Financial Market Weekly

Abbreviated format this week.

CHRISTOPHER S. RUPKEY, CFA
MANAGING DIRECTOR
CHIEF FINANCIAL ECONOMIST
ECONOMIC RESEARCH OFFICE (NEW YORK)
(212) 782-5702
crupkey@us.mufg.jp

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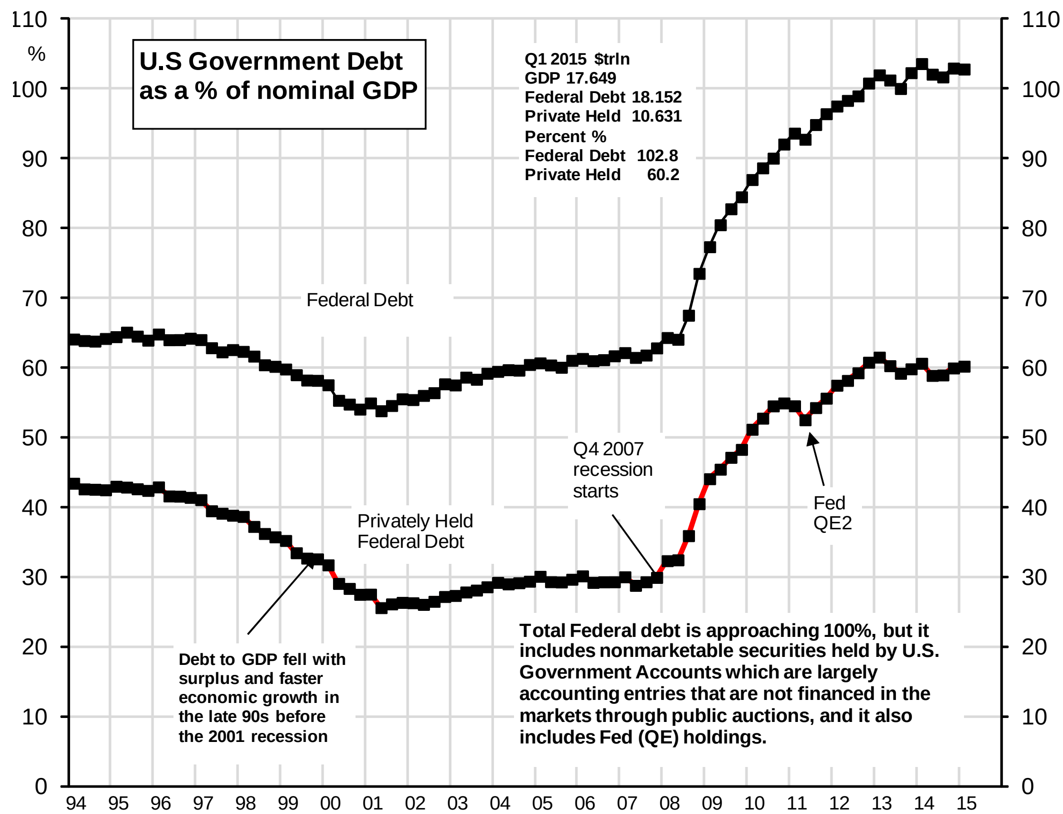
SOCIAL SECURITY BENEFITS: COULD YOU INVEST THE MONEY BETTER YOURSELF?



The presidential election cycle is back in full swing. The country's national debt remains high at 100% of nominal GDP spending in the economy. There will be a renewed focus on entitlement spending in the U.S., and whether the aging baby boomers' retirements will bankrupt the nation. The baby boom generation is the surge in the birth rate to 4 million annually after World War II -- those born from 1946 to 1964. Some politicians want to cut the baby boomers retirement benefits. Other politicians argue the payments should be boosted as they are not enough to keep seniors' living standards above the poverty line. It is important to note in this debate that this is not a long run problem for economy as the baby boom generation will not always be here of course. We would be cautious in letting Washington Inc. try to fix these entitlements, or at least it would be better to wait until the full costs of social security are better understood. The economy's growth rate 10 to 15 years from now cannot be known with much certainty, so estimates of tax collections won't be accurate. Still, D-Day is coming closer. Around the year 2030 the last of a twenty year wave of boomers will have reached retirement age at 65 years old. A couple of things could be done to pay for the costs of providing social security benefits to these retired folks when the crunch time comes.

One, the Federal government could borrow in the credit markets if tax-based revenues are not enough. The Federal budget deficit is less than 3% of GDP currently, and deficit spending could be pushed back out to 10 percent of GDP temporarily like it was for a time in the recent recession and financial crisis with its three years of trillion dollar deficits. Second, taxes could be raised temporarily. President Johnson asked Congress for a temporary 6% surcharge on personal and corporate income taxes in 1967 to help pay for the Vietnam War. Congress just cut payroll taxes 2 percentage points in 2011 and 2012, and raised it back by 2 percentage points in 2013 without harming the economy.

Periodically, there are proposals to privatize social security without realizing the investment monies of all workers would run out of places to invest the funds. Nevertheless, this always leads to an intriguing question on whether you would be better off investing the money, withheld by the Federal government to pay for your retirement, by yourself.

45 YEARS OF SOCIAL SECURITY CONTRIBUTIONS						
WHAT IF YOU INVESTED IT YOURSELF?						
(1)	(2)	(3)	(4)	(5)	(6)	(7)
					Matched	Matched
Years		SS	OASI	Your	Future	Future
On the		Earnings	Tax	Contri-	Value	Value
Job	Year	Base $	Rate %	bution	at 5%	at 10%
1	1970	7,800	3.65	285	5116	41504
2	1971	7,800	4.05	316	5406	41866
3	1972	9,000	4.05	365	5941	43915
4	1973	10,800	4.3	464	7209	50865
5	1974	13,200	4.375	578	8538	57502
6	1975	14,100	4.375	617	8686	55839
7	1976	15,300	4.375	669	8976	55083
8	1977	16,500	4.375	722	9219	54003
9	1978	17,700	4.275	757	9203	51460
10	1979	22,900	4.33	992	11486	61304
11	1980	25,900	4.52	1171	12915	65798
12	1981	29,700	4.7	1396	14666	71324
13	1982	32,400	4.575	1482	14832	68853
14	1983	35,700	4.575	1633	15565	68969
15	1984	37,800	5.2	1966	17840	75457
16	1985	39,600	5.2	2059	17799	71864
17	1986	42,000	5.2	2184	17979	69290
18	1987	43,800	5.2	2278	17857	65691
19	1988	45,000	5.53	2489	18581	65248
20	1989	48,000	5.53	2654	18876	63271
21	1990	51,300	5.6	2873	19457	62252
22	1991	53,400	5.6	2990	19289	58909
23	1992	55,500	5.6	3108	19093	55660
24	1993	57,600	5.6	3226	18871	52515
25	1994	60,600	5.26	3188	17761	47177
26	1995	61,200	5.26	3219	17083	43313
27	1996	62,700	5.26	3298	16668	40341
28	1997	65,400	5.35	3499	16841	38907
29	1998	68,400	5.35	3659	16775	36993
30	1999	72,600	5.35	3884	16957	35695
31	2000	76,200	5.3	4039	16792	33740
32	2001	80,400	5.3	4261	16874	32364
33	2002	84,900	5.3	4500	16970	31068
34	2003	87,000	5.3	4611	16561	28943
35	2004	87,900	5.3	4659	15936	26584
36	2005	90,000	5.3	4770	15540	24744
37	2006	94,200	5.3	4993	15490	23545
38	2007	97,500	5.3	5168	15270	22154
39	2008	102,000	5.3	5406	15214	21070
40	2009	106,800	5.3	5660	15171	20055
41	2010	106,800	5.3	5660	14449	18232
42	2011	106,800	5.3	5660	13761	16575
43	2012	110,100	5.3	5835	13510	15534
44	2013	113,700	5.3	6026	13288	14583
45	2014	117,000	5.3	$6,201	$13,022	$13,642
46	2015		Total	$135,468	$653,331	$2,013,698

Your contribution to social security (OASI old-age survivors insurance) is 5.3% up to a maximum earnings base level of $117,000 in 2014, or $6,201 is withheld from your paycheck. Assume you worked for 45 years starting in 1970; your total contributions were $135,468. Your employer matched this amount, so you have over $270K set aside in a cookie jar to retire on. If you invested the money over the years and earned 5%, you had $653,331 in 2015 including you and your employer contributions. If you averaged investment returns of 10%, you would have $2 million to retire on. But most people do not earn the maximum earnings base level of income and we don't know any investor who made 10% each year for 45 years. It is hard to beat what social security will pay you at retirement: they pay for the rest of your life, and the yearly benefits increase with inflation. If you had $653K at retirement and withdrew 4% per year to live on, you would not run out of money in a hurry, but you would have to live on $26K income your first year and be living on $10K at age 87. Much less when accounting for inflation. According to the Social Security Quick Calculator, your annual benefit this year is $26K retiring today, born in 1950, and earning $117,000 in 2014. Basically, you cannot beat what Uncle Sam is prepared to pay you at retirement.

FEDERAL RESERVE POLICY

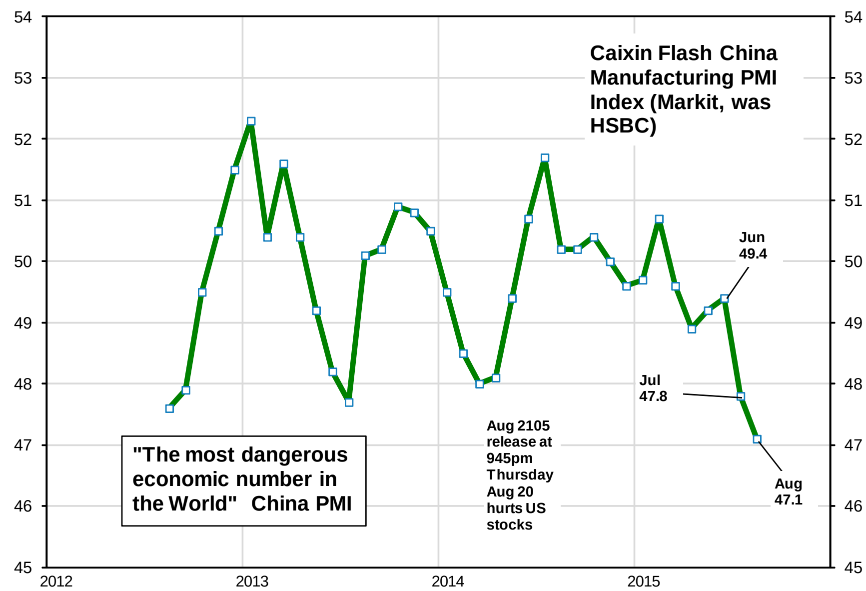
Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	19-Aug	12-Aug	5-Aug	29-Jul	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2461.785	2461.694	2461.603	2461.502	479.782
Federal agency debt securities	35.093	35.093	35.093	35.093	0.000
Mortgage-backed securities	1748.075	1734.884	1734.861	1734.834	0.000
Primary credit (Discount Window)	0.088	0.025	0.003	0.008	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)	1.701	1.702	1.702	1.701	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	0.000
Central bank liquidity swaps	0.132	0.229	0.308	0.359	62.000
Federal Reserve Assets	4532.1	4533.9	4531.1	4530.3	961.7
3-month Libor %	0.33	0.31	0.31	0.30	2.82
Factors draining reserves					
Currency in circulation	1376.384	1376.776	1375.066	1372.718	834.477
Term Deposit Facility	123.262	66.066	0.000	0.000	0.000
Treasury supplemental bill auctions	0.000	0.000	0.000	0.000	0.000
Reserve Balances (Net Liquidity)	2553.587	2555.790	2624.012	2632.830	24.964
Treasuries within 15 days	0.000	1.287	1.287	0.001	14.955
Treasuries 16 to 90 days	0.327	0.002	0.002	1.288	31.549
Treasuries 91 days to 1 year	159.980	153.952	153.949	146.753	69.272
Treasuries over 1-yr to 5 years	1137.997	1098.292	1098.278	1099.429	170.807
Treasuries over 5-yrs to 10 years	525.548	563.327	563.314	569.324	91.863
Treasuries over 10-years	637.933	644.835	644.775	644.707	101.337

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

The Fed meets September 16-17 to consider its monetary policy. It sounds like they are inching their way to a decision to raise rates on September 17. That would be our call. At the July meeting, they made a small but important change to the forward-guidance paragraph, inserting the word, "some," as in they were waiting for "some" more confirmation, additional data, that the labor market was closer to full employment. Why bother inserting the word "some" if you were not all but certain you were going to liftoff at the next meeting? Give the markets a heads up, like the signal in 2004. But the Fed has spoofed the markets before, saying they would go at such and such a time and then end up extending and delaying liftoff. The economy is normal and the Fed funds rate is supposed to be normal, i.e. 3.75% neutral, when the economy is at full employment. Yet here we sit waiting still for the first move. The recession ended in June 2009. Former FOMC members must wonder what on earth the Fed's current policymakers are doing.

Date	Forward Guidance or Fed Low-Rates Pledges
Dec 2008	"for some time"
Mar 2009	"for an extended period"
Aug 2011	"at least through mid-2013"
Jan 2012	"at least through late 2014"
Sep 2012	"at least through mid-2015"
Dec 2012	as long as unemployment above 6.5%
July 2015	until it has seen some further improvement in the labor market and reasonably confident inflation moves back to 2% over the medium term

*"The Committee anticipates that it will be appropriate to raise the target range for the federal funds rate when it has seen **some** further improvement in the labor market and is reasonably confident that inflation will move back to its 2 percent objective over the medium term." July meeting minutes inserts the word "some"*

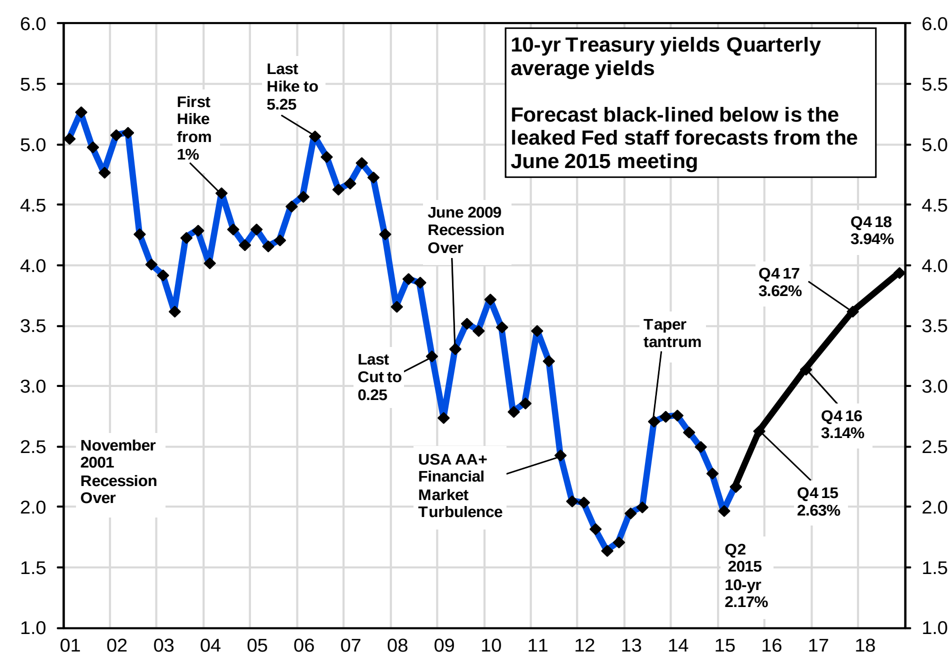


The stock market has entered into the Fed's decision-making process. An unwelcome development. We cannot recall a time that monetary policy was tightened, or in the current context made less easy, when stocks were down as much as they are. Friday's decline was news headline dramatic with the Dow industrials down 530 points or 3.1%. We hope the catalyst for the global sell-off in stock markets was not really the Caixin Flash China General Manufacturing Purchasing Managers' Index (Markit) released 945PM EDT Thursday night: 47.1 in August versus 47.8 in July, the lowest since 2009. Hopefully, the FOMC will remain objective and its policy centered on the U.S. labor market- Dow industrials on Friday are down 7.6% and the S&P 500 down 4.2% year-to-date. Not a big enough decline yet to call this true "financial market turmoil" on the order of 2011 that could worry consumers and businesses and slow economic growth. At any rate there are about four more weeks to go before the Fed's decision and markets can always change.

FOMC MINUTES FROM THE JULY 28-29 MEETING

Bond yields are in a declining trend and the market is focused on the recent China devaluations and looking for additional signs that China growth will slow further and worsen the deflation picture with less China demand for commodities. Crude oil futures broke $40 on Friday, trading at $39.86, but closing at $40.45. Many economists are still looking for a September meeting Fed liftoff, so the market wanted to take a look at the July Fed meeting minutes that were to be released Wednesday, August 19 at 2pm EDT. The market reaction was complicated due to the early mistaken release of the minutes by Bloomberg News about 25 minutes early. The market seemed to sell-off slightly on the initial errant headline, but then rallied strongly for not completely explainable reasons. Perhaps the minutes did not provide the Green Light the market was looking for, or maybe it was simply the short-covering of some large positions. In any case, December 2015 Eurodollar futures rallied strongly that day, and after closing the week at 0.475% on Friday, they are not prepared for a September rate hike. Three-month Libor was 0.33% on Friday, so Eurodollar futures (14.5 bps away) are not doing a very good job at discounting a December 25 bps liftoff either. Like our earlier comment on the Fed and stocks, we also cannot remember a time that the Fed hiked rates when the market had not partially discounted a move, and December Eurodollar futures say maybe go in December, and don't go at all in September.

It is possible the market took a September hike completely off the table with the news headlines of the July Fed meeting minutes. It stepped over a discussion saying the economy is "reaching that point" for liftoff, focusing instead on China risks and maybe some mentioning of the weak trend in investment. We aren't sure how China became so important for the Fed. The word "China" is mentioned six times in the meeting minutes. Ironically, the first mention was in the discussion of foreign economies saying "second-quarter economic growth was strong in China…" Not strong enough for the bond market who wants to see more purchases of bags of cement and barrels of crude oil, greater demand for commodities from China. The next three mentions were in the staff review of financial market conditions, mentioning how weak China stocks had not spread to the rest of the world and had little impact on U.S. financial institutions. China mention #5 was among the comments from Fed contacts, sources who viewed the recent slowdown in manufacturing as being temporary although "the possibility of adverse spillovers from slower economic growth in China raised some concerns." Finally, China mention #6 was from Fed officials where "several participants noted that a material slowdown in Chinese economic activity could pose risks to the U.S. economic outlook."



“Committee Policy Action” Section of Fed meeting minutes

Ten Voting "Members"
Yellen, Chair
Dudley, New York
Brainard, Governor
Evans, Chicago
Fischer, Vice Chairman
Lacker, Richmond
Lockhart, Atlanta
Powell, Governor
Tarullo, Governor
Williams, San Francisco

This policy discussion section of the minutes comes at the end before the 10 voting members give a thumbs up, or thumbs down. There were no dissents at this meeting of course although it looks like Richmond Fed President Lacker wanted to hike rates (no surprise), but would wait for “additional data.” This could mean the “some” further improvement. This section details the thinking of the ten voting members as opposed to the 17 participants, the 5 Governors (normally 7) and all 12 reserve district presidents. The members themselves look a little more split which could delay the liftoff beyond September despite the insertion of the word “some” in there. Many members out of ten voters thought labor market slack would be gone shortly if the economy goes the way they thought it would. However, several (4 out of 10?) thought it would take longer to achieve, the goal of true “full employment,” citing things like weakness in wages. This could mean 4 out of 10 are not in favor of going in September. Not exactly sure what four members these would be, Chicago Fed President Evans certainly, probably Fed Governors Brainard and Tarullo as well. We aren’t sure the minutes would characterize Yellen’s view, which is dovish certainly, but we can’t be sure Fed Governor Powell is that dovish as he seems ready to vote “Yes” once the data tell him to, the data meaning the unemployment rate. None of the other voters, Dudley, Fischer, Lacker, Lockhart, Williams, seem in favor of delaying liftoff much longer. We think all of them would vote September.

Committee Policy Action excerpt
“In assessing whether economic conditions had improved sufficiently to initiate a firming in the stance of monetary policy, the Committee noted that, on balance, a range of labor market indicators suggested that underutilization of labor resources had diminished further. Most members saw room for some additional progress in reducing labor market slack, although several viewed current labor market conditions as at or very close to those consistent with maximum employment. Many members thought that labor market underutilization would be largely eliminated in the near term if economic activity evolved as they expected. However, several were concerned that labor market conditions consistent with maximum employment could take longer to achieve, noting, for example, the lack of convincing signs of accelerating wages, which might be signaling that the natural rate of unemployment could currently be lower than they previously thought.”

This is a hard meeting to call and the Fed has tended to delay liftoff repeatedly. The decision may depend on the final Friday, September 4 employment report to convince the doves that there has indeed been “some” further improvement in the labor market. Certainly another 200K payroll jobs number would give them confidence, and another tenth or two off the 5.3% unemployment rate would seal the deal. This is a tall order for one economic news report, to change people’s hardened views, so keep your fingers crossed. The unemployment rate is 5.3% and no one at the Fed thinks full employment is below 5.0%. Won’t be long now. Bet on it.

Two Important Quotes from July 28-29 FOMC meeting minutes showing action is close

“Most [participants] judged that the conditions for policy firming had not yet been achieved, but they noted that conditions were approaching that point.”

“The Committee agreed to continue to monitor inflation developments closely, with almost all members indicating that they would need to <u>see more evidence that economic growth was sufficiently strong</u> and labor markets conditions had firmed enough for them to feel reasonably confident that inflation would return to the Committee's longer-run objective over the medium term.” On Thursday, July 30, the morning after they met, real GDP in the second quarter was reported at +2.3% (Q1 revised to +0.6%) versus the -0.2% real GDP growth reading in the first quarter available when they met. On Thursday, August 27, the first revision to real GDP in Q2 2015 is expected to be revised up to +3.2%, evidence that economic growth is “sufficiently strong” to return inflation to the Fed’s target.

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