Financial Market Weekly

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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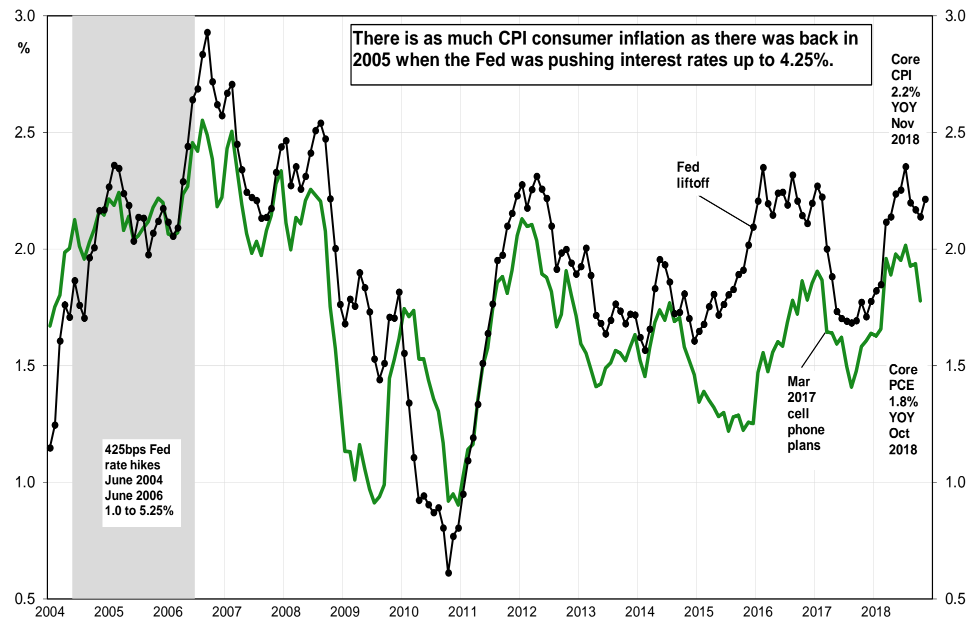
PERSONAL CONSUMPTION EXPENDITURES DEFLATOR: INFLATION THAT ONLY AN ECONOMIST COULD LOVE

Inflation doesn't seem to be gaining any traction. The personal consumption expenditures (PCE) deflator for core goods and services (minus food & energy) slipped back to 1.8% year-to-year in the October report. November data are due out Friday, December 21. Headline inflation won't be going anywhere soon after crude oil prices plummeted from $75 in October to $50 recently.



Maybe the Fed chose the wrong inflation indicator way back when. Cynics would say Greenspan chose PCE inflation over the tried-and-true CPI index back in 2000 because it was lower and showed the Fed was doing a better job at containing inflation. The basic problem on inflation from the graph up top here is that there is as much core CPI inflation now as there was back in 2005 when the Fed thought there was inflation and pushed rates up to 4.25% that year. It is just that the Fed's now preferred measure, core PCE inflation is coming up short. Beauty and inflation are in the eye of the beholder we guess. Shouldn't the Fed move rates up to at least neutral from 2.25% now because CPI inflation is where it was back in 2005 when they decided interest rates needed to be 4.25%?

What's the difference in the two measures of consumer inflation? PCE inflation is a measure of price appreciation for everything that everyone buys in the economy, where CPI inflation is based on a basket of goods for some "mythical consumer" spending 13% of their budget on food, 4% on gasoline,

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and on down the list. Despite the claims Greenspan made for PCE inflation back in 2000, it comes with some problems where 9.0% of "core inflation" is the prices of financial services. Not many Americans spend 9% of their budgets on banking and insurance as much as we might like them to.

This brings us to the inflation measurement problem with the relative weights of what people are buying CPI versus PCE. What goods and services are they purchasing? Core PCE inflation is 1.8% and core CPI inflation is 2.2%. In a nutshell, the difference between the two is that something that is running slower like medical care services has a big weight in core PCE purchases and inflation, where faster inflation in home prices, even if running the same in PCE as in CPI, has a much larger weight in core CPI. Housing costs and medical care explains much of the disparity in the two measures.

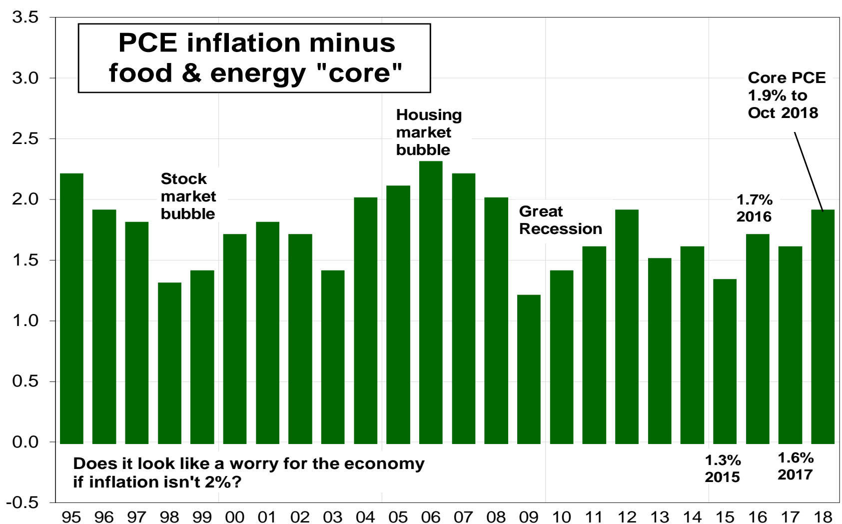
> In past Monetary Policy Reports to the Congress, the FOMC has framed its inflation forecasts in terms of the consumer price index. The chain-type price index for PCE draws extensively on data from the consumer price index but, while not entirely free of measurement problems, has several advantages relative to the CPI. The PCE chain-type index is constructed from a formula that reflects the changing composition of spending and thereby avoids some of the upward bias associated with the fixed-weight nature of the CPI. In addition, the weights are based on a more comprehensive measure of expenditures. Finally, historical data used in the PCE price index can be revised to account for newly available information. This switch in presentation notwithstanding, the FOMC will continue to rely on a variety of aggregate price measures, as well as other information on prices and costs, in assessing the path of inflation.

Key Differences in Core Inflation

Weight	PCE inflation	YOY	Weight	CPI inflation	YOY
(88.7)	Core inflation	1.8	(78.8)	Core inflation	1.8
18.0	Housing/shelter	3.4	41.8	Housing/shelter	3.4
19.2	Medical care services	1.4	8.7	Medical care services	2.4

Year/Year (YOY) inflation is October for PCE, November for CPI
Housing/Medical care weights relative to core purchases

What does PCE inflation mean for monetary policy? The world. Fed Chair Powell is not an economist, but he is observant. In a speech to NABE in October, we were startled to hear the Fed Chair say that we had the same tight labor markets today as we did in the late 90s, and yet in the late 90s, core PCE inflation never made it above 2%. Maybe it takes a noneconomist to see the obvious.

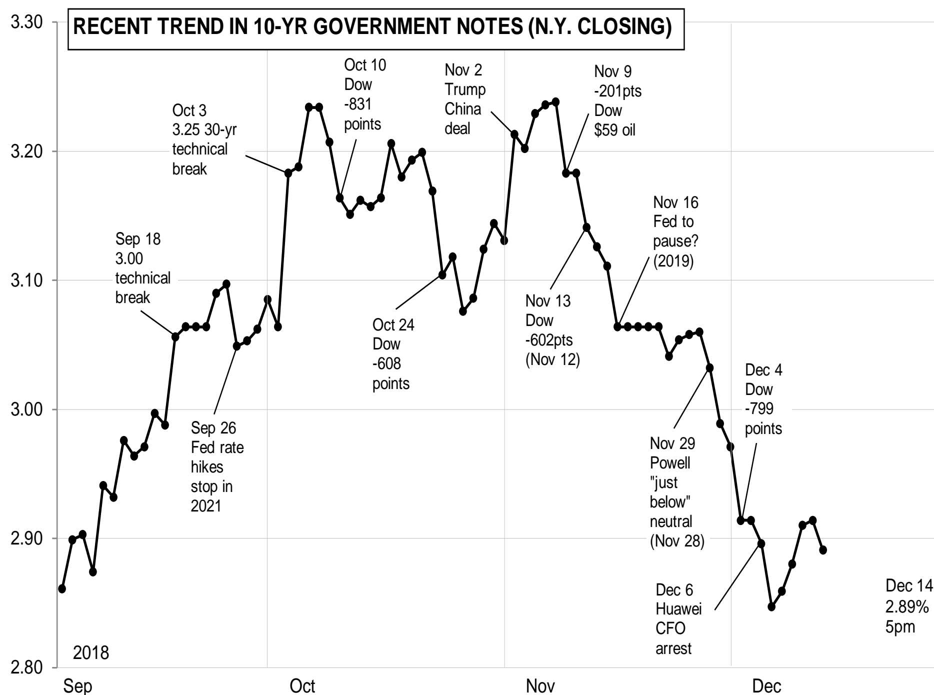


Powell asked his staff economists why no inflation in 1999 and 2000 with the same tight labor market and they said

Our conclusion, is that core PCE inflation is not going to breakout to sharply higher levels that feeds the public's inflation fears and leads the Federal Reserve to raise interest rates much higher to purposely slow the economy. And the gradual pace of rate hikes has been gradual in part because inflation isn't 2.2% like CPI says, it is 1.8% like PCE says. The weighting of housing and medical care services prices which goes into inflation is part of the reason why inflation will not easily catch fire. Higher interest rates are also less likely because the noneconomist Fed Chairman looked back in history and found the example of the late 90s where the economy was hot but inflation was not. The labor market may be hot enough for the president to crow about, but it is not so hot that the Fed has to overdo it on the upside with too many more rate hikes. That's a good thing, not a bad thing.

MARKETS OUTLOOK

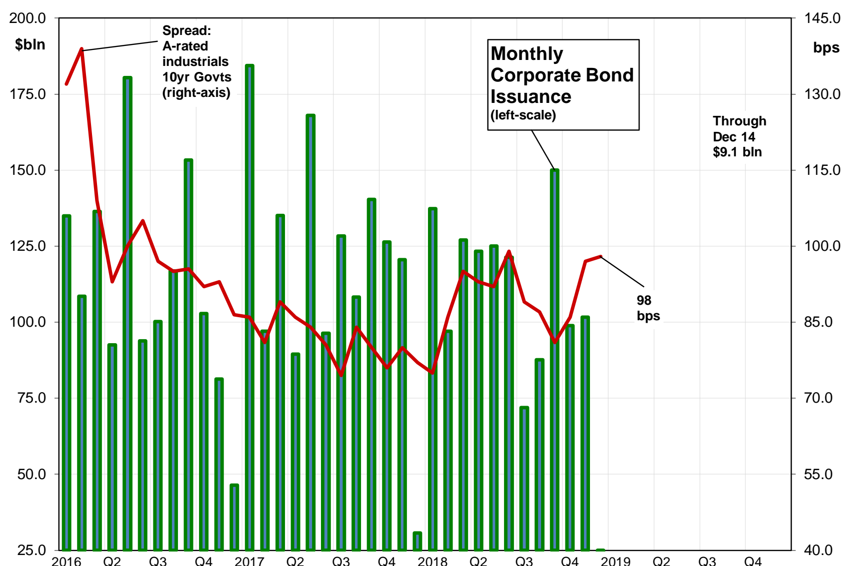
	28-Sep 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021
30-Yr Treasury	3.21	3.25	3.40	3.45	3.65	3.60	3.80	3.85	3.85	3.95	3.95
10-Yr Note	3.06	3.10	3.20	3.30	3.50	3.50	3.70	3.80	3.80	3.95	3.95
5-Yr Note	2.95	3.00	3.10	3.20	3.40	3.45	3.65	3.75	3.80	3.95	3.95
2-Yr Note	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



Bond yields recovered somewhat this week. Treasuries closed 2.89% on Friday 4 bps higher than last week. Bond yields following stocks and stocks following China-US trade news. Dow industrials fell 4.5% last week, and 1.2% this week and yet yields were a little higher. 3-month Libor is 2.80% and bond yields were as low as 2.82% on Monday and cannot go much lower unless the low yields are discounting recession and Fed easing. Treasury auctions of 3-yrs, 10-yrs, and 30-yrs this week went smoothly. The Fed dots forecasts at 2pm EST Wednesday, December 19 will be big as the market thinks Powell thinks they are about done. Powell explains it all at press conference starting at 230pm. Stay tuned.

CORPORATE BOND ISSUANCE: UNITEDHEALTH GROUP, EVERSOURCE ENERGY

Corporate offerings were $4.6 billion in the December 14 week versus $4.5 billion in the December 7 week. On Thursday, UnitedHealth Group sold $3.0 billion 5s/7s/10s/30s. It priced a $850 million 3.875% 10-yr (m-w +15bp) at 100 bps (A3/A+). The health care company will use the proceeds for refinancing commercial paper borrowings and $1.25 billion of two notes maturing February/March 2019. Corporate bond yields (10-yr Industrials rated A2) were 98 bps above 10-yr Treasuries this week versus 102 bps last Friday.



FEDERAL RESERVE POLICY

The Fed meets December 18-19 to consider its monetary policy. The odds of a rate hike to 2.5% are 76%. The odds of a rate hike at the March 2019 meeting are high at 12 percent.

Part of the reason for the bond rally is that the market thinks Powell thinks that the Fed is close to finishing up on that gradual pace of rate hikes. The Fed forecasts are released at 2pm EST on Wednesday, December 19 and Powell will take questions on what the committee did at a press conference starting at 230pm EST. The dots forecasts currently are three more rate hikes in 2019 and just one is the loneliest number rate hike in 2020. (The year 80% of CFOs and countless economists see a recession.) We will see if they take one (or more) of these rate hikes off the table. In thinking about our own rates forecast, maybe the most sense is for them to bring rates up to neutral 3% levels with two rate hikes next year, June and September 2019 if you like, and then two more rate hikes in 2020. Takes a lot to bring about a recession. Hard to forecast one although the world economy looks/feels a little shaky even if there isn't a lot of hard data yet.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	12-Dec	5-Dec	28-Nov	21-Nov	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2240.606	2240.551	2253.117	2253.085	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities	1653.470	1653.470	1653.468	1661.830	0.000
Primary credit (Discount Window)	0.009	0.010	0.004	0.015	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	0.007	0.007	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	0.120	0.194	0.068	0.058	62.000
Federal Reserve Assets	4136.0	4133.7	4144.9	4154.1	961.7
3-month Libor %	2.78	2.77	2.71	2.68	2.82
Factors draining reserves					
Currency in circulation	1705.801	1706.179	1706.501	1706.046	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	0.461	3.135	1.559	16.205	0.000
Reserve Balances (Net Liquidity)	1751.413	1736.305	1758.681	1757.502	24.964
Treasuries within 15 days	0.000	0.000	24.916	24.916	14.955
Treasuries 16 to 90 days	90.542	90.541	78.011	78.011	31.549
Treasuries 91 days to 1 year	302.120	302.120	306.254	306.254	69.272
Treasuries over 1-yr to 5 years	964.800	964.792	961.680	961.676	170.807
Treasuries over 5-yrs to 10 years	264.567	264.547	263.727	263.716	91.863
Treasuries over 10-years	618.578	618.551	618.528	618.512	101.337
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08					

Neutral "Longer run" interest rates are mostly 2.5 to 3.0 percent in the Fed's mind, and the decision to raise rates above neutral, to actually tighten monetary policy to slow the economy with the president breathing down their necks doesn't seem like a winning bet in the near term. Maybe table more rate hikes above 3.0% until 2020 when people see the economy continues to grow. The economy will enter the longest expansion in modern economic history starting July 2019.

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

Eurodollar futures never look for a Fed rate hike ever again.

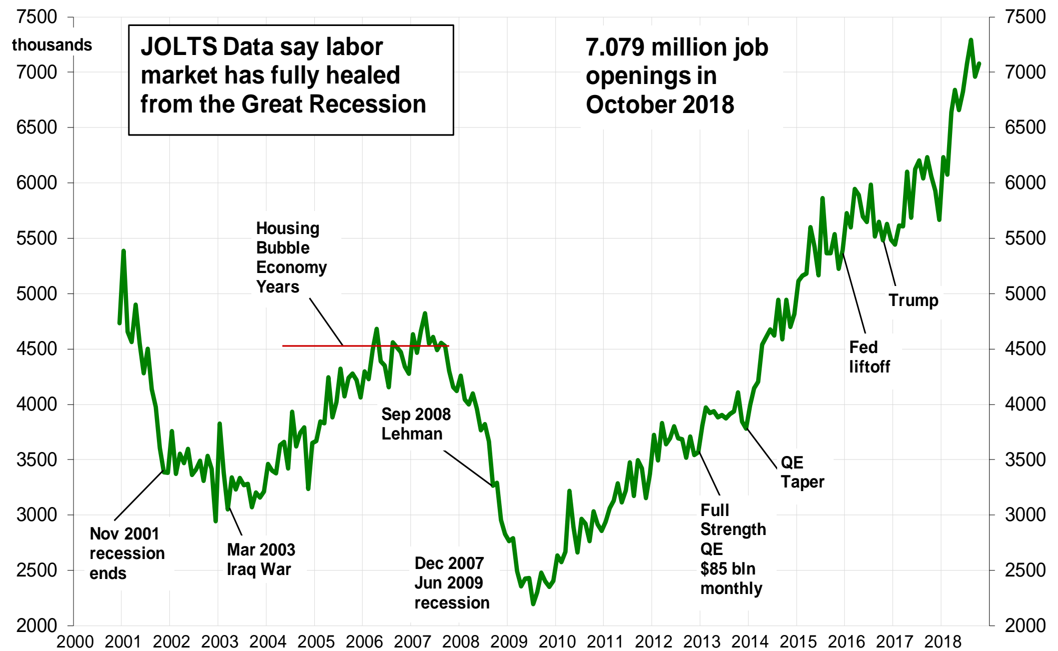
Year-ends for Interest Rates				
Percent %	2018	2019	2020	2021
Eurodollar futures	2.805	2.905	2.800	2.775
Fed's Sept forecast	2.5	3.25	3.5	3.5

Eurodollar futures price where 3-month Libor will be in the future.
Friday, December 14, 2018 3-month Libor 2.80%

OTHER ECONOMIC NEWS THIS WEEK

7 million job openings should jolt the markets and calm investor nerves (Monday)

Breaking economy news. Job openings and labor turnover statistics for October. Same old story. 7.079 million job openings in October and 6.075 million people officially unemployed. This remains one of the most lopsided labor markets in modern economic history which has both good and bad characteristics for the outlook. If you are a worker, your wages are probably going to go up faster than they would have as companies scramble to retain and bring in new workers. The bad thing about 7 million job openings and only 6 million unemployed is that the country is running out of workers and this will eventually slow economic growth within the next few years.



7.079 million job openings, 802 thousand wanted to work in shops at the malls (we were there this weekend, not sure how the help there can stand the holiday music for eight hours a day). Health care needs 1.194 million (don't get sick). Restaurants and hotels need 968 thousand (service was lousy Saturday night dining out, and we question who is back there in the kitchen). Even the Federal government says they need to hire 80 thousand people (don't tell the president).

And quitters? Americans don't quit when the going gets tough, so it must not be very tough out there; jobs must be plentiful with 3.514 million confident enough to quit their jobs in October. Factories may be streaming back to the USA, but that didn't stop 201 thousand manufacturing workers from hanging it up in October.

Net, net, there is a lot of talk of recession coming the economy's way next year, but the labor market remains tight as a drum with the most help wanted signs out there in the country ever. The labor market is strong at the moment and there would have to be quite a hard-hitting external economic shock to prompt businesses to change their hiring plans. The economy is strong and companies are begging for help to produce and sell their goods and services out there.

One final thought. 7 million job openings should jolt the markets and calm investor nerves. We had to repeat this as no one is listening. Stocks are falling. Market technicians are strangely focused on the S&P 500 closing low of 2632.56 from November 23 that broke today. That doesn't mean it is lights out for the stock market surely. All our money is invested in stocks. Stay tuned. Story developing.

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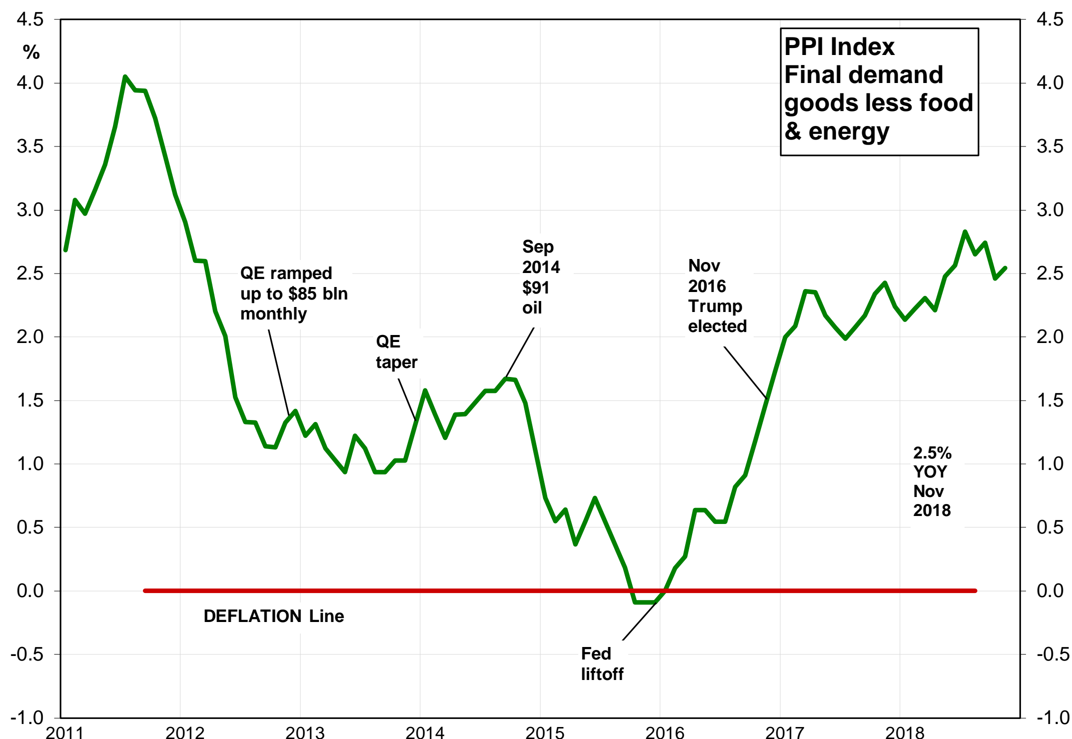
PPI inflation just 0.1% with some intermittent core goods inflation percolating (Tuesday)

Breaking economy news. Very productive conversations going on with China! Watch for some important announcements! Sorry, that was the President's tweet at 819 am this morning. Thank God, he watches stocks and puts out these helpful comments to push stock prices higher. As far as economic news, PPI inflation just 0.1% in November with some intermittent core goods inflation percolating beneath the surface.

Old-style commodity goods inflation is moving up in fits and starts. PPI final demand prices are up 0.1% in November, held down by energy prices and are still up 2.5% the last year. Fed officials disbelieve inflation's existence as long as it rises at a low to mid-two percent annual rate like it has been. The longest economic expansion almost in economic history and tariffs on imported goods has yet to put inflation up on the Fed's radar screen. They are not going to over-tighten anytime soon, tighten meaning pushing the Fed funds rate higher than 3.0% neutral. All systems are go for a fourth rate hike this year when Fed officials meet next week.



Old-fashioned commodity inflation at the producer level is called final demand goods prices less food and energy and it has been sporadic after steady gains of 0.3% monthly from January to July (excepting 0.2% in May). Sporadic or off and on lately with 0.0 in August, 0.2 in September, 0.0 in October and now 0.3% today in November. Core final demand goods inflation is up 2.5% the last year.

Net, net, inflation pressures are building for some core producer goods that companies use to make the final products they sell to other businesses and consumers, but inflation overall is held down by declining energy prices. In many economic cycles over the last twenty to thirty years, a spike in energy prices was the spark that led to the inflation fire, and right now there is no energy price inflation to be seen. Stay tuned. This economic cycle can go longer than most economists are forecasting if inflation never warms up to alarming levels. On and on and on and on. The endless wave. Bet on it.

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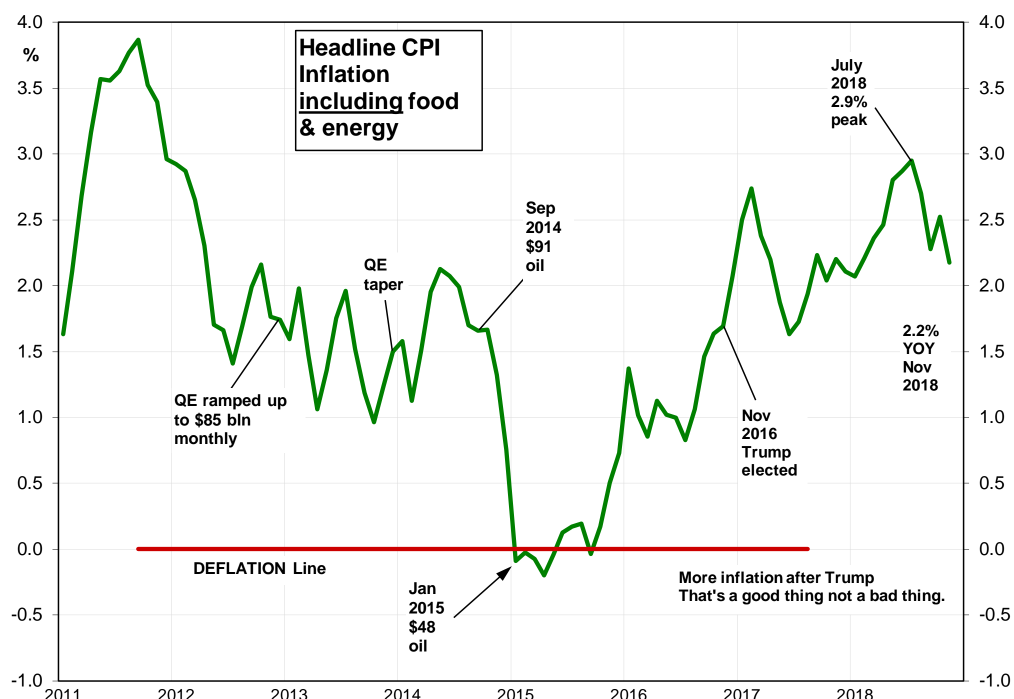
No inflation, no rate hikes. Federal Reserve are you listening! Donald J. Trump (Wednesday)

Breaking economy news. CPI inflation in November was 0.0% and 0.2% for the core, up 2.2 and 2.2 percent year-year, respectively.

Trade tariffs and talk of more to come has not boosted the price of imports enough to move the needle on inflation higher. Core CPI prices minus food and energy rose 0.2%, but the contribution came from services that are largely immune to trade war frictions. Shelter costs rose 0.3% after two months of 0.2% increases and are up 3.2% the last year. Medical care services jumped 0.4% the most since June and are up 2.4% this year from year ago levels.

It doesn't appear that Fed officials have anything to worry about when it comes to an inflation outbreak where inflation is more like 2 percent instead of a more headline-grabbing, worrisome level of 3 percent, and so rising price pressures will not be on the radar of businesses or consumers. Inflation, what inflation is what the public says.



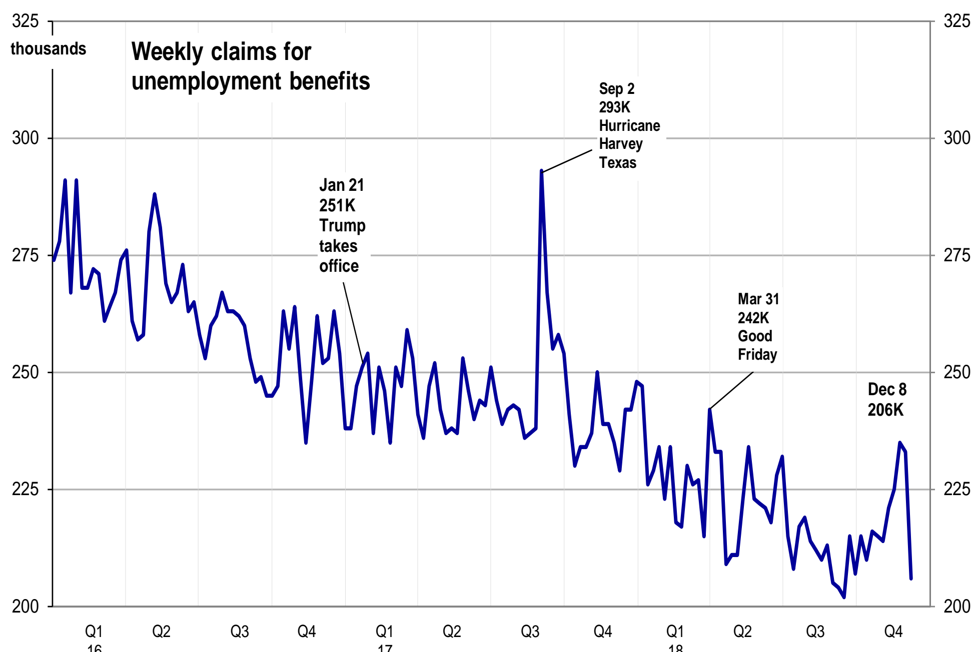
Net, net, the economy is strong and the nation is at full employment, but the economy isn't hot enough to light the spark of inflation. Even if there are some core price pressures, the downward spiral of oil and gasoline prices is holding overall headline inflation in check this month, and the negative inflation effect from plummeting energy prices in December will be even more pronounced.

The odds of a final rate hike this year at next week's Fed meeting have dwindled somewhat, even if a move is still expected. But how many more rate hikes can the Fed have up its sleeve in 2019 if inflation remains this well behaved is the question markets are asking. At the September meeting the Fed forecast three more rate hikes in 2019 ending the year at 3.25 percent, but right now the futures markets are saying not even one rate hike is likely to happen.

The markets have been wrong before, but the message from the markets is likely to make Fed officials even more cautious about their gradual path of rate hikes next year. And if the markets don't make the Fed more cautious, then the president will. Bet on it.

Whoa, Nellie! Claims collapse 27K. Economy is off recession watch. (Thursday)

Breaking economy news. Jobless claims and import prices. Unemployment claims tumbled 27K to 206K in the December 8 week so that rising trend, especially noticeable through November was wiped out. Layoffs are not rising in a worrisome manner that suggested companies were trimming their headcounts in response to the financial market turbulence and on-again, off-again trade tensions since October. Caution does not prevail on the part of corporate America, it's full speed ahead. Pay no attention to those CEO surveys saying half of them see a recession in 2019. Here's a thought, let's let economists forecast recessions and let corporate CEOs get back to running their companies.



Jobless claims fell sharply, and the economy is off recession watch, but keep in mind the statisticians at the Bureau of Labor Statistics have a devil of a time correcting for seasonal trends this time of year. Cold weather, winter-related layoffs surge each time this year from the start of December to the high point in the first weeks of January before subsiding. Not seasonally adjusted jobless claims were 198K at the end of October, and last week they jumped 99K to 317K in the December 1 week before coming back down 57K to 260K in the December 8 week. We are talking volatile here with these baby it's cold outside job layoffs this year. It's not stay or go, it's just go if you work outside this time of year. Not seasonally adjusted claims are reloading here and should peak near 400K in the first week of January 2019. Anyway, seasonally adjusted claims are back down to 206K this week, and that's a good thing not a bad thing folks.

Meanwhile, import prices are tumbling showing goods imports coming to our shores are not adding to inflation yet from the trade war. The tariffs get slapped on once they hit our shores. Blame the strong dollar for this as nonfuel import prices fell 0.3% in November after a small 0.1% rise in October. Core PCE inflation is 1.8% year-to-year, short of the Fed's target, and import price inflation certainly isn't going to help Fed officials reach their goal. Most of the nonfuel import price drop was in food, although capital goods were lower. Year-to-year nonfuel import price inflation cooled to 0.3% from 1.5% the year before, a slim gain mostly from industrial supplies and materials, consumer goods and autos.

Net, net, jobless claims fell back to Earth this week showing the labor market's strength is not fading. Not that anyone's watching all that closely, but markets can breathe a sigh of relief that the economy is not going all wobbly. China is slowing, trade tensions are still smoldering, stock markets have fallen sharply, but none of these risks rise to the point where companies actually start to lay off workers. That would be bad. Not happening.

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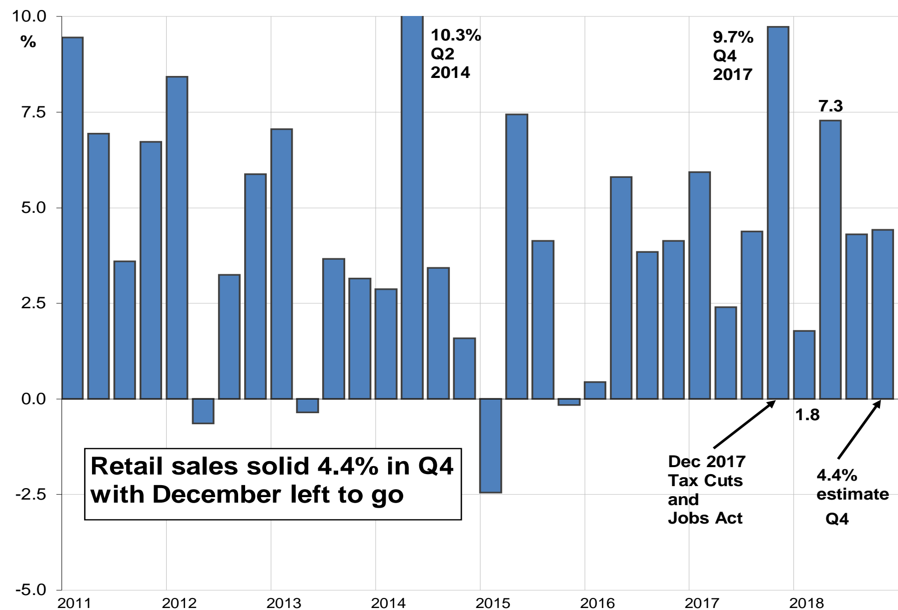
Retail sales slow due to gasoline price drop (Friday)

Breaking economy news. Retail sales slow to 0.2% in November from 1.1% in October. Spending for the fourth quarter is running 4.4% so far which is slightly faster than 4.3% in the third quarter which helped GDP grow 3.5%. Most spending categories were up, excepting the 2.3% drop at gasoline stations that was price-driven. Building materials were down 0.3% and are still up 3.5% the last year despite worries over the housing sector. Clothing sales down 0.2% and up 4.1% from last year. Eating and drinking places, our favorite this time of year, was down 0.5% in November, and up 6.9% from last year. Consumers have enough tax cuts income to dine out that's for sure.

Net, net, consumers are still spending their tax cuts money with abandon and are not worried enough about the heated back-and-forth trade rhetoric or turbulence in the stock market to stop visiting the shopping malls of America yet. There were large revisions to retail sales down in September and up in October, but for the fourth quarter, retail sales are running at the same 4% pace that they did in the third quarter which helps sharpen our forecast for continued strong 3.0% real GDP in the fourth quarter.



Spending at retail stores slowed to 0.2% in October, mainly due to the sharp decline in gasoline prices at the pump. Retail sales minus gasoline sales actually rose 0.5%. There is a lot of economic uncertainty out there on the horizon and talk of recession clouds, but consumers aren't buying the doom and gloom as they continue to spend money at a moderate pace. Today's report shows Fed officials consumers just aren't confident, they are also putting their money where the mouths are and buying enough goods to keep the economy humming. With consumers staying strong and spending, Fed officials can remain confident that a fourth rate hike this year next week will not derail one of the longest economic expansions in history. Stay tuned. Story developing. The 2019 outlook is all clear for now.

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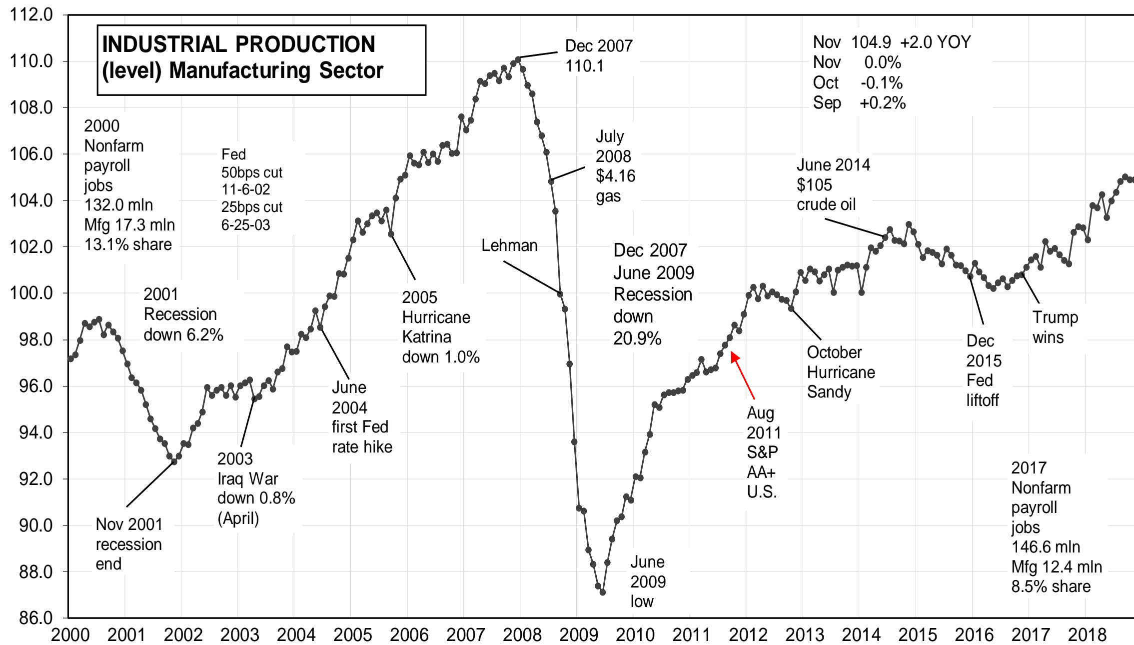
Manufacturing production sputters despite factories moving back to USA, USA, USA (Friday)

Manufacturing production is sputtering despite the Trump economics team's carrot and stick attempt, mostly stick, to change the long-established world order and bring overseas factories back to USA.



Breaking economy news. Industrial production rose 0.6% in November after a downward revision to October. But all is not well for American factories, as manufacturing production was unchanged in November, and October's 0.3% gain was revised to a 0.1% drop. After dust-clearing revisions, manufacturing production is 0.5% lower than we thought in last month's report which makes us wonder whether the uncertainty over trade and the threat of even greater supply chain disruptions are curbing factory run times this month.

Stay tuned. This is an important development. Manufacturing has been a labor market star in engendering the jobs that Trump's economics team has been banking on, adding 288K jobs the last year, and if factory production is starting to sputter, the jobs count is going to start to dwindle which will take a toll on wages and and economic growth.

Percent changes			Industrial Production November 2018		
Sep	Oct	Nov	YOY		Weight
0.1	-0.2	0.6	3.9	Total Index	100.0
0.2	-0.1	0.0	2.0	Manufacturing	75.5
0.6	-0.7	1.7	13.2	Mining	14.1
-1.2	0.2	3.3	4.3	Utilities	10.4
			Manufacturing payroll jobs 12.8 million +288K YOY 10.0% of Private Payroll Jobs		

Mixed signals on the economy today with factory production hitting the brakes on supply chain disruptions while consumers continue to spend at the shops and malls for now. The long economic expansion may be showing signs of its age, and the economic outlook in 2019 will be unlikely to match that of 2018 unless every sector of the economy, including weaker sectors like housing and manufacturing production, pulls their own weight. Stay tuned. It's not lights out next year by any means, but the tea leaves are increasingly saying economic growth is going to slow in 2019 as the Tax Cuts and Jobs Act effect on business and consumer bottom lines starts to fade.

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