurped global efforts to boost growth with highly stimulative government programs. Ironically, despite the

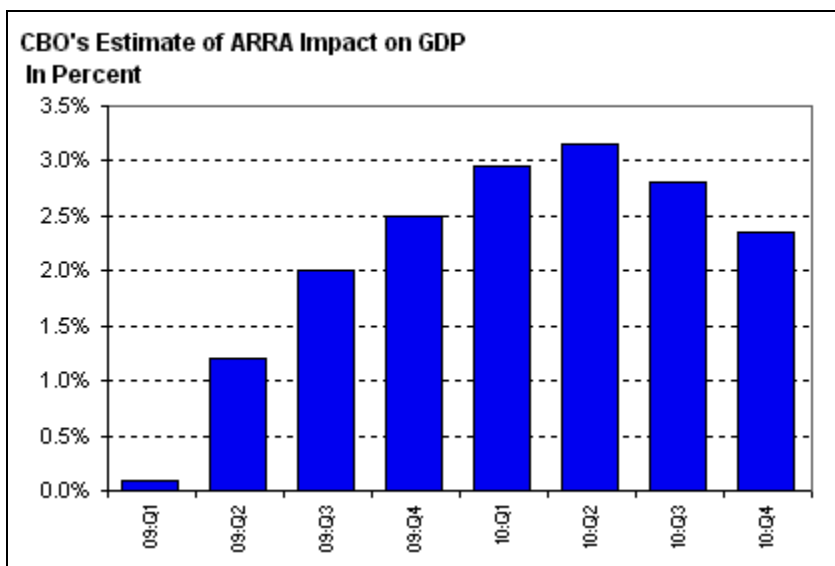
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growth-dampening implications of these austerity measures, the ECB has just raised its forecast of European growth for this year, which only adds to the confusion surrounding the economic outlook.

It is the conflicting data on the U.S. economy that seems to be the major source of uncertainty in the markets. What makes the step-like progression of events particularly unsettling is that the U.S. economy is entering a critical stage of the recovery. There is no denying that most of the heft behind the recovery so far has come from Washington, with the heavy lifting provided by the spending and tax cuts authorized under the American Recovery and Reinvestment Act of 2009 (ARRA), also known as the stimulus bill. The \$787 billion of fiscal thrust was designed to impact the economy over several years, but the most pronounced effect was decidedly front-loaded. Indeed, more than half of the spending and tax cuts have already occurred, and the “recovery” phase of the package will be giving way to the “reinvestment” phase after 2010.

Hence, the recovery will be receiving less support from government stimulus in coming quarters. The diminishing impact of ARRA can be gleaned in the following chart that was derived from the Congressional Budget Office’s projections made in January. As can be seen, the maximum impact is expected to take place in the current quarter, when the package of tax cuts and spending increases is estimated to boost GDP by an average of 3 percent over what would occur without the stimulus bill. That positive thrust fades over the second half of the year and its contribution to growth is projected to be cut in half next year. Simply put, the stimulus bill was designed to jump start the recovery and then fade away as self-sustaining forces from the private sector take the mantle of growth from the government.



For the most part, the economy seemed to be following that script. The private sector responded to the stimulus in time-honored cyclical fashion. Consumers put aside some of the tax relief in the form of savings and spent the rest, giving a solid consumption boost to growth over the past three quarters. Businesses also responded positively, rebuilding depleted inventories and increasing capital spending, reflecting growing confidence in the economic outlook. While the rebound in GDP has been weaker relative to recoveries that followed past harsh recessions, it has exceeded the dire forecasts made in the aftermath of the financial crisis. What’s more, it seemed to be gaining traction as time went on.

But recent data cast a pall over that happy scenario, raising questions anew as to whether the recovery can be sustained without additional government aid. The first backward step occurred a week ago with the release of the jobs report for May. After showing steadily increasing strength since turning positive in January, the pace of job growth slowed considerably last month as payrolls in the private sector rose by a

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only 41,000 - less than one-third of the 144,000 average increase over the previous three months. Nothing poses more of a threat to the recovery than a weak labor market, as only a pickup in wages and salaries can sustain consumer spending, the most important component of economic activity. Needless to say, Friday's retail sales report, which revealed a 1.2% dip in retail activity in May, only reinforced the tight linkage between jobs and spending, giving more credence to the view that the economy may be heading for trouble.

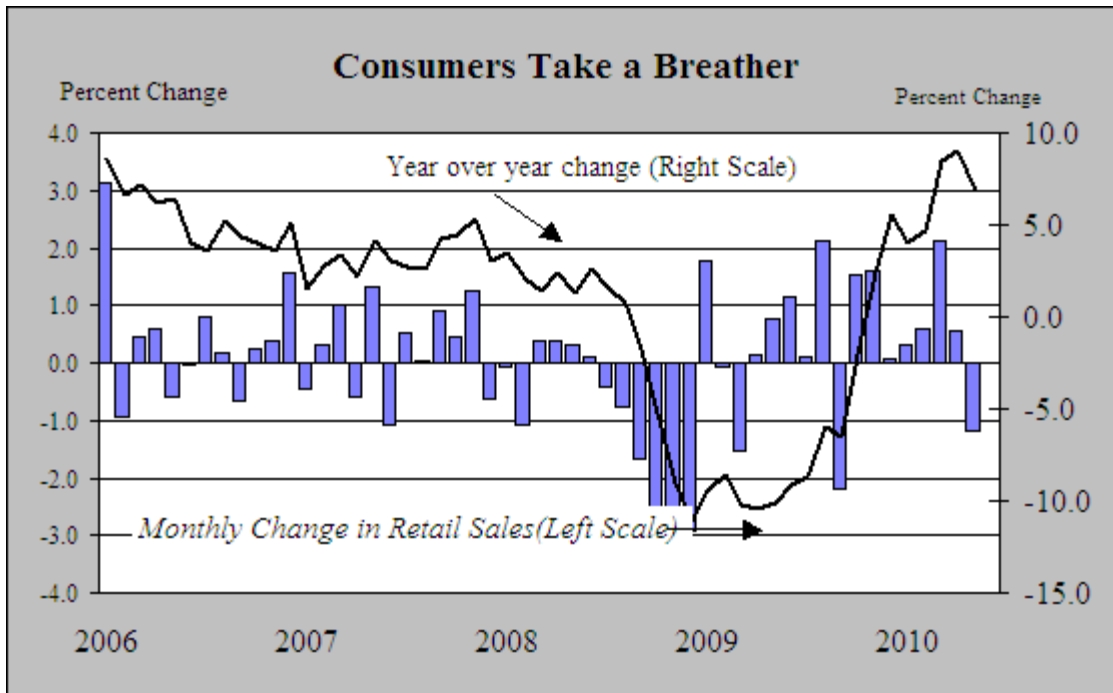
Like most other observers, we too were surprised and disappointed with the jobs and retail sales reports and recognize that the economy faces many hurdles on the way to a self-sustaining recovery. However, as we have often noted, recoveries rarely move in a straight line, particularly during the early stages when it is still finding its legs. This upturn is no exception, but recent developments give us no reason to throw in the towel. To be sure, the job market remains fragile and is likely to under-perform for some time to come. Even under the most optimistic projections wherein payrolls expand by a healthy 300,000 a month, it would take years to recapture the more than 8 million jobs that were extinguished since the recession started in late 2007. Under the more likely scenario of 150,000 to 200,000 monthly increases over the balance of this year, the process will be stretched out even longer. Hence, the unemployment rate will remain elevated, topping 9 percent for the foreseeable future, dampening household spirits and restraining spending more than would otherwise be the case.

But the setback last month did not short-circuit the improvement in the job market that is clearly underway. Companies are adding to payrolls and lengthening the workweek even as hourly earnings are picking up, which is putting more cash in worker paychecks. As a result, while private payrolls in May stood almost 1 percent below the level of a year ago, average weekly earnings are up 2.1 percent and are rising at the fastest pace in two years. Nor should the slowdown in job growth last month be viewed as the start of a trend. If, as we suspect, the June reading will be considerably stronger, so too will be the growth in wages and salaries. Simply put, households are enjoying a solid increase in purchasing power, which should underpin a sustained increase in spending in coming months.

True, the hefty 3.5 % increase in real consumption registered during the first quarter is not likely to be equaled in the near future. That gain was assisted by tax credits, rebates and refunds – tailwinds from the stimulus package – as well as pent-up demands from the recession. But the current quarter will not be a slouch. Keep in mind that the surprising 1.2% drop in retail sales in May follows hefty increases of 0.6% in April and 2.1% in March. Hence, the April/May average is on track for a 6.4% growth rate during the second quarter. After allowing for price changes and the inclusion of the larger services component of spending, we estimate that real consumption will increase at about a 2.5% annual rate in the April - June period – not great but certainly enough to support a GDP growth rate of roundly 3 percent.

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What's more, the May decline in retail sales contains some dubious elements that may overstate the weakness in consumer behavior. For one, it includes a 9.3% plunge in purchases of building materials and supplies, which may reflect poorer weather conditions in May than earlier in the spring. Indeed, such purchases surged by 8.1% and 8.4% in March and April, respectively, and are increasing at a remarkable 9.7% annual rate over the last three months. Second, a 1.7% drop in auto sales dragged down the total sales number, but the industry reported an increase in motor vehicle sales from 11.2 million to 11.6 million last month. This is a disconnect that may well be corrected in the revised sales figure next month.

Finally, the May report includes an 0.8% drop in gasoline service sales, the first decline in ten months. But this probably reflected lower gasoline prices, which fell by about a penny a gallon during the month. While that doesn't seem like much of a fall, it's important to realize that May is the start of the driving season when gasoline prices usually rise by about 7 percent from April. Indeed, lower fuel prices leaves more cash in the wallets of motorists that can be spent elsewhere. All in all, we would not read too much into a one-month weakness in retail sales, which are still standing a muscular 6.9% above the year earlier level.

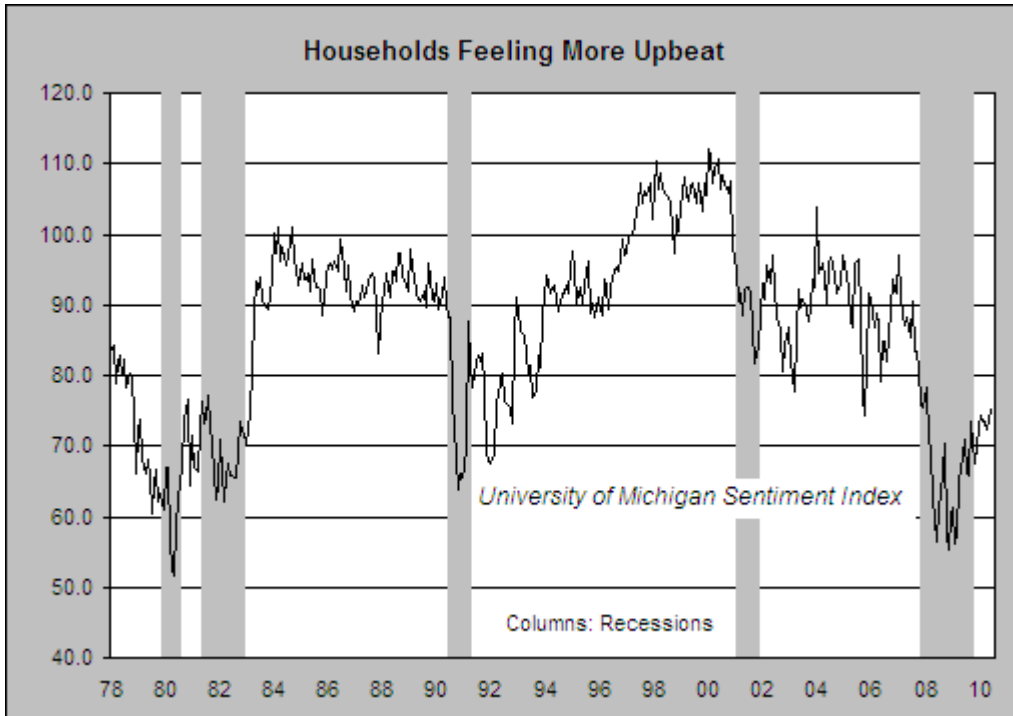
No doubt, the fading impact government stimulus on economic activity over the balance of the year increases the odds that the recovery will lose some momentum. The expiration of the tax credit alone should have a dampening influence on the housing market, removing what had been a major spur to home sales and housing-related purchases over the past six months. The spending boost from tax credits and refunds will disappear and the political climate is not conducive to another dose of fiscal stimulus, although a smaller targeted package aimed at softening the budget cuts at state and local governments may be forthcoming. Households are no longer drawing on their diminished housing equity to finance spending and banks are no longer aggressively mailing out credit cards that would encourage people to borrow beyond their income means.

That said, we view a potential slowdown in growth over the next quarter or two as a sign that the recovery is collecting its breath, not running out of steam. There are more headwinds than tailwinds underpinning the economy at this juncture, which should generate enough forward momentum to keep the recovery on a positive growth track. The job market is healing, although progress is slower than desired. Financial conditions are improving and household net worth is rising, increasing by another \$1 trillion in the first

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quarter. While fiscal stimulus may be fading, monetary policy remains supportive of growth as the Federal Reserve seems destined to keep interest rates at near zero until the recovery gathers far more traction than is currently in train. Finally, despite the setbacks in job growth and retail sales last month, household spirits are becoming more upbeat. The widely watched University of Michigan consumer sentiment index, released on Friday, rose by 1.9 points in early June, reaching the highest level in eighteen months. That's another reason to downplay the significance of the May retail sales report.



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