Financial Market Weekly

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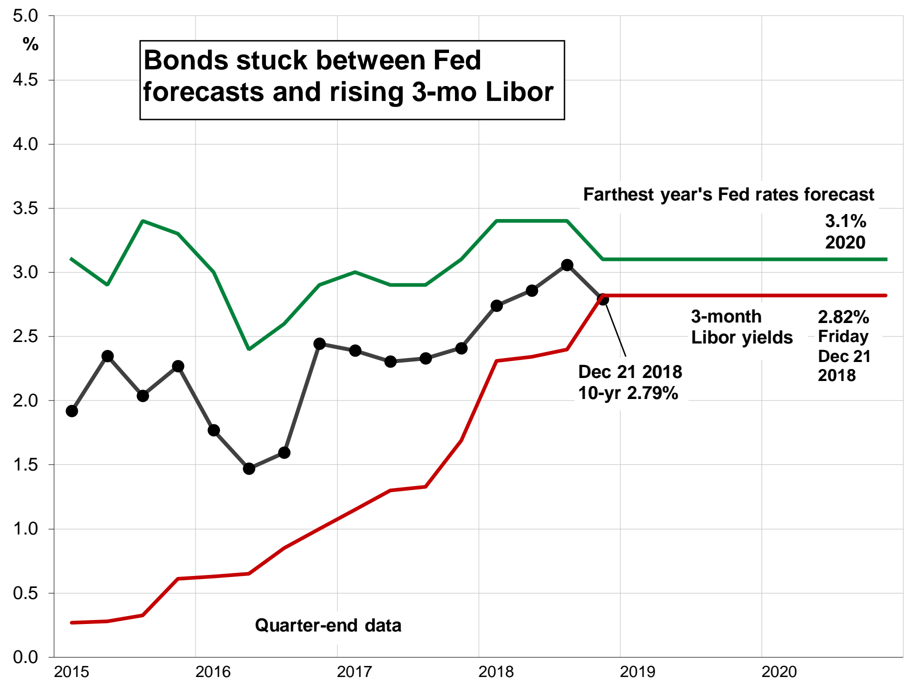
21 DECEMBER 2018

NOT GOING TO BE MUCH TO REPORT FROM THE FEDERAL RESERVE IF THEY ARE ONLY GOING TO INCREASE RATES 3 TIMES THE NEXT TWO YEARS. 3X MAYBE



Don't ask for whom the bell tolls, it tolls for the fixed income markets if the Fed's latest rates path comes to pass. The Fed funds rate moved to 2.5% Wednesday, and let's see, 2.75 and 3.0 percent later next year some time, and maybe 3.25% way out there at one of the "future" Fed's eight live meetings in the year 2020. 2020, the year when 80% of CFOs see a recession. I guess we could hope for a recession for more Fed rate changes and more bond market volatility. Make fixed income on Wall Street great again. But I guess we always have the stock market for volatility. And how.

A lot of head-scratching going on after the Fed put out its press statement and forecasts at 2pm EST on Wednesday when the Dow industrials were up 285 points on the day, and ended at the close two hours later down 351 points, crashing to a new 2018 low. Stocks in October were up 8.5% year-to-date, and Wednesday ended down 5.6% year-to-date, a full hard downward swing from have to have-not of 14.1%. That's a big loss. Not sure what kind of hole investors are digging for themselves here, just what are they are trying to discount. Stocks only fell 21.8% during the entire 1990-91 recession that put President Bush out of office with unemployment climbing to 7.8%. Maybe stock investors feel the Fed's rate hikes are helping deflate the famous Trump stock rally, bettering the economy through

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a policy of tax cuts and deregulation that will produce sustainable 3% growth forever. The Trump rally from election night was up 46.3% in early October, and Wednesday after the Fed, it was up 27.2%. [After two days of government shutdown selling, Trump rally is now up 22.4% at Friday's close.]

Okay, the news flow is rather fast. Is there anything we need to know from the Q&A at Powell's press conference. (1) If inflation less than 2%, why hike rates at all? The economy is healthy, policy can move to neutral (neutral has moved down to 2.75 from 3.0 percent last meeting as a median forecast: clustered around the 4 votes for 2.5%, 5 votes for 2.75% and 5 votes for 3.0%). (2) Yes, core PCE inflation still a good indicator, but… "What's happened over really 50 years is that inflation has become much less reactive to changes in growth. There was a time when inflation reacted really quickly to changes in growth and changes in unemployment. And that time is behind us." [This eliminates the need for the Fed to raise rates too high in this cycle fighting inflation which has been the trigger for all prior recessions looking back to the 1970s.] (3) Eight press conference Fed meetings in 2019, how will market know which one? "If we want to communicate about something that's going to happen in a future meeting, I think we know how to do that in speeches, in press conferences and such." (4) Now that we are at the bottom of the neutral range for rates, "there's real uncertainty about the path, the pace rather, and the destination for further rate increases. And we're going to be letting incoming data inform our thinking about the appropriate path." [Appropriate as it can be with 3 left to go. Three.]

Review and Outlook: The FOMC downgraded its economic outlook so it took a rate hike off the table and sees the Fed funds rate going to 3.25% at the end of 2020 now where in September they thought 3.5%. The downgrade can be seen in the forecast for 2.3% GDP in 2019 now where they had 2.5% in September and PCE inflation (including food & energy) is seen at 1.9% now in 2019 down from 2.0% in the September forecasts. Less growth and inflation means one less rate hike. Two rate hikes to 3.0% in 2019 should be the focus as Powell says they can't see very far out anyway. The hawks have disappeared. In September, there were 9 votes for at least three rate hikes in 2019, and 5 had at least four rate hikes next year. Now there are just 6 votes for three rate hikes in 2019, and not one vote for more than three rate hikes.

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

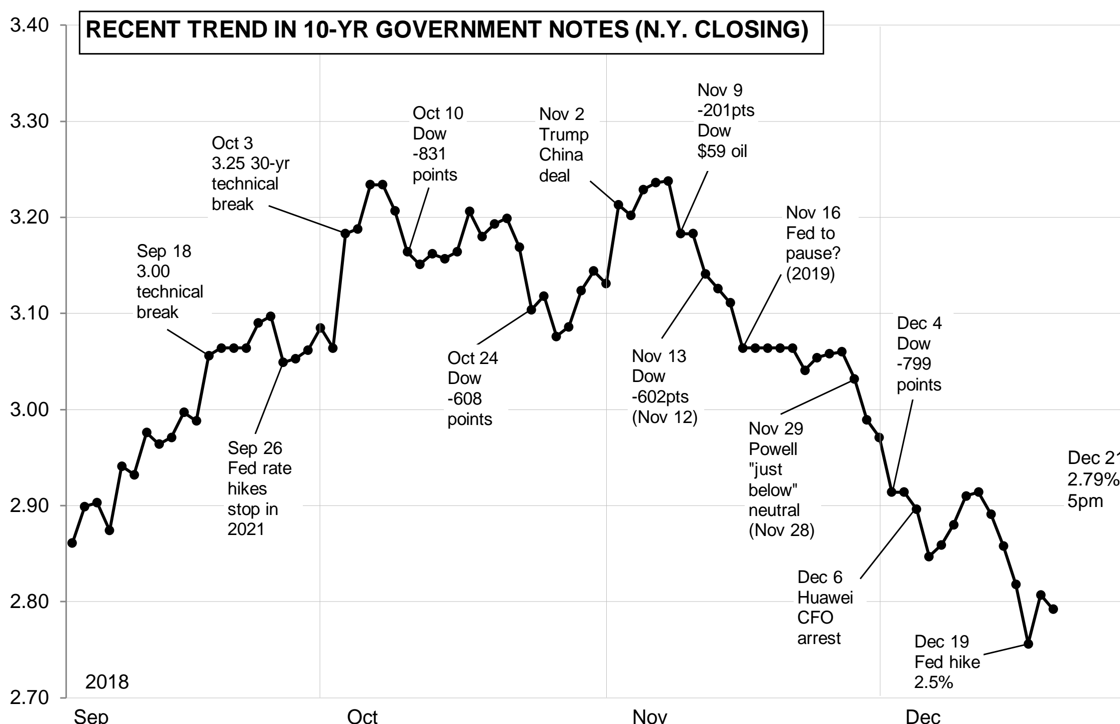
Eurodollar futures never look for a Fed rate hike ever again.				
Year-ends for Interest Rates				
Percent %	2018	2019	2020	2021
Eurodollar futures	2.803	2.805	2.645	2.67
Fed's Dec forecast	2.5	3.0	3.25	3.25
Eurodollar futures price where 3-month Libor will be in the future.				
Friday, December 21, 2018 3-month Libor 2.82%				

Fed Policy-All You Need to Know				
	2018	2019	2020	2021
Fed funds	2.4	2.9	3.1	3.1
PCE	1.9	1.9	2.1	2.1
Unemployed	3.7	3.5	3.6	3.8
GDP	3.0	2.3	2.0	1.8
December 2018 median Fed forecasts				

MARKETS OUTLOOK

	21-Dec 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	3.03	3.20	3.30	3.35	3.45	3.45	3.50	3.60	3.70
10-Yr Note	2.79	3.00	3.10	3.20	3.30	3.30	3.40	3.50	3.60
5-Yr Note	2.64	2.85	3.00	3.10	3.20	3.25	3.35	3.45	3.60
2-Yr Note	2.64	2.80	3.00	3.10	3.20	3.20	3.35	3.45	3.60
3-month Libor	2.82	2.70	2.95	2.95	3.20	3.20	3.45	3.45	3.70
Fed Funds Rate	2.50	2.50	2.75	2.75	3.00	3.00	3.25	3.25	3.50
2s/10s spread	15	20	10	10	10	10	5	5	0

Looks like the markets wanted a more dovish Fed hike. Bond yields fell 10 bps to 2.79% this week, following the chaos out of Washington that wrecked the stock market both from the Federal Reserve and from President Trump and Congress' failure to avert a government shutdown as of 5pm EST Friday. Whatever happened to stocks, it was bad. Very bad. Dow industrials were at 23,960, up 285 points going into the Fed announcement at 2pm EST on Wednesday (2.83% 10-yr), and by the end of the week had fallen 1,500 points or 6.3 percent to 22,445.37. Unbelievable. And unexplainable. Unless you want to blame the president or the Fed, or maybe both. Seems like a panic that can be reversed, but the magnitude of the loss in historical terms is frightening. From the October 3 high, Dow industrials are down 16.9% high to low. What the heck? On Black Monday, October 19, 1987, the Dow fell 22.6% all on one day, the first time Americans found out the stock market wasn't their friend. And this was back when workers' investments in 401Ks had much less money in them. In 1987, the twenty-year wave of baby boomers was only to 23-41 years old. How bad is it for the outlook? You tell us. Write us at Chief Financial Economist's Office, MUFG, 1251 Avenue of the Americas, New York, N.Y. 10020. We keep remembering the words of that European markets regulator who said his job was to protect investors and make financial markets stable. Maybe we can bring him over here to America because financial markets don't look too safe at the moment. **The Federal government shutdown at midnight, kind of like the 69-hour shutdown back in January 2018? Stay tuned.
P.S. Forecast—going with two rate hikes in 2019 to 3.0%, and two rate hikes in 2020 to 3.50% as long as Powell is there. Too early for a major change. Don't make big changes. Ever.



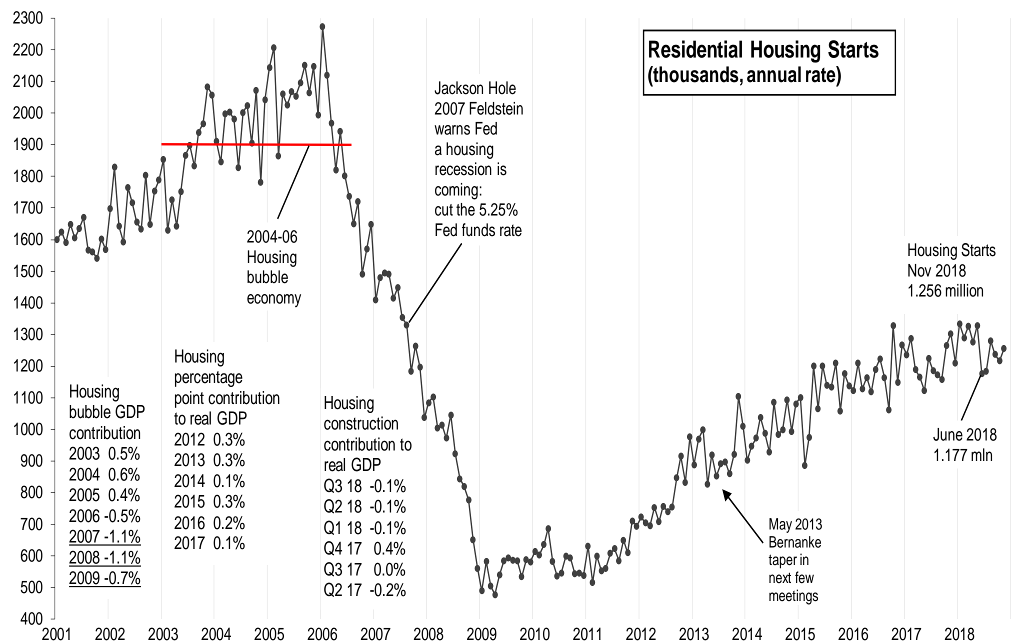
OTHER ECONOMIC NEWS THIS WEEK

Weakest sector of economy, battered by Fed rate hikes bounces back (Tuesday)

Breaking economy news. Housing construction is noticeably better after we all had written off the sector a month ago. Housing starts were down 1.6% in October and now revised to up 1.5%, and November housing starts rose 3.2% higher to 1.256 million. Housing permits made a stronger 5.0% gain to 1.328 million so housing starts may move up even higher in December with a solid finish to the year. Maybe the markets wrote off housing too early in this cycle.

On the glass half empty side of things, the 3.2% rise in housing starts was all multifamily units, as single family starts fell 4.6% to 824K, a new low for 2018. A huge 24.4% drop in the West, and only the biggest market in the South kept the total from plummeting, as the South rose 6.8% to 457 thousand. We hope Fed officials ignore the weakness in single family home construction and the president's critical tweets and keep policy on its gradual path of rate hikes. Mortgage rates have already priced in a 3.0% Fed funds rate more or less, so a few more Fed rate hikes won't sting the housing market any further.

Net, net, housing is one of the most interest-rate sensitive sectors of the economy so it was welcome news that residential housing construction starts and permits jumped in November, which helps keep those recession clouds off the economy's shore for now. The economic expansion will set records for longevity next summer and has markets and economists on high alert for something to go wrong as it always does late in the economic cycle.



The Fed is likely to take today's news on housing as a sign their monetary policy is not too tight, and vote for a fourth consecutive rate hike this year at tomorrow's all-important Fed meeting. It is important to stay on a gradual path of rate hikes or they risk telegraphing to the markets and investors that they are worried about the economic outlook. Neutral rates are 3% and economic theory says that Fed officials aren't tightening anything, or taking the punch bowl away and slowing the economy down... not until interest rates move higher than neutral levels. Stay tuned. Story developing. Tomorrow at 2pm Eastern time. Be there. Or be square.

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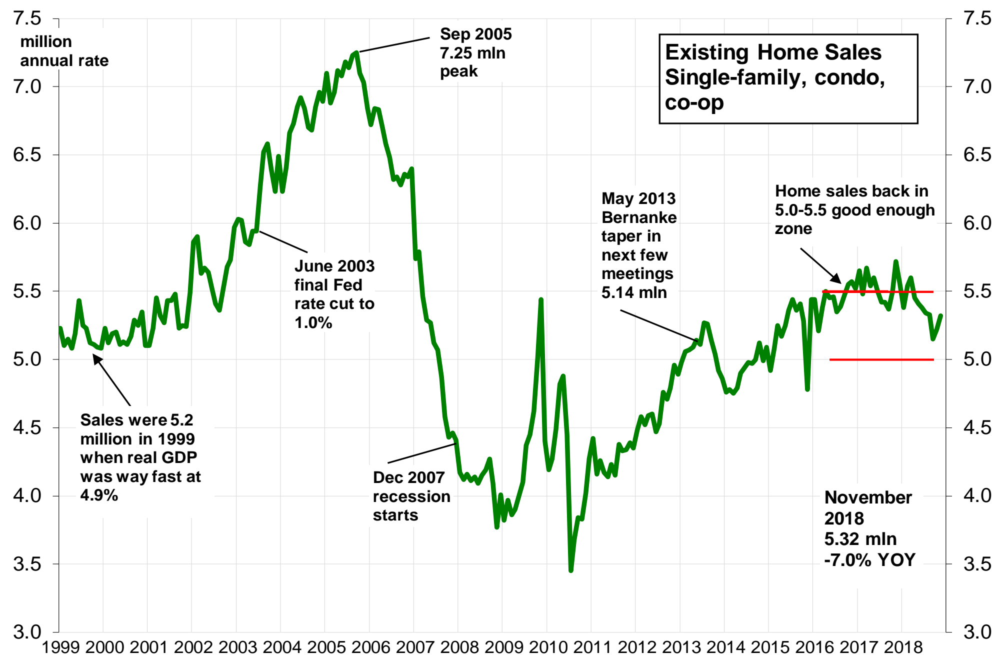
Existing homes sales stabilize despite higher rates and home valuations (Wednesday)

Breaking economy news. Existing home sales rise back for a second consecutive month, increasing 1.9% to 5.32 million at an annual rate in November. The last two months almost completely offsets the 3.4% drop in September to 5.15 million which is the low for the year. The September home sales weakness looks increasingly weather related with Hurricane Florence hitting the Carolinas in mid-September affecting sales and new construction.

Regionally, there is a question mark about home sales in the West dropping 6.3% which is the highest priced market in the country with average homes going for $401,900 in November if you got it. Home sales in all other regions were up in November: Northeast 7.2%, Midwest 5.5%, and South 2.3%.



Single-family existing home prices rose a bit in November to $260,500, but are on their way down to normal seasonal lows made in January each year. Home prices are up 5.0% the last year so the housing bubble in prices has not popped yet if that's what markets are afraid of. Prices are appreciating faster than worker wages, but there is no sign this is negatively affecting sales activity, despite homebuilder surveys saying foot traffic taking a look at their properties is off significantly this year.

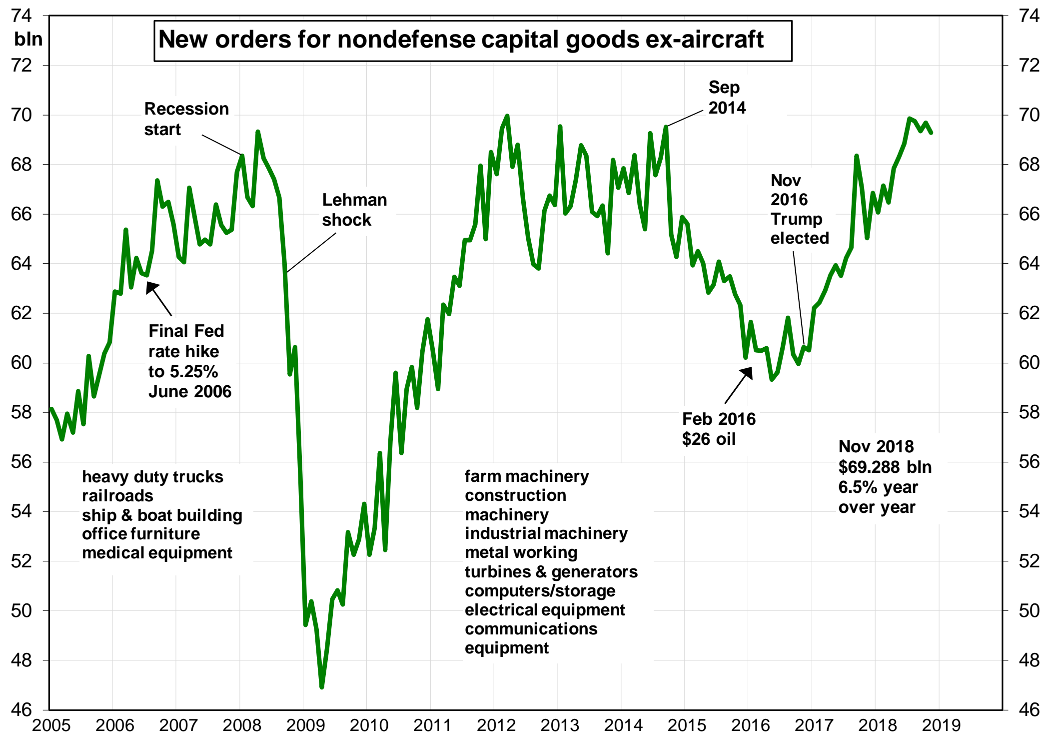
Net, net, existing home sales have rebounded to a moderate pace despite the headwinds of higher mortgage rates and higher home prices. There is some lingering weakness in the West with its sky-high home prices, but nationally, the sales turnover is acceptable for a late cycle economic expansion. There is no sign that homebuyers are panicking with higher interest rates and this should allow the Fed to be confident that their gradual pace of rate hikes is not bringing down the house, literally. In any case, mortgage rates have already risen to levels consistent with a 3% Fed funds rate, so there is no worry that the Fed's policy of gradual rate hikes is halting the recovery in the housing markets. Stay tuned. Story developing, starting with the Fed announcement at 2pm EST today.

Business investment in equipment remains strong despite loco stock market (Friday)

Breaking economy news. Third and Final look at third quarter GDP 3.4%. Durable goods orders, nondefense capital goods ex-aircraft fell 0.6% in November, but from a higher level, as October's 0.0% change in orders was revised to +0.5%. Business orders on equipment from this measure of capex have seen monthly order flow of over $69 billion every month since July showing companies are not pulling back their spending for tomorrow.

Everything is higher. In the last year, orders of Primary metals +15.6%, Fabricated metals +9.1%, Machinery +5.6%, Communications equipment +7.3%, Electrical equipment and appliances +5.9%, Motor vehicles and parts +8.0%.

GDP growth was revised down to 3.4% from 3.5% for the third and final look at the third quarter of 2018. Consumers bought fewer nondurable goods, mostly gasoline at the pump.



Net, net, there are rumors of impending recession for the economy, but no hard data to back up such a pessimistic forecast. Business capital spending on equipment continues to run at a strong rate in November showing CFOs may worry about the outlook, but have taken no steps to cut back their investment spending that fuels future growth. You can't have a recession without falling investment.

The key ingredient in economic growth is always investment spending, and right now, all signs are go for companies next year despite the market volatility. Stay tuned. Story developing.

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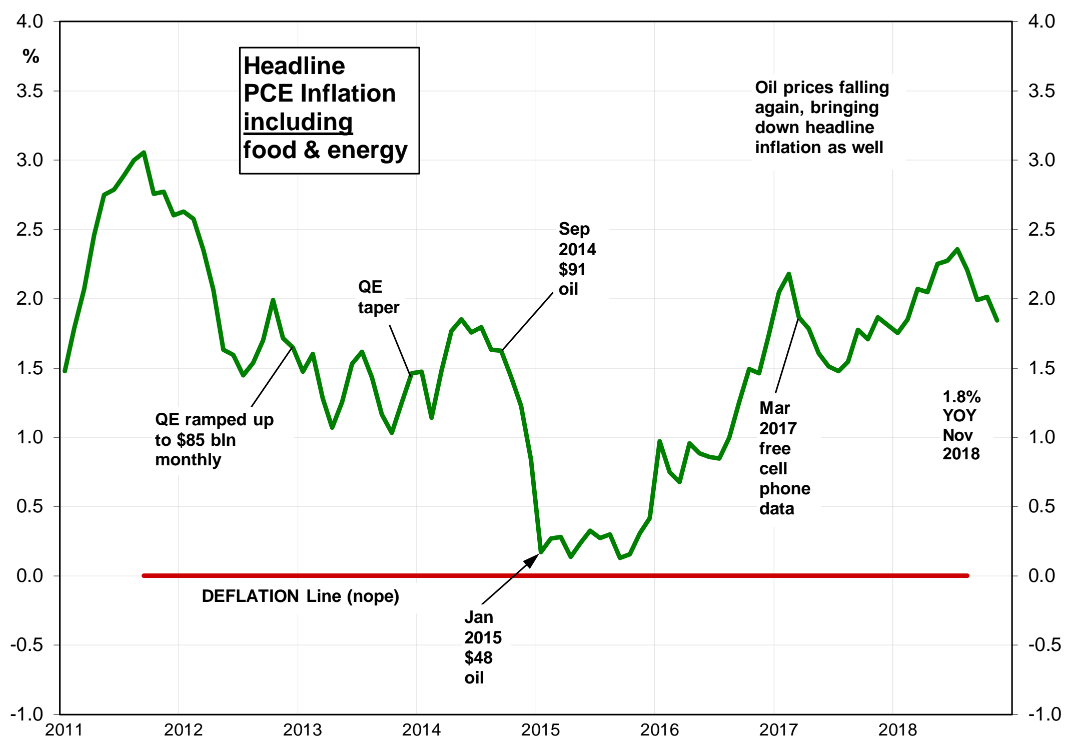
Consumer spirits and spending still soaring (Friday)

Breaking economy news. The personal income report for November and consumer sentiment. Consumer spending is as strong as it was in the third quarter is the big news and it bolsters our forecast for 3.0% real GDP in the fourth quarter when the data are released on Wednesday, January 30, 2019. Happy New Year for the economy. Who says the economy has to stop in its tracks when it hits the 10-year mile mark? The party can go on and on with the Federal Reserve's blessing. Anyway, real consumption expenditures are rising 3.4% this quarter with December data left to go which more or less matches the 3.5% growth in the third quarter that powered the third quarter's 3.4% real GDP.

Inflation? Forget about it. The Fed Chair is. The PCE deflator is 1.8% in November and going lower still with gasoline prices still falling in December. Powell already answered in the press conference Wednesday that he would not tighten policy with inflation below target. Tighten as in moving the Fed funds rate above neutral of 2.5, 2.75 or 3.0 percent, depending on what Fed official we are talking here.

Net, net, there is no recession coming, no way, no how, when consumers are buying up everything that isn't nailed down this quarter. We don't know what the stock market can be thinking. Instead of trading tweet to tweet, investors should be focused on the economic fundamentals, and the economy still has its sails full and is moving briskly along with fair tailwinds which is remarkable for this late in the economic cycle.



The well of money from the Tax Cuts and Jobs Act has not gone dry yet with consumers clearing the store shelves this month, and bet your bottom dollar, more spending is coming from the sharp drop in gasoline prices that is also putting more money in the consumer's pockets.

The economy is strong. Be strong as well. Things are better than you think. Bet on it. Consumer spirits and spending are still soaring which means next year might just turn out to be a happier new year than the stock market is thinking. Stocks should keep their heads down and focus on the economy. Things look good for now. The economy is strong.

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