Financial Market Weekly

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

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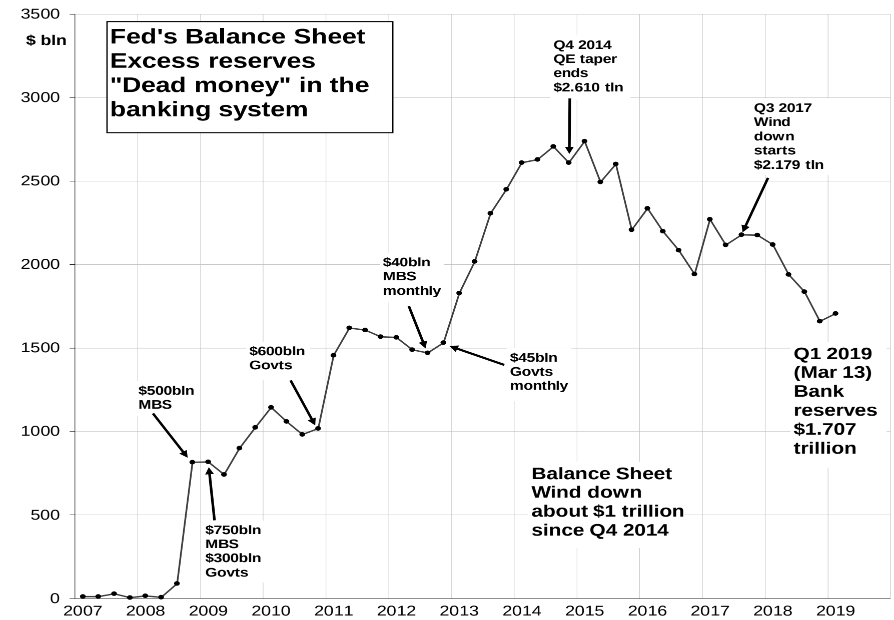
THE FED WILL STOP UNWINDING ITS $4 TRILLION BALANCE SHEET LATER THIS YEAR. NOW MAYBE OUR STOCK PORTFOLIO WILL GO UP



We hate to talk about the Fed's balance sheet even though it was our first job on the Street when the Fed was steering its monetary policy by providing reserves to the banking system and trying to meet its targets for money supply growth. There was no mention of interest rates. That policy was all wrong, completely discarded, so you can forgive us if we are skeptical that the latest version of the Fed's monetary policy as per Fed Chair Powell saying interest rates at 2.5% are at neutral, whether that assumption will prove to be correct. An unexpected shock to the economy is what causes a recession, unexpected as in it cannot be foreseen in advance, and although there are reasons to think a shock happened last December, if the economy does go into a decline at this point, we won't blame it on the Fed's 2.5% Fed funds rate or its gradual rates path or 3.25% Treasury bond yields, we will blame it on businesses cutting back on their investment after seeing recession-scale stock market losses due to news out of the Trump administration late last year. The 2001 recession was the stock market bubble recession, the 2007-09 recession was the housing bubble recession and if there is a recession this year that CEOs agree is the top risk, it will be the Trump recession. The economy does not like too many changes, too many big changes or threats of changes, because change generates uncertainty and the greater the uncertainty the greater the cutback in spending that makes the economy grow.

So quickly unfortunately, as we digressed, the market has misunderstood the Fed's balance sheet for quite some time. Remember the 2013 taper tantrum. Market misunderstood. Waste of time. Looking ahead, as Powell said in testimony, winding down the balance sheet was an issue behind the stock market's collapse after the December Fed meeting. It did not help that President Trump tweeted that the Fed should stop the 50 B's on the first day of the December Fed meeting, helping to stoke the market's fears and doubts. The excess reserves in the system don't help the economy grow, not sure why the Treasury secretary told the President it did. What can we tell you. Markets aren't rational. In any case, the Fed is not going to continue to wind down its balance sheet past the end of the year. So the reason for the stock market collapse after the December 18-19 meeting when during the press conference Powell said, "I don't see us changing balance sheet-policy" …that is not going to happen again. The Fed will leave more dead-money reserves in the banking system. Maybe $1 trillion where there were just $25 billion in reserves pre-Lehman in September 2008: banks need to keep more money for liquidity purposes as required by regulators is one reason why reserves will remain higher.

The Fed's QE effect on markets equation looks kind of simple, money-in, money-out, and you really have to wonder how the Fed's QE purchases ever came to matter for markets and bond yields strictly in dollar terms. We think it was the Fed announcement effect of these QE purchases that was most important where the Fed was saying "we are here to help you." QE probably won't work again… unless the QE purchases are big enough to reduce 10-yr Treasury yields… which we don't recommend policymakers do, drive down bond yields, unless they want America to be more like Europe and Japan.

We can't be certain that it was the dollar volume of the Fed's purchases that lowered long-term interest rates. Money-in: (1) $300 billion March 2009 (the bottom of the stock market rout, who knew?), (2) $600 billion December 2010, and (3) $45 billion per month "open-ended" in December 2012, that lasted about a year, with another year of tapering off the purchases, the total about $800 billion using year-end changes in the Fed's Treasury securities held from 2012 to 2014. The three QE Treasury purchase programs were roughly $1.7 trillion. Money out: the Obama trillion dollar-plus Federal budget deficits were from 2009 to 2012. The 2013-14 fiscal year (ends September) budget deficits that needed to be financed by selling Treasuries was $1.163 trillion, so maybe the final QE purchase program of $800 billion helped finance the Federal red ink and kept 10-yr yields lower than they would have been. Anyway, if you are an "all-in" stock investor like we are you can rest assured, the Fed is just about done with unwinding its balance sheet, so no more worries the Fed is withdrawing badly needed liquidity for the economy and the markets.

FED BALANCE SHEET

QE Taper ends Q4 2014, QE Wind Down starts Q3 2017

		Adds Reserves		Drains Reserves
	Bank	Govt	Mortgage	Currency
$ blns	Reserves	securities	securities	Outstanding
Q4 2014	2610	2461	1747	1339
Q3 2017	2179	2465	1768	1580
2014-17	-431	4	21	-242
Q1 2019*	1707	2175	1608	1721
2017-19	-472	-290	-160	-141

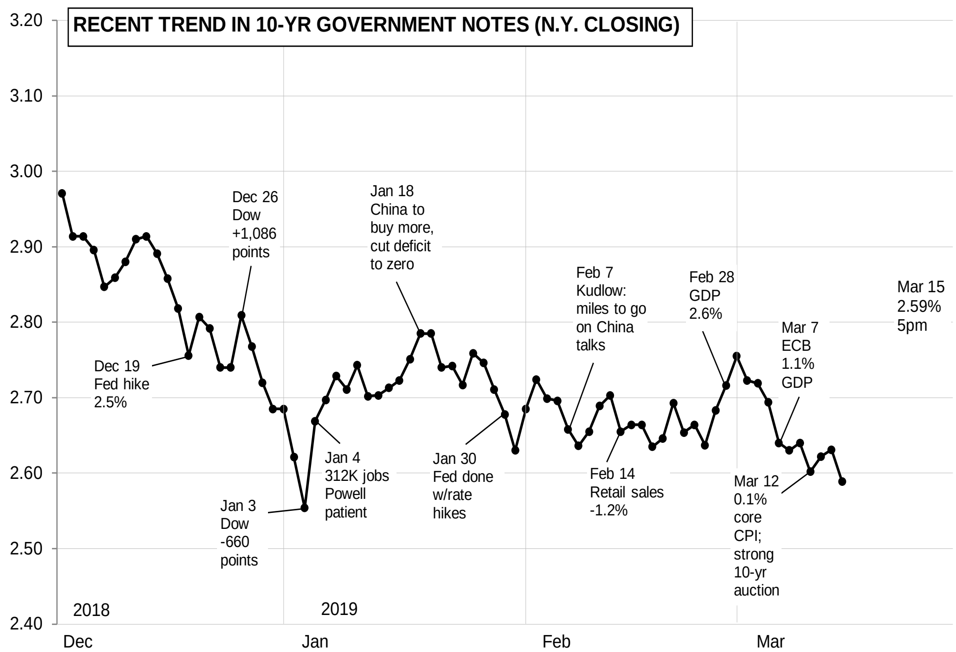
* March 13, 2019

Donald J. Trump 12-18-18 7:13AM EST
@realDonaldTrump
I hope the people over at the Fed will read today's Wall Street Journal Editorial before they make yet another mistake.
Also, don't let the market become any more illiquid than it already is. Stop with the 50 B's. Feel the market, don't just go by meaningless numbers. Good luck!

Half the reduction in bank reserves is more currency in circulation, the other half is maturing securities.

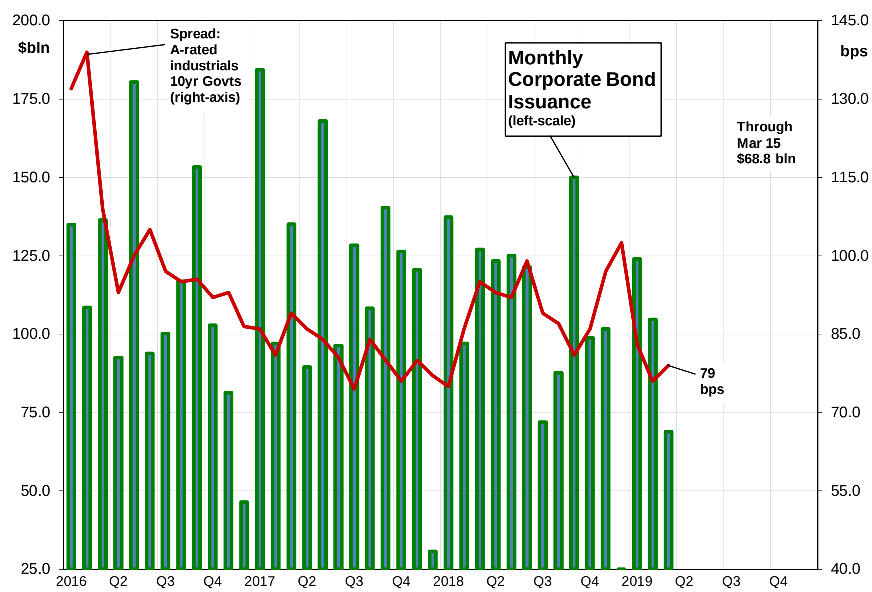
MARKETS OUTLOOK

	31-Dec 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	3.02	3.20	3.30	3.35	3.45	3.45	3.50	3.60	3.70
10-Yr Note	2.68	3.00	3.10	3.20	3.30	3.30	3.40	3.50	3.60
5-Yr Note	2.51	2.85	3.00	3.10	3.20	3.25	3.35	3.45	3.60
2-Yr Note	2.49	2.80	3.00	3.10	3.20	3.20	3.35	3.45	3.60
3-month Libor	2.81	2.70	2.95	2.95	3.20	3.20	3.45	3.45	3.70
Fed Funds Rate	2.50	2.50	2.75	2.75	3.00	3.00	3.25	3.25	3.50
2s/10s spread	19	20	10	10	10	10	5	5	0



Treasury bond yields fell 4 bps to 2.59% this week from 2.63% last week. A lot going on but yields were still 2.63% at Thursday's close. The reason for the drop in yields Friday is a little on the murky side, and we'd love to think bonds are back to trading the eco news with industrial production falling for a second month in February, as the Fed reported at 915am EDT, but bonds were rallying well before the economic news. We will see what the Fed does with their interest rate forecasts on Wednesday, March 20 at 2pm EDT. 10-year Treasury yields are fairly priced for the 2.5% Fed funds rate sitting here for months or years. Fed may say one hike this year and one in 2020.

CORPORATES: AMERICAN TOWER, SOUTHERN CAL ED, DOMINION ENERGY



Corporate offerings were $28.5 billion in the March 15 week versus $36.6 billion in the March 8 week. On Wednesday, UPS sold $1.5 billion 10s/30s. It priced a $750 million 3.4% 10-yr (m-w +15bp) at 80 bps (A1/A+). The transportation and logistics company will use the proceeds to repay $1.0 billion 5.125% notes due on April 1. Corporate bond yields (10-yr Industrials rated A2) were 79 bps above 10-yr Treasuries this week versus 77 bps last Friday.

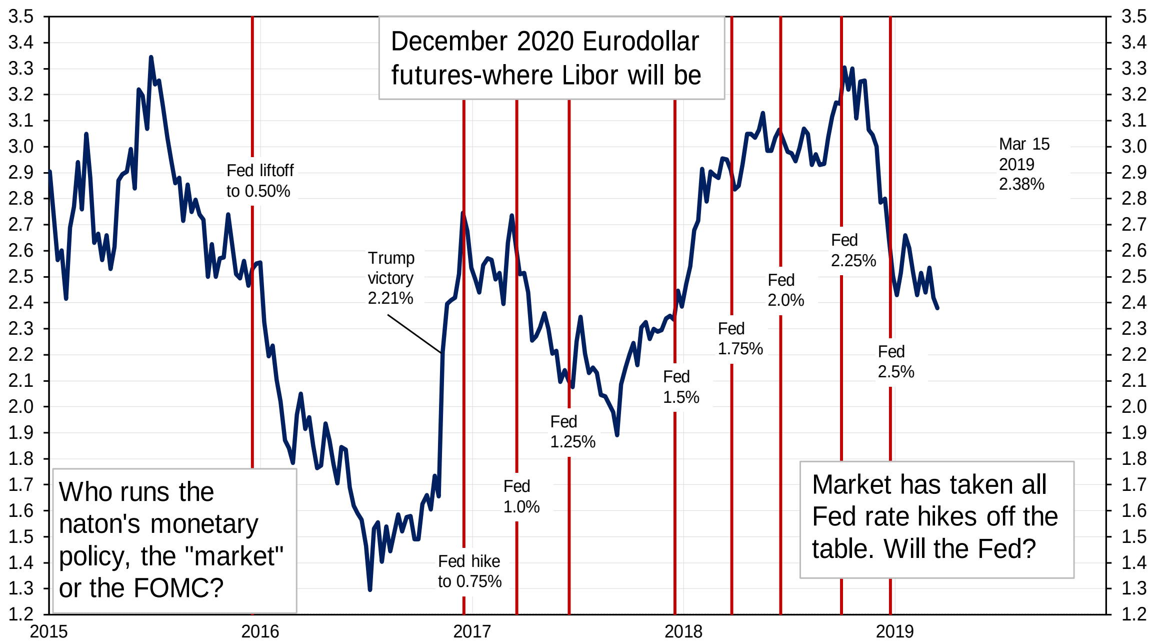
FEDERAL RESERVE POLICY

The Fed meets March 19-20 to consider its monetary policy. The Fed's on hold for now -- sure, sure. Global risks, China, Europe, and lingering effects from the Federal government shutdown, and China trade talks, stock market death plunge on Christmas Eve. Okay, these are reasons for the Fed to wait… past March, but the low inflation stuff seems a little hokey. Headline inflation dropped with the precipitous $75 to $42 decline in crude oil prices from October to December last year shadowing the stock market collapse. Headline inflation will not rise back for another year however until the oil mini-crash effect washes out of the year-on-year data. Does this mean there is no possible chance for a resumption in the gradual rates path for another year? Waiting for inflation, actual inflation to come back, and not waiting for the economic theory of tight labor markets, strained economic resources with "shortages" to push up inflation? We will see how many Fed rate hikes come off the tabled forecast on Wednesday, March 20 at 2pm EDT. The Fed caved after the stock market sold off at the December meeting when Powell said at the press conference there was no change in their plans regarding the balance sheet wind down or quantitative tightening (QT). But at the January 29-30 meeting, the Fed minutes suggested many participants, several of the many participants, and several other participants had different views on the outlook for interest rates. Seems pretty clear.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	13-Mar	6-Mar	27-Feb	20-Feb	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2175.479	2175.420	2182.092	2182.201	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities (MBS)	1607.767	1607.609	1607.609	1614.150	0.000
Primary credit (Discount Window)	0.000	0.000	0.003	0.009	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)	0.000	0.000	0.000	0.000	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	
Central bank liquidity swaps	0.067	0.065	0.088	0.068	62.000
Federal Reserve Assets	4019.4	4016.6	4021.7	4029.2	961.7
3-month Libor %	2.61	2.59	2.63	2.66	2.82
Factors draining reserves					
Currency in circulation	1721.355	1719.446	1712.356	1712.038	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	0.016	2.115	1.915	2.275	0.000
Reserve Balances (Net Liquidity)	1707.125	1736.547	1682.210	1619.745	24.964
Treasuries within 15 days	0.000	0.000	12.529	12.529	14.955
Treasuries 16 to 90 days	112.837	112.837	92.780	92.780	31.549
Treasuries 91 days to 1 year	270.527	270.526	274.117	274.118	69.272
Treasuries over 1-yr to 5 years	922.071	922.063	930.742	930.757	170.807
Treasuries over 5-yrs to 10 years	252.470	252.449	254.779	254.819	91.863
Treasuries over 10-years	617.574	617.546	617.145	617.197	101.337

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

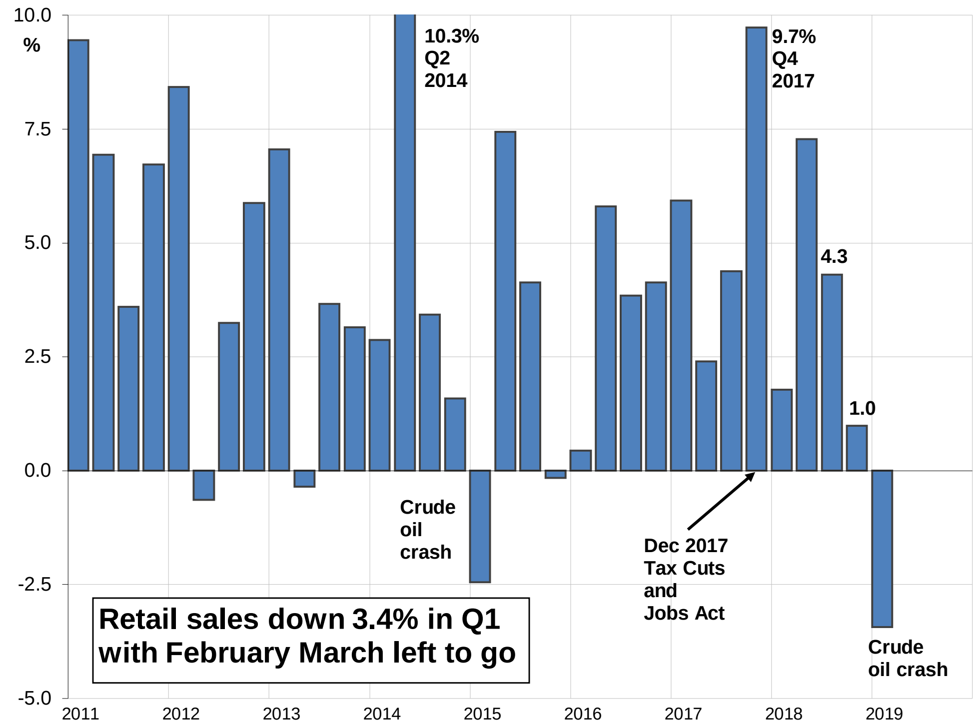
Participants noted that maintaining the current target range for the federal funds rate for a time posed few risks at this point. The current level of the federal funds rate was at the lower end of the range of estimates of the neutral policy rate. Moreover, inflation pressures were muted, and asset valuations were less stretched than they had been a few months earlier. Many participants suggested that it was not yet clear what adjustments to the target range for the federal funds rate may be appropriate later this year; several of these participants argued that rate increases might prove necessary only if inflation outcomes were higher than in their baseline outlook. Several other participants indicated that, if the economy evolved as they expected, they would view it as appropriate to raise the target range for the federal funds rate later this year.



OTHER ECONOMIC NEWS THIS WEEK, ON AND ON, AND ON AND ON

Consumer leaves their December doubts and troubles behind (Monday)

Breaking economy news. Retail sales are better than expected in January. Fed Chair Powell was asked on CBS 60 Minutes last night about what the drop in retail sales meant for the outlook, and he replied that there were indications that January would show some improvement. He was right as overall retail spending rose 0.2% in January this morning after that 1.6% drop in December. Retail spending in January was actually held down by the fall of gasoline prices “hurting” gasoline station sales, and auto sales fell sharply as well, and frankly it was a mystery why car sales even went up in December given the weakness recently in unit auto sales.



Almost all spending categories were up except of course for autos and gasoline station sales. The weak spots were furniture sales down 1.2%, electronics and appliance stores down 0.3%, and clothing down 1.3% in January.

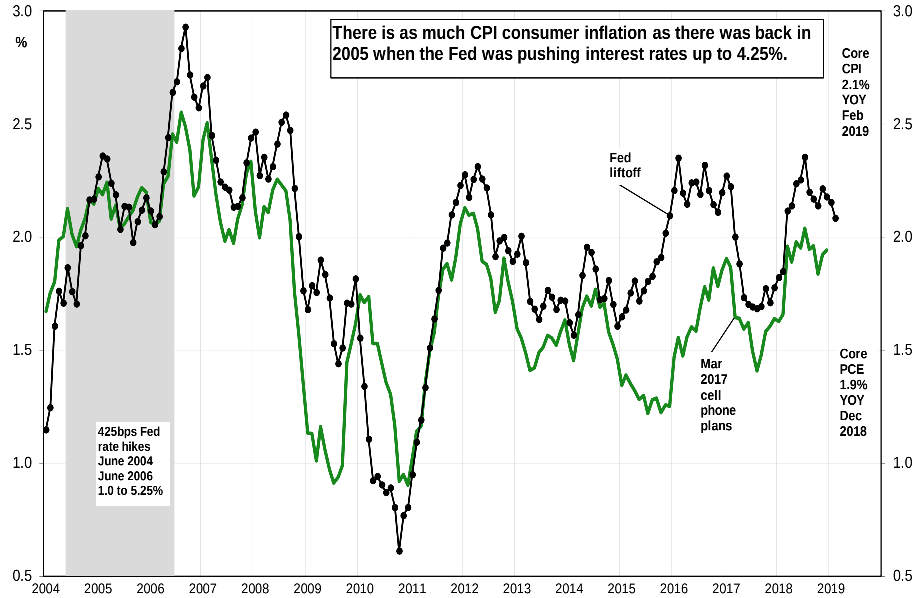
Net, net, it looks like the consumer weathered the storms in financial markets and the approach of the Federal government shutdown in December. The skies have cleared and greater consumer spending is going set the economy’s sails heading toward better economic conditions this year. Much of the weakness the last two months has been in auto sales and gasoline station sales. Pull back the tarp and the underlying strength of the consumer looks relatively stable with retail sales ex-autos and gasoline bouncing back 1.2% in January after that surprising 1.6% drop in December. Consumer confidence surveys have improved and with the consumer feeling more upbeat, they took a few more trips to the shops and malls in January to start the year. The weather was cooler than seasonal but sales bounced back in January anyway, and we feel more confident that real GDP in the first quarter will make it to 1.5% growth.

It looks like the consumer has left their troubles behind and although the economy isn’t out of the woods yet, with the downside risks posed by the world economy and the ongoing trade talks with China, the 2019 economic outlook is brighter than it was a month ago. Don’t count the consumer out yet. They’ve got more wages to spend and it looks like they are spending every last dime of it. The economy is better than you think. Bet on it.

Core consumer price inflation modest despite rising wage pressures (Tuesday)

Breaking economy news. CPI inflation, the consumer inflation data the Fed has discarded in favor of the inflation measure that never moves or registers any inflation pressure: the personal consumption expenditures deflator. PCE inflation.

Headline CPI inflation had been unchanged from November to January with the crash in the price of crude oil, and now it is core inflation's turn to slow almost to zero. Core CPI inflation rose just 0.1% to 2.1% year-on-year in February. This is the first monthly core CPI inflation slowdown this year. Monthly core CPI inflation rose 0.1% just twice in 2018. Still, 2.1% is above the Fed's "all's well" 2.0 target.



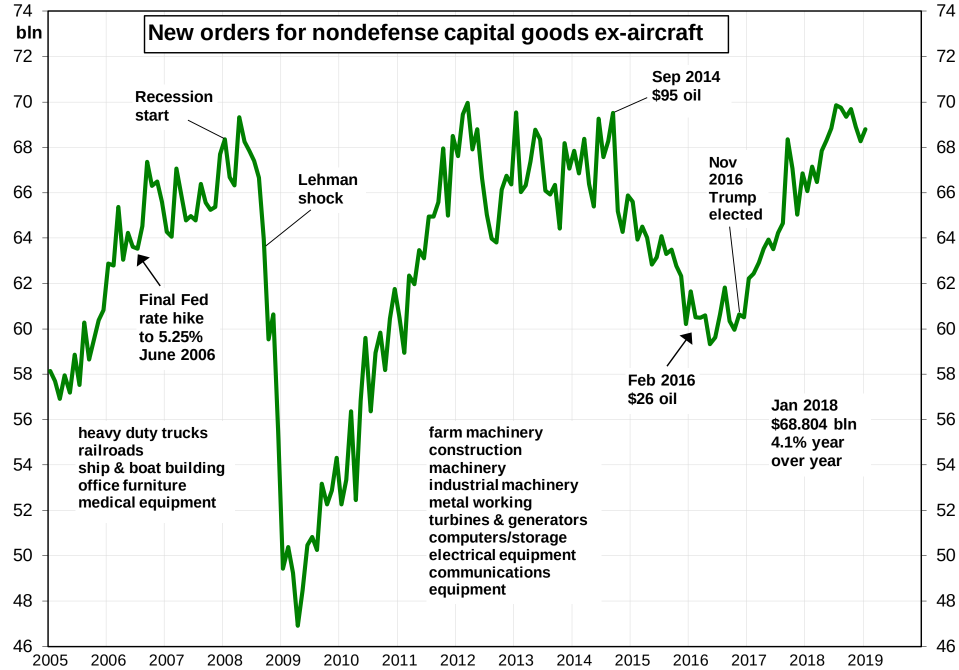
As far as core consumer inflation the modest 0.1% rise occurred in part due to the sharp 1.0% drop in medical care commodities and 0.0% monthly change in medical care services inflation in February. Used cars and trucks also fell 0.7%. Shelter costs continue to rise 0.3% each month recently, 3.4% the last year, and with its large 41.1% weight in core consumer purchases, shelter costs should certainly keep deflationary pressures at bay if the economy slows later this year.

Net, net underlying price pressures of consumer goods and services are not heating up despite the tight labor market and rising wages kettle on the stove blowing off a lot of steam. At this stage of the business cycle nearly ten years long, resources should be getting scarce and consumer demand should be causing inflation to heat up.

The kettle is on the stove whistling away giving off the traditional warning of inflation, but price pressures remain contained for now and this is likely to keep Fed Chair Powell and crew on the sidelines for longer. No inflation, then no more rate hikes seems to be the prevailing show-me view of Fed officials. Stay tuned. Story developing.

Too early to write the economy's final chapter: PPI and durable goods orders (Wednesday)

Breaking economy news. Durable goods orders and PPI inflation. Nondefense capital goods orders ex-aircraft rose 0.8% in January after posting declines in November and December where the order flow remains at a high level of operation for most industries. It is too early to write off manufacturing for this economic expansion and there is no sign that companies are growing more cautious either from the global economic slowdown's effect on trade or from the Fed's higher interest rates. A 2.5% Fed funds rate is not affecting the appetite of companies for new equipment. They see better economic times ahead and are ordering the equipment needed to meet the demand for their goods and services from other companies and consumers alike. The downside risks that Fed officials see is not slaking the thirst of companies for new machinery.



Producer price inflation has slowed from last summer when it was rising over 3% for final demand goods prices less food and energy and trade, but it is still rising 2.3% in February from year earlier levels. If the Fed is watching for signs of economic weakness and falling prices or deflation, it is nowhere in this report. Final demand goods prices less food and energy rose 0.1% in February after rising 0.3% in January, so the Federal government shutdown has had little demonstrable effect on companies' pricing power.

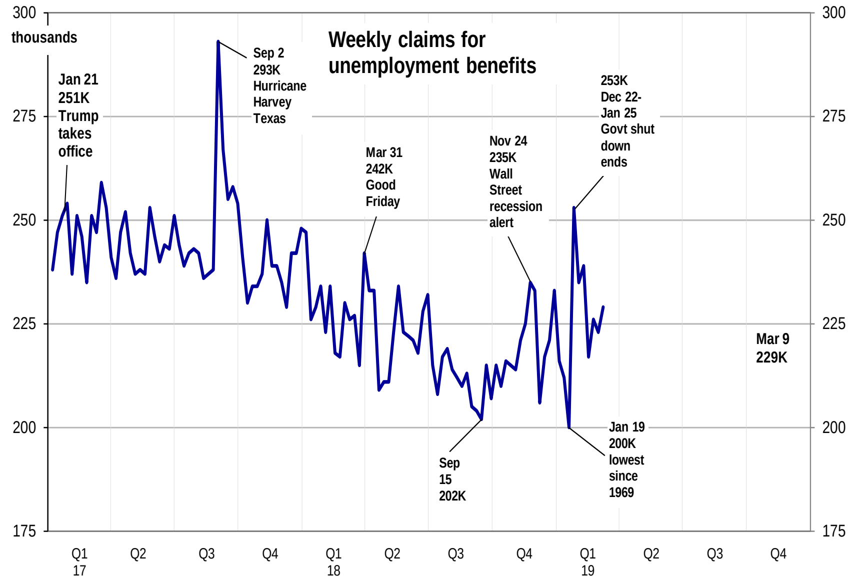
Net, net, businesses still have the confidence in this economy to order long-lived equipment and invest in the country's future. Companies also have pricing power where the economy is strong enough for them to raise the price of goods they sell.

It is too early to write the final chapter yet for one of the longest economic expansions in the nation's history. Better days lie ahead. The Fed can remain prudent and watch and wait for a while longer, but they have not finished the job yet when it comes to normalizing their stimulative policies that were meant for an economy fighting recession and financial crisis. The economy is better than you think so far this year. Bet on it.

Companies continue to invest in their businesses and this is just the capital infusion the economy needs to keep going into the record books.

Jobless claims still higher than we'd like to see for continued economic growth (Thursday)

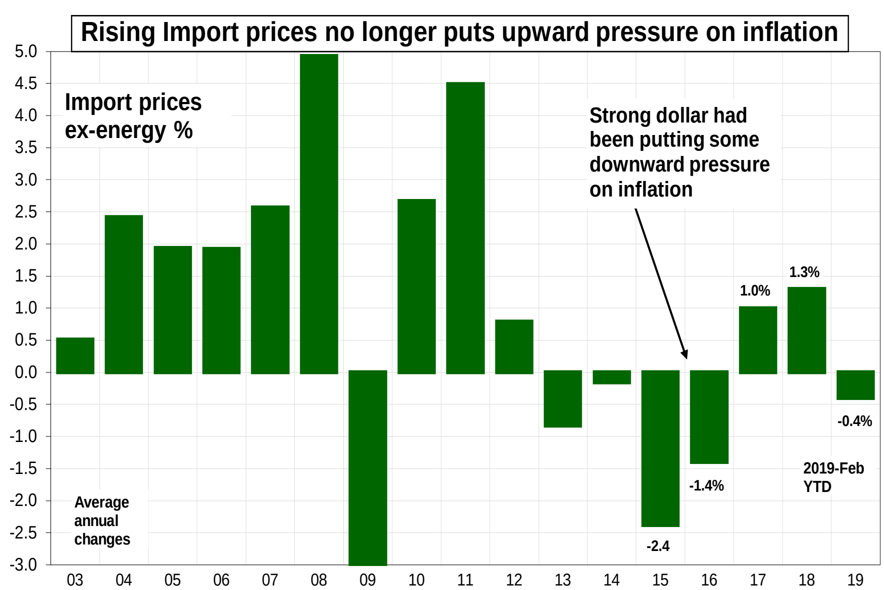
Jobless claims are still higher than we'd like to see for the continued economic growth story. Maybe the economy does actually hit the wall for growth when it reaches ten years old like it will in June which is just three months away. We can confirm this, yes, June is three months away.



Weekly jobless claims are higher than they were last September, rising to 229K in the March 9 week, which raises some questions about the outlook. The economy generally has two speeds, forward and backward, and right now the labor market looks distinctly cooler than it did last year.

Import prices are out. If the domestic economy can't produce any inflation sparks then maybe America can import some inflation from overseas. Nope. Not so much. The dollar rally over the last year, mostly April/May in 2018 against the Euro, has held imported inflation in check if you will. Nonfuel import prices were unchanged in February and the monthly changes have been flat to down starting in June 2018 except for a modest 0.1% uptick in October. Nonfuel import prices are down 0.6% the last twelve months after rising 2.0% the year before that. America can't import its way out of the inflation shortage here in the USA, USA, USA. If Fed Chair Powell is waiting for inflation to pick up before resuming that gradual pace of rate hikes, today's report isn't going to impress him much.

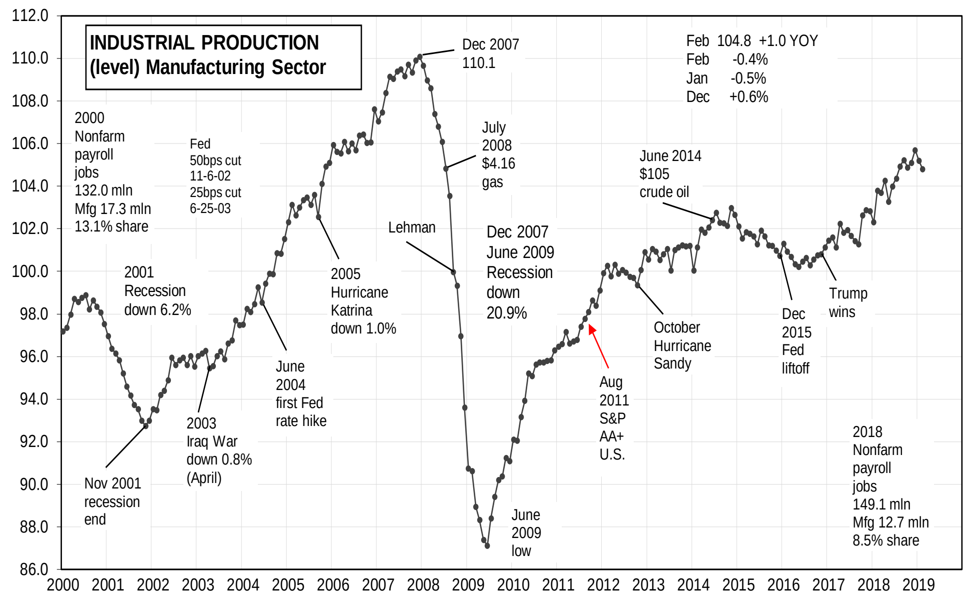
Net, net, the economy isn't out of the woods yet from the financial market turbulence and Federal government shutdown at the end of last year as company layoffs remain somewhat elevated. Companies are still cautious and more are letting some workers go as the business outlook this year is not as bright as it was a year ago. The Tax Cuts and Jobs Act boosted the economy's fortunes in 2018, but the spending boost is a one-off event that starts to fade over time. Time will tell if the outlook is dimming again. Don't ask for whom the bell tolls, it tolls for thee.



CEO Alert: Manufacturing output starting to smell like recession (Friday)

Breaking economy news. The Fed's own economic statistic is pointing towards a recession. Industrial production. Manufacturing industrial production has fallen two months in a row. Oh no. Not all bad news as the January 0.9 percent drop was revised to a decline of just 0.5 percent, but now it has fallen another 0.4 percent in February. There's probably not many times that real GDP, also a measure of "output," rose more than a sickly 1.0 percent with industrial production falling this sharply. Maybe we need to rethink our 1.5 percent real GDP forecast for the first quarter.

Net, net, the economy is spinning its wheels and not gaining any traction yet in this soft patch produced by trade wars and stock market turbulence and the government shutdown. Thank God Fed officials were smart enough to take their foot off the rate hikes accelerator as the economy cried uncle. The interesting thing is that all the economy's problems were caused by policies straight out of Washington. Stay tuned. Story developing.



We hope we're wrong. We don't like blaming Washington and Trump's economics team and Congress and the Federal Reserve. We suspect a lot of the economy's problems are temporary with the colder than seasonal winter weather. Time will tell. The only question is how many rate hikes the Fed takes down from its interest rate forecasts when they meet next week. The market sees no more rate hikes ever after the stock market collapsed last year. The Fed only saw three more hikes to 3.25 percent in December. Will they take one hike off the table or two. Either way it's going to be a boring year ahead if you watch Treasury yields. Bet on it.

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