



WEEKLY ECONOMIC COMMENTARY – WEEK OF JUNE 7, 2010

FINANCIAL INDICATORS				
INTEREST RATES	June 4	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.12%	0.15%	0.12%	0.18%
6-month Treasury bill	0.21	0.22	0.19	0.32
3-month LIBOR	0.54	0.54	0.43	0.63
2-year Treasury note	0.73	0.77	0.82	1.29
5-year Treasury note	1.98	2.09	2.16	2.83
10-year Treasury note	3.20	3.28	3.42	3.85
30-year Treasury bond	4.13	4.20	4.27	4.65
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	1.65	1.68	1.81	2.05
10-Year	3.02	3.02	3.13	3.27
30-Year	4.41	4.38	4.40	4.74
30-year fixed mortgage rate	4.79	4.78	5.00	5.29
15-year fixed mortgage rate	4.20	4.21	4.36	4.79
1-year adjustable rate	3.95	3.95	4.07	4.81
STOCK MARKET				
Dow Jones Industrials	9931.97	10136.63	10380.43	8763.13
S&P 500	1064.88	1089.41	1110.88	940.09
NASDAQ	2219.17	2257.04	2265.64	1849.42
Commodities				
Gold (\$ per troy ounce)	1221.20	1216.10	1208.70	955.10
Oil (\$ per barrel) - Crude Futures (NYMerc)	70.98	74.11	75.35	68.54
ECONOMIC INDICATOR (Latest Month/Quarter)		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Manufacturing Index (May)	59.7	60.4	59.6	58.3
ISM Nonmanufacturing Index (May)	55.4	55.4	55.4	55.3
Nonfarm Payrolls (May) - change in 000s	431	290	208	146
Unemployment Rate (May) - Percent	9.7	9.9	9.7	9.8

Prime Rate: 3.25%

1-Month LIBOR: 0.35%

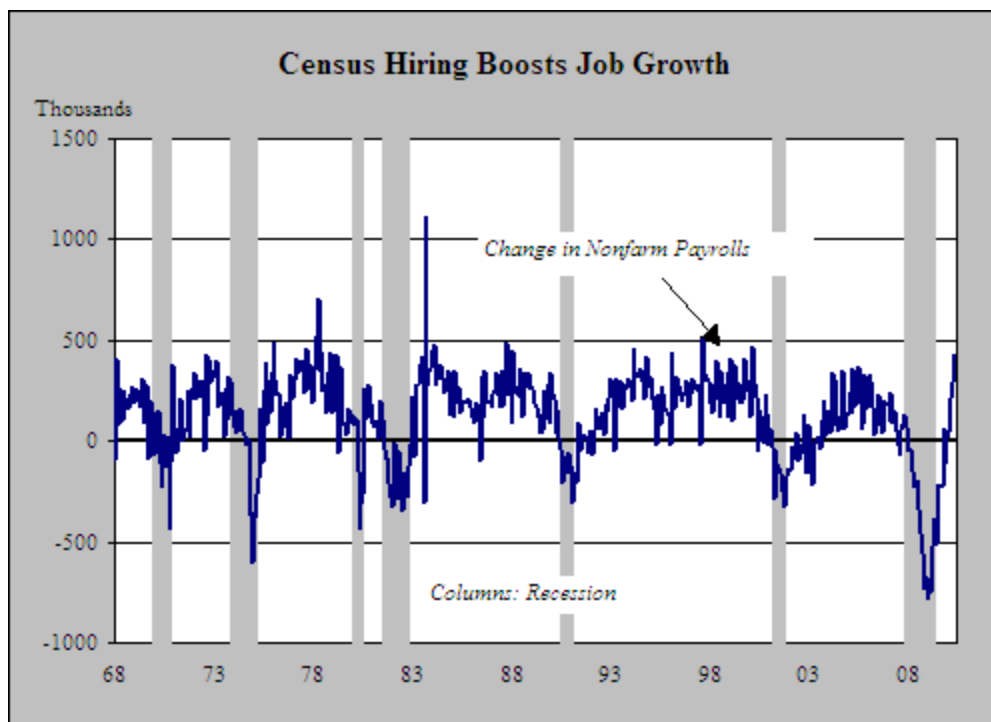
With all of the extraneous shocks buffeting the public psychology – the horrific oil spill, sovereign debt crises, and rising geopolitical tensions in the Middle East and Northeast Asia – the U.S. economy may have gotten short shrift in recent weeks. One reason, aside from the headline-grabbing nature of the aforementioned shocks, is that things appeared to be unfolding smoothly. The recovery that presumably began just about a year ago has shown steady progress, consistently picking up strength and embracing a

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broader swath of economic activity. To be sure, growth has still been weaker than the upturns that followed past harsh recessions. But the economy's recent performance has consistently exceeded expectations, spurring ever-more optimistic forecasts among private economists and policymakers. Indeed, at least three monetary officials last week stated that the time is drawing closer for the Fed to start raising interest rates.

However, the cheerleaders for the economy received a rude awakening on Friday, as the Labor Department issued what appeared to be a disappointing employment report. Yes, the economy generated a healthy 431,000 net new jobs in May (according to the establishment (payroll) survey) the strongest in more than a decade and one that the administration quickly trumpeted as additional signs of gathering strength. But the devil is in the details, and a deeper look into the report reveals a weaker picture than that portrayed by the headline number. For one, most of the increase, 411,000, reflected the government hiring of Census workers. These are temporary positions that are already being eliminated as the decennial census count is nearing an end. By next month, more than 200,000 of them will drop off of the payroll tally, which could possibly drag the June jobs report into negative territory. That could surely dampen household confidence and prove to be a big political negative for the administration as the campaign season for the midterm elections heats up.



If the recovery is to become a self-sustaining upturn that gathers momentum heading into the election, the private sector must step up hiring and generate fatter paychecks. Only then will households gain the confidence and necessary income to consume more goods and services that will fuel the growth engine. For the most part, that trend seemed to be well on track. After a modest 16,000 increase in January, private companies expanded payrolls at an accelerated rate in each subsequent month; 62,000, 158,000 and 218,000 gains in February, March and April, respectively. But then, net job growth in the private sector slowed to 41,000 in May – about 150,000 less than expected. Needless to say, the disappointing report reinforced the above-noted extraneous shocks, sending stock prices sharply lower on Friday and extending a month-long market correction sparked by the European debt crisis.

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The question is, was the abrupt weakening in private job creation last month an aberration or a sign that the recovery is downshifting? Clearly, the job market is the most important link in the recovery process, underpinning consumer spending, home sales, capital spending and even the healing of the financial system. Keep in mind that loan defaults and foreclosure activity remain exceptionally high and pose the biggest threat to the willingness and capacity of banks to extend credit, the lifeblood of economic activity. While loan modification efforts by the government and low refinancing rates help ease that threat, the biggest palliative would come from a vibrant job market that generates strong income growth, boosting the debt repayment ability of households. No doubt, the setback in private hiring in May can understandably be a compelling reason to reassess what had been an ever-increasing optimistic outlook for the economy.

That said, while a pause for reflection may be in order, we see no reason for the optimists to head for the hills – at least not yet. True, if the geopolitical backdrop worsens considerably – and the entrance of Hungary into the group of financially distressed nations last week is not a good sign – that would deepen the simmering European debt crisis and heighten the potential contagion effects throughout the global financial markets. The current tailspin of the U.S. stock market at least partly reflects that possibility, as investors are growing increasingly nervous over the similarities between the sovereign debt crisis and the subprime mortgage debacle that sparked the financial meltdown a year later. However, one big difference between the two episodes is that policy makers both here and abroad now have the advantage of experience under their belts, having just lived through a crisis that provided some valuable lessons on how to contain its consequences. Simply put, they are better prepared – and have more of an incentive – to take decisive action before the crisis becomes as intense as it did in the fall of 2008.

Assuming that the overseas shocks are contained, we do not view the latest jobs report as a game changer for the economy. Admittedly, the economy's sterling performance in recent months may have overstated the fundamental strength underpinning the recovery. By the same token, economists could have overreacted to incoming reports, extrapolating the headline strength revealed by key indicators into the future. History shows that recoveries rarely move in a straight line; this one should follow a particularly jagged course, if only because of the recurring pattern of some powerful temporary influences. During the first stage that lasted through the early months of this year, for example, growth was heavily dependent on a strong inventory cycle and stimulus from Washington, reinforced by some temporary tax credits aimed at boosting home and car sales. Those catalysts jump-started the recovery, but their influence is now waning.

On the surface, it would be reasonable to conclude that the fading impact of these influences will lead to a downshifting in growth in coming quarters. Although that prospect would be a big disappointment to economists who have been raising their forecasts in recent months, it is consistent with the consensus view that prevailed earlier in the year. A key difference between now and then is that fears of a double-dip recession were much higher then than now. The key reason why most economists expect the recovery to be sustained is the stronger than expected revival in the job market that has taken place since the start of the year. While the May jobs report is a setback, it does not alter that perception. Indeed, despite the disappointing growth in private jobs – and the overall downbeat tenor of the report – not all of the news was negative.

For one, the slim 41,000 increase in private payrolls follows outsized gains in March and April. Just as the previous monthly gains probably overstated the actual strength in hiring practices, the abrupt slowdown in May likely exaggerated the weakness in job creation. To get a clearer sense of the trend, it is more appropriate to smooth out the month-to-month fluctuations. By this metric, total payrolls show an average gain of 310,000 over the past three months, more than double the 146,000 average over the past six months. Private payrolls show a similar pick-up, rising from a 69,000 average increase over the past six months to a 140,000 average over the most recent three months. The major difference between the absolute changes in these measures, of course, is the more than half-million Census workers added to payrolls over the past three months. That divergence will continue over the next few months, with total payrolls showing far more weakness than private payrolls due to the elimination of the temporary Census jobs.

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In reality, the strength of the job market falls between the robust March/April reading and the weak May tally. To be sure, some of the weakness in May reflects underlying fundamentals. For example, the big drop in construction jobs (- 35,000) during the month is consistent with developments in the construction industry. The May drop fully reversed the 27,000 and 14,000 gains in construction jobs in March and April, which were no doubt assisted by the housing tax credit that encouraged homebuilding during those months. With the expiration of the credit at the end of April, homebuilders probably cut back hiring as they built fewer single-family homes. However, the drop off in residential construction should be mitigated in coming months by the bottoming out in nonresidential activity, which appears to be finally showing some signs of life.

On the positive side, manufacturing payrolls continued to register a healthy increase, rising by another 29,000 in May. That was the fifth consecutive gain in jobs at factories and spot on with the 25,000 average gain over the previous three month period. Manufacturing, of course, has been the consistent bright spot throughout the recovery, reflecting a rebound in inventory building and strong gains in export orders. It's unclear how much of a negative impact the pending slowdown in Europe will have on manufacturing activity. Keep in mind that sales to Asia and other developing nations in Latin America are taking a larger slice of the export pie than is Europe, and those nations continue to grow rapidly. If the latest surveys of purchasing managers at leading manufacturing companies are any indication, manufacturing should continue to make a strong positive contribution to growth in coming months. The latest ISM manufacturing index for May slipped ever-so-slightly from the six-year high hit in April.



More broadly, a positive takeaway from the May jobs report is that worker paychecks are getting a lift from wage increases and longer working hours. Average hourly earnings of all private employees increased by a solid 0.3% during the month and the average workweek expanded to 34.2 hours, the longest in about a year and a half. Higher wages and a longer workweek mean that folks with jobs are taking home bigger weekly paychecks, injecting more purchasing power into the spending stream. And with weekly earnings increasing at a faster pace than inflation, those dollars are going a longer way in real terms. The recent pronounced weakness in oil prices, coming as it does at the start of the peak driving season, will be the

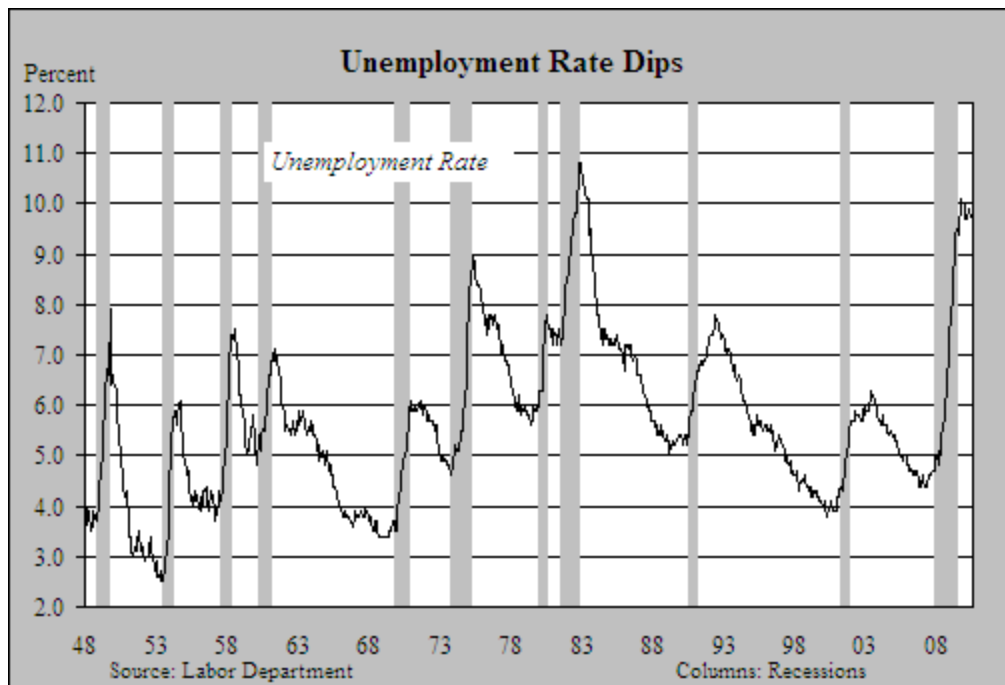
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most visible near-term impetus to discretionary purchasing power that households will experience over the summer months.

Another positive component of the jobs report was the drop in the unemployment rate to 9.7% from 9.9%, as well as the decline in the so-called underemployment rate from 17.1% to 16.6%. These dips were larger than expected and are encouraging developments on the margin. However, it would be wrong to draw too much optimism from these metrics as they may be declining for the wrong reasons – i.e. more people are dropping out of the labor force. That, of course, is a disturbing trend, which is consistent with the lengthening of the time it takes for an unemployed worker to find a job. In May, nearly 6.8 million, or a record 45.2% of the 15 million people officially unemployed, were out of work for at least 27 weeks. The longer someone is out of a job, the harder it is to find one. This is a distressing reminder of how deep a hole the economy is still in, and how much of an uphill climb still lies ahead. Again, these numbers might be taken with a grain of salt, as continued extensions of unemployment benefits could be a factor in the amount of time some workers are taking to find a job. Lastly, the growth in temporary workers has continued for 8 straight months – adding over 361,000 workers for the largest 8-month gain since the collection of data on this sector began in 1990. Given the uncertainty employers face on so many fronts (taxes, health care, etc.), it's no surprise that they are cautious about adding permanent workers.

Friday's headlines chose to focus on the disappointing number of private sector jobs created (41,000) in May. Keep in mind that is only one side of the employment coin - the establishment survey side. The other side is the 178,000 new private sector jobs that were uncovered by the household survey (which calculates the 9.7 % unemployment rate). Growth in private sector jobs, according to the household survey, has totaled 1.33 million new jobs so far this year, while we have seen only 495,000 new jobs according to the establishment survey. Historically, the household survey tends to lead the establishment survey (particularly in the first years of a recovery), so we are not ready to throw in the towel just yet. The real truth may well fall somewhere in the middle of the two surveys. The road to recovery is not a straight one, but we are headed in the right direction and, more importantly, still on the road.



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