

WEEKLY ECONOMIC COMMENTARY – WEEK OF MAY 24, 2010

FINANCIAL INDICATORS				
INTEREST RATES	May 21	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.15%	0.15%	0.15%	0.17%
6-month Treasury bill	0.21	0.21	0.23	0.29
3-month LIBOR	0.50	0.45	0.32	0.66
2-year Treasury note	0.75	0.78	1.07	0.88
5-year Treasury note	2.00	2.16	2.59	2.20
10-year Treasury note	3.21	3.46	3.81	3.45
30-year Treasury bond	4.08	4.34	4.66	4.38
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	1.75	1.81	1.83	1.84
10-Year	3.09	3.14	3.20	3.08
30-Year	4.39	4.40	4.44	4.59
30-year fixed mortgage rate	4.84	4.93	5.07	4.82
15-year fixed mortgage rate	4.24	4.30	4.39	4.50
1-year adjustable rate	4.00	4.02	4.22	4.82
STOCK MARKET				
Dow Jones Industrials	10193.39	10620.16	11204.28	8277.32
S&P 500	1087.69	1135.68	1217.28	887.00
NASDAQ	2229.04	2346.85	2530.15	1692.01
Commodities				
Gold (\$ per troy ounce)	1177.30	1231.10	1156.50	957.20
Oil (\$ per barrel) - Crude Futures (NYMerc)	70.19	71.91	85.07	61.56
ECONOMIC INDICATOR (Latest Month/Quarter)		Previous Month/ Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
Housing Starts (April) - 000s	672	635	606	615
Consumer Price Index (April) - % change	-0.1	0.1	0.0	0.1
Core CPI (ex. Food & energy) - % change	0.0	0.0	0.1	0.0
Producer Price Index (April) - % change	-0.1	0.7	-0.6	0.6
Core PPI (April) - % change	0.2	0.1	0.1	0.2

Prime Rate: 3.25%
1-Month LIBOR: 0.34525%

Something is rotten in Denmark (or is it Athens?) Whether it's the Greek Tragedy, financial reform legislation, new stock market rules, or just a general apprehension over the direction of the economy - something is clearly amiss in the financial markets. With the major stock indexes plunging last week, and the much-ballyhooed 10% correction now in the books, anxiety has clearly usurped optimism in the minds of investors. Nor is it just stocks; everything in sight seems to be in the crosshairs of the bears - gold, industrial commodities, the Euro and any bonds that do not have "Treasury" in their names.

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The troubling state of affairs is not likely to subside until more clarity on Europe's sovereign debt quagmire comes into focus. Germany, belatedly and reluctantly, agreed to commit funds to the \$1 trillion in loan guarantees to EU members in distress (final approval was granted by the upper parliament on Friday), but with Greek workers demonstrating on the streets to keep their lucrative pensions and Spain's labor unions planning a strike against austerity measures, it's clear that not all is quiet on the European front. So the question is: how bad can the European mess get? More to the point, how could it affect us here in the U.S.? With so many variables involved – politics, ego, cultural differences, tradition, etc. – it is extremely difficult to answer the first question. That said, the longer the crisis is allowed to fester, the deeper that negative psychology will become ingrained in the minds of investors and traders - heightening the threat of another financial crisis. As it is, risk aversion is running rampant, which is a time-honored precursor of a credit squeeze, something that is readily apparent in the abrupt widening out of quality yield spreads.

Clearly, the ripple effects of the European debt crises have spread to the U.S. markets and are causing many to re-evaluate the prospects for the U.S. recovery. At least one Federal Reserve Board Governor has come out with cautionary statements regarding the threat posed by overseas headwinds. From our lens, however, it is too early to conclude that the U.S. economy will be severely affected. Indeed, the Fed itself just released its latest forecast, which contains an upward revision to its growth outlook this year. As the graphic shows, the central bank now sees real GDP expanding within a range of 3.2% – 3.7% in 2010, up from a January forecast of 2.8% – 3.5%. This is the third consecutive upward revision, consistent with the steadily more upbeat forecasts being held by private economists, as reflected in the Blue Chip indicators.

Table 1. Economic projections of Federal Reserve Governors and Reserve Bank presidents, April 2010

Percent

Variable	Central tendency ¹				Range ²			
	2010	2011	2012	Longer run	2010	2011	2012	Longer run
Change in real GDP	3.2 to 3.7	3.4 to 4.5	3.5 to 4.5	2.5 to 2.8	2.7 to 4.0	3.0 to 4.6	2.8 to 5.0	2.4 to 3.0
January projection	2.8 to 3.5	3.4 to 4.5	3.5 to 4.5	2.5 to 2.8	2.3 to 4.0	2.7 to 4.7	3.0 to 5.0	2.4 to 3.0
Unemployment rate	9.1 to 9.5	8.1 to 8.5	6.6 to 7.5	5.0 to 5.3	8.6 to 9.7	7.2 to 8.7	6.4 to 7.7	5.0 to 6.3
January projection	9.5 to 9.7	8.2 to 8.5	6.6 to 7.5	5.0 to 5.2	8.6 to 10.0	7.2 to 8.8	6.1 to 7.6	4.9 to 6.3
PCE inflation	1.2 to 1.5	1.1 to 1.9	1.2 to 2.0	1.7 to 2.0	1.1 to 2.0	0.9 to 2.4	0.7 to 2.2	1.5 to 2.0
January projection	1.4 to 1.7	1.1 to 2.0	1.3 to 2.0	1.7 to 2.0	1.2 to 2.0	1.0 to 2.4	0.8 to 2.0	1.5 to 2.0
Core PCE inflation ³	0.9 to 1.2	1.0 to 1.5	1.2 to 1.6		0.7 to 1.6	0.6 to 2.4	0.6 to 2.2	
January projection	1.1 to 1.7	1.0 to 1.9	1.2 to 1.9		1.0 to 2.0	0.9 to 2.4	0.8 to 2.0	

To be sure, the latest Fed forecast was generated at the most recent policy-setting meeting on April 27-28, and revealed in the minutes of that meeting released last week. It remains to be seen if the escalation of the crisis since then has sparked second thoughts among policy makers. So far, only the aforementioned cautionary remarks by Fed Governor Daniel Tarullo last week has been made public. However, beginning Friday, and throughout this coming week, at least five members of the Fed will be delivering remarks with a heavy international content, which should give us a better idea of what the evolving thinking is. We suspect that their comments will be laced with cautionary language, which will reinforce the prevailing view that the Fed is prepared to retain a low-rate accommodative policy for a longer period of time than was envisioned before the European crisis erupted.

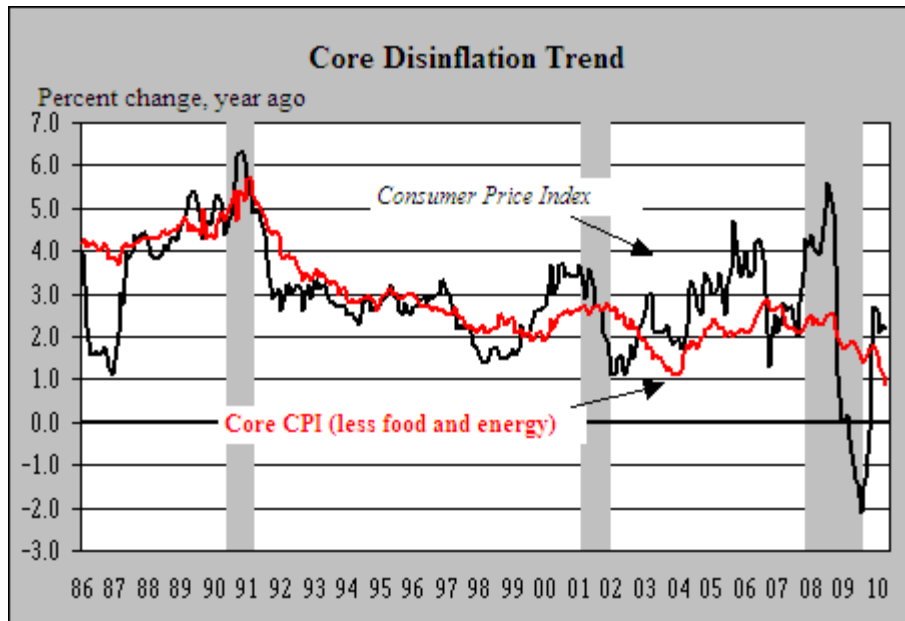
Indeed, notwithstanding the improving growth forecasts, there is clearly little urgency for the Fed to start rescinding its easy policy. The one catalyst for such a move would be a sign that inflationary pressures are starting to percolate alongside a more rapidly growing economy. Aside from the downside growth risks associated with the European debt crisis, the inflation threat is looking more remote than any time in generations. If anything, a strong disinflationary trend prevails, with a whiff of deflation in the air. That's the inescapable reality brought strikingly to the fore by incoming data on retail and wholesale prices. The most visible – and policy-sensitive – barometer of price developments can be found in the consumer price index, where the rate of increase is sliding alarmingly close to zero.

According to the Labor Department's latest figures, the CPI fell 0.1% in April, owing largely to a big drop in energy prices that more than offset a 0.2% increase in food prices. The core CPI, which excludes volatile

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food and energy prices, was flat for the second consecutive month and now stands a mere 0.9% above the level of a year ago. That annual gain is the slimmest in 44 years, since January 1966 – the tail end of the last true Goldilocks era of low inflation and strong economic growth before the ill-fated “guns and butter” philosophy associated with the Vietnam War was adopted as a policy mantra.



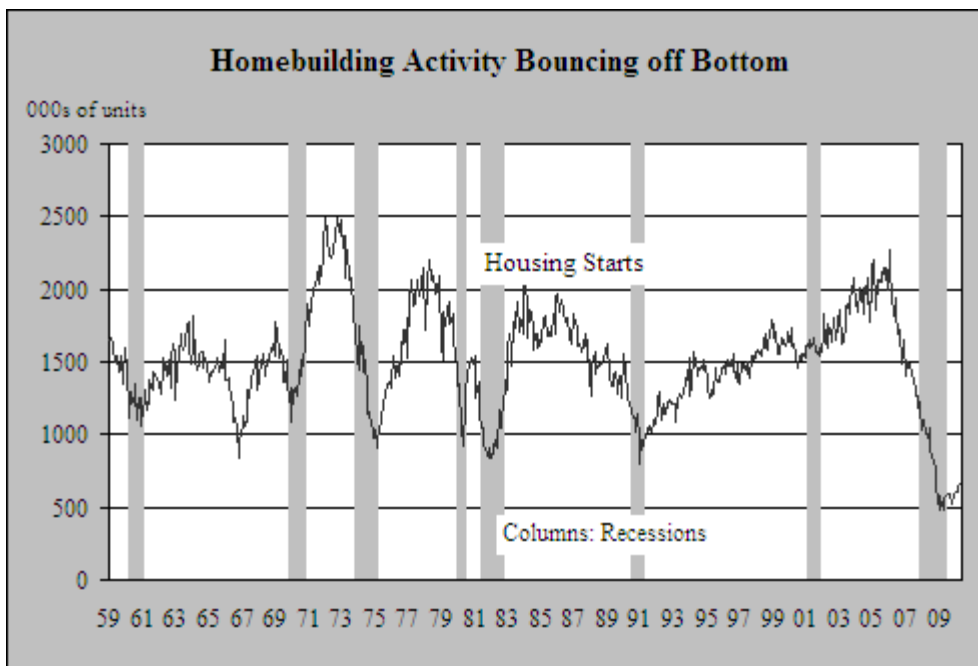
Still, the persistent slowdown in the core inflation rate has not been a unanimously accepted fact. Over the past couple months there has been a vibrant debate among financial market economists and within the Federal Reserve System about whether the weakness in certain housing price indexes is exaggerating the degree of disinflation in the US. If so, one might make the case that the behavior of recent inflation measures -- including the core CPI and other popular inflation gauges -- has been misleading, exaggerating the disinflationary trend.

The nearby peak in core CPI growth was a 2.9% year-over-year gain in September 2006. At the time, the CPI's owners' equivalent rent (OER) and residential rent components accounted for about 1.5 percentage points of that 2.9% gain. In the April 2010 data, these shelter price components are contributing about zero to the 0.9% annual gain in the core CPI. Clearly, most of the deceleration in core retail inflation has been due to flat-to-lower residential rents and OER. But there is little doubt that core inflation is declining even without the inclusion of rent and OER. This is true whether one looks at the core CPI or the other price measures. And at this juncture, it still appears that greater-than-desired disinflation is a larger risk in the near term than is faster-than-desired inflation.

Perhaps the most appropriate way to view the inflation picture is to separate the housing from other broader economic influences. The housing impact is palpable, reflecting the real estate meltdown that continues to drag the price measures lower. Indeed, despite tentative signs that the residential collapse has ended and a slow recovery has set in, it is still unclear how much of the nascent strength stems from the government's tax credits, which undoubtedly boosted sales, cleared out inventories of unsold new homes, and stimulated construction activity. That was apparent in April, as builders broke ground on 635,000 housing units, up 5.6% from March and a hefty 41.0% above the all-time low of 477,000 units hit exactly one year ago.

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But with the expiration of the tax credits, the question remains if the April spike represented the last hurrah from the tax-related wave. On this score, building permits for future construction plunged by 11.5% during the month, the steepest drop since November 2008, and household intentions to purchase a new home fell to the second lowest level in 25 years, according to the latest consumer confidence report. Time will tell if the housing industry can stand on its own two feet without the tax stimulus. We suspect that further downward pressure on the owners' equivalent rent and actual rents is in store as the housing market continues to unwind from its overheated state prior to the bust. However, rather than view this adjustment as part of a systemic deflationary trend, we see it more as a healthy realignment between rents and incomes from what had been an unsustainable trajectory.

We also suspect that the broader economic influences will reinforce the disinflationary trend coming from the housing side over the near term. After all, with so much slack still in the labor and product markets, it is hard to see where upward price pressures will come from. Labor costs are still well contained and scattered increases in some commodity prices have been short-circuited by the latest financial turmoil, which threatens to reduce the demand for all industrial commodities as global economic growth slows. Oil prices have already staged a significant drop, settling around \$70 a barrel on Friday from a recent high of over \$88 on April 30, just before the Euro debt crisis hit the radar screens.

Indeed, cheaper oil might be one of several positive influences that the European debt crisis could have on the U.S. economy. Just as sky-high oil prices helped puncture the housing bubble in 2008, the steep descent now could act as an economic lubricant, freeing up household cash for spending. Meanwhile, the fear factor underpinning the crisis is spurring a flight to quality, which means foreign capital is flooding the market for dollar-denominated assets, particularly Treasury securities. That's driving Treasury bond yields down to the lowest level of the year, with knock-on effects on mortgage interest rates, which hit the lowest level in more than five months this week. Finally, the disinflationary impact of slower European growth, cheaper oil and a potential reining in of expectations regarding the strength of the U.S. recovery gives the Federal Reserve a mandate to retain its ultra easy monetary policy for a longer period of time. Unless the sovereign debt crisis leads to a confidence-shattering global credit crunch, the U.S. economy should weather the storm without much damage. Time will tell.

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