Financial Market Weekly

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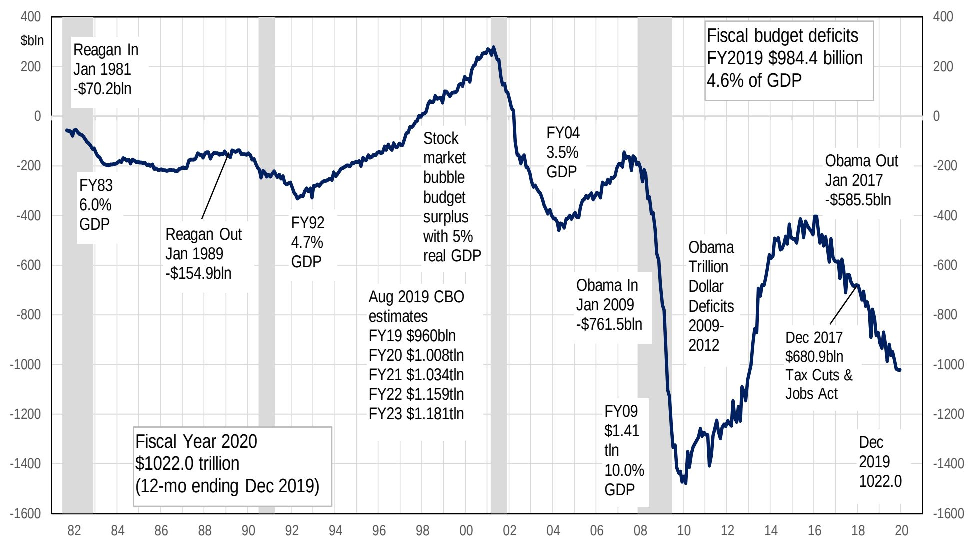
17 JANUARY 2020

FEDERAL BUDGET DEFICIT CROSSES $1 TRILLION MARK



The Federal budget deficit crossed the $1 trillion mark for the first time in the fourth quarter of 2019. Back to the Obama trillion dollar deficit years from 2009 to 2012. For the red ink that has to be financed by the U.S. Treasury in the markets, there's no upward effect on interest rates to be seen. For now. For all the talk of bond yields being held down by the demographic fact of baby boomers saving for their retirement years or yield-starved overseas investors in Europe and Japan buying more U.S. government securities (don't even get into whether there is not enough investment "demand"), we still think it is the Federal Reserve with its 1.75% interest rate that sets the benchmark for market yields. It will be an interesting test in the next few years, maybe not until the next decade, whether the supply of government securities to finance the deficits will one day push yields significantly higher above the Fed funds rate anchor for bond yields.

The Federal budget deficit in the graph here is on a 12-month rolling sum basis to annualize it. The deficit is $1.022 trillion in the 12 months ending December 2019, where the December quarter of 2019 is the first quarter of fiscal year (FY) 2020. The deficit was $585.5 billion in January 2017 when Obama left office and Trump came to Washington. The deficit was $680.9 billion in December 2017 when the Tax Cuts & Jobs Act was signed on a wave of public support following the Senate's 51-49 vote. The deficit is now $1.022 trillion and the Congressional Budget Office (CBO; August 2019) says it will climb gradually to $1.181 trillion by FY2023.

Total Federal government budget outlays are running 6.7% greater than last year so far in FY2020. Defense is up 9.0%, but at least the interest on the public debt is down 2.5%.

Where is the money coming from? Total receipts are up 4.6% so far in FY2020. Corporate tax collections continue to recover from the biggest corporate tax cut in history. Corporate taxes fell 31.1% in FY2018, and recovered 12.5% in FY2019. Corporate taxes are up 23.2% to $65.4 billion in the first quarter of FY2020. Corporate taxes in the first fiscal quarter of FY2019 were 23% of the annual total, which if it holds means corporate taxes would come back further to just over $280 billion in FY2020. Maybe earnings will be better than forecast this year with the increase in taxes paid. Similarly, customs duties are up 18.6% in the first quarter of FY2020 which would put total year collections at just under $85 billion for the full year. We don't know if China or someone else is paying billions and billions, but the $85 billion is greater than the $34.6 billion customs duties in FY2017 before the trade war.

Federal Government Spending ($bln) **Where to cut?**	1 Qtr FY20 Q4 19-Q4 19	1 Qtr FY19 Q4 18-Q4 18	Fiscal Year Changes	Fiscal Year % chg	Full Year FY 2019
TOTAL BUDGET OUTLAYS	1,163.090	1,090.170	72.920	6.7	4,446.584
Legislative	1.394	1.278	0.116	9.1	4.957
Judicial	2.166	2.077	0.089	4.3	7.959
Agriculture	52.725	50.660	2.065	4.1	150.121
Commodity Credit Corporation	15.582	15.037	0.545	3.6	21.389
Food Stamps	15.812	16.793	-0.981	-5.8	63.465
Child Nutrition	7.266	6.579	0.687	10.4	23.273
Commerce	4.613	3.783	0.830	21.9	11.324
Defense	187.348	171.933	15.415	9.0	653.979
Military Personnel	55.216	52.963	2.253	4.3	156.270
Operation Maintenance	66.414	63.773	2.641	4.1	271.695
Procurement	36.291	28.687	7.604	26.5	124.698
Research Development	24.822	21.161	3.661	17.3	89.281
Military Construction	2.112	1.973	0.139	7.0	7.412
Education	17.651	16.983	0.668	3.9	104.364
Office of Federal Student Aid	8.401	7.841	0.560	7.1	69.397
Energy	7.974	6.622	1.352	20.4	28.936
Health Human Services	309.340	289.027	20.313	7.0	1213.805
Medicare	197.761	183.790	13.971	7.6	782.548
Medicaid States Grants	100.952	95.930	5.022	5.2	409.421
Homeland Security	15.387	16.527	-1.140	-6.9	56.327
Housing Urban Development	11.690	11.400	0.290	2.5	29.188
Interior	3.605	3.671	-0.066	-1.8	13.907
Justice	8.937	8.838	0.099	1.1	35.107
Labor	5.136	5.164	-0.028	-0.5	35.810
State Unemployment Benefits	6.333	6.171	0.162	2.6	27.205
State	8.362	8.305	0.057	0.7	28.000
Transportation	20.496	19.220	1.276	6.6	80.715
FAA	4.416	4.427	-0.011	-0.2	16.670
Federal Highway Admin.	12.098	11.171	0.927	8.3	45.712
Treasury	185.298	177.367	7.931	4.5	689.496
TARP	0.253	0.393	-0.140	-35.6	1.453
IRS	23.839	19.256	4.583	23.8	166.004
Earned Income Credit	0.311	0.402	-0.091	-22.6	59.209
Child Tax Credit	0.283	0.171	0.112	65.5	28.898
Interest on Public Debt	160.187	164.221	-4.034	-2.5	572.913
Veterans Affairs	71.761	58.481	13.280	22.7	199.573
Corps of Engineers	2.179	1.676	0.503	30.0	6.454
Other Defense Civil Programs	20.835	19.868	0.967	4.9	60.931
Environmental Protection	2.437	2.299	0.138	6.0	8.064
Exec. Office of President	0.099	0.110	-0.011	-10.0	0.422
International Assistance	3.071	3.498	-0.427	-12.2	23.578
NASA	5.854	5.486	0.368	6.7	20.179
National Science Foundation	1.823	1.735	0.088	5.1	7.255
Personnel Management	26.159	25.015	1.144	4.6	103.138
Small Business Admin.	0.267	0.342	-0.075	--	0.456
Social Security Admin.	285.056	270.043	15.013	5.6	1101.833
Retirement Benefits	229.852	215.217	14.635	6.8	888.080
Federal Disability Payments	36.318	36.151	0.167	0.5	145.020
Other Independent Agencies	7.540	7.958	-0.418	-5.3	19.610

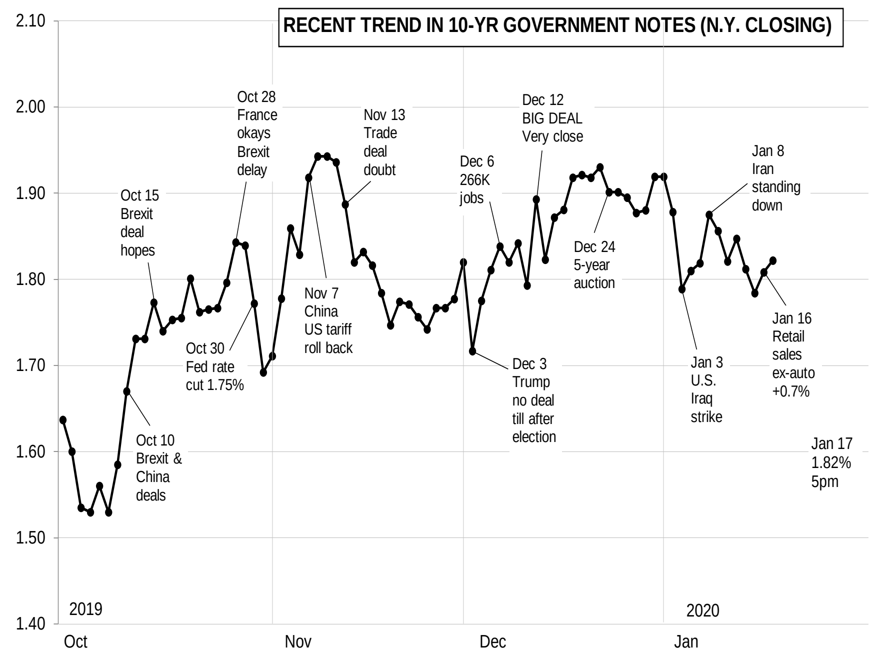
Federal Government: Where's the Money Coming From?

FY20/FY19 Year-to-Date	Fiscal Years $billons	Sep 2019	%	Sep 2018	%	Sep 2017	%	Sep 2016
4.6%	Budget Receipts	$3462.2	4.0	$3328.7	0.4	$3314.9	1.5	$3266.8
3.2%	Income taxes	1,717.9	2.0	1,683.5	6.1	1,587.1	2.7	1,546.1
23.2%	Corporation taxes	230.2	12.5	204.7	-31.1	297.0	-0.8	299.5
5.9%	Social retirement taxes	1,197.4	6.8	1,121.1	0.8	1,111.9	4.7	1,062.3
-4.8%	Unemployment insurance	40.9	-9.1	45.0	-1.7	45.8	-6.1	48.8
-30.1%	Excise taxes	98.9	4.1	95.0	13.4	83.8	-11.8	95.0
-8.1%	Estate and Gift Taxes	16.7	-27.4	23.0	0.9	22.8	6.5	21.4
18.6%	Customs Duties	70.8	71.4	41.3	19.4	34.6	-0.6	34.8
7.0%	Miscellaneous	84.6	-23.4	110.5	-13.5	127.7	-17.5	154.8

MARKETS OUTLOOK

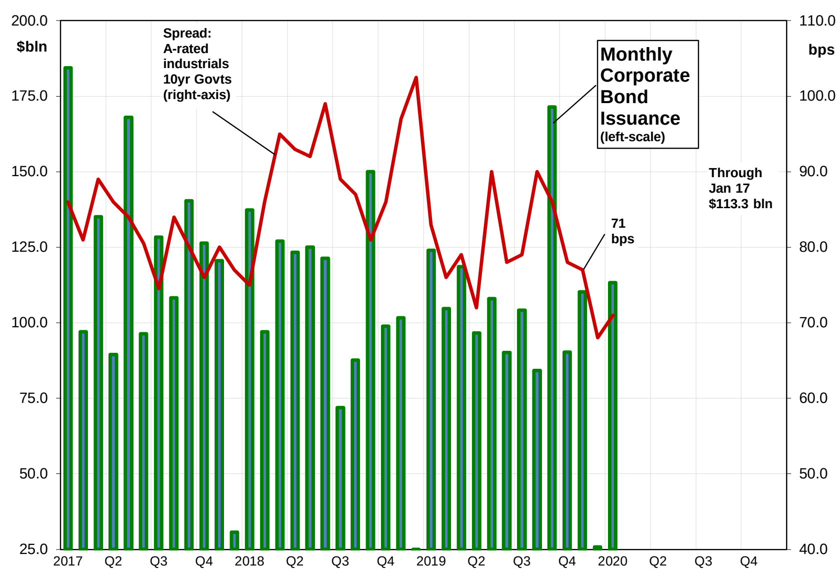
	29-Mar 2019	28-Jun 2019	30-Sep 2019	31-Dec 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020	Q1 2021	Q2 2021
30-Yr Treasury	2.81	2.53	2.11	2.39	2.30	2.30	2.40	2.50	2.60	2.70
10-Yr Note	2.41	2.01	1.67	1.92	1.85	1.90	2.10	2.20	2.30	2.40
5-Yr Note	2.23	1.77	1.55	1.69	1.65	1.75	1.90	2.05	2.15	2.25
2-Yr Note	2.26	1.76	1.62	1.57	1.60	1.70	1.80	2.00	2.10	2.20
3-month Libor	2.60	2.32	2.09	1.90	1.90	1.90	1.90	1.90	1.90	1.90
Fed Funds Rate	2.50	2.50	2.00	1.75	1.75	1.75	1.75	1.75	1.75	1.75
2s/10s spread	15	25	5	35	25	20	30	20	20	20

That was easy. Yields closed 1.82% a week ago and closed 1.82% again on Friday. No harm, no foul. Here we sit. The daily closes ranged from 1.85 to 1.78 percent each day this week. 7 basis points. The market got some interesting economic news reports, but still not all that much happening when "the Fed is on hold in 2020" awaiting a material change in the outlook. No change in the outlook seems just fine with stock market investors with the S&P 500 closing Friday up 3.1% this year, following 2019's 28.9% increase. Back to the bond market for as long as it continues to trade: the week's 10-yr yield low was 1.77% Thursday before the stronger retail sales and drop in unemployment claims. Bonds sold off more Friday on the jump in housing starts.



CORPORATE BONDS: WEEK WAS HEAVY ON BANKS/FINANCIALS

Corporate offerings were $40.3 billion in the January 17 week versus $72.8 billion in the January 10 week. On Monday, Deutsche Telekom priced a $1.25 billion 3.625% 30-yr (m-w +25bp) at 137.5 bps (Baa1/BBB+). The European telecom company operating as T-Mobile in the US will use the proceeds for general corporate purposes. Corporate bond yields (10-yr Industrials rated A2) were 71 bps above 10-yr Treasuries Friday versus 72 bps last Friday.



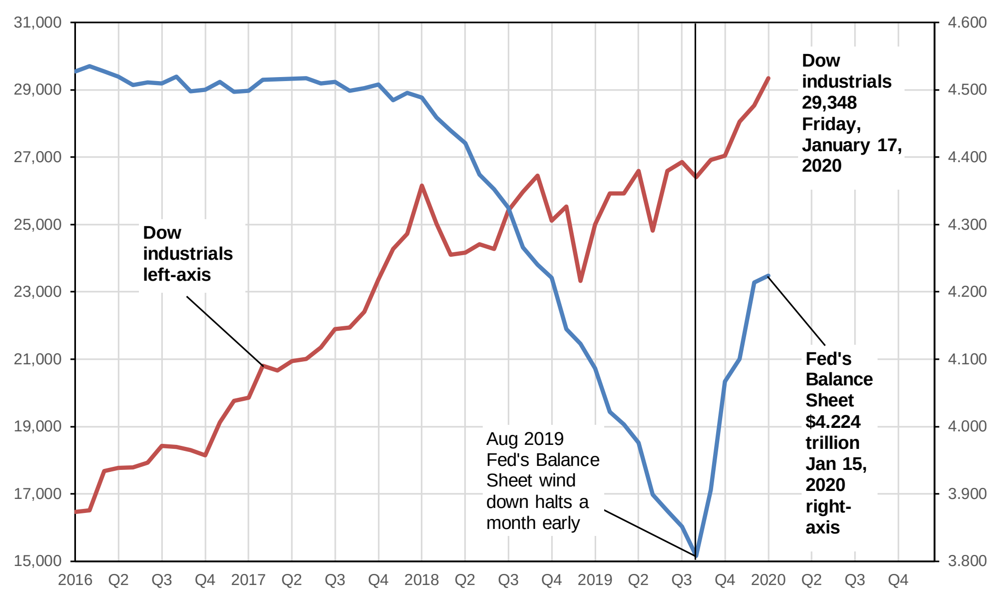
FEDERAL RESERVE POLICY

The Fed meets January 28-29, 2020 to consider its monetary policy. We don't care what they do as long as they keep pumping that liquid gold into the stock market that pumps up investor returns for the "55 percent" of Americans that own stocks, any stock actually, and increasing the divide between the Haves and Have-Nots that worsens income inequality. Nonsupervisory employees are seeing their wages increase 3.0% in the year ending December 2019, but the stock market, S&P 500, closed up 3.1% for the year-to-date on Friday, January 17. What a life for stock holders after the S&P 500 28.8% gain in 2019. Back to the increase in the Fed's balance sheet that isn't QE according to Fed officials, who might as well be shouting in the wind, because many investors think even if it isn't QE it sure is doing something great for stocks.

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	15-Jan	8-Jan	1-Jan	25-Dec	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2362.635	2347.714	2328.933	2328.862	479.782
Federal agency debt securities	2.347	2.347	2.347	2.347	0.000
Mortgage-backed securities (MBS)	1404.318	1408.677	1408.677	1419.980	0.000
Repurchase agreements	229.468	210.587	255.619	234.969	126.750
Primary credit (Discount Window)	0.009	0.000	0.032	0.001	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	0.059	3.728	3.728	3.729	62.000
Federal Reserve Assets	4224.1	4197.8	4221.4	4213.9	961.7
3-month Libor %	1.84	1.83	1.91	1.96	2.82
Factors draining reserves					
Currency in circulation	1795.725	1802.383	1807.740	1802.362	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	0.068	0.876	64.087	4.423	0.000
Reserve Balances (Net Liquidity)	1673.362	1656.629	1548.849	1648.238	24.964
Treasuries within 15 days	14.867	18.271	8.260	18.371	14.955
Treasuries 16 to 90 days	131.504	125.491	115.689	114.373	31.549
Treasuries 91 days to 1 year	349.598	344.202	341.875	345.124	69.272
Treasuries over 1-yr to 5 years	907.750	894.850	900.972	888.264	170.807
Treasuries over 5-yrs to 10 years	315.612	324.301	321.591	322.208	91.863
Treasuries over 10-years	643.304	640.599	640.547	640.522	101.337

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

What goes up must come down, so when will the Fed stop increasing its balance sheet. After all the shouting the last year about QT (quantitative tightening) from the president no less, the Fed stopped the gradual wind down ("running silently in the background") a month early in August last year. Since then the Fed's balance sheet has started going back up, helped along by that surprise September 17 spike in overnight yields (daily effective Fed funds rate) to 2.30%. There's a whole lot of whoopee, free-money, liquidity for the stock market now, but when is the music going to stop? Well they said repo liquidity above might end in January ($229.468 billion outstanding January 15 in the table above), and their Treasury bill purchases could last into the second quarter. Stay tuned. Story developing.



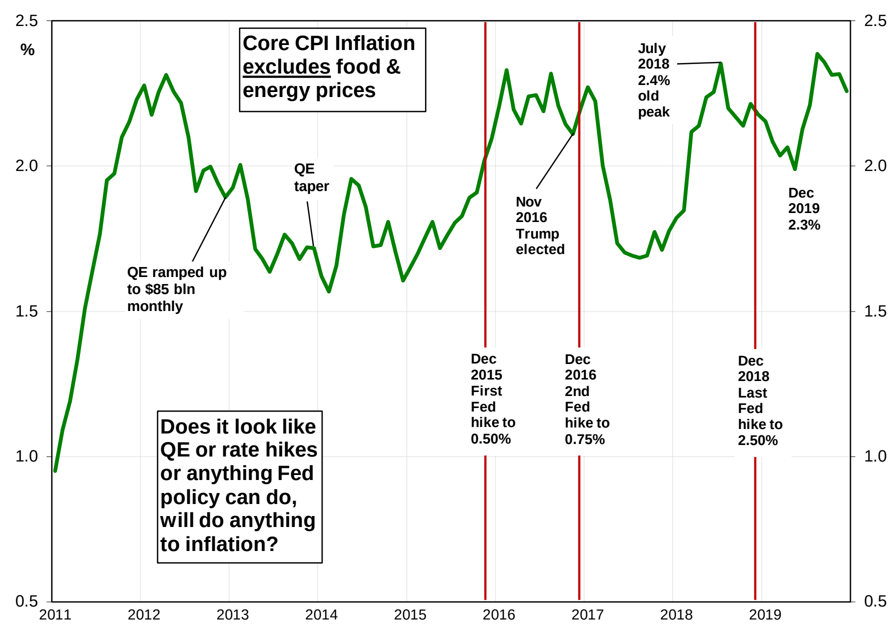
OTHER ECONOMIC NEWS THIS WEEK

Inflation above Fed's 2% target, but core prices are slower in December (Tuesday)

Breaking economy news. CPI inflation rose 0.2% in December and is up 2.3% from year ago levels. Core CPI rose just 0.1% in December and is also up 2.3% from year earlier levels. The 0.1% rise in core CPI in December is slightly weaker than the 0.2% monthly increases in October and in November. Home prices were only up 0.2% in December (3.2% year-on-year), and used cars and trucks fell 0.8%. Medical care services inflation is running 5.1% the last year which is faster than how PCE inflation measures medical services, so core PCE inflation, the Fed's preferred measure of inflation, is likely to remain short of its 2.0% target. Core PCE inflation is increasing 1.6% year-year in November, and December data are not out until Friday, January 31, which is after the next Fed press conference with Fed Chair Powell following the meeting on Wednesday, January 29.

The bond market barely lifted its weary head in response to the "weak" 0.1% core CPI inflation reading. Put a fork in it, it's dead. No reason to trade the fundamental economic news as much if the Fed isn't going to change interest rates, or even think of changing interest rates. For all the talk of Fed officials saying bond yields are low due to demographics, more retiring baby boom savers, it is really their own policy that is setting the yield on 10-yr yields, their own communication that they will not raise interest rates without more inflation. And even the talk that they might allow inflation to run above 2%, to offset the lean years of inflation below 2%, without raising interest rates, that talk is suppressing yields.

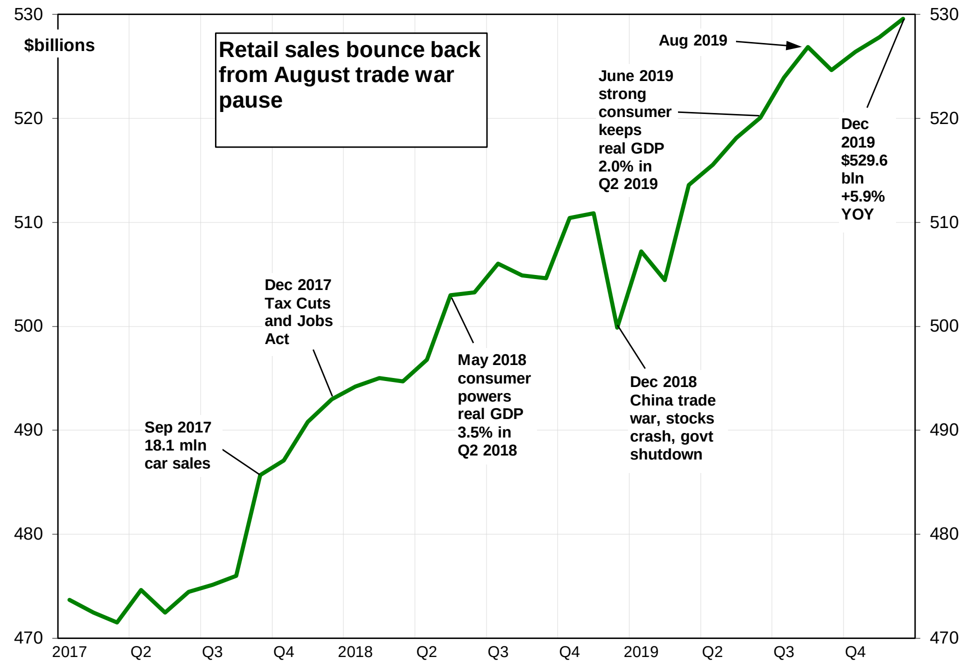
Net, net, labor markets ended the year on a weak note, and now consumer inflation of core goods and services has slowed, giving rise to the fear that maybe economic demand is showing early signs of hitting a new soft patch for growth that will carry into the first quarter of 2020. The Federal Reserve is on the sidelines this year, but that could swiftly change if overall economic demand weakens and inflation shows little sign of returning to target. In any case, inflation pressures remain muted and this pushes off the day when interest rates might move significantly higher. Every recession since the 1970s has been caused by the Fed raising interest rates too high to fight inflation, and with rates only 1.75%, the economic expansion might just run on and on which should help stock market valuations when recession risks are minimal. Stocks are cheap if there is no recession. Bet on it.



Consumers open the throttle at year end (Thursday)

Consumers open the throttle at year end, and boy, is the economy ever glad. The slowdown in business fixed investment is not hurting the consumer one little bit.

The economic data are out of sight this morning showing there's more fuel in the tank of this economic expansion that's going to continue to bust records in the history books. Consumers opened the throttle and took more shopping trips to the malls across America which ensures GDP growth will be comfortably above 2 percent in the fourth quarter. Labor markets continue to astound us with the number of workers filing for jobless benefits back to normal after a recent flare up.



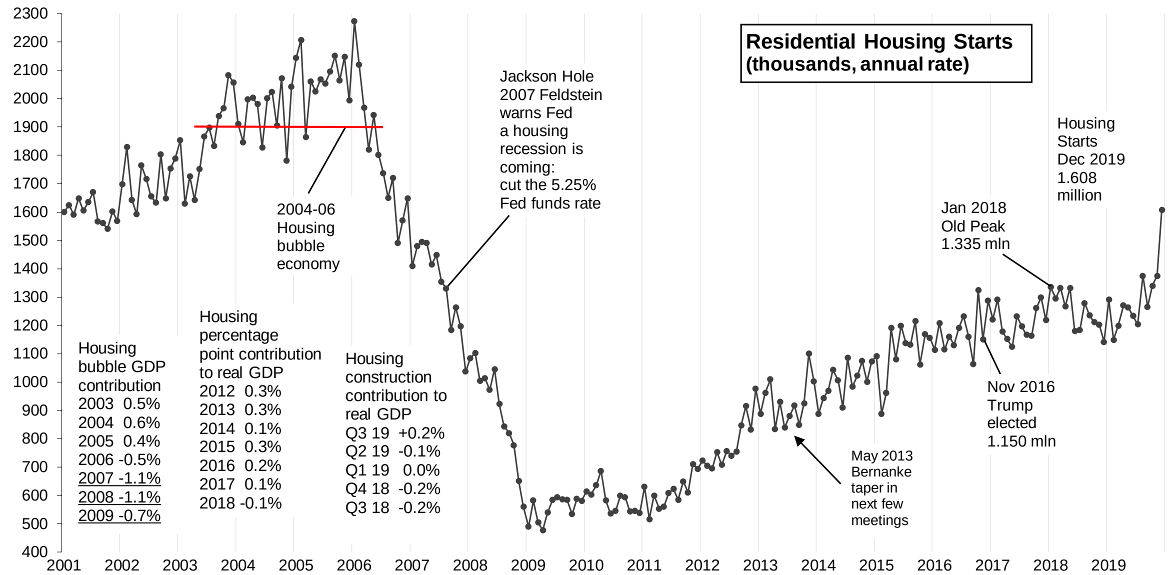
Markets simply cannot keep getting economic data like this showing the labor market is the strongest in history and with consumers spending their hearts out and still believe that the economy could be anywhere near the edge of the recession cliff.

If the economy could be traded like stocks trading on an exchange, we would advise everyone to back up the truck and buy it all. The economy is going higher. Bet on it. There's nothing limiting this economic expansion. This indeed may be the best economy in US economic history.

Housing starts up 16.9% in December. Sure. (Friday)

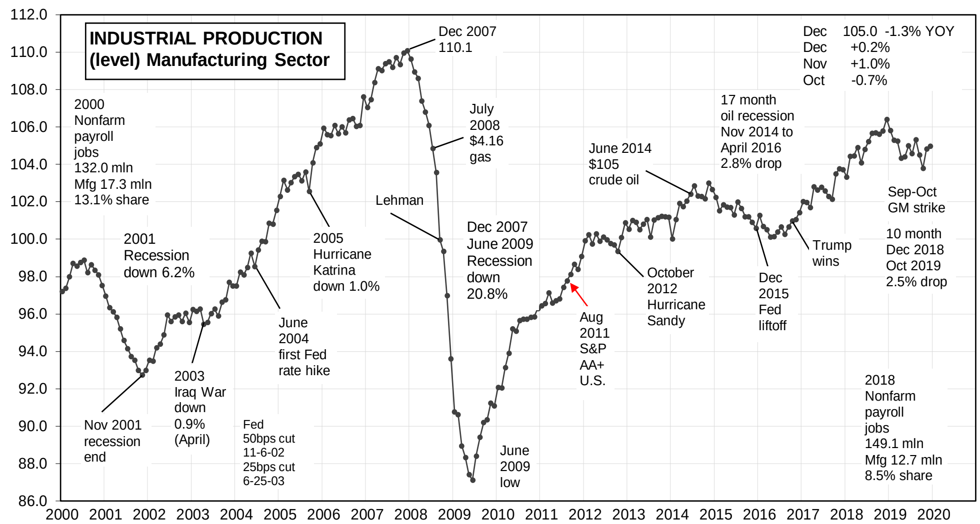
Breaking economy news. Housing starts up 16.9% in December to 1.608 million and housing permits down 3.9% to 1.416 million. Housing starts have been below housing permits lately so today's figures look suspicious, meaning the good news cannot last. Single-family starts were up big in the Midwest and in the South which may mean the seasonal factors had trouble adjusting for the cold winter weather that is highly variable each year.

Net, net, the housing market continues to recover from the collapse of construction during the housing bust a decade ago, but while the progress is good, it can't be this good. Consumer wages are up significantly this year, mortgage rates are sharply lower, there are more new jobs and workers with paychecks to buy a new home, all the ingredients are there for a strengthening of the housing construction market, it's just that today's results look over-the-top. We have no doubt there will be 1.6 million in housing starts later in 2020, but today's number may come back down to Earth in January. Stay tuned. The economy may be better than you think. It's just not this good. The trend in residential housing construction is trending up since the final Fed rate hike to 2.5% in December 2018. But we would be shocked if today's results stick.



Manufacturing output climbs a second month before the coming Boeing storm (Friday)

Breaking economy news. Industrial production fell 0.3 percent in December on the warm winter weather that caused utility output to drop a sharp 5.6% in December. We don't remember it being all that hot, although we are chained to our desk in midtown most days. Manufacturing production rose 0.2% in December following November's 1.0% jump after the GM strike ended in late October. The manufacturing recession looks to be all but over if today's data hold. Let's see what the ISM purchasing managers in manufacturing say in the next report out on February 3. Last month they still thought the sky was falling for manufacturers.



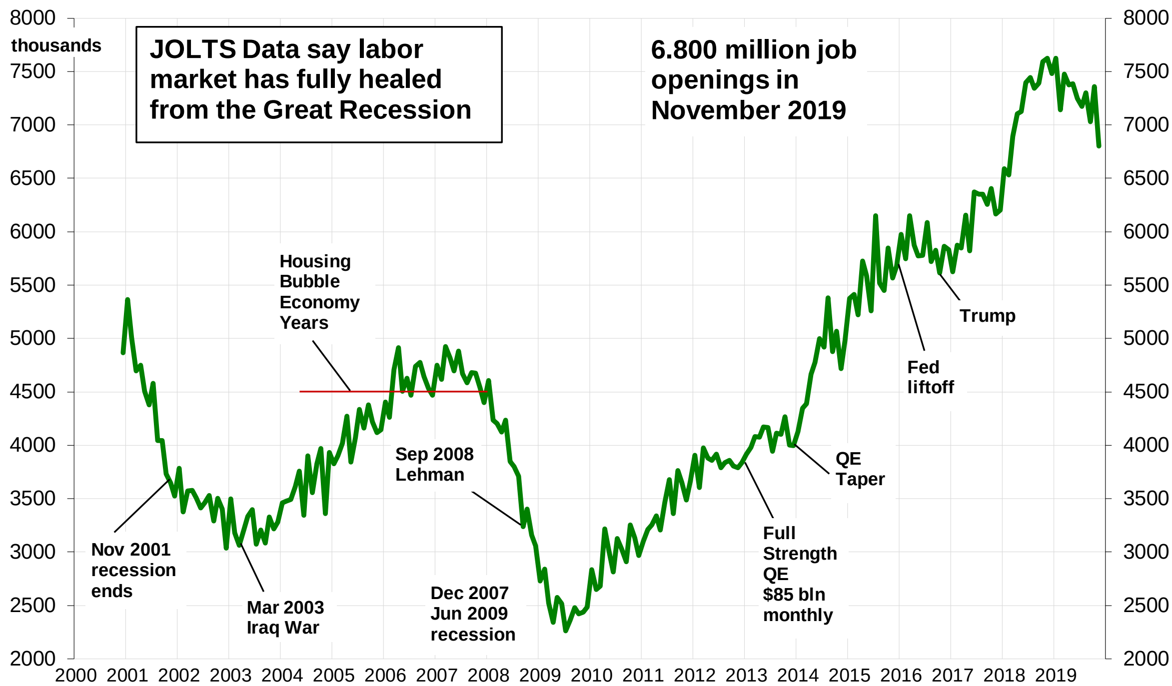
The big drop in utility production in December confirms there was unseasonably warm weather last month that boosted housing starts in December.

Net, net, factory production recovered for a second month following the September and October lost output during the GM strike, but it remains an open question how much production will suffer in the first quarter of 2020 as Boeing halts the production of the 737 Max. Today's rebound in factory output may be the calm before the storm. Stay tuned. Story developing.

Better hurry up, job openings plummet as companies have their fill for now (Friday)

Breaking economy news. Job openings plummeted in November to 6.8 million from 7.361 million in October. Today's result clearly extends the downtrend in jobs available since November 2018's 7.626 million peak as the Fed was getting ready to hike rates to 2.5% in December when the stock market tumbled as much as it would in a recession, the same month the Federal government shut down. It looks like a trend. The labor market has peaked. As uncertainty over the outlook rises, companies are just as certain they don't need as many employees.

Net, net, the labor market may be starting to lose its shine as companies have scaled back their hiring in the face of continued economic uncertainty in this longest economic expansion in history. Common sense should tell you that indeed, after an eleven-year run of economic growth that many companies have hired all the help they need for now. Today's sharp reduction in jobs available may be telling us that the economy has finally reached full employment. The good news is that perhaps the Federal Reserve can be more confident that inflation will start rising back to its 2 percent target. The bad news is that anyone holding out for their dream job may have already missed the boat. The labor market has peaked. Stay tuned story developing.



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