FEDERAL BUDGET DEFICIT: ALL IS QUIET BEFORE THE STORM

The last budget estimates from the outgoing Obama administration were for lower deficits the next three fiscal years ending Septembers always. It’s all quiet for now but Team Trump storms into Washington later this month with new ideas on tax cuts and infrastructure spending. It is unclear where the deficit goes as deficits don’t match with the Republican congress’ long-held core values like a smaller government and revenue-neutral spending, if any Federal government spending must be done at all.

The budget deficit was $438 billion in FY15 and swung out to $587 billion in FY16. Part of the increase was “technical” benefits payment-timing issues ($40 billion), but outlays did rise 4.5%, while revenues rose just 0.6%. Revenues caught our eye. It is a progressive personal income tax system, and with personal incomes rising, why didn’t taxpayers get kicked up into higher income brackets and pay more taxes? Nonwithheld income taxes fell $20 billion; the stock market was flat in 2015. In addition, corporate taxes are down about $40 billion; less profit in the second half of the year (oil & gas?) and partly tax law changes accelerating deductions for investment.

CHRISTOPHER S. RUPKEY, CFA
MANAGING DIRECTOR
CHIEF FINANCIAL ECONOMIST
ECONOMIC RESEARCH OFFICE (NEW YORK)
(212) 782-5702
crupkey@us.mufg.jp
MUFG | 1251 Avenue of the Americas
New York, New York 10020
Lots of talk in Presidential campaign about getting corporations to pay more… not a lot of there there.

### Corporate Taxes fiscal years $billions and percent changes

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>353.9</td>
<td>370.2</td>
<td>304.3</td>
<td>138.2</td>
<td>191.4</td>
<td>181.1</td>
<td>242.3</td>
<td>273.5</td>
<td>320.7</td>
<td>343.8</td>
<td>299.6</td>
</tr>
<tr>
<td>Change</td>
<td>27.2</td>
<td>4.6</td>
<td>-17.8</td>
<td>-54.6</td>
<td>38.5</td>
<td>-5.4</td>
<td>33.8</td>
<td>12.9</td>
<td>17.3</td>
<td>7.2</td>
<td>-12.9</td>
</tr>
</tbody>
</table>

That was the past, so what about the future? The future is always uncertain and now the coming changes in Washington make it more so. The White House Office of Management and Budget (OMB) did its midsession review last summer and looks for FY deficits of $441 billion in 2017, $330 billion in 2018, and $427 billion in 2019. Not a lot of Federal deficit spending with the deficit remaining below the 3% of nominal GDP threshold level below which Bernanke said the government’s red ink had just minimal impact on the economy.

As far as reviewing spending trends in the first three months of FY2017, no single category stands out. Total spending is down 3.3% in Q4 2017 versus Q4 2016-the first three months of these two fiscal years. Spending is down 3.3% or $32.1 billion so far this year due to timing differences on benefit payments due to posting dates falling on a weekend. Spending is actually about $50 to 60 billion higher.

There is not a lot to go on yet when it comes to assessing Team Trump’s spending and tax cut ideas. There are no concrete proposals to analyze. More deficit spending might help push growth to 3-4 percent GDP, one of Trump’s campaign promises. More deficit spending might push up interest rates. Our forecast for higher bond yields could use a boost itself. The Congressional Budget Office (CBO) did a long term outlook with economic assumptions back in August 2016. And brave enough to put out another Budget and Economic Outlook on Tuesday, January 24, just days after Trump’s inauguration. Maybe he’ll say something in his address to the Nation.
Anyway the CBO last August was looking for sharply higher interest rates when making their budget forecasts years (and years) into the future. 10-yr Treasury yields would not go above 3% until Q4 2019 when it averages 3.1% and 3-month Treasury bills (the Fed funds rate, close enough for government work) will average 2.2% in Q4 2019. Not high enough on the rates forecast for us, but okay. They do “see” 10-yr yields averaging 3.6% from the years 2022 to 2026 if you can wait for that. Here is their reasoning.

“That projected rise in interest rates reflects the expectation that both foreign and domestic economic growth will improve, which should result in higher interest rates abroad as well as in the United States. In addition, CBO expects the “term premium”—the extra return paid to bondholders for risk associated with holding long-term Treasury securities—to increase from historically low levels. In CBO’s estimation, the term premium has remained low, in part, because of low foreign interest rates, heightened concern about global economic growth, and increased demand for Treasury securities as a hedge against possible adverse economic outcomes.” Not a lot here to “Bet on it!” but okay, thanks.

Speaking of interest rates, here is our current forecast. We show rates rising. But basically there is no interest rate “forecast.” How could there be after the Bernanke/Yellen Fed has left rates at zero since December 2008. The interest rate “cycle” is broken. Our “interest rate forecast” is based on this Fed or the next Fed under Donald Trump returning interest rates to normal levels. Normal? Normal is about 4% for the Fed funds rate. Once it gets there we can start “forecasting” rates again.

The trend in 10-yr Treasury yields has been relatively lifeless so far in 2017 after falling the day before the Friday, January 6 payroll jobs report with its “better” wage data (2.9%, just not for working people). On Thursday, January 5 the 153K ADP jobs report did not suggest a big number on Friday, the dollar and stocks fell, and the technicals did not look good on the charts. Yields closed this week at 2.40%, after falling at the start of the week on Monday with a $2 drop in crude oil (to $51.96 only). The retail sales and PPI inflation reports brought out sellers with 10-yr yields rising from 2.33 to 2.38% five minutes after the 8:30am New York time release of the economic news.
Other News This Week

Consumer hits the car lots in December while inflation shoots higher

Breaking economy news.

Retail sales and Producer Prices (PPI). We don’t know about PPI anymore, but retail sales are still the second most important economic statistic of the month after the employment report, and yet we did not read many stories on this important economic news in the newspapers the next morning.

Retail sales rose 0.6% in December as car buyers were out in force. Gas prices are up with energy overall during the Trump rally but that did nothing to kill the consumer’s thirst for great big SUVs, those thinly disguised trucks parked in the way at the supermarket. We already know car & light truck sales rose 3.1% to 18.3 million in December, a record high for this long expansion from recession now in its eighth year. (Year number nine starts this summer in July at your local picture theatre.)

If there’s growth, there must eventually be inflation. Final demand PPI goods prices ex-food and energy have risen steadily since July and kicked it up a notch the final two months of the year, +0.2% in November and +0.3% in December. Inflation is arising.

Net, net, consumers still got it and they’re spending it, even though it is more at the car lot than at the shopping malls this month. Whenever we hear the lament about the low turnover and subpar let’s make America great again growth, we always point people
to retail sales at the cash register with sales up 4.4% the last year. This is growth, count it, retailers are. Ka-ching noises coming from their cash registers opening and closing, opening and closing. Sure, some of it is lazy, Internet sales made on smart phones from people’s couches rising 10.4% in 2016, but bricks-and-mortar shops are not dead yet.

Meanwhile, as the economic expansion hits full maturity, inflation is picking up at the lowest production level for goods. Final demand goods prices ex-food and energy are now up 1.7% the last 12-months which is the highest in two years. Even Fed officials can see where inflation is headed. We expect Fed officials to keep with their promise to raise rates two or three times this year. This is not the picture of an economy that requires the support of the central bank's policymakers. The economy is stronger than you think. 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 2016 Bank of Tokyo-Mitsubishi UFJ 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 Union Bank, N.A.

MUFG Union Bank, N.A., is a full-service bank with offices across the United States. We provide a wide spectrum of corporate, commercial and retail banking and wealth management solutions to meet the needs of customers. We also offer an extensive portfolio of value-added solutions for customers, including investment banking, personal and corporate trust, global custody, transaction banking, capital markets, and other services. With assets of $115.4 billion, as of December 31, 2015, MUFG Union Bank has strong capital reserves, credit ratings and capital ratios relative to peer banks. MUFG Union Bank is a proud member of the Mitsubishi UFJ Financial Group (NYSE: MTU), one of the world's largest financial organizations with total assets of approximately ¥295.8 trillion (JPY) or $2.5 trillion (USD), as of December 30, 2015. The corporate headquarters (principal executive office) for MUFG Americas Holdings Corporation, which is the financial holding company and MUFG Union Bank, is in New York City. The main banking office of MUFG Union Bank is in San Francisco, California.