Financial Market Weekly

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

MUFG | 1251 Avenue of the Americas
New York, New York 10020
A member of MUFG, a global financial group

16 MARCH 2018

FED'S 2018 INTEREST RATE FORECAST DEAD AHEAD: TWO HIKES, THREE HIKES, FOUR HIKES OR MORE?

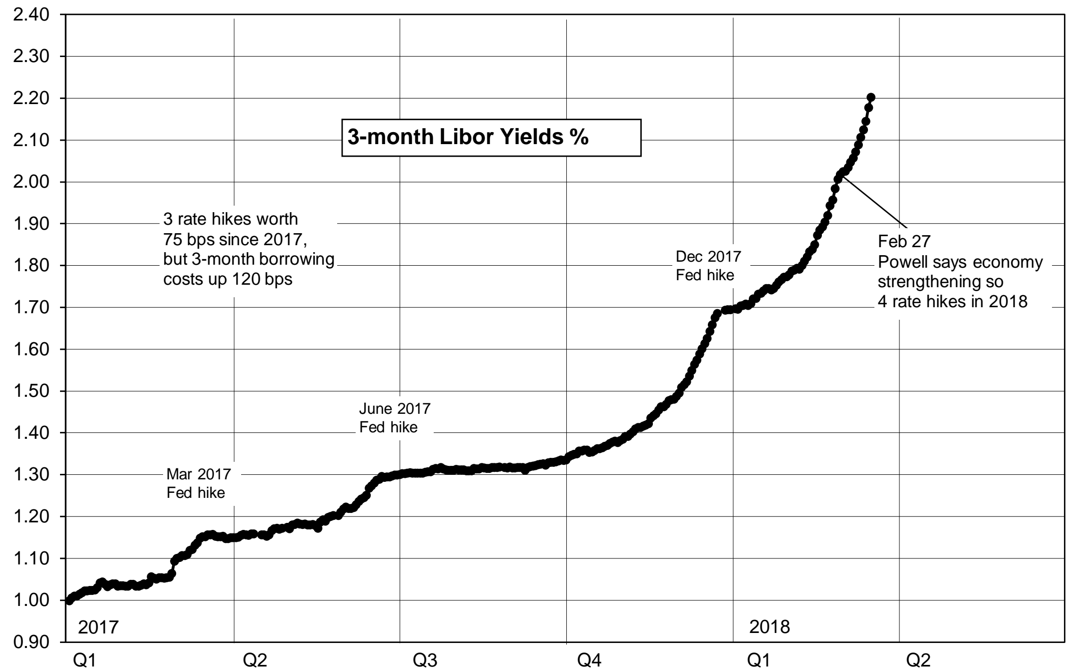
The million dollar question for Powell's first Federal Reserve meeting as Chairman in March is whether the economy is still strengthening enough for policymakers to raise the interest rate hike forecast from three times in 2018 to four times. The market thought it heard Fed Chair Powell say he would raise rates four times this year, one step beyond the Yellen Fed's three rate hike forecast made last December, when Powell gave his Monetary Policy Report testimony before the House on Tuesday, February 27. The second million dollar question is why the 3-month Libor yield, the only short-term "money market" yield that real people pay, is soaring ahead of the Fed's widely expected 25 bps rate hike to 1.75% on March 21. Three-month Libor was 1.60% on December 14 the day after the Fed raised rates to 1.50%, a 10 bps spread, which okay, it is what it is. But now 3-month money is already 2.20% just before the March Fed meeting which is ahead of the game and will be an even wider spread of (2.20-1.75) 45 bps even after they indeed pull the trigger and raise rates 25 bps to 1.75% on March 21.

Fed Individual Forecasts			
Fed funds rate			
Votes	2020 End	2020 End	Change
1	1.375	1.125	0.250
2	2.375	2.375	0.000
3	2.625	2.375	0.250
4	2.625	2.500	0.125
5	2.875	2.625	0.250
6	3.000	2.625	0.375
7	3.000	2.750	0.250
8	3.000	2.875	0.125
9	3.125	2.875	0.250
10	3.125	2.875	0.250
11	3.125	3.000	0.125
12	3.125	3.125	0.000
13	3.125	3.500	-0.375
14	3.500	3.500	0.000
15	4.125	3.625	0.500
16	4.125	3.875	0.250
17			
Median	3.063	2.875	0.188
Meeting	Dec 2017	Sep 2017	

In other words, investors are interested in, or at least market commentary and financial news coverage is focused on three or four rate hikes this year, but the greater concern should be what the heck is going on with soaring short-term borrowing/funding costs as represented by 3-month Libor. Didn't we put the Libor trader criminals in jail already? Then why are short-term borrowing costs still moving up? Natural market forces not dealer manipulation? Whatever. Higher short-term rates certainly are not going to make America great again and lead companies to borrow and invest more in our future. 3-month Libor closing the week at 2.20% we mean.

MUFG

Three or four hikes in 2018 means the 1.5% Fed funds rate ends the year at 2.25 or 2.50 percent. Important news certainly, but the valuation of 10-yr Treasury yields might depend more on where the Fed sees rates at the end of 2020. 2020 being closer to the final maturity date of the current 10-yr Treasury in February 2028. The December median forecast said the Fed funds rate would be 3.1% at the end of 2020, which is 3.25% more or less. Bond yields cannot rise too far beyond this level even with the talk of the Treasury needing to auction as much as $1.5 trillion in "bonds" in fiscal year 2019 starting on October 1.



We are still forecasting four rate hikes this year. This seems to be the most sensible course, raising rates at each of the four regularly scheduled Fed press conference meetings, eliminate the guessing game about which meeting they would take a pass, and just bring rates up to more normal levels at a measured pace. If they do move it up four times in 2018 to 2.5% it leaves them in a bit of a pickle about what to do in 2019? We don't think the too-low inflation, go-slow on rate hikes crowd at the Fed was completely scattered by Powell's 4-hikes, "the economy is strengthening," testimony in February. Although we were a little taken aback by Fed Governor Brainard's more hawkish comments at Money Marketeers on March 6, which seemed to signal a change in her view that falls more into line with the Fed Chair's testimony. She said the strong headwinds against the economic recovery had "weighed down the path of policy," but that now the headwinds have turned into tailwinds. Sounds like she would not be against a faster pace of policy normalization.

Fed Meeting	2017	2018	2019	2020	Longer run
Dec 17	1.4	2.1	2.7	3.1	2.8
Sep 17	1.4	2.1	2.7	2.9	2.8
Jun 17	1.4	2.1	2.9		3.0
Mar 17	1.4	2.1	3.0		3.0
Dec 16	1.4	2.1	2.9		3.0
Sep 16	1.1	1.9	2.6		2.9
Jun 16	1.6	2.4			3.0
Mar 16	1.9	3.0			3.3

Fed rate forecasts getting more reliable.

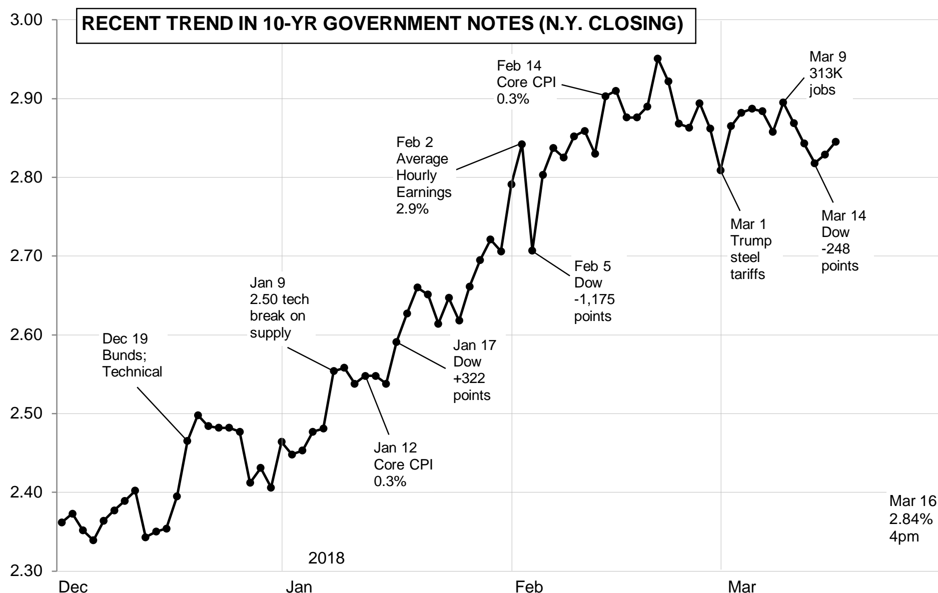
Anyway, the longer run neutral rate in the December forecasts was 2.75%; there was a time that the bond market thought longer run represented the terminal rate in the cycle, i.e. the peak in the Fed funds rate as in 5.25% in 2006 and 6.5% in 2000. (Those were the days.) It will be important to see whether the Fed's longer run and 2020 forecasts change at 2pm EDT on Wednesday, March 21, it's not just the three hikes or four hikes in 2018 that is likely to move the bond market.

MUFG

MARKETS OUTLOOK

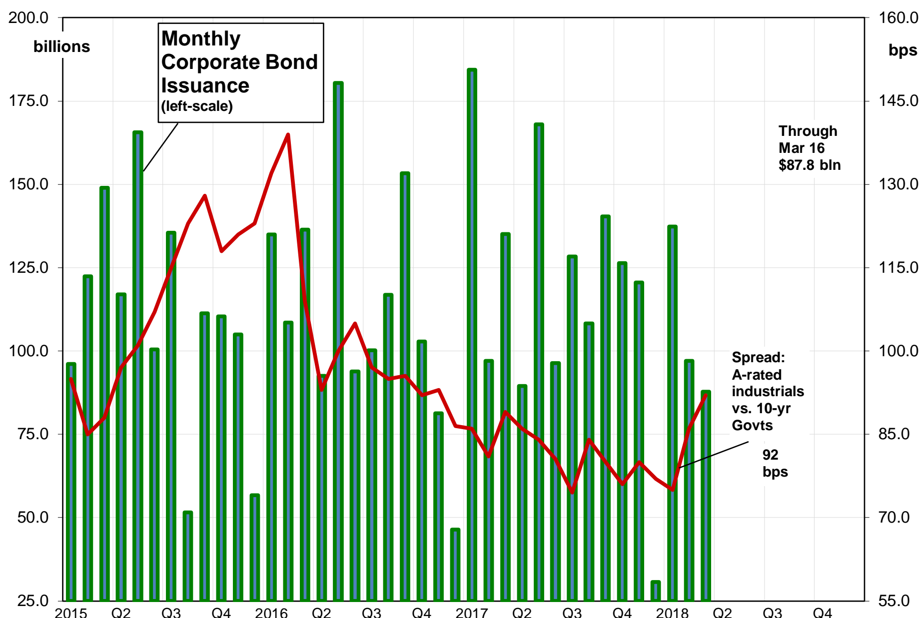
	29-Dec 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020
30-Yr Treasury	2.74	3.00	3.10	3.20	3.30	3.40	3.45	3.65	3.60	3.80	3.75
10-Yr Note	2.41	2.70	2.80	2.90	3.00	3.20	3.30	3.50	3.50	3.70	3.70
5-Yr Note	2.21	2.50	2.50	2.70	2.85	3.05	3.20	3.45	3.45	3.65	3.70
2-Yr Note	1.89	2.15	2.30	2.55	2.80	3.00	3.15	3.40	3.40	3.60	3.80
3-month Libor	1.69	2.05	2.20	2.45	2.70	2.95	3.10	3.35	3.35	3.60	3.85
Fed Funds Rate	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50	3.75
2s/10s spread	52	55	50	35	20	20	15	10	10	10	(10)

A quiet week despite the flow of news, perhaps waiting for the Fed decision on Wednesday, March 21. Yields were already falling for the week ahead of the 0.2% core CPI number with its unchanged 1.8% year/year rate on Tuesday. Maybe bonds rallied further, though that's a stretch, on a second month of weaker retail sales for February on Wednesday morning. Dow industrials fell 248 points on Wednesday, closing up just 0.2% year-to-date, and bonds finished the day at 2.82% the low close for the week.



CORPORATES: MCDONALD'S, CATERPILLAR, TOYOTA, NISSAN, PENTAIR

Corporate offerings were $30.4 billion in the March 16 week versus $54.2 billion in the March 9 week. On Wednesday, McDonald's sold $1.5 billion 5s/10s/30s. It priced a $500 million 3.8% 10-yr (m-w +15bp) at 100 bps (Baa1/BBB+). The global fast food retailer will use the proceeds for general corporate purposes, including debt refinancing, capex, dividends, share repurchases. Corporate bonds (10-yr Industrials rated A2) were 92 bps above 10-yr Treasuries this week versus 87 bps last Friday.



MUFG

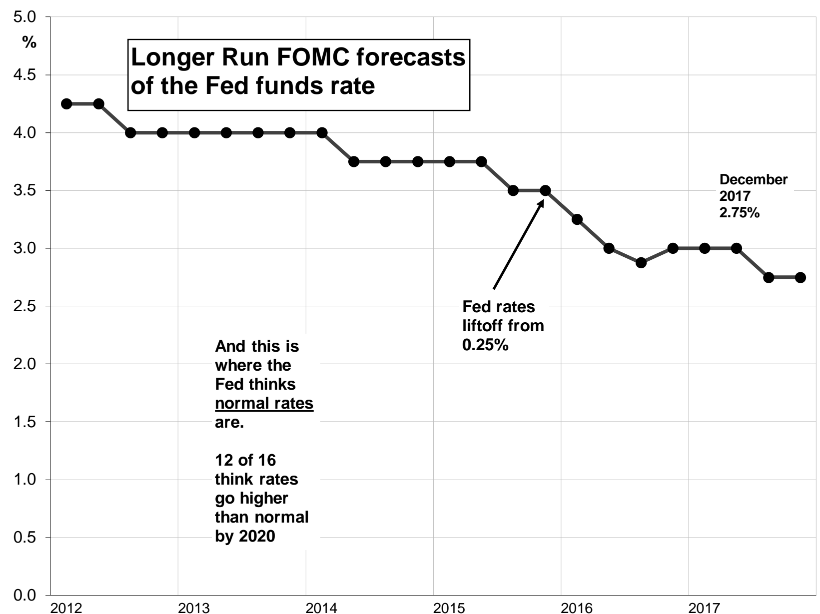
FEDERAL RESERVE POLICY

Selected Fed assets and liabilities

Fed H.4.1 statistical release billions, Wednesday data	14-Mar	7-Mar	28-Feb	21-Feb	Sep 10 2008** pre-LEH
Factors adding reserves					
U.S. Treasury securities	2424.562	2424.402	2424.242	2432.066	479.782
Federal agency debt securities	4.391	4.391	4.391	4.391	0.000
Mortgage-backed securities	1768.588	1759.991	1759.972	1768.298	0.000
Primary credit (Discount Window)	0.004	0.003	0.013	0.018	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)	1.708	1.708	1.708	1.710	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	0.064	0.065	0.072	0.067	62.000
Federal Reserve Assets	4454.6	4443.1	4440.1	4458.9	961.7
3-month Libor %	2.15	2.06	2.02	1.92	2.82
Factors draining reserves					
Currency in circulation	1634.992	1633.084	1627.259	1621.652	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	4.970	14.295	44.510	45.171	0.000
Reserve Balances (Net Liquidity)	2190.143	2261.352	2208.308	2215.339	24.964
Treasuries within 15 days	0.000	0.000	0.000	32.047	14.955
Treasuries 16 to 90 days	120.481	120.481	92.002	92.002	31.549
Treasuries 91 days to 1 year	298.430	298.426	326.901	314.372	69.272
Treasuries over 1-yr to 5 years	1081.470	1081.448	1081.426	1069.165	170.807
Treasuries over 5-yrs to 10 years	297.929	297.887	297.846	300.215	91.863
Treasuries over 10-years	626.253	626.160	626.067	624.265	101.337

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

The Fed meets March 20-21 to consider its monetary policy. One 25 bps rate hike to 1.75% is expected. But the future course of rates, however uncertain they always say their forecasts are, is most important; thinking beyond the three or four rate hikes likely this year. (We vote four.) The high yield mark is 3.1% at the end of 2020 for the median Fed funds forecast, which is higher than 2.8% neutral. Rates above the normal level, by definition, start to take away the punch bowl and slow the economy. Of course, they have also brought down "neutral" over the last several years, but they think these longer run, neutral estimates might come back up as the natural rate of interest rises over the next few years as the economic headwinds die down.



The "economy strengthening" comment from Powell on February 27 can only move rates so far one might think. He was referring to conditions since the December meeting. At the December meeting they did change their long-held view that GDP would grow just 2.1% in 2018, moved the growth forecast up to 2.5% in 2018. Yellen said at her last press conference on December 13 that the faster growth was due to "changes in tax policy." But maybe that 2018 GDP number goes up higher still in the March forecasts? Brainard said in her March 6 speech that tax cuts add 0.5 percentage points to real GDP growth and the budget spending deal adds 0.4 percentage point. But the point here is that growth from fiscal stimulus will have a limited effect of one or two years on the economy; it will not engender the 3% sustainable growth forecasts from the Trump administration. If you are looking for stronger growth to push up interest rates, the Fed says it is just a 2018-19 story. We will see if they move up the 2.8% longer run median forecast for rates and the 2020 3.1% median Fed funds rate forecast. The 10-yr Treasury yield may have stalled here at 2.8 to 2.9 percent waiting to see what the Fed is thinking. It wasn't that long ago that outgoing New York Fed President Dudley was saying they might only need to move rates up to 2.5%... and that was only a "maybe." Not sure there would be such an urgency to go four times this year, instead of three times, if they are just going to 2.5% and then stop. Trump doesn't want higher rates, we will see about his man Powell.

MUFG

OTHER ECONOMIC NEWS THIS WEEK

Core CPI Inflation holding at 1.8% (Tuesday)

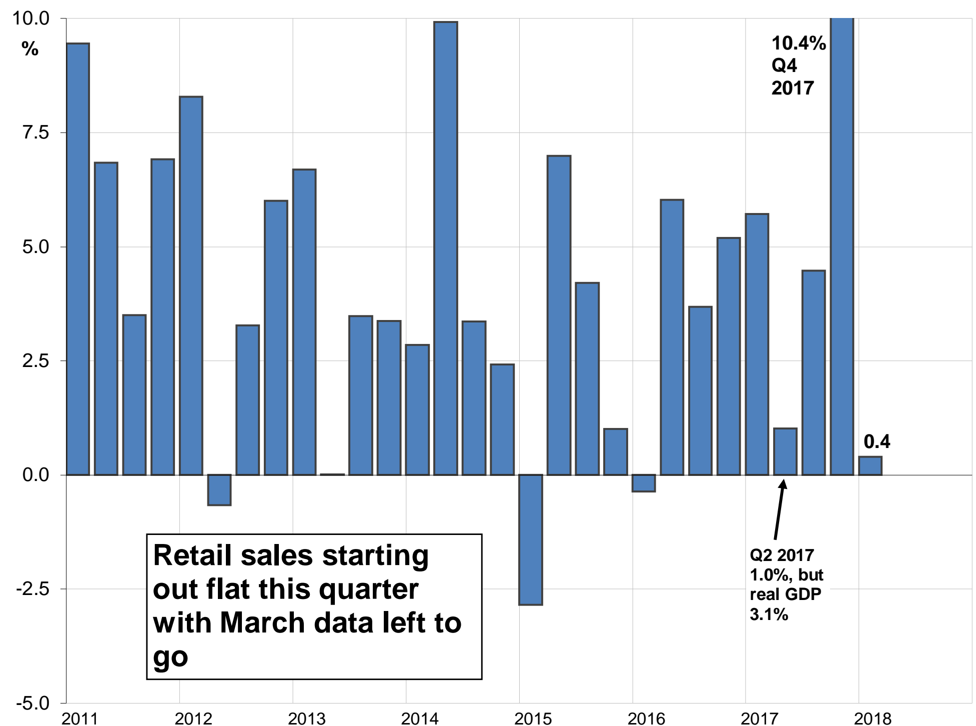
February core CPI inflation rose 0.2% for the month, 1.8% year-on-year, matching the market's expectations. Bond market inflation scares come and go, but core CPI inflation has been steady through most of it with the year/year rate steady at 1.8% for three consecutive months. In the March report on April 11, core CPI inflation could bump up to 2.0 or 2.1% when the inflation-crushing, cell phone data plan freebie from March 2017 drops out of the year-on-year data. One interesting new finding is that medical care services inflation is slowing. It has risen 1.8% over the last year, a distinct slowdown from earlier years. Another reason it will be difficult for an inflation outbreak to spread rapidly like wildfire.

Core CPI Inflation monthly and year-on-year changes

2018	% chg	YOY	2017	% chg	YOY
Dec			Dec	0.2	1.8
Nov			Nov	0.1	1.7
Oct			Oct	0.2	1.8
Sep			Sep	0.1	1.7
Aug			Aug	0.2	1.7
Jul			Jul	0.1	1.7
Jun			Jun	0.1	1.7
May			May	0.1	1.7
Apr			Apr	0.1	1.9
Mar			Mar	-0.1	2.0
Feb	0.2	1.8	Feb	0.2	2.2
Jan	0.3	1.8	Jan	0.3	2.3

Retail sales disappoint, auto sales in the doldrums, but there is more (Wednesday)

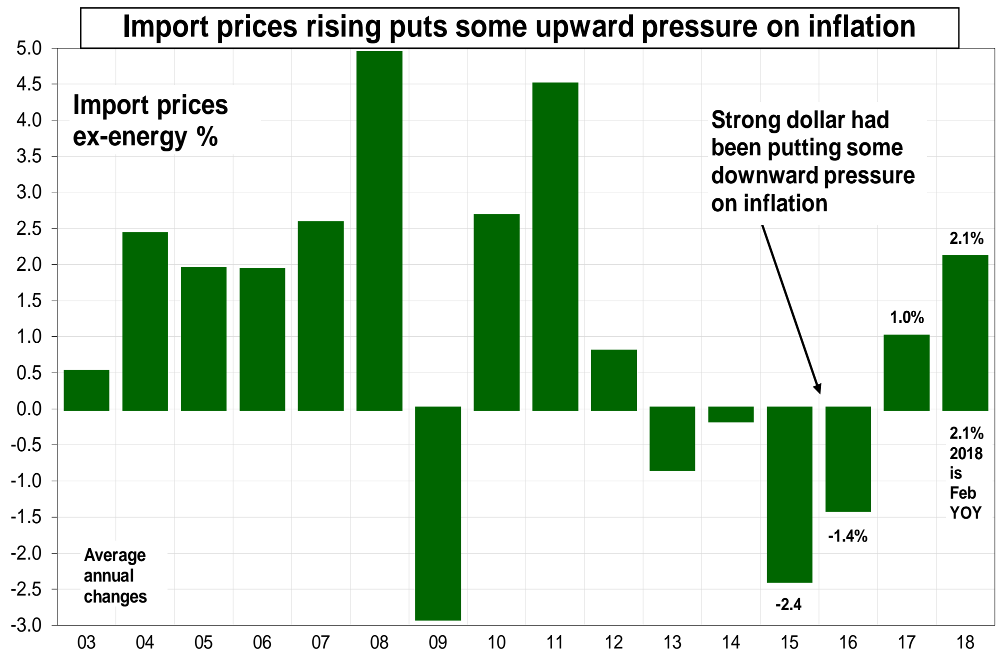
Retail sales fell 0.1% in February. This is the third consecutive month of 0.1% declines. In the old days, three months of declining retail sales was a recession indicator. The recent three months of weakness was modest however and comes after a huge jump in retail sales in the fourth quarter. Still it is a little hard to reconcile this slowdown with the massive tax cuts. Weakness happened in the first quarter two years ago as well, and may be winter weather related, so we still expect consumer spending to pick up again. The data do make our first quarter real GDP estimate of 2.5% difficult to achieve, unless inventories add a lot. Inventories are not a GDP component that leads to sustainable economic growth however.



MUFG

Import prices arising (Thursday)

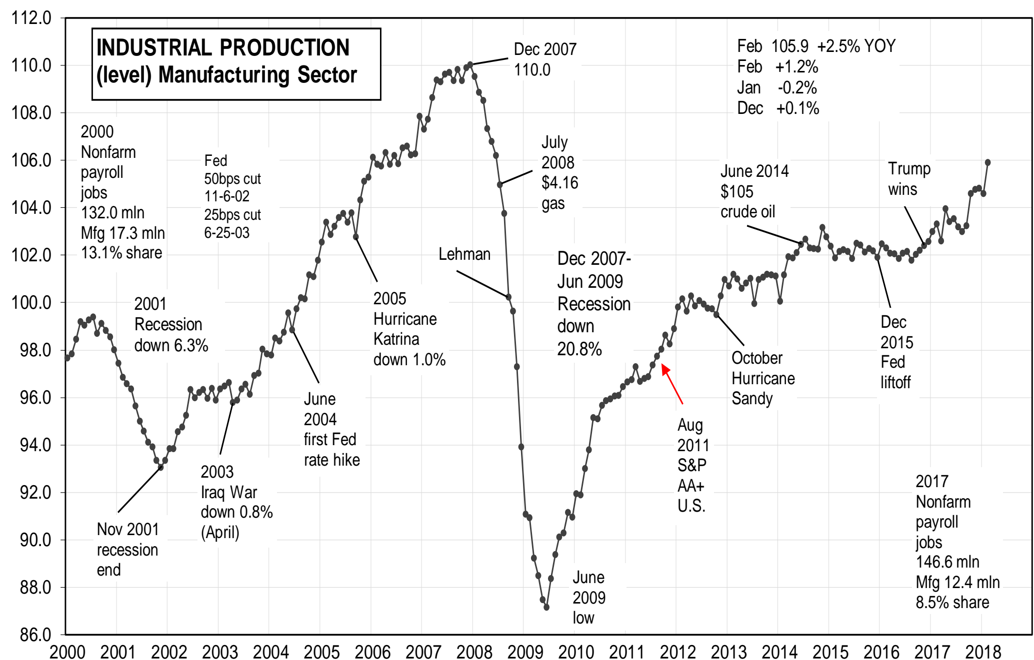
One of Yellen's favorite reasons why inflation was low in the past was import prices. But now import prices are rising again which counts as one reason why Powell can be more confident that inflation will rise to the Fed's 2.0% target. He could use a shot of confidence after that 2.9% wage data came back down to 2.6% a month later as reported on Friday, March 9.



Import prices jumped 0.5% in February and in January and are up 2.1% from last year.

Industrial production jumps without much explanation (Friday)

Retail sales fell for three consecutive months, but the economy cannot be stalling or in danger of recession, if industrial production, factory output, is going straight up. Production seems to have shaken off whatever ailed it in 2015-16; in the doldrums moving sideways during the crude oil price crash we expect. Manufacturing production makes up



75% of the industrial production index. Manufacturing production jumped 1.2% in February and is 2.5% higher than year earlier levels of output. If the President wants to win, he is winning on increased industrial production, even if no factories are being brought back home to America from overseas… domestic factory output has improved.

The consumer stopped spending this quarter and real GDP growth may find it hard to break above 2.0%. But the winds of recession are certainly far, far away with industrial production picking up.

MUFG

Analyst Certification

The views expressed in this report accurately reflect the personal views of **Christopher S. Rupkey**, the primary analyst responsible for this report, about the subject securities or issuers referred to herein, and no part of such analyst's compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed herein.

The information herein is provided for information purposes only, and is not to be used or considered as an offer or the solicitation of an offer to sell or to buy or subscribe for securities or other financial instruments. Neither this nor any other communication prepared by The Bank of Tokyo-Mitsubishi UFJ, Ltd. (collectively with its various offices and affiliates, "BTMU") or should be construed as investment advice, a recommendation to enter into a particular transaction or pursue a particular strategy, or any statement as to the likelihood that a particular transaction or strategy will be effective in light of your business objectives or operations. Before entering into any particular transaction, you are advised to obtain such independent financial, legal, accounting and other advice as may be appropriate under the circumstances. In any event, any decision to enter into a transaction will be yours alone, not based on information prepared or provided by BTMU. BTMU hereby disclaims any responsibility to you concerning the characterization or identification of terms, conditions, and legal or accounting or other issues or risks that may arise in connection with any particular transaction or business strategy. While BTMU believes that any relevant factual statements herein and any assumptions on which information herein are based, are in each case accurate, BTMU makes no representation or warranty regarding such accuracy and shall not be responsible for any inaccuracy in such statements or assumptions. Note that BTMU may have issued, and may in the future issue, other reports that are inconsistent with or that reach conclusions different from the information set forth herein. Such other reports, if any, reflect the different assumptions, views and/or analytical methods of the analysts who prepared them, and BTMU is under no obligation to ensure that such other reports are brought to your attention.

Copyright 2018 MUFG All Rights Reserved

The articles and opinions in this publication are for general information only, are subject to change, and are not intended to provide specific investment, legal, tax or other advice or recommendations. The information contained herein reflects the thoughts and opinions of the noted authors only, and such information does not necessarily reflect the thoughts and opinions of MUFG or its management team. We are not offering or soliciting any transaction based on this information. We suggest that you consult your attorney, accountant or tax or financial advisor with regard to your situation. Although information has been obtained from sources we believe to be reliable, neither the authors nor MUFG vouch for its accuracy, and such information may be incomplete or condensed. Neither the authors nor MUFG shall be liable for any typographical errors or incorrect data obtained from reliable sources or factual information.

About MUFG Americas Holdings Corporation

Headquartered in New York, MUFG Americas Holdings Corporation is a financial holding company and bank holding company with total assets of $148.1 billion at December 31, 2016. Its main subsidiaries are MUFG Union Bank, N.A. and MUFG Securities Americas Inc. MUFG Union Bank, N.A. provides an array of financial services to individuals, small businesses, middle-market companies, and major corporations. As of December 31, 2016, MUFG Union Bank, N.A. operated 365 branches, comprised primarily of retail banking branches in the West Coast states, along with commercial branches in Texas, Illinois, New York and Georgia, as well as two international offices. MUFG Securities Americas Inc. is a registered securities broker-dealer which engages in capital markets origination transactions, private placements, collateralized financings, securities borrowing and lending transactions, and domestic and foreign debt and equities securities transactions. MUFG Americas Holdings Corporation is owned by The Bank of Tokyo-Mitsubishi UFJ, Ltd. and Mitsubishi UFJ Financial Group, Inc., one of the world's leading financial groups. The Bank of Tokyo-Mitsubishi UFJ, Ltd. is a wholly owned subsidiary of Mitsubishi UFJ Financial Group, Inc. Visit http://www.unionbank.com/ or http://www.mufgamericas.com/ for more information.

About MUFG (Mitsubishi UFJ Financial Group, Inc.)

MUFG (Mitsubishi UFJ Financial Group, Inc.) is one of the world's leading financial groups, with total assets of approximately $2.6 trillion (USD) as of December 31, 2016. Headquartered in Tokyo and with approximately 350 years of history, MUFG is a global network with more than 2,200 offices in nearly 50 countries. The Group has more than 140,000 employees and about 300 entities, offering services including commercial banking, trust banking, securities, credit cards, consumer finance, asset management, and leasing. The Group's operating companies include Bank of Tokyo-Mitsubishi UFJ, Mitsubishi UFJ Trust and Banking Corporation (Japan's leading trust bank), and Mitsubishi UFJ Securities Holdings Co., Ltd., one of Japan's largest securities firms.

Through close partnerships among our operating companies, the Group aims to "be the world's most trusted financial group," flexibly responding to all of the financial needs of our customers, serving society, and fostering shared and sustainable growth for a better world. MUFG's shares trade on the Tokyo, Nagoya, and New York (MTU) stock exchanges. Visit www.mufg.jp/english/index.html.