Financial Market Weekly

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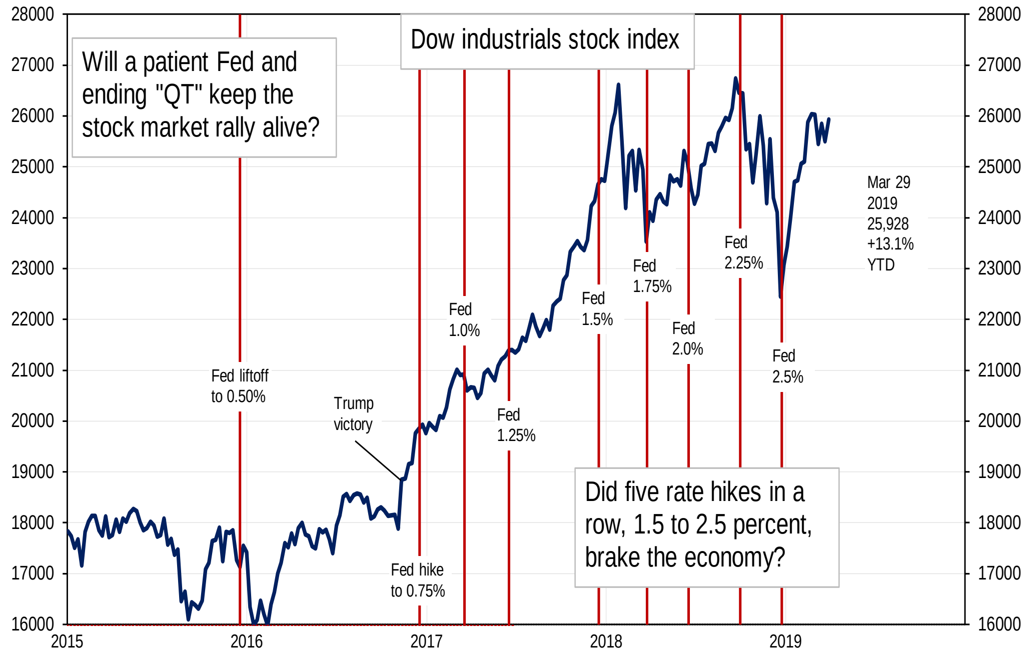
29 MARCH 2019

FED ON SIDELINES CITING DOWNSIDE RISKS THAT THE STOCK MARKET DOES NOT SEE



The President and all his men don't like the last two Fed rate hikes. The stock market has rallied back from the December lows however. Is it because the Fed altered its policy, its path for interest rates as New York Fed President Williams told The Economic Club of New York on March 6? He said, "So if we hadn't, I think, shifted our communication around the likely path of interest rates, I don't think financial conditions would have responded as much as they have." We hope the Fed is not steering its policy on which way the stock market winds are blowing. On the other hand, we sure like higher stock prices, the Dow industrials closing up 13.1% year-to-date on Friday, and we are keeping our fingers crossed that no news (China?) coming out of Washington fouls things up.

> Donald J. Trump 3-29-19 5:41PM EDT
> @realDonaldTrump
> Had the Fed not mistakenly raised interest rates, especially since there is very little inflation, and had they not done the ridiculously timed quantitative tightening, the 3.0% GDP & Stock Market, would have both been much higher & World Markets would be in a better place!

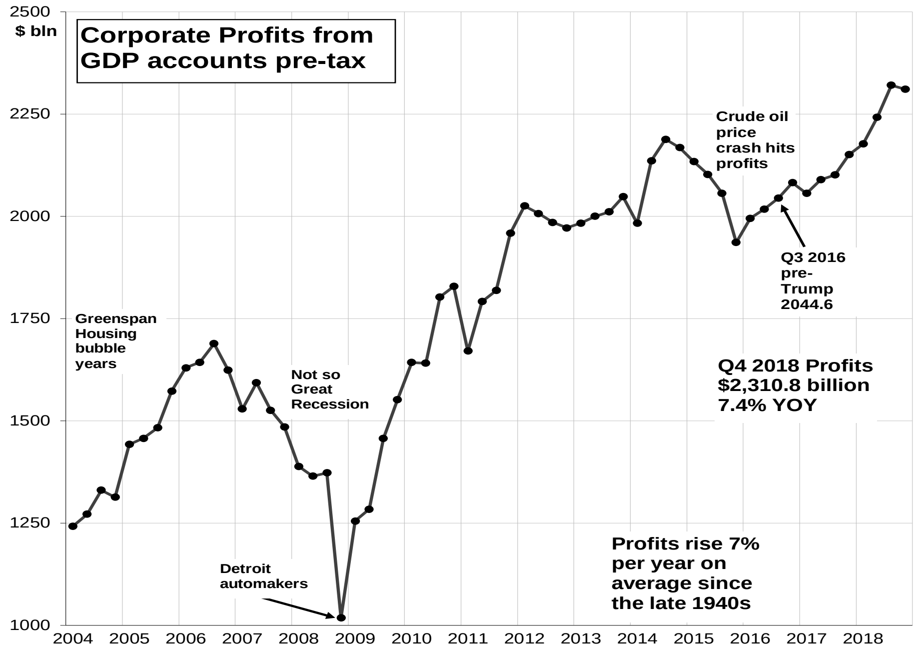
Financial market conditions other than stocks have certainly improved. Who was that Fed governor who said the only reason we cut our rate is to bring down long-term interest rates? Done. Mission accomplished. Pay no attention to the

President's tweets. 10-yr Treasury yields peaked at 3.25% last October/November and fell as low as 2.34% this week when markets thought we were doomed (Recession!) and three Fed rate cuts in 2019 were on the way. Mortgage rates were 4.94% last November and are 4.06% this week which should help the housing sector of the economy. Future stock returns look more valuable now that bond yields have come back down almost a percentage point.

Corporate Profits

$bln	Q4 2018	Q3 2018	Q2 2018	Q1 2018	Q4 2017	2018	2017	2016
Pre-tax	2,310.8	2,320.5	2,242.3	2,177.3	2,150.7	2,262.8	2,099.3	2,035.0
% change	-0.4	3.5	3.0	1.2	2.4	7.8	3.2	-1.1
Taxes	234.7	243.7	234.8	212.0	333.8	231.3	350.7	392.9
% change	-3.7	3.8	10.7	-36.5	-8.6	-34.0	-10.7	-1.1
After-tax	2,076.2	2,076.8	2,007.5	1,965.3	1,816.8	2,031.5	1,748.6	1,642.1
% change	0.0	3.5	2.1	8.2	4.7	16.2	6.5	-1.1

Is there value in stocks based on corporate earnings? Thursday's fourth quarter GDP report had corporate profits as well. Pre-tax profits were $2.262 trillion in 2018 which is up 7.8% from 2017. The top line of the table here is more of an economic sense of profits that adjusts for depreciation and inventory valuation. These GDP corporate profits increase over the long run the same as corporate earnings as reported by S&P 500 companies; both measures rise about 7% annually on average. Corporate profits after tax were even better, rising 16.2% in 2018 after the Tax Cuts and Jobs Act, with corporate taxes falling from $350.7 billion in 2017 to $231.3 billion in 2018.



We don't know if the Fed altering the rates and QT path was the main reason for the stock market rebound from the 16.1% decline last December. They do tend to step in when stocks fall double digits… something to keep in mind next time around.

Dow industrials market sell-offs

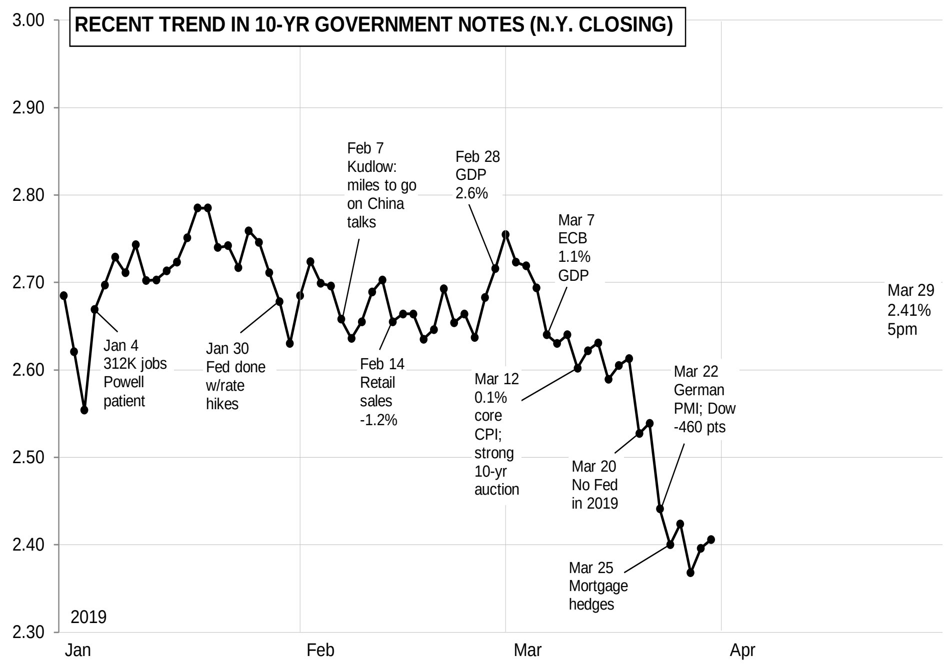
Week ending Fridays

Chg %	Points	High	Low	High	Low	Reason
-15.1	-1909.7	7-22-11	9-23-11	12681.2	10771.5	S&P USA AA+, Fed sees "significant" downside risks
-8.4	-1109.7	4-27-12	6-1-12	13228.3	12118.6	European sovereign debt crisis pre-Draghi do whatever
-7.5	-1021.8	10-5-12	11-16-12	13610.2	12588.3	Fiscal cliff
-5.4	-848.05	8-2-13	8-30-13	15658.4	14810.3	Bond yields taper tantrum, Syria
-5.2	-899.33	9-19-14	10-17-14	17279.7	16380.4	Ebola, IMF cuts world growth forecast
-11.9	-2170.2	5-15-15	9-4-15	18272.6	16102.4	China, oil, 1,000 point flash crash Monday, Aug 24
-10.8	-1936.5	11-6-15	2-12-16	17910.3	15973.8	Fed liftoff, China, $20 oil, world growth, Japan negative rates
-5.3	-947.99	June 2016		18011.1	17063.1	Brexit: Two days June 23 close to Monday, June 27 low
-11.6	-3083.5	1-26-18	3-23-18	26616.7	23533.2	VIX-Linked Notes; China; Trade war(s)
-16.1	-4298.1	9-21-18	12-21-18	26743.5	22445.4	Fed hikes, 3.2% 10-yr, China war, Trump shutdown

The Fed has responded to double-digit stock market losses 4 of the last 5 times.
-15.1% Sep 2011 Announces $400 billion QE Twist
-11.9% Sep 2015 Delays liftoff for interest rates
-10.8% Feb 2016 Halts rate hikes for a year after the first rate hike in December
-11.6% Mar 2018 Doesn't stop, hikes rates to 1.75% on March 21, keeps going
-16.1% Dec 2018 Jumps off gradual rate hikes path

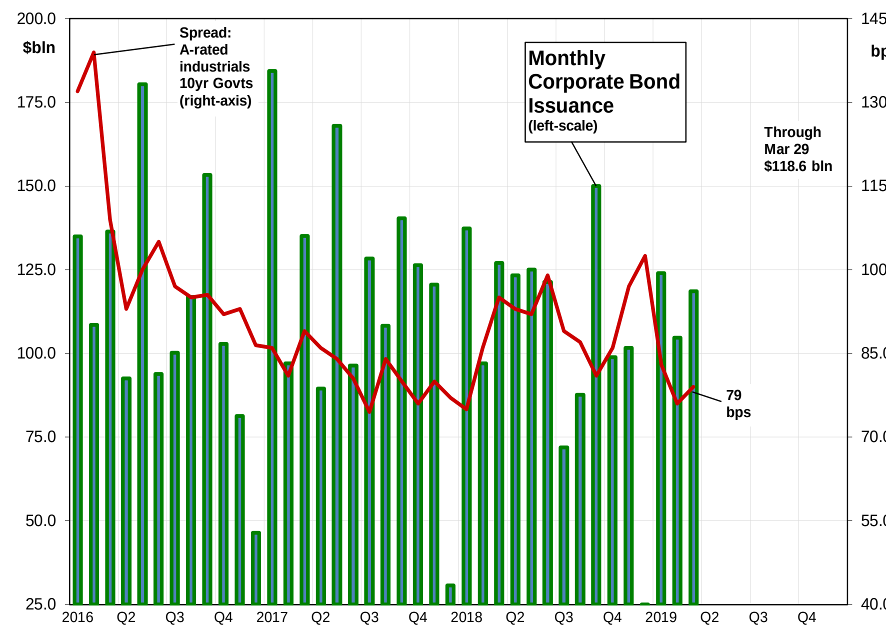
MARKETS OUTLOOK

	29-Mar 2018	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q2 2020	Q3 2020	Q4 2020
30-Yr Treasury	2.81	3.00	3.00	3.10	3.10	3.25	3.20	3.20
10-Yr Note	2.41	2.60	2.70	2.90	2.90	3.10	3.10	3.10
5-Yr Note	2.23	2.45	2.60	2.80	2.80	3.05	3.05	3.05
2-Yr Note	2.26	2.45	2.50	2.70	2.70	2.90	2.95	3.00
3-month Libor	2.60	2.60	2.60	2.90	2.90	3.10	3.10	3.10
Fed Funds Rate	2.50	2.50	2.50	2.75	2.75	3.00	3.00	3.00
2s/10s spread	15	15	20	20	20	20	15	10



There are many people who enjoy great big bond rallies of course, people who don't have to worry about the reinvestment risk at lower yields over the long years ahead down the road. But the biggest market moves always reflect that many are hurting and just have to get out. 10-year yields closed below 2.50% last Friday and set off hedge buying of Treasuries from mortgage-backed securities (MBS) portfolio managers early this week. Duration hedging by MBS holders, GSEs (Fannie/Freddie), REITs, mortgage servicers, tend to make yields fall further in bond rallies and make yields rise higher in bond market sell-offs. Duration hedging is over for now.

CORPORATE BONDS: MARS, NEXTERA ENERGY, DUKE ENERGY, WH GROUP



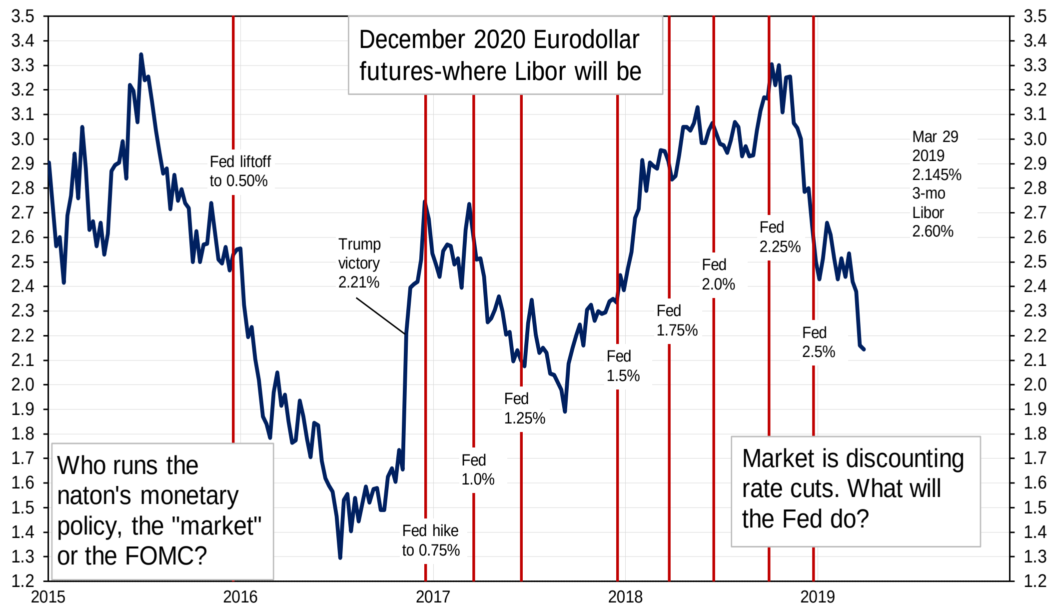
Corporate offerings were $28.8 billion in the March 29 week versus $21.0 billion in the March 22 week. On Friday, Broadcom Inc. sold $11.0 billion 2s/3s/5s/7s/10s. It priced a $3.0 billion 4.75% 10-yr (m-w +40bp) at 240 bps (Baa3/BBB-). The company, one of the world's largest chipmakers, will use the proceeds to repay outstanding indebtedness under its existing credit agreement. Corporate bond yields (10-yr Industrials rated A2) were 79 bps above 10-yr Treasuries this week versus 78 bps last Friday.

FEDERAL RESERVE POLICY

The Fed meets April 30 - May 1 to consider its monetary policy. It is getting harder to be a Fed watcher when you don't know who or what to watch. We used to watch the data and the comments of Fed officials, now we have to start watching the President of the United States. Read the tea leaves. Read the handwriting on the wall. Read the tweets. Maybe the President is angrier at Powell than we thought and maybe this helps explain the Fed's swift retreat to the sidelines the last three months. An abrupt move done to praise Caesar and keep your head from getting chopped off. Trump's tweet Friday night suggests he doesn't like the last two Fed rate hikes and he wants them reversed. Now.

Odds of Rate Cuts Fed funds futures	
F3-29-2019	
24%	2.25% June
66%	2.25% September
104%	2.25% December
Odds at June, September, December Fed meetings	

The Fed the last two decades and business/economic cycles has only cut interest rates when it found itself staring at the whites of the eyes of recession. Rate cuts were done at the last second for emergency reasons when it thought the economy was falling off a cliff. No recession, then no rate cuts, but now the President wants rate cuts to pump up the volume on growth going into the 2020 elections. Fed officials aren't being singled out, hope they don't think they are so special. Trump also tweeted Thursday morning trying to jawbone oil prices lower to help foster stronger economic growth. "Very important that OPEC increase the flow of Oil. World Markets are fragile, price of Oil getting too high. Thank you!" Oil was $58.50 call it, at 830am Thursday tweet time, and it closed the week at $60.14.



We doubt the President will stand down on his criticisms sent over to Fed officials. Sounds like he wants 50 bps of rate cuts. The market is looking for 50 bps of rate cuts by December 2020 in the Eurodollar futures graph above. Guess the Fed could always cite rate cuts were done not because they see weak economic data, but for "risk management" reasons… just in case. Chicago Fed President Evans jetlagged in a Hong Kong speech early Monday morning said as much. He reminisced about his younger days as a young Fed staffer in 1998 where the Fed went to the sidelines and then cut rates three times during the Global financial markets crisis of 1998. We guess he was trying to be helpful, saying the Fed could cut rates three times again to "help the economy." His comment caused the market to discount rate hikes ahead more aggressively. Stay tuned. Story developing. We hope the Fed will continue to do its job and do what's best for the American people. It's just that ahead of the 2020 elections there might be a disagreement down in Washington about what's best for the American people.

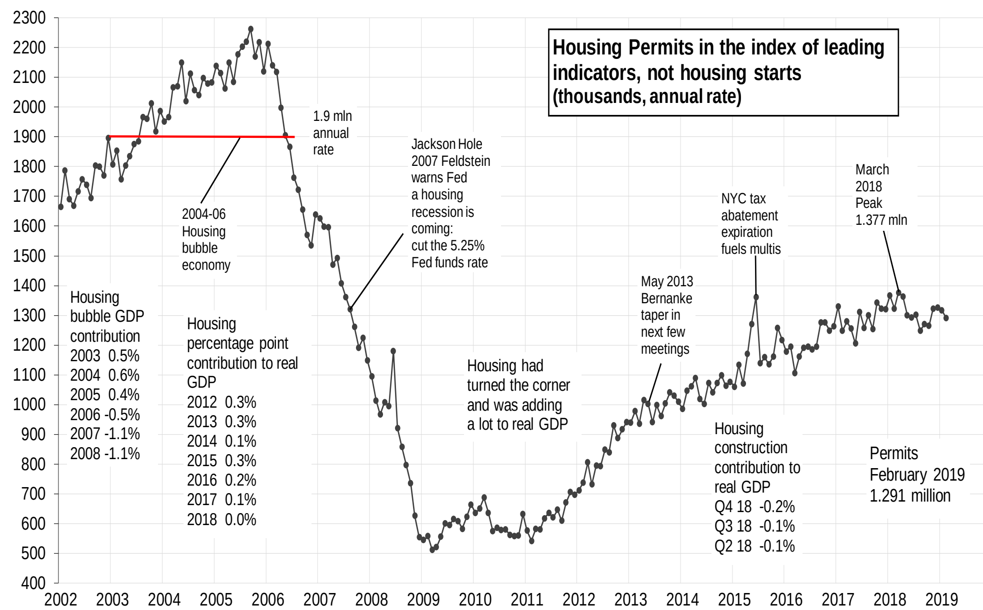
OTHER ECONOMIC NEWS THIS WEEK

Lots of drama for residential housing starts, but permits steady (Tuesday)

Breaking economy news. February housing starts tumbled 8.7% to 1.162 million from a revised gain in January of 18.6% to 1.273 million at an annual rate. The volatility the last three months in housing starts makes it hard to characterize, and it looks like housing permits are much steadier at 1.296 million in February. It is still true that permits usually become housing starts so we would hesitate to say the housing sector is in trouble.

Trouble? How could it be with worker wages up and mortgage rates tumbling almost 1 percent from the high. Most of the weakness in February was out in the West where construction continues to decline. February starts in the West fell 18.9% to 236 thousand and are down a whopping 38.3% from February 2018 levels.

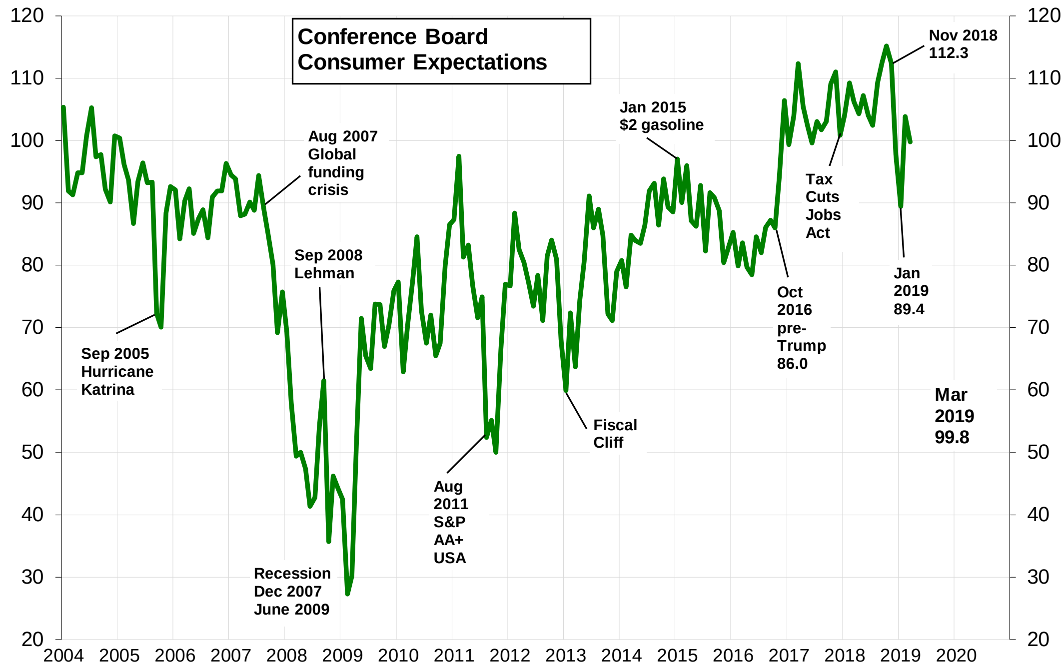
Net, net, in spite of the wild ride some months, the trend in residential housing construction is moving broadly sideways since Trump was elected in 2016 and there is no reason to be concerned about this latest decline in February as permit activity remains on firmer ground. The housing sector is one of the most interest-rate sensitive sectors of the economy so Fed officials will be watching these construction figures like a hawk to see if the downside risks are gaining.



The only mystery is why residential housing construction remains much weaker than the bubble years in the middle of the last decade. Housing starts are 1.162 million in February 2019 which is nowhere near the 2.273 million constructed in January 2006 at the zenith of the housing bubble. There is a shortage of affordable housing and right now, there is no construction in the pipeline to alleviate the lack of housing. Stay tuned. Story developing. The canary is singing in the coal mine when it comes to recession risks looking at today's housing report, but so far it is a happy tune and not expected to get worse.

Consumer confidence is apparently exhausted following the news (Tuesday)

Breaking economy news. Wish the consumer would make up their minds. I'm hot. I'm cold. I'm hot. I'm cold. Like a bunch of coddled eggs. Consumer confidence fell back 7.3 points to 124.1 in March after rallying 9.7 points in February. We hope they aren't following the Fed's messages of caution, patience and pause. We'd hate to think the Fed is injecting an air of caution into the economy by telling consumers and business leaders that the economy isn't strong enough to handle higher interest rates. Maybe it's another story of income inequality in the country as the confidence of those making more than $100,000 was mostly higher in February, while those making less saw confidence levels that were mostly lower. Let them eat cake. There's no plan in Washington to make the Have Nots feel better.



Net, net, the consumer is all mixed up and it's difficult to get an accurate reading the last several months. On balance, the consumer's outlook is downbeat relative to November before getting hit by the triple-whammy news of the Federal government shutdown, sell-off in equity markets and the ongoing Trump administration trade war with China. Consumer confidence certainly matches the pullback in their spending that looks likely for the first quarter. In addition to the news, it was cold outside, colder than normal for winter, and this likely kept the consumer cooped up at home instead of taking a trip to the shopping mall. Who knows what ails the consumer, but you can also throw in the fact that income tax refunds, the total paid out this year, is running less than it was last year, call it $5 to 10 billion less than last year. Stay tuned. Story developing. The consumer is apparently exhausted following the news and their confidence is suffering as a result. Hopefully, they will cheer up later this spring because two-thirds of the economy runs on their spending. The economy is still likely to finish the ten-year race for the record books in June, but after that, who knows.

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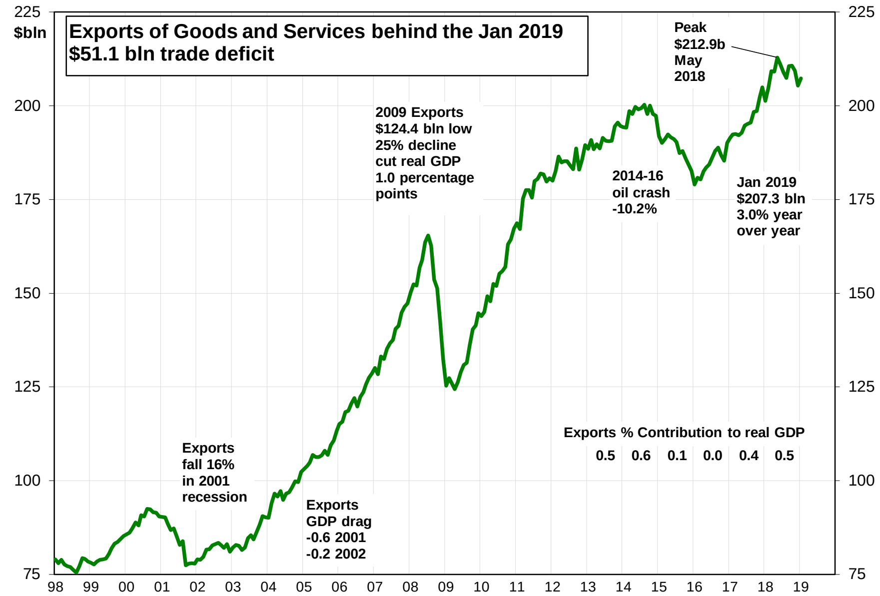
Yo-yo economic data continues with $8.8 billion narrowing in trade deficit (Wednesday)



Breaking economy news. It's up, it's down, it's up, it's down. The crazy economic data the last several months continues with the trade deficit in January narrowing $8.8 billion to $51.1 billion in January. Ahoy! Where's landfall? At least the narrowing makes our first quarter 1.5% real GDP forecast look a little more like it's on solid, higher ground this morning. Geez.

Not sure why the Fed keeps pointing to the risks from world economic growth. The impact from economic troubles abroad always hits the economy here by hurting the amount of exported goods we can sell them. Hate to be selfish, but it's the truth. What can our trading partners buy from us? (They don't really want our cars, but American consumers sure want theirs.) Exports mean jobs, jobs, jobs.

The trade war and Trump administration threats of economic war with the world did not hurt exports in January. The trade deficit narrowed with exports of goods jumping $1.8 billion, while imports dropped dramatically by $6.5 billion. Imports of goods from China were down sharply ($4.4 billion), which were perhaps tariff related, and this may clear up after there is a China-U.S. trade agreement. As far as exports, soybeans were $1.2 billion in January up from $299 million in December. Energy exports were unchanged, probably on the price effect that should end in February. Autos and parts jumped from $12.3 billion in December to $13.5 billion in January. Consumer goods were up about $700 million where cell phones were only $100 million of it.

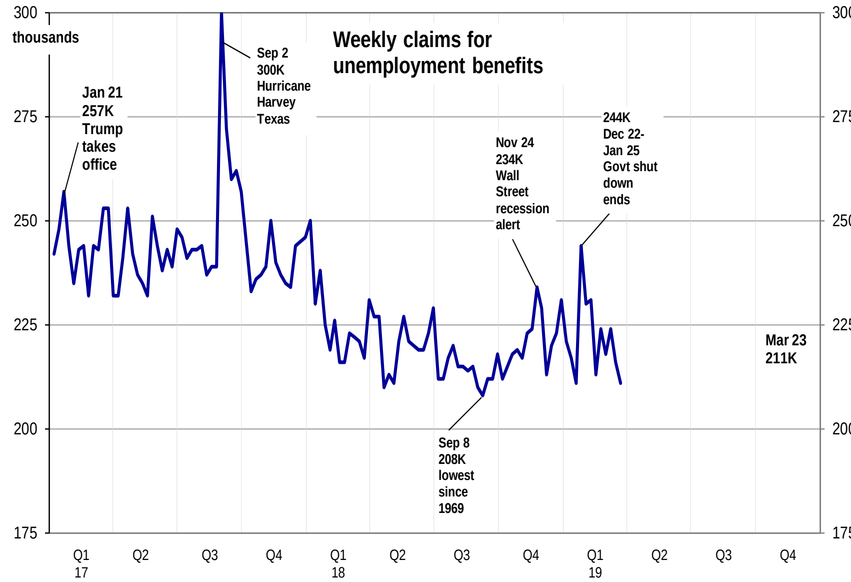
Net, net, the trade deficit narrowed sharply in January mostly due to the reduction in imports which may be in part tariff-threat caution related and part energy related given the sharp drop in crude oil prices. Stay tuned. Story developing. The trade wars may have injected an air of caution into the world markets and U.S. companies did not import as much capital goods including computer accessories and semiconductors and industrial machines this month. Time will tell whether this is a one-off or the start of an alarming new trend where businesses pull back from making needed investment in economic growth this year.

It looks like the Fed was wise to head to the sidelines awaiting clarification on the outlook because businesses and consumers certainly bought less from overseas in January which is a telling sign of caution on their part. Let's hope that the America First policy from the Trump administration does not mean America is last when it comes to economic growth. There have been a lot of changes coming out of Washington and it has made it a much less certain world out there for business. We are keeping our fingers crossed that companies continue to invest in the future that helps make the economy grow.

Economy off death watch, whew, and GDP still 3.0% last year if you're bragging (Thursday)

Breaking economy news. Weekly jobless claims and a revision to fourth quarter GDP last year. You can take the economy off death watch if you were rooting for it, you bond market vigilantes out there driving bond yields lower, buying it all because you think the economy is doomed and Fed rate cuts are on the way. Where did bond traders get such a stupid idea? Oh. We forgot. Federal Reserve officials rushed to the sidelines and are saying that the downside risks are mounting, but don't worry we stand ready to help just like we did in 1998, when our risk management approach cut rates three times and the economy rebounded. Geez. No risk of any management at the Fed. They don't know what they are doing, don't know the harm they are doing to public expectations by shouting the sky is falling. Warning of downsides risks.

Yes, take a breath. You can take the economy off death watch (for now) as weekly jobless claims fell back from where we thought they were last week, 221K, down to 211K in the March 23 week. We have to study this more because this is the week they do their annual revision and the trend may have changed somewhat, but at the very least companies are not laying off workers in a way that they would if the economy was headed over a cliff.



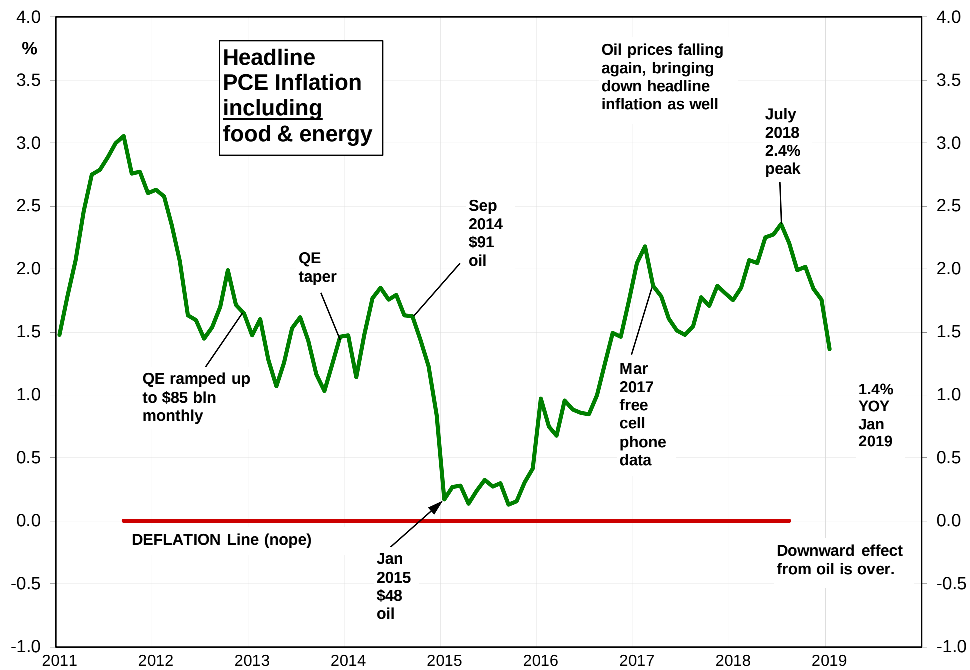
GDP was revised down to 2.2% in the fourth quarter from 2.6% as consumers spent less after more data came in. Consumer spending was 2.5% in the fourth quarter not 2.8%. If you are the Trump economics team you can still brag about 3.0% GDP growth for all of 2018 fourth quarter to fourth quarter. It is indeed 3.0% in 2018 not 3.1%, but no big deal. 3.0% growth is not that much different than 2.7% in President Obama's term so you can't brag too much, as if our admonishment would stop any of the tweets coming out of Washington.

Net, net, the economy slowed more than we thought at the end of 2018 which heightens the sense of foreboding over the outlook for growth this year. Fed officials have penciled in a forecast of 2.1% this year. Bunch of gloomy Gus's and Gail's that they are. Critical to the forecast for the year however is just how weak the first quarter is, as 1% or less after the government shutdown and cold winter weather will tear the full year 2019 forecast to shreds. Still, 2.1 percent seems a little too pessimistic, we expect 2.4% growth in 2019. No recession. No recession. No recession. Bet on it.

Economic growth slowed last year, but there is no indication despite the risks that companies are taking steps to reduce staff which would signal a significant slowdown of the economy. GDP was revised down today, but spring is in the air and the green shoots of better times are ahead with companies continuing to hold on tight to their workers.

Cold in January, consumer still in hibernation; inflation further from target (Friday)

Breaking economy news. The monthly personal income report. Real consumer spending rallied 0.1% in January from the 0.6% plunge in December. Consumer spending is starting out in a rut in the first quarter with spending falling 0.6% so far with February and March data still to be reported after rising 2.5% in the fourth quarter. There was uncertainty out there, but most of the uncertainty from the stock market got cleared up in a hurry in the first quarter as Fed Chair Powell said he could be patient.



Consumers have often gone into hibernation in the first quarter in many years recently. Spending was 0.5% in Q1 2018, 1.8% in Q1 2017, 1.6% in Q1 2014. Rising 1.6% in Q1 2019 would actually count as a victory of sorts for the economy. We expect the consumer to reengage as the weather starts to warm up and the uncertainty from the government shutdown and stock market turbulence starts to fade. We still expect GDP growth of 1.5% in the first quarter.

Inflation pressures diminished in January as the plunge in oil prices dragged down the energy prices that consumers pay. Headline PCE inflation fell 0.1% in January and is running at 1.4% year-on-year which is well below the Fed's 2.0% target. Even if economic growth picks up, headline inflation won't pick up for another year unless crude oil prices rally further from those $40 lows hit in December. Even core inflation is modest falling to 1.8% year-on-year from 2.0% in December.

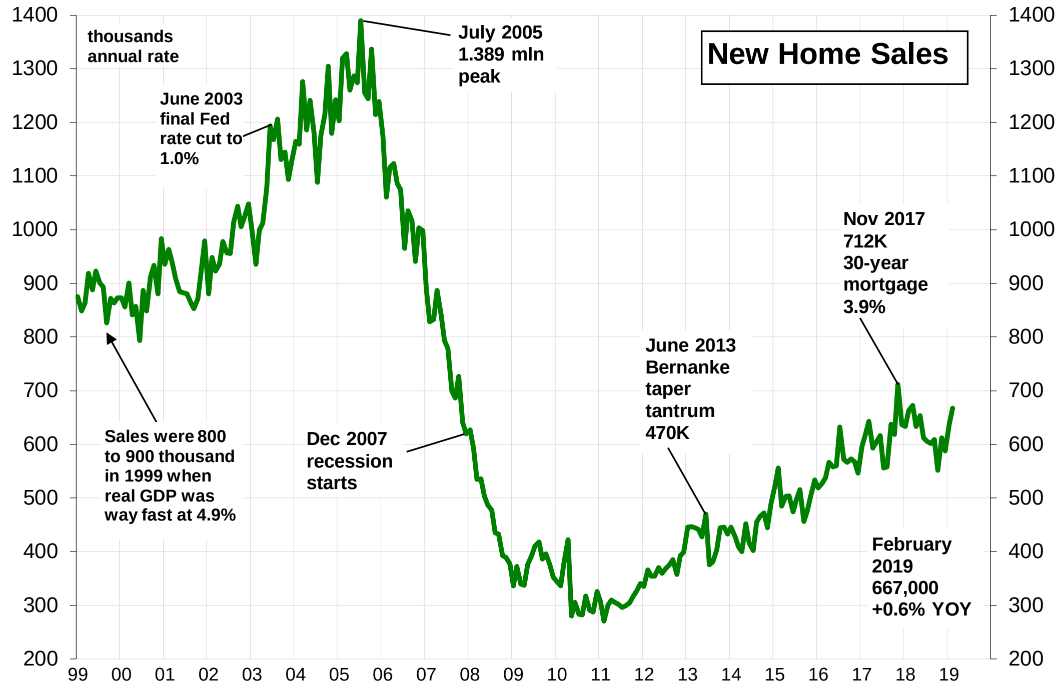
Net, net, the consumer is crawling their way back in a cold January and actually managed to spend a little despite the harsh winter weather conditions in much of the country and of course the Federal government shutdown that wasn't over until January 25. With consumer spending modest and inflation falling away further below target this is likely to reinforce the Fed's disposition to sit the year out without any further interest rate hikes. At the same time, there is not enough weakness for the Fed to panic and actually cut interest rates. Why would they need to with mortgage rates falling almost 1 percentage point from last year to 4.06% this week. The market cut long-term interest rates for the Federal Reserve already which should steady the housing sector and the broader economy.

It was cold out there in January and with the consumer still in hibernation and inflation falling lower relative to target, Fed officials can take their sweet time in determining where interest rates go next. The economy is in a sweet spot of sorts right now with economic growth that is just right and interest rates that are low enough to continue to support the expansion. There is no sign the economy is about to go off the rails and we expect growth to hit the 10 year mile mark in June this year. Bet on it.

Consumer is happy enough to buy a new home this winter (Friday)

Breaking economy news. Consumer sentiment and new home sales. The trend in new home sales has completely turned around with today's February report and revisions to the prior 3 months of data. The new home sales low was made in October at 552 thousand, a one-off really, and the trend has been up, up, up since that time with 667 thousand new homes bought in February (annual rate).

Consumer sentiment has rebounded and this is helping to drive the new home sales. Consumer sentiment was 98.3 in December and plunged to 91.2 in January as the Federal government shutdown and stock market turbulence finally caught up with the consumer and dragged down confidence, but now consumer spirits have improved markedly with sentiment jumping 4.6 points in March to 98.4.



Net, net, the sky isn't as dark as some had thought as consumers remain upbeat and they bought the most new homes since March 2018. Consumers are happy and you know it because they just bought a lot more new homes in February despite the cold winter weather conditions. We think the plunge in mortgage rates was a big part of the story here which makes it significantly cheaper to finance the purchase of a new home. Stay tuned. Story developing.

It looks like the Fed's patience is starting to get rewarded as the latest data on confidence and home sales really shine. We have every reason to think that the first quarter economic soft patch for growth will be the low point for the year. Growth should come back strongly later on this spring as the green shoots on confidence and home sales point the way forward to a better tomorrow.

Analyst Certification

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