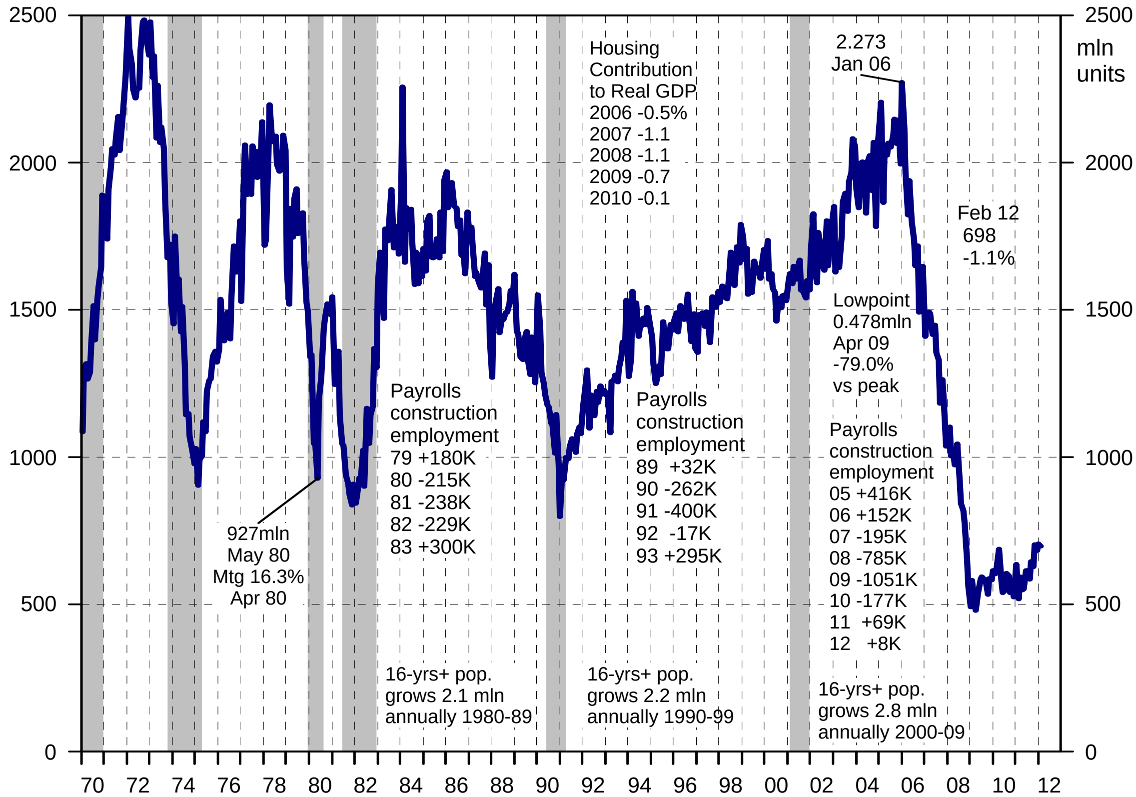
Financial Market Weekly

Christopher S. Rupkey, CFA
Managing Director
Chief Financial Economist
(212) 782-5702

March 23, 2012

ONE STUMBLING BLOCK TO THE RECOVERY HAS BEEN HOUSING

Housing starts have hit bottom for this recession expected to recover further in 2012

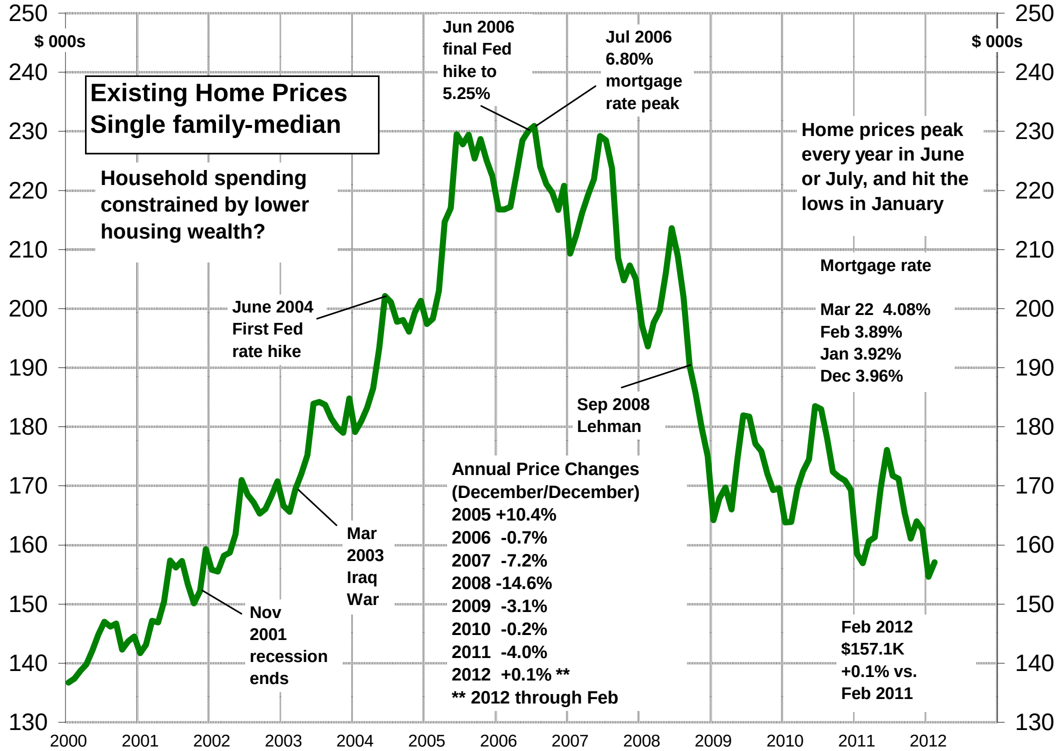


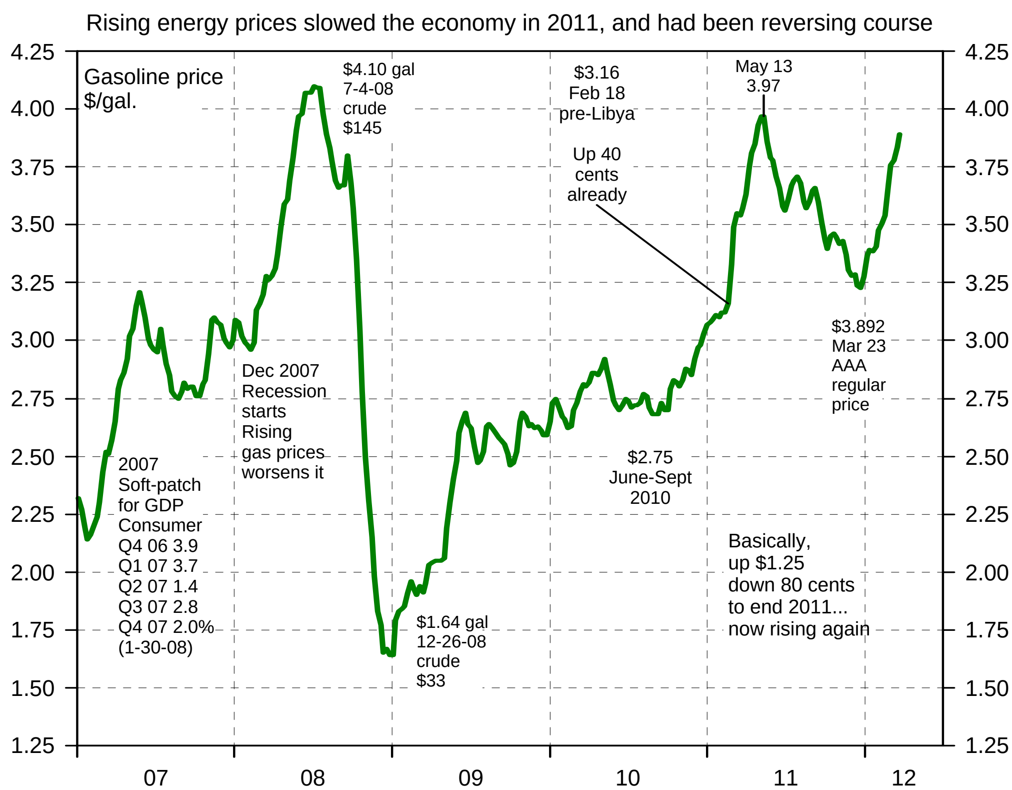
Shaded areas represent economic recessions

Housing starts peaked at 2.273 million in January 2006 and the unprecedented decline in construction activity eventually brought the rest of the economy down with it. Since housing figured importantly during the bad times, "fixing housing" is seen as one of the keys to the recovery. Federal Reserve Governor Duke gave testimony to congress on February 28 on "The Housing Market." Her remarks drew on the January 4, 2012 famous Fed staff paper, "The U.S. Housing Market: Current Conditions and Policy Considerations," which has been criticized by some in congress for making recommendations on public policy issues. Fed Governor Duke summarized the Fed's concern: "the failure of the housing market to respond to lower interest rates as vigorously as it has in the past indicates that factors other than financial conditions may be restraining improvement in mortgage credit and housing market conditions and thus impeding the economic recovery." Private payroll jobs creation is running quite fast now at 200K per month, so housing's slowing of the recovery seems less of a concern. But the real GDP recovery does seem to be more on the wrong side of the 3% divide between moderate growth and growth that is a subpar 2%.

Looking at housing construction over the last four decades this big drop fits the profile of the worst recession since the great recession. Housing starts hit bottom in April 2009, and now, three years later, it looks like the recovery in payroll employment is likely to raise construction to the 1 million annual rate level this year.

Housing starts have recovered so far to 698K in February. How much can rising residential construction add to the real GDP economy? After the early 90s recession and the thrift crisis, housing starts lifted from a 1 million annual rate to 1.5 million by 1994. In percentage points, the housing contribution to real GDP was 0.5% in 1992, 0.3% in 1993, and 0.4% in 1994. GDP will probably get another 0.5 percentage point boost the next couple of years with a housing starts forecast of 1.2 million by the end of 2013. Driving this forecast is the reduced number of homes built since 2009. Housing is a very cyclical industry, but it is also one that moves with longer term demographic fundamentals. As time goes on, there have been fewer homes constructed since 2009, yet the population has been growing an average of 2.8 million per year from 2000-09. The longer housing stays in the dumps, the more pent-up demand there is going to be which will boost construction closer to our forecast.

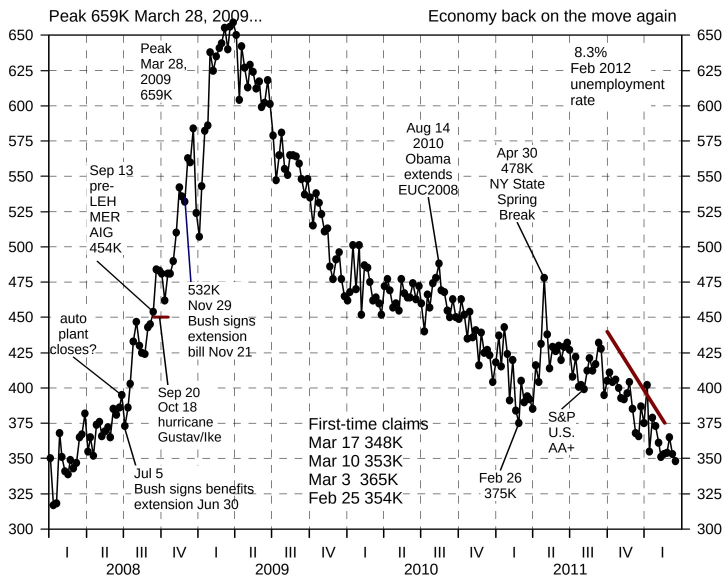


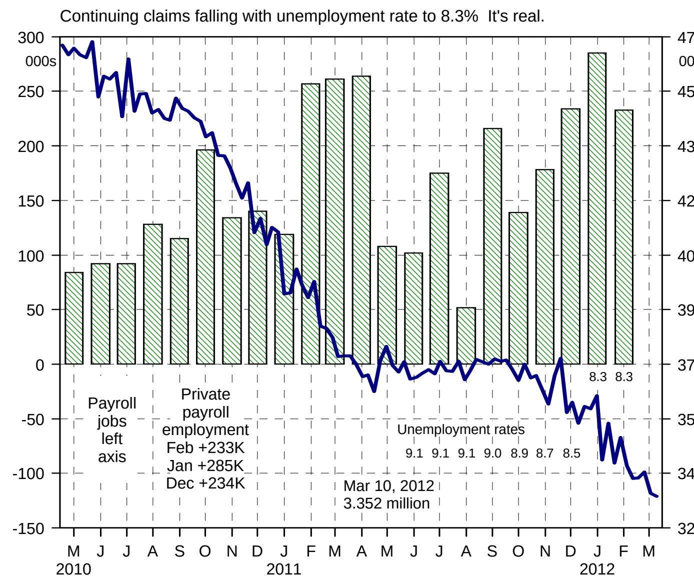


We aren't sure it is appropriate to target zero interest rates just because housing construction is not where it was prior to the recession. But there are always risks out there even if "strains in global financial markets have eased," and if the Fed needs one to justify its subpar expectations for economic conditions until "late 2014," there is always the price of gasoline. Gasoline prices of $3.89 are not a roadblock to the expansion yet, but prices of $4.25-4.50 would likely slow consumption expenditures for a quarter or two.

INITIAL JOBLESS CLAIMS AT POST-RECESSION LOW: 200K+ JOBS TO CONTINUE

Initial unemployment claims fell to a new low since the recession ended at 348K in the March 17 week. The overall picture of weekly unemployment claims is consistent with a fourth consecutive month of 200K-plus payroll jobs when the March data are released Friday, April 6. Gasoline prices have not risen as much as in 2011, but could still become a factor which slows growth. Unemployment claims rose about 50-75K from the February 26, 2011 low of 375K last year, and a move of similar magnitude in 2012 would mean a slowdown.

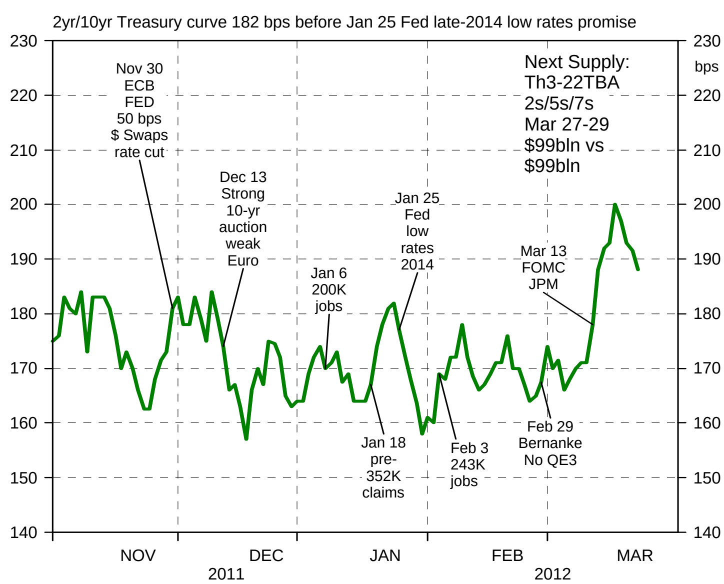


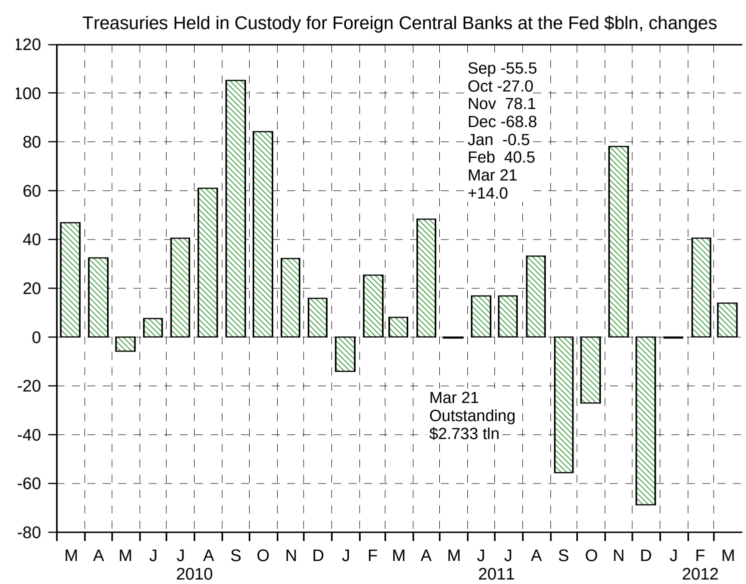


10YR YIELDS RISE: FEARS OVER EURO AREA EASE: 20% OF WORLD ECONOMY

The yield curve between 2-yrs and 10-yrs was +188 bps on Friday versus +193 bps last week. The curve steepening after the Fed statement and JPMorgan stock buyback last week stalled at 200 bps on Monday. Some new worries about Europe, focusing on Spain, and stock market weakness Tuesday, Wednesday and Thursday, brought 10-yr Treasury yields back down about 15 bps from 2.42% resistance.

	30-Dec 2011	Q1 2012	Q2 2012	Q3 2012	Q4 2012	Q1 2013
10-Yr Note	1.88	2.20	2.50	2.90	3.20	3.40
2-Yr Note	0.24	0.30	0.30	0.50	0.80	1.80
3-month Libor	0.58	0.50	0.50	0.50	0.60	1.25
Federal Fund Rate	0.25	0.25	0.25	0.25	0.25	0.75
2s/10s spread	164	190	220	240	240	160





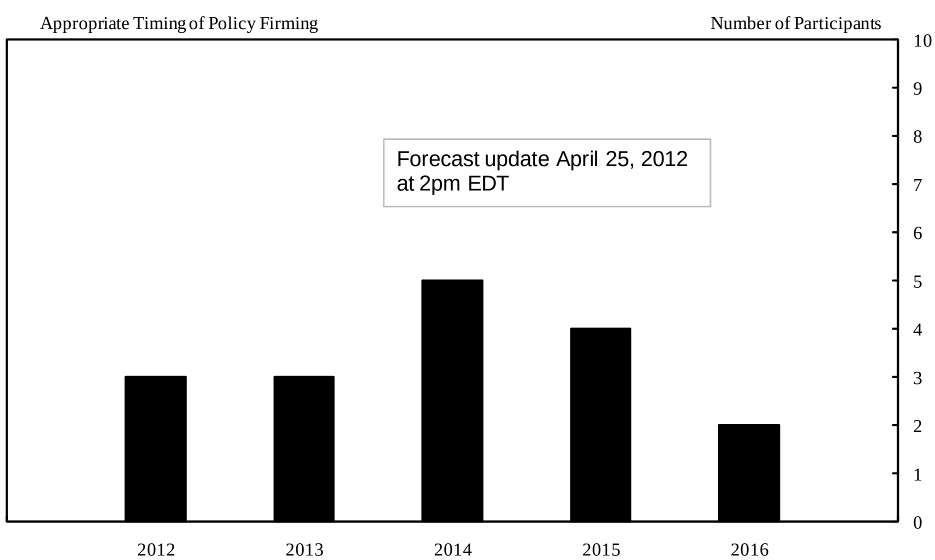
UnionBank MUFG

FEDERAL RESERVE POLICY

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	21-Mar	14-Mar	7-Mar	29-Feb	pre-LEH
Factors adding reserves					
U.S. Treasury securities	1663.484	1659.768	1659.279	1661.601	479.782
Federal agency debt securities	98.992	99.803	99.803	100.817	0.000
Mortgage-backed securities	851.260	853.885	840.796	840.795	0.000
Primary credit (Discount Window)	0.003	0.003	0.009	0.015	19.000
Term auction credit (TAF auctions)	0.000	0.000	0.000	0.000	150.000
Asset-backed TALF	7.289	7.374	7.417	7.564	
Maiden Lane (Bear)	5.422	5.362	6.453	6.439	29.287
Maiden Lane II (AIG)	0.019	3.635	3.635	7.301	0.000
Maiden Lane III (AIG)	17.449	17.434	17.720	17.611	0.000
Central bank liquidity swaps	65.593	64.873	71.386	107.763	62.000
Federal Reserve Assets	2936.2	2936.6	2927.8	2968.9	961.7
3-month Libor %	0.47	0.47	0.47	0.48	2.82
Factors draining reserves					
Term Deposit Facility	0.000	0.000	0.000	0.000	
Treasury supplemental bill auctions	0.000	0.000	0.000	0.000	
Reserve Balances (Net Liquidity)	1542.805	1564.372	1602.126	1605.170	24.964
Treasuries within 15 days	16.991	17.067	20.587	16.720	14.955
Treasuries 16 to 90 days	28.040	27.886	24.364	28.228	31.549
Treasuries 91 days to 1 year	53.727	55.709	55.708	64.782	69.272
Treasuries over 1-yr to 5 years	581.934	591.007	599.626	600.747	170.807
Treasuries over 5-yrs to 10 years	707.665	697.055	691.931	687.885	91.863
Treasuries over 10-years	275.127	271.044	267.063	263.238	101.337

**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08

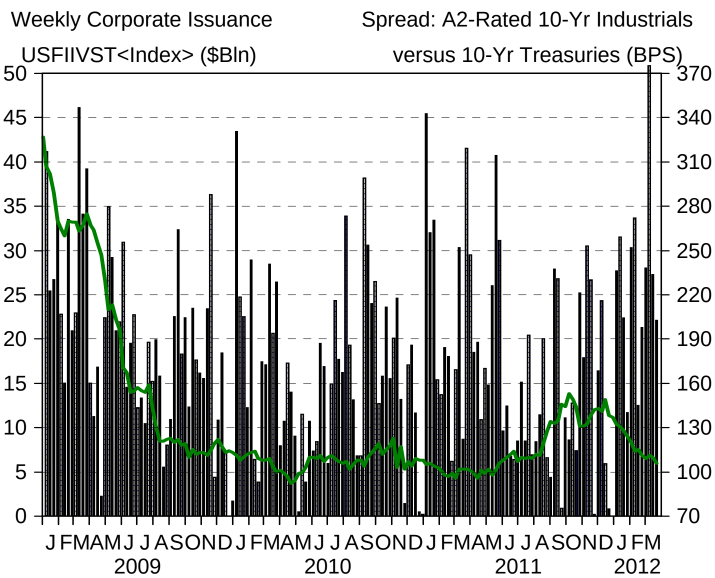
The Fed meets April 24-25 to consider its monetary policy. They will release their new forecasts of the likely timing of the first rate hike for this cycle. The table below of the forecasts released January 25 are the origin of the conditional low rates till "late 2014" promise even if there are three of seventeen members wanting to hike rates in 2012, yes, even before our early 2013 call, and 2 wanting to hike rates in 2016. We assume Chicago Fed President Evans is one of those 2016ers, as he has said he wants to do even more as long as the unemployment rate is 7% or higher. Payroll jobs are running over 200K per month now however, and out bet is the 8.3% unemployment rate will decline closer to Evans' 7% by early next year.

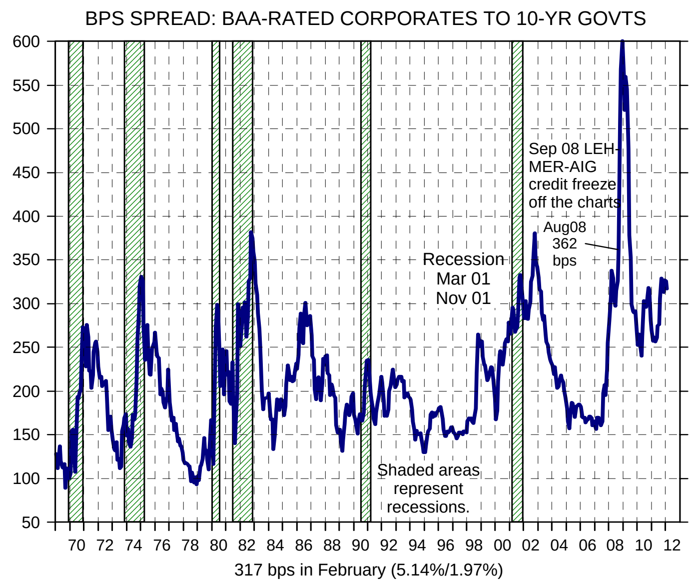


The Fed Chairman is speaking on "Recent Developments in the Labor Market" on Monday, March 26 at the National Association for Business Economics conference in Arlington, Virginia. The one-variable unemployment rate has become crucial to the timing of the first Fed rate hike. Since the Fed made its forecasts on January 25, the economy has created almost 800 thousand additional private nonfarm payroll jobs. It sounds like a big number and it is. The economy has now created 3.938 million private nonfarm payroll jobs since the lows following the 2007-09 recession. We would like to think Bernanke will say there has been sound improvement in the labor market outlook-improvement would bring the market's expectation of the first rate hike forward from "late 2014." But we expect nothing will change much from his comments in recent testimonies. It is rare for new information on monetary policy to come out in between FOMC meetings even from the Chairman. He has said that even though the unemployment rate is 8.3% in February (already achieving the Fed's Q4 2012 8.2-8.5% forecast 11 months ahead of schedule), other labor market indicators show signs of stress. The labor market is far from normal as far as the Fed is concerned as 5.4 million have been out of work for more than six months (43% of the total), and an additional 8 million are only working part-time because they cannot find full time work. We are keeping our early 2013 first Fed rate hike call however, conditional on payroll jobs running close to 200K for the rest of this year.

CORPORATES: AMERICAN EXPRESS, CATERPILLAR, SEMPRA ENERGY, RIO TINTO

Corporate bond offerings were $22.1 billion in the March 23 week versus $27.3 billion in the March 16 week. On Monday, Husky Energy priced $500 million 3.95% 10-yrs at 160 bps (Baa2/BBB+). The company is one of Canada's largest integrated energy companies and will use the proceeds for general corporate purposes including the repayment of some of its debt securities. Corporate bonds (10-yr Industrials rated A2) were 106 bps above 10-yr Treasuries on Friday versus 110 bps last Friday.





TREASURY MARKET OUTLOOK

EXPECTED 10-YR 2-3 WEEK TRADING RANGE 2.10% to 2.42%

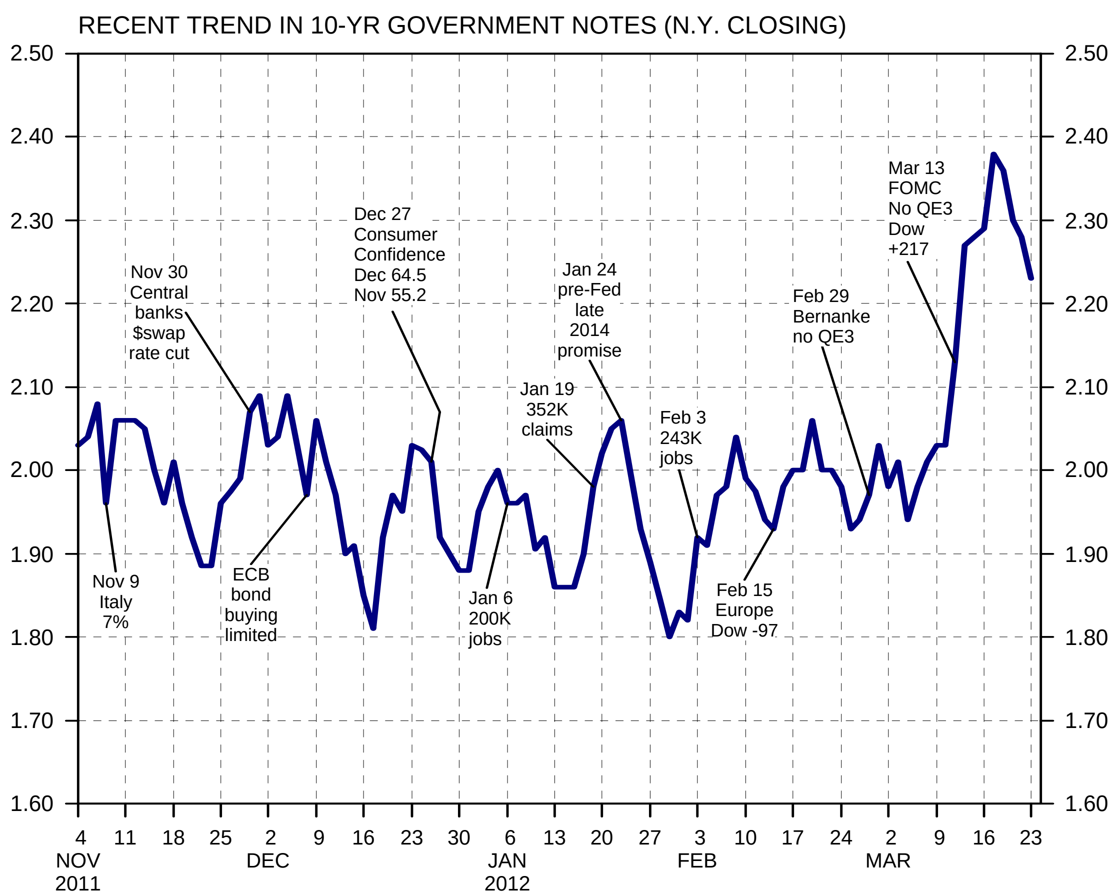
Week's 10-YR Range

HIGH 98-04+ 2.21%

Friday, March 23, Bunds rallying on Europe worries

LOW 96-17 2.40%

Tuesday, March 20, continued follow-through selling early in week until Bernanke tells CNBC economic conditions are still challenging



Analyst Certification

The views expressed in this report accurately reflect the personal views of **Christopher S. Rupkey**, the primary analyst responsible for this report, about the subject securities or issuers referred to herein, and no part of such analyst's compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed herein.

About UnionBanCal Corporation & Union Bank, N.A.

Headquartered in San Francisco, UnionBanCal Corporation is a financial holding company with assets of $89.7 billion at December 31, 2011. Its primary subsidiary, Union Bank, N.A., is a full-service commercial bank providing an array of financial services to individuals, small businesses, middle-market companies, and major corporations. The bank operated 414 branches in California, Washington, Oregon, Texas and New York, as well as two international offices, on December 31, 2011. UnionBanCal Corporation is a wholly-owned subsidiary of The Bank of Tokyo-Mitsubishi UFJ, Ltd., which is a subsidiary of Mitsubishi UFJ Financial Group, Inc. Union Bank is a proud member of the Mitsubishi UFJ Financial Group (MUFG, NYSE:MTU), one of the world’s largest financial organizations.