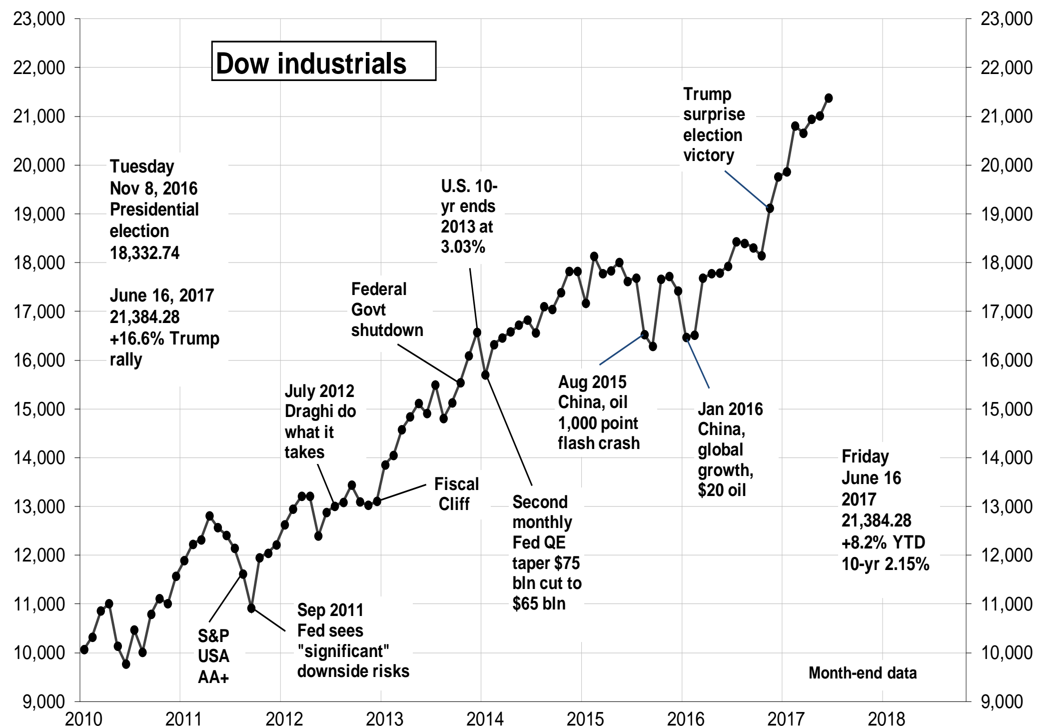
Financial Market Weekly

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

MUFG | 1251 Avenue of the Americas
New York, New York 10020

16 JUNE 2017

STOCK MARKET SELL-OFF: STILL WAITING FOR IT, YOU SHOULD TOO



It's coming. Or rather maybe it's not. There hasn't been a major market sell-off of over 5% since late 2015 to early 2016. The Trump stock rally continues to hold despite the investigations, some missteps, and the failure in Congress to advance any new legislation on healthcare, tax reform "where's my tax cut?" infrastructure spending etc. We aren't sure the stock market has traded higher on the hopes that Trump's campaign promises would ever become law. As Senate Majority Leader Mitch McConnell said, "We haven't paid a whole lot of attention to any president's budget since I've been here." And similarly, maybe the stock market isn't listening either to what is going on down in Washington. In fact, the economic outlook looks good from where we sit regardless of any plans down in Washington.

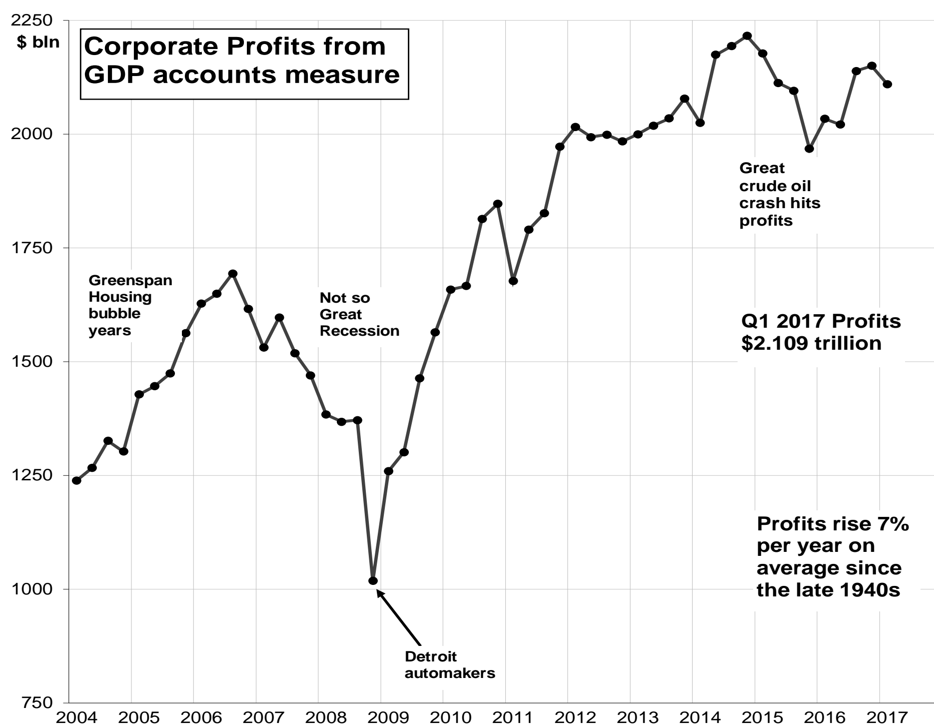
Dow industrials market sell-offs

Week ending Fridays

Chg %	Points	High	Low	High	Low	Reason
-15.1	-1909.7	7-22-11	9-23-11	12681.2	10771.5	S&P USA AA+, Fed sees "significant" downside risks
-8.4	-1109.7	4-27-12	6-1-12	13228.3	12118.6	European sovereign debt crisis pre-Draghi do whatever
-7.5	-1021.8	10-5-12	11-16-12	13610.2	12588.3	Fiscal cliff
-5.4	-848.05	8-2-13	8-30-13	15658.4	14810.3	Bond yields taper tantrum, Syria
-5.2	-899.33	9-19-14	10-17-14	17279.7	16380.4	Ebola, IMF cuts world growth forecast
-11.9	-2170.2	5-15-15	9-4-15	18272.6	16102.4	China, oil, 1,000 point flash crash Monday, Aug 24
-10.8	-1936.5	11-6-15	2-12-16	17910.3	15973.8	Fed liftoff, China, $20 oil, world growth, Japan negative rates

MUFG

Point One: the economy doesn't need fiscal stimulus. Maybe that's why stocks are doing better. The economic expansion begins year nine next month. Moreover, as the graph of corporate profits on this page makes clear, companies continue to make money in their halting, uneven way perhaps, just as they always do. Corporate profits have averaged 7% per year since the late 1940s; we reject the market call of some heads of asset managers, private equity funds and others that America needs to get used to reduced returns on equites in the future. We are uncertain where they are coming up with these ideas, but we have not seen any well-designed research pointing to reduced investment returns in the future. Throwing out slower growth GDP estimates, productivity weakened by the lack of innovation and exciting new products to produce and purchase, and demographics scare-mongering, as reasons does not support their arguments for reduced profitability in the future. There has been a lull in "GDP" company profits since the fallout from the crude oil crash, but we expect corporate profits to pick up again shortly.



MARKETS OUTLOOK

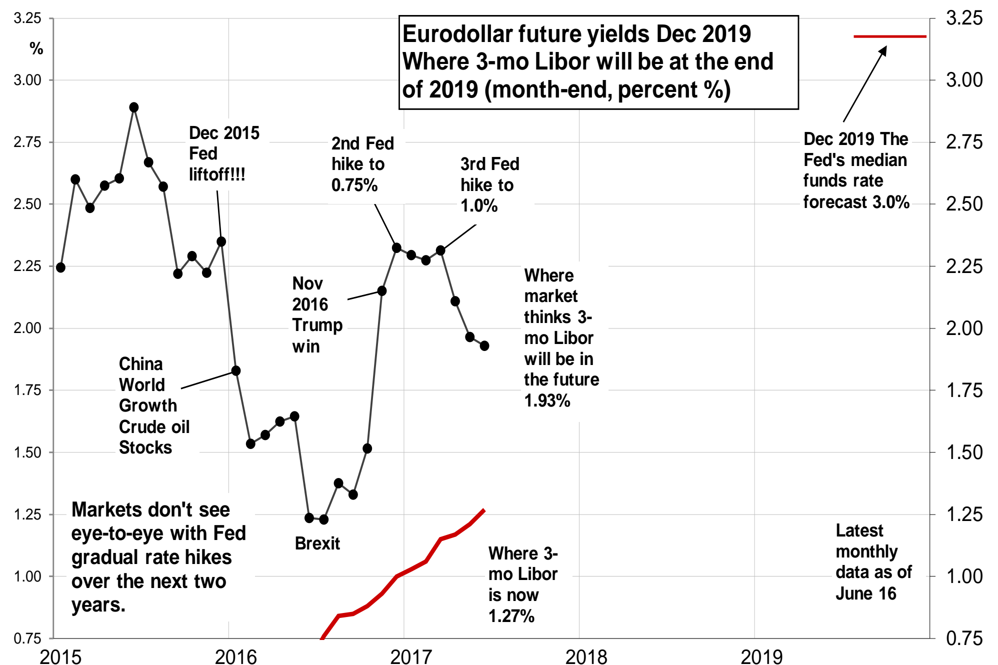
	16-Jun 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019
30-Yr Treasury	2.78	3.10	3.20	3.40	3.60	3.70	3.80	4.00	4.10	4.10	4.10
10-Yr Note	2.15	2.50	2.70	3.00	3.20	3.40	3.50	3.70	3.80	3.90	3.90
5-Yr Note	1.74	2.10	2.40	2.70	3.00	3.20	3.30	3.50	3.60	3.70	3.70
2-Yr Note	1.32	1.60	1.85	2.10	2.40	2.60	2.85	3.10	3.35	3.35	3.60
3-month Libor	1.27	1.65	1.90	2.20	2.45	2.70	2.95	3.20	3.45	3.35	3.70
Fed Funds Rate	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50
2s/10s spread	83	90	85	90	80	80	65	60	45	55	30
Libor/funds spd	2	15	15	20	20	20	20	20	20	10	20

We updated the interest rate forecast after the Fed meeting pushing the higher rates story out a quarter. We are keeping with a 100 bps, 4 rate hikes per year pace of Fed action. The unemployment rate is too low to have a Fed funds rate of just 1.25%. Whether core PCE inflation is 1.5% or 2.0% is irrelevant. Rates need to be normal right now, 100 bps above "inflation," not three years from now. We are a little uncertain what to make of the tight spread between 3-month Libor and the top of the Fed funds target. Seems like it should be 20 bps if the Fed is hiking rates again. On Friday, the new Fed funds rate is 1.25% and 3-month Libor is just 1.27%. Maybe the thinking is that the Fed will indeed skip a rate hike in September. Market content to sit and wait on Fed to push rates up.

The 10-yr Treasury yield came down on Wednesday morning's economic news reports before the Fed announcement. Retail sales in May fell 0.3% where an unchanged 0.0% reading was anticipated, and headline CPI at the same time fell 0.1% where an unchanged 0.0% reading was expected. The Fed has waited so long now that even headline CPI, warts and all, we mean, energy and food prices as well, is down to 1.9% YOY short of the Fed's 2.0% target, where it had been 2.7% on a year-to-year basis in February. Before retail sales and CPI, 10-yr yields were 2.20% and traded 10 bps lower in yield to 2.10%, before the Fed unwind announcement story sent yields back up. 10-yr yields closed the week at 2.15%, and are waiting for, they are waiting for, it is unclear what they are waiting for, maybe the next tweet.

FEDERAL RESERVE POLICY

The Fed met June 13-14 to consider its monetary policy. The Fed raised rates 25 bps to 1.25% as expected. They left the path of rates broadly unchanged from the March meeting which means one more rate hike this year, and three in 2018 and three more rate hikes in December 2019 to 3% (brought down to 2.9% this meeting, but who's counting). We got the details on the Fed's balance sheet wind down, and that's news that was not expected. The market has made a lot of this balance sheet reduction, thinking it might take the place of a rate hike at one of the upcoming meetings. Heck, maybe they skip a September 2017 meeting



MUFG

rate hike and instead commence with the balance sheet wind down which the committee expects to begin implementing this year with the usual caveat "if the economy evolves broadly as anticipated" whatever that means. This is what we thought at the time of the 2pm announcement, but Yellen in the press conference said they have made no decision on whether they could announce the unwind and raise rates at the same time. It depends on the outlook and conditions at the time of the meeting. Rates remain the primary tool of monetary policy. And the great unwind is supposed to run quietly in the background.

We don't know how much to make of the balance sheet unwind. Fed research saying the $4.5 trillion balance sheet depresses 10-yr Treasury yields down to 2.2% where they should be really at 3.2% seems pretty unconvincing. And this is from an economist who wants to see the Fed "Make Interest Rates Great Again." Put rates back up to normal where they were before you caused the financial crisis and worsened the recession.

Selected Fed assets and liabilities Fed H.4.1 statistical release billions, Wednesday data	14-Jun	7-Jun	31-May	24-May	Sep 10 2008** pre-LEH
Factors adding reserves					
U.S. Treasury securities	2464.871	2464.783	2464.696	2464.660	479.782
Federal agency debt securities	8.097	8.834	8.834	8.834	0.000
Mortgage-backed securities	1782.601	1770.958	1770.958	1780.383	0.000
Primary credit (Discount Window)	0.010	0.003	0.016	0.011	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)	1.709	1.709	1.709	1.710	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	0.036	0.040	0.035	0.041	62.000
Federal Reserve Assets	4522.6	4508.9	4505.9	4517.5	961.7
3-month Libor %	1.25	1.22	1.21	1.20	2.82
Factors draining reserves					
Currency in circulation	1555.470	1556.333	1556.472	1551.551	834.477
Term Deposit Facility	0.000	0.000	0.000	16.347	0.000
Reverse repurchases w/others	163.056	165.138	270.326	184.946	0.000
Reserve Balances (Net Liquidity)	2291.433	2270.846	2129.606	2206.163	24.964
Treasuries within 15 days	0.000	0.000	0.000	11.910	14.955
Treasuries 16 to 90 days	47.807	47.806	44.608	44.608	31.549
Treasuries 91 days to 1 year	256.065	256.062	259.257	230.778	69.272
Treasuries over 1-yr to 5 years	1174.347	1174.333	1174.320	1195.577	170.807
Treasuries over 5-yrs to 10 years	353.806	353.787	353.768	349.059	91.863
Treasuries over 10-years	632.846	632.794	632.743	632.730	101.337

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

After a year phase-in period following the start of the Great Unwind, Treasury holdings will run off a maximum of $30 billion per month or $360 billion per year, and MBS will be allowed to unwind at up to $20 billion per month. This is a maximum of $600 billion per year once they get up to full speed perhaps sometime next September or so. Keep in mind in the table above they are only winding down the amount of reserve balances, the deposits at the banks. In the June 14, 2017 week, reserve balances were $2.291 trillion so it will take about four years to bring it down to $24.9 billion where it was pre-Lehman in September 2008.

For their MBS holdings of roughly $1.8 trillion, these will wind down as much as $20 billion per month or $240 billion per year and this is easily achievable. We thought the committee at one time said they would allow the MBS holdings only to wind down, to keep the balance sheet pure with U.S. Treasuries, but apparently not. MBS prepayments could be faster and so the monthly amount needs to be capped each month otherwise it would be closer to $350 billion the run down each year. But maybe they want MBS to roll off their balance sheet more slowly so they don't cause a disruption in the home financing markets, disruption that could lead to higher financing costs for buying a home and shoot the nascent housing recovery in the foot. (See our comment on housing starts later.)

Last week Freddie Mac 30-yr money was 3.89% for a yield spread over 10-yr Treasuries of 172 bps. This market is the chief worry for us, if the Fed gets the great unwind all wrong. Don't forget the first QE way back in 2008 was $500 billion of MBS purchases done to help the housing finance markets. Yield spreads above Treasuries are 170 bps now, but back in 2008 after the Lehman shock, homebuyers brave enough to step in to the financial crisis storm had to pay over 250 bps above

Treasuries to get that 30-yr loan to buy a house. The first $500 billion MBS quantitative easing brought home loan yields back down and tightened yield spreads to Treasuries back to normal. It is one QE that actually worked, the first one, no debate about it.

So, the market was clearly caught off guard with the nitty gritty details of the Fed's balance sheet unwind on Wednesday. The unwind giveth and taketh away we guess for the higher rates story. New York Fed President Dudley said they could skip a meeting for a rate hike and instead start the unwind. On the other hand, the unwind means the Treasury will send the Fed up to $360 billion per year from its maturing securities holdings that will be used to bring down the $2.2 trillion "excess" reserves in the banking system. The Treasury will then need to auction $360 billion more bills, notes and bonds each year to make up the difference. Will this additional Treasury supply push up 10-yr Treasury yields? We'd like some help with our 3% wishful thinking bond yield forecast certainly, but the Obama trillion dollar budget deficits 2009-2012 didn't force yields higher. In fiscal year 2016 ending last September, the Federal budget deficit was $585 billion, but the Treasury actually sold $795 billion at securities auctions to "fund" the deficit and some other technical things. Could an additional $360 billion of issuance as a result of the Fed's balance sheet unwind push up Treasury yields? Doesn't seem like it. The level of the Fed funds rate is the more important factor for 10-yr yields, even if the market is ignoring the Fed forecasts of a 3% Fed funds rate at the end of 2019. Stay tuned. Story slowly evolving.

FED PRESS STATEMENT

No real change in their assessment of the economy. In May they thought the slower growth in Q1 was likely to prove transitory, and in June "economic has been rising moderately." Okay. And inflation is expected to stay below 2% in the "near term," but they all look for at least one more rate hike in 2017 anyway. (Well, 12 out of 16 vote for it, with 4 complainers.)

June 14, 2017

Information received since the Federal Open Market Committee met in May indicates that the labor market has continued to strengthen and that economic activity has been rising moderately so far this year. Job gains have moderated but have been solid, on average, since the beginning of the year, and the unemployment rate has declined. Household spending has picked up in recent months, and business fixed investment has continued to expand. On a 12-month basis, inflation has declined recently and, like the measure excluding food and energy prices, is running somewhat below 2 percent. Market-based measures of inflation compensation remain low; survey-based measures of longer-term inflation expectations are little changed, on balance.

May 3, 2017

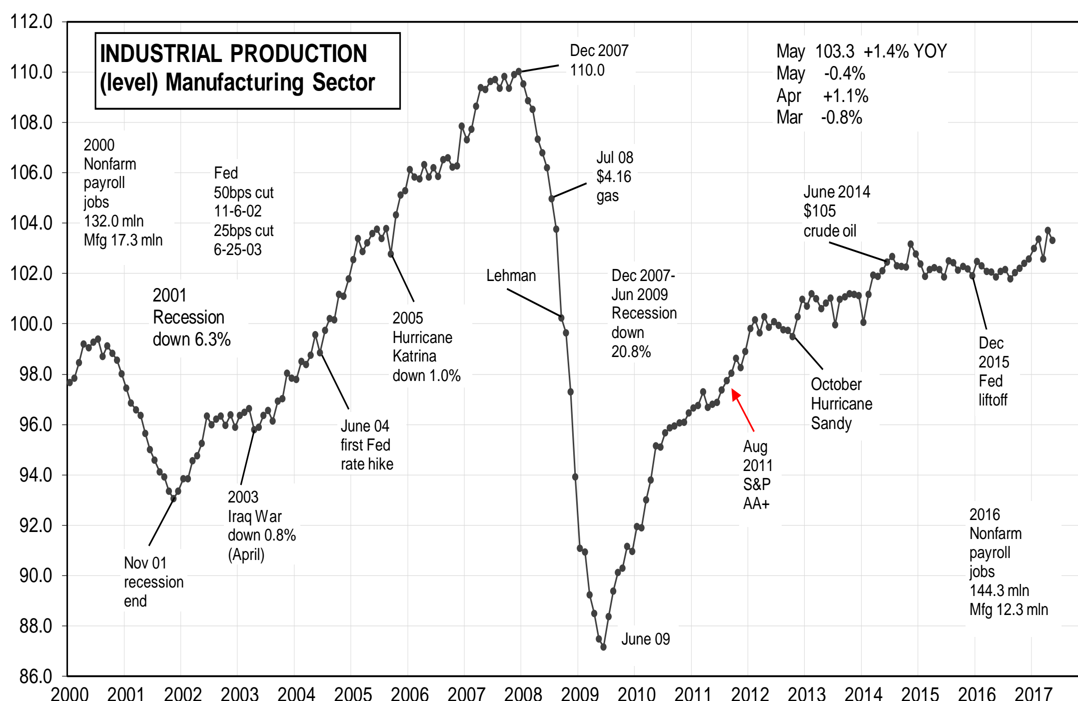
Information received since the Federal Open Market Committee met in March indicates that the labor market has continued to strengthen even as growth in economic activity slowed. Job gains were solid, on average, in recent months, and the unemployment rate declined. Household spending rose only modestly, but the fundamentals underpinning the continued growth of consumption remained solid. Business fixed investment firmed. Inflation measured on a 12-month basis recently has been running close to the Committee's 2 percent longer-run objective. Excluding energy and food, consumer prices declined in March and inflation continued to run somewhat below 2 percent. Market-based measures of inflation compensation remain low; survey-based measures of longer-term inflation expectations are little changed, on balance.

OTHER ECONOMIC NEWS THIS WEEK

(It's a good thing that all is well and the economy has reached the recovery finish line of full employment after eight straight years of growth because not all the numbers point to a better tomorrow.)

One step forward, one step back for industrial production

Breaking economy news. Don't bring those new robots in to displace workers at your factories yet because industrial production fell back from last month's big gain. We don't know what ails the industrial sector, but factories clearly are not producing, especially in manufacturing. We guess on a bright note, mining production continues to recover from the oil crash in 2014 with output up strongly the last two months which at least eliminates one headache for the economic outlook. Mining output jumped up 1.6% in May, following up on April's 1.5% gain, and is now 8.3% above prior year levels.



The best we can say about manufacturing output is that the trend is a little erratic and hard to read perhaps with a 0.8% drop in March, 1.1% bounce in April, and now down 0.4% in May. Business equipment is weak and that can't be positive for the outlook.

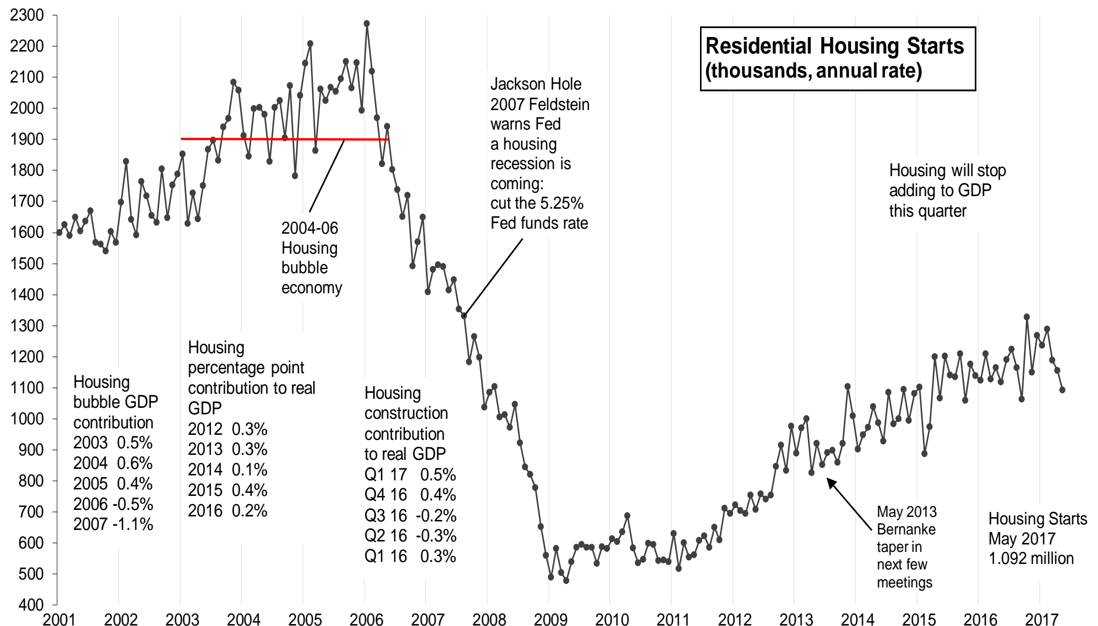
Net, net, Trump's economics team has its work cut out for it to try and make America's factories great again. This is the only economic expansion in U.S. history where industry output has not gone to new all-time record highs. And this is over an expansion that has all but completed its eighth year. We'd say let's get this sector going again, maybe Washington has some ideas, but it is really just shouting in the wind. It's too late to bring back those jobs from overseas anyway, because as the labor market tightness tells us, there is no one to fill those jobs on shop floors in the nation's heartland.

Flagging housing construction points to risks to the economic outlook

Breaking economy news, and we do mean breaking. Housing starts down 5.5% in May to 1.092 million at an annual rate, and building permits down 4.9% to 1.168 million also at an annual rate.

MUFG

Housing starts have gone nowhere for a couple of years now. Put up a graph of residential housing construction, we don't care if it is housing starts or housing permits and it looks like the sector has entered a downturn. One thing is for sure the economy just encountered major turbulence and has lost one of its major engines for growth. Housing construction added a hefty 0.5 percentage points to that sluggish 1.2% real GDP growth at the start of the year, and for the second quarter you can put out the Mayday calls already as construction is diving and won't add a nickel to second quarter growth. The economic outlook has suddenly turned very dark if the tea leaves from residential housing are to be believed. Sure single-family home construction is up in the Northeast and the Midwest, but these are the two smallest regions of the country and these increases cannot carry the whole country forward.



Net, net, this sputtering home construction data are a major blow to Trump's economics team who after inheriting the best economic conditions since President Bush in 2001, seem to be unable to capitalize on the stronger consumer and business confidence when it comes to boosting the nation's economic growth. You can lead a horse to water, but you can't make him drink.

Simply put, you can kiss those hopes the President has for 3 percent GDP growth good-bye if homebuilders don't start putting up new homes again. This is a major imbalance that could bring the economy to a halt if whatever ails construction doesn't get fixed and fast. Right now, home prices are soaring and more and more fingers are pointing directly at the lack of supply as the culprit. Consumer spending is going to suffer if more of workers' incomes keep going to pay the rent and the interest on their home loans.

We hope it's going to turn out okay. The Fed may take a pass on hiking rates for a fourth straight "press conference" meeting in September if housing starts, a key driver of "investment" in the economy, don't bounce. Even announcing the start of the balance sheet unwind is just a 50/50 proposition at the moment for September. To conclude, we don't know what homebuilders are thinking, but multi-family housing starts have declined every single month this year. And the pullback is severe. This seems to be driving the weakness in new home building. Single-family starts are also off from recent highs, although they never recovered anywhere near the highs in the housing bubble years a decade ago; not enough land to build perhaps, not enough financing for the builders.

Whatever the reason, residential housing construction data at the end of this week are a risk to the overall economic outlook this year. Stay tuned. Story developing.

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.

The information herein is provided for information purposes only, and is not to be used or considered as an offer or the solicitation of an offer to sell or to buy or subscribe for securities or other financial instruments. Neither this nor any other communication prepared by The Bank of Tokyo-Mitsubishi UFJ, Ltd. (collectively with its various offices and affiliates, "BTMU") or should be construed as investment advice, a recommendation to enter into a particular transaction or pursue a particular strategy, or any statement as to the likelihood that a particular transaction or strategy will be effective in light of your business objectives or operations. Before entering into any particular transaction, you are advised to obtain such independent financial, legal, accounting and other advice as may be appropriate under the circumstances. In any event, any decision to enter into a transaction will be yours alone, not based on information prepared or provided by BTMU. BTMU hereby disclaims any responsibility to you concerning the characterization or identification of terms, conditions, and legal or accounting or other issues or risks that may arise in connection with any particular transaction or business strategy. While BTMU believes that any relevant factual statements herein and any assumptions on which information herein are based, are in each case accurate, BTMU makes no representation or warranty regarding such accuracy and shall not be responsible for any inaccuracy in such statements or assumptions. Note that BTMU may have issued, and may in the future issue, other reports that are inconsistent with or that reach conclusions different from the information set forth herein. Such other reports, if any, reflect the different assumptions, views and/or analytical methods of the analysts who prepared them, and BTMU is under no obligation to ensure that such other reports are brought to your attention.

Copyright 2017 MUFG All Rights Reserved

The articles and opinions in this publication are for general information only, are subject to change, and are not intended to provide specific investment, legal, tax or other advice or recommendations. The information contained herein reflects the thoughts and opinions of the noted authors only, and such information does not necessarily reflect the thoughts and opinions of MUFG or its management team. We are not offering or soliciting any transaction based on this information. We suggest that you consult your attorney, accountant or tax or financial advisor with regard to your situation. Although information has been obtained from sources we believe to be reliable, neither the authors nor MUFG guarntee its accuracy, and such information may be incomplete or condensed. Neither the authors nor MUFG shall be liable for any typographical errors or incorrect data obtained from reliable sources or factual information.

About MUFG Americas Holdings Corporation

Headquartered in New York, MUFG Americas Holdings Corporation is a financial holding company and bank holding company with total assets of $148.1 billion at December 31, 2016. Its main subsidiaries are MUFG Union Bank, N.A. and MUFG Securities Americas Inc. MUFG Union Bank, N.A. provides an array of financial services to individuals, small businesses, middle-market companies, and major corporations. As of December 31, 2016, MUFG Union Bank, N.A. operated 365 branches, comprised primarily of retail banking branches in the West Coast states, along with commercial branches in Texas, Illinois, New York and Georgia, as well as two international offices. MUFG Securities Americas Inc. is a registered securities broker-dealer which engages in capital markets origination transactions, private placements, collateralized financings, securities borrowing and lending transactions, and domestic and foreign debt and equities securities transactions. MUFG Americas Holdings Corporation is owned by The Bank of Tokyo-Mitsubishi UFJ, Ltd. and Mitsubishi UFJ Financial Group, Inc., one of the world's leading financial groups. The Bank of Tokyo-Mitsubishi UFJ, Ltd. is a wholly owned subsidiary of Mitsubishi UFJ Financial Group, Inc. Visit http://www.unionbank.com/ or http://www.mufgamericas.com/ for more information.

About MUFG (Mitsubishi UFJ Financial Group, Inc.)

MUFG (Mitsubishi UFJ Financial Group, Inc.) is one of the world's leading financial groups, with total assets of approximately $2.6 trillion (USD) as of December 31, 2016. Headquartered in Tokyo and with approximately 350 years of history, MUFG is a global network with more than 2,200 offices in nearly 50 countries. The Group has more than 140,000 employees and about 300 entities, offering services including commercial banking, trust banking, securities, credit cards, consumer finance, asset management, and leasing. The Group's operating companies include Bank of Tokyo-Mitsubishi UFJ, Mitsubishi UFJ Trust and Banking Corporation (Japan's leading trust bank), and Mitsubishi UFJ Securities Holdings Co., Ltd., one of Japan's largest securities firms.

Through close partnerships among our operating companies, the Group aims to "be the world's most trusted financial group," flexibly responding to all of the financial needs of our customers, serving society, and fostering shared and sustainable growth for a better world. MUFG's shares trade on the Tokyo, Nagoya, and New York (MTU) stock exchanges. Visit www.mufg.jp/english/index.html.