GDP SIGNIFICANTLY STRONGER IN REVISIONS TO 2014 AND 2015, AND GROWTH NOW 2.6% IN Q2 2017; EMPLOYMENT COST INDEX (WAGES) TOO

Not sure the economy is all that short of the 3% mark that Trump’s economics team is shooting for. Economy is at full employment and doesn’t need much fixing. The payroll tax cut in 2011 and 2012 did not push GDP that much faster, and we can’t remember the last time Washington tried to give Americans a tax cut unless the economy was in recession. Nevertheless…

Breaking economy news. Data for the second quarter on GDP and the Employment Cost Index, also known as wages. People use the word "wages" almost as often as they mention the word "robot." Too many robots not enough wages.

Real GDP was 2.6% in the second quarter and the first quarter is now just 1.2% down from 1.4%. They revised the data today in this once a year benchmark revision back to 2014. Not too much change here in the overall profile of spending in the economy. Economic growth was better than we thought in 2014 and 2015 before it slowed in 2016. We view the 2016 slowdown to 1.5% as due to temporary factors which in no way, shape, or form, stops the economy from challenging the ten-year expansion of the Clinton years. Year nine of the current expansion began in July.
Maybe the 2016 slowdown is the pause that refreshes. In any case, the fears that the retiring baby boom generation will take a toll on growth as they sit on the porch in increasingly rocking chairs watching the sun set is not happening. Real consumer spending was pretty good at 2.7% in 2016 so it was not responsible for the 1.5% GDP growth slowdown.

Wages? You want more wages? The employment cost index is out for the second quarter and total compensation is running about the same at 2.4% the last year. If Congress was voting on our paychecks this would be the skinny version. Salaries are up 2.3%, and benefits are rising 2.5%, both measured on a year-on-year basis. Time will tell whether wages march higher with the economy at full employment. We really need to wait and see what happens over the next couple of years before concluding better wages will never get doled out by tight-fisted corporations.

Net, net, the economy is running this race just as fast as it can and is doing pretty well given its age. The Trump economics team is concentrating on 3% GDP and now we see that growth was 2.9% in 2015 not 2.6%, this goal they have set for themselves looks attainable. Real economic growth slowed in 2016 largely due to weaker business investment in equipment and structures during the oil price crash that hit oil & gas drilling hard, and a one-off drag from inventories.

That's all behind us now with real economic growth up 2.6% in the second quarter of 2017 largely on the backs of consumers that continue to do all the heavy lifting. Business spending on equipment bounced this quarter, while housing starts were a drag. The economy is close to 3% growth, but may have trouble actually getting there if government spending does not pick up. Nondefense Federal
spending has fallen for two straight quarters during the Trump administration and State & local spending is restrained.

The bottom line is that growth has rebounded from the sluggish 1.2% rate in the first quarter as the Fed expected and at 2.6% in the second quarter, the economy's wheels are running above the Fed's expectations for the entire year. This pattern of rebounding growth shows Fed officials can continue with the gradual pace of rate hikes with another rate hike forecast for this year, and three more in 2018. Whatever the signal is from the slower inflation in recent months it is not the result of stagnating growth. The Fed needs to acknowledge this stronger growth and move on. Business spending on equipment was the biggest surprise jumping 8.2% as there were concerns companies were awaiting clarification on tax rates and reforms before ordering more equipment that helps make the economy go. So far so good for the economy this year. Things are better than you think.

MARKETS OUTLOOK

We can't say nothing happened in bond land this week as 10-yr yields lifted dramatically from the 2.24% close on Friday, July 21. Yields jumped 8 bps on Tuesday to the 2.34% highs for the week. U.S. bonds closely followed the jump in Bunds where 10-yr yields rose 6 bps higher to 0.57%, after technical levels were broken. 10-yr Treasuries fell not once but twice from the 2.30-something yield level this week. A delayed response to the Fed statement where a rate hike isn’t coming until December if that is news (more likely following the dollar’s response to the “Dovish” Fed statement), and coming down a little on the 2.6% GDP report and lower than expected Employment Cost Index (no wages for you) on Friday. The whisper number on GDP was above 3% after Thursday's advance trade deficit and inventories data.
FEDERAL RESERVE POLICY

The Fed met July 25-26 to consider its monetary policy. They only changed a few words in the statement. The most important ones said the balance sheet unwind could take place “relatively soon.” The markets are unanimous in the belief that this means the formal wind down announcement will be made at the September Fed meeting. This means there will not be a rate hike until December as the Fed cannot do two things at once. The bond market actually rallied on the press statement on Wednesday in a lagged response, possibly to the appreciation of the Euro against the dollar on the news, foreign exchange markets being smarter than the domestic U.S. fixed income market always, and possibly as it dawned on traders and investors that the next possible rate hike is not until December 13, 2017 which is 135 days away.

How many “relatively soons” do we need before they actually do it? The first relatively soon for the timing of the unwind official start came in Yellen’s response to a question at the June 13-14 press conference, where she said they could put this into effect relatively soon “if the economy evolves in line with our expectations.” After three months of hearing “relatively soon,” September looks like the last possible month to be considered soon.

After the the formal announcement expected at 2pm EDT on September 20, it will take them a year to gradually work up to the full strength unwind: letting $20 billion per month of MBS roll-off, and $30 billion per month of Treasuries. This means starting September 2018, the balance sheet will unwind at a $600 billion per year pace. How low will the $4.5 trillion balance sheet go? We expect the $2.293 trillion of Reserve Balances in the table above to come back down to where it was before they let Lehman go bankrupt: the $24.964 billion of excess reserves outstanding on September 10, 2008.

What will be the effect on the markets? Trader lore around the world has long held that the huge scale of these unprecedented quantitative easings (QE), i.e. the massive asset purchases by global central banks, has reduced yields. Hard to tell if this is true or not. The proof will be in the eating. The Fed bought an extra $2 trillion of securities that will now have to be absorbed by the markets as the balance sheet is unwound. The $360 billion of Treasuries rolling off will force the Treasury to sell $360 billion more Treasuries each year, which could lead to higher yields. The $240 billion of estimated annual MBS prepayments will have to be absorbed by the markets and could possibly lead to higher financing costs on your newly purchased or refinanced home.

What else was in the Fed statement on Wednesday? Anyone, anyone. Oh yeah, some of the squeaky wheels on the Committee don’t seem to want to hike rates again unless they have proof positive, like
Bam! right between the eyes kind of certainty, that inflation is headed back up to the Fed’s 2% target. In case you weren’t following this, core PCE inflation was 1.8% in January and now has slowed down to 1.4% in May... going, going the wrong way! Heaven forbid, say it ain’t so. Tuesday, August 1 the June PCE data are announced.

We thought there was a chance that they might call out inflation in the Fed meeting press statement on Wednesday and say they were watching it extremely closely or something, meaning nod-nod, wink-wink, if inflation doesn't move back up in short order then they may alter the path of their gradual rate hikes that is basically 75 bps each year. But nope, little change in the wording on inflation, they just report that core inflation has declined on a 12-month basis and is running below 2%, same wording as last month. Oh, and “the Committee is monitoring inflation developments closely” just as they were last month.

***UPDATE June core PCE data are not out until Tuesday, August 1 at 8:30am EDT, but Friday’s GDP report revealed the Q2 data which of course is the average of April, May, June. Core PCE inflation was revised up in 2016, “If only we’d known, we would have raised rates 4 times last year,” and the second quarter average for 2017 is 1.5% YOY. So at least the May 1.4% core PCE inflation data didn’t “worsen” any further if worsen is the word.

The point is there is less reason for some of the inflation hobgoblins of little minds worriers at the Fed to be so concerned. This is not an economy facing a downturn or stagnant economic conditions. Inflation is hanging in there, if that’s what you’re rooting for. For gosh sakes, the Dow industrials stock market averages, a leading indicator which partly discounts future economic growth, ended this week up 10.5% year-to-date, following on 2016’s 13.4% gain. Looks like President Trump was correct in saying he made a lot of people a lot of money since he was elected... for now.

OTHER ECONOMIC NEWS THIS WEEK

American's confidence remains high and points to a better tomorrow

Breaking economy news. American’s confidence remains high and points to a better tomorrow for growth. The confidence survey index rose almost 4 points to 121.1 in July from 117.3 in June. The labor market is on fire and boy does the consumer ever know it as those saying jobs are plentiful jumped to a new high of 34.1 in July for this economic cycle. We will have to wait until next week's payroll jobs report to see if businesses indeed stepped up their hiring plans in July.

Obamacare, Washington swamp, Federal government shutdown, nothing but nothing seems to get the consumer down. Retail sales fell in May and June so we will...
eagerly wait to see if consumers match their sky-high confidence by taking additional trips to the mall in July.

Net, net the consumer is back and full of confidence which brightens the outlook for the economy as we enter the second half of the year. One thing for certain is the consumer is not concerned at all about the too-low inflation worry that some Fed officials are talking about. The economy entered its ninth year of expansion in July and instead of focusing on the economy’s old age the consumer is confident that this long-lived expansion can keep on going. The labor market is tight and jobs are there for the taking the consumer reports, so higher wages from a fully employed economy must be on the way. We expect Federal Reserve officials will continue with their gradual pace of rate hikes secure in the knowledge that a confident consumer means that more spending is on the way. The economy is better than you think the consumer is saying. Bet on it.
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 guarantee 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 550 years of history, MUFG is a global network with more than 2,200 offices in nearly 50 countries. The Group has more than 148,000 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.