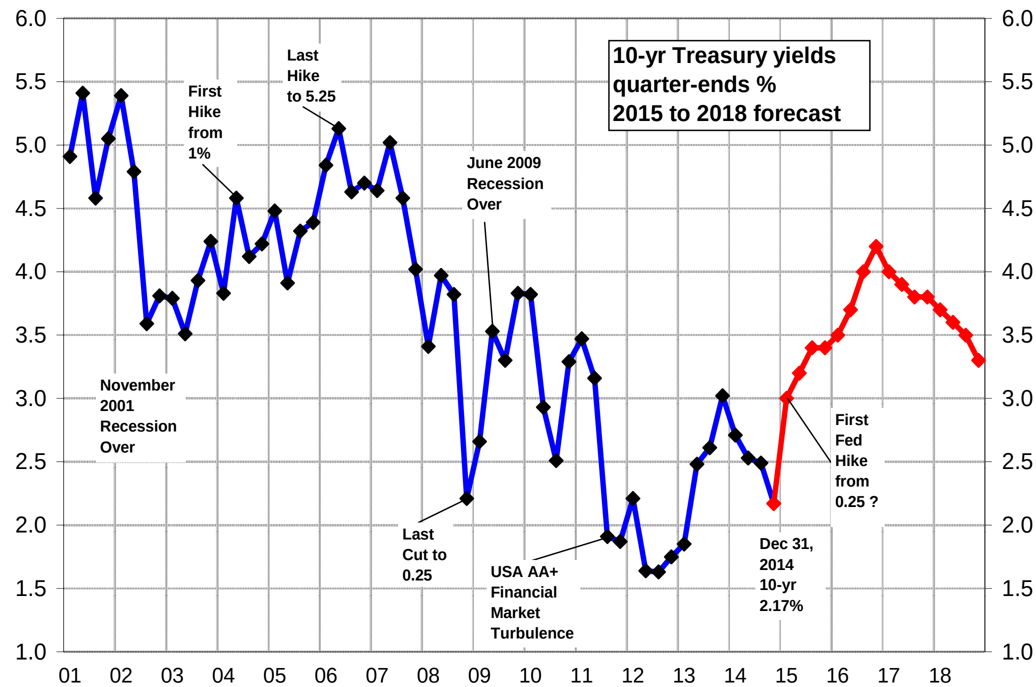
Financial Market Weekly

CHRISTOPHER S. RUPKEY, CFA
MANAGING DIRECTOR
CHIEF FINANCIAL ECONOMIST
ECONOMIC RESEARCH OFFICE (NEW YORK)
(212) 782-5702
crupkey@us.mufg.jp

The Bank of Tokyo-Mitsubishi UFJ, Ltd.
A member of MUFG, a global financial group

2 JANUARY 2015

2015 ECONOMIC OUTLOOK

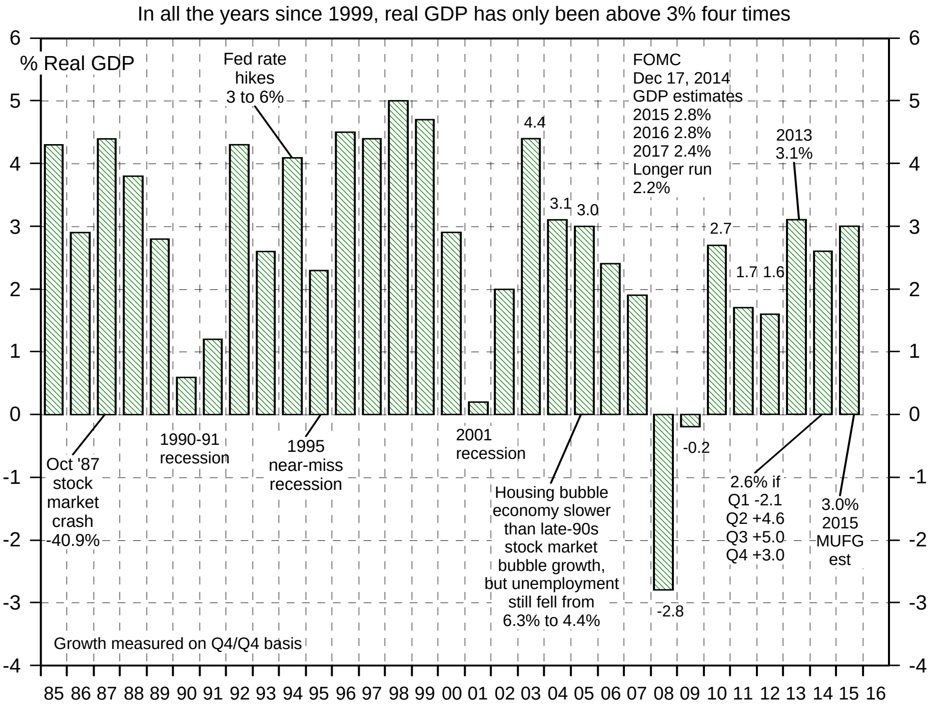


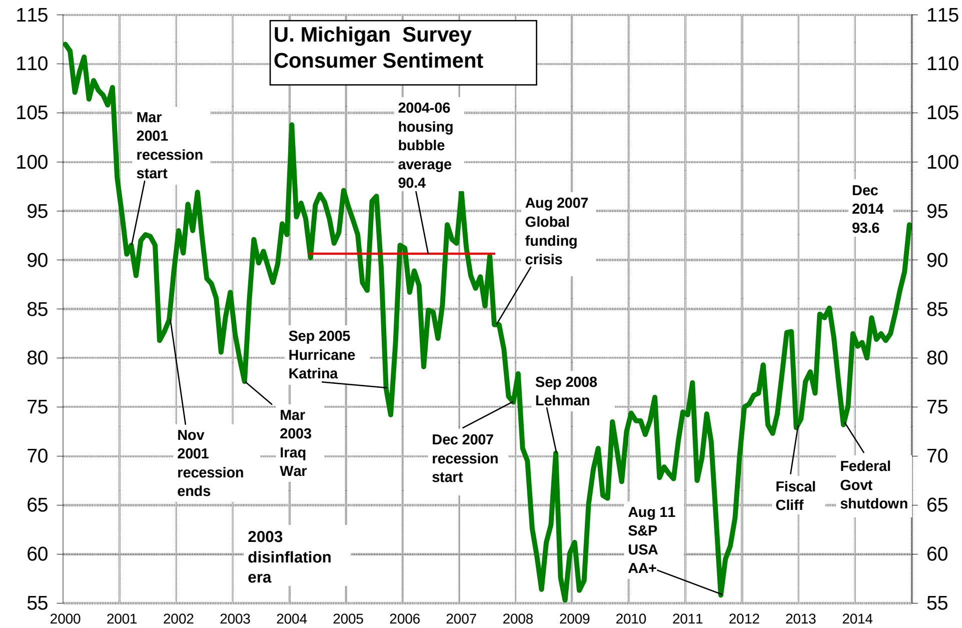
<u>How much do you think the US economy will grow in 2015? What will drive the growth?</u> We are looking for a pickup in economic growth for 2015 as the economy finally reaches escape velocity. Growth will be strong enough to leave the problems from the recession behind. Durable goods orders at record highs near the end of 2014, exports of goods to the world and factory production are both also at/near record levels. Car and light truck sales completely back to normal running at a 17 million annual rate. This is not an economy that can be said to still be in the wake of financial crisis and recession. The watchword for 2015 will be normalization. A normal economy needs a normal interest rate, Fed Chair Yellen said it, and we believe her. The Fed's rates liftoff timing from most Federal Open Market Committee members is somewhere in the middle of 2015. By the numbers then we look for real GDP growth of 3.0% in 2015 which is better than what is looking to be a growth rate of 2.6% in 2014. Of course, 2015 may not look terribly different than the economy does right now, although unemployment should fall further in 2015. Growth in 2014 was actually pretty good and the slower 2.6% reading was due chiefly to the coldest winter in decades that depressed economic output temporarily in the first quarter of 2014.

Quarterly changes at an annual rate % for GDP and Consumer spending	Q4 13a	Q1 14a	Q2 14a	Q3 14a	Q4 14e	Q1 15e	Q2 15e	Q3 15e	Q4 15e
Real GDP	3.5	-2.1	4.6	5.0	3.0	2.7	3.2	3.2	2.9
Consumer spending	3.7	1.2	2.5	3.2	4.0	2.9	3.2	3.1	3.2
Unemployment rate	6.7	6.7	6.1	5.9	5.7	5.5	5.4	5.2	4.9
Core PCE Inflation YOY	1.3	1.3	1.5	1.5	1.3	1.4	1.6	1.8	2.0
CPI Inflation (YOY %)	1.5	1.5	2.1	1.7	-0.1	-0.9	-0.5	-0.3	1.5

Unemployment rate and inflation are the final month of each quarter. YOY is year-to-year % change

What about Europe? Generally we find Americans are too pessimistic about the prospects for Europe. A lot of the slow growth in 2014 was the result of the Russia/Ukraine crisis. European Central Bank President Draghi said they would do what it takes back in 2012, and even though they have not gone with full-blown QE stimulus yet like monetary officials in Japan, the U.S. and the U.K. did, they did cut rates twice in 2014 (starting from 0.25% no less) and these cuts had the desired effect of bringing down long-term bond yields which aids investment, and it led to a weaker Euro against the dollar which will help stimulate exports and so their manufacturing. We expect Euro area growth to be running around 1-1/2% by the end of 2015. It was supposed to be this in 2014, but those hopes were dashed by the Russia/Ukraine military crisis.





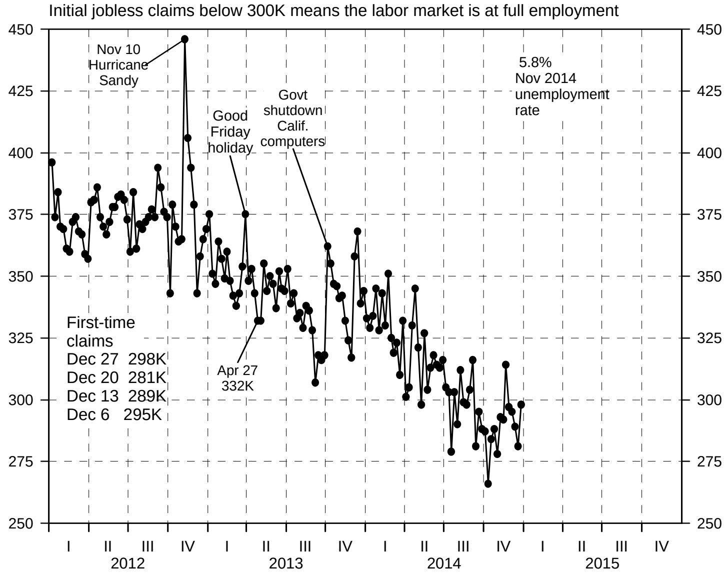
What surprised you about the US economy in 2014?

We were surprised about how rapid jobs creation was in 2014. Payroll jobs growth has been strong in excess of 2 million jobs in 2011, 2012, and 2013. But this year it is closing in on almost 3 million jobs. This is why we know that the unemployment rate is coming down for the right reasons. There are a lot of risks always for the economy looking ahead, but as economists we have to be careful not to discourage risk-taking in the economy and damaging consumer and business confidence with our prognostications of looming gloom and doom. That's what we do here for our corporate clients. We are careful to emphasize the positive. All risks to future growth are normal ones with normal business risk. The first rate hike by the Federal Reserve in 2015 should not be seen as policymakers taking away the punchbowl, the party isn't over, it is really the sign, these rate hikes, that the economy is finally strong enough to stand on its own two feet. The economy is better than people think and we think the numbers are going to confirm this in 2015. It's shaping up to be a good year. Bet on it.

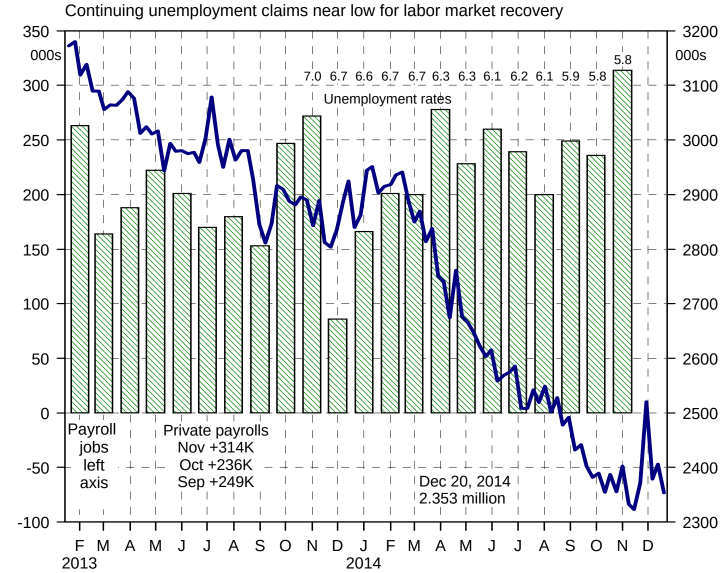
JOBLESS CLAIMS BACK BELOW 300K FULL EMPLOYMENT LINE

Unemployment claims jumped 17K to 298K in the December 27 Christmas holiday week. Initial jobless claims have not made a new low since early October; there is little room for them to fall as the best level for the housing bubble economy years was 282K when unemployment was on its way down to 4.4%. Still, claims are sideways. We will see what will happen to payroll jobs in December when the data (along with the annual benchmark revision) are released on Friday, January 9. It was a year ago that the market was surprised by a weaker 74K, hopefully that will not repeat this year.

Initial jobless claims below 300K means the labor market is at full employment



Continuing unemployment claims near low for labor market recovery

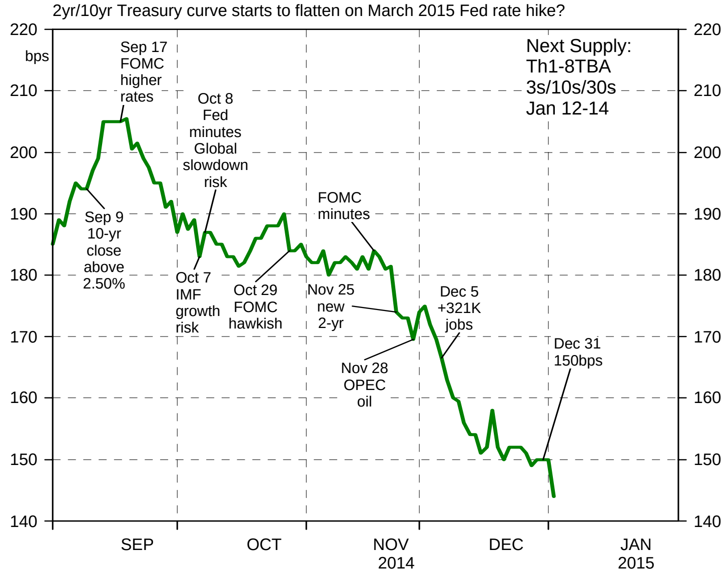


TREASURY YIELD CURVE FLATTENS ON 2015 FED RATE LIFTOFF

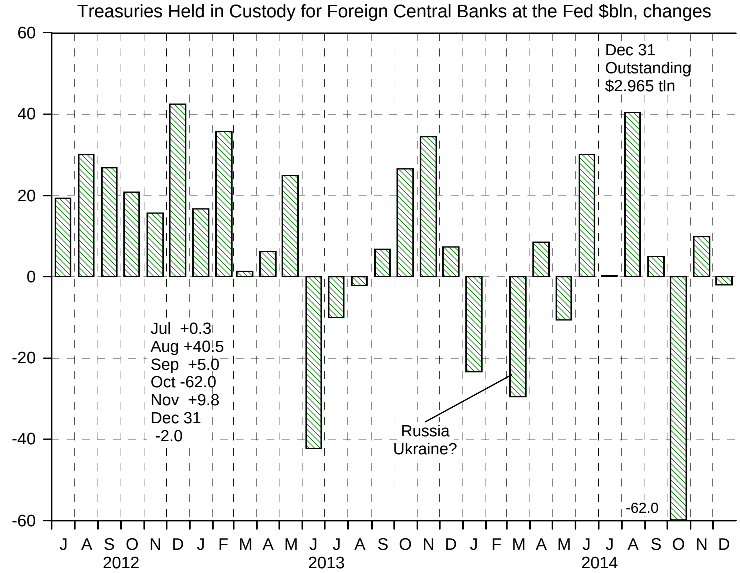
The yield curve between 2-yrs and 10-yrs was +144 bps on Friday versus +151 bps last week. A quiet week of course, yet bond yields keep falling. 10-yr Treasury yields were about 2.20% at the start of the year on Friday before noticing German Bunds had fallen to 0.50%, and the final move down was on the ISM purchasing managers survey falling 3.2 points to 55.5. We marked down the 2015 year-end forecast to 3.4% for 10-yr notes, and left the first Fed hike in March. The economy is too strong for zero rates.

	31-Dec 2014	Q1 2015	Q2 2015	Q3 2015	Q4 2015	Q1 2016
30-Yr Bond	2.75	3.60	3.70	3.90	3.80	3.90
10-Yr Note	2.17	3.00	3.20	3.40	3.40	3.50
5-Yr Note	1.65	2.50	2.70	2.90	3.00	3.10
2-Yr Note	0.67	1.80	2.00	2.20	2.25	2.40
3-month Libor	0.26	0.55	0.80	1.10	1.35	1.60
Federal Fund Rate	0.25	0.50	0.75	1.00	1.25	1.50
2s/10s spread	150	120	120	120	115	110

2yr/10yr Treasury curve starts to flatten on March 2015 Fed rate hike?



Treasuries Held in Custody for Foreign Central Banks at the Fed $bln, changes



MUFG

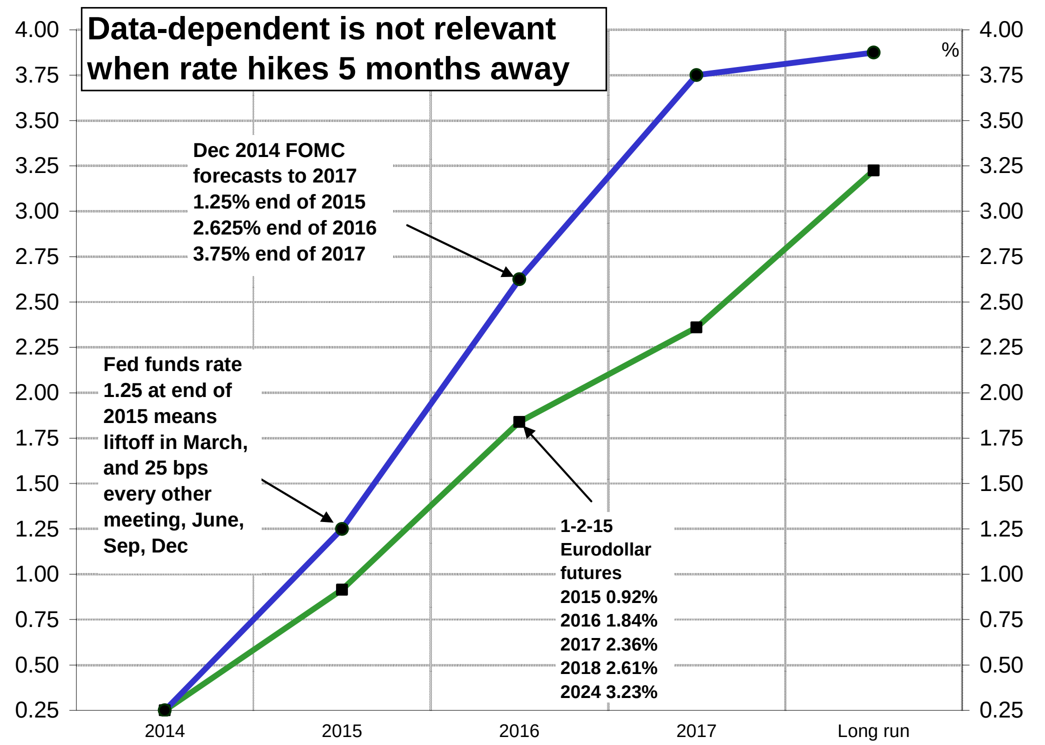
FEDERAL RESERVE POLICY

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	31-Dec	24-Dec	17-Dec	10-Dec	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2461.364	2461.420	2461.495	2461.560	479.782
Federal agency debt securities	38.677	38.677	38.677	38.677	0.000
Mortgage-backed securities	1736.832	1747.377	1741.957	1729.816	0.000
Primary credit (Discount Window)	0.079	0.032	0.009	0.022	23.455
Term auction credit (TAF auctions)	0.000	0.000	0.000	0.000	150.000
Asset-backed TALF	0.000	0.000	0.000	0.000	
Maiden Lane (Bear)	1.678	1.678	1.678	1.681	29.287
Maiden Lane II (AIG)	0.000	0.000	0.000	0.000	0.000
Maiden Lane III (AIG)	0.000	0.000	0.000	0.000	0.000
Central bank liquidity swaps	1.528	0.030	0.002	0.002	62.000
Federal Reserve Assets	4541.5	4553.3	4546.1	4532.7	961.7
3-month Libor %	0.26	0.26	0.25	0.24	2.82
Factors draining reserves					
Currency in circulation	1343.008	1338.522	1326.814	1321.672	834.477
Term Deposit Facility	0.000	0.000	0.000	402.153	0.000
Treasury supplemental bill auctions	0.000	0.000	0.000	0.000	0.000
Reserve Balances (Net Liquidity)	2377.995	2609.634	2739.110	2428.934	24.964
Treasuries within 15 days	0.000	0.001	0.001	0.000	14.955
Treasuries 16 to 90 days	0.005	0.004	0.004	0.004	31.549
Treasuries 91 days to 1 year	3.516	3.516	3.516	3.517	69.272
Treasuries over 1-yr to 5 years	1112.927	1105.853	1105.863	1105.872	170.807
Treasuries over 5-yrs to 10 years	686.627	693.716	693.726	693.735	91.863
Treasuries over 10-years	658.289	658.330	658.385	658.433	101.337

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

The Fed meets January 27-28 to consider its monetary policy. The Fed said they could be patient at the December meeting when it comes to hiking rates. They hastened to add that this was not an important change from the October meeting statement when they said it could be a considerable time before the first rate hike. When we hear the word patient we think back to the last first rate hike following recession under the Greenspan Fed. The Fed dropped its considerable period phrase in January 2004, said they could be patient, and hiked rates in June 2004, three meetings later. If patient means now what it did in 2004, they go at the April 28-29, 2015 meeting.

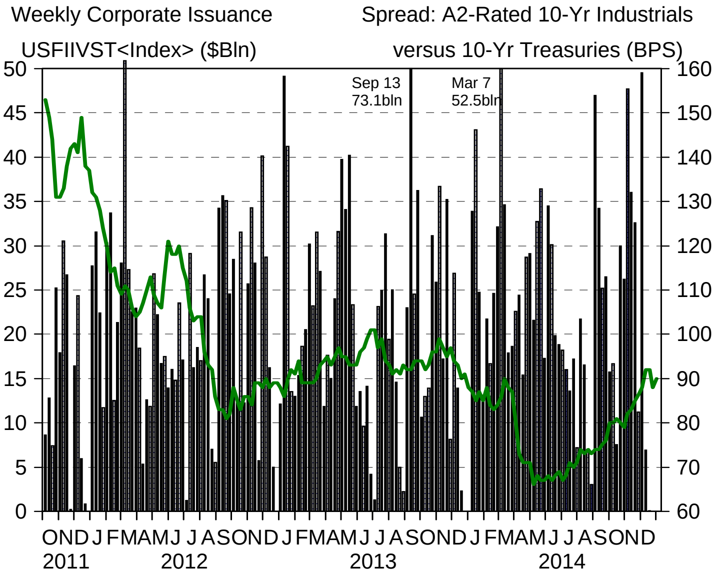
Current inflation is not an appropriate guide for the setting of current monetary policy. It is not important for the economy that CPI inflation is now 1.3% YOY-short of the Fed's 2.0% target. It is not important that CPI YOY will probably swing negative in the next few months as energy prices turn inflation in to deflation. The U.S. economy is not on dangerous ground.

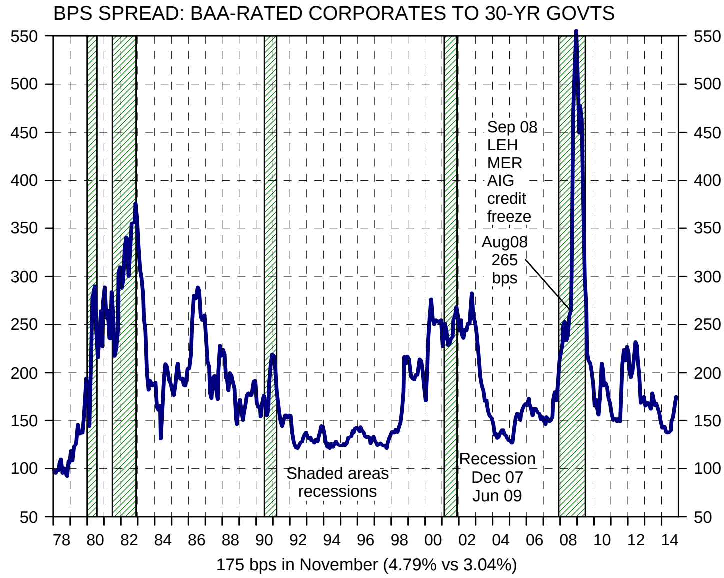


The Fed says they are data dependent. If the economy evolves the way they forecast it will then they will act. Raise rates. We are sure they will. Unemployment is 5.8% and their forecasts say if it is 5.2-5.3 percent at the end of 2015, then the Fed funds rate should be 1.25%. To get to 1.25% in December they need to liftoff in March 2015, and that would be our call. 1.25% is the median of the 17 forecasts. It moves around a little. The median was higher at 1.5% in the September 2014 meeting forecasts. Keep in mind that currently, while the median year-end Fed funds rate forecast is 1.25%, behind the median, 13 of 17 Fed officials say it should be 1% or higher at the December 2015 meeting, which means a June 2015 first rate hike at the latest. The market is not discounting this much Fed tightening, the Fed's data-dependent warnings, if that's what they are, falling on deaf ears for now.

CORPORATE BONDS: END OF THE YEAR, LITTLE ACTIVITY UNTIL 2015

Corporate bond offerings were $zero million in the January 2 week versus $100 million in the December 26 week. Corporate bonds (10-yr Industrials rated A2) were 90 bps above 10-yr Treasuries on Friday versus 88 bps last Friday.





TREASURY MARKET OUTLOOK

EXPECTED 10-YR 2-3 WEEK TRADING RANGE 2.00% to 2.30%

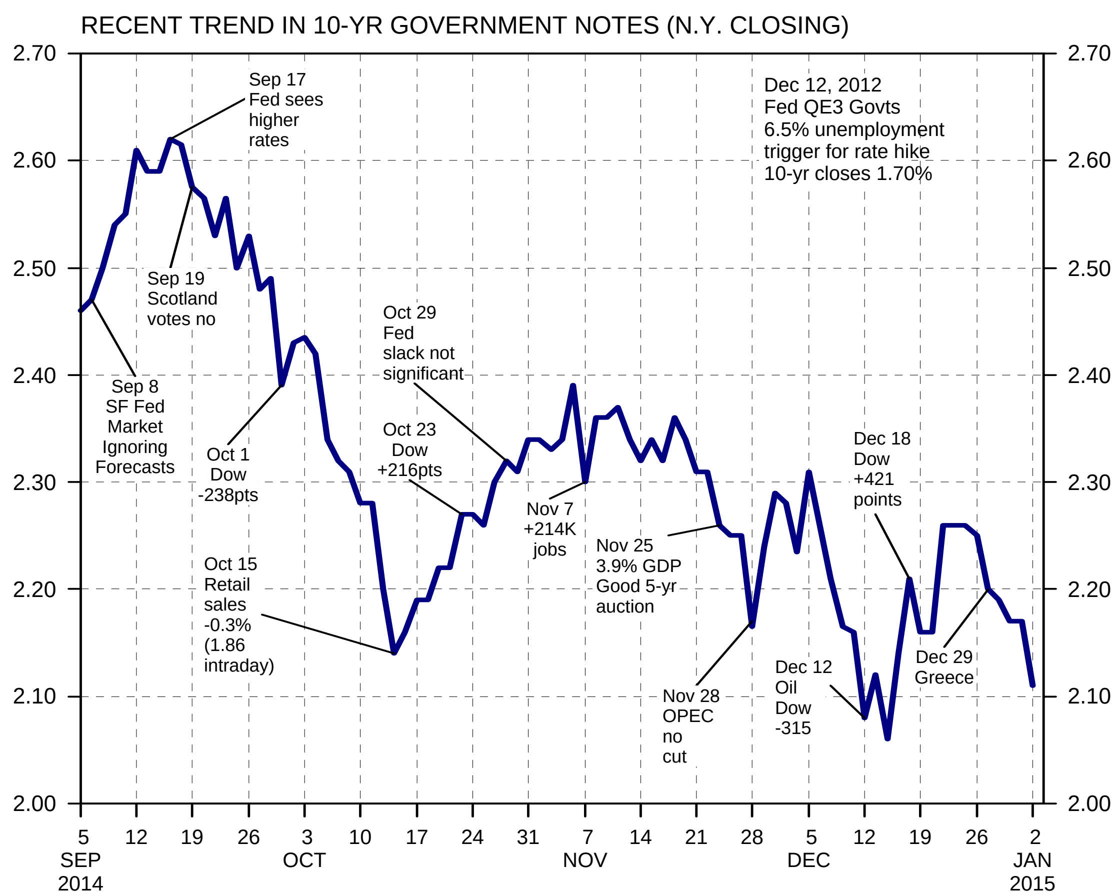
Week's 10-YR Range

HIGH 101-10+ 2.10%

Friday, January 2, German Bund yields at new 0.50% low, ISM manufacturing falls 3.2 points to 55.5

LOW 99-31+ 2.25%

Monday, December 29, start of the week lows



MUFG

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.