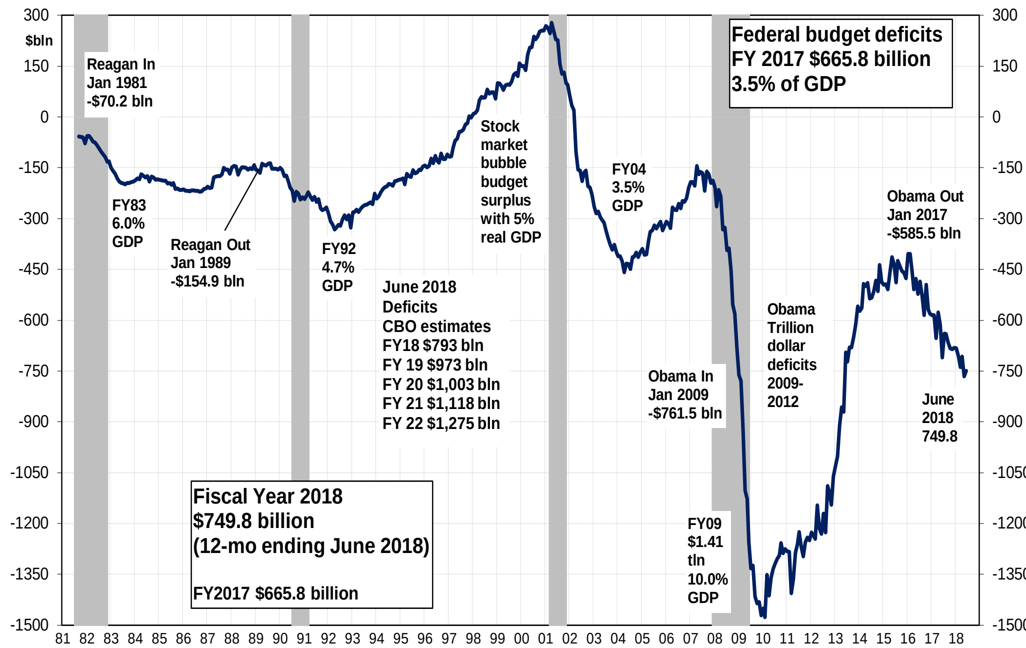
MUFG UNION BANK, N.A.
ECONOMIC RESEARCH (NEW YORK)
CHRISTOPHER S. RUPKEY, CFA
MANAGING DIRECTOR
CHIEF FINANCIAL ECONOMIST
(212) 782-5702
crupkey@us.mufg.jp

MUFG Bank, Ltd.
A member of MUFG, a global financial group

13 JULY 2018

FEDERAL BUDGET DEFICIT RUNNING NEAR $750 BILLION WITH THREE MORE MONTHS LEFT TO GO

One of the triggers for higher bond yields was more supply, but so far, the Federal budget deficit is taking its sweet time in climbing towards the trillion dollar mark. The Congressional Budget Office (CBO) recently adjusted the Fiscal Year (FY) 2019 budget deficit estimate to $973 billion for the year that begins in October. This was to cause a perfect storm in the Treasury markets that was to send bond yields soaring. In addition to financing the $973 billion of red ink from Washington, the Treasury would also have to sell the bonds coming off the Fed's balance sheet. The unwinding of the Fed's Treasury holdings will start a $360 billion annual rate of reduction beginning in October. Investors would have to absorb $1.333 trillion (973+360) more paper beginning October 1 this year.



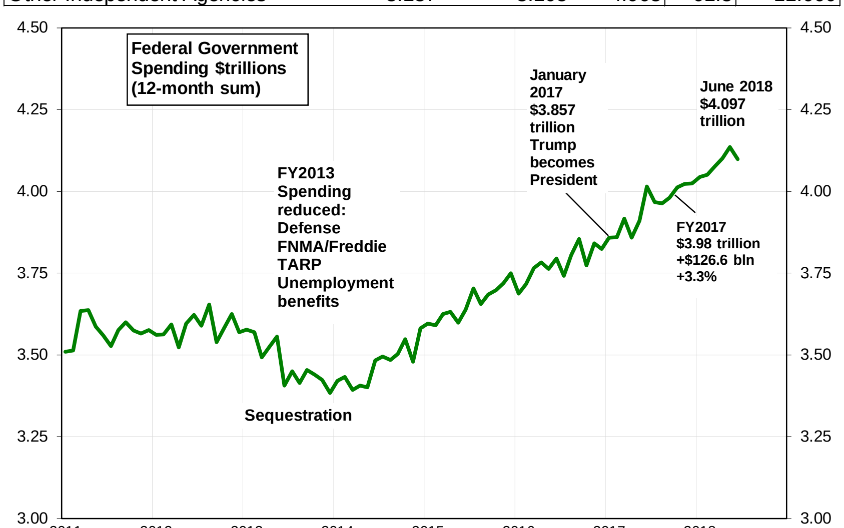
We thought the budget deficit could widen more quickly after the massive tax cuts which robs the government of revenue. Massive isn't an exaggeration. In the first 9 months of FY2018, corporate taxes fell 27.6% to $161.7 billion from $223.3 billion in the comparable period of FY2017. And the deficit is also supposed to move higher after the President signed the bipartisan budget agreement in February this year. The agreement breaks the 2011 "sequester" budget law which capped spending and lets Congress spend roughly $300 billion more over the next two years. But so far, Federal outlays through June 2018 are running $3.147 trillion, an increase of $117.0 billion or 3.9%.

Federal government spending is $117.0 greater in FY2018, but part of the increase is due to mandated programs that cannot be altered where social security retirement benefits are up $30.1 billion this year, although disability benefits have stopped rising and were roughly unchanged at $107.7 billion. Interest on the public debt is $38.0 billion higher. Interest on the public debt is $413.7 billion in FY2018 year-to-date which is a 13.1% share of $3.147 trillion of total budget outlays, a share that is going to go higher over the next few decades.

Other Federal spending programs in the news. Defense spending up 5.8% or $24.8 billion to $449.7 billion even if the country is not at war. Our Veterans, discussed during the election campaign, saw an increase of $7.6 billion to $138.5 billion. Medicare and Medicaid are still rising up 4.6 and 3.7 percent, respectively. Executive Office of the President is down 9.4% to $289 million this year.

On a 12-month trailing sum "annual" basis, Federal spending is $4.097 trillion in June 2018, which is 2.9% higher than FY2017 spending of $3.98 trillion, and almost matches 2017's 3.3% spending increase. Federal outlays looked flat from 2011 to 2014 before picking up again. If you have any ideas on what Federal programs can be cut back, write your Congressional representative.

Federal Government Spending ($bln) **Where to cut?**	3 Qtrs FY18 Q4 17-Q2 18	3 Qtrs FY17 Q4 16-Q2 17	Fiscal Year Changes	Fiscal Year % chg	Full Year FY 2017
TOTAL BUDGET OUTLAYS	3,147.903	3,030.904	116.999	3.9	3,980.605
Legislative	3.462	3.371	0.091	2.7	4.499
Judicial	5.821	5.703	0.118	2.1	7.566
Agriculture	111.770	109.787	1.983	1.8	127.563
Food Stamps	52.191	52.750	-0.559	-1.1	70.148
Child Nutrition	19.834	19.460	0.374	1.9	22.471
Commerce	6.284	7.859	-1.575	-20.0	10.304
Defense	449.710	424.935	24.775	5.8	568.905
Military Personnel	113.736	109.546	4.190	3.8	144.706
Operation Maintenance	188.603	181.669	6.934	3.8	245.186
Procurement	83.458	78.343	5.115	6.5	104.126
Research Development	56.408	48.780	7.628	15.6	68.126
Military Construction	5.057	5.144	-0.087	-1.7	6.673
Education	46.704	90.206	-43.502	-48.2	111.702
Office of Federal Student Aid	33.988	66.671	-32.683	-49.0	84.986
Energy	19.342	18.798	0.544	2.9	25.796
Health Human Services	851.089	823.914	27.175	3.3	1116.764
Medicare	545.448	521.392	24.056	4.6	708.299
Medicaid States Grants	288.412	278.161	10.251	3.7	374.681
Homeland Security	53.838	35.304	18.534	52.5	50.502
Housing Urban Development	45.815	49.498	-3.683	-7.4	55.474
Interior	10.543	8.396	2.147	25.6	12.141
Justice	26.462	23.367	3.095	13.2	30.977
Labor	29.807	31.251	-1.444	-4.6	40.120
State Unemployment Benefits	21.978	23.880	-1.902	-8.0	30.388
State	18.975	19.162	-0.187	-1.0	27.061
Transportation	52.547	55.771	-3.224	-5.8	79.440
FAA	11.540	11.546	-0.006	-0.1	15.866
Federal Highway Admin.	29.207	29.749	-0.542	-1.8	44.167
Treasury	542.581	485.733	56.848	11.7	546.434
TARP	1.696	3.371	-1.675	-49.7	4.146
IRS	125.525	123.423	2.102	1.7	139.539
Earned Income Credit	57.861	58.976	-1.115	-1.9	59.749
Child Tax Credit	18.298	19.107	-0.809	-4.2	19.408
Interest on Public Debt	413.656	375.632	38.024	10.1	456.955
Veterans Affairs	138.546	130.970	7.576	5.8	176.050
Corps of Engineers	4.280	5.006	-0.726	-14.5	6.453
Other Defense Civil Programs	45.199	43.308	1.891	4.4	58.695
Environmental Protection	6.134	6.285	-0.151	-2.4	8.088
Exec. Office of President	0.289	0.319	-0.030	-9.4	0.411
International Assistance	9.478	10.479	-1.001	-9.6	18.922
NASA	14.755	14.157	0.598	4.2	18.698
National Science Foundation	5.041	5.074	-0.033	-0.7	7.215
Personnel Management	73.288	71.283	2.005	2.8	95.461
Small Business Admin.	-0.322	0.184	-0.506	--	--
Social Security Admin.	780.732	748.951	31.781	4.2	1000.812
Retirement Benefits	620.717	590.587	30.130	5.1	791.098
Federal Disability Payments	107.733	107.192	0.541	0.5	142.957
Other Independent Agencies	3.137	8.105	-4.968	-61.3	11.660

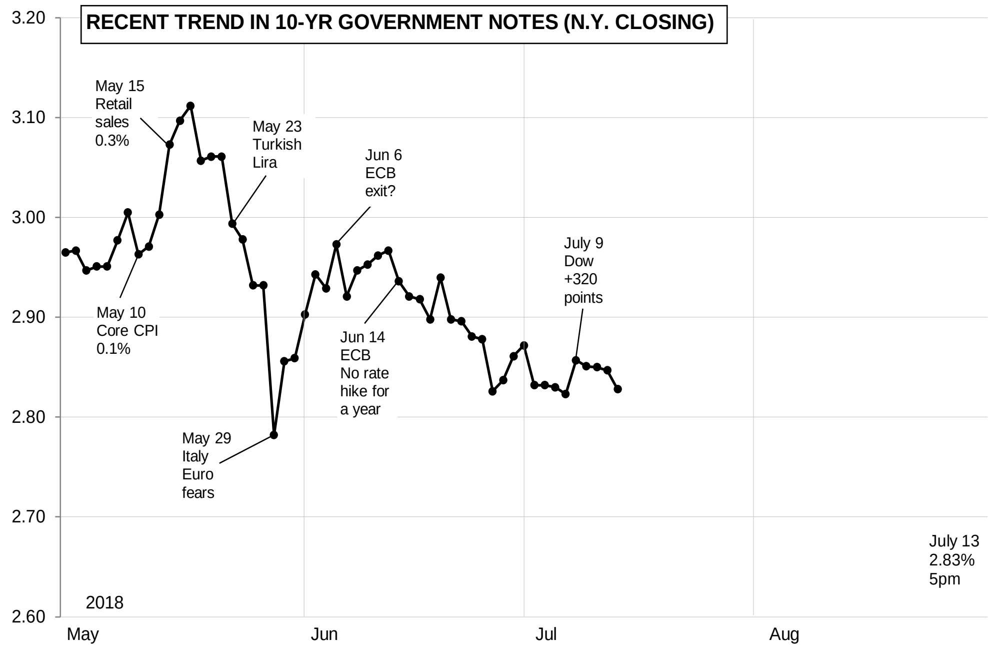


MUFG

MARKETS OUTLOOK

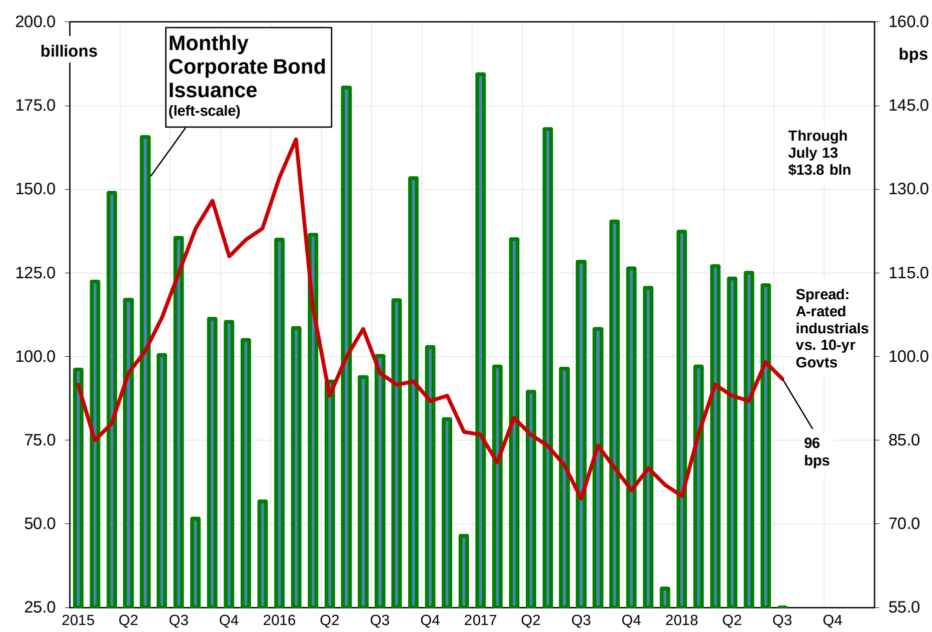
	29-Jun 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.99	3.10	3.20	3.35	3.45	3.60	3.60	3.75	3.85	3.80	3.95
10-Yr Note	2.86	2.90	3.00	3.20	3.30	3.50	3.50	3.70	3.80	3.80	3.95
5-Yr Note	2.74	2.70	2.90	3.10	3.20	3.45	3.45	3.65	3.75	3.80	3.95
2-Yr Note	2.53	2.55	2.80	3.00	3.15	3.40	3.40	3.60	3.75	3.80	4.00
3-month Libor	2.34	2.55	2.80	2.95	3.20	3.45	3.45	3.70	3.95	3.95	4.20
Fed Funds Rate	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	33	35	20	20	15	10	10	10	5	0	(5)

We haven't missed much with 10-yr yields still at 2.83%, same as the day we left. No change in yields this week either even with the Treasury selling $69 billion 3s/10s/30s, and with Dow stocks climbing over 500 points. Another trade war salvo, the U.S. list of $200 billion China imports subject to tariffs, on Tuesday evening, dropped stocks 219 points Wednesday, before climbing higher. We moved the interest rate forecast forward another quarter, time marches on. The curve inverts in Q4 2020, an event that has many Fed members afraid of their own shadows, afraid their interest rate hikes will invert the curve and cause a recession. We agree with Powell-curve inversion is meaningless.



CORPORATES: OFFERINGS DOMINATED BY BANKS; HONDA, TOYOTA

Corporate offerings were $13.8 billion in the July 13 week versus zero in the July 6 week. On Tuesday, PacifiCorp priced a $600 million 4.125% 30-yr (m-w +20bp) at 117 bps (A1/A+). The Oregon-based electric utility will use the proceeds to repay 5.65% bonds due in July. Corporate bonds (10-yr Industrials rated A2) were 96 bps above 10-yr Treasuries this week versus 99 bps last Friday.



MUFG

FEDERAL RESERVE POLICY

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	11-Jul	4-Jul	27-Jun	20-Jun	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2360.504	2360.377	2378.250	2378.124	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities	1721.275	1721.272	1721.271	1731.488	0.000
Primary credit (Discount Window)	0.006	0.005	0.007	0.021	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)	1.711	1.711	1.710	1.713	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	0.096	1.091	0.090	0.095	62.000
Federal Reserve Assets	4338.8	4337.3	4352.7	4363.6	961.7
3-month Libor %	2.34	2.34	2.33	2.33	2.82
Factors draining reserves					
Currency in circulation	1672.158	1672.170	1665.308	1661.714	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	1.230	4.852	20.680	0.320	0.000
Reserve Balances (Net Liquidity)	1980.868	1954.210	1940.916	1952.143	24.964
Treasuries within 15 days	1.133	1.132	30.454	30.454	14.955
Treasuries 16 to 90 days	93.310	93.310	75.435	75.434	31.549
Treasuries 91 days to 1 year	307.881	307.879	305.421	305.419	69.272
Treasuries over 1-yr to 5 years	1042.558	1042.539	1051.171	1051.152	170.807
Treasuries over 5-yrs to 10 years	296.037	295.992	296.305	296.261	91.863
Treasuries over 10-years	619.586	619.525	619.464	619.404	101.337

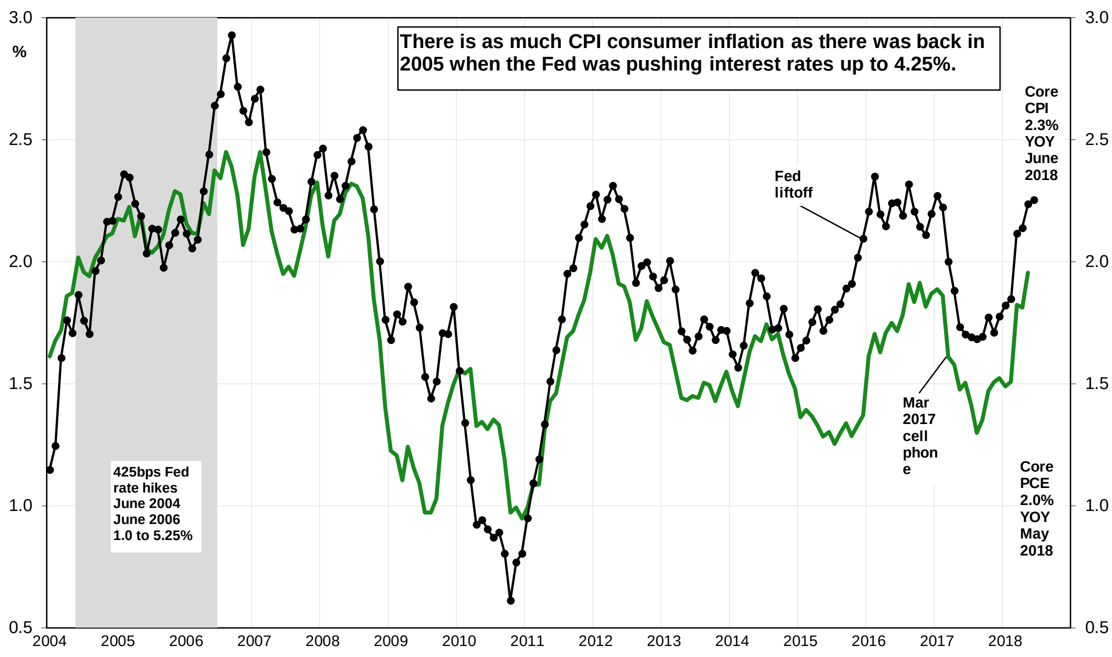
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08

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. The odds of a 25 bps rate hike to 2.25% in September closed the week at 86%.

OTHER ECONOMIC NEWS THIS WEEK

Core CPI inflation of 2.3% as high now as it was in 2006 when Fed pushed rates to 5.25% (Thursday)

Breaking economy news. Another tick higher for core CPI inflation to 2.3%. Consumer inflation for core goods and services as measured by CPI is now as high as it was when the Fed last had an inflation scare in 2006 and pushed the Fed funds rate to its 5.25% peak. The Fed funds rate is 2.0% today. How times change. Core CPI inflation moved up a "rounded" tenth to 2.3% in June (2.24 to 2.26 percent year-year actually). Both core consumer inflation measures are at 2% or above now. May core PCE inflation moved up to the Fed's 2.0% target in a report out on Friday, June 29. Inflation is moving up but it is hard to forecast core PCE inflation moving higher than 2.2% on a sustained basis.



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.

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 MUFG Bank, Ltd. and Mitsubishi UFJ Financial Group, Inc., one of the world's leading financial groups. MUFG Bank, 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 MUFG Bank, 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 (MUFG) stock exchanges. Visit www.mufg.jp/english/index.html.