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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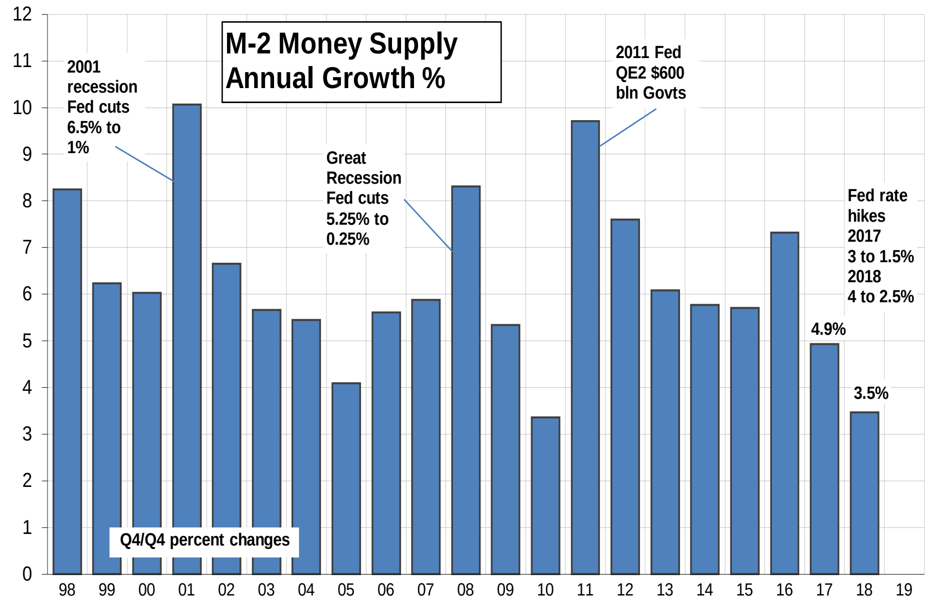
IS THE FED PROVIDING ENOUGH LIQUIDITY TO ALLOW THE ECONOMY TO RUN ON AND ON AND ON FOREVER?



The Fed is doing a pretty good job and "improving financial conditions" as Bernanke used to say. After the market meltdown in December Powell told a reporter that he got out a yellow legal pad (he is a lawyer) and sketched out a way to walk back the messaging from that final bridge-too-far rate hike in December. The stock market recovered. The Fed thinks stocks recovered because they jumped off the gradual rate hikes path. But what we want to know: is there enough liquidity out there to grease the wheels of the economy and keep it expanding into the cloud of history's record books. M-2 money supply growth rose 3.5% in 2018, the weakest since 2010. Are banks lending? The economic expansion will beat the ten-year record of the Clinton years in the 90s starting a couple of months from now in July. Is there enough liquidity to make that happen? Not the QE liquidity that pundits on TV and the president rail about. Is there enough M-2 growth? How much money is out there anyway? Another Fed survey is out saying many American's cannot come up with 400 dollars cash in an emergency, but someone has money. M-2 money supply was $14.556 trillion in the May 13 week reported on Thursday. Who the heck owns all that money?

M-2 Money Supply Definition
Currency
Demand deposits
Other checkable deposits
Savings deposits
Small denomination time deposits
Retail money market mutual funds

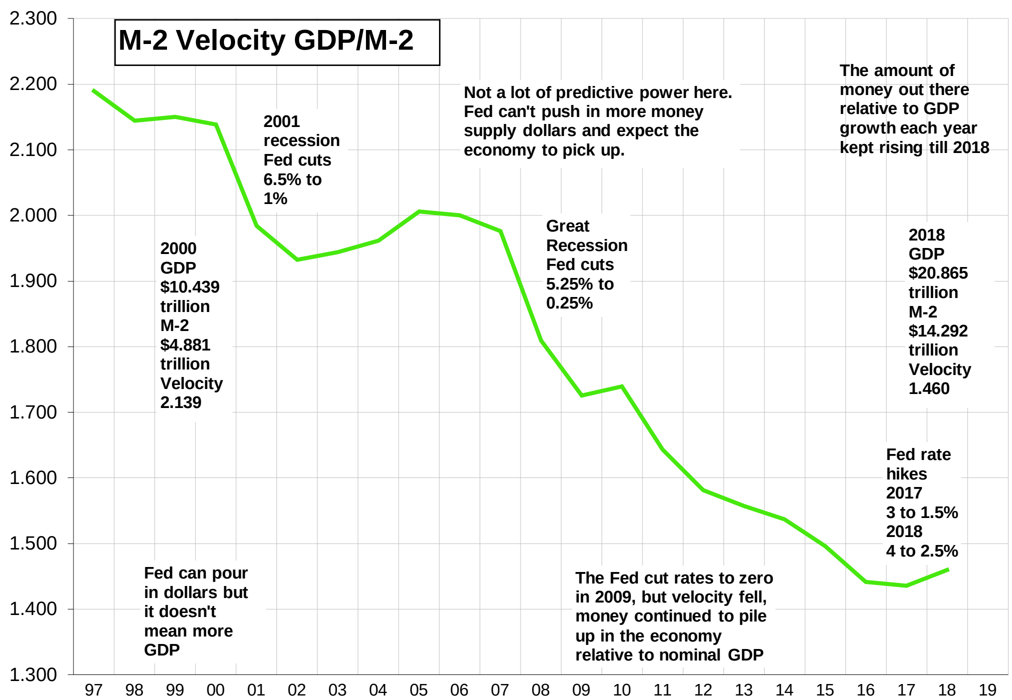
Money supply grows over time as there are more transactions as the economy grows. Nominal GDP rises then money supply rises. The level of interest rates plays a role as low interest rates means there is less of a reason to move cash out of the banking system to seek higher rates of return on securities elsewhere. M-2 piles up relative to nominal GDP and the ratio, GDP/M-2 equals velocity, declines. Velocity has declined when interest rates fell in the 2001 and 2007-09 recessions. It has continued to fall for other liquidity preference reasons, maybe the Fed's QE purchases increased the bank reserves that the textbooks say creates money. Recently velocity ticked up slightly in 2018 with the Fed raising interest rates. In 2018, nominal GDP increased $1.033 trillion and money supply increased $479.4 billion and velocity increased to 1.460 in 2018 from 1.436 in 2017.

Cut interest rates and you increase money supply which helps make the economy grow. Fed policy couldn't be simpler.

Money Supply (M-2) and its effect on the economy (MV=PT… money times velocity = GDP)

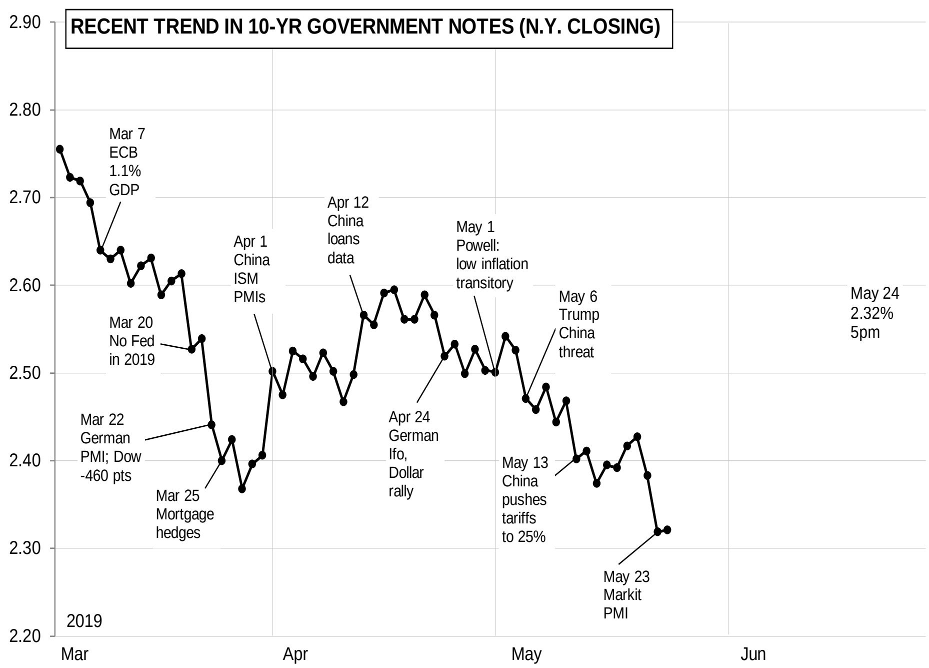
Q4/Q4 & Q4s Years	Annual Increases: Nominal GDP $ Amount	Annual Increases: Money Supply M2 $ Amount	Dec/Dec Interest Rate Chg (2-yr, bps)	2-Yr Yield % (Dec.)	Percent Change %: Nominal GDP	Percent Change %: Money Supply M2	Level Nominal GDP $ billions	Level Money Supply M2 $ billions	Ratio: Velocity GDP/M2
2018	1033.3	479.4	84	2.68	5.2	3.5	20865.1	14292.9	1.460
2017	852.6	648.9	64	1.84	4.5	4.9	19831.8	13813.5	1.436
2016	624.8	897.4	22	1.20	3.4	7.3	18979.2	13164.6	1.442
2015	515.9	662.4	34	0.98	2.9	5.7	18354.4	12267.2	1.496
2014	755.4	633.3	30	0.64	4.4	5.8	17838.5	11604.9	1.537
2013	724.2	629.1	8	0.34	4.4	6.1	17083.1	10971.6	1.557
2012	562.4	730.7	0	0.26	3.6	7.6	16,358.9	10342.5	1.582
2011	555.7	850.3	-36	0.26	3.6	9.7	15,796.5	9611.8	1.643
2010	612.8	284.3	-25	0.62	4.2	3.4	15,240.8	8761.5	1.740
2009	68.5	429.6	5	0.87	0.5	5.3	14,628.0	8477.2	1.726
2008	-122.0	617.6	-230	0.82	-0.8	8.3	14,559.5	8047.5	1.809
2007	644.3	412.4	-155	3.12	4.6	5.9	14,681.5	7430.0	1.976
2006	704.9	372.4	27	4.67	5.3	5.6	14,037.2	7,017.6	2.000
2005	809.9	260.9	139	4.40	6.5	4.1	13,332.3	6,645.1	2.006
2004	753.1	330.0	110	3.01	6.4	5.5	12,522.4	6,384.2	1.961
2003	697.8	324.7	7	1.91	6.3	5.7	11,769.3	6,054.3	1.944
2002	411.2	357.1	-127	1.84	3.9	6.6	11,071.5	5,729.6	1.932
2001	221.3	491.5	-224	3.11	2.1	10.1	10,660.3	5,372.5	1.984
2000	539.6	277.5	-75	5.35	5.5	6.0	10,439.0	4,881.0	2.139
1999	605.4	270.0	159	6.10	6.5	6.2	9,899.4	4,603.4	2.150

To conclude, money supply M-2 moves up over time with the growing economy. Low interest rates means money tends to increase relative to nominal GDP as higher yields outside banks are not as available. Velocity of money thus has fallen, but there are no major implications from this. There is more money out there relative to the size of the economy, but we cannot say that this means there will be more growth or more inflation in the future. It is interesting to note historically that the Federal Reserve's monetary policy used to target money supply growth and interest rates moved up and down based on the Fed's provision of net reserves into the banking system. They now move interest rates up and down, but the science behind setting interest rates at any given level is still lacking.



MARKETS OUTLOOK

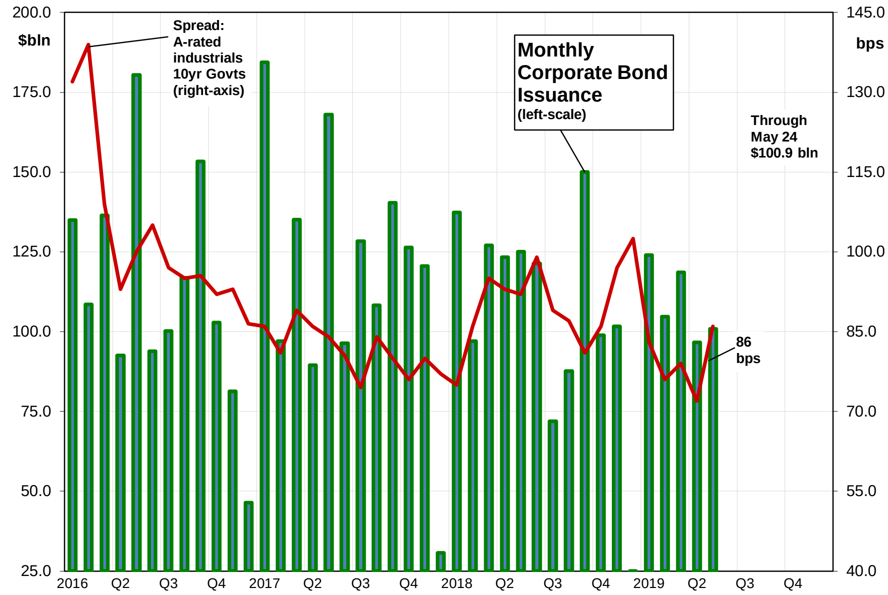
	29-Mar 2018	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.81	3.00	3.00	3.10	3.10	3.25	3.20	3.20
10-Yr Note	2.41	2.60	2.70	2.90	2.90	3.10	3.10	3.10
5-Yr Note	2.23	2.45	2.60	2.80	2.80	3.05	3.05	3.05
2-Yr Note	2.26	2.45	2.50	2.70	2.70	2.90	2.95	3.00
3-month Libor	2.60	2.60	2.60	2.90	2.90	3.10	3.10	3.10
Fed Funds Rate	2.50	2.50	2.50	2.75	2.75	3.00	3.00	3.00
2s/10s spread	15	15	20	20	20	20	15	10



A new low this year for 10-yr yields keeps the bond rally alive. The yield break of the prior 2.34% 2019 low back on March 28 occurred Thursday on, believe it or not, the Markit Purchasing Manager survey of manufacturers at 945am NY Time. Seriously, how many surveys can the bond market react to? Plenty we guess when it is switched to full-on rally mode. This is right about the time you hear from the longs that the Fed needs to cut interest rates because inflation is so low it's dangerous for the economy and for the country. The dollar sold off against the Euro on the same Markit PMI news. The low yield on 10-yr Treasury yields was 2.29% Thursday, psychological resistance is at 2.25%.

CORPORATES: SEMPRA ENERGY, FORD MOTOR, SCHWAB, DUKE ENERGY

Corporate offerings were $15.2 billion in the May 24 week versus $30.2 billion in the May 17 week. On Monday, Cargill sold $1.0 billion 10s/30s. It priced a $650 million 3.25% 10-yr (m-w +15bp) at 90 bps (A2/A). The agricultural products company will use the proceeds for a $500 million special dividend and a tender offer for common stock. Corporate bond yields (10-yr Industrials rated A2) were 86 bps above 10-yr Treasuries this week versus 82 bps last Friday.



FEDERAL RESERVE POLICY

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	22-May	15-May	8-May	1-May	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2114.569	2114.444	2124.129	2123.954	479.782
Federal agency debt securities	2.347	2.347	2.347	2.347	0.000
Mortgage-backed securities (MBS)	1564.428	1569.584	1575.433	1575.433	0.000
Primary credit (Discount Window)	0.001	0.022	0.030	0.000	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	0.017	0.050	0.055	0.055	62.000
Federal Reserve Assets	3908.5	3912.7	3940.2	3937.4	961.7
3-month Libor %	2.52	2.53	2.55	2.58	2.82
Factors draining reserves					
Currency in circulation	1734.927	1732.314	1733.109	1730.760	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	3.751	0.562	0.021	0.027	0.000
Reserve Balances (Net Liquidity)	1532.833	1516.418	1490.680	1460.010	24.964
Treasuries within 15 days	20.057	0.000	38.475	38.475	14.955
Treasuries 16 to 90 days	97.826	63.117	63.116	43.808	31.549
Treasuries 91 days to 1 year	251.024	255.980	255.978	275.285	69.272
Treasuries over 1-yr to 5 years	867.384	917.215	902.527	902.502	170.807
Treasuries over 5-yrs to 10 years	266.380	257.102	258.739	258.659	91.863
Treasuries over 10-years	611.899	621.030	605.292	605.225	101.337

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

The Fed meets June 18-19 to consider its monetary policy. The market is pushing harder for rate cuts. This week we discovered that some European Central Bank officials expressed concern at their April policy meeting that euro-area inflation remains too low and expectations of price growth are falling, after years of failing to reach their goal. Sorry, we meant to say that the release of the April 30-May 1 Fed meeting minutes on Wednesday this week said some Federal Reserve officials expressed concern that US inflation remains too low and expectations of price growth are falling, after years of failing to reach their goal. Maybe the Fed is talking to ECB officials too much. Either way, even if low inflation is a problem for their respective economies, there's nothing the ECB or the Fed can do about it. ECB has no rate-cuts bullets left, and Fed officials would be daft to cut interest rates from the low level of 2.5%. Market odds of one 25 bps rate cut to 2.25% by the December Fed meeting are 124% versus 118% last week.

Few say higher rates, several becoming unhinged

April 30 – May 1 Fed meeting minutes look like they add little to our understanding of what they might do next. They are on the sidelines and being patient and regard the decline in core PCE inflation to 1.6 percent to be transitory. Okay by us because core CPI inflation is steady as a rock at the Fed's 2 percent target.

Maybe it looks like nothing has changed. But dive beneath the surface and you can see several Fed members are increasingly becoming unhinged.

The minutes read:

Several participants commented that if inflation did not show signs of moving up over coming quarters, there was a risk that inflation expectations could become anchored at levels below those consistent with the Committee's symmetric 2 percent objective.

Uh oh. Coming quarters. How long will several members wait before cutting rates to produce greater inflation expectations? This whole focus on inflation being short of hitting 2 percent seems increasingly unhinged on the part of some Fed officials. The public has lost interest in inflation and cannot even tell you where it is today. It looks like Fed officials have done all they can to improve financial conditions and to aid and support the broader economy. They should not be teasing markets by saying rates could go up or down. Unemployment is 3.6 percent. Earth to Fed. You've hit the target already. Quit scaring people that there are increasing deflation risks just because you cannot get PCE inflation to 2 percent.

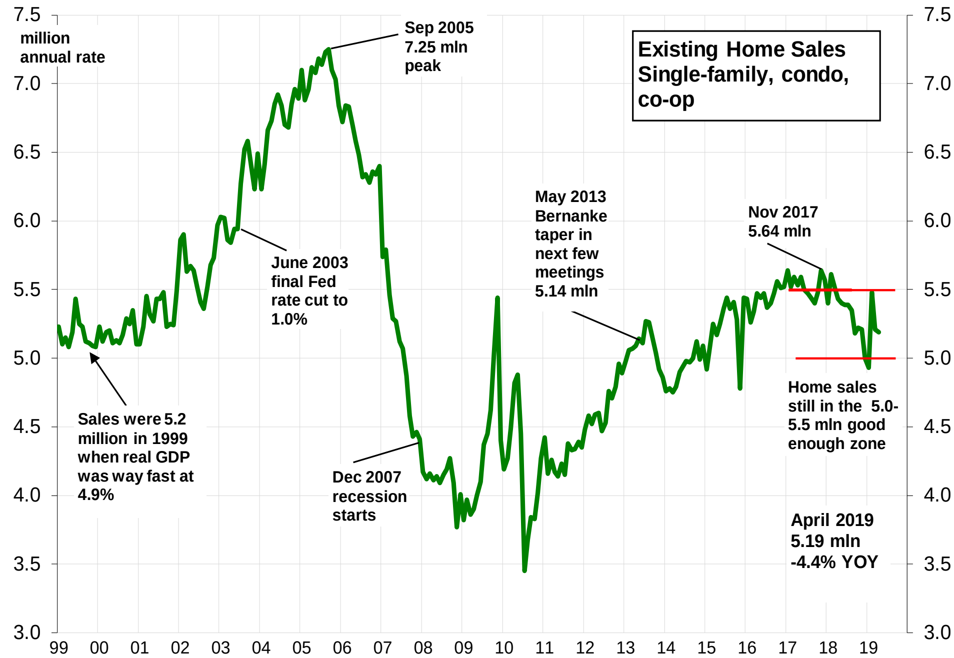
We hope we are wrong but it looks like the doves are gaining an upper hand in these deliberations and Fed Chair Powell may well have a revolt on his hands if inflation doesn't pick up in coming quarters. Rate cuts. If you are on Wall Street in fixed income your days are numbered if Fed officials take the nuclear option and push rates down across the curve. USA USA USA. Japan and Europe here we come. Doomed.

OTHER ECONOMIC NEWS THIS WEEK

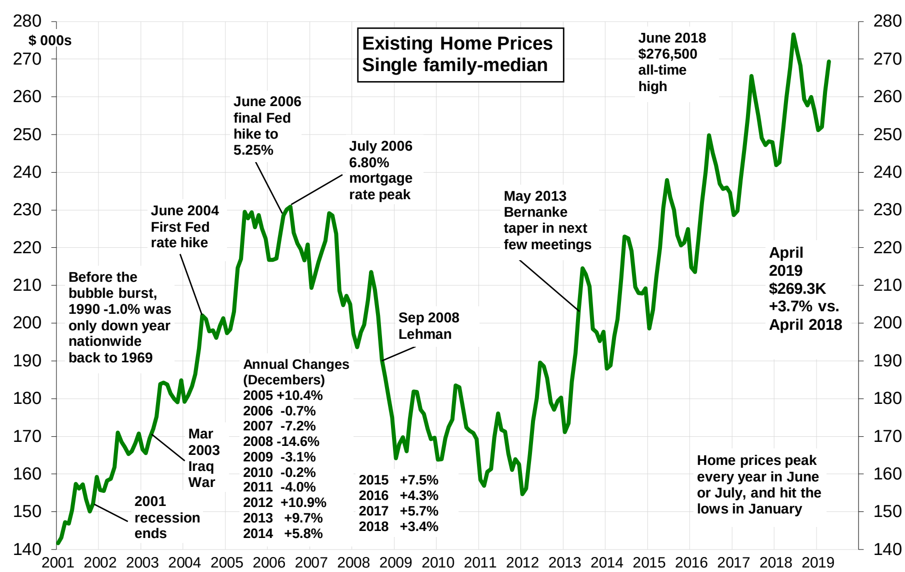
Existing home sales steady after interest rate shock fades (Tuesday)

Breaking economy news. Existing home sales were steady in April at a 5.19 million annual rate of turnover which is down just 0.4% from March. Home buyers were flipping homes like flap-jacks back in the housing bubble over a decade ago with over 7 million homes per year changing hands. Those days are probably not coming back any time soon, but home sales are running at an acceptable pace to sustain economic growth powered with the added consumer purchases of appliances and furnishings that go into a new home. Risk-adverse consumers may have shied away from making home purchases late last year during the financial market turbulence, with the absolute 4.93 million low in January being made during the Federal government shutdown. The veil of uncertainty over the economic outlook has lifted and home buyers have returned to the housing markets.

Home prices keep on rising which is likely to drive sales in the future as well before homes get even more expensive. Single-family home prices were $269.3 thousand in April which is an increase of 3.7% from year earlier levels. Home prices nationwide have risen steadily each year from 2012 to 2018 and show no sign of stopping despite the escalation of trade tensions between the US and China.

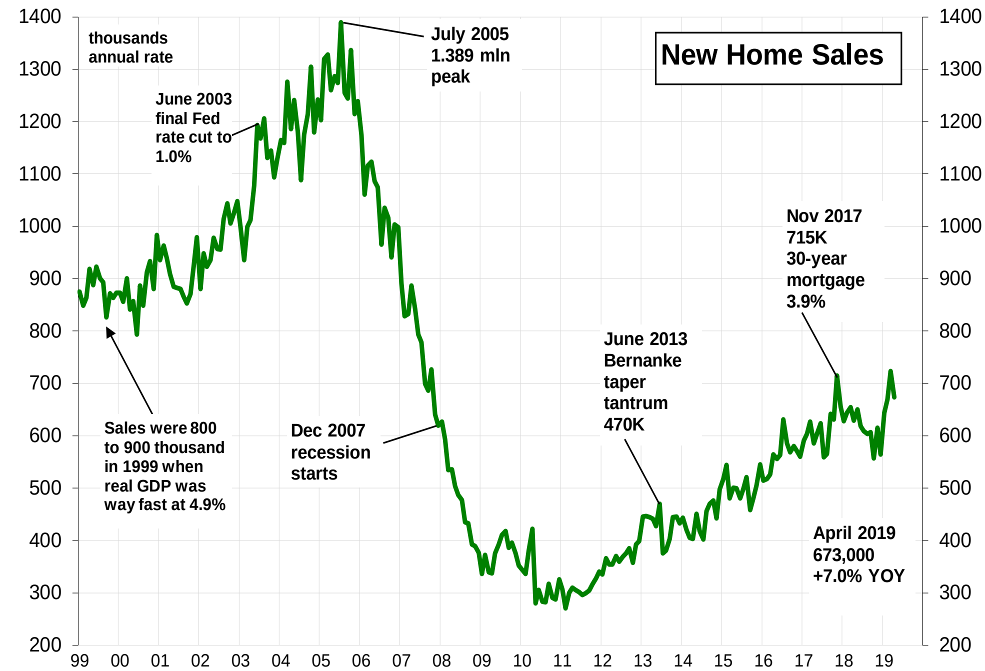


Net, net, home buyers have returned to the markets after the wild swings in mortgage rates last year that may have sent them to the sidelines. Mortgage rates were closing in on 5% before Thanksgiving and are now back down at more affordable levels of 4.06% last week. The Tax Cuts and Jobs Act threatens higher-priced markets with fewer deductions for state & local taxes, but existing home sales turnover remains at a steady overall pace.



America looks solid as a rock as markets and global growth burns (Thursday)

Breaking economy news. Jobless claims and new home sales. No recession, no collusion, with initial jobless claims at 211K in the May 18 week. The labor market remains tight as a drum which will give Fed officials greater confidence that the current low inflation trend is just in a transitory soft patch. The concerns of some Fed officials about inflation being less than target looks misplaced when considering the public is most familiar with CPI inflation, where core CPI inflation is running 2.1%, and the American public has little knowledge of the Fed's preferred measure of inflation, the personal consumption expenditures (PCE) deflator, where core PCE inflation is running 1.6% (just missed 1.5%, 3 decimals is 1.553).



Bond yields keep falling and the stock market is down today on trade jitters, but companies continue to hold on tight to their workers with the economy at full employment. The break-up of the China-US trade talks has not created enough uncertainty yet to lead employers to trim their headcounts. Payroll employment has risen 1.8% over the last year and this strong jobs trend will serve to keep economic growth on track at over 2% in 2019 despite the long expansion that is close to setting records for longevity.

New home sales tumbled 6.9% to 673 thousand in April from 723 thousand in March. The data were revised back to 2014 in today's report. The 723 thousand level of sales in March 2019 is the best since the housing bubble burst over a decade ago. Sales were down everywhere in April except for the Northeast where just 4% of new home sales are recorded in the country. It was a soggy start to the spring selling season perhaps, with cooler than seasonal temperatures, but we expect the sales pace to pick up this summer as it is supported by low 4% mortgage rates.

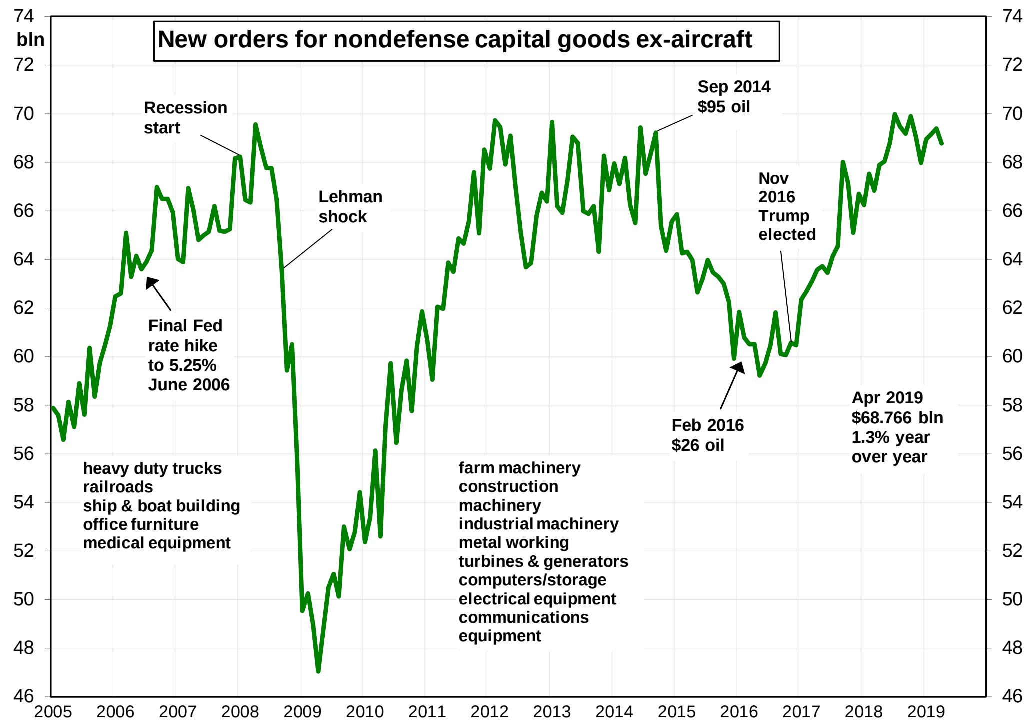
New home sales are more real-time data than existing home sales released Tuesday, as new home sales are recorded when the sales contract is signed rather than the lagged data on existing home sales which are recorded at closing with the sales taking place a month or two earlier.

Net, net, the American economy continues to chug along with no uncertainty or hesitation seen in the real economy despite the trade war fears that are causing turbulence in the financial markets. Main Street is okay for the moment, and the US can go its own way despite slower world growth as internal domestic demand looks solid as a rock.

Oops, purchasing managers were right, business investment pivots (Friday)

Breaking economy news. No one is in New York City working today judging by the empty seats on our early morning, high-achiever train from the suburbs. Happy Memorial Day weekend. Corporations have decided to pull the plug on new business investment in April even before the stock market sell-off from the president's tweets/threats on Sunday, May 5 to raise tariffs on the $200 billion of China imports from 10% to 25%.

Durable goods orders/shipments for April are out. Our proxy for business capital spending goes by the long handle of nondefense capital goods orders ex-aircraft and these orders after having reached the tippy-top summit last month, reaching the highest level of new orders since the Great Recession, now this month, the March gain of 1.4% was revised down to a 0.3% increase, and orders in April fell 0.9%. We were wondering as industrial production has been falling while equipment orders were rising this year, but now orders are off along with manufacturing production. The revisions go way back, but the level of nondefense capital goods orders is a full 1.7 percent lower than the last report we had on business capital spending. Don't ask for whom the bell tolls, it tolls for thee.



Net, net, business investment in the future is sputtering at the start of the second quarter as uncertainty and geopolitical risks are a heavy anchor that appears to be a big drag on companies' willingness to order up new equipment. Business confidence is clearly lacking in the manufacturing sector of the economy. Maybe CFOs truly believe like the surveys say that there are increased odds of economic recession this year so they have canceled their new orders in March and are ordering less new equipment in April.

Primary metals down 0.8%, computers and electronic products down 0.4%, communications equipment -5.5% which look to be especially trade war related.

There are no green shoots in today's report of caution from some of the biggest companies in America that are scaling back their investment in the economy. We can't sugar-coat today's news. Business investment is absolutely critical for the economy to move forward and investment is normally the swing factor that pumps up growth or pulls out the support from the economy and makes a recession a recession with negative growth. Stay tuned. Story developing.

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