Financial Market Weekly

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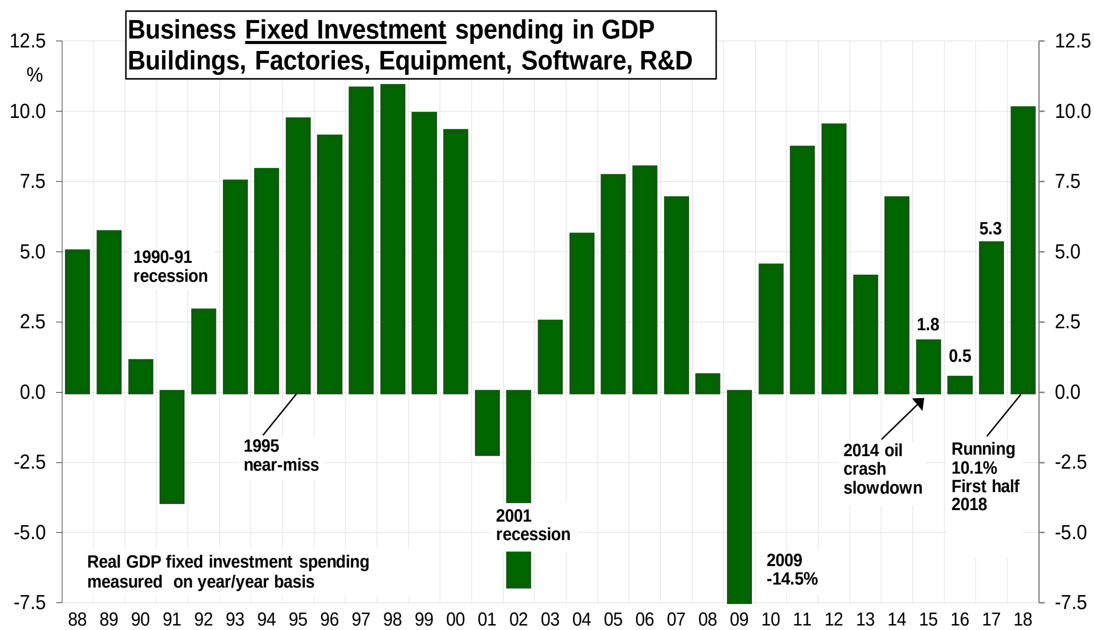
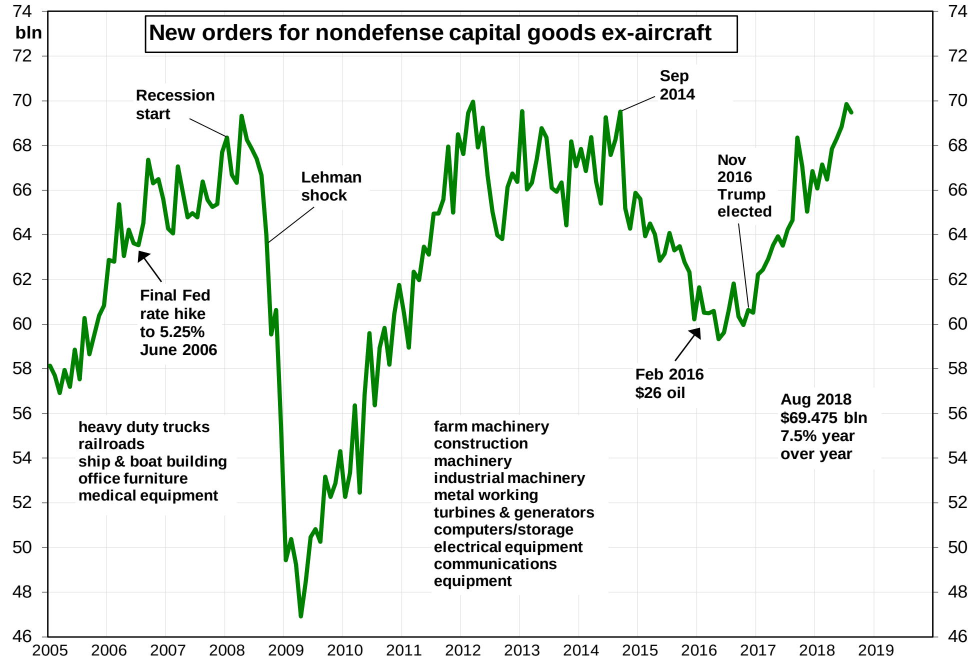
INVESTMENT AFTER THE BIGGEST TAX CUTS IN HISTORY



We will look at the current investment climate this week, investment being the biggest swing factor in upturns and downturns for the economy. We were going to lead with the Fed meeting, but they aren't doing enough to write about. After the long wait for this quarter's rate hike to 2.25%, we will now wait on tenterhooks another three months for them to do something again. They now have more conviction about the need to raise rates 25 bps to 2.5% on December 19 (a little close to the holidays, no?) where 12 of 16 Fed officials want to do it in December up from 8 out of 15 officials at the last "voting" meeting in June. The markets reacted swiftly to the breaking news of Wednesday's Fed meet-up: odds of a rate hike to 2.5% in December were 76% Tuesday night and 80% on Wednesday night. Okay. All eyes on Washington just not on the Fed.

Fed officials are driven by the data they say and for this week's data we want to examine investment trends, in the GDP report Thursday, the third and final estimate for Q2 2018, and in the durable goods report for August released today. Starting with real GDP the third estimate for Q2 2018 was 4.2% same as the second estimate. Investment in GDP is the swing factor in recession and upturns as we said. Nonresidential fixed investment in the GDP accounts (not including temporary movements in inventory levels, or residential housing construction) includes business spending on structures, equipment, software and R&D. Real fixed investment in GDP as defined has a low share of total output, Q2 2018 real GDP $18.511 trillion and fixed investment $2.710 trillion or 14.6 percent, but the investment outlook can change dramatically. Let's put it this way, historically in the Great Recession that thankfully people in Washington have stopped talking as much about, the bad times are over and we have moved far beyond it (unemployment is way-low at 3.9% full-recovery, full employment etc., real GDP in "the worst downturn since the Great Depression, hence 'Great Recession'" fell 4.0% but real GDP fixed investment from "business" plunged 17.6%. Businesses cut back their spending much more than consumers in recessions.



So that was a long-winded historical background. What's happening now? Business investment is rising 10.1% midway through 2018. The historic tax cuts under the Trump administration helped. But business investment was already in the process of recovering when Trump was elected as can be seen in the durable goods orders chart here. There was a downturn in capex when oil prices crashed and hurt the manufacturing sector, and now orders have moved back to 2012-14 full economic recovery levels, and probably have maxed out for now.

Business Investment Spending in the real GDP accounts			$Bln
Q2 2018 $bln	Level	% YOY	YOY
Equipment	1264.9	8.2	95.4
Intellectual Property	897.9	6.6	55.6
Construction			
Business structures	551.7	5.6	29.5
Mining, shafts, wells	129.1	34.3	33.0
Other	422.6	-0.8	-3.5
Total	2710.1	7.1	179.3

Equipment and intellectual property spending is up a lot at the year's halfway mark, but for construction the picture is murkier as most of the new structures are oil & gas drilling as opposed to factories or office building or other commercial/health care construction. In nominal terms in the table below, the trend is the same, equipment has rebounded, R&D a standout, but further double-digit gains, talking 2019, seem unlikely to be there to support sustainable 3% GDP growth. Investment spending is cyclical as the goods/structures have a long life.

$BLN Nominal GDP expenditures	Q4 15	YOY%	Q1 16	Q2 16	Q3 16	Q4 16	YOY%	Q1 17	Q2 17	Q3 17	Q4 17	YOY%	Q1 18	Q2 18	Annual rate
Equipment & Intellectual Property	1891.3	2.2	1878.6	1895.9	1903.4	1908.0	0.9	1947.7	1988.3	2021.7	2052.0	7.5	2105.3	2147.4	9.3%
EQUIPMENT	1113.7	0.9	1092.8	1091.4	1090.2	1089.3	-2.2	1112.3	1137.4	1162.8	1189.1	9.2	1212.6	1228.8	6.7%
Information processing equipment	357.4	2.8	349.0	353.1	356.3	358.8	0.4	368.5	379.0	386.5	393.7	9.7	401.9	410.2	8.4%
Computers	99.8	-3.7	99.1	99.8	98.2	100.1	0.3	103.2	110.1	113.9	109.7	9.6	116.9	121.0	20.6%
Other processing equipment 1	257.5	5.4	249.9	253.2	258.2	258.6	0.4	265.4	268.8	272.6	284.0	9.8	285.0	289.1	3.6%
Industrial equipment	218.0	0.1	212.2	214.2	215.3	218.1	0.0	222.1	230.1	234.6	238.5	9.4	243.9	243.4	4.1%
Transportation equipment	303.3	8.3	298.8	295.2	287.5	280.5	-7.5	282.4	279.4	285.0	290.4	3.5	300.7	303.5	9.0%
Other equipment 2	235.0	-8.9	232.7	228.8	231.0	231.9	-1.3	239.2	249.0	256.8	266.4	14.9	266.1	271.7	4.0%
INTELLECTUAL PROPERTY	777.6	4.1	785.8	804.5	813.2	818.7	5.3	835.4	850.9	858.9	862.9	5.4	892.7	918.6	12.9%
Software	311.7	3.3	319.0	325.5	330.0	335.4	7.6	342.7	353.5	359.7	355.9	6.1	370.3	381.6	14.4%
Research & Development (R&D)	387.4	4.1	388.1	400.1	403.7	403.2	4.1	412.1	416.5	417.8	425.0	5.4	439.7	453.1	13.2%
Entertainment, literary, artistic	78.5	7.5	78.7	78.9	79.5	80.0	1.9	80.6	80.9	81.4	82.0	2.5	82.7	83.8	4.4%
1 Communication, medical, photocopy, office and accounting equipment; nonmedical instruments															
2 Furniture; agriculture, construction, mining/oilfield, and service industry machinery; electrical equipment															

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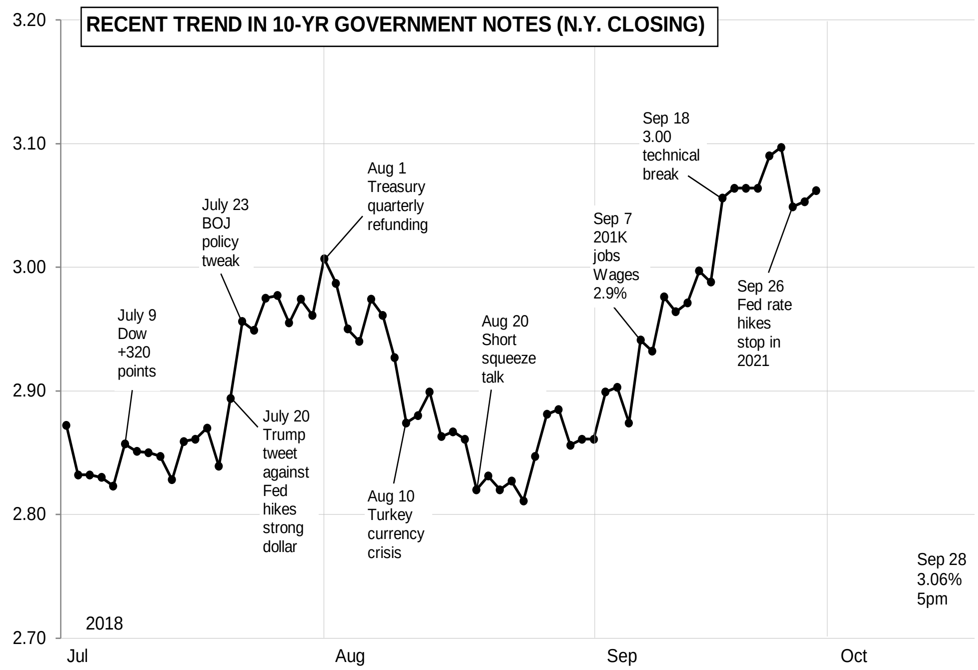
MARKETS OUTLOOK

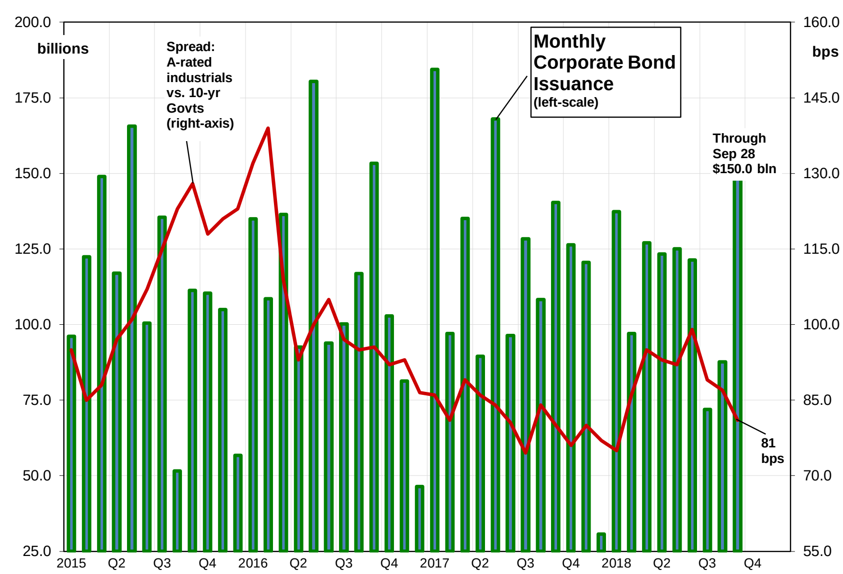
	28-Sep 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021
30-Yr Treasury	3.21	3.25	3.40	3.45	3.65	3.60	3.80	3.85	3.85	3.95	3.95
10-Yr Note	3.06	3.10	3.20	3.30	3.50	3.50	3.70	3.80	3.80	3.95	3.95
5-Yr Note	2.95	3.00	3.10	3.20	3.40	3.45	3.65	3.75	3.80	3.95	3.95
2-Yr Note	2.82	2.90	3.00	3.15	3.40	3.40	3.60	3.75	3.80	4.00	4.00
3-month Libor	2.40	2.70	2.95	3.20	3.45	3.45	3.70	3.90	3.90	4.20	4.15
Fed Funds Rate	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75	3.75	4.00	4.00
2s/10s spread	24	20	20	15	10	10	10	5	0	(5)	(5)
Libor/funds spd	15	20	20	20	20	20	20	15	15	20	15



We moved the interest rate forecast along another quarter. Not sure our forecast for core PCE inflation is going to make this Federal Reserve under Chair Powell want to raise interest rates as high as we see. Not with New York Fed President Williams and Fed Vice Chair Clarida in the senior Fed official positions that Powell asked for. Our 3.5% 10-yr yields forecast for the end of 2019 that has become a market consensus forecast is still out there. It's a long way away however. 10-yr Treasury yields closed 3.06% on Friday unchanged from last week. Yields were 3.10% at Tuesday's close and came down to 3.05% on Wednesday after the Fed meeting announcement. The Fed did not change the gradual rates path and doesn't see a rate hike in 2021.

CORPORATES: SEVERAL BANKS, TYSON FOODS, TORCHMARK, BEST BUY

Corporate offerings were $12.7 billion in the September 28 week versus $40.5 billion in the September 21 week. On Monday, International Flavors & Fragrances sold $1.5 billion 2s/10s/30s. It priced a $400 million 4.45% 10-yr (m-w +25bp) at 138 bps (Baa3/BBB). The company provides ingredients for food, beverage, beauty products and will use the proceeds for its merger with Frutarom Industries. Corporate bond yields (10-yr Industrials rated A2) were 81 bps above 10-yr Treasuries this week versus 83 bps last Friday.



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FEDERAL RESERVE POLICY

The Fed met September 25-26 to consider its monetary policy. Nothing changes. We were going to do a front page, breaking-news, write-up this week, but nothing happened. Did they meet? If a tree falls in the forest does it make any noise? Anyone, anyone? No major changes were made to their press statement. They dropped the word "accommodative" when describing their policy. A big deal. Policy, the setting on interest rates after raising rates to 2.25% is no longer "stimulus," mana from heaven for the economy, because short-term interest rates are nearing normal. No more easy money when it comes to borrowing costs. Well, check it out. The 15 Fed official forecasts (should be sixteen but one official says "they don't know"… Don't make us say it.), the details of the 15 Fed official forecasts of neutral rates for the economy that don't speed growth up (as if) or slow it down, are 3 votes for 2.5%, 4 votes for 2.75%, and 6 votes for 3.0%. Okay then at 2.25% the Fed funds rate is now close enough to the wide spread of what neutral rates are for the economy, so drop the word "accommodative."

Selected Fed assets and liabilities

Fed H.4.1 statistical release billions, Wednesday data	26-Sep	19-Sep	12-Sep	5-Sep	Sep 10 2008** pre-LEH
Factors adding reserves					
U.S. Treasury securities	2313.208	2313.206	2313.204	2313.202	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities	1681.763	1695.223	1697.016	1697.006	0.000
Primary credit (Discount Window)	0.064	0.152	0.065	0.001	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)	0.007	0.007	1.720	1.719	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	0.090	0.100	0.091	0.090	62.000
Federal Reserve Assets	4240.4	4255.8	4258.5	4255.8	961.7
3-month Libor %	2.39	2.35	2.33	2.32	2.82
Factors draining reserves					
Currency in circulation	1686.023	1685.759	1686.970	1688.628	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	5.625	8.915	1.315	0.010	0.000
Reserve Balances (Net Liquidity)	1837.874	1822.718	1924.008	1897.901	24.964
Treasuries within 15 days	19.033	19.007	0.000	0.000	14.955
Treasuries 16 to 90 days	83.128	83.154	102.160	102.160	31.549
Treasuries 91 days to 1 year	315.819	315.819	315.819	315.819	69.272
Treasuries over 1-yr to 5 years	1010.629	1010.629	1010.629	1010.628	170.807
Treasuries over 5-yrs to 10 years	267.467	267.466	267.465	267.464	91.863
Treasuries over 10-years	617.133	617.132	617.131	617.130	101.337

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

September 26, 2018 statement

Information received since the Federal Open Market Committee met in August indicates that the labor market has continued to strengthen and that economic activity has been rising at a strong rate. Job gains have been strong, on average, in recent months, and the unemployment rate has stayed low. Household spending and business fixed investment have grown strongly. On a 12-month basis, both overall inflation and inflation for items other than food and energy remain near 2 percent. Indicators of longer-term inflation expectations are little changed, on balance.

Consistent with its statutory mandate, the Committee seeks to foster maximum employment and price stability. The Committee expects that further gradual increases in the target range for the federal funds rate will be consistent with sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2 percent objective over the medium term. Risks to the economic outlook appear roughly balanced.

In view of realized and expected labor market conditions and inflation, the Committee decided to raise the target range for the federal funds rate to 2 to 2-1/4 percent.

August 1, 2018 statement

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In view of realized and expected labor market conditions and inflation, the Committee decided to maintain the target range for the federal funds rate at 1-3/4 to 2 percent. The stance of monetary policy remains accommodative, thereby supporting strong labor market conditions and a sustained return to 2 percent inflation.

Fine. What else didn't they do? THEY MADE NO CHANGE TO THE GRADUAL PATH OF RATES, AND LEFT THE 2021 FORECAST THE SAME AS THEIR CALL FOR 2020. Trump should be happy, he's a low rates guy and the Fed says rates won't go above 3.5% in 2020 or 2021. Prepare for that. One Fed rate hike only over two whole years in 2020 and 2021, so if you are in fixed income on Wall Street, brace yourselves as the risk managers are constantly telling us. Not going to be a lot of need for your services.

Fed Individual Forecasts					
Fed funds rate by year-end					Longer
Votes	2018 End	2019 End	2020 End	2021 End	run
1	2.125	2.125	2.125	2.125	2.500
2	2.125	2.375	2.625	2.625	2.500
3	2.125	2.625	2.875	2.875	2.500
4	2.125	2.875	3.125	2.875	2.750
5	2.375	2.875	3.125	2.875	2.750
6	2.375	2.875	3.125	3.000	2.750
7	2.375	2.875	3.125	3.125	2.750
8	2.375	3.125	3.375	3.375	3.000
9	2.375	3.125	3.375	3.375	3.000
10	2.375	3.125	3.625	3.375	3.000
11	2.375	3.125	3.625	3.375	3.000
12	2.375	3.375	3.625	3.500	3.000
13	2.375	3.375	3.625	3.625	3.000
14	2.375	3.375	3.625	3.625	3.250
15	2.375	3.375	3.625	3.875	3.500
16	2.375	3.625	3.875	4.125	
17					
Median	2.375	3.125	3.375	3.375	3.000
Meeting	Sep 2018	Sep 2018	Sep 2018	Sep 2018	Sep 2018

Fed Meeting	2017	2018	2019	2020	Longer run
Sep 18		2.4	3.1	3.4	3.0
Jun 18		2.4	3.1	3.4	2.9
Mar 18		2.1	2.9	3.4	2.9
Dec 17	1.4	2.1	2.7	3.1	2.8
Sep 17	1.4	2.1	2.7	2.9	2.8
Jun 17	1.4	2.1	2.9		3.0
Mar 17	1.4	2.1	3.0		3.0
Dec 16	1.4	2.1	2.9		3.0
Sep 16	1.1	1.9	2.6		2.9
Jun 16	1.6	2.4			3.0
Mar 16	1.9	3.0			3.3
Tax cuts and fiscal spending stimulus moved 2020 forecast to 3.4% in March. No higher.					

<u>We said the President should be happy on the Fed's decision, but here is what he said in his press conference at the UN on Wednesday:</u>

And our economy now is hotter than it's ever been. I don't know you if you saw the confidence levels this morning that just came out. Fantastic. And in all fairness to the Fed raising rates, they're raising rates because we've never done like we're doing now. And one of the things that is nice about the rates – the people that were hurt the worst by these zero interest rates and, you know --

When President Obama had an economy that was -- it was the worst comeback since the Great Depression and all that --you've all heard that. But remember, he was playing with zero-interest money. He was playing with funny money. That's easy. I'm playing with fairly expensive money.

So when he does that, the people that benefit are people that actually -- in their whole life, they would save 10, 15, 20 percent of their salary and put it in the bank. Those people got killed because they put their money in the bank. They were going to live off the interest, and there was no interest.

Now, those people are starting to get interest. And those are the people, frankly, that deserve to -- you know, they did a great job. The people that did it right, the people that did the best job got hurt the most.

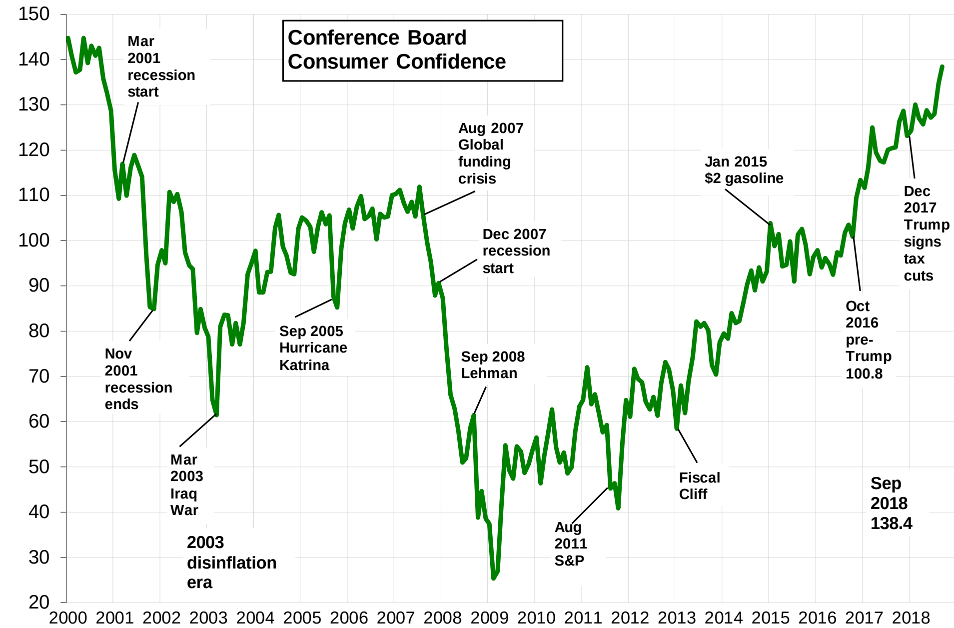
So in one sense I like it, but basically, I'm a low-interest-rate person. I hate to tell you.

OTHER ECONOMIC NEWS THIS WEEK

Consumer confidence soars the last two months (Tuesday)

Breaking economy news. Consumer confidence levels jump again by 5 whole points to 138.4 in September from where we thought the index was a month ago. In the old days of Fed watching, we thought Fed officials would just read in the morning newspapers the latest consumer confidence readings and vote accordingly. Today's sharp rise of consumer confidence to the highest since 2000, over two economic cycles ago, is literally screaming for Fed officials to take their foot off the accelerator and move interest rates to higher levels. There is absolutely no need for the Fed's monetary policy to remain stimulative at this late stage of the business cycle. None.

45.7 percent of consumers surveyed said jobs are plentiful, bolstered by a notable downshift in those saying jobs are not so plentiful, dropping from 45.6 in August to 41.1 in September. And believe it or not, those saying jobs are hard to get rose a notch, from 12.1 in August to 13.2 in September. Hurry someone and get them to a guidance counselor as there are certainly jobs for everyone.



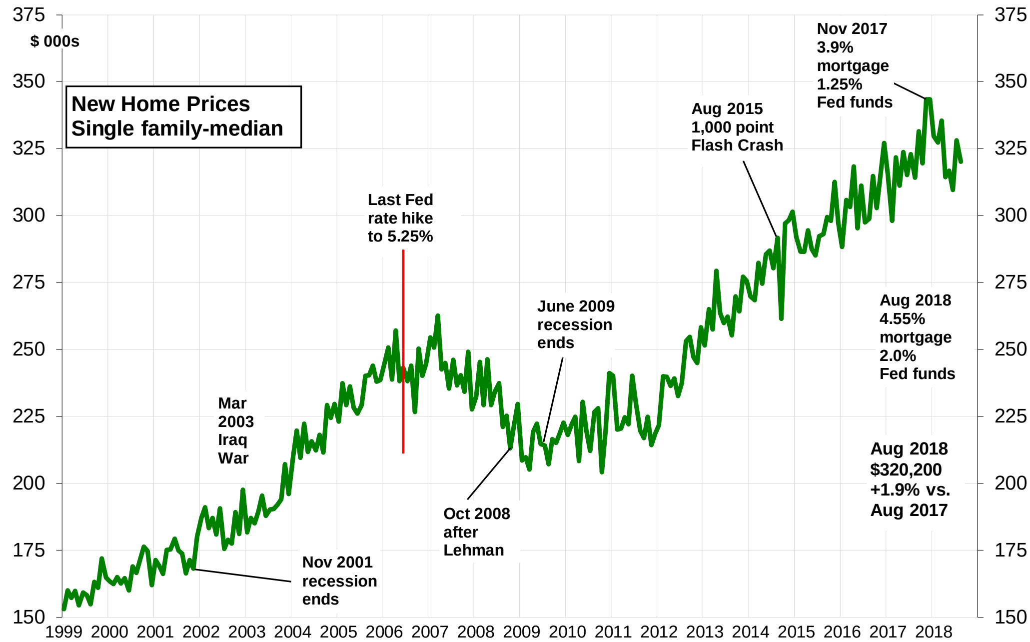
Net, net, the consumer is always in the driver's seat when it comes to stoking the fires that run the engines of economic growth, and the way things stand now this economy could run a million years; it's that good out there in the country. Right now, consumers are the most bulled up that they have been since the year 2000 over two recessions ago.

The most jobs available on record and all-time highs in the stock market are the key drivers behind this leap in faith from consumers since July. It's no longer the economy stupid for consumers, this soaring confidence is not about GDP growth, it is about the plethora of jobs available to choose from and the record highs in the stock market for the half of society who own shares in American corporations.

And many people aren't going to like this, but the confidence level has soared since Trump was elected, from 100.8 in October 2016 before Trump won the election to 138.4 in September 2018 which is an incredible run... even for reality TV, that's pretty unreal. We can't explain it, we are just reporting it. Stay tuned. If consumers remain this upbeat in the months to come, this economic expansion is destined to be entered into the record books as the longest period of growth and prosperity in modern economic history.

New home sales stuck in a rut (Wednesday)

Breaking economy news. New home sales were 629 thousand in August, up 3.5% from last month, but keep in mind July was 627 thousand and got revised down to 608 thousand. If consumers are brimming with confidence and happy as they know it clap their hands, they aren't rushing out and buying new homes like they once did back in the middle of the last decade. The US economy would be on much stronger footing today if new home sales were back to pre-crisis levels a decade ago.



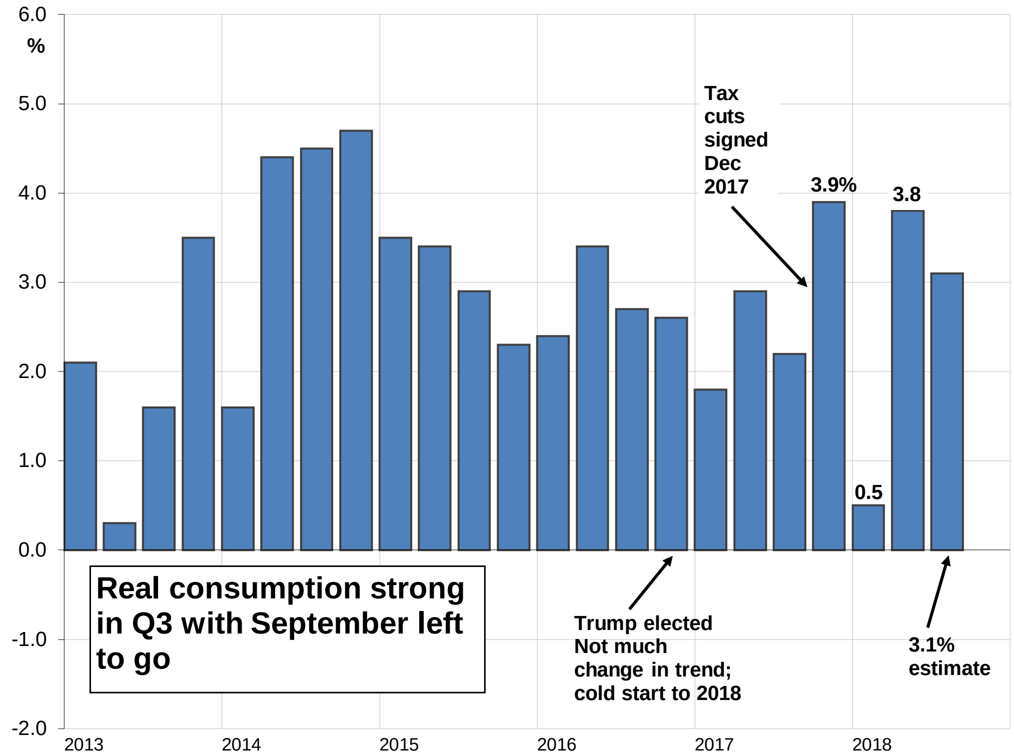
It is kind of a chicken or egg thing here, consumers can't buy new homes if builders aren't offering them for sale. Although single-family home construction was 876 thousand in August as reported in the housing starts data earlier this month.

Net, net, the stock market is at all-time highs and most measures of consumer confidence also near record levels, yet new home sales are tepid at best. We believe new home sales will stay relatively weak as they face the increasing headwinds of expense and costs. New home prices are too expensive both in terms of price and the expense of financing the purchases. Mortgage rates were 3.4% when Trump was elected in November 2016 nearly two years ago and are 4.65% today 125 basis points higher in yield. New home prices continue to rise faster than worker wages with the average sales price at $388,400 in August an increase of 5.2% from a year ago. Workers are falling behind and aren't keeping up with the Jones' in their fancy new homes down the street.

New home sales are a leading indicator of the economy and the weakness in sales does not corroborate the sky-high confidence readings of the consumer. One thing is for certain, new home sales aren't running fast enough to engender another quarter of 4% real GDP growth. No way, no how. Consumers aren't putting their tax cuts monies to work in the economy and buying new homes, and until they do, the economic outlook is not as good as the markets are pricing in. The housing mystery in this long economic expansion remains unsolved. But it may simply turn out to be the case that homes are just too expensive and more costly to finance with mortgage rates at current levels. Fed officials are going to hike rates today and more rate hikes are coming based on their forecasts, but the housing market says rates are already high enough. Housing has brought down the entire economy before, and it just might do it again if Fed officials aren't careful. Stay tuned. Story developing.

Consumers still moving ahead, inflation steady, really steady (Friday)

Breaking economy news. The August personal income report. Got any? The nation does. Personal income was up 0.3% in August and consumers spent all of it with personal spending rising 0.3%. After subtracting inflation, real consumer expenditures rose 0.2% after rising 0.3% in July. Core consumer inflation pressures were 0.0%, nothing in August, showing those higher priced imported goods have not yet made it to our shores to give the consumer sticker shock.



3% economic growth remains in the picture for the third quarter despite the drag from America's increasing import bill largely due to the consumer's buying power where they haven't reached the end of their tax cuts credit line yet. Real consumer spending is running 3.1% in the third quarter, one more month to go, after the consumer's 3.8% splurge in the second quarter that helped make that 4.2% GDP growth so great again for America. Friday, October 26 will be our first look at third quarter economic growth. Consumers aren't buying a lot of new homes or autos, but they are sure buying up almost everything else.

Net, net, the economy is rolling along not too hot and not too cold where growth is solid and inflation pressures modest. This is exactly the environment the Fed needs to move interest rates up at a gradual pace as further rate hikes start to look like tightening where taking away the punch bowl from an aging ten year expansion poses risks. Core inflation pressures seem to have crested at the Fed's 2% target the last several months backing up Fed Chair Powell's contention that inflation was unlikely to pose a problem in the future. Stay tuned. Story developing.

The economy is running not too hot and not too cold, it is moving ahead at a pace that is all right for now thanks to the consumer who at the moment is saying let the trade wind wars blow. Let's see how this works out for them later this year and into 2019 as the 25% China tariffs on that extra $200 billion of imports start showing up on the store shelves with their higher priced goods. We hope the consumer doesn't get sticker shock and go into hibernation. This has all the makings of a perfect storm for the economy next year where the consumer runs out of tax cuts monies just at the time the higher prices from the trade war chickens come home to roost. 3% economic growth today, but tomorrow is anyone's guess.

Analyst Certification

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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.