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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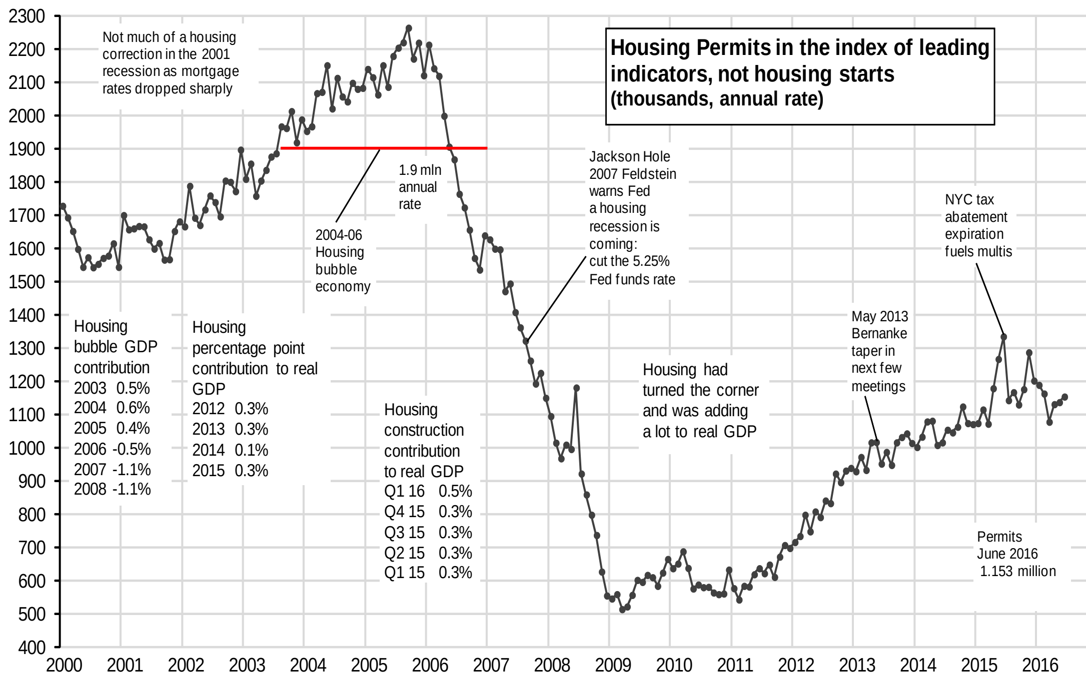
MUFG | 1251 Avenue of the Americas
New York, New York 10020

HOUSING CONSTRUCTION NOWHERE NEAR 2001 RECESSION LOWS LET ALONE HOUSING BUBBLE HIGHS

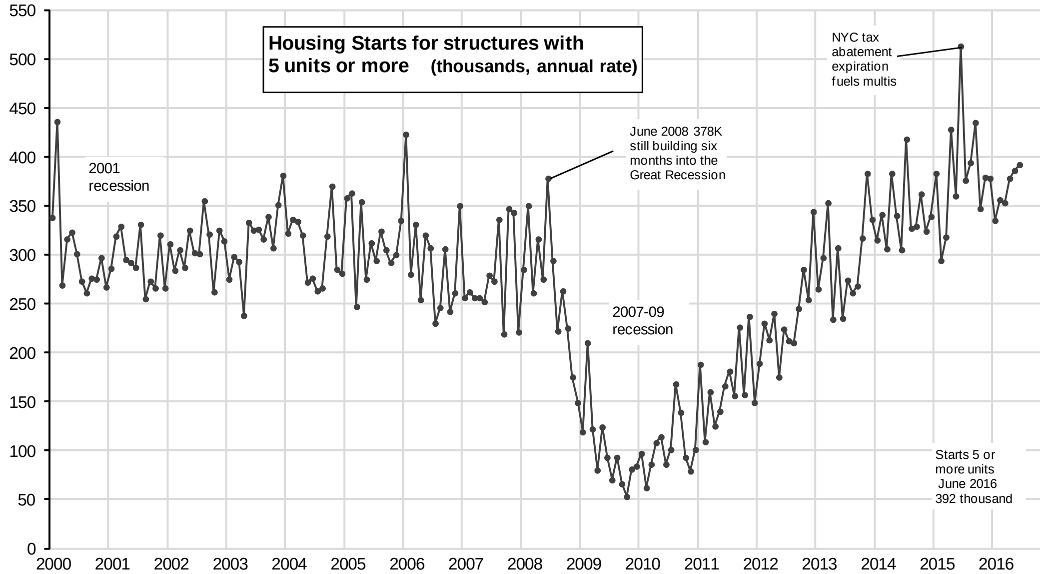


Housing permits were 1.153 million in June as reported this week which is well below the 1.9 million "minimum" level from late 2003 to early 2006 during the housing bubble. Yet the economy is at "full employment." So what's going on?

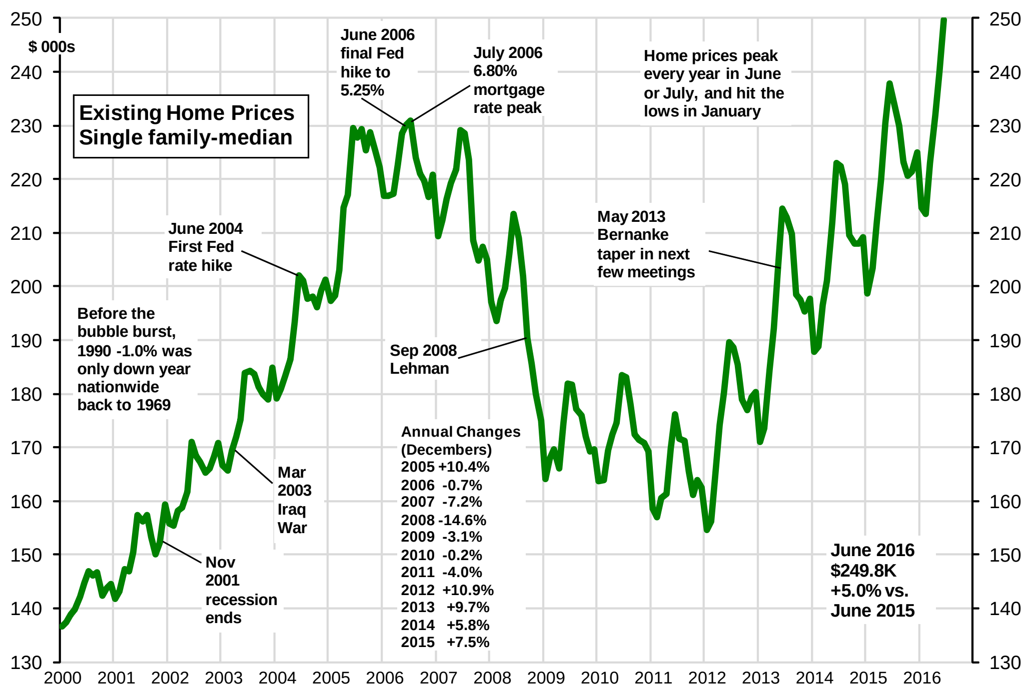
One of the reasons the Fed says it cannot normalize rates except at a gradual and cautious pace is that there is not enough productivity out there in the land, which basically means investment in the economy is weak. Residential housing construction is counted as investment in the GDP accounts on the economy. Investment isn't just companies ordering new equipment or building factories to meet the future demand for their products and services. It's housing starts stupid. If Yellen is waiting for housing permits to move construction activity back to where it was before the "Great Recession" savers could be in for a long wait.

Business Investment Spending in the real GDP accounts		
Q1 2016 $bln	Level	% YOY
Equipment	1042.5	-0.3
Intellectual Property	706.9	2.9
Construction		
Business structures	441.5	-3.6
Mining, shafts, wells	40.9	-65.5
Other	400.6	17.9
Residential housing	567.6	10.8
Total	2760.6	2.2

Housing permits are 1.153 million not at the "1.5 million lows" from the 2001 recession. The major reason is single-family detached homes (SFD) are lagging. Multi-family construction, buildings with five units or more, are getting built at a faster rate than they were during the housing bubble years just a decade ago. It is single family home construction that is lagging. There could be a change in buyer preferences; the Millennials don't have much money after deducting their tuition debt to society and are not forming families. Maybe they like apartment life. Looking at the top ten homebuilders which still account for less than 20% of the single-family home construction market, they are concentrating their building activity in the fastest growing markets--Texas, Florida, California, North and South Carolina, Georgia, and throw Nevada and Washington state in there too. Perhaps the two-decades of strong single-family home construction have already saturated the market in many communities around the country. There's no open land left to build on. And baby boomers have stopped buying homes and have started retiring. New single-family construction permits averaged 1.2 million each year from 1985 to 2005. In 2015 they were 0.696 million.



Despite housing starts/permits being "relatively low," residential construction was adding a lot to real GDP in the first quarter: pushing real GDP 0.5 percentage points. That may not last as permits look toppy for now, although remodeling expenditures could continue to add some to growth.



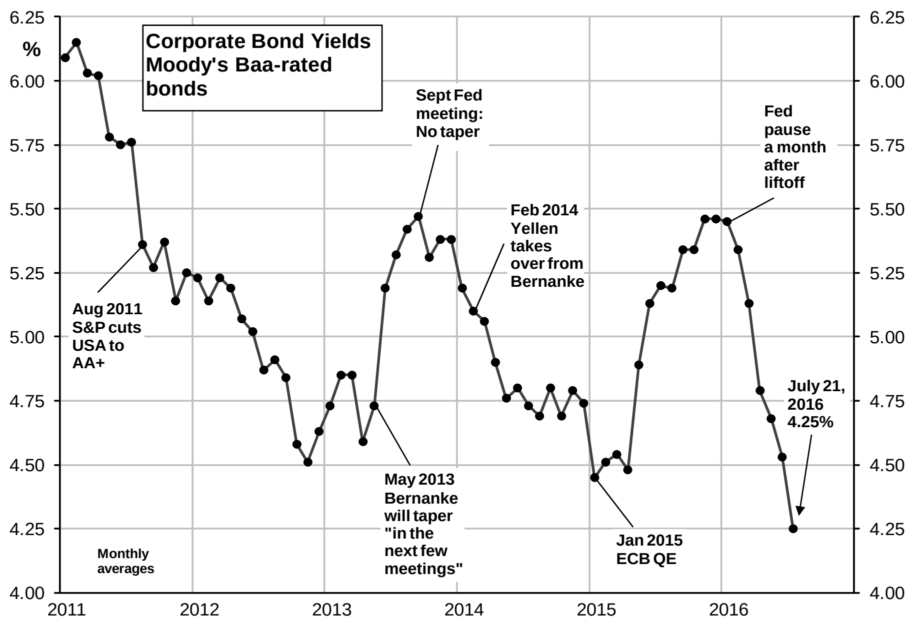
Meanwhile, home prices are running amok, fueled by years of the Fed's free money policy. If all those breathless stories in newspapers about stagnant wages are true then single family homes are increasingly unaffordable for many Americans. Existing single-family home prices are at record highs in June 2016 at $249,800, an increase of 5.0% above last year's level. If home prices are the "financial conditions" that monetary policy is seeking to bolster, zero rates are no longer necessary.

FEDERAL RESERVE POLICY

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	20-Jul	13-Jul	6-Jul	29-Jun	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2462.652	2462.541	2462.427	2462.303	479.782
Federal agency debt securities	22.492	25.096	25.096	25.096	0.000
Mortgage-backed securities	1757.254	1743.541	1743.541	1743.541	0.000
Primary credit (Discount Window)	0.015	0.123	0.000	0.027	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)	1.713	1.712	1.712	1.712	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	0.185	2.220	2.994	0.002	62.000
Federal Reserve Assets	4526.7	4517.7	4516.2	4511.2	961.7
3-month Libor %	0.70	0.68	0.66	0.65	2.82
Factors draining reserves					
Currency in circulation	1462.600	1464.626	1466.893	1462.755	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	79.368	48.357	83.401	143.206	0.000
Reserve Balances (Net Liquidity)	2318.251	2327.301	2308.282	2199.118	24.964
Treasuries within 15 days	7.193	3.647	3.644	13.567	14.955
Treasuries 16 to 90 days	20.153	27.346	27.346	24.159	31.549
Treasuries 91 days to 1 year	147.715	146.458	146.455	140.394	69.272
Treasuries over 1-yr to 5 years	1197.133	1195.901	1195.883	1199.997	170.807
Treasuries over 5-yrs to 10 years	452.290	451.872	451.851	447.746	91.863
Treasuries over 10-years	638.167	637.317	637.247	636.440	101.337
**September 10, 2008 is pre-Lehman bankruptcy of 9-15-08					

The Fed meets July 26-27 to consider its monetary policy. Brexit is kind of a dud when it comes to risks to the American economy. Of course one can never be too careful if you are a policymaker so keep the yellow caution light out certainly. Financial markets could always head south again in a hurry. So don't tell the public the danger has passed. Ever. ECB President Draghi could have been speaking for many on the FOMC when he said in regards to "Brexit" this week: "It's too early to say what is going to be the final impact. The only thing that we can say is that it's a risk that has materialized, and it's a downside risk." The ECB, BOJ, BOE, and FOMC have all gone their own ways, slight differences we mean in terms of what they are doing and why. The ECB is doing QE, branching out to buying corporate bonds (how would we like it here if the Fed came into the market and bought Apple bonds or GE debt obligations). The effect that the ECB is trying to achieve seems unclear. Policy is at the central-banker speed limit certainly. Bernanke was the first in the world to start down the QE road and he thought the purpose was to lower long term yields, but long term yields in Europe are already low. In the dust really. Maybe the ECB gets some headline announcement effect, saying they are [still] doing what it takes, but this assertion is starting to wear a little thin and becoming less credible day by day. Central banking 101: if the public doesn't know how the central bank's actions are helping them, then it probably is not helping them; not helping consumers, businesses, the markets, the werks.

Anyway, in the USA unemployment claims were 253K in the latest July 16 week, 254K the week before for July 9, and 254K for July 2. No job layoffs due to Brexit. Nada. The needle is stuck at full employment and the Fed funds rate is stuck at 0.50% instead of 3.0% neutral (3% is the Fed's lowball estimate of course.) Dow industrials closed Friday up 6.6% for the year to date. And we don't want to think stocks are only up because the Fed won't raise rates due to lingering Brexit concerns. Stocks are going to have to get used to rate hikes at some point and love them. Rate hikes won't slow the economy and take the punch bowl away until the Fed funds rate is hundreds of basis points higher.



What might the Fed do at the July meeting? There is only the press statement at 2pm EDT on Wednesday, July 27 to look forward to. Wait for it. They can't raise rates can they because the market is not expecting it, although frankly, why not? Bond market volatility is off the charts, we mean it is virtually non-existent its reactions to the news. A few basis point swings here and there. If Fed officials are afraid of another 2013 taper tantrum, don't be. Have you seen corporate bond yields? Look at the graph here. The bond market has been put to sleep awash in a sea of Fed-sponsored, free-money cash looking for a home.

What could they do? Well in October 2015, the meeting before the December 2015 meeting blast-off that got off the ground but never made orbit, the press statement said, "In determining whether it will be appropriate to raise the target range at its next meeting, the Committee…" Next meeting were the key word changes in the press statement. It telegraphed the move in December.

They paused in January of course this year, they were less sure the risks were balanced during the market turmoil. At the March 2016 meeting, they skipped a rate hike, no surprise, but in a twist, the median Fed officials forecasts for rates changed to 1.0% at the end of 2016 which meant just two more rate hikes. The market was expecting a "gradual" pace of three more rate hikes in June, September and December. Yellen cited the world economy and credit spreads as a reason for caution in March.

At the April 26-27, 2016 meeting, they dropped the word "risks" from the statement meaning June was perhaps a "Live" meeting. The April Fed meeting minutes released on Wednesday, May 18, 2016 had the market thinking June was going to see a rate hike. The April meeting minutes were hawkish at least in terms of saying June was "likely." The market sold off on the April Fed meeting minutes with 10-yr Treasury yields climbing from 1.82% to as high as 1.89%. A June rate hike didn't happen and we don't want to go over why not, not wishing to revisit a bridge over troubled waters. We would note that 6 of 12 reserve bank presidents including Boston Fed Rosengren and San Francisco Fed Williams wanted to hike rates in June.

So here we sit. Stay tuned. Will they hint at a rate change at the September meeting next week or won't they? The press statement is released 2pm New York time Wednesday, July 27, don't miss it.

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