

WEEKLY ECONOMIC COMMENTARY – WEEK OF AUGUST 9, 2010

FINANCIAL INDICATORS				
INTEREST RATES	August 6	Week Ago	Month Ago	Year Ago
3-month Treasury bill	0.14%	0.14%	0.15%	0.13%
6-month Treasury bill	0.18	0.19	0.19	0.28
3-month LIBOR	0.41	0.45	0.53	0.46
2-year Treasury note	0.50	0.55	0.62	1.30
5-year Treasury note	1.50	1.60	1.84	2.82
10-year Treasury note	2.82	2.91	3.06	3.85
30-year Treasury bond	3.99	3.99	4.04	4.61
Tax-Exempt Revenue Bonds (Triple-A)				
5-Year	1.33	1.33	1.56	1.72
10-Year	2.75	2.76	2.95	3.25
30-Year	4.37	4.37	4.38	4.83
30-year fixed mortgage rate	4.49	4.54	4.57	5.22
15-year fixed mortgage rate	3.95	4.00	4.07	4.63
1-year adjustable rate	3.55	3.64	3.75	4.78
STOCK MARKET				
Dow Jones Industrials	10653.56	10465.94	10197.72	9370.07
S&P 500	1121.64	1101.60	1077.93	1010.48
NASDAQ	2288.47	2254.70	2196.45	2000.25
Commodities				
Gold (\$ per troy ounce)	1206.80	1183.70	1210.00	956.90
Oil (\$ per barrel) - Crude Futures (Nymex)	80.92	78.93	76.25	70.55
ECONOMIC INDICATOR (Latest Month/Quarter)		Previous Month/Qtr	Two-Months/ Qtrs Ago	Average-Past 6 Months or Qtrs.
ISM Manufacturing Index (July)	55.5	56.2	59.7	58.0
ISM Non-manufacturing Index (July)	54.3	53.8	55.4	54.6
Personal Income (June) - % change	0.0	0.3	0.4	0.3
Personal Consumption (June) - % change	0.0	0.1	-0.1	0.2
Nonfarm Payrolls (July) - change in 000s	-131	-221	432	-136
Unemployment Rate (July) - Percent	9.5	9.5	9.7	9.7

Prime Rate: 3.25%

1-Month LIBOR: 0.29%

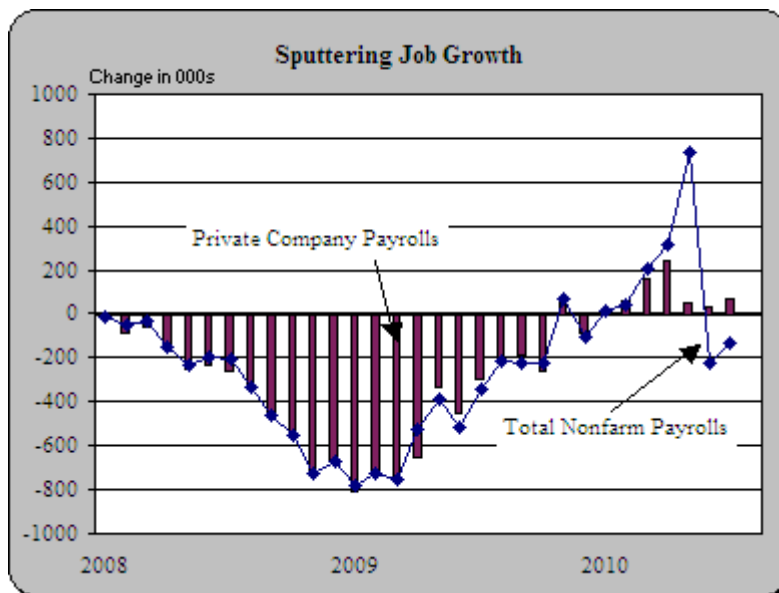
As we get closer to the mid-term elections in November, incumbents are going to have a tough time finding positive things to say about the economy. Granted, the worst recession in the postwar period ended a year ago and the administration can argue that the aggressive and unprecedented steps taken by Washington has prevented a catastrophe from happening. What's more, the recovery would be considerably weaker than it

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is turning out to be if not for those measures. It remains to be seen, however, if that argument resonates with a voting public that remains extremely anxious about a sickly job market that shows few signs of healing anytime soon.

Clearly, the latest jobs report on Friday did not shine a brighter light on the employment situation. The economy shed another 133,000 jobs in July, following a 221,000 drop in June - which was about 100,000 more than originally estimated last month. As expected, the termination of 144,000 government census workers was the main culprit behind the dismal reading. But the private sector is barely taking up the slack. During the month, private companies added 71,000 workers to payrolls, which was less than the 90,000 or so that Wall Street economists were expecting. Not surprisingly, Wall Street did not react well to the news. Stocks slumped on Friday as investors fled to the safety of Treasury securities, knocking yields down to barely visible levels. Short term yields out to two years are already at record lows, and the 10-year issue slipped below the tight 2.85% - 3.15% range it held over the past six weeks, closing at 2.82%. As recently as early April, the 10-year note was yielding just a tad under 4.00%.



Of course, the economy looked much different in early April than it does now. Back then, the recovery appeared to be progressing according to a time-honored cyclical script that promised to whittle down unemployment at a steady pace. Indeed, with more growth cylinders kicking in, including a solid rebound in consumer spending, the Federal Reserve started to consider an exit strategy from its overly easy monetary policy, lest inflation pressures begin to flare-up. That was then. After adding an average of 200,000 workers a month to payrolls in March and April, private companies have since pulled back sharply. Over the past three months, private job creation has averaged an anemic 51,000. On the positive side, the 71,000 gain in July was the largest of the three months - but even that comes with a caveat, as about 20,000 of the gain reflects unusual activity in the auto sector. GM kept open 9 of 11 plants during what would normally be a summer shutdown for re-tooling purposes.

Nor is it just the private sector that is not living up to expectations. Government workers are joining the unemployment lines in droves. Forget the falloff of census jobs, which were temporary to begin with and are scheduled to disappear almost entirely over the next two months when the final 150,000 or so enumerators will stop receiving paychecks. A severe and growing problem is occurring on the state and local level, where burgeoning property and income tax revenues during the prerecession years padded public payrolls. Those halcyon years, however, have evaporated along with the housing bust and Great Recession, which vaporized tax revenues. As a result, state and local authorities are under severe financial

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strains, and are forced to lay off workers at an astonishing rate. In July, they reduced payrolls by 48,000 workers, bringing the total reduction for the year to 170,000. Add to that the millions of public-sector employees who are being forced to work shorter hours because of budget constraints.

Quite possibly, the bleeding at the state and local level is thinning out. The Senate (thankfully?) returned from recess to pass a \$26 billion emergency aid bill aimed at helping states fund incremental Medicaid and education spending. The long slide in tax revenues also seems to have been arrested. That should stanch the layoffs of teachers and other public employees. But job security in the government sector is no longer the bulwark it had been during past periods of economic adversity. Facing yawning deficits and a public becoming less tolerant of the lucrative pensions embedded in labor contracts made during more prosperous years, the government workforce could continue to shrink in the months ahead. In Washington, fiscal austerity is the mantra of the day; hence, in addition to the 144,000 laid-off census workers, another 11,000 Federal employees lost their jobs last month.

But it is in the private sector where the rubber meets the road as far as the economy's fundamental performance is concerned. The reluctance of corporations to step up hiring more than they have is creating the most angst among policy makers worried about the sustainability of the recovery. Clearly, the monthly average of 90,000 private-sector jobs created over the first seven months of the year is not nearly enough to keep up with the growth in the labor force, much less the adult population. The fact that the unemployment rate held steady at 9.5% in July should not detract from an overall discouraging jobs picture. Only a fall in the labor force prevented the rate from rising. Indeed, the labor force participation rate, the fraction of the working-age population in the labor force, fell back to 64.6%, which matches the lowest rate in more than two decades.

Simply put, people are likely dropping out of the labor force because of poor job prospects. Those who continue to look for gainful employment may soon run out of patience. The average duration of unemployment stands at a lofty 34.2 weeks. While that is off from the record high of 35.2 weeks in June, the current level is far above the peaks reached in previous recessions. The corollary to this dispiriting reading is the outsize number – 6.57 million – of workers that have not drawn a paycheck for at least 27 weeks. The plight of the long-term unemployed is one of the most tenacious problems facing the nation; the longer a person is out of a job, the more difficult it becomes to get hired. Job skills erode over time if not used, and companies are reluctant to hire someone who has been unemployed for an extended period.

To be sure, the disappointing performance of the job market in recent months mirrors that of the overall economy, which takes the element of surprise out of the latest employment report. After all, companies do not operate in a vacuum. When the economy is going good – or at least improving – the incentive to take on more workers is greater. Such was the case during the spring, as the March / April spurt in job creation noted earlier followed a sturdy increase in economic growth reported for the fourth quarter of last year and the early months of this year. Corporate optimism turned higher, buoyed by a resurgence in profits and stock prices. But after posting impressive quarterly growth rates of 5 percent and 3.7 percent, the economy downshifted abruptly in the second quarter, with real GDP increasing by a sub-par 2.4 percent during the period. At the same time, the clouds overhanging the business environment turned murkier, punctuated by the sovereign debt crisis.

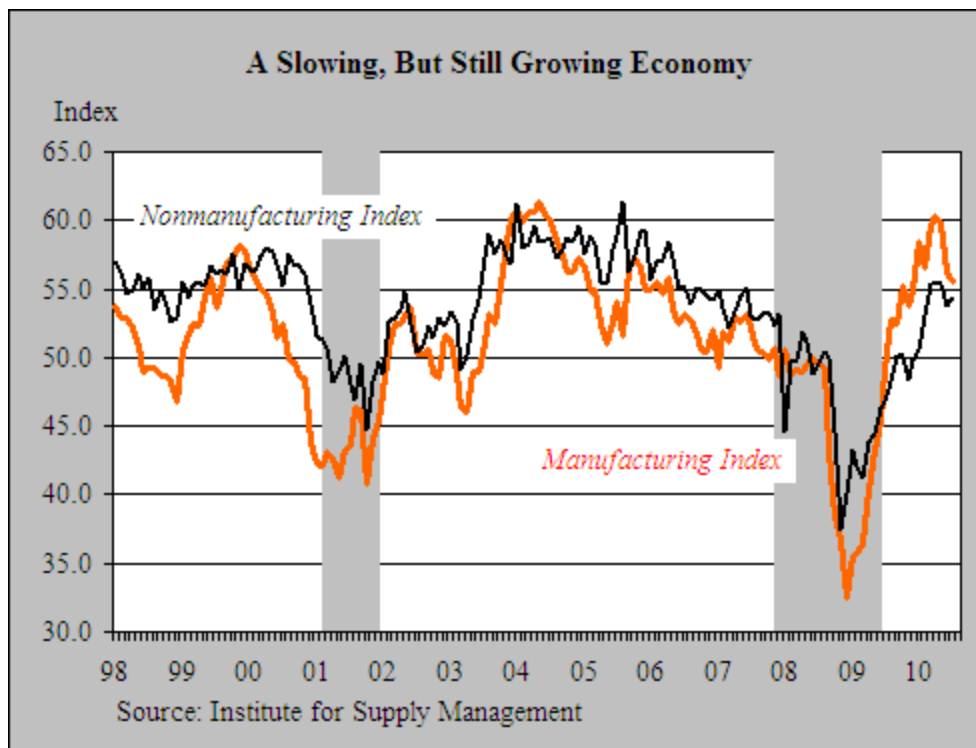
Suddenly, talk of a double-dip recession took center stage, which further darkened the outlook for corporate CEOs. With inventories replenished and demand softening, the incentive to take on additional workers clearly diminished, leading to the pullback in hiring that has unfolded in recent months. As we have discussed in previous commentaries, we do not subscribe to the double-dip scenario, but it would be foolish to dismiss that prospect out of hand. Expectations of a downturn can become a self-fulfilling prophecy if it promotes negative behavior on the part of consumers and businesses. The plunge in household confidence in recent months, largely in response to the poor job market, may well lead to a sharp spending retrenchment that would amplify the slowdown. Likewise, expectations of sluggish demand for their

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products may well keep companies from hiring workers or, more ominously, motivate them to extinguish more jobs.

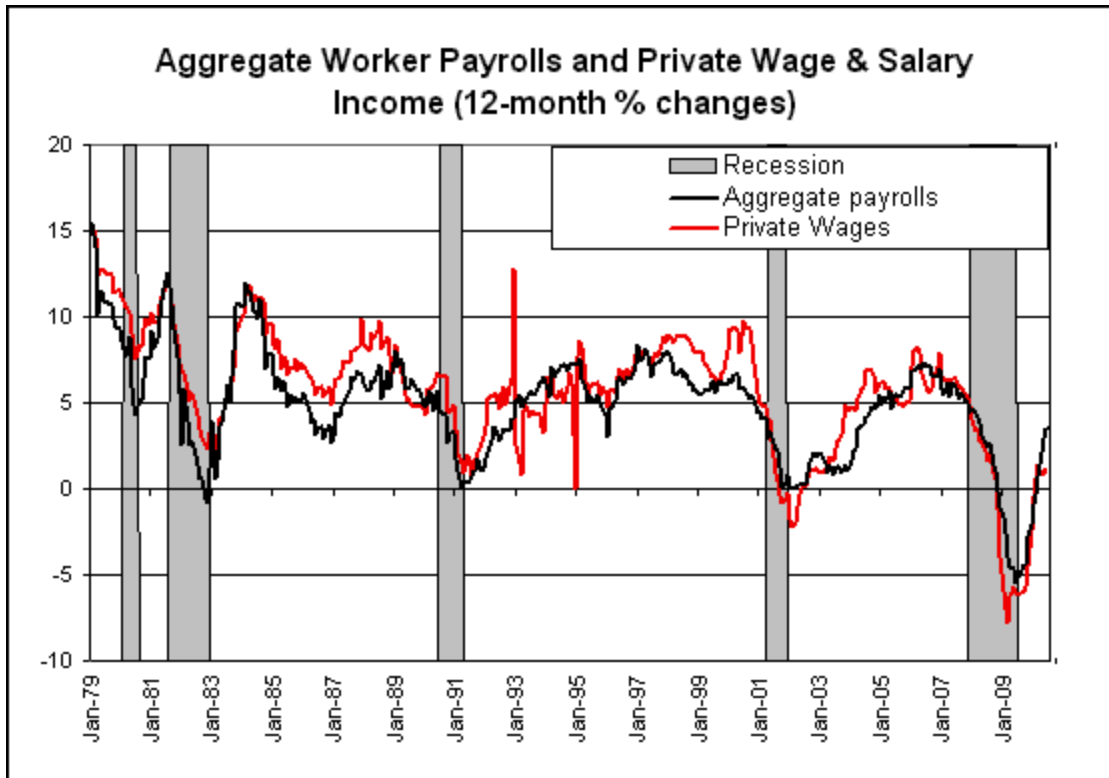
From our lens, the economy has indeed hit a speed bump but is not poised to fall off a cliff into another recession. Barring an unexpected external shock, there is no reason to think that companies will shrink payrolls in the months ahead. While the economy has slowed, it is still growing. For example, the latest surveys of manufacturing and non-manufacturing activity by the Institute for Supply Management are consistent with a growth rate in the neighborhood of 2% – 2.5%. With employment growing at 1% (barely enough to keep pace with the growth in the labor force, but growing nonetheless), and productivity tracking its long-term average of 2%, we see growth closer to 3%. While not robust by any means, it is still supportive of a recovery that remains firmly on a positive track. Recent reports from overseas reveal that Europe turned in a solid growth rate in the second quarter, notwithstanding the debt crisis, which has positive implications for U.S. exporters and, hence, manufacturing.



Even the otherwise disappointing jobs report contained some silver linings (you knew they were coming) that bode modestly well for consumer demand. While more jobs were lost, workers put in longer hours and their average pay rose. The Labor Department has recently compiled a new series, called aggregate payrolls, which captures the essence of changes in employment, hours worked and hourly earnings in the private sector, which has turned out to be a reliable barometer of wages and salaries. This measure jumped by a sizeable 0.6% in July, more than reversing a 0.3% drop in June. According to last week's personal income report by the Commerce Department, incomes were flat in June and wages and salaries actually fell by 0.1%. However, if the aggregate payroll measure holds true to its historical record, workers should enjoy a nice rebound in their paychecks for July.

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Whether that translates into stronger consumer demand or goes into higher savings remains to be seen. The point is that households are building a base of purchasing power that should put a floor under spending and prevent an outright contraction in overall activity. That said, the prospect of a further downshifting in growth to below a 2 percent pace in the current quarter remains a possibility, which will keep the double-dip debate front and center in the immediate future. It should be interesting to see what the Federal Reserve does at its next policy meeting Tuesday (August 10). With the economy on perilous turf, many are calling on the Fed to provide more stimulus (or at least indicate that it will sustain the existing support for a longer period than it previously asserted). It will be an interesting meeting, which we will discuss in greater detail next week.

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