

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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BOND MARKET VALUATION: SUPPLY, DEMAND AND INFLATION

Where should 10-year Treasury yields be? Pretty simple really. Supply, demand and inflation. Except that demand isn't known until after it has "set" the price already. Supply doesn't always work, as many times demand jumps at the same time that supply does and yields don't go anywhere. And inflation? Inflation hasn't set where bond yields trade in years, partly because the Fed has muddied the public's understanding of what inflation is and where inflation "trades" currently. Maybe that's not fair. The public doesn't listen to much of anything the Fed says, partly because there are too many of them. 12 Federal Reserve Bank Presidents and 7 Fed governors in Washington including the Chair.

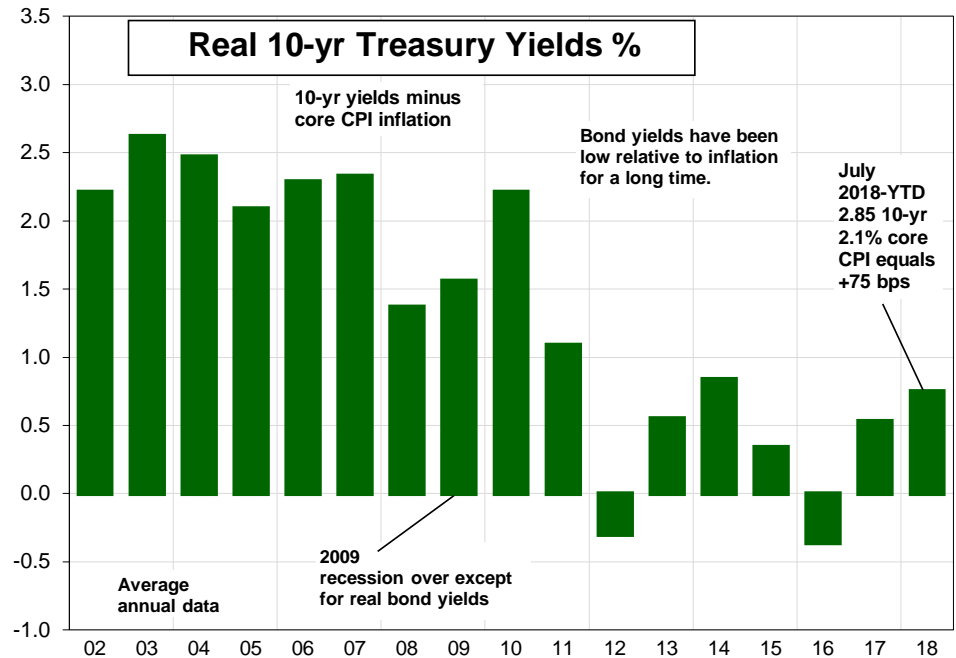
The best valuation of bond yields currently is probably Fed policy itself. Where the Fed funds rate is now, 2%, and where it is going in 2019 (3.25%) and in 2020 (3.5%). We don't feel comfortable forecasting 10-yr yields all that much higher than the Fed funds rate right now or maybe where they see it a year from now. Bond yields have a tendency not to move too high, get too far out in front of the Fed. The market doesn't trade like it used to. Fewer active managers, speculators, something has changed. Fewer participants with a view of where interest rates are headed. The market doesn't tend to actively discount where bond yields might move to in the future. We don't think low yields are due to some more theoretical reason to do with the balance between investment and saving in the economy like in your college textbooks, the IS curve, for you who are fortunate to remember your Macroeconomics 101 course. There isn't a glut of savings or not enough investment. The Fed itself may have broken the market's vitality and cyclical behavior, day-to-day trading dynamism, after sitting on bond yields for so long, keeping rates at zero from December 2008 to December 2015. Seven long years of winter for Fixed Income on Wall Street. They still haven't taken their boots off our necks either as interest rates are just at 2% and they are leading expectations by the nose, eliminating all the uncertainty with their gradual path of rate hikes the next several years. The market never had an explicit path or roadmap before in other cycles. Don't fight the Fed indeed is truer than ever.

Bond Market Search for Value

Most READ Stories: Bloomberg
Tuesday afternoon, August 14

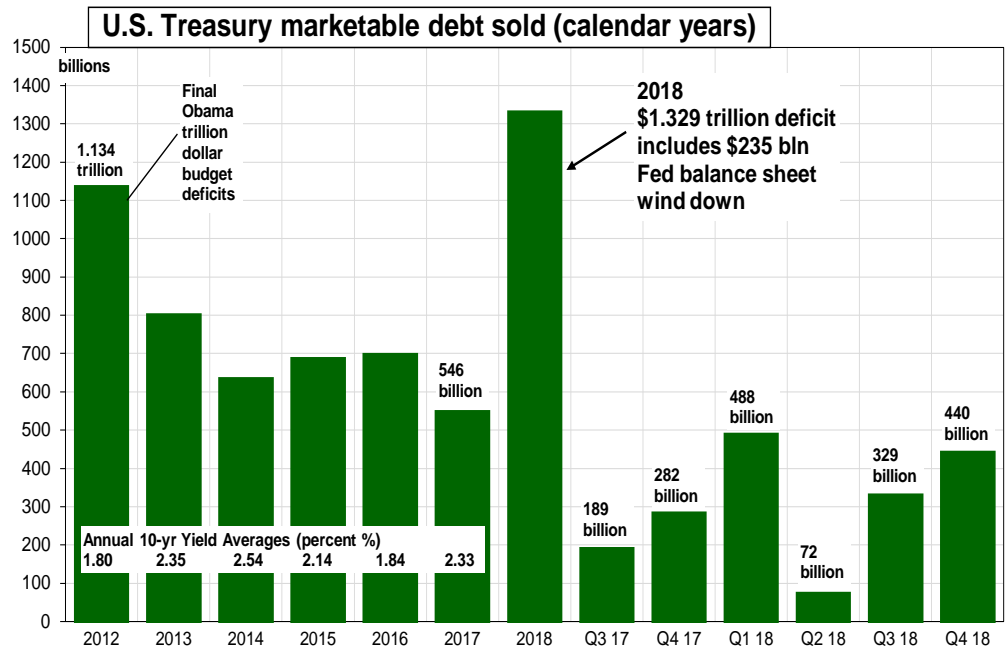
- 1 Junk-Bond Star Is a Bully Who Terrified Subordinates, Peers Say
- 2 CFA Level II Pass Rate Declines From Last Year's Decade High
- 3 Erdogan to Boycott iPhones as Turkey Steps Up Row with U.S.
- 4 Trump Campaign Says Omarosa Violated Non-Disclosure Agreement
- 5 Italy Highway Bridge Collapses, Reportedly Killing 35 People
- 6 Goldman Is Said to Have Had No Mandate When Musk Tweeted

CPI inflation that we all know and love is 2.9% and core CPI inflation is 2.4%. CPI inflation is as high as it was back in the late 90s when Greenspan pushed interest rates to 6.5%. CPI inflation is as high now as it was when Bernanke thought there was inflation and pushed interest rates to 5.25%. We are stuck here with Powell and a 2 percent Fed funds rate because we hate to be a lawyer but the Fed's inflation is the personal consumption expenditures deflator, and PCE inflation is 2.2% not 2.9% like the CPI inflation Greenspan and Bernanke fought the last two cycles. PCE inflation is lower basically because it measures health care inflation differently, it finds there is less health care inflation. Housing inflation is about the same for both PCE and CPI, yet PCE says it has a smaller weight in determining inflation so this is another reason PCE inflation is lower than CPI. Anyway, you can see in this graph, that 10-yr yields have traded closer to inflation in recent years. The bond market vigilantes that ruled the markets and saw inflation everywhere have retired and stopped trading bonds.



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Finally, supply. More auctions of Treasuries. The last great hope for our forecast for higher bond yields, 3.5% by the end of 2019. We will see. It is a little early to say greater supply won't push up bond yields. The Trump administration says the FY2019 Federal budget deficit that starts October 1 this year will be \$1.085 trillion, and add to this the full-speed wind down of the Fed's balance sheet that



also starts October 1 at a \$360 billion annual rate. This is the supply the market has to absorb. In the graph here, for calendar year ending 2018, the new cash need, the issuance of marketable securities by the Treasury is already at \$1.329 trillion including \$235 billion of the Fed's balance sheet runoffs with the third and fourth quarters obviously estimated. Anyway, a lot of extra supply this year relative to the Treasury new cash needs of \$546 billion in 2017 and yet bond yields are not much higher than they were. 2.33% in 2017 and 2.85% this year through July 2018. Stay tuned. Story developing.

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)

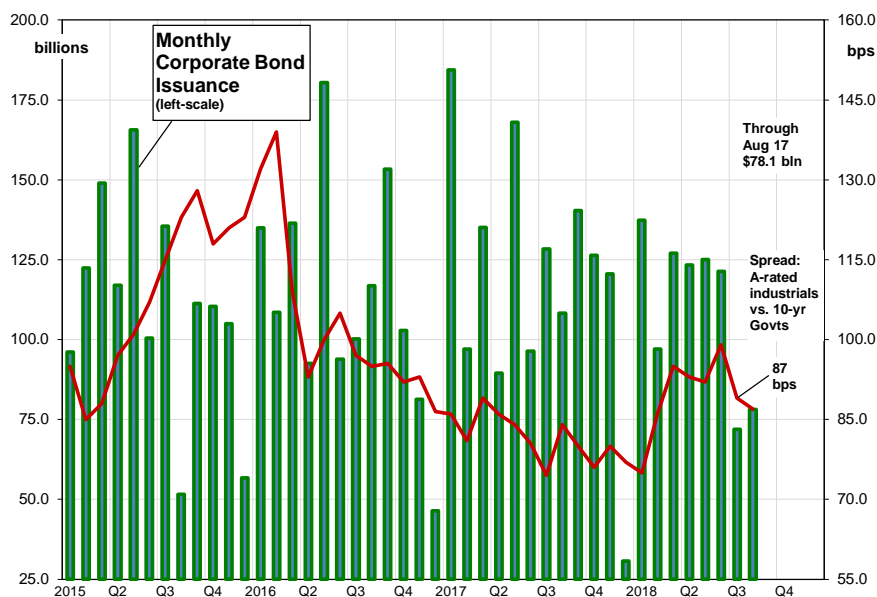
Feels like a more volatile week than it was in fixed income land with 10-yr yields closing 2.86% versus 2.87% the week before. Closing yields on the 5 days of trading ranged from 2.86 to 2.90 percent. The Turkish lira hit its low Sunday night and recovered for a few days yet the stock market collapsed at one point on Wednesday, Dow industrials down 373 points at worst, on fears of weakness in emerging markets elsewhere. The Dow



rallied back 396 points on Thursday leaving bonds in the dust. The trigger for stocks on Thursday we guess was Walmart earnings and a story that China officials were coming to the U.S. to talk. Lower level officials. Late Friday a Wall Street Journal story on future Trump and Xi talks lifted stocks briefly.

CORPORATES: SALVATION ARMY, ASTRAZENECA, MCDONALD'S, UNITED TECH

Corporate offerings were \$30.2 billion in the August 17 week versus \$38.8 billion in the August 10 week. On Monday, Zoetis Inc. sold \$1.5 billion 3s/10s/30s/FRNs. It priced a \$500 million 3.9% 10-yr (m-w +20bp) at 105 bps (Baa1/BBB). The animal health sciences company will use the proceeds to repay a revolving credit facility and a commercial paper program. Corporate bond yields (10-yr Industrials rated A2) were 88 bps above 10-yr Treasuries this week versus 88 bps last Friday.



FEDERAL RESERVE POLICY

The Fed meets September 25-26 to consider its monetary policy. The market isn't in doubt (never is, there's always a price where securities trade). Fed funds futures say the odds are still high for a rate hike to 2.25% on September 26, 90% at Friday's close versus 90% on Friday August 10.

Powell speaks at Jackson Hole 10am EDT Friday, August 24. The topic: "Monetary Policy in a Changing Economy." Maybe something on The Times They Are A-Changin' and there isn't a blessed thing that we the Fed can do about

it. A lot of important news has been made by Number #1 at these Federal Reserve Jackson Hole Symposiums (look it up) in August over the years. The mountain air seems to clear their vision of what needs to be done. Provide leadership. Tell the Committee where they are going to steer them next. Forgetting about the year 2007 when economist Marty Feldstein told them a recession was coming, get ready, and you could have heard a pin drop in the room. Real economists never mention "recession" unless they are selling newsletters or consulting services. Policy changes have been telegraphed from Jackson Hole before, but next week, about the only thing that can happen is that some of those gradual rate hikes (six more by the end of 2020 to 3.5%) come off the table due to turbulence in emerging markets and the U.S. trade wars with the world, now mostly with China, 2017 \$375 billion goods deficit, and Canada 2017 \$17 billion goods trade deficit (375 versus 17 is correct, don't ask).

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	15-Aug	8-Aug	1-Aug	25-Jul	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2324.391	2336.925	2336.876	2359.893	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities	1708.187	1709.545	1709.544	1709.528	0.000
Primary credit (Discount Window)	0.007	0.003	0.003	0.002	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)	1.719	1.719	1.716	1.715	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	
Central bank liquidity swaps	0.106	0.100	0.100	0.122	62.000
Federal Reserve Assets	4276.5	4305.6	4303.0	4325.3	961.7
3-month Libor %	2.31	2.34	2.35	2.34	2.82
Factors draining reserves					
Currency in circulation	1673.616	1671.632	1669.707	1668.294	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	0.315	1.659	0.795	0.720	0.000
Reserve Balances (Net Liquidity)	1918.744	1966.103	1966.432	1947.287	24.964
Treasuries within 15 days	0.000	23.069	23.069	30.302	14.955
Treasuries 16 to 90 days	63.772	63.772	39.939	63.008	31.549
Treasuries 91 days to 1 year	360.363	305.548	329.380	310.069	69.272
Treasuries over 1-yr to 5 years	1016.026	1028.055	1028.048	1040.552	170.807
Treasuries over 5-yrs to 10 years	258.449	296.639	296.622	296.199	91.863
Treasuries over 10-years	625.780	619.841	619.818	619.762	101.337

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

Year-ends for Interest Rates				
Percent %	2018	2019	2020	2021
Eurodollar futures	2.615	2.98	2.97	2.95
Fed's June forecast	2.5	3.25	3.5	

Eurodollar futures price where 3-month Libor will be in the future.
Friday, August 17, 2018 3-month Libor 2.31%

OTHER ECONOMIC NEWS THIS WEEK

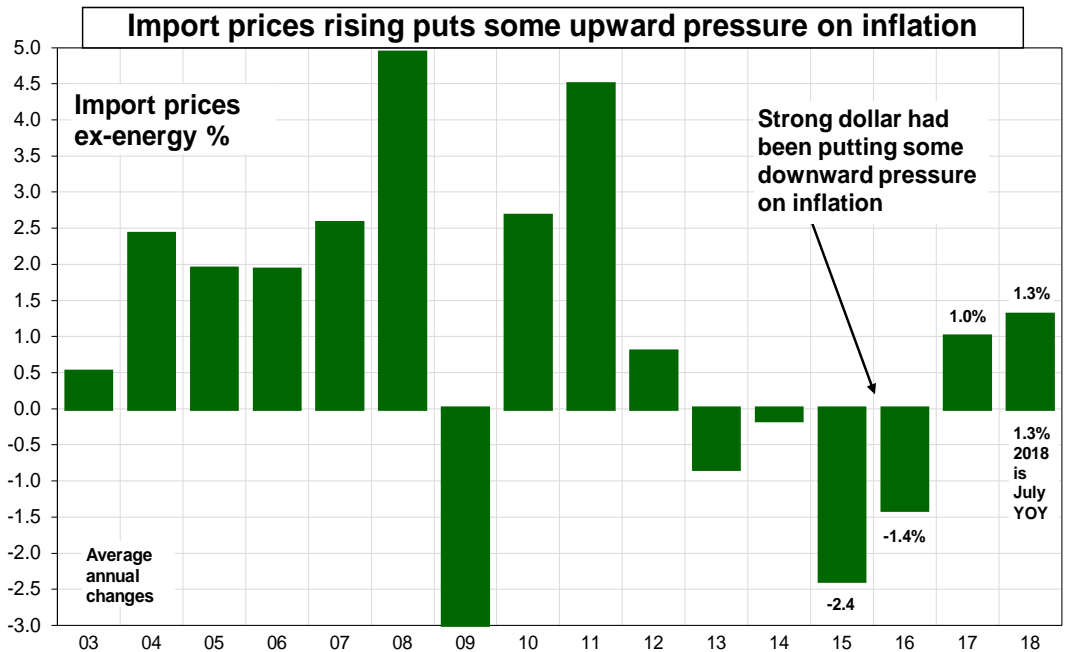
No import price pressure from trade war yet (Tuesday)

Breaking economy news. Import/export prices for July. Import prices were unchanged in July with fuel imports prices rising 1.6% and nonfuel imports prices falling 0.3%. Agricultural foods import prices are tumbling, down 2.4%. Paper prices keep on rising, up 11.4% the last year which makes it more costly to print the fake news in America. Consumer goods prices ex-autos actually rose 0.3% in July.

Net, net, the U.S. is slapping tariffs on imported overseas goods left and right, but nonenergy import prices have actually fallen sharply the last two months with the dollar's rally on the Fed's tightening monetary policy. Import prices collapsed with the price of crude oil in 2015 with nonfuel import prices tumbling 2.4% during the dollar's rally that year.

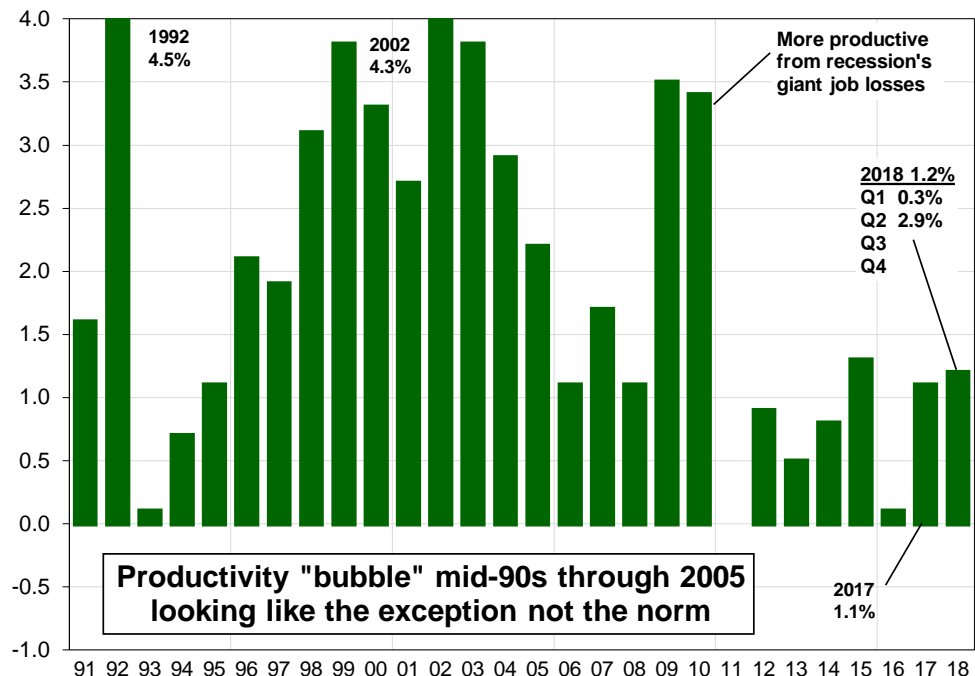
Nonfuel import prices have reversed their positive trend early in the year and have fallen 0.6% the last two months. Less inflation from imported goods means the Federal Reserve is unlikely to respond aggressively to incipient inflationary pressures and push interest rates too much higher than normal in the next year.

It's early yet in the trade wars battle, and more inflation from higher priced imported goods may still be on the way. Today's report said China imports prices fell 0.2% in July, the first monthly decline since September 2017. The good news can't last however. The \$34 billion tariffs of 25% on China goods went into effect July 6. The second round of \$16 billion more China goods tariffs of 25% are effective August 23, next week. And the \$200 billion more tariffs, initially 10%, talk of maybe being 25%, the comment period on these ends September 5. Stay tuned. Story developing.



Country is more productive and consumers spending all of it (Wednesday)

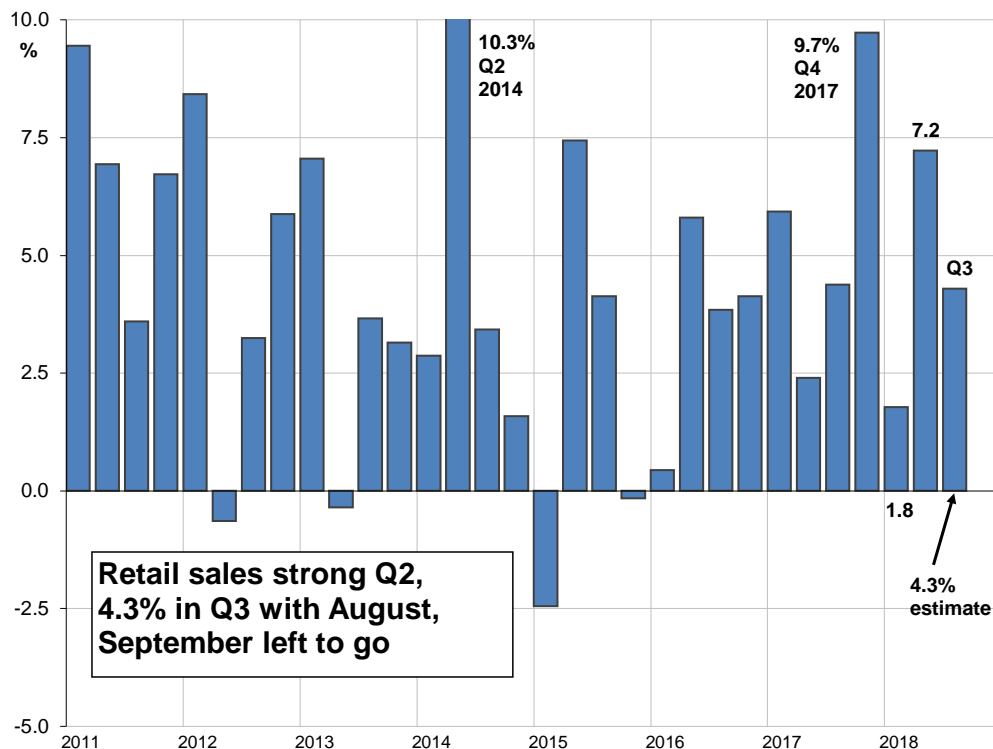
Breaking economy news. Q2 productivity (and yes, another measure of wages), and July retail sales. Right now, the country is more productive than ever and consumers seem hell bent on spending every last dime of their wages and tax cuts windfalls on themselves. The country is turning more inward and consumers are spending it on themselves.



Productivity jumped 2.9% in the second quarter after rising 0.3% in the first quarter and 1.1% for all of 2017. It was 0.1% for all of 2016. Maybe Trump's economic policies are making America more productive again, although there isn't a lot of new manufacturing plants being constructed at the moment, so the second quarter productivity spurt is unlikely to last.

Wages? Did we hear anyone cry out (literally) about their stagnant wages? Plenty of tax cuts for companies but no wages? Well wages in the productivity report are pretty strong right now, maybe that's what is driving the better retail sales figures.

Hourly compensation was 1.1% in 2016, 3.4% in 2017, 3.7% in the first quarter this year and 2.0% in Q2 2018. The second quarter was back at 2.0%, where average



hourly earnings data in the employment report, and the quarterly employment cost index pegs the wage trend, but let's see what happens going forward. As the economy continues to grow through full employment levels, firms could start trading workers, bidding wars, like homes trading like hot cakes out in California. Wages could heat up in a hurry as labor shortages increasingly become the norm for many industries.

Retail sales are powering the economy ahead early in the third quarter. President Trump's 5% forecast isn't on the radar, but 3% economic growth certainly is a defensible forecast.

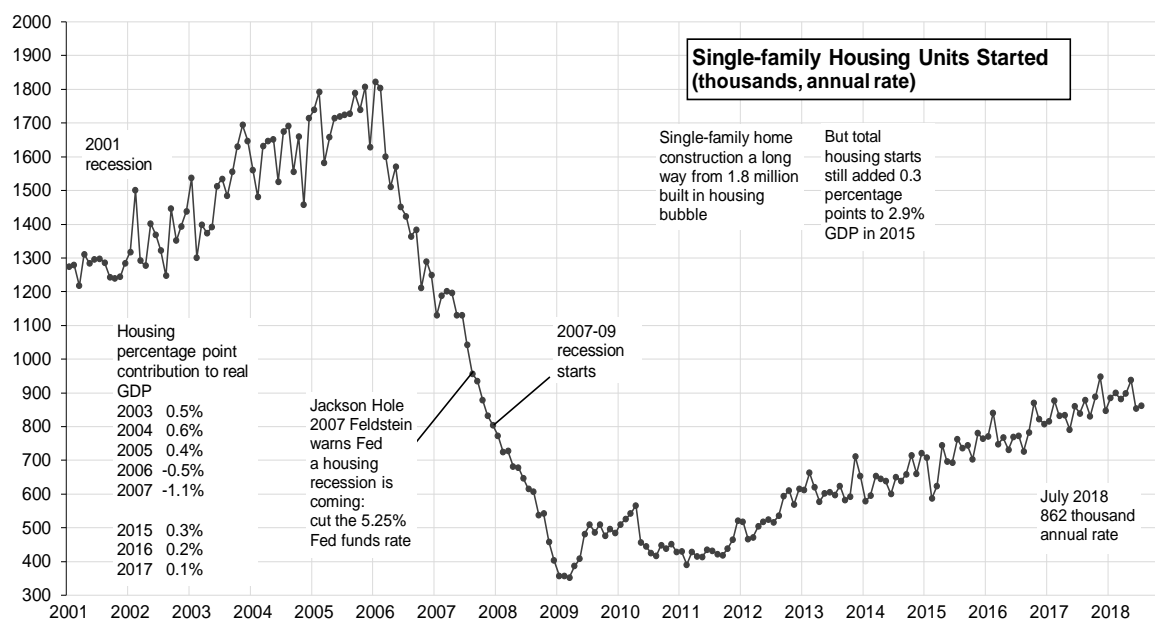
Car & light truck sales plummeted 2.9% in July from 17.2 million to 16.7 million at an annual rate, but somehow retail sales showed stronger consumer purchases. Motor vehicles and parts actually rose 0.2% in July's retail sales report. Go figure. Retail sales rose 0.5% in July and retail sales ex-autos rose 0.6%. Right now, retail sales are growing 4.3% in the third quarter not too shabby with two more months to go and not that much slower than the rapid 7.2% pace in the second quarter that helped to fuel that wickedly fast 4.1% real GDP growth. Growth that was like something seen on reality TV.

Almost everything was up. Another sharp drop for sporting goods for some reason now down 5.7% the last year, the weakest category of spending. Baby boomers too unbalanced to go out and ride a new bike. And we don't mean Harleys. Health and personal care is down 0.4% after gains of over 1% each of the prior four months, with sales still up 6.2% from last year levels. Even furniture sales falling 0.5% are still up 3.9% the last year even if new and existing home sales have been modest.

Net, net, there is still a lot of tax cuts money left to drive retail sales faster this month and the shops and malls are all grateful for it. Who knows about next year, but for today, spend it while you got it is what these strong retail sales figures are saying. The economy really has the wind at its back this quarter with stronger retail sales spending where shoppers are seemingly turning a blind eye to volatile markets and talk of trade war clouds developing out there on the horizon. Stay tuned.

Home prices won't stop rising until they start building more homes (Thursday)

Breaking economy news. Housing starts in July started out the third quarter on the weak side. This is the only area of the economy that has struggled to regain anywhere near the level of activity seen prior to the 2007-09 recession. The recession that wasn't as bad by the way after the GDP numbers were revised last month. (Certainly felt bad, 10.0% unemployment, even if GDP did not fall as hard.) Housing starts were up 0.9% in July to a 1.168 million annual rate, but from a downward revised 12.9% drop in June. Building permits were better at 1.311 million so we assume these will get "started" at some point, but residential housing construction remains disappointing. It also remains needed as the housing shortage in many areas of the country is sending home prices up and up and up.



Interestingly, most of the weakness in July was centered in the West where total housing starts (including multifamily units) plummeted 19.6% and single-family homes fell 10.0%. The only other area of the country with a decline was the 4.0% drop in total housing starts in the Northeast. Residential housing construction in the mature market of the Northeast is much smaller at 97 thousand at an annual rate versus housing starts of 262 thousand at an annual rate out in the West. The Northeast and West are also some of the pricier housing markets in the country which makes us wonder if the change in the tax laws, disallowing some deductions for state & local taxes and mortgage interest, it makes us wonder if the softness in these markets is because homebuilders are fearing the income tax changes will affect demand for new homes negatively.

Net, net, residential housing construction is down in the dumps and will not be a big contributor to real GDP growth in the third quarter certainly. Housing construction counts as investment in the economy and it hasn't added to economic growth in the entire first half of 2018, and now today with July, it looks

like residential homebuilding will be a no-show for economic growth in the third quarter. We hope it isn't a shortage of labor that has kept homebuilders from putting up new homes.

It looks like a combination of higher construction costs like lumber prices, trade war uncertainty, and questions over the demand for new homes, has led to a cooling in the housing market. Simply put, it is more expensive to buy a new home for the American worker.

Housing Starts Total, Single-Family, Multi-Family											
000s	United States			Northeast		Midwest		South		West	
	Total	1 unit	Multi	Total	1 unit	Total	1 unit	Total	1 unit	Total	1 unit
July 18	1168	862	306	97	66	173	137	636	460	262	199
June 18	1158	854	304	101	70	155	112	576	451	326	221
July 17	1185	839	346	119	68	161	116	611	462	294	193
% Chgs											
July/June	0.9	0.9	...	-4.0	-5.7	11.6	22.3	10.4	2.0	-19.6	-10.0
July/July	-1.4	2.7	...	-18.5	-2.9	7.5	18.1	4.1	-0.4	-10.9	3.1

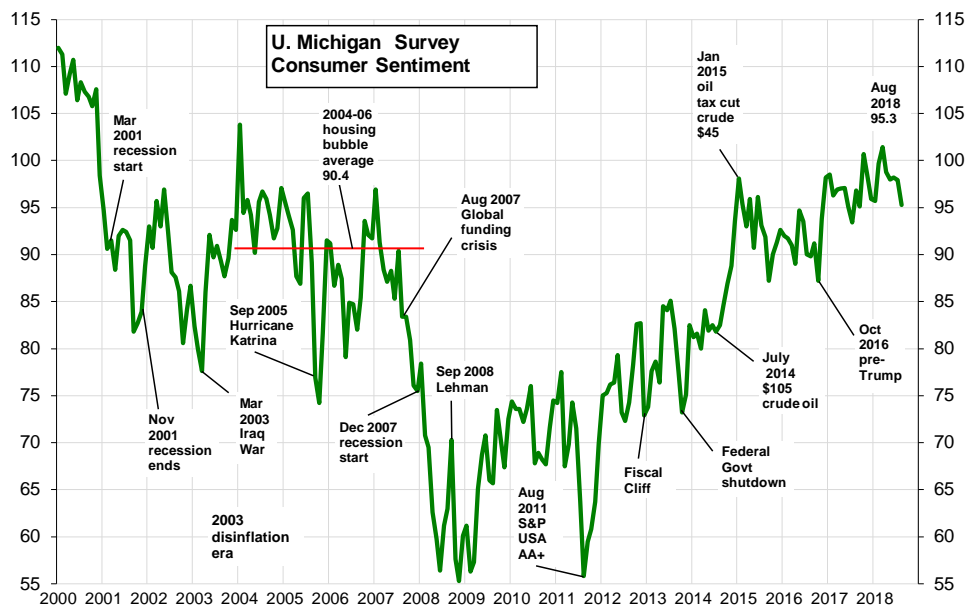
Out of sight home price appreciation is making homes go up faster than worker wages. Mortgage rates are a little above 4.5% versus 3.75% last September and with the Fed still pushing on interest rates, financing costs can only go higher. The massive tax cuts have eliminated deductions for many of the costs that go into buying a new home like state & local taxes and mortgage interest.

Stay tuned. We cannot be confident that home construction will pick up in the near future. That new bubble in home prices that is percolating out there is likely to grow bigger without the added supply of new homes. We are keeping our fingers crossed that the bubble won't pop again. Stay tuned. Story developing.

Consumer confidence takes a dip on vacation this summer (Friday)

Breaking economy news. Consumer sentiment fell to 95.3 in August from 97.9 in July. It's been a pretty rocky road for financial markets this month which can't be good for confidence. The news flow and tweets might be starting to make the consumer a little weary as they read the headlines from the beach this summer. The consumer's assessment of current economic conditions plummeted to 107.8 in August from 114.4 in July which doesn't bode well for August's monthly economic data that will be reported over the next thirty days.

Net, net, the trade wars and market volatility might be triggering the weakest consumer confidence readings seen yet this year which doesn't bode well for the future. Those trade war winds out there on the horizon may have moved in closer to shore and unsettled the consumer's sense of financial well-being and confidence in the outlook.



The consumer isn't panicking certainly, after clearing the store shelves with their purchases in the second quarter. Still, there is less spring in the consumer's step this August as the sugar high from the tax cuts monies may be starting to run dry.

Consumer confidence takes a dip this summer with many on vacation perhaps. We can't be sure the consumer will continue to spend at a faster rate with these diminished confidence levels. We already saw a sharp drop in motor vehicles, cars and SUVs, in July to a 16.7 million annual rate from 17.4 million in June. It's looking like that 4.1% GDP growth in the second quarter may well indeed prove to be the best we will see all year. Stay tuned. Story developing.

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