Financial Market Weekly

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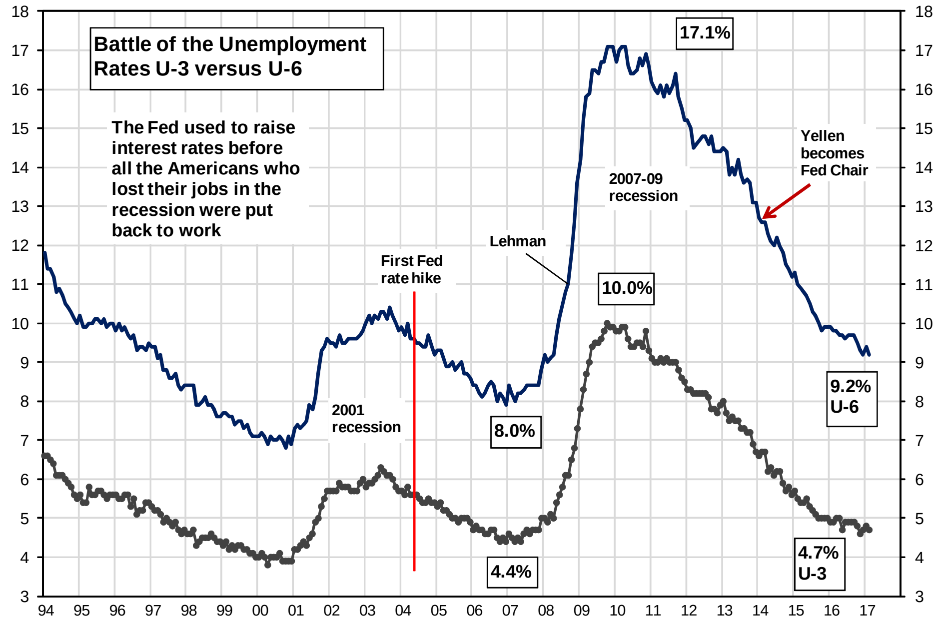
MUFG | 1251 Avenue of the Americas
New York, New York 10020

FED POLICY IN 2017: ONE DOWN TWO TO GO



We feel a little hung out to dry after this week's Fed meeting. At least they actually raised the rate to 1.0%, so we should probably count our blessings. So soon too after hiking in December. We just thought that they would see the need to raise rates four times in 2017 at every press conference meeting, a gradual pace like Bernanke suggested before he left the building. February 3, 2018. It feels like we kind of had the rug drawn out from under us, expectations for faster normalization dashed, after all the sudden urgency to go, go, go in March materializing barely two weeks ago. New York Fed President Dudley saying something about "compelling." Nope. Nothing doing. Fed officials left the markets at the altar saying, no, we are still going three times this year, Not four.

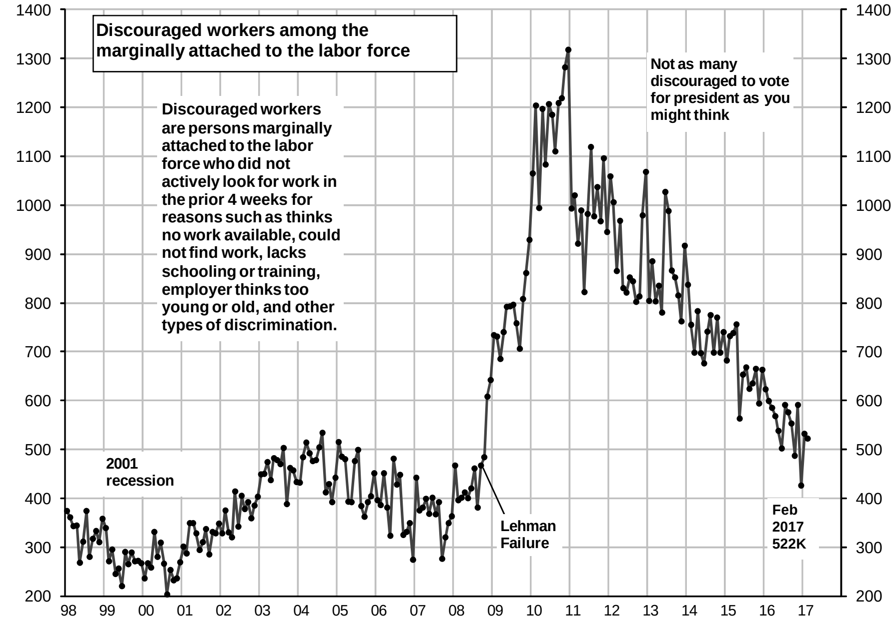
"The future is uncertain we are not on a preset course." Okay, samo samo, let's see what happens to monetary policy if the 4.7% unemployment rate actually falls further below "4.8% full employment," and/or core PCE inflation (they still got the wrong inflation indicator!) actually rises above 2% and stays above there. Let's see if the Fed's forward path of rates lifts higher in response if this happens. Yellen may not be there though to test this out though as her last day in office is February 3, 2018. Remember that date. Because we have no earthly idea what the next central bank leader will want to do. Might want to go back to the gold standard. February 3, 2018.

What we want to talk about this week however is Yellen's downbeat characterization of current labor market conditions. If she really believes what she said at the press conference that "Americans should see this rate hike as good," we're not feeling it. The economy is never good enough for the Fed Chair. Never good enough for the President either who is trying to make America great again.

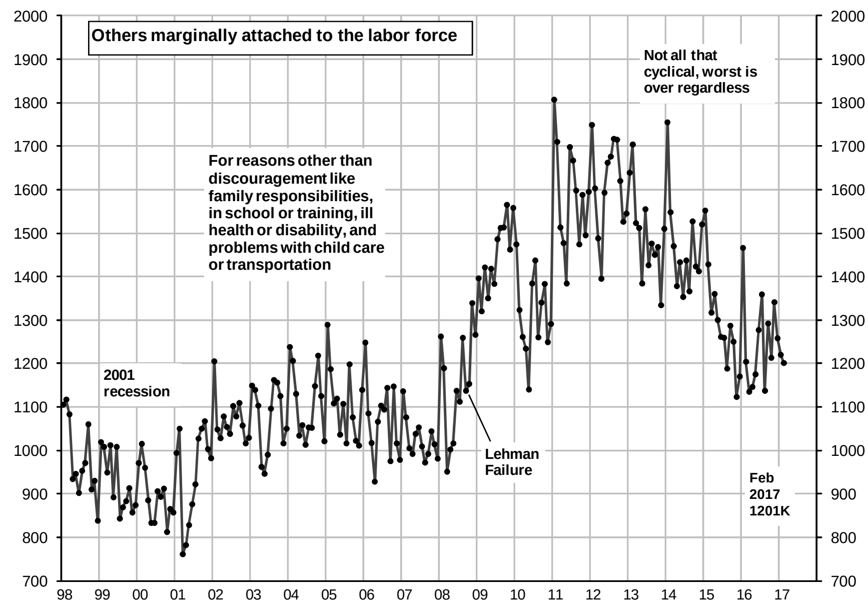
U-3 to U-6 mainly involuntary part-timers

000s	Rate	Unemployed	Labor Force	Adds	Feb 2017
U-3	4.7	7,528	160,056	- - -	Traditional unemployment
U-4	5.0	8,050	160,578	522	Discouraged
U-5	5.7	9,251	161,779	1,201	Others Marginally Attached
U-6	9.2	14,955	161,779	5,704	Part time for eco reasons

Okay maybe we exaggerated saying her current labor market assessment was "downbeat." But she certainly believes it is not quite there yet otherwise they would not still have their foot down hard on the gas pedal. As we learned this year, Yellen explained that the Fed is still trying to get the economy moving with its easy monetary policy stance until interest rates get to neutral, which they say is a Fed funds rate of 3.0%. When the economy has fully met the Fed's objectives, then and only then must interest rates be at 3.0% normal levels. Why their objectives will not be met until the end of 2019 is beyond us. But one line of reasoning that we find faulty is in her [January 18 speech] this year in San Francisco. "A broader measure of unemployment isn't quite back to its pre-recession level. It includes people who would like a job but have been too discouraged to look for one and people who are working part time but would rather work full time." This is U-6 unemployment that is graphed on the first page. The number of people who have been too discouraged to look for a job are actually very few in number. In fact there is not a lot of cyclical, recession-type, economic stress in the U-6 unemployment measure.



U-6 is supposed to be a broader measure of the "economy's problems," but we don't see problems here in a cyclical macroeconomy sense. The number of the 14.955 million U-6 unemployed in February Yellen says are discouraged is actually miniscule at just 522K. Here is the graph and these numbers are back down over the last eight years after the recession. No need to keep interest rates low for the discouraged. Same thing for the 1.201 million Others Marginally Attached who have noneconomic reasons for being marginally attached to the labor force that has nothing to do with the business cycle or strength of the economy; reasons like family obligations, in school or getting trained, poor health or disabled, childcare issues and transportation problems. The graph of these Marginally Attached Others does not look very cyclical and should not be a reason to keep interest rates low eight years after the recession ended. February 3, 2018. Finally, involuntary part-timers are 5.704 million or 38% of the U-6 unemployed and we still don't view these workers with paychecks a sign of economic distress.



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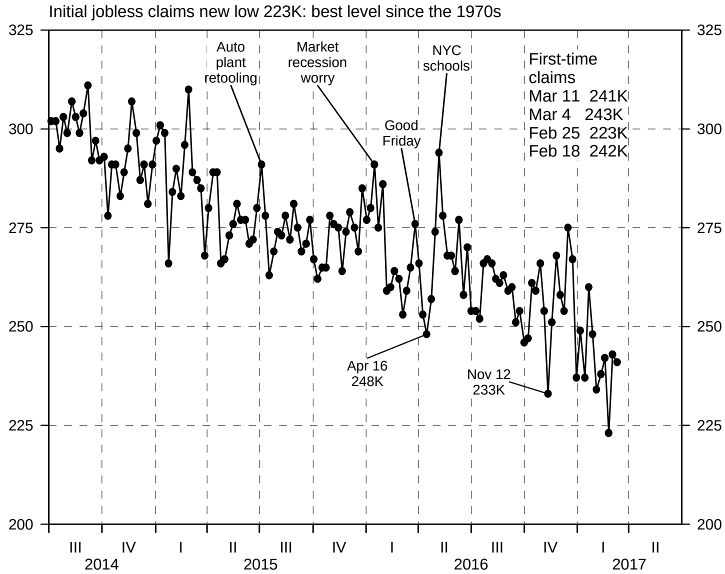
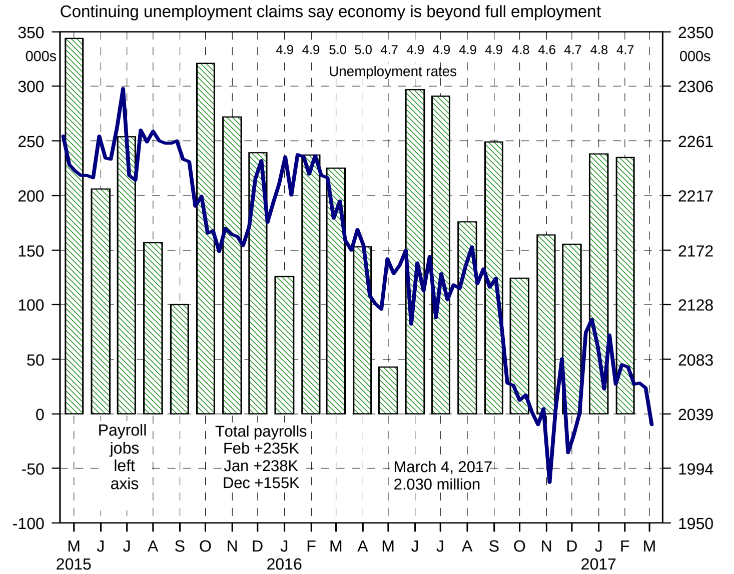
JOBLESS CLAIMS—BEST OF BEST TIMES RIGHT NOW FOR LABOR MARKET

Unemployment claims remain near the new low for this cycle and were 241K for the March 11 week. The lowest level (meaning best) in 44 years was 223K in the February 25 week. Jobless claims, the series that is in the index of <u>leading</u> economic indicators. What in the world is the Fed's policy interest rate doing at 1.0%? The economy is at full employment so there is no pressing need for fiscal stimulus to create jobs. The timing is completely off. Historically, no other administration has done fiscal stimulus with the economy where it is today.

President takes Office		Unemployment
Clinton	Jan 1993	7.3%
Bush	Jan 2001	4.2%
Obama	Jan 2009	7.8%

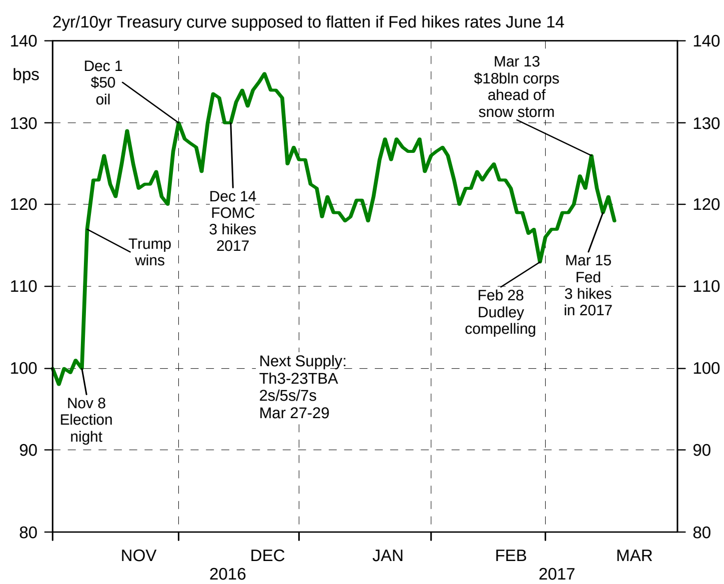


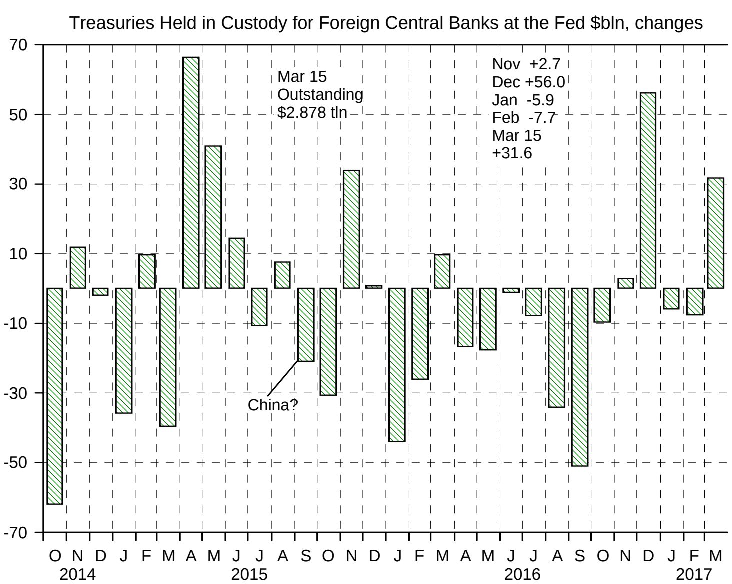


TREASURY CURVE WAS STEEPER: TRUMP FISCAL STIMULUS MUMBO JUMBO

The yield curve between 2-yrs and 10-yrs was 118 bps on Friday versus 123 bps last week. The biggest upward move in yields came on Wednesday afternoon on the Fed headlines sticking with just three rate hikes in 2017. The bond market is still unsure of the Fed's path of rates in 2017 let alone in the next few years. Ten year Treasury yields cannot go up and stay up unless there is more clarity on what the next Fed Chair might do: how high the Fed funds rate might go under new leadership.

	30-Dec 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018
30-Yr Bond	3.07	3.10	3.10	3.20	3.40	3.60	3.70
10-Yr Note	2.45	2.40	2.50	2.70	3.00	3.20	3.40
5-Yr Note	1.93	2.00	2.10	2.40	2.70	3.00	3.20
2-Yr Note	1.19	1.60	1.80	2.00	2.20	2.50	2.75
3-month Libor	1.00	1.25	1.50	1.70	1.95	2.20	2.45
Federal Fund Rate	0.75	1.00	1.25	1.50	1.75	2.00	2.25
2s/10s spread	126	80	70	70	80	70	65





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FEDERAL RESERVE POLICY

The Fed met March 14-15 to consider its monetary policy. 10-yr Treasury yields were 2.57% before the 2pm EDT Fed announcement and closed 11 bps lower on the day at 2.49% from Tuesday night's close. The market was thinking there might be three more rate hikes in 2017 where the Fed forecasts said just two remaining rate hikes in 2017. Two more rate hikes at three remaining press conference meetings in June, September, and December. When is the next one?

Selected Fed assets and liabilities Fed H.4.1 statistical release billions, Wednesday data	15-Mar	8-Mar	1-Mar	22-Feb	Sep 10 2008** pre-LEH
Factors adding reserves					
U.S. Treasury securities	2463.812	2463.650	2463.488	2463.456	479.782
Federal agency debt securities	13.329	13.329	13.329	13.329	0.000
Mortgage-backed securities	1771.184	1763.191	1763.186	1773.621	0.000
Primary credit (Discount Window)	0.010	0.013	0.001	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)	1.707	1.704	1.705	1.705	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	0.917	0.491	1.132	0.143	62.000
Federal Reserve Assets	4515.9	4506.0	4504.3	4514.6	961.7
3-month Libor %	1.15	1.11	1.09	1.05	2.82
Factors draining reserves					
Currency in circulation	1531.006	1528.995	1521.561	1512.508	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	226.510	212.124	156.010	177.833	0.000
Reserve Balances (Net Liquidity)	2368.120	2351.131	2307.954	2243.156	24.964
Treasuries within 15 days	0.000	0.000	0.000	13.175	14.955
Treasuries 16 to 90 days	60.469	60.468	48.558	48.558	31.549
Treasuries 91 days to 1 year	183.357	183.351	195.256	163.208	69.272
Treasuries over 1-yr to 5 years	1216.841	1216.815	1216.789	1240.509	170.807
Treasuries over 5-yrs to 10 years	376.170	376.137	376.104	372.215	91.863
Treasuries over 10-years	626.975	626.878	626.781	625.791	101.337

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

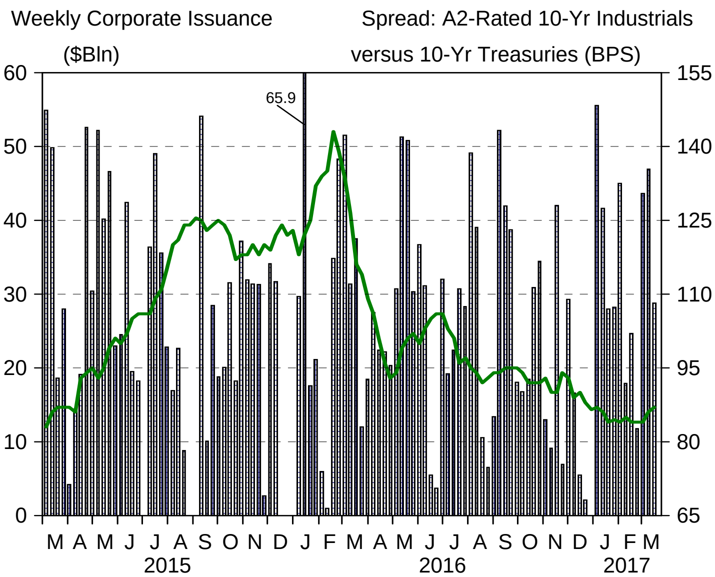
No guidance was provided. July Fed funds futures closed the week at a 48% chance of a June Fed meeting rate hike to 1.25%. A hike in June would make it three consecutive press conference meeting hikes in a row. Almost sounds like a "measured" pace three in a row: if you trust what these Fed funds futures contracts are telling you. It is only a 50/50 shot and a long way to go before we get there. We aren't convinced these Fed funds futures contracts are back to normal yet in terms of setting market expectations this far ahead after the Fed left rates at zero since December 2008. The money market is still kind of broken in terms of pricing and as a barometer of "market expectations" of Fed policy. Look at the edge if you will of the money market with 2-yr Treasury yields closing Friday at 1.32%. Isn't the Fed saying the Fed funds rate will be 1.5% at the end of this year? See, broken.

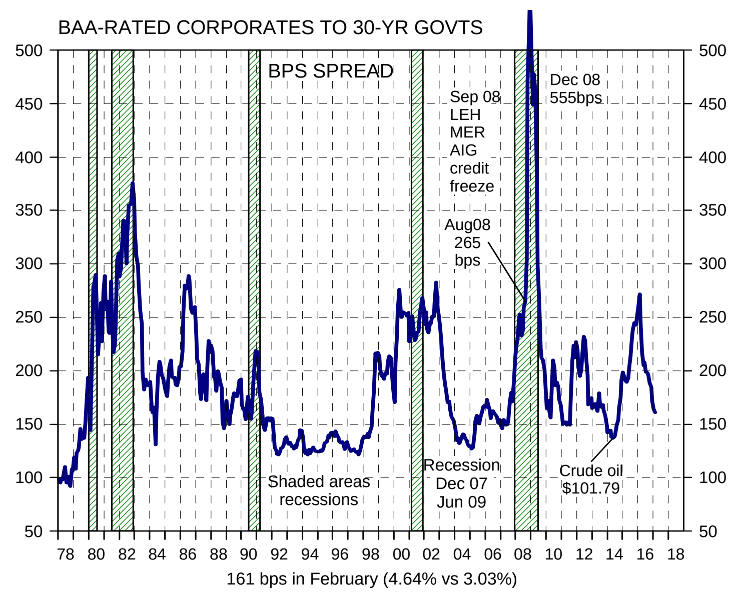
There were a few minor word changes between the February 1 and March 15 Fed meeting press statements. One looked more than minor, but Yellen said the change wasn't significant during the Q&A session. "The Committee expects that economic conditions will evolve in a manner that will warrant ~~only~~ gradual increases in the federal funds rate" they said in February and they cut the word "only" in this week's statement. "Gradual" sounds quicker than "only gradual," but Yellen said forget it. It wasn't a meaningful change. The March dots forecasts have firmed up a bit since the December forecasts, with more on board for three rate hikes in 2017 (14 out of 17 members now up from 11 out of 17 in December), even if the median still looks for a 1.5% Fed funds rate at the end of 2017.

The Fed press statement also had a minor change in the talk about inflation-this may be more of a major change however. We guess they had to acknowledge that headline PCE inflation (1.9% YOY in January) is moving closer to 2% target, so they no longer have in there that it is "still below" the Committee's objective. 1.9% is close enough to 2.0%. They said it is "moving close" to 2% but then dumbed this down by saying that core PCE inflation excluding food & energy (1.7% YOY in January) "was little changed and continued to run somewhat below 2 percent." Yellen said more on this in the Q&A session seemingly elevating the importance of core PCE inflation needing to rise to the 2 percent Fed target. Is it just us or do others think the Fed deliberately tries to pick data that show they are always just short of achieving their objectives so interest rates need to stay low until 2019? We will see. Congress may want to change their objectives for one thing. And as far as inflation is concerned, core CPI inflation is still way up there at 2.2% YOY and one reason core PCE inflation is lower at 1.7% YOY is the reduced Medicare payments to doctors under Obamacare. Maybe this will change ahead. Also PCE inflation tends to get revised higher and closer to CPI inflation in the annual benchmark revisions which this year will be announced on July 28. Either way maybe core PCE inflation will be moving higher. And maybe it will make this Fed or the next one want to raise rates more quickly to 3% normal currently not expected to be reached until the end of 2019.

CORPORATE BONDS: VERIZON, HUMANA, WYNDHAM, PENSKE, APA GROUP

Corporate bond offerings were $28.8 billion in the March 17 week versus $46.9 billion in the March 10 week. On Monday, DXC Technology sold $1.5 billion 3s/7s/10s. It priced $500 million 4.75% 10-yrs (m-w +35bp) at 215 bps (BBB/Baa2). DXC Technology will own the Computer Sciences Corporation and Hewlett Packard's Enterprise Services business, referred to Everett SpinCo. Inc., when the merger closes. Corporate bonds (10-yr Industrials rated A2) were 87 bps above 10-yr Treasuries on Friday versus 86 bps last Friday.





TREASURY MARKET OUTLOOK

EXPECTED 10-YR 2-3 WEEK TRADING RANGE 2.00% to 2.75%

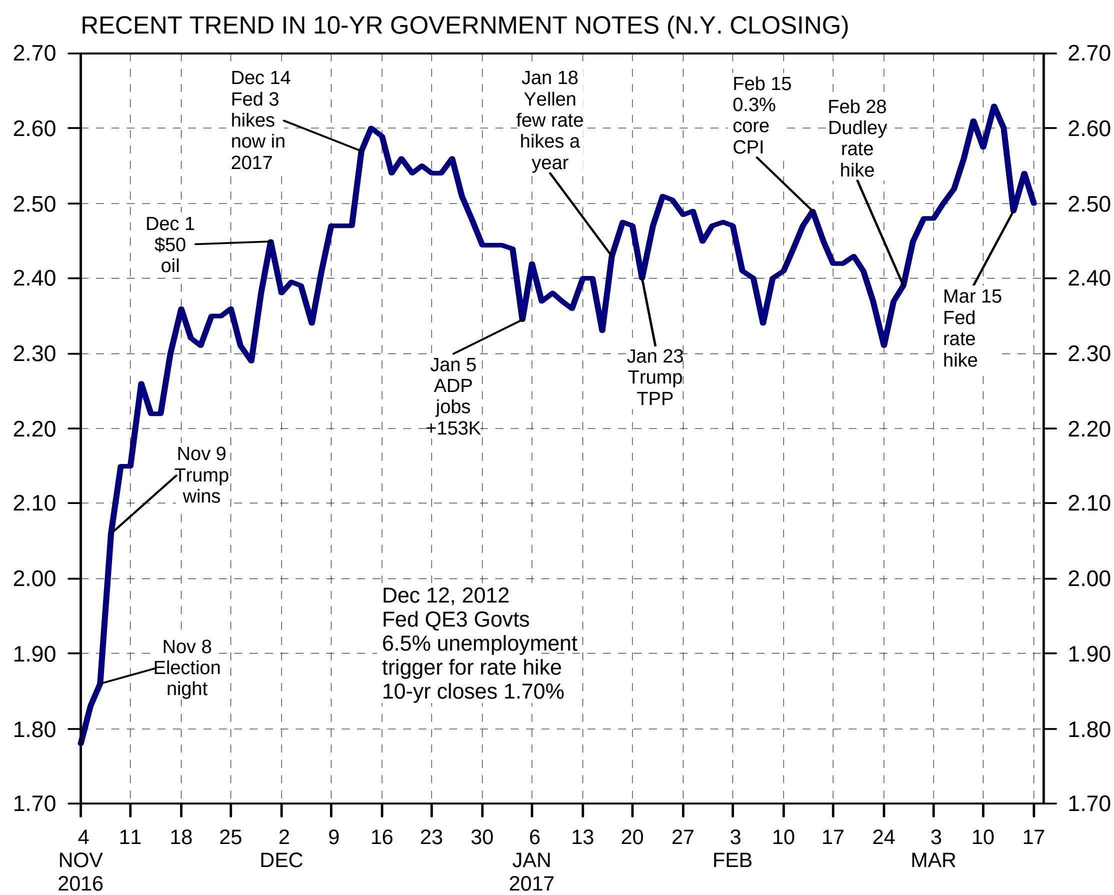
Week's 10-YR Range

HIGH 97-30+ 2.48%

Thursday, March 16, early in Asia trading after Fed decision sticking with three rate hikes in 2017

LOW 96-23 2.63%

Tuesday, March 14, lows made in Asia trading after $18 billion of corporate bond issuance on Monday



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