



WEEKLY ECONOMIC COMMENTARY – WEEK OF MAY 31, 2010

FINANCIAL INDICATORS					
INTEREST RATES	May 28	Week Ago	Month Ago	Year Ago	
3-month Treasury bill	0.15%	0.15%	0.16%	0.12%	
6-month Treasury bill	0.22	0.21	0.23	0.18	
3-month LIBOR	0.54	0.50	0.35	0.25	
2-year Treasury note	0.77	0.75	0.96	0.80	
5-year Treasury note	2.09	2.00	2.42	2.31	
10-year Treasury note	3.28	3.21	3.66	3.62	
30-year Treasury bond	4.20	4.08	4.52	4.56	
Tax-Exempt Revenue Bonds (Triple-A)					
5-Year	1.68	1.75	1.78	1.54	
10-Year	3.02	3.09	3.15	3.10	
30-Year	4.38	4.39	4.44	4.45	
30-year fixed mortgage rate	4.78	4.84	5.06	5.05	
15-year fixed mortgage rate	4.21	4.24	4.39	4.40	
1-year adjustable rate	3.95	4.00	4.25	4.15	
STOCK MARKET					
Dow Jones Industrials	10136.63	10193.39	11008.61	10325.26	
S&P 500	1089.41	1087.69	1186.69	1104.49	
NASDAQ	2257.04	2229.04	2461.92	2238.26	
Commodities					
Gold (\$ per troy ounce)	1216.10	1177.30	1179.30	1116.90	
Oil (\$ per barrel) - Crude Futures (NYMerc)	74.11	70.19	86.02	79.69	
ECONOMIC INDICATOR (Latest Month/Quarter)		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.	
New Home Sales (April) - 000s of units		504	439	338	392
Existing Home Sales (April) - 000s of units		5770	5360	5010	5520
Consumer Confidence (May) - Index		63.3	57.7	52.3	55.0
Durable Goods Orders (April) - % change		2.9	0.0	0.5	1.5
Personal Incomes (April) - % change		0.4	0.4	0.0	0.3
Personal Consumption (April) - % change		0.0	0.6	0.5	0.4

Prime Rate: 3.25%

1-Month LIBOR: 0.35088%

Although the sovereign debt crisis still casts a dark cloud over the financial markets, the turbulence it created subsided over the course of last week. That said, investors are hardly at peace with the consequences of a potential default by Greece or by other weaker members of the European Union. Nor are they indifferent to the negative impact that the austere measures required to bring deficits under control will

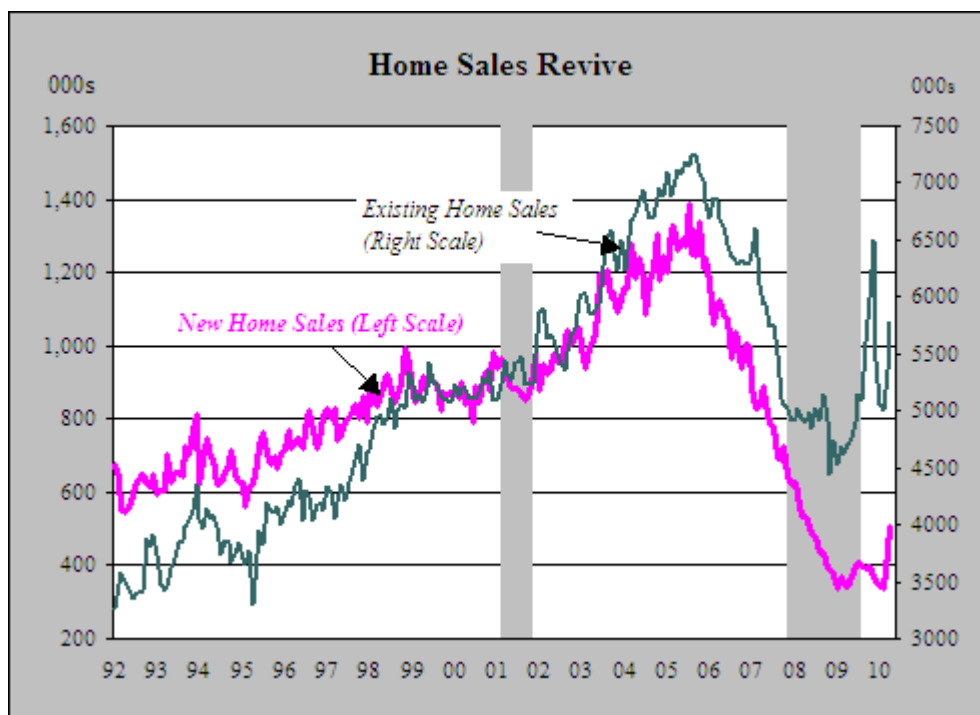
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have on global growth. Lingering concerns over these issues continue to underpin a flight to quality, although the flood of foreign capital into dollar-denominated assets has receded somewhat, putting at least a temporary floor under the free-falling Euro.

Quite possibly, market participants have already priced in a worst-case scenario, and are hopeful that policymakers have gotten enough of a grip on the situation to contain the crisis. It's also quite possible that another unexpected shock could erupt in coming weeks, causing market turmoil to flare up again. We'll keep our helmets on until a clearer picture emerges. Investors are undoubtedly drawing some comfort from incoming economic data, which continue to reveal a recovery that is looking more and more consistent and sure-footed. At least that's the impression conveyed by the latest reports on housing, personal income, consumer confidence and capital spending.

On the surface, the housing data look the most promising - revealing a sharp jump in sales for new and existing homes in April. The sales data follow an equally upbeat report on housing starts last week, which should come as no surprise. Homebuilders clearly anticipated the tax-related spike in sales, which encouraged them to break ground on more new homes. The question is, however, the same as the one we raised last week. Is this merely the last hurrah of a housing rebound sparked by the generous tax credit that expired at the end of April? Or is a solid foundation finally being formed that will lead to a sustainable housing recovery?



There should be little doubt that the tax credit has had an impact. One clear sign of this is the mix of homes being sold, which is skewed towards lower-priced units aimed at buyers who are more likely to be influenced by the credit. This pattern of sales has also contributed to the decline in median home prices, reinforcing the downward pull coming from an upsurge in supply from distressed sales and from sellers coming out of the woodworks, willing to unload their homes at lower prices. To the extent that the tax credit has inflated sales, some payback can be expected in coming months. There will be a lag before the payback is reflected in the housing data, as contracts signed and closings associated with the tax credit will continue to have an influence over the next month or two. But some relapse in both starts and sales can be expected over the summer months.

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Having said that, the relapse should be less severe than the one that followed the first installment of the tax credit, which was originally set to expire in November before being extended through April. For one, the extension did not generate as much of a spike in sales as did the first installment; hence, the payback should be less pronounced. For another, the financial backdrop is more favorable now than they were just a few months ago. Lenders are more willing to extend credit to mortgage applicants and mortgage rates are hovering near the lowest levels in a generation. With new home prices almost 10 percent below year-earlier levels and bargains galore available from existing home sellers, housing affordability is the highest it has been in decades. These are powerful supports for an industry that is steadily emerging from the worst meltdown in modern history, and should help to sustain a modest housing recovery over the balance of the year once the distortions from the tax credit are unwound.

But while housing appears to be on the recovery track, it will not provide the usual spark to the broader economy that it usually does coming out of a recession. The problems in the housing market run deep, with the foreclosure wave continuing to be a major depressant that will take years to resolve. That missing spark is a major reason that many doubt that a “V-shaped” recovery will play out this time around. Still, the recovery is looking more impressive with each passing month, and the vigor of the upturn continues to surprise most forecasters. As noted last week, the Federal Reserve upgraded its growth outlook for the year, and last week the OECD joined the growing chorus of prognosticators expecting stronger growth in the global economy. To be sure, the latest iteration of forecasts was made before the sovereign debt crisis became as intense as it has in recent weeks. But assuming the crisis is contained – a big if, to be sure – there is no reason to doubt the more optimistic outlook now commanding headlines.

Our own sense of optimism is being reinforced by the behavior of consumers, which is the linchpin of any recovery. The latest revision to the first quarter GDP figures took the overall growth rate down by a notch – from 3.2% to 3.0% – reflecting a small downward revision in consumer spending, from an initial estimate of a 3.6% increase to 3.5%. That’s hardly an alarming revision, and still reveals a solid spending pace by households. If anything, an argument could be made that for the longer-run sustainability of the recovery, households need to rein in spending and focus more on repairing balance sheets that were badly damaged during the recession. That means paying down debt and rebuilding savings, which had been drawn down to woefully low levels during the housing and credit bubbles of a few years ago.

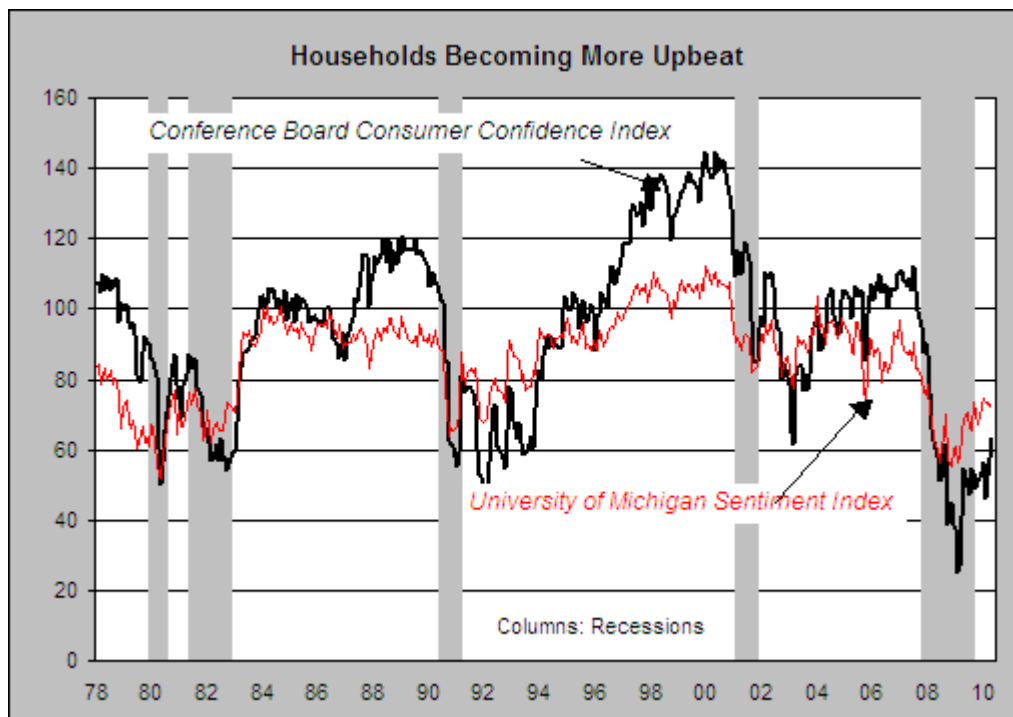
During the first several months of the recovery last year, it was thought that the balance sheet repair process would be a long drawn-out affair that would see the personal savings rate climb to 6 or 7 percent (or even higher) over a period of years. Since the rate plunged to under 1 percent in the spring of 2008, a climb of that magnitude would have taken a big bite out of consumption, all but dooming any chance of a normal recovery. And with the prospect of lackluster consumer demand looming on the horizon, the odds of a solid rebound in job growth seemed remote, further inhibiting the income capacity of households to step up spending. But a variety of positive forces coalesced to usher in a faster rebound in consumer spending than expected, enabling the economic recovery to gain a more substantial foothold than generally envisioned toward the end of last year.

The positive thrust was spearheaded by the government in the form of rebate checks and other tax incentives aimed at encouraging spending, particularly for autos and houses. The effects of Washington’s massive stimulus package were palpable, giving a big lift to consumption last summer and fall. While the incentives waned in the fourth quarter as did consumer spending, forces were set in motion that gave the recovery more “oomph” and substance. The spending binge cleared out inventories, prompting companies to step up orders to refill shelves with merchandise. That, in turn, spurred manufacturers to rev up production and start hiring more workers, which fed back to the spending stream. While household incomes were slow to respond, the balance-sheet repair process received a major assist from the stock market. An astonishing rally in stock prices restored more than \$5 trillion in household wealth over the second half of last year. Meanwhile, residential property values stabilized which, together with heavy mortgage paydowns, enabled homeowners to recapture some equity in their homes. Slowly but surely, households

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were feeling more secure in their financial condition, and that sense of security heightened as the job market came to life. Not surprisingly, key measures of consumer confidence have been on a solid uptrend since last fall.



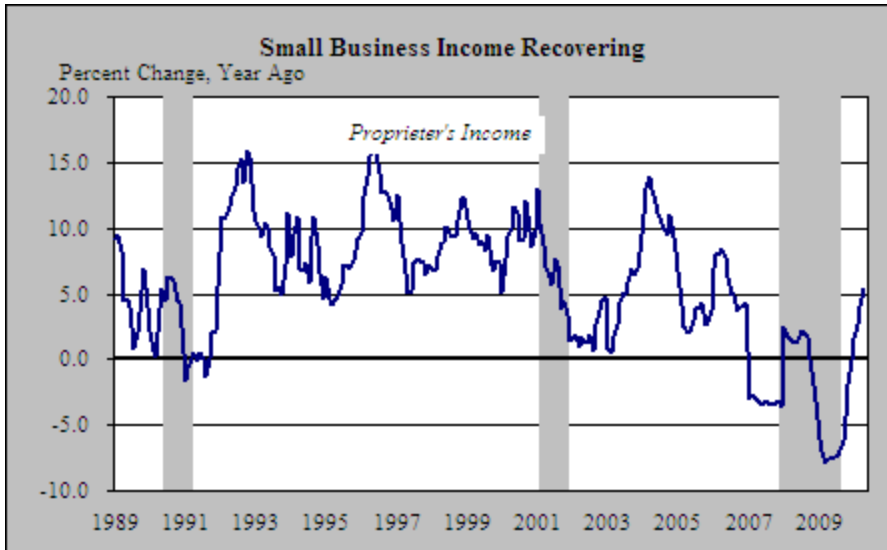
Going forward, households will not be able to rely on government incentives to sustain spending, and you have to wonder if the stock market will provide the boost to wealth that it has over the past year. Hence, organic sources of income growth will have to kick in, something that can only come from more jobs and fatter paychecks. Fortunately, that's precisely the phase of the recovery that is now in gear. Since reviving at the start of the year, the job market has been boosting payrolls at a faster pace than thought possible a few months ago. We will get a better sense of how that trend is being maintained with the May jobs report due this Friday (June 4), but the rebound in job growth is having the predictable positive impact on income. That was evident in the latest income and spending figures released last week.

Forget the relatively modest 0.4% increase in personal incomes for April, which was a tad below expectations. The increase, for one, was held down by reduced government transfer payments, something that is supposed to happen when employment conditions improve. The more relevant component is for wages and salaries – the organic source of income growth derived from the job market. In April, labor compensation increased by a solid 0.4%, only the second time it increased as much for any month since November 2007. True, the income increase was not matched by spending, which remained essentially flat for the month. That means households chose to put aside more of their paychecks into savings, which rose to 3.6% of disposable incomes from 3.1% in March. However, we view that as a positive rational development, indicating that consumers are on a gradual and steady course of rebuilding savings. What's more, the unchanged spending last month follows robust – and unsustainable – gains of 0.6% and 0.5% in March and February, respectively. Hence, there was hardly any giveback of those increases, leaving spending at a high level going into the second quarter. Assuming even modest monthly gains of 0.2% in May and June, consumer spending in the second quarter should equal the hefty 3.5% growth rate posted in the January-March period.

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What we find equally as impressive in the April income report is the resurgence of revenues at small businesses. The 1.3% increase in proprietors' income was the largest for any month in nearly five years, and lifted the annual growth rate to 5.4%, the highest since June 2006. This is important for two reasons. First, stronger income gains increase the creditworthiness of small businesses, which have been starved for credit for more than two years. Improving profits and incomes will no doubt make banks and other institutions more willing to extend loans to these companies, ending the long drought. Second, small businesses constitute the major engine of job growth during recoveries. With income growth accelerating, reflecting stronger sales, and credit becoming more available, the brightening prospects for this key sector of the economy may well jump-start a faster pace of hiring in coming months. More than anything, that would help to offset the headwinds blowing in from the sovereign debt crisis and keep the recovery in the U.S. on track.



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