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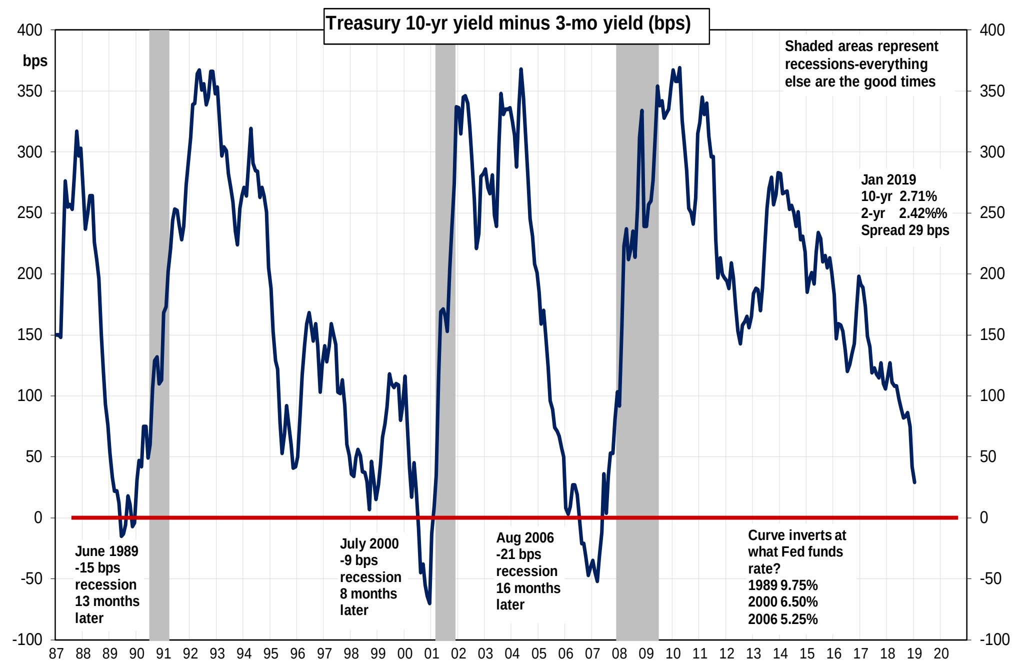
8 FEBRUARY 2019

BEST RECESSION'S COMING SIGNAL EVER! ABSOLUTELY PERFECT

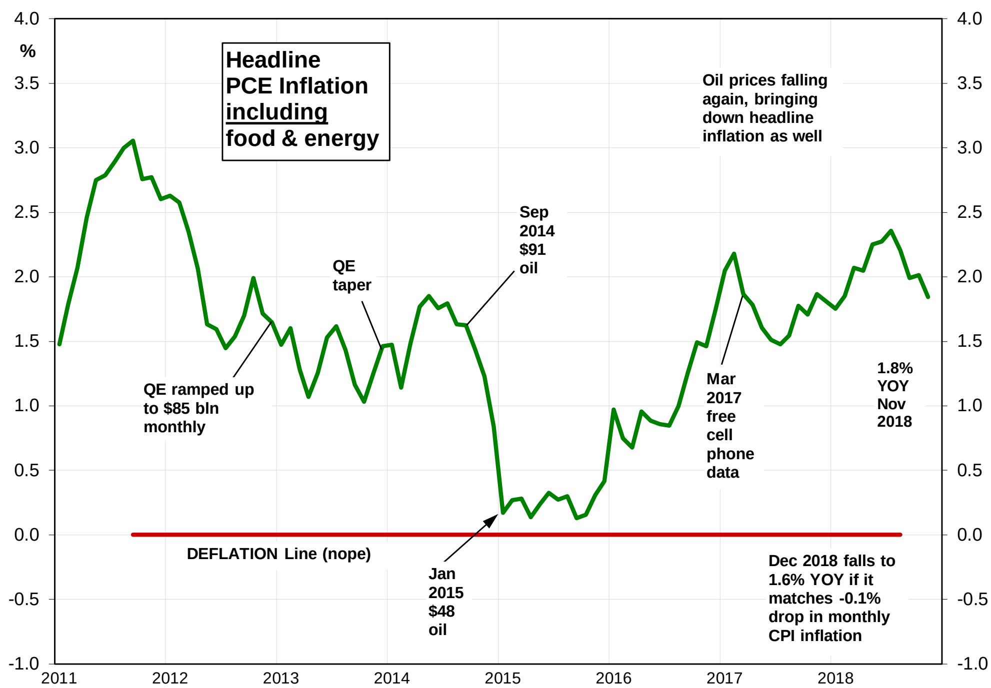


It's a good thing the Fed hit the pause button on its gradual path of rate hikes because raising interest rates just one or two or three more steps higher could break the economy's bank and send America spiraling downward into another recession. How so? Fed rate hikes could have been even closer to inverting the yield curve which is a harbinger of economic doom. We had been using the 2-yr to 10-yr yield curve as the best indicator of curve-inversion that brings on recession. But now we did some research and found a new stronger, super-duper recession indicator: it's 3-month Treasury bill yields ("T-bills" for those unfamiliar with the boring money markets) and not 2-yr note yields that are so doggone important. At Friday's close 3-month T-bill yields were 2.43% and 2-yr Treasury note yields were 2.48%. Only 5 basis points difference but it makes all the difference in recession forecasting. Just by dropping 2-yr notes and instead looking at the 3-month T-bill to 10-yr Treasury note yield curve which has not inverted (yet) at 2.64 – 2.43 = 21 bps. Phew. Rest easy tonight--not inverted yet. And it won't be if the Fed stops raising rates at the bottom 2.5% rung of neutral. Heck it was only back on December 19 that most Fed officials thought neutral rates that wouldn't harm a hair on the economy's head was 2.5 to 3.0 percent which still sounds low to us. In December out of seventeen members, 4 said 2.5%, 5 said 2.75%, and 5 said 3.0% was the level of normal rates.

What happened since December 19 to cause the Fed to say they would be patient which means to us “we will look at this more closely again at the June Fed meeting?” Powell didn’t directly answer the question at the press conference on January 30 besides saying inflation was key. (See text box comment of Powell.) We think “financial market conditions” scared Fed officials to death however with the stock market collapsing after their December meeting. As far as the stock market sell-off in December, there were some news headlines for investors to sell on from no change of the Fed’s balance sheet to Federal government shutdown to Mnuchin’s calls to bank executives asking whether there was sufficient liquidity. But we think a lot of the sell-off in stocks was technical again, not flash-crash or VIX-linked notes, but something wasn’t right in late December’s sell-off, perhaps it was due to some problem with equity derivatives market-making at Wall Street dealers where heavy index derivative hedging losses were incurred. Anyway, the stock market is back. The Trump stock market effect is riding high. Okay, okay. But at the worst point in December when the Treasury secretary was speed-dialing Wall Street over the weekend on vacation from Acapulco, the Trump stock market rally from election night November 8, 2016 was 18.9% at Monday, December 24’s Christmas Eve close; and now on Friday the rally has resumed after a brief program intermission with Dow industrials closing this week up 36.9% since Trump was elected. (18,332.74 11-8-16)

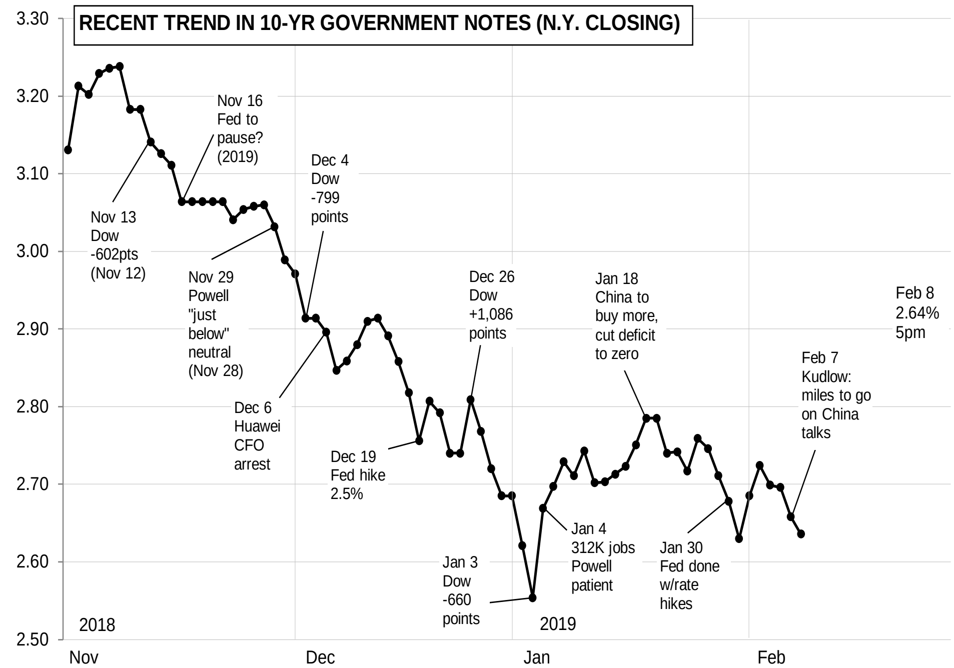
Powell January 30, 2019 We'll be looking at everything but I do think that, you know, muted inflation pressures -- you know, you would want -- I would want to see a need for further rate increases and, for me, a big part of that would be inflation. It wouldn't be the only thing but it would certainly be important.

If inflation is the key, for Fed Chair Powell, we haven’t had a report since December 21 when November 2018 PCE inflation was reported at 1.8% year-on-year. The Federal government shutdown has postponed the data, but now the Commerce Department says December PCE inflation will be released on Friday, March 1. Still a long wait, and no announcement yet on the January 2019 inflation report which was normally expected to be released on March 1. To tell you the truth, not sure it makes any sense for Powell to pause the Fed’s rate hikes given this picture of inflation. The Fed isn’t the ECB yet. He may be waiting more for other uncertainties to be clarified like a possible second government shutdown, the China trade talks, European growth outlook, Brexit… a long list. One thing is for certain, pushing interest rates above 3.0%, the last rung of neutral, will be more difficult for him without (1) a lot more inflation, and (2) with having that extra Fed governor over at the White House keeping the heat on the Fed going into the 2020 elections as well.



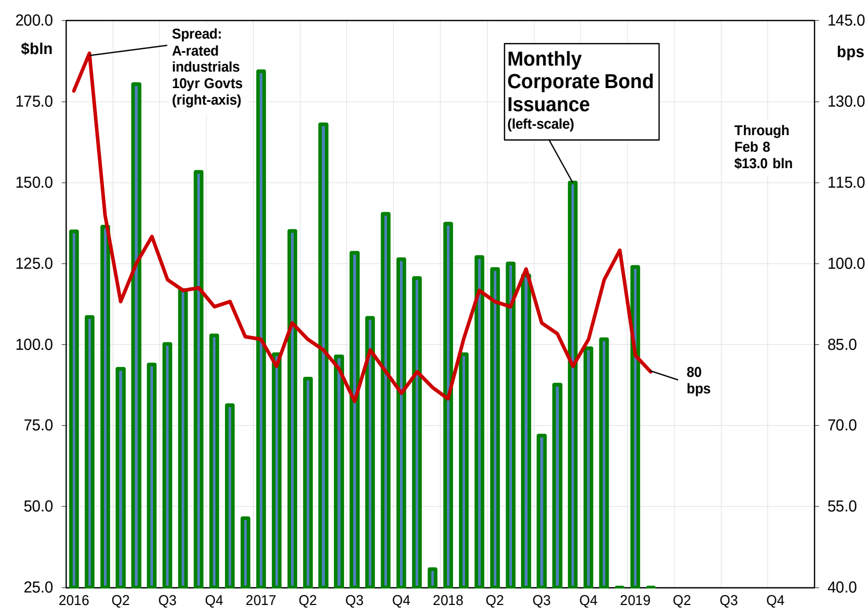
MARKETS OUTLOOK

	31-Dec 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	3.02	3.20	3.30	3.35	3.45	3.45	3.50	3.60	3.70
10-Yr Note	2.68	3.00	3.10	3.20	3.30	3.30	3.40	3.50	3.60
5-Yr Note	2.51	2.85	3.00	3.10	3.20	3.25	3.35	3.45	3.60
2-Yr Note	2.49	2.80	3.00	3.10	3.20	3.20	3.35	3.45	3.60
3-month Libor	2.81	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	19	20	10	10	10	10	5	5	0



An exciting week: plenty of tweets and Washington politics and China trade talk news to read. Markets too. Very interesting, the first full week of trading after the Fed said they would be patient and will let us know when their patience has been exhausted. 10-yr yields rallied from 2.62 to 2.69%, just missing 2.70, last Friday on the stronger economic news for the data-dependent Fed: 304K payroll jobs, and ISM manufacturing recovering from its death plunge a month earlier. Yields went a little higher to 2.74% this week before falling back. All the excitement was Thursday when the European Commission at 5am NY time revised down 2019 euro area growth from 1.9% to 1.3%. Then Trump's National Economic Council (NEC) head Kudlow on Fox News TV sent stocks and bond yields down saying there was a sizable distance to go yet on the U.S.-China trade talks.

CORPORATE BONDS: VERIZON, FIRSTENERGY, CMS ENERGY



Corporate offerings were $12.7 billion in the February 8 week versus $21.6 billion in the February 1 week. On Monday, Micron Technology sold $1.8 billion 5s/7s/10s. It priced a $700 million 5.327% 10-yr (m-w +40bp) at 260 bps (Baa3/BB+). The semiconductor company will use the proceeds to redeem $1.0 billion 3% convertible notes due in 2043. Corporate bond yields (10-yr Industrials rated A2) were 80 bps above 10-yr Treasuries this week versus 83 bps last Friday.

FEDERAL RESERVE POLICY

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	6-Feb	30-Jan	23-Jan	16-Jan	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2205.713	2220.012	2220.115	2220.219	479.782
Federal agency debt securities	2.409	2.409	2.409	2.409	0.000
Mortgage-backed securities (MBS)	1621.809	1621.809	1628.895	1632.729	0.000
Primary credit (Discount Window)	0.002	0.027	0.013	0.012	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)	0.000	0.000	0.000	0.000	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	0.066	0.077	0.086	0.088	62.000
Federal Reserve Assets	4074.2	4086.6	4094.7	4097.9	961.7
3-month Libor %	2.74	2.74	2.77	2.78	2.82
Factors draining reserves					
Currency in circulation	1705.408	1703.424	1704.945	1705.632	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	1.926	0.990	11.415	1.316	0.000
Reserve Balances (Net Liquidity)	1658.863	1609.140	1611.716	1625.501	24.964
Treasuries within 15 days	43.523	14.191	14.191	14.191	14.955
Treasuries 16 to 90 days	66.834	110.357	78.611	78.611	31.549
Treasuries 91 days to 1 year	275.448	260.766	292.514	292.515	69.272
Treasuries over 1-yr to 5 years	942.603	957.302	955.541	955.556	170.807
Treasuries over 5-yrs to 10 years	259.314	259.354	261.168	260.811	91.863
Treasuries over 10-years	617.990	618.041	618.090	618.535	101.337

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

The Fed meets March 19-20 to consider its monetary policy. We expect a 25 bps rate hike to 2.75%. Haha. Big joke. Just trying to wake traders up now that the 10-yr bond yield has stopped moving after the Fed went with an explicit policy of patience. Bond yields can stick close to the 2.5% Fed funds rate for now, waiting for Godot. Sure, we can be patient. We still expect a 25 bps rate hike to 2.75% at the June 18-19 meeting once the skies clear with no more worries like Brexit, US-China wars, European growth slowdown, another Federal government shutdown and clarification on whether those auto imports from Europe indeed raise the Administration's national security concerns. We know our neighbors might be willing to go to war on this given all the Mercedes, BMWs and Audis sitting in their driveways, if they can't buy more cars from Europe. We will be interested to know what the Fed does with its rate forecasts at the March meeting, currently two more in 2019 to 3.0% and that one is the loneliest number rate hike in 2020 to 3.25%. They might get cold feet about raising rates above 3.0% neutral, not wanting to "tighten," just like their President, we mean Chairman Powell. (same difference, Freudian slip). San Francisco Fed President Daly said Friday that patience is data-dependent, not time-dependent. Interesting that she cited the deterioration in these many so-called financial conditions indexes as being the reason for pausing. Short-term interest rates are in the index so of course after the Fed raising rates four times the last year, that is not going to reverse. BBB-rated corporate yields versus 10-yr Treasury yields are wider not sure why that dictates tighter financial conditions after the biggest tax cut in history. Companies aren't hurting financially. The dollar hasn't moved much the last year, and stocks have now recovered from the December lows. Looks like this is not a serious reason to be patient for too much longer.

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

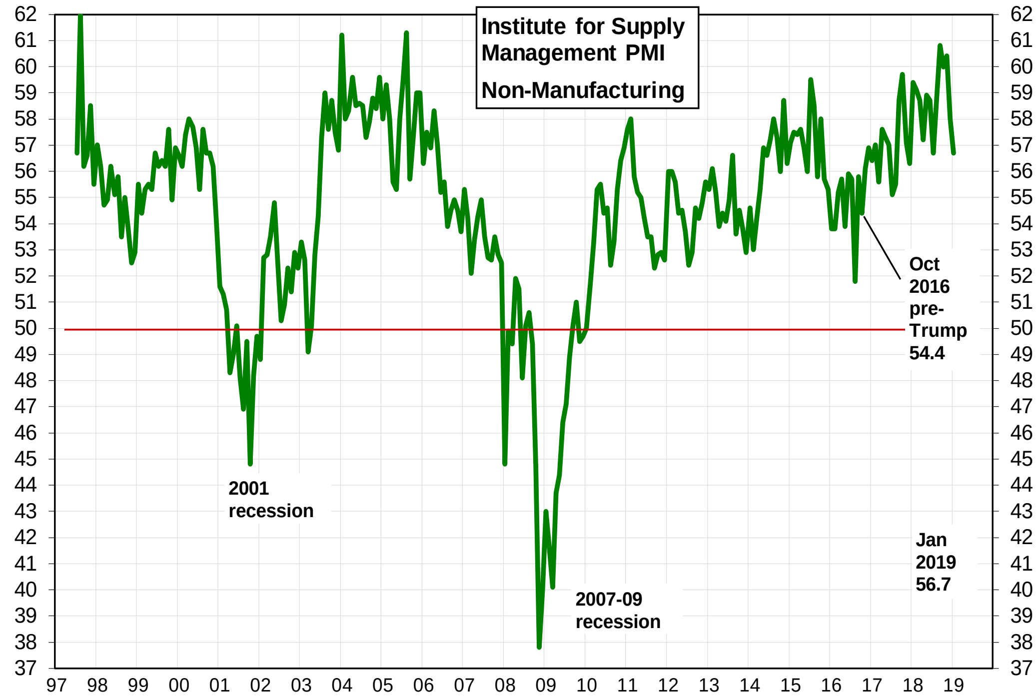
Eurodollar futures say no more Fed rate hikes				
Year-ends for Interest Rates				
Percent %	2018	2019	2020	2021
Eurodollar futures	2.803	2.625	2.43	2.435
Fed's Dec forecast	2.5	3.0	3.25	3.25

Eurodollar futures price where 3-month Libor will be in the future.
Friday, February 8, 2019 3-month Libor 2.70%

OTHER ECONOMIC NEWS THIS WEEK

ISM Services Index back to 2018 lows (Tuesday)

Breaking economy news. ISM non-manufacturing index falls another 1.3 points in January to 56.7. Services companies are hiring more workers, but new orders dropped from 62.7 in December to 57.7 in January. It is also somewhat troubling for the outlook that new export orders plummeted from 59.5 in December to 50.5 in January hinting that the dollar's strengthening trend and trade-talk frictions are starting to have a deleterious effect.



Eleven services industries are up and seven are down. Some of the industries that are contracting are retail, information, arts & entertainment, management of companies & support services. Many of the concerns companies listed were the government shutdown, and volatile prices due to the import tariffs. Uncertainty seems to be the key and the risks are almost all due to economic policies coming out of Washington. The policies from the Trump economics team are meant to improve business conditions, but so far it is having the opposite effect on sentiment.

Net, net, services industry executives remain cautious in January not at all certain the all-clear sign has emerged yet following the precipitous stock market slide in December along with the Federal government shutdown. The shutdown just ended January 25 so it will take some time for service company executives' deflated confidence to heal.

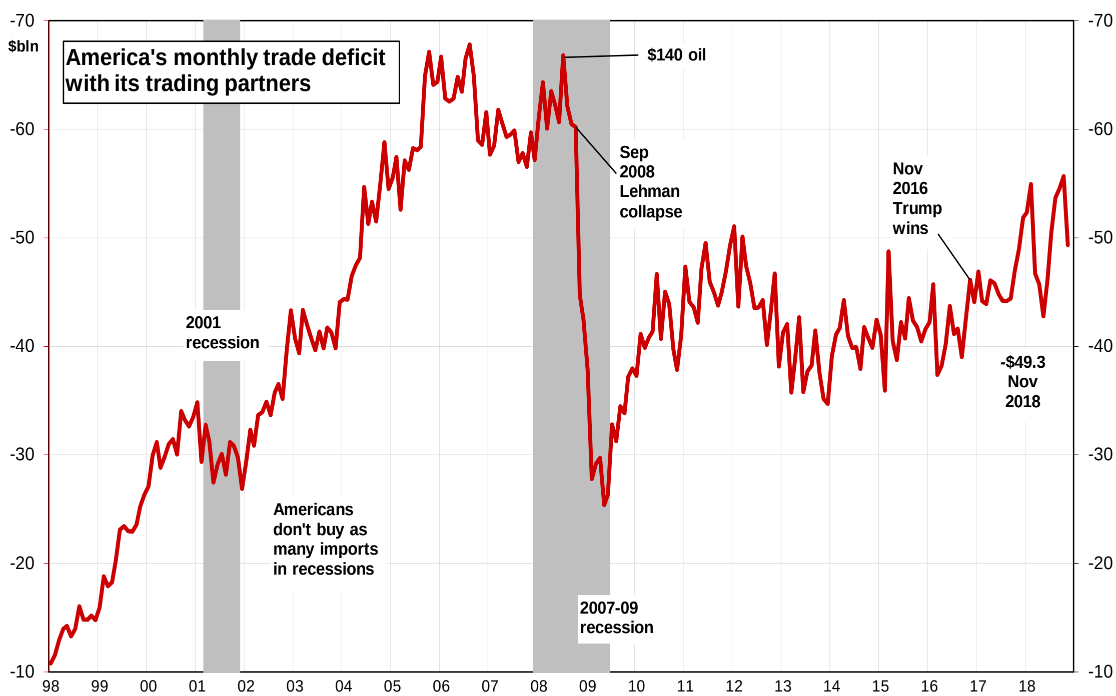
The non-manufacturing purchasing managers index is one of the most volatile surveys there is, so we would not take today's downward fall as a sign that the economy is entering a soft patch. Surveys bounce with the news headlines and it will be of paramount importance for the economic outlook this year whether the Trump economics team can indeed seal the deal and end its economic war with China. The markets are counting on economic peace between China and the U.S., and the economic fallout will be a disaster if the two sides cannot find common ground. Stay tuned. Story developing.

America's trade fight with the world is starting to slow global trade (Wednesday)

Breaking economy news. The trade deficit data is finally back online after the government shutdown and the November trade deficit dropped sharply from $55.7 billion in October to $49.3 billion in November. Exports ran out of steam in November which will not be good for U.S. manufacturers. November goods exports of $140.3 billion are still 4.5% greater than $134.2 billion a year ago. Civilian aircraft exports increased $1.0 billion in November which limited the overall blow to exports. Imports took it on the chin with imported goods falling $7.9 billion. Energy products fell $2.9 billion as crude oil prices tumbled in November, a trend that will continue in December. Consumer goods fell $4.3 billion including a $2.3 billion drop in cell phones and other household goods. Ouch.

America is winning the trade battle with China for now with goods imports from China tumbling $5.7 billion in November. America is winning the trade battle with China, but don't tell that to American consumers hungry for consumer goods manufactured in China by American companies or companies here in the U.S. who import supply-chain badly needed inputs for domestic production. America's trade fight with the world has finally started to slow global trade and only time will tell whether this is a good thing for the economy in the long run.

Net, net, the Trump tariffs and trade war with the world appears to have halted some of those imports at the border as the trade deficit fell from the widest levels seen since before the recession over a decade ago. Oil and cellphones and consumer goods imports fell the hardest. It is possible that some of the consumer goods imports were brought into the country in greater numbers to build a stockpile before the import tariffs took effect or grew even worse. Even with the sharp drop today, November imported goods of $211.9 billion are still 3.5% greater than year ago levels. But the sharp slowdown may reflect increasing caution given the unpredictable outcome of the administration's current trade talks. The good news in the report is that the sharp turnaround in America's trade fortunes will temporarily boost real GDP in the fourth quarter. We still expect 3.0% economic growth when the data postponed by the shutdown finally get released on February 28. Stay tuned. Story developing.



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