Financial Market Weekly

Abbreviated format this week.

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The Bank of Tokyo-Mitsubishi UFJ, Ltd.
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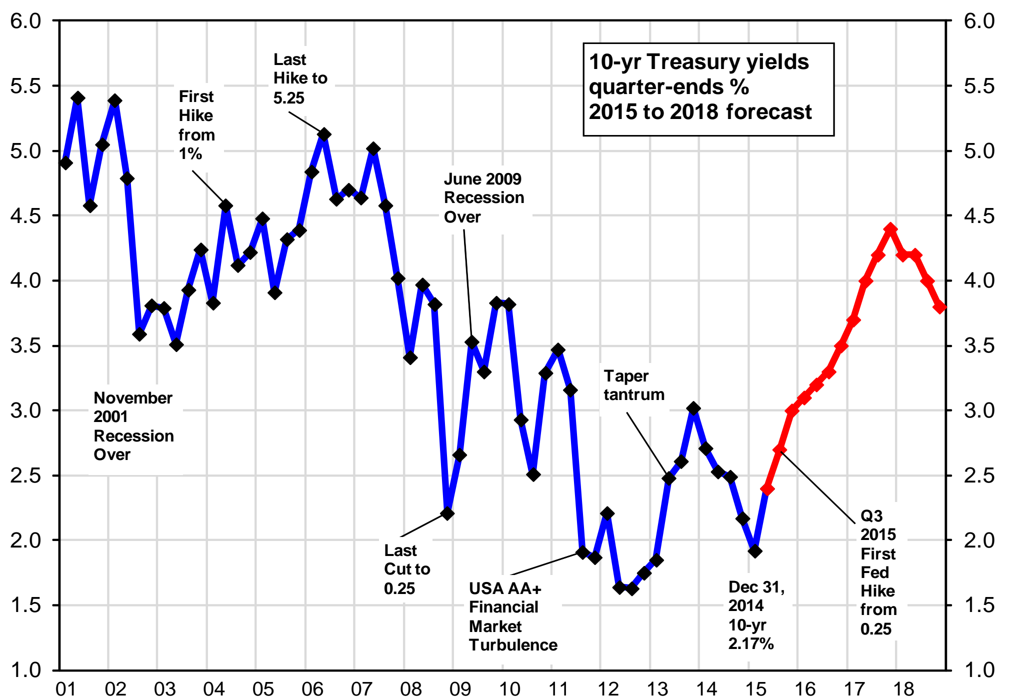
MIDYEAR OUTLOOK FOR U.S. ECONOMY



There was news out over the weekend that the Euro Area is very strong despite the breakdown of talks between Greece and its creditors. What about the outlook for the U.S. economy as we head into the second half of the year?

The economy will reach its seventh year of expansion from the end of the recession next month in July. We expect the laws of economics have not been repealed and that long term Treasury yields will rise in the next couple of years as economic growth continues and credit demand naturally builds. Fed rate hikes, the first expected in September 2015 (Q3 2015) will provide the backbone for higher bond yields. Additionally, the yield spread from Treasuries to inflation had gotten too tight, and we expect these spreads to move back out towards historical norms. Specifically, we look for 10-yr Treasury yields to move above 4% by the end of 2017; the peak for 10-yr yields in the housing bubble years prior to the Great Recession was 5.11% in June 2006 (monthly average). The table on our interest rate outlook through 2018 is at the end of this report.

GDP	2014a	2015	2016	2017
MUFG	2.4	2.2	2.8	2.6
FOMC	2.4	1.9	2.6	2.3
IMF	2.4	3.1	2.8	---
	Q4/Q4 annual percent % changes			
	Yellen: "It's just a forecast, we could be right,			
	or we could turn out to be wrong."			

The GDP economy is slower and the hopes for a faster 3%-plus growth rate have been scuttled, 2%-best now, but the outcome for the labor markets has been better than expected. It did not take a 3% economy to put America back to work, bring down the unemployment rate, 2%-plus was sufficient.

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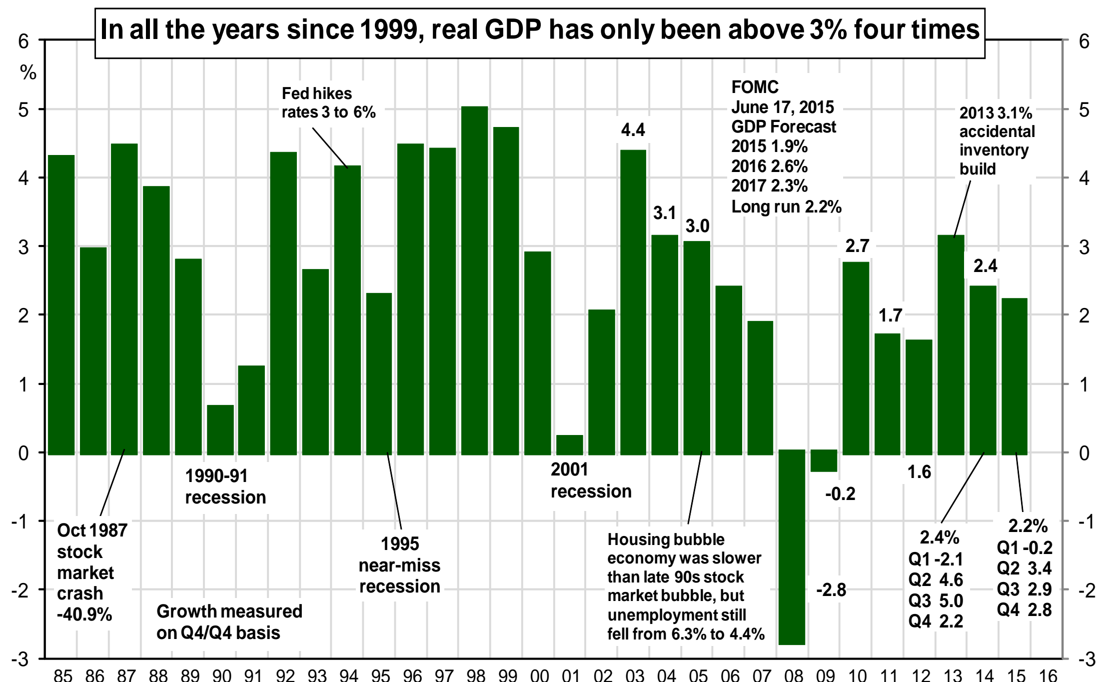
Current labor market conditions are the best in three decades.



We look for real GDP growth of 2.2% in 2015, after accounting for the 0.2% decline in the first quarter due to the weather. Not as bad as the 2.1% drop last year in Q1 2014. The Fed midpoint of the central tendency range of forecasts is 1.9% in 2015, they look for less of a bounce back than we do perhaps, later this year. The IMF sees faster 3.1% growth in 2015, with their April forecast perhaps being made before the weak Q1 start to the year was published. However, their January estimate for 2015 was even higher at 3.4% as they thought falling gasoline prices would boost GDP more than other economists did. Falling crude oil prices from $100 last fall subtracted more from business spending on structures (mining/drilling construction) and perhaps capital goods orders: a drag which wasn't fully factored into anyone's initial forecasts at the start of the year.

	Quarterly changes at an annual rate % for GDP and Consumer spending								
	Q4 13a	Q1 14a	Q2 14a	Q3 14a	Q4 14a	Q1 15a	Q2 15e	Q3 15e	Q4 15e
Real GDP	3.5	-2.1	4.6	5.0	2.2	-0.2	3.4	2.9	2.8
Consumer spending	3.7	1.2	2.5	3.2	4.4	2.1	3.2	2.9	3.0
Unemployment rate	6.7	6.6	6.1	5.9	5.6	5.5	5.3	5.1	4.9
Core PCE Inflation YOY	1.3	1.3	1.5	1.5	1.3	1.4	1.3	1.5	1.7
CPI Inflation (YOY %)	1.5	1.5	2.0	1.6	0.7	0.0	0.1	0.6	2.2

Unemployment rate and inflation are the final month of each quarter. YOY is year-to-year % change

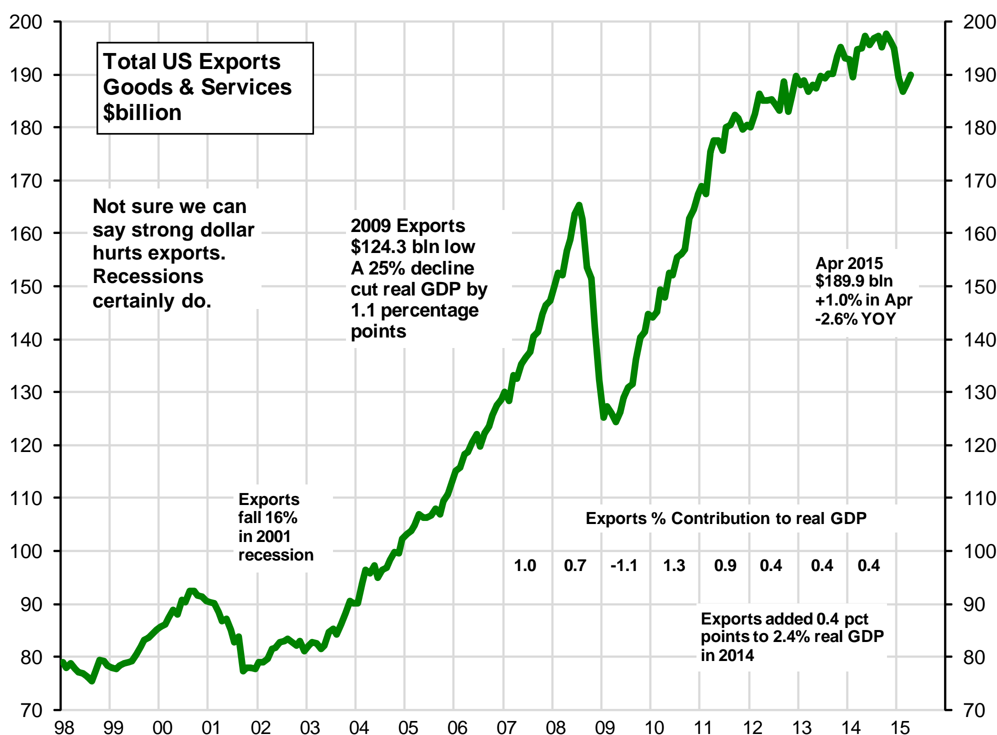
What are the drivers of growth? The consumer, as always. Two-thirds of GDP. It isn't a good idea to paint a picture of economic weakness when consumer spending continues to be moderate. Real GDP was -0.2% in Q1 2015, but real consumption expenditures are fairly normal at 2.1% in the first quarter. Consumer confidence is very high according to the Michigan survey of sentiment.

What are the headwinds, or better, what factors used to be a push forward and now are not there? Don't like big government? Well, real State & local government expenditures are not adding what they used to. In the late 90s with its fast, mid-4% real GDP growth, real government spending was 0.4 or 0.5 percentage points back then, not for nothing, and today it is adding zero. More headwinds from the strong dollar trend, a move which seems to have run its course for now. U.S. exports of goods had added 0.3 or 0.4 percentage points to GDP in 2012, 2013, and in 2014. In Q1 2015 however, the contribution was a drag at -1.1 percentage points helping to make that -0.2% real GDP number what it was. Finally, business spending on structures subtracted 0.6 percentage points from growth in Q1 2015, but this is the mining/drilling collapse which seems to have hit bottom looking at rig count data. Most of the headwinds look manageable, if anyone down in Washington is actually at the helm steering us, and are unlikely to delay the economy's return to full employment.

	Q1 14	Q2 14	Q3 14	Q4 14	Q1 15f
REAL GDP	-2.1	4.6	5.0	2.2	-0.2
CONSUMPTION	0.8	1.8	2.2	3.0	1.4
Durables	0.2	1.0	0.7	0.5	0.1
Nondurables	0.0	0.3	0.4	0.6	0.1
Services	0.6	0.4	1.2	1.9	1.2
INVESTMENT	-1.1	2.9	1.2	0.6	0.4
Business Plant	0.1	0.4	0.1	0.2	-0.6
& Equipment and	-0.1	0.6	0.6	0.0	0.2
Intellectual Property	0.2	0.2	0.3	0.4	0.2
Homes	-0.2	0.3	0.1	0.1	0.2
Inventories	-1.2	1.4	0.0	-0.1	0.5
EXPORTS	-1.3	1.4	0.6	0.6	-0.8
IMPORTS	-0.4	-1.8	0.2	-1.6	-1.1
GOVERNMENT	-0.2	0.3	0.8	-0.4	-0.1
Federal defense	-0.2	0.0	0.7	-0.6	-0.1
Fed nondefense	0.2	-0.1	0.0	0.0	0.1
State and local	-0.1	0.4	0.1	0.2	-0.1

Percentage point contributions to Q1 15 -0.2% real GDP

In conclusion, real GDP growth should quicken this year from the negative growth pothole on the road to recovery in the first quarter. We blame the weather for that. We look for 3.4% growth in the second quarter in the report out on Thursday, July 30. We really cannot call the economy on the road to recovery as the seventh year for steady positive economic growth begins on July 1. This is no longer a recovery: there is steady growth. The economy is very near full employment, the unemployment rate has come down about as far as it can without generating inflation pressures—inflation pressures that could prompt a too aggressive Federal Reserve response that brings the economy back down. All recessions in modern economic history have been caused by the Fed over-tightening its policy. Not their fault completely because its interest rate tool is not that precise of a means to steer the economy with. But at the moment, they need to get going as they don't have a rudder to steer the economy with at all with neutral, normal interest rates hundreds of basis points away. They say and we believe them that they cannot wait for inflation before raising rates. The whole theory is that inflation will build over time with rates at too low levels once the economy is at full employment. There do not need to be signs of inflation on the horizon right now for them to move. The economy does not slow until and unless they raise rates above 3.75% neutral. And the fact they don't see the need to push it there before the end of 2018 looks like a problem.



Rates Forecast through 2018

	26-Jun 2015	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016	Q4 2016
30-Yr Bond	3.24	3.30	3.50	3.60	3.60	3.70	3.90
10-Yr Note	2.47	2.70	3.00	3.10	3.20	3.30	3.50
5-Yr Note	1.75	2.10	2.50	2.60	2.80	2.90	3.10
2-Yr Note	0.71	1.30	1.70	1.90	2.10	2.40	2.60
3-month Libor	0.29	0.60	0.85	1.10	1.35	1.85	2.35
Federal Fund Rate	0.25	0.50	0.75	1.00	1.25	1.75	2.25
2s/10s spread	176	140	130	120	110	90	90

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	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
30-Yr Bond	4.00	4.30	4.40	4.60	4.40	4.30	4.10	3.90
10-Yr Note	3.70	4.00	4.20	4.40	4.20	4.20	4.00	3.80
5-Yr Note	3.40	3.70	4.00	4.20	4.00	4.10	3.90	3.70
2-Yr Note	2.85	3.10	3.50	3.90	3.90	4.10	4.10	4.00
3-month Libor	2.60	2.85	3.35	3.85	3.85	4.10	4.35	4.60
Federal Fund Rate	2.50	2.75	3.25	3.75	3.75	4.00	4.25	4.50
2s/10s spread	85	90	70	50	30	10	(10)	(20)

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