Financial Market Weekly

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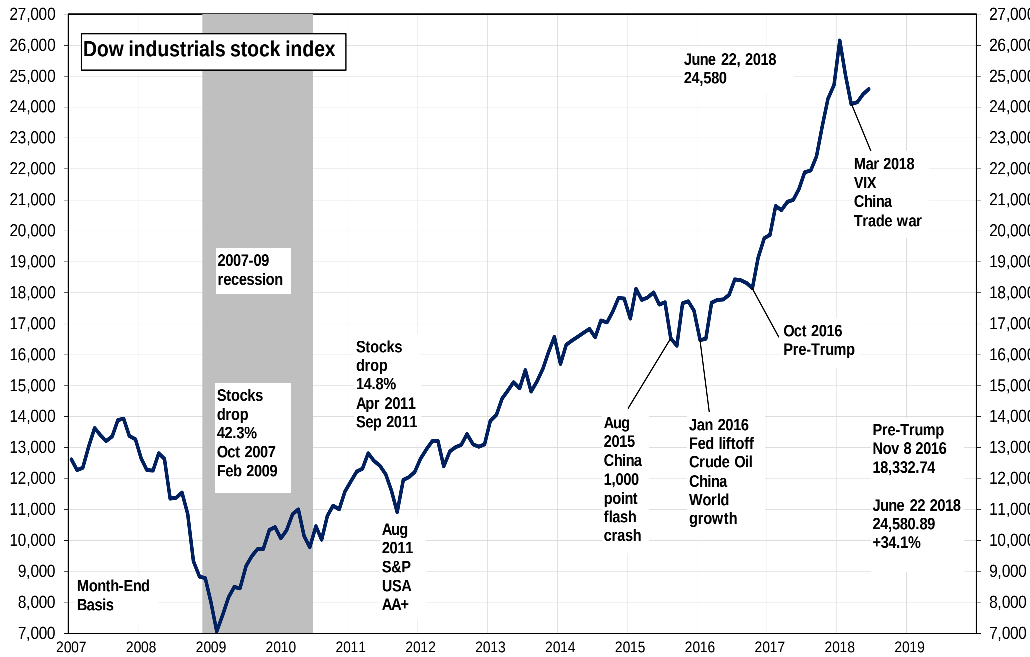
22 JUNE 2018

TRADE WAR AND THE STOCK MARKET—HOW BAD CAN IT GET? TRUMP STOCK MARKET RALLY TO DATE IS HOLDING AT 34%



The Trump rally in Dow industrials from November 8, 2016 "election eve" closed up 34.1% this week even if it is well off the highs of the year. Doesn't seem like enough to compensate for all that the world and markets have gone through. Biggest tax cuts in history notwithstanding, the financial world keeps wondering why the trade wars have not sunk the stock market more than it has, especially given the news since last week. Maybe one reason for the muted reaction in stocks is markets don't know how bad it will get as the trade story never seems to be over. New headlines and tweets every day. The $50 billion in China tariffs announced by the White House Friday morning June 15 was matched by same-scale tariffs on U.S. goods by China the same day. On Monday, June 18 Trump directs the US trade rep to find another $200 billion of retaliatory 10% tariffs against imported goods from China.

Maybe one other reason stocks have not sold off further is because the trade wars can stop as quickly as they started with a tweet. Like Trump tweeting Friday morning he might put a 20% tariff on car imports from Europe. This is all just the process of negotiation: Trump-style. Didn't convince you probably. And given what the White House put out on Monday regarding China, you are probably right. This story isn't going away. We will try to just stick with trade flows and the stock market, mostly stocks this week, and leave the China economic aggression topic for others to analyze.

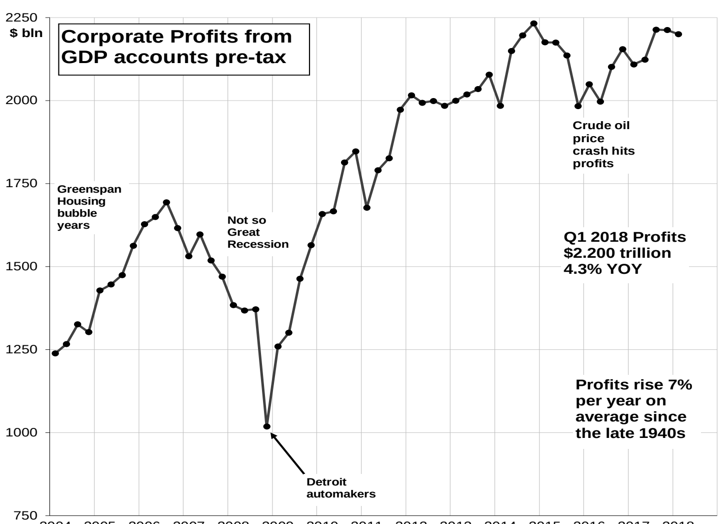
Are stocks overvalued? We'll look at corporate earnings in a minute, but it is important to remember that stocks never fully recovered from this 11.6% sell-off since the end of January so the market is already down here discounting a lot of bad news already. If the trade tweets stop and/or Fed rate hikes stop, stock prices could suddenly rebound. Not yet though. And this sell-off in 2018 rivals the stock market rout in early 2016 on world growth fears, and China. Stock losses in early 2016 were 10.8% which stopped the Fed cold in its tracks for almost a year, after the initial liftoff in December 2015. Stocks dropped 11.6% on a weekending Friday basis from the end of January to March 23 this year and as of Friday, June 22, the loss was still 7.6%.

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
-5.3	-947.99	June 2016		18011.1	17063.1	Brexit: Two days June 23 close to Monday, June 27 low
-11.6	-3083.5	1-26-18	3-23-18	26616.7	23533.2	VIX-Linked Notes; China; Trade war(s)

Companies are still making money, although the GDP accounts measure of profits is stronger lately due to the biggest corporate tax cuts since at least the 1980s. Pre-tax profits had returned to the record level seen before the oil price crash in 2014 even if they were unable to move higher. Before taxes, corporate profits were $2.232 trillion in Q4 2014 and $2.213 trillion in Q3 2017 before dipping 0.1% in Q4 2017 and 0.6% in Q1 2018. The changes in Washington have not boosted corporate earnings to record highs yet. All of the improvement in corporate profits comes from the massive tax cuts. Corporate taxes were $479.6 billion in Q2 2017 and are now just $328.2 billion in Q1 2018 a drop of 31.6% or $151.4 billion.



Corporate Profits

$bln	Q1 2018	Q4 2017	Q3 2017	Q2 2017	2017	2016
Pre-tax	2,200.1	2,212.5	2,213.7	2,123.4	2,164.6	2,073.5
% change	-0.6	-0.1	4.3	0.7	4.4	-2.1
Taxes	328.2	445.6	475.5	479.6	466.7	471.0
% change	-26.4	-6.3	-0.9	2.9	-0.9	-7.2
After-tax	1,872.0	1,767.0	1,738.2	1,643.8	1,697.9	1,602.4
% change	5.9	1.7	5.7	0.1	6.0	-0.5

The stock market wasn't ringing any alarm bells for the Fed at the May 1-2 meeting according to the minutes. They were expecting to raise rates another 25 bps step to 2.0% at the June 12-13 meeting. Their attitude was much different back in early 2016 where a sharp decline in stock prices stopped a second follow-up rate hike after the initial liftoff from 0.25 to 0.50 percent in December 2015. Markets were slightly different back then in that there was a dramatic widening in risk spreads on corporate bonds in early 2016 that was worrisome for Fed officials. Still, Fed officials seem less concerned about the stock market under Powell than they were during Yellen's leadership.

Part of the reason that stocks are less of a concern is that prices overall are little changed in 2018. In fact, the S&P 500 was up 3.0% year-to-date on Friday, June 22 after rising 19.4% in 2017. Dow industrials are down 0.6% so far in 2018 with big swings from a few stocks up and down. Double-digit gains this year from Boeing, UnitedHealth and Verizon are offset by double-digit losses from 3M, Goldman and Caterpillar.

What the Fed said about the stock market at the May meeting

Equity prices declined early in the intermeeting period, reportedly in response to trade tensions between the United States and China as well as negative news about the technology sector. However, equity prices subsequently retraced some of the earlier declines as concerns about trade policy seemed to ease and corporate earnings reports for the first quarter of 2018 generally came in stronger than expected.

Dow loss in 2018
Winners/Losers
June 22 YTD

3.0%	S&P 500	
-0.6%	Dow 30 industrials	
24,719.22 to 24, 580.89		
-138.33	points	
Price	% Chg	
338.91	14.9	Boeing
254.37	15.4	UnitedHealth Group
135.33	18.7	Verizon
196.5	-16.5	3M
226.02	-11.3	Goldman
139.94	-11.2	Caterpillar

Conclusion: Uncertainty over where the trade war spreads next is part of the reason why stocks don't fall further. Stock prices remain well below the all-time record highs made at the end of January which discounts a lot of bad news. It remains an open question how much companies will earn in the future, but stocks don't look extremely overvalued with the S&P 500 PE ratio at 21 this week. Stock valuations are less than the late 90s internet stock bubble years though higher than valuations during the housing bubble economy years over a decade ago now. Storm clouds on the horizon from a potential trade war slowdown in world growth (and profits) are being ignored for the moment.

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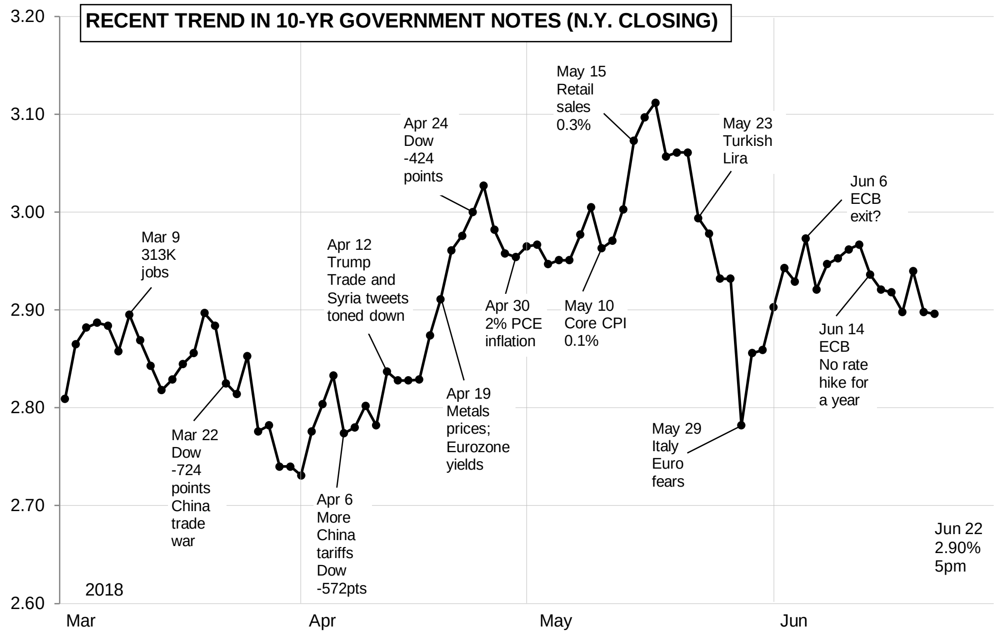
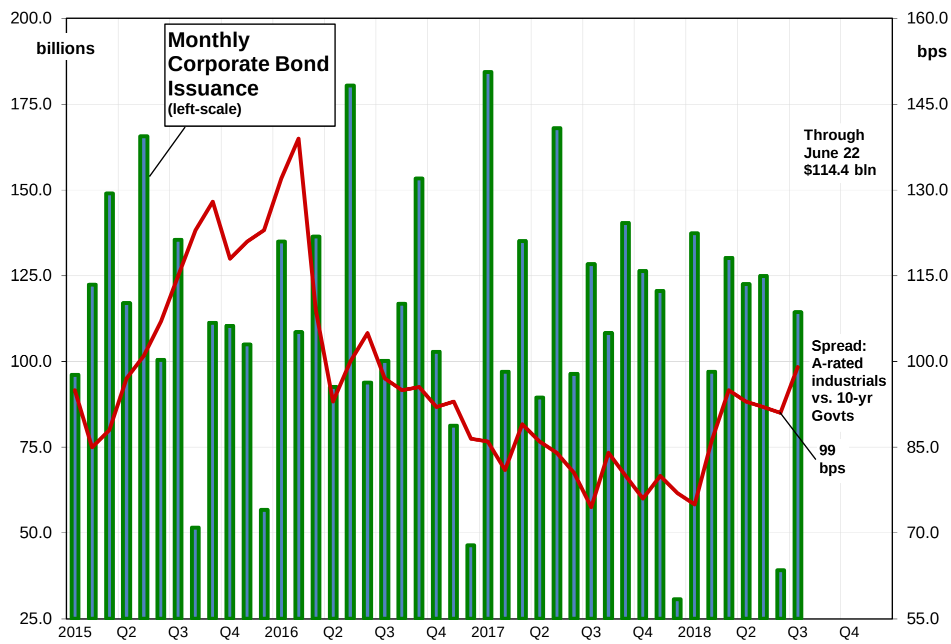
MARKETS OUTLOOK

	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)



Hard to keep up with the flow of news and tweets on the trade war, but the overall range to Treasury yields this week was 10 bps from 2.85 to 2.95%, closing Friday at the why don't you just meet me in the middle. It is unclear what the bond market would do if one of the Fed's four rate hikes this year comes back off the table. We are a little worried about China's growth right now, let alone export-driven world growth. Bond yields hit the 2.85% low on Tuesday after Trump announced Monday night he looked to impose tariffs on $200 billion more China imports. The stock market never fully recovered from the news, but bond yields did not retest the lows.

CORPORATES: WALMART $16 BILLION, BAYER AG $15 BILLION



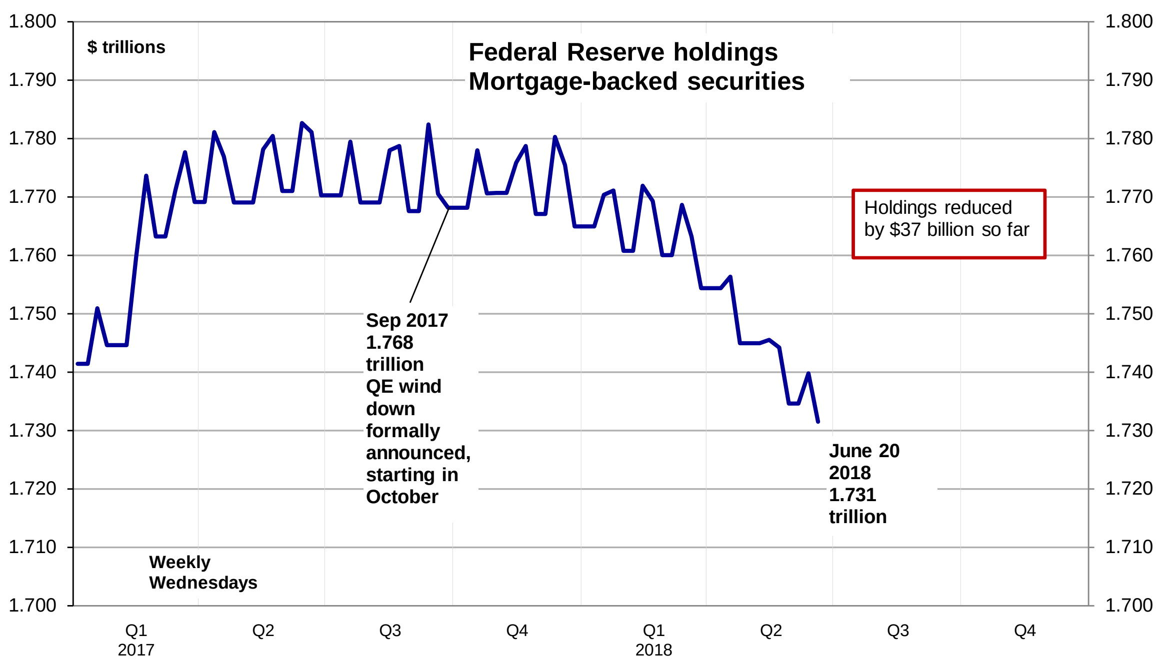
Corporate offerings were $49.8 billion in the June 22 week versus $25.4 billion in the June 15 week. On Wednesday, Walmart sold $16.0 billion 2s/3s/5s/7s/10s/20s/30s/FRNs. It priced a $2.75 billion 3.7% 10-yr (m-w +12.5bp) at 80 bps (Aa2/AA). The discount retailer will use the proceeds partly for its Flipkart acquisition. Corporate bonds (10-yr Industrials rated A2) were 99 bps above 10-yr Treasuries this week versus 95 bps last Friday.

FEDERAL RESERVE POLICY

The Fed meets July 31-August 1 to consider its monetary policy. It isn't a live meeting where anything could possibly happen because there is no press conference, but next summer it will be Live! when Chair Powell starts his eight times a year press conferences in January. It's going to be a lot of Powell all the time next year. When you are only thinking of moving rates 3 or 4 times a year, there is no reason to have eight formal meetings, let alone hold a press conference to explain to the public what you didn't do. Move rates up to 3% and then stop and take a closer look would be our advice. We realize there won't be as many votes to raise rates above 3%, take the punch bowl away from the economy, unless core PCE is above 2.2% and heading higher. Monetary policy is on autopilot the next four rate hikes.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	20-Jun	13-Jun	6-Jun	30-May	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2378.124	2377.998	2377.872	2387.103	479.782
Federal agency debt securities	2.409	2.409	4.391	4.391	0.000
Mortgage-backed securities	1731.488	1739.733	1734.593	1734.588	0.000
Primary credit (Discount Window)	0.021	0.054	0.016	0.038	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)	1.713	1.713	1.713	1.712	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	0.095	0.091	0.070	0.063	62.000
Federal Reserve Assets	4363.6	4372.5	4366.8	4374.3	961.7
3-month Libor %	2.33	2.34	2.32	2.30	2.82
Factors draining reserves					
Currency in circulation	1661.714	1661.773	1662.415	1661.292	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	0.320	3.025	16.772	3.920	0.000
Reserve Balances (Net Liquidity)	1952.143	2063.038	2031.965	2005.886	24.964
Treasuries within 15 days	30.454	0.000	0.000	28.479	14.955
Treasuries 16 to 90 days	75.434	105.886	105.885	84.952	31.549
Treasuries 91 days to 1 year	305.419	305.417	305.415	306.289	69.272
Treasuries over 1-yr to 5 years	1051.152	1051.134	1051.115	1059.169	170.807
Treasuries over 5-yrs to 10 years	296.261	296.217	296.172	288.986	91.863
Treasuries over 10-years	619.404	619.344	619.284	619.228	101.337
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08					

The daily effective Fed funds rate (it does trade, doesn't it?) is moving around and is 1.92% currently, and if it sticks here it means the September 2018 meeting odds of a 25 bps rate hike to 2.25% closed the week at 78%. They are going we assume unless China's economy slows or the trade wars spread to where Americans cannot buy imported iPhones and BMWs anymore. God forbid. One further note: the balance sheet wind down that the market feared last September? The Fed's Mortgage-backed security (MBS) holdings were $1.731 trillion this week, down $37 billion from September 2017… only two trillion more to go for the balance sheet. The more the reduction comes from MBS, there will be less of a drop in Treasuries; the Treasuries reduction that "adds" to the Federal budget deficit that must be financed in the markets. Draining the liquidity swamp intensifies starting October 1.

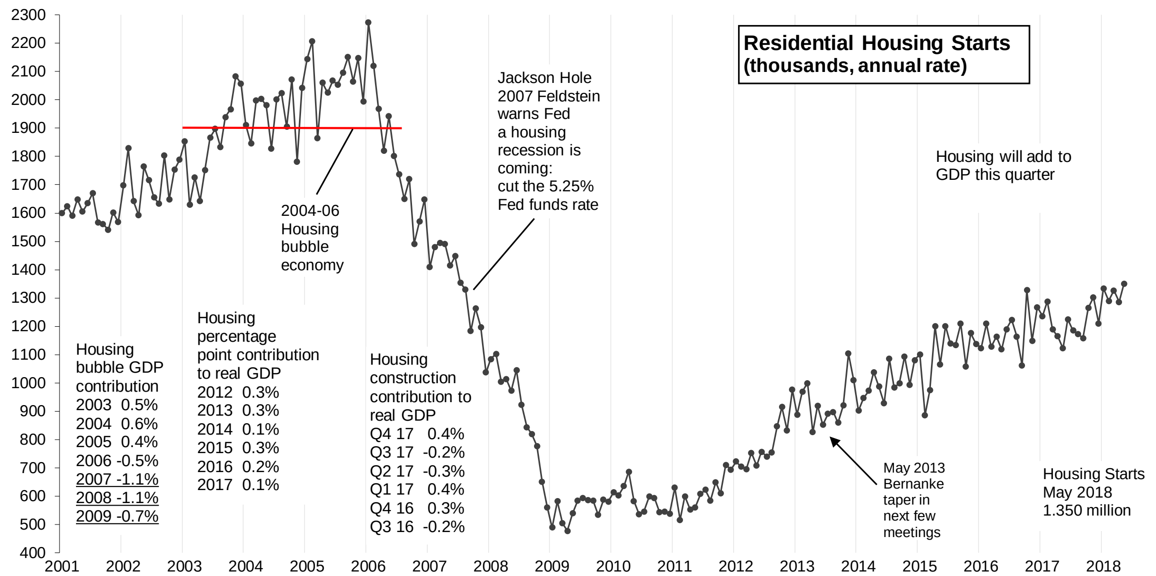


OTHER ECONOMIC NEWS THIS WEEK

Trade war hasn't hit housing construction: starts at new recovery high (Tuesday)

Breaking economy news. Housing starts rise 5.0% in May to 1.350 million which is a new record for this long recovery from the recession. Residential construction is one of many sectors of the economy that will push GDP growth above the 3% mark this quarter when the data are released Friday, July 27.

Regionally, housing construction was uneven this month with Midwest starts jumping 62.2% to 266 thousand in May from 164 thousand in April. Midwest starts must be due to Trump's energized base. Residential housing construction was down everywhere else, -15.0% Northeast, -0.9% South, and -4.1% West.



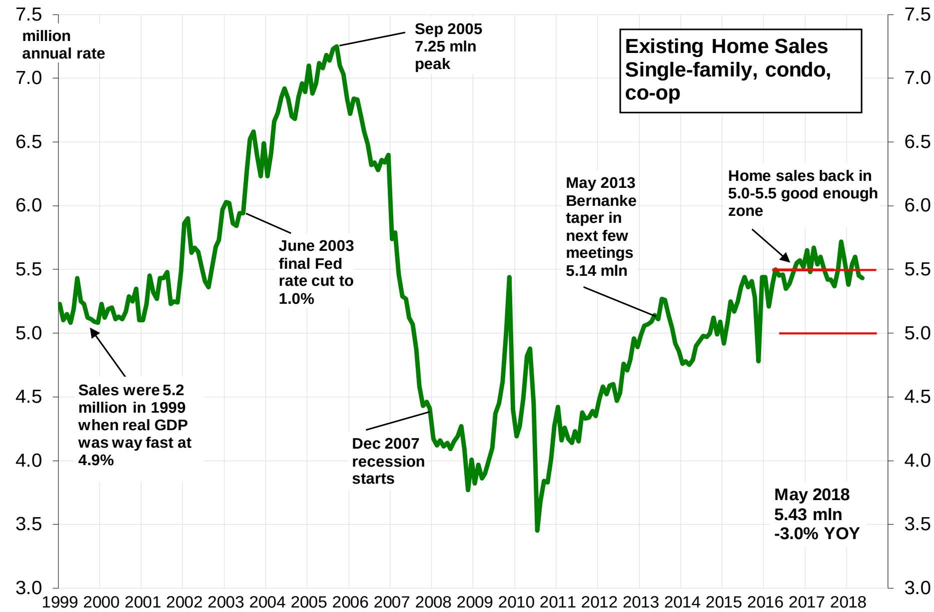
Net, net, housing construction continues its long recovery from the crash over a decade ago with builders still breaking ground despite talk of trade wars, higher lumber prices and mortgage rates. Builders are betting if they build it home buyers will come which is especially true in the growing number of markets where there are shortages of housing leading to higher prices that are starting to look like a bubble. If there is a housing bubble it is nothing like what happened in the mid-2000s where there was too much construction. Not enough single family homes have been built for several years now which is leading to protracted shortages in many of the faster growing areas of the country.

Housing construction should continue to recover even with those storm clouds on the horizon with the higher cost of imported construction materials, lumber, aluminum and steel. The Federal Reserve's policy of gradual rate hikes is also a yellow caution light as mortgage rates keep creeping higher. We are watching housing construction like a hawk to see whether the economy is crying uncle yet over the Fed's policy tightening moves they have forecast over the next few years with short term rates moving up another 150 bps by the end of 2020. Stay tuned. Story developing.

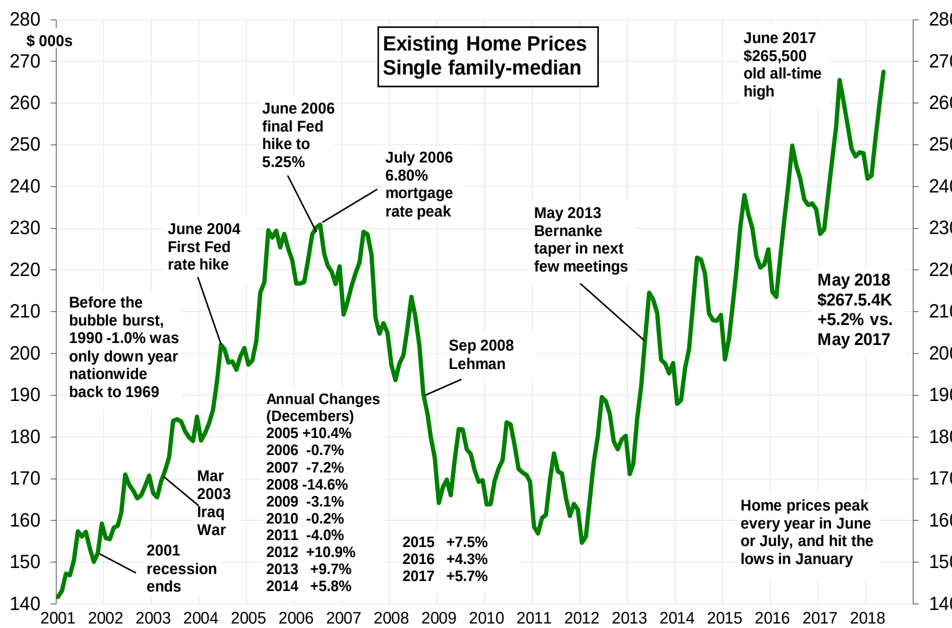
Existing home sales little changed at 5.43 million annual turnover--shows no caution on the part of home buyers (Wednesday)

Breaking economy news. Existing home sales for May fell 0.4% to 5.43 million. Buying a home is one of the biggest life decisions a consumer can make, so confidence in their economic futures is very important of course as is the level of home prices and financing costs and the availability of credit. None of these factors are a serious deterrent at this time.

There is talk that there is not a lot of supply on the market now and that is what is holding down existing home sales. Baby boomers are staying in place and not moving out of their homes. Statistics from the National Association of Realtors show there are just 4.1 months of supply on the market right now which is a measure of the listings out there. It has been down here for a while however. Existing home sales were faster at 6.5 million in 2004 also with 4 months of supply on the market.



Existing home prices in May moved up to a new record high of $267.5 thousand. Single family home price appreciation at 5.2% the last year continues to outpace workers average hourly earnings which rose 2.8% in the year ending in May. Home prices peak in June every year during the peak selling season and should rise another 4% to $278 thousand next month. Higher interest rates can slow home price appreciation but Fed policy remains well below the 5.25% peak back in June 2006. If it's a bubble, it is still filling up with hot air for now.



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