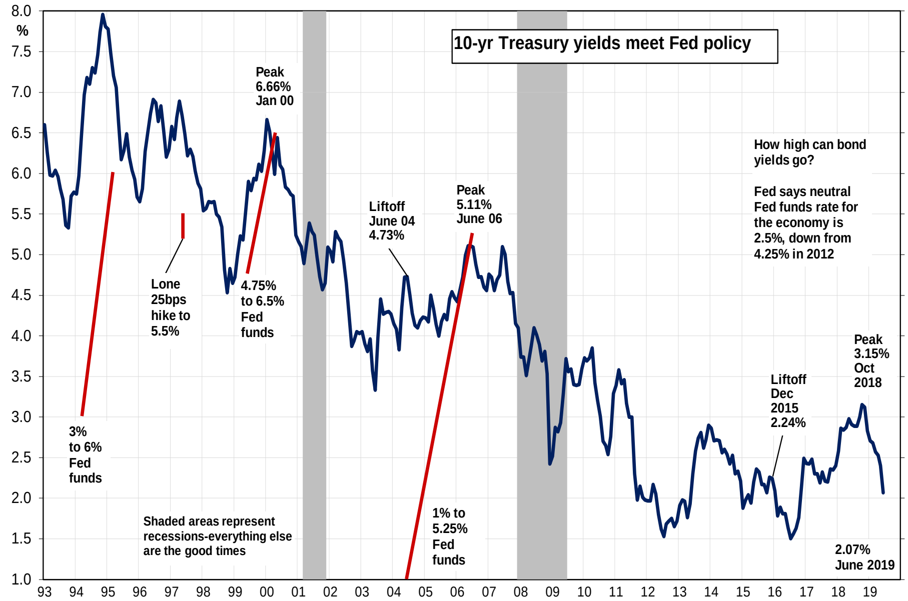
Financial Market Weekly

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

MUFG Bank, Ltd.
A member of MUFG, a global financial group

19 JULY 2019

DOWNWARD DEATH SPIRAL IN BOND YIELDS SHOULD FRIGHTEN EVERYONE



A couple more weeks left before the start of the widely expected Fed rate cuts. The bond market, 10-yr Treasury yields, has been preparing for this day for some time. Yields fell decisively below the 2.5% Fed funds rate in early May waiting for the Fed to cut rates at least a couple of times. The original death plunge over the cliff was on the pair of Sunday afternoon tweets on May 5 from the president escalating the trade war by moving up tariffs on $200 billion of imported goods from China from 10 to 25 percent. That was an external shock to the economy, not too long ago, so it is not unreasonable to still be on a recession watch, and see if companies lay off workers and make the bond market’s recession hopes and fears a reality. [Nothing so far with jobless claims low at 216K in July 13 week.] In recent interest rate cycles, Treasury bond yields never went higher than the Fed funds rate, so if the Fed is cutting rates, that is going keep bond yields lower.

> Federal Reserve’s Dual Mandate
>
> Congress amended The Federal Reserve Act in 1977
>
> "The Board of Governors of the Federal Reserve System and the Federal Open Market Committee shall maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices and moderate long-term interest rates."

Ahead of the Fed’s July 30-31 meeting we are rereading the Fed’s mandate from congress, and having a Fed Chair who is a lawyer is a benefit. Who would have guessed? By our analysis, it looks like Fed rate cuts will not be in keeping with the Fed's mandate. It's not a dual mandate. There are three goals, and try to forget the Fed is supposed to achieve the goals by increasing the money supply. The third goal is moderate long-term interest rates; that won't be achieved if the Fed cuts rates.

Bernanke-Corker rates fight at Senate February 26, 2013

Senator Corker R-Tenn.

So I think that, you know, I don't think there's any question that you would be the biggest dove, if you will, since World War II. I think it's something you're rather proud of.

...Just wondering if you -- if y'all talk at all in your meetings about the degrading effect that's having on our society and how it's basically punishing people who've done the right things and throwing seniors under the bus and others that have saved money, do y'all ever talk about the longer-term degrading effect of these policies as we try to, you know, live for today?

Fed Chairman Bernanke

You mentioned in particular the issue of savers and I think that is an important issue. I would just point out that if we -- if we tried to raise interest rates to -- from, say, the current 10-year yield is two percent, if we tried to raise it to three or four or five percent while the economy was still weak, it could not be sustained... If we tried to do that, we would throw our economy back into recession and we would have low interest rates, like the Japanese do.

The only way to get interest rates up for savers is to get a strong recovery. And the only way to get a strong recovery is to provide adequate support to the recovery.

We want to go back to the time when Senator Corker and Bernanke had some words over low interest rates, why were they so low? Maybe it helps explain how we got here with interest rates well below normal levels ten years after the recession. Keep in mind this was 2013 when the unemployment rate was 7.9 percent. We can't see any justification for monetary stimulus, interest rates below normal, at this point with the unemployment rate at 3.7%, despite the claims from some over "uncertainty" and inflation below the 2% target, and the "slowing world economy." The recovery Bernanke hoped for by providing monetary stimulus with ultra-low interest rates was strong enough to put people back to work and push unemployment down. Mission accomplished.

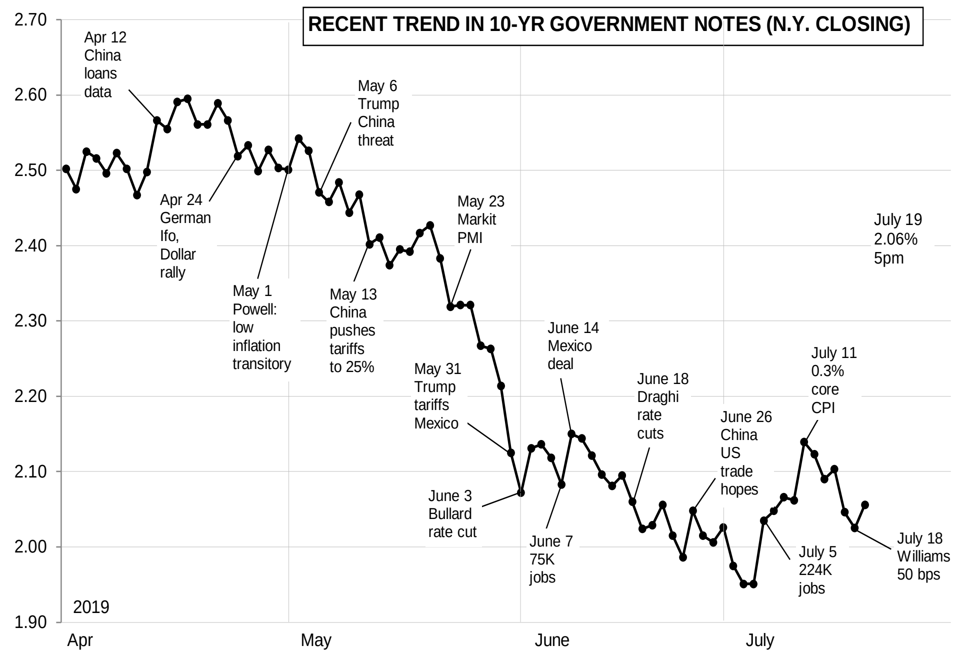
Back to the present… Senator Tina Smith D-Minn. asked Powell on July 11— "What can we learn from the experience with Europe?" We would think the answer would be don't do what the ECB did, and Japan did before them. Don't push rates to zero because it will not achieve anything: the economy would have created as many jobs as it was ever going to with or without the central bank. Unfortunately it sounded like Powell said the lesson is indeed cut the central bank rate to zero: "-- you don't want to get behind the curve and let inflation drop well below 2 percent, because what happens is you get in to this unhealthy dynamic potentially where lower expected inflation gets baked in to interest rates which means lower interest rates, which means less room for the central bank to react, and that becomes a self-reinforcing thing. We've seen it in Japan, we're now seeing it in Europe, and that's why we think it's so important that we defend our 2% inflation goal here in the United States and we're committed to doing that." We're committed alright. Get behind the curve sounds like Powell's policy will drive down the meager real returns to bond holders ever further. Those early 2000s 4% bond yields with juicy 200 bps real yields look to be history.

	Treasury Yield	Core PCE	Yield bps
2002	4.61	1.7	291
2003	4.01	1.4	261
2004	4.27	2.0	227
2005	4.29	2.1	219
2006	4.80	2.3	250
2007	4.63	2.2	243
2008	3.66	2.0	166
2009	3.26	1.2	206
2010	3.22	1.4	182
2011	2.78	1.6	118
2012	1.80	1.9	-10
2013	2.35	1.5	85
2014	2.54	1.6	94
2015	2.14	1.3	84
2016	1.84	1.7	14
2017	2.33	1.6	73
2018	2.91	1.9	101
2019	2.58	1.6	98

2019-to May

MARKETS OUTLOOK

	29-Mar 2019	28-Jun 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.81	2.53	2.25	2.30	2.40	2.50	2.50	2.70
10-Yr Note	2.41	2.01	1.75	1.80	2.00	2.10	2.20	2.40
5-Yr Note	2.23	1.77	1.50	1.55	1.80	1.90	2.00	2.20
2-Yr Note	2.26	1.76	1.50	1.60	1.70	1.80	2.00	2.20
3-month Libor	2.60	2.32	2.00	2.00	2.00	2.00	2.00	2.00
Fed Funds Rate	2.50	2.50	2.00	2.00	2.00	2.00	2.00	2.00
2s/10s spread	15	25	25	20	30	30	20	20



10-year Treasury yields rose to 2.14% on the stronger retail sales data Tuesday, getting close to the Sunday night high for the week in yields. Yields started falling with Dow stocks Wednesday afternoon on earnings and reports the China-US talks were not making progress. The 2.02% low for the week was Thursday afternoon after the market thought it heard NY Fed President Williams, saying a 50 bps rate cut was possible on July 31. His comment about the need to be aggressive when facing an adverse outlook for the economy was later clarified to be just a summary of two decades of academic research.

FEDERAL RESERVE POLICY

The Fed meets July 30-31 to consider its monetary policy. Rate cuts are coming. Here is our reasoned University level Fedwatcher 101 course analysis of the pros and cons. Mostly cons.

Friday, July 19, 2019 Donald J. Trump @realDonaldTrump

843am EDT tweet Because of the faulty thought process we have going for us at the Federal Reserve, we pay much higher interest rates than countries that are no match for us economically. In other words, our interest costs are much higher than other countries, when they should be lower. Correct!

938am tweet .... but it is no thanks to the Federal Reserve. Had they not acted so fast and “so much,” we would be doing even better than we are doing right now. This is our chance to build unparalleled wealth and success for the U.S., GROWTH, which would greatly reduce % debt. Don’t blow it!

938am EDT tweet I like New York Fed President John Williams first statement much better than his second. His first statement is 100% correct in that the Fed “raised” far too fast & too early. Also must stop with the crazy quantitative tightening. We are in a World competition, & winning big,...

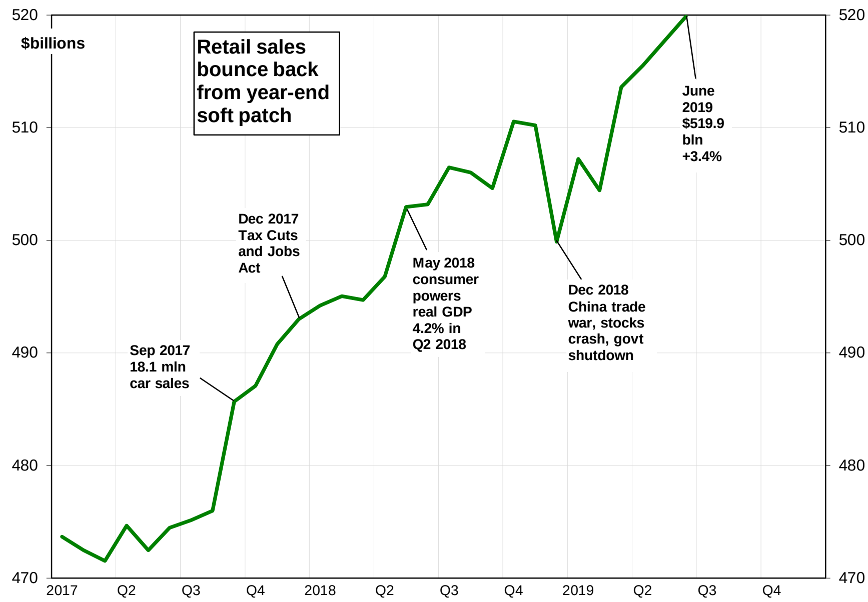
942am EDT tweet …Fed: There is almost no inflation!

Growth? Fed policy is supposed to sustain the economic expansion. Real GDP in the second quarter is due Friday, July 26 at 830am EDT Consensus is 1.8% which is a slowdown from 3.1% in the first quarter. For the Fed, the heat is on. Wait till the White House sees a 1.8% growth print.

OTHER ECONOMIC NEWS THIS WEEK

Ahoy Fed. Consumers have weathered the storm (Tuesday)

Breaking economy news. Consumer spending is very strong at the moment rising 0.4% in June and 0.4% in May. The consumer was frightened to death at the turn of the year with retail sales dropping in December during the stock market's plunge and in February after the Federal government shutdown. But now spending is running flat out at 7.5% in the second quarter which makes one wonder how the Federal Reserve can make the case for interest rate cuts. The consumer can't possibly buy any more goods and services than they are right now. Retail spending is so strong in recent months that the third quarter is running 1.7% even before we get the data for July, August, September.



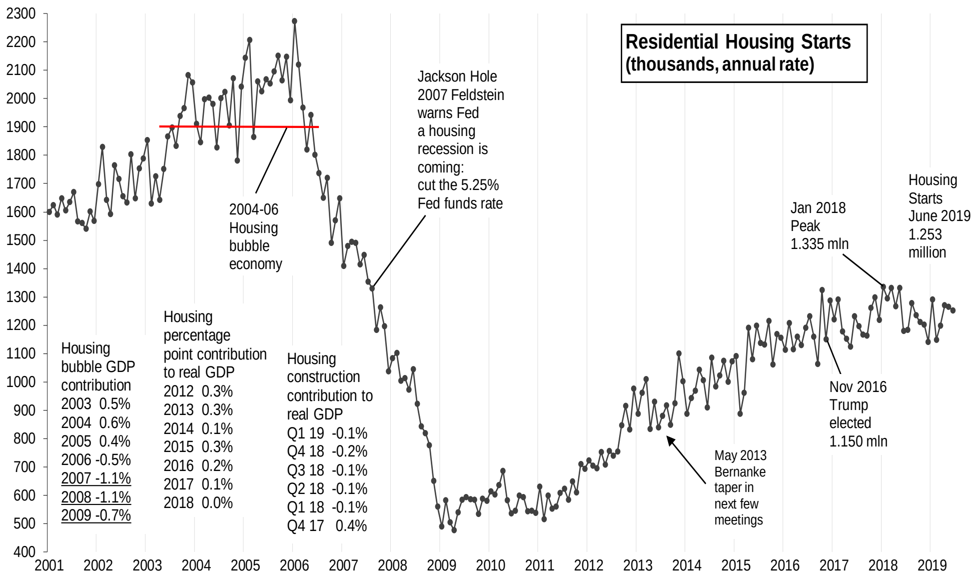
Net, net, the economy looks solid from where the consumer is standing and they continue to take shopping trips to the mall despite the worrying headlines about trade wars and slowing world growth. China and Europe are a long way away from American shores and the growth slowdown there does not appear to be hurting consumer confidence and spending here. The stronger retail sales figures effectively shut the door on a Fed rate cut for traditional weak economy reasons after weathering the storm at the turn of the year. The Fed can talk about the need for risk management rate cuts all they want, but the risk is their interest rate cuts will fall on deaf ears. We have never seen a time where the Fed had such limited ammo to try to steer the course of the economy, and by cutting rates now, they risk having no firepower if the economy actually turns down and goes into recession. Save the rate cuts for a rainy day is what consumers are telling the Fed. We don't need them. The Fed says they listen, let's see if that's the case.

Retail spending, actual dollars, each month

	$million	% to	Percent Changes %		
	Jun 2019	Total	Jun	May	Year/year
Total Retail Sales	519,885	100.0	0.4	0.4	3.4
Motor vehicles/parts	104,500	20.1	0.7	0.7	4.1
Furniture/furnishings	9,840	1.9	0.5	-0.1	0.8
Electronics/appliances	8,123	1.6	-0.3	-0.1	0.8
Building materials/garden	31,156	6.0	0.5	-1.5	-2.5
Food & beverage	64,662	12.4	0.5	0.1	2.9
Health/personal care	30,102	5.8	0.5	0.9	5.5
Gasoline stations	42,039	8.1	-2.8	-0.8	-1.7
Clothing/accessories	22,486	4.3	0.5	-0.2	-0.9
Sporting goods, books	6,507	1.3	0.0	-0.1	-3.3
General merchandise	60,026	11.5	0.2	0.2	2.5
Department stores	11,352	2.2	-1.1	-0.6	-5.2
Miscellaneous retailers	11,196	2.2	0.6	0.8	3.2
Eating & drinking places	64,532	12.4	0.9	1.0	4.0
Nonstore retailers (internet)	64,716	12.4	1.7	1.7	13.4

America has a homeless problem (Wednesday)

Housing: no recovery in sight



Residential housing construction is one of the leading indicators of a recession and while construction activity isn't dropping precipitously, housing is stuck in a rut and is so far unable to recover fully from the housing bubble crash over a decade ago. If the Fed thinks rate cuts are going to send housing construction up like a rocket, they better think again. Mortgage money is already cheap with the cost of borrowing to buy a new home falling from 4.9 percent last November to 3.75 percent today.

Net, net, don't tell homebuilders there is a critical shortage of housing in the country because they aren't listening. It's a construction zone after all and they can't hear you. Homebuilders can't get permits, can't get financing, can't get skilled labor, and the cost of building materials is going through the roof. The critical housing shortage is a supply side problem not a demand side. Cutting interest rates to stimulate demand won't do a darn thing, and Fed officials will be wasting precious ammunition if they do. Save the rate cuts for a recession. Rate cuts to help make America great again won't help anybody. Bet on it.

Housing Starts Total, Single-Family, Multi-Family

	United States			Northeast		Midwest		South		West	
000s	Total	1 unit	Multi	Total	1 unit	Total	1 unit	Total	1 unit	Total	1 unit
Jun 19	1253	847	396	109	46	197	122	635	478	312	201
May 19	1265	818	437	83	49	155	113	699	473	328	183
Jun 18	1180	854	316	104	70	164	113	567	449	345	222
% Chgs											
Jun/May	-0.9	3.5	…	31.3	-6.1	27.1	8.0	-9.2	1.1	-4.9	9.8
Jun/Jun	6.2	-0.8	…	4.8	-34.3	20.1	8.0	12.0	6.5	-9.6	-9.5

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.

About Mitsubishi UFJ Financial Group, Inc.'s U.S. Operations including MUFG Americas Holdings Corporation

The U.S. operations of Mitsubishi UFJ Financial Group, Inc. (MUFG), one of the world's leading financial groups, has total assets of $326.5 billion at September 30, 2018. As part of that total, MUFG Americas Holdings Corporation (MUAH), a bank holding company and intermediate holding company, has total assets of $161.0 billion at September 30, 2018. MUAH's main subsidiaries are MUFG Union Bank, N.A. and MUFG Securities Americas Inc. MUFG Union Bank, N.A. provides a wide range of financial services to consumers, small businesses, middle-market companies, and major corporations. As of September 30, 2018, MUFG Union Bank, N.A. operated 354 branches, consisting primarily of retail banking branches in the West Coast states, along with commercial branches in Texas, Illinois, New York and Georgia, as well as 22 PurePoint® Financial Centers. MUFG Securities Americas Inc. is a registered securities broker-dealer which engages in capital markets origination transactions, private placements, collateralized financings, securities borrowing and lending transactions, and domestic and foreign debt and equities securities transactions. MUAH is owned by MUFG Bank, Ltd. and Mitsubishi UFJ Financial Group, Inc. MUFG Bank, Ltd., a wholly owned subsidiary of Mitsubishi UFJ Financial Group, Inc., has offices in Argentina, Brazil, Chile, Colombia, Peru and Canada as well as branches, agencies and representative offices in the U.S. Visit https://www.unionbank.com/ or https://www.mufgamericas.com/ for more information.

About MUFG

Mitsubishi UFJ Financial Group, Inc. (MUFG) is one of the world's leading financial groups. Headquartered in Tokyo and with over 360 years of history, MUFG has a global network with over 1,800 locations in more than 50 countries. The Group has over 150,000 employees and offers services including commercial banking, trust banking, securities, credit cards, consumer finance, asset management, and leasing. The Group aims to "be the world's most trusted financial group" through close collaboration among our operating companies and flexibly respond 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 stock exchanges. For more information, visit https://www.mufg.jp/english.