# 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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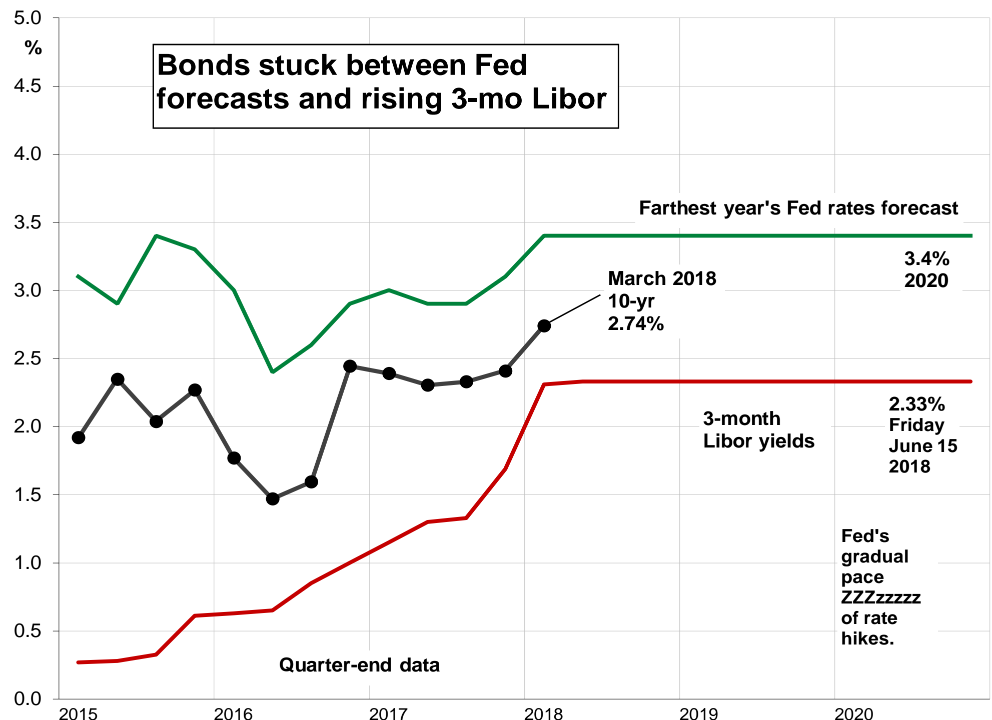
## FED GETS INTEREST RATES UP CLOSER TO NORMAL

The Federal Reserve isn't the ECB, Draghi telling us Thursday that interest rates weren't going anywhere at least through the summer of 2019. But Fed officials haven't loosened their grip on longer term interest rates either, leaving bonds trapped between a rock and a hard place. We aren't sure why Powell suddenly decided to do eight press conferences a year starting in January; they certainly aren't going to have enough newsworthy things to tell us about policy over the next few years. Maybe they should just tweet whatever little news they have to tell us, just like others do down there in Washington. Short term rates are going up slowly to 3.5% by the end of 2020. Got it. And we can't wait for their thinking about the year 2021 when they issue their forecasts on economic growth and inflation and interest rates on Wednesday, September 26, 2018 at 2pm New York time. (Is there any other time really.)

> Powell on rates: "We had a lot of encouragement to go much faster and I'm really glad we didn't."




So, what exactly did the Fed do this week on Wednesday. Here are our thoughts after the conclusion of the meeting.



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## Fed says 4 hikes (barely) this year to 2.5%, and 2020's 3.5% sticks

Breaking economy news. The Fed tacks on another rate hike this year making it easy for us forecasters: that would be the September meeting and December meeting. This puts the Fed funds rate at 2.5% in December which is getting so close to neutral that they dropped the language in the press statement saying the Fed funds rate would be below neutral levels for some time.

The bond market reacted slightly to the four rate hikes in 2018 versus three rate hikes they thought were likely back at the March meeting. 10-yr yields were in a tight 2 bps range from 2.95 to 2.97 percent all day. On the news at 2 o'clock, yields moved up from 2.95 to 2.99 percent... 4 basis points higher in the first ten minutes of trading, and another couple of basis points to 3.01% at 2:30pm EDT. Why not a stronger rise in bond yields you ask? Probably because the consensus for 4 rate hikes shifted by just one vote. In March eight saw a Fed funds rate of 2.25% or lower, and seven saw a Fed funds rate of 2.5% or higher. Now in June, seven see a Fed funds rate of 2.25% or lower, and eight see a Fed funds rate of 2.5% or higher. Four rate hikes wins by one vote which is not a big enough majority to ensure it will actually happen.

| Fed Individual Forecasts | | | |
|---|---|---|---|
| Fed funds rate | | | |
| Votes | 2018 End | 2018 End | Change |
| 1 | 1.875 | 1.625 | 0.250 |
| 2 | 1.875 | 1.625 | 0.250 |
| 3 | 2.125 | 2.125 | 0.000 |
| 4 | 2.125 | 2.125 | 0.000 |
| 5 | 2.125 | 2.125 | 0.000 |
| 6 | 2.125 | 2.125 | 0.000 |
| 7 | 2.125 | 2.125 | 0.000 |
| 8 | 2.375 | 2.125 | 0.250 |
| 9 | 2.375 | 2.375 | 0.000 |
| 10 | 2.375 | 2.375 | 0.000 |
| 11 | 2.375 | 2.375 | 0.000 |
| 12 | 2.375 | 2.375 | 0.000 |
| 13 | 2.375 | 2.375 | 0.000 |
| 14 | 2.375 | 2.375 | 0.000 |
| 15 | 2.625 | 2.625 | 0.000 |
| | | | |
| | | | |
| Median | 2.375 | 2.125 | 0.250 |
| Meeting | Jun 2018 | Mar 2018 | |

Net, net, the gradual pace of rate hikes stays gradual at this Federal Reserve meeting with the same number of rate hikes seen over the next few years and a slight shuffling in the order. Three hikes in 2018, three hikes in 2019, two hikes in 2020 has been replaced with four hikes in 2018, three hikes in 2019, and one lone-wolf rate hike in 2020. Howl, howl, howl!!! Blink and you'll miss the change.

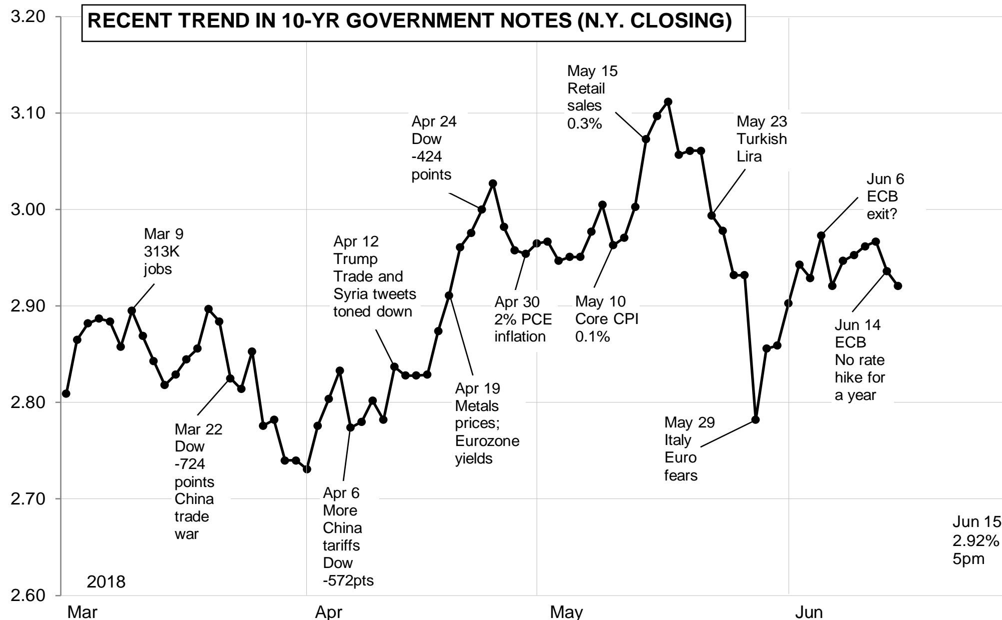
The Fed likes the plan they have in place and is not really changing it. Emerging market turmoil and trade wars are not enough to alter the course of Federal Reserve policy. The rate hikes are not on autopilot Powell says, but you sure could have fooled us. And as far as having eight press conferences each year, we don't know why they would bother if they are only going to raise rates four times a year... max. Three times actually in 2019 with the every meeting press conferences starting at the January 2019 meeting.

Eight press conferences a year. Maybe it is just us, but it seems like just as there are too many tweets coming out of Washington that we are forced to listen to, now there are going to be too many Fed press conferences that we have to listen to. Maybe meet when you have some news to give us. Maybe do that. Otherwise it's overkill. The Federal Reserve Chair is no longer the second most important person in the world anymore. Geez.

Slow and steady wins the race in the Fed's mind as the path of rates is set in stone over the next few years. The economy isn't hot enough to hike rates any faster and the economy isn't cool enough to hike rates any slower. Monetary policy ahead is as certain as we have ever seen it with not a lot of risk out there to hedge if the economy continues to move at its current pace. The key to higher interest rates is inflation. If it does not move higher than it did back in the housing bubble economy years a decade ago, then it doesn't look like the Fed will move interest rates any higher than 3.5% in this cycle. Stay tuned. Story developing. Developing slowly, but developing. We look for a rate hike in September, and a rate hike in December. Bet on it.

## MARKETS OUTLOOK

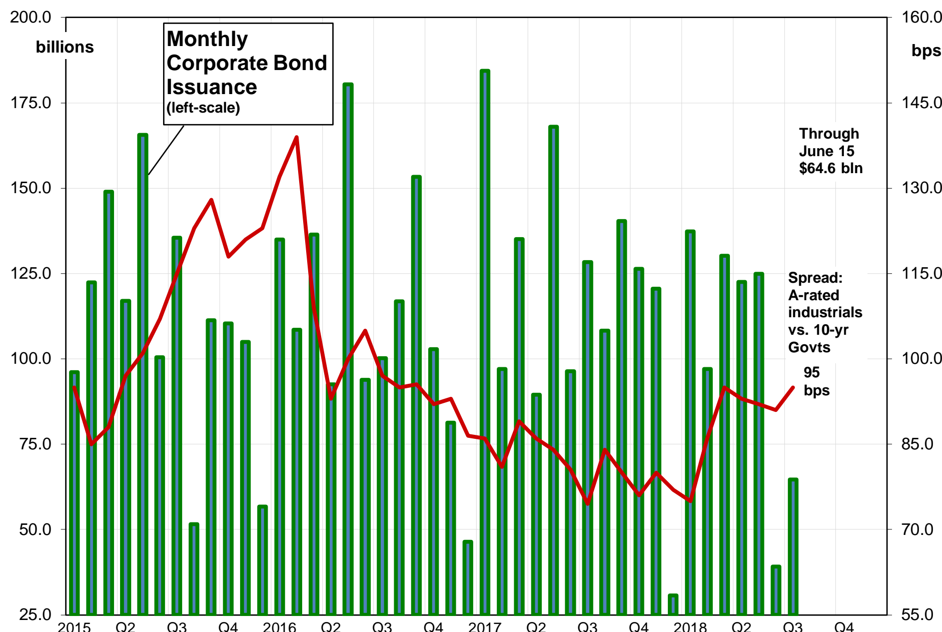
| | 29-Mar 2018 | Q2 2018 | Q3 2018 | Q4 2018 | Q1 2019 | Q2 2019 | Q3 2019 | Q4 2019 | Q1 2020 | Q2 2020 | Q3 2020 | Q4 2020 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 30-Yr Treasury | 2.97 | 3.10 | 3.10 | 3.20 | 3.35 | 3.45 | 3.60 | 3.55 | 3.75 | 3.75 | 3.90 | 4.00 |
| 10-Yr Note | 2.74 | 2.80 | 2.90 | 3.00 | 3.20 | 3.30 | 3.50 | 3.50 | 3.70 | 3.70 | 3.90 | 4.00 |
| 5-Yr Note | 2.56 | 2.60 | 2.70 | 2.80 | 3.05 | 3.15 | 3.40 | 3.45 | 3.65 | 3.65 | 3.90 | 4.00 |
| 2-Yr Note | 2.27 | 2.40 | 2.55 | 2.80 | 3.00 | 3.15 | 3.40 | 3.40 | 3.60 | 3.80 | 4.00 | 4.20 |
| 3-month Libor | 2.31 | 2.30 | 2.55 | 2.80 | 3.05 | 3.30 | 3.55 | 3.55 | 3.70 | 3.95 | 3.95 | 4.20 |
| Fed Funds Rate | 1.75 | 2.00 | 2.25 | 2.50 | 2.75 | 3.00 | 3.25 | 3.25 | 3.50 | 3.75 | 3.75 | 4.00 |
| 2s/10s spread | 47 | 40 | 35 | 20 | 20 | 15 | 10 | 10 | 10 | (10) | (10) | (20) |




The yield high for the week of 3.01% was on Wednesday after the Fed said they would hike 4 times this year versus the three times forecast at the March meeting. Yields did not stick as the consensus for 4 rate hikes is not strong. Yields came back down on Thursday with Draghi saying QE exit, but no rate hike for a year as well. Trade sanctions against China on Friday brought Dow industrials down as much as 280 points. Bond yields fell as low as 2.89% before recovering. Market odds of a 25 bps rate hike to 2.25% at the September Fed meeting are 88%.

## CORPORATES: PROLOGIS, E*TRADE, PPL, AIR LEASE, UNITEDHEALTH

Corporate offerings were $25.4 billion in the June 15 week versus $38.4 billion in the June 8 week. On Tuesday, Sanofi sold $2.0 billion 5s/10s. It priced a $1.0 billion 3.625% 10-yr (m-w +15bp) at 75 bps (A1/AA). The pharmaceutical company will use the proceeds for general corporate purposes, including the repayment of existing borrowings. Corporate bonds (10-yr Industrials rated A2) were 95 bps above 10-yr Treasuries this week versus 91 bps last Friday.



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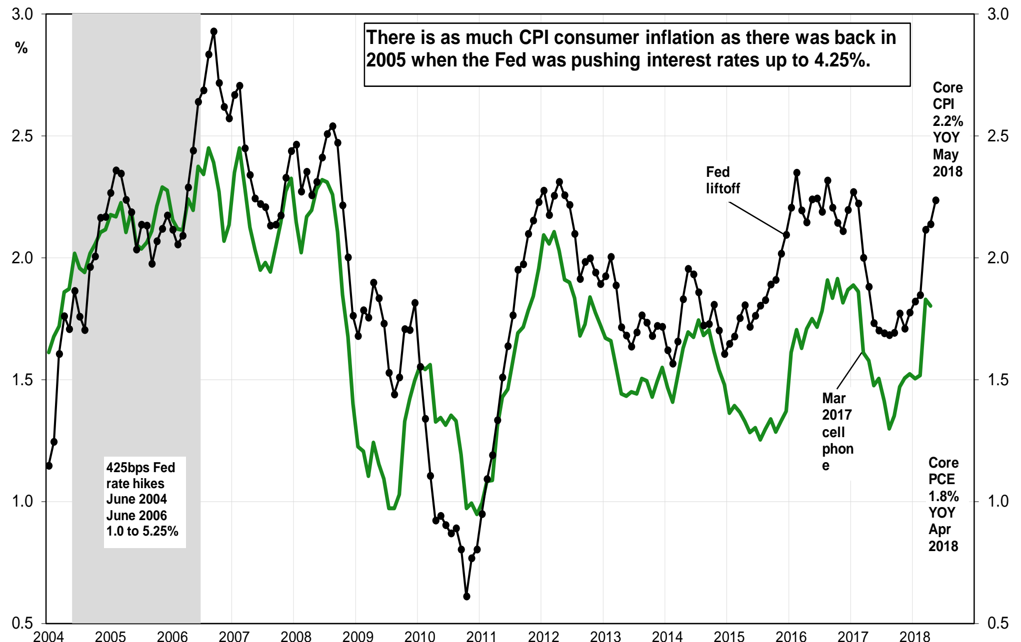
## OTHER ECONOMIC NEWS THIS WEEK

### Simon says 2.8% CPI is not inflation (Tuesday)

Simon says put your hands on your head, Simon says 2.8% CPI is not inflation. No need to speed up the gradual pace of rate hikes. 2.8 percent. That's not inflation. Paper money, the dollar bills in your pocket, will only buy a third less goods and services ten years from now if inflation holds at this rate.




How times have changed. 2.8% headline CPI inflation in May, based on a market-basket of goods we buy, which is higher than 2.5% last month in April and yet the bond market gave the report a great big yawn. Maybe traders are still reading about North Korea.

Net, net, inflation is warming up but the heat is not enough to light a fire under Fed officials and panic them into moving interest rates more quickly to normal levels. There is inflation out there on the horizon but it is largely a mirage policymakers think which will disappear when the economy gets there. Inflation pressures may well build as they normally do when the economy is at full employment, but the Fed is unlikely to overreact this time and actually tighten its policy and move rates above normal to slow the economy down.

Don't rock the boat will be the new mantra of Fed policymakers. Don't jeopardize the economy's chances of breaking the ten year expansion of the 90s. Inflation is warm enough to take their foot off the gas, but not hot enough for Federal Reserve officials to apply the brakes. Stay tuned. Story developing.

### Inflation pressures continue to build driven by fully employed economy (Wednesday)

Breaking economy news. PPI inflation data for May. Total final demand producer prices up 0.5% in May driven by the biggest pop in energy prices in at least a year. Final demand goods prices less foods and energy have risen 0.3% for three consecutive months now raising the specter that Federal Reserve officials will have to switch sides and start playing offense to keep this economic expansion on track. These core final demand goods prices have increased 2.5 percent over the last year which is the most inflation seen since the year 2011. If this keeps up, the Federal Reserve will have to go even higher than neutral on interest rates which could put the economic expansion at risk of not finishing its tenth year that starts next month.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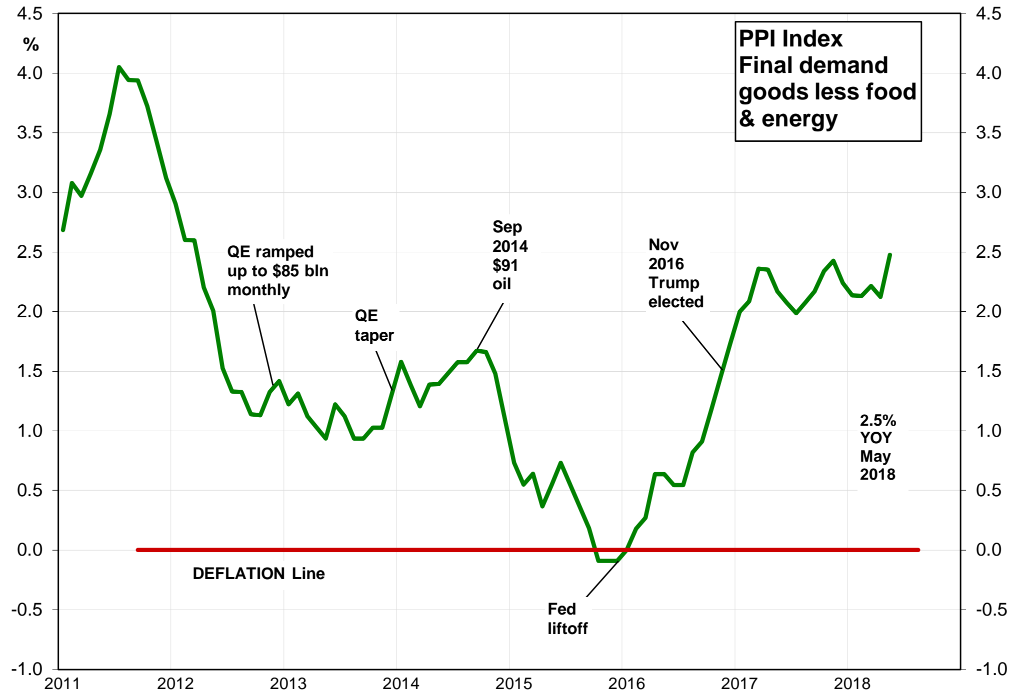
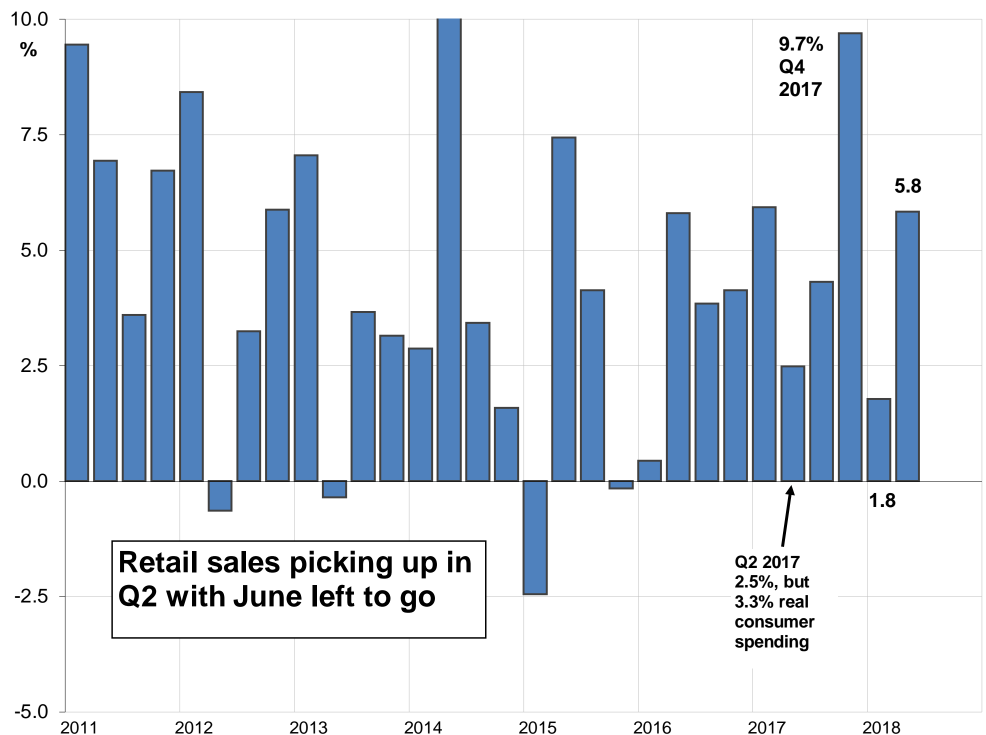
Net, net, with inflation pressures building at the producer level, it is just a matter of time before inflation breaks out at the consumer level. The Fed is on the right course with its gradual pace of rate hikes because the inflation heat may yet lead to fire and the risk that monetary policy has to move faster and put the long economic recovery in jeopardy. With the economy throwing off the sparks of inflation, there is no longer a need for monetary policy stimulus this late in the economic expansion. The Fed is behind the curve in trying to keep inflation pressures down because the inflation genie has already popped the cork from his bottle and price pressures are spilling out all over. We expect the Fed to continue to move rates at a gradual pace, we just hope they are not too late.




## ECB cuts growth forecast; US retail sales boosts our US GDP forecast (Thursday)

Breaking economy news. Draghi is saying interest rates aren't going anywhere over in Europe, at least through next summer, but rates are going places here in the good old USA, higher and higher and higher if US consumers have anything to say about it. There has been turbulence in overseas markets and the threat of trade wars is out there on the horizon, but that hasn't dented consumer confidence, and now they finally went out to the shops and malls this month and bought the ranch in May and everything you can put in a ranch. They aren't buying cars, but everything else is being cleared off the store shelves. Retail sales rose



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0.8% in May, and it's not just higher gas prices as sales ex-gas rose 0.7%. Everything went up except furniture and sporting goods. They actually went to the mall too, as Internet retail sales made on the phone from your couch rose just 0.1% this month, even if they are up 9.1% the last year.

Retail sales had cooled in the first quarter to 1.8% from the fourth quarter's blistering 9.7% pace. But with only one more month to go in the second quarter, retail sales have strengthened back to a 5.8% annual rate, ensuring that growth will indeed hit the Trump administration's target of 3.0%.

Net, net, consumers are back in a big way and provide the rocket fuel that is powering the stronger 3 percent growth we are forecasting this quarter. This is exactly what we should expect to see when the economy is giving everyone a job and workers have their pockets stuffed with massive tax cuts cash. Jobless claims signal the economy is way beyond full employment falling 4K to rock-bottom lows of 218K in the June 9 week.

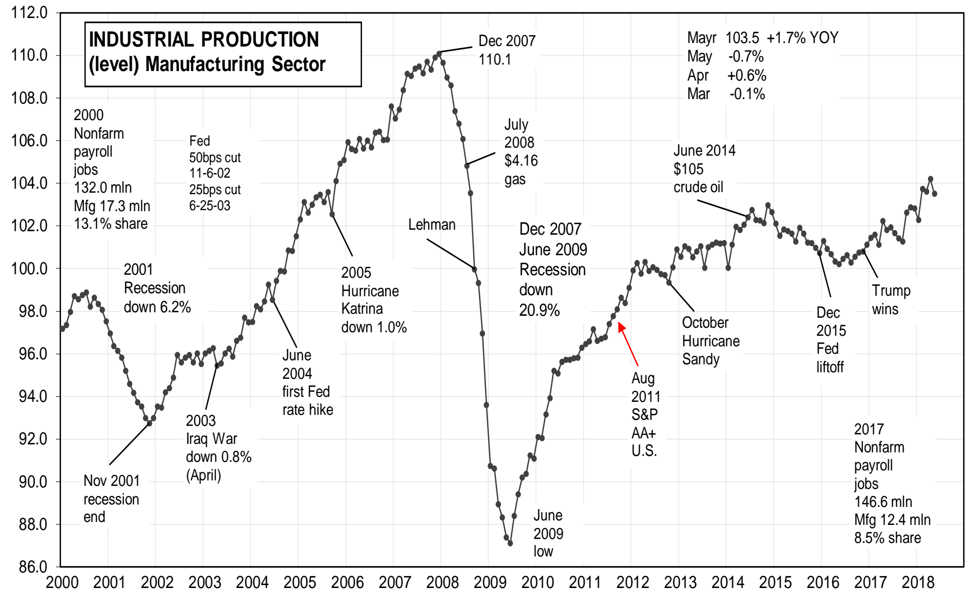
This isn't bitcoin, this economy is seeing a real surge in activity that keeps the Fed on the gradual path for normalizing interest rates. Fed officials were split on the need to raise rates two more times this year at yesterday's meeting, the odds narrowly favoring a faster pace, but with stronger retail sales data like these in hand, there is no question that they will raise rates another step at the upcoming September press conference meeting. The economy is stronger than you think. Bet on it. Consumers make it true.

The Fed has to keep going, taking the stimulus away, before inflation pressures build. Import prices ex-fuel are still rising, up 0.2% this month, and prices are accelerating. In the last year, import price ex-fuel are up 1.9%, where the year before, the 12 months ending May 2017, these core import prices rose just 0.9%. The US is getting hit from all sides when it comes to inflation, the domestic economy is heating up, and imports are bringing in inflation on ships and planes from abroad as well. We've seen enough. Retail sales are strong, we advise those policymakers sitting on the fence to vote with the majority of their colleagues for another rate hike in September.

## Factory production crash and burns this month, on fire, literally (Friday)

Breaking economy news. Industrial production for manufacturing drops a sharp 0.7% in May. No, the trade war has not disrupted America's great export machine yet, in fact, quite the opposite, it looks like importers and exporters are scrambling to bring in and push out extra amounts of goods before getting slapped with tariffs. Manufacturing production took a dive in May as truck production was taken off line due to a fire at a major parts supplier. Without this decline in truck assemblies, manufacturing industrial production fell just 0.2%. Well, it is still down, and this doesn't bode well for factory production later this year.

Net, net, production took a dive this month, overstated due to a special factor which disrupted truck production temporarily. Manufacturing at factories was still down overall however, and the future prospects for many industries are growing dimmer by the moment as America's trade war with Europe and China grows more heated by the day. Manufacturing output in the US is highly dependent on exports of goods to America's trading partners and it will be a miracle if the economy doesn't take a hit from the uncertainty of protectionism and trade sanctions. America is great again right now, but it won't be if the economic growth provided by exports sinks due to America's trade war with the world. Stay tuned. Story developing.




| | | | Industrial Production May 2018 | | |
|---|---|---|---|---|---|
| Percent changes | | | YOY | | Weight |
| May | Apr | Mar | 3.5 | Total Index | 100.0 |
| -0.7 | 0.6 | -0.1 | 1.7 | Manufacturing | 75.5 |
| 1.8 | 1.0 | 1.4 | 12.6 | Mining | 14.1 |
| 1.1 | 3.2 | 4.1 | 4.0 | Utilities | 10.4 |
| | | | Manufacturing payroll jobs<br>12.7 million +259K YOY<br>10.0% of Private Payroll Jobs | | |

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