



WEEKLY ECONOMIC COMMENTARY – WEEK OF JUNE 28, 2010

FINANCIAL INDICATORS					
INTEREST RATES	June 25	Week Ago	Month Ago	Year Ago	
3-month Treasury bill	0.13%	0.09%	0.15%	0.17%	
6-month Treasury bill	0.19	0.16	0.22	0.29	
3-month LIBOR	0.53	0.54	0.54	0.60	
2-year Treasury note	0.65	0.71	0.77	1.10	
5-year Treasury note	1.89	2.01	2.09	2.55	
10-year Treasury note	3.10	3.22	3.28	3.53	
30-year Treasury bond	4.06	4.15	4.20	4.34	
Tax-Exempt Revenue Bonds (Triple-A)					
5-Year	1.76	1.77	1.68	2.22	
10-Year	3.18	3.23	3.02	3.54	
30-Year	4.45	4.47	4.38	4.86	
30-year fixed mortgage rate	4.69	4.75	4.78	5.42	
15-year fixed mortgage rate	4.13	4.20	4.21	4.87	
1-year adjustable rate	3.77	3.82	3.95	4.93	
STOCK MARKET					
Dow Jones Industrials	10143.81	10450.64	10136.63	8438.39	
S&P 500	1076.36	1117.51	1089.41	918.90	
NASDAQ	2223.48	2309.80	2257.04	1838.22	
Commodities					
Gold (\$ per troy ounce)	1255.40	1258.50	1216.10	941.00	
Oil (\$ per barrel) - Crude Futures (Nymex)	79.04	77.34	74.11	69.34	
ECONOMIC INDICATOR (Latest Month/Quarter)		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.	
New Home Sales (May) - 000s		300	446	389	365
Existing Home Sales (May) - 000s		5660	5790	5360	5385
Durable Goods Orders (May) - % change		-1.1	3.0	0.1	1.4

Prime Rate: 3.25%

1-Month LIBOR: 0.34719%

The financial markets had little to cheer about this past week. Dismal news continued to come out of Europe, with Greek yield spreads exploding and other weaker members of the EU (particularly Spain and Portugal) paying up as well - reflecting growing concerns that the sovereign debt crisis is far from resolved. Here in the States, meanwhile, things aren't looking much better. Housing is suffering once again and that, coupled with a soggy durable goods report and a downward revision to first-quarter GDP, has reinforced the pendulum shift in perceptions regarding the strength and sustainability of the U.S. recovery. Stock

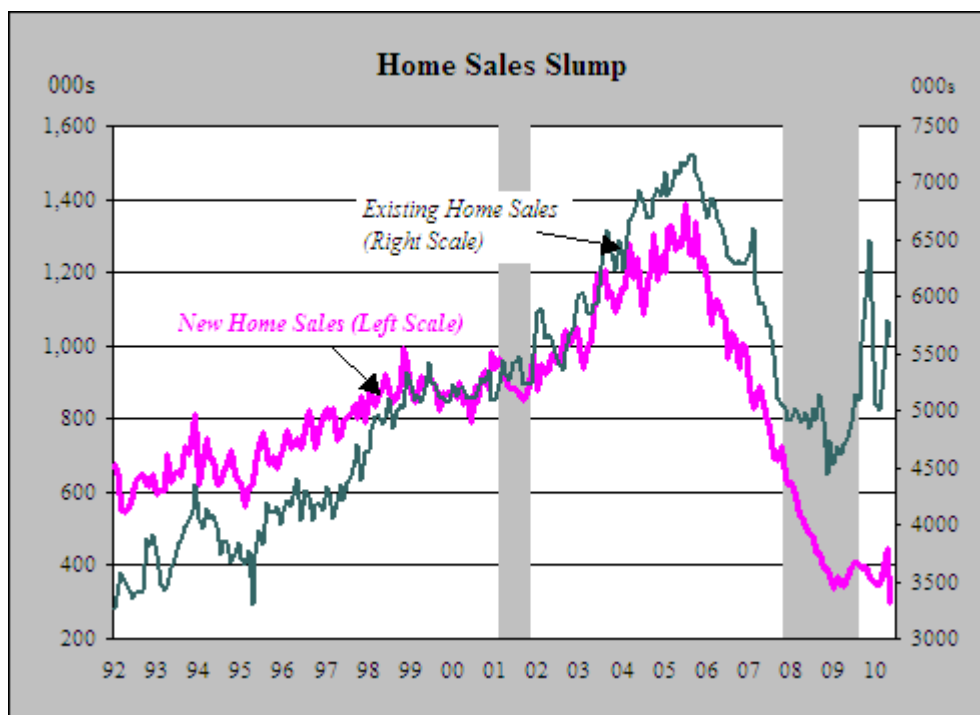
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prices slid and investors fled to the safety of Treasury securities once again, driving the 10-year yield down to the lowest level in 13 months, when the Great Recession was still underway.

The Fed has also downgraded its outlook, asserting at the latest policy-setting meeting held last week that the recovery is merely “proceeding,” not “strengthening” as was described in the previous confab six weeks ago. The downgrade was blamed mainly on deteriorating financial conditions, reflecting the aforementioned sovereign debt crisis, although a nod was made to the relapse in the housing market. Nothing particularly earth-shattering came out of the Fed’s meeting, as the information provided in the accompanying policy statement had been well known for some time. Still, the more circumspect language in the statement puts another nail in the coffin for those who expected a rate hike in 2010. Talk of an “exit strategy” has all but faded into the woodworks, buried ever more deeply not only by the recent spate of disappointing economic data but also by an utterly benign inflation backdrop.

It’s unclear how much of an impact the nosedive in housing activity is having on the Fed’s thinking. Chairman Bernanke has often alluded to the importance of housing as a barometer of the economy’s health and as a lever to sustain growth. If the latest data on the industry’s performance is any indication, the Fed chief has much to be worried about. According to last week’s Commerce Department report, sales of new homes collapsed in May, plunging by 33 percent to 300,000 units. That was the lowest volume of new homes sold on record and the decline was the steepest for any month. The resale market for existing homes didn’t fare much better. Instead of posting a modest rise as the consensus of economists thought, sales of existing homes slipped in May, with more than 30 percent of transactions consisting of distressed sales.



The housing market was widely expected to suffer a setback with the expiration of the homebuyers’ tax credit. However, the magnitude of the latest slump in new home sales sent shock waves through the industry and will almost certainly keep builders on the sidelines until they get a sense that demand is finding a floor. That’s not good news for construction workers or for those in ancillary industries that turn out the goods and services associated with building a home. And, with foreclosures running at about 300,000 a month, builders are facing intense competition from the existing home market where sellers and banks trying to unload repossessed properties are doing so at steep price discounts. Put simply, housing

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expenditures will not be making any contribution to economic growth for a while, and will likely be a drag on GDP over the near term.

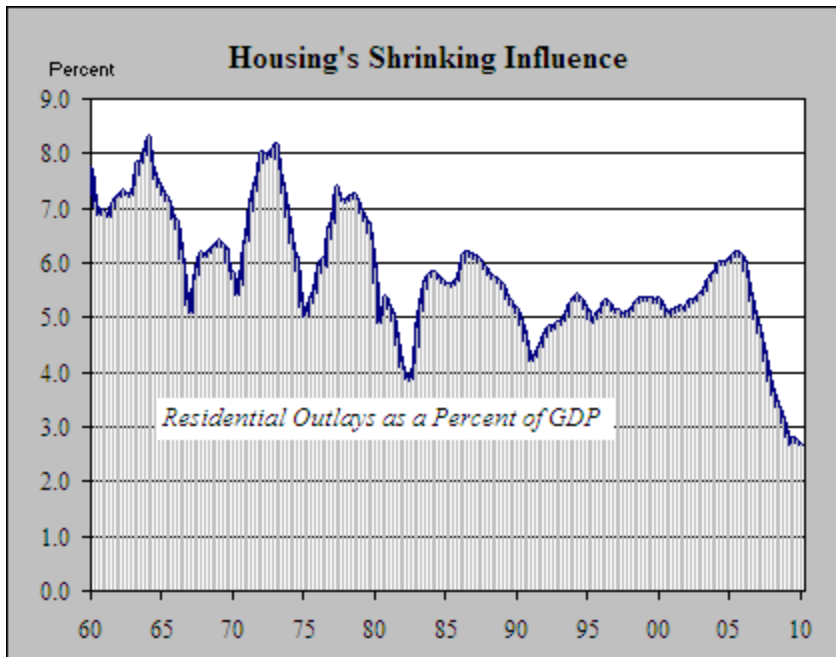
The absence of positive thrust from housing marks a dramatic departure from the time-honored cyclical role played by this key sector. Ordinarily the locomotive of growth coming out of recessions, the housing market has acted more like a caboose. Not only has it trailed past cyclical norms, the meager recovery in residential activity has been driven almost entirely by the fiscal steroids of tax incentives, which have now expired. The homebuyers' tax credit pulled forward transactions that would have taken place in the fall and winter, and the expected payback in the form of sagging sales and housing starts is taking place in spades. Even with the artificial boost from the government, the paltry 2.4% rebound in real residential outlays during the first three quarters of the recovery pales in comparison to the 17.7% spike over the comparable period of the nine previous recoveries.

Not surprisingly, the stunning nosedive in housing activity is giving new life to the notion that the economy is heading into a double-dip recession. Given the historical link between housing and business cycles in the U.S., that perception is understandable. However, we are reluctant to buy into the double-dip scenario until there is evidence that the job market is following the same path as the housing market. Despite disappointing trends in recent months – the paltry 41,000 increase in private employment in May and the ongoing elevated pace of jobless claims – such evidence is far from forthcoming. The job market may not have turned sufficiently vibrant to meaningfully lower the unemployment rate or generate the type of income growth that would resuscitate the demand for housing. But the recent gains are not about to disintegrate – as was the case in the housing market – and a variety of leading indicators point to better labor market conditions over the second half of the year.

What's more, while the housing market may not contribute to the recovery over the foreseeable future, it won't have as much of a negative impact on the broader economy than it did a few years ago, when the bursting of the housing bubble was a prime catalyst sending the nation into the Great Recession. Indeed, thanks to the housing bust, the residential sector now has a much smaller influence on economic activity than ever before. In the first quarter, for example, total residential outlays accounted for 2.7% of real GDP, the smallest share on record and less than half the relative size of four years ago. To be sure, it is hard to measure the impact on economic activity that comes from a sustained fall in property values and persistent weakness in home sales. That not only takes a bigger bite out of housing equity, thus eating into net worth and eroding the sense of financial well-being of households; it also greatly restricts the mobility of homeowners and their ability to seek out job opportunities in other locales.

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On balance, the ongoing housing meltdown certainly puts another crimp in the economic outlook and gives the double-dippers a compelling argument to make their case for a broader economic relapse. It is important to keep in mind, however, that recoveries don't usually end because of internal dynamics. The U.S. economy is a huge behemoth with many interchangeable parts to keep its growth engine running. On the rare occasion when a recovery is prematurely aborted, it is usually due to a policy mistake or some external shock, like a war or oil crisis. The festering European debt crisis may yet qualify for such a shock, if it creates severe havoc in the financial markets. Thus far, however, it appears the markets are suffering another bout of heightened volatility but not extreme turmoil and financial panic that ushered in the global recession in 2008. Stock prices have given up their gains for the year and yield spreads, as noted earlier, have widened out considerably. But credit is still flowing, world trade has not dried up and deal making in the capital markets has actually picked up in recent months.

Should the next jobs report, due on July 2, extend the weakness revealed in the May report, we would reassess the recovery's prospects. Admittedly, the spate of data for May – including a weak retail sales report to go along with the disappointing increase in private jobs not to mention the dismal housing figures – puts the recovery on a lower growth trajectory. If the June data also come in as weak as they were in May, the third quarter will have little momentum to build on and will be starting out with a statistical handicap that would just about assure a slower growth rate over the second half of the year. We concur that a growth haircut of about half-percent or so is likely over the coming quarters, if only because of the setback in housing and the deepening budget retrenchment of state and local governments, whose fiscal straits are taking on alarming proportions. The stringent fiscal austerity measures being adopted by European nations should also impede growth overseas somewhat and cut into U.S. exports.

That said, we are not as downcast over recent events as are the double-dip prognosticators. Yes, the housing news is disappointing. But even here, the headlines may overstate the severity of the situation. It appears that at least some of the shortfall in the sales data reflects bottlenecks in the mortgage application process, which may have been clogged up by confusing reporting requirements to qualify for the tax credit. Certainly, the slippage in existing home sales reported by the National Association of Realtors did not square with the strength in pending sales contracts reported earlier by the very same industry group. For another, the fundamentals underpinning the housing industry are not as dire as they might seem. True, the foreclosure pipeline is daunting and poses more of a threat to a housing recovery than anything else. But

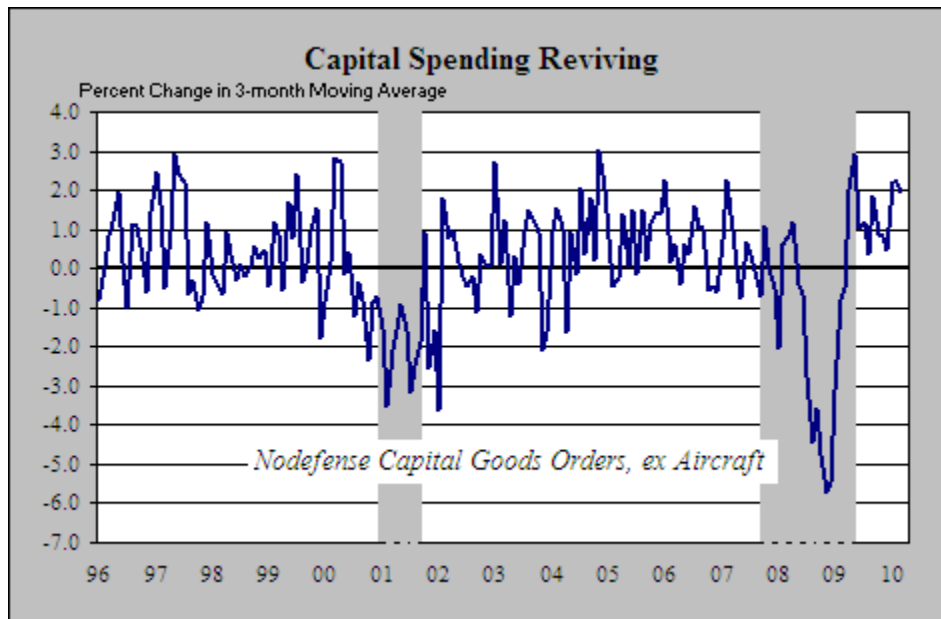
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mortgage rates are currently the lowest in more than fifty years and with home prices down substantially from their peak, housing affordability is at the highest level in decades.

No doubt, the demand for housing remains hostage to the ability of prospective buyers to find jobs. We remain optimistic, however, that the weak employment numbers reported for May will be usurped by a solid rebound in the upcoming jobs report. As income growth accelerates along with the expected job gains, affordability will become more of a magnet that lures a broader swath of the population into the housing market, putting a solid floor under demand and prices. While that will not deter the payback in sales that is bound to occur with the expiration of the tax credit, any sign that the housing market is stabilizing could have amplified positive ramifications for household confidence.

Finally, while the housing market has abdicated its time-honored role as a recovery catalyst, that function is being taken over by business capital spending, which is showing far more vigor than usual during the early stage of an upturn. Last week's Durable Goods report provided further confirmation of that trend. While the headline number was weak, the 1.1% decline in overall durable goods bookings for May was due entirely to a drop in civilian aircraft orders, which typically swings widely (and wildly) from month to month. Extracting just orders for non-defense capital goods, excluding aircraft, a reliable barometer of capital spending, shows that businesses are planning to step up outlays at least as vigorously as they had over the past two quarters. These orders increased by 2.1% in May and stand a robust 17.3% above the same month last year. As the chart shows, that is a torrid showing for this stage of a recovery; more importantly, businesses would not be expanding capital budgets unless they had confidence in future demand prospects and had the cash flow to support such expenditures. Those are fundamental drivers that we believe will lead to a pickup in hiring and sustain the recovery.



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