Financial Market Weekly

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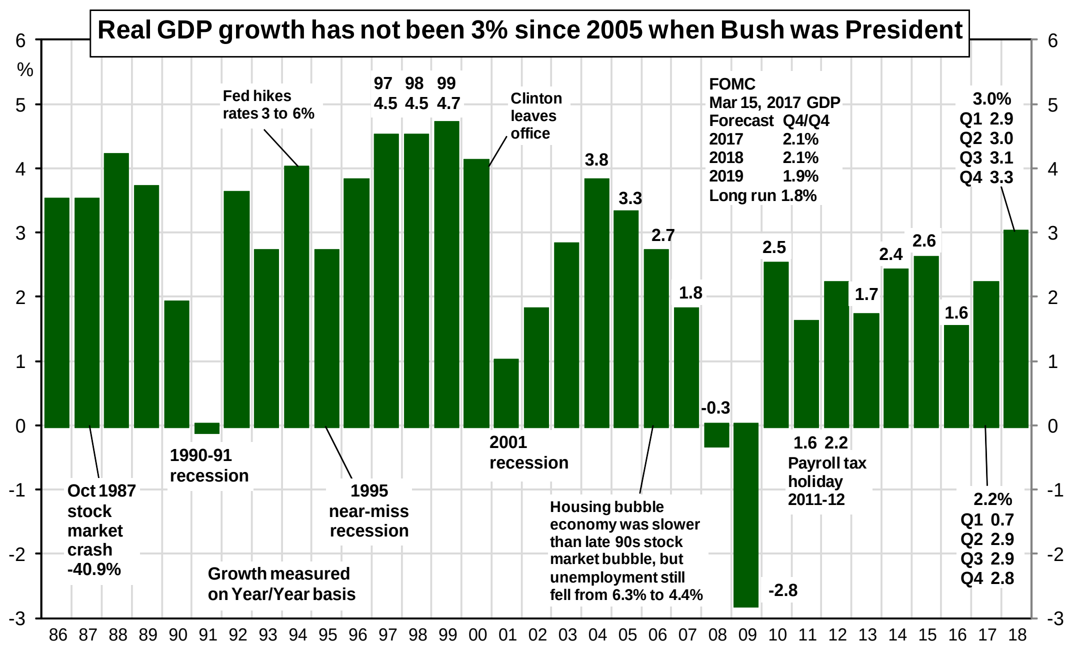
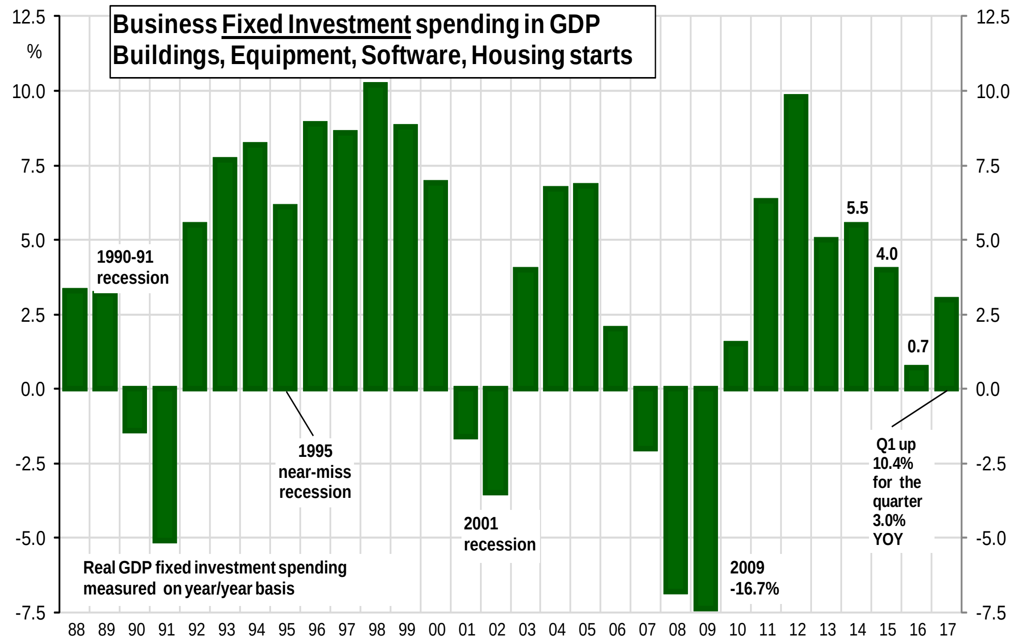
REAL GDP SLOWS TO 0.7% IN Q1 2017, HURTING FULL YEAR FORECAST



Real GDP slowed to 0.7% in Q1 2017, less growth than Obama's final quarter of 2.1% growth in Q4 2016. What's going on? Growth is slower, is it President Obama's economic policies? What happened to the animal spirits (let's not forget Dow Jones industrials rose 7.9% Q4 2016 and 4.6% Q1 2017) unleashed after the unexpected Trump victory last year? Well growth in 2017 is starting out the year in a 0.7% hole perhaps, and we had to give up on our official MUFG 2017 real GDP forecast of 2.5% this year. Growth of 2.5% is mathematically impossible for the full year 2017 without some big 3% plus quarters coming up. It sounded high the 2.5% in 2017 forecast after 1.6% economic growth in 2016, but don't forget 2016 was slower than 2015's 2.6% largely due to the crash in crude oil prices. Consumer expenditures had been fairly consistent, and strong, looking back to 2014. Our forecast in 2017 of 2.5 percent really just represented a rebound back to 2015's 2.6% growth as the inventory drag is

Year-on-year growth	2014	2015	2016	2017e	2018e
REAL GDP	2.4	2.6	1.6	2.2	3.0
Consumer Spending	2.9	3.2	2.7	2.4	2.7
CONSUMPTION	2.0	2.2	1.9	1.6	1.9
Durables	0.5	0.5	0.4		
Nondurables	0.4	0.4	0.4		
Services	1.1	1.3	1.1		
INVESTMENT	0.7	0.8	-0.3	0.6	0.9
Business Plant	0.3	-0.1	-0.1	0.1	0.2
& Equipment and	0.3	0.2	-0.2	0.1	0.2
Intellectual Property	0.2	0.2	0.2	0.2	0.2
Homes	0.1	0.4	0.2	0.2	0.3
Inventories	-0.1	0.2	-0.4	0.0	-0.1
EXPORTS	0.6	0.0	0.0	0.5	0.4
IMPORTS	-0.7	-0.7	-0.2	-0.6	-0.5
GOVERNMENT	-0.2	0.3	0.1	0.2	0.4
Federal defense	-0.2	-0.1	0.0	0.0	0.2
Fed nondefense	0.0	0.1	0.1	0.0	0.0
State and local	0.0	0.3	0.1	0.1	0.2

Below line: Percentage point contributions to 2016 1.6% real GDP gone, business investment is perking up, as well are exports as the world economy is "doing better." Getting to 2.5% was no big deal. After getting Friday's GDP report, 2.5% growth for 2017 would be a big deal, unless you want to pencil in a rebound in inventories-but we don't normally like to think of inventory accumulation being "growth." We marked the GDP growth forecast in 2017 down to 2.2% basically due to the soft patch for spending by consumers in the first quarter.



Meanwhile, the Make It Great Again growth of 3.0% in 2018 is not impossible, yet. The 2018 story is a little more on the heroic side and requires government spending at all levels to kick in 0.4 percentage points of growth. Tax cuts for business and consumers are not really assumed to take place on a massive scale, and in any event we don't see "taxes" fueling more consumption (strong enough already) or more business investment in structures, equipment or software. There is a business/economic cycle, and companies may have bought all the investment they need for this expansion for now. The economy isn't not great right now. The nation is at full employment: 4.5% unemployment. There is no one out of work. The 1.6% real GDP growth last year was fast enough to lower the unemployment rate from 5.3% in 2015 to 4.8% in 2016 on an annual average basis.

Business investment was stronger in Q1 2017 even as the consumer was AWOL last quarter. Fed officials often decry the lack of investment as if it is something that keeps them from putting rates up to even 3% any time soon (not till December 2019 latest forecast). Companies shipped more equipment in Q1 2017 which matches with the durable goods orders here, but we are not sure it will last. There is still talk in Washington of changes in taxes possibly allowing for the immediate expensing of equipment purchases. Until this uncertainty over potential tax policy changes lifts, spending on equipment could actually get postponed.

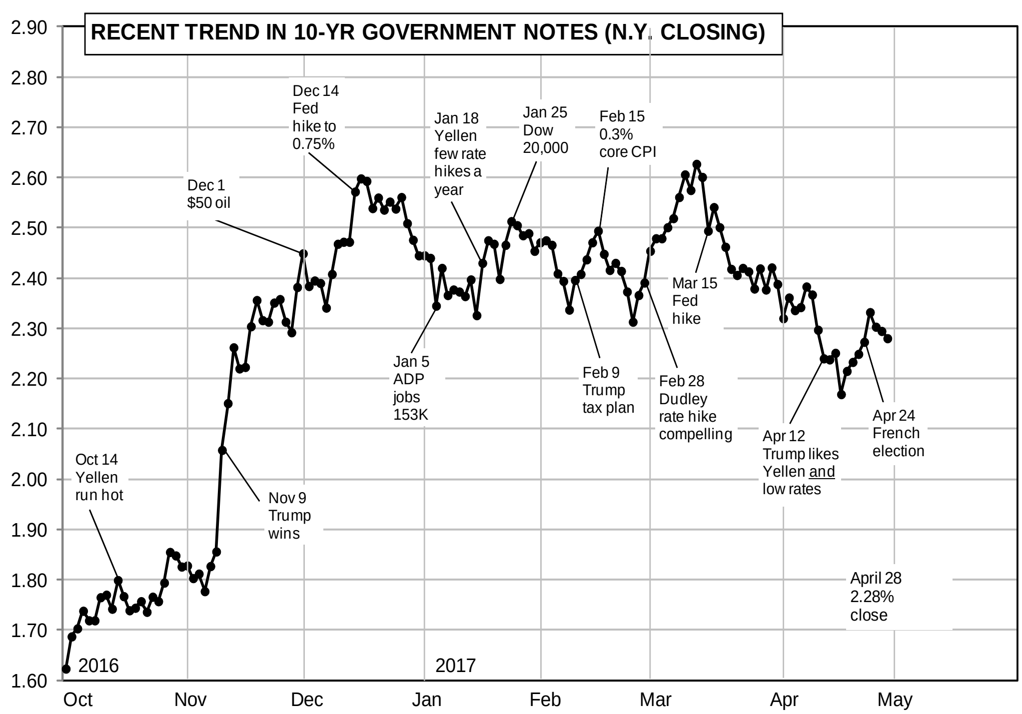
$BLN Nominal GDP expenditures	Q4 15	YOY%	Q1 16	Q2 16	Q3 16	Q4 16	YOY%	Q1 17	Annual rate
Equipment & Intellectual Property	1823.5	4.4	1806.4	1817.4	1813.2	1822.9	0.0	1854.3	6.9%
EQUIPMENT	1092.6	4.2	1066.3	1058.7	1049.3	1053.5	-3.6	1079.2	9.8%
Information processing equipment	322.1	4.6	319.9	316.8	322.8	324.4	0.7	334.3	12.2%
Computers	75.4	-7.1	76.0	78.2	77.0	74.4	-1.3	76.8	12.9%
Other processing equipment 1	246.6	8.7	243.9	238.6	245.8	250.0	1.4	257.5	12.0%
Industrial equipment	224.7	3.8	222.2	227.3	226.1	228.7	1.8	236.5	13.6%
Transportation equipment	310.7	10.3	301.3	297.6	286.7	286.6	-7.8	292.6	8.4%
Other equipment 2	235.1	-3.2	222.9	217.0	213.7	213.8	-9.1	215.8	3.7%
INTELLECTUAL PROPERTY	730.9	4.9	740.1	758.7	763.9	769.4	5.3	775.1	3.0%
Software	330.1	3.8	336.0	339.4	342.6	343.7	4.1	346.2	2.9%
Research & Development (R&D)	320.3	5.7	323.0	337.9	338.8	342.3	6.9	345.5	3.7%
Entertainment, literary, artistic	80.6	6.2	81.1	81.4	82.5	83.4	3.5	83.4	0.0%

1 Communication, medical, photocopy, office and accounting equipment; nonmedical instruments

2 Furniture; agriculture, construction, mining/oilfield, and service industry machinery; electrical equipment

MARKETS OUTLOOK

	31-Mar 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019
30-Yr Treasury	3.03	3.10	3.20	3.40	3.60	3.70	3.80	4.00	4.10	4.10	4.10	4.20
10-Yr Note	2.40	2.50	2.70	3.00	3.20	3.40	3.50	3.70	3.80	3.90	3.90	4.00
5-Yr Note	1.93	2.10	2.40	2.70	3.00	3.20	3.30	3.50	3.60	3.70	3.70	3.90
2-Yr Note	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.20	3.35	3.35	3.50
3-month Libor	1.15	1.50	1.70	1.95	2.20	2.45	2.70	2.95	3.20	3.45	3.45	3.70
Federal Fund Rate	1.00	1.25	1.50	1.75	2.00	2.25	2.50	2.75	3.00	3.25	3.25	3.50
2s/10s spread	115	100	95	100	95	90	75	70	60	55	55	50
Libor/funds spread	15	25	20	20	20	20	20	20	20	20	20	20



Bonds yields closed 3 bps higher at 2.28% this week. The first look at first quarter GDP (0.7%) did not provide much excitement either. 10-yr Treasury yields were 2.31% at GDP release time, and actually rose to 2.33% on the news from a second report, the Employment Cost Index (wages), which rose 0.8% in Q1 2017, the biggest quarterly jump looking back to 2009 when the recession ended. Treasury yields then drifted down to the 2.28% close of the week in quiet trading conditions.

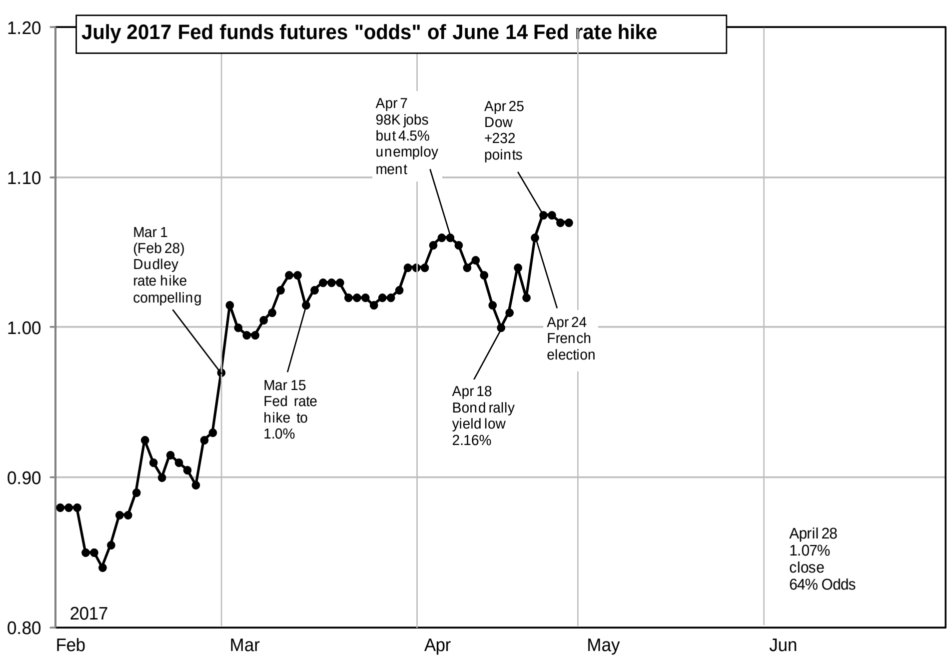
FEDERAL RESERVE POLICY

Selected Fed assets and liabilities					Sep 10
Fed H.4.1 statistical release					2008**
billions, Wednesday data	26-Apr	19-Apr	12-Apr	5-Apr	pre-LEH
Factors adding reserves					
U.S. Treasury securities	2464.730	2464.638	2464.546	2464.454	479.782
Federal agency debt securities	11.829	11.829	13.329	13.329	0.000
Mortgage-backed securities	1769.013	1776.917	1781.091	1769.122	0.000
Primary credit (Discount Window)	0.011	0.043	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)	1.709	1.708	1.708	1.718	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	0.080	0.035	0.045	5.075	62.000
Federal Reserve Assets	4516.5	4525.6	4530.7	4520.8	961.7
3-month Libor %	1.17	1.16	1.16	1.15	2.82
Factors draining reserves					
Currency in circulation	1542.724	1541.322	1540.933	1540.054	834.477
Term Deposit Facility	0.000	0.000	0.000	0.000	0.000
Reverse repurchases w/others	122.323	116.567	105.528	174.644	0.000
Reserve Balances (Net Liquidity)	2200.670	2256.670	2367.767	2337.776	24.964
Treasuries within 15 days	14.058	14.058	0.460	0.460	14.955
Treasuries 16 to 90 days	46.551	46.550	59.336	59.336	31.549
Treasuries 91 days to 1 year	200.650	200.648	201.692	201.689	69.272
Treasuries over 1-yr to 5 years	1194.564	1194.549	1194.562	1194.547	170.807
Treasuries over 5-yrs to 10 years	381.211	381.191	381.007	380.988	91.863
Treasuries over 10-years	627.696	627.642	627.489	627.435	101.337

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

The Fed meets May 2-3 to consider its monetary policy. This is a non-regularly scheduled press conference meeting so no action is expected. The median Fed forecast made at the March meeting looks for three rate hikes this year. They've done one 25 bps rate hike to 1.0%, and now have two more left to go, presumably at one of the three remaining meetings with press conferences in June, September, and December.

If we can forget next week's Fed meeting, the odds of a June meeting rate hike to 1.25% are surprisingly high. July Fed funds futures closed Friday at odds of 64% versus last Friday, April 21 when the odds were much lower at just 44%. The only problem with the Fed funds market-based odds of the Fed springing into action, is that most of the adjustment took place immediately on Monday after the "Euro is safe" election results from France in last Sunday afternoon's first election results. Why Fed officials, many and most residing a long distance away from Europe, would think the first election result in France means a greater likelihood of a U.S. June rate hike right here in the good ol' USA is beyond us. And the 0.7% real GDP report on Friday for the first quarter? Fed funds futures odds were unchanged at 64% as perhaps New Yorkers and Wall Street still control much of world markets expectations, and they seemed to take the warm spring weather day off.



March 15, 2017 Press Statement
Paragraph 1

"Information received since the Federal Open Market Committee met in February indicates that the labor market has continued to strengthen and that economic activity has continued to expand at a moderate pace. Job gains remained solid and the unemployment rate was little changed in recent months. Household spending has continued to rise moderately while business fixed investment appears to have firmed somewhat. Inflation has increased in recent quarters, moving close to the Committee's 2 percent longer-run objective; excluding energy and food prices, inflation was little changed and continued to run somewhat below 2 percent. Market-based measures of inflation compensation remain low; survey-based measures of longer-term inflation expectations are little changed, on balance."

In Wednesday's statement on May 3, the jobs market tells two stories with the 98K weakling payroll jobs report for March, yet two-tenths drop of unemployment to 4.5% [4.4% was the best during the Greenspan Housing Bubble Years]. "Household spending" is no "longer expanding at a moderate pace" obviously and is the soft patch behind Friday's tepid 0.7% GDP report for the first quarter. And core PCE inflation probably slipped back a notch from reaching the 2.0% Holy Grail. Core PCE inflation was 1.8% in February and no higher than 1.7% in March according to our estimate. But who knows how they will describe current economic conditions in this paragraph, and whether the 64% odds of a rate hike in June shades their characterization of how well the economy is doing right now.

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