

Financial Market Weekly

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

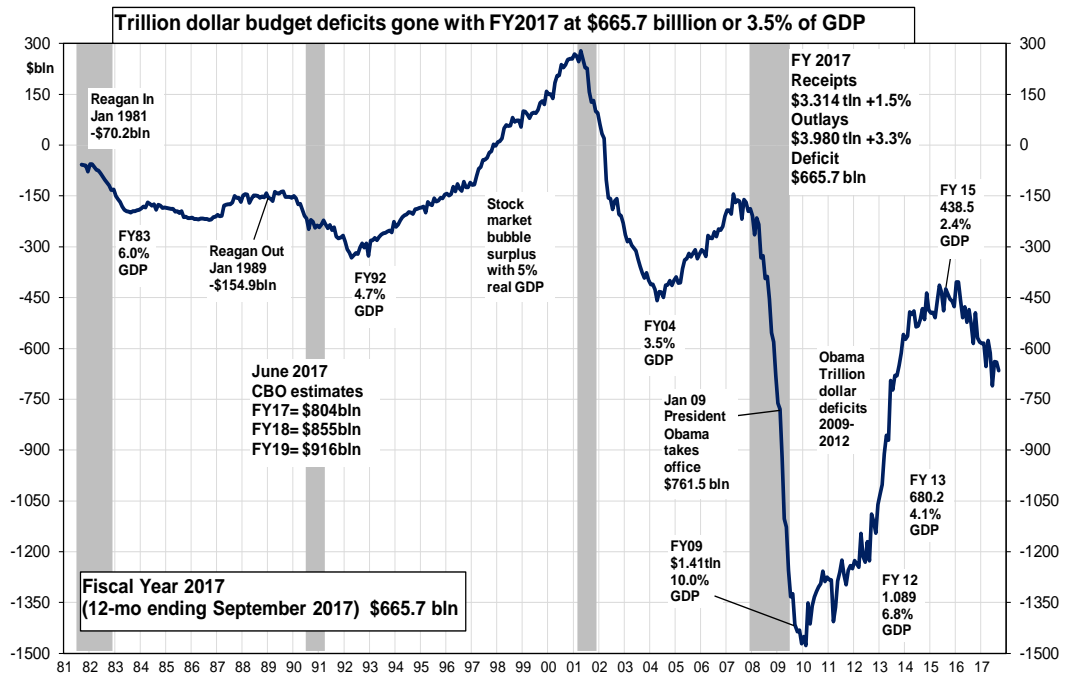
20 OCTOBER 2017

MUFG Union Bank
 A member of MUFG, a global financial group

\$666 BILLION FEDERAL BUDGET DEFICIT LAST YEAR, WITH TAX CUTS ON THE WAY; WHY NOT? THE NATIONAL DEBT IS ONLY \$20 TRILLION

It's hard to keep up with the latest thinking down in Washington when it comes to the budget and taxes. The stock market rallied on Friday in part because the Senate voted through (51-49) a budget resolution for fiscal year 2018 late on Thursday night. It includes \$1.5 trillion for "comprehensive tax reform" over ten years.

But it needs to be reconciled somehow with the House budget resolution which is deficit neutral. Meanwhile, on Friday, the actual Federal budget results for the final month of fiscal year 2017 (FY17) were released. The number is 6-6-6, setting the new Administration up for an ominous start when it comes to government spending: how much money will it take to make America great again. The budget deficit starting out is already at \$666 billion in FY17.



If the eventual budget with tax cuts, corporate/individual, does indeed make its way to the President's desk for signature, keep in mind consumers got a tax cut in 2011 and 2012 which was roughly the same dollar order of magnitude. We've done this experiment before. Payroll taxes withheld from worker paychecks that basically fund social security were cut from 6.2% to 4.2% putting as much as

\$2,100 back in some top-of-the heap workers' pockets, those making the maximum social security taxable earnings base of \$106,800.

In total, the payroll tax holiday put about \$110 billion back into consumer paychecks and the economy each of those two years, increasing the budget deficit. While it isn't clear how or when the Senate and House will agree on a joint concurrent budget resolution, and we don't know the breakdown of the Senate's \$1.5 trillion tax reform, we will assume for now they are going to give us tax cuts of \$150 billion per year that increases the deficit. So about \$110 billion of stimulus through payroll tax reductions back then in 2011 and 2012, and \$150 billion proposed now. Will \$150 billion of tax cuts per year help the economy grow at a faster 3% pace?

Well, it is hard to see what that "payroll tax holiday" fiscal stimulus did for the economy back then. Real GDP growth was 1.6% in 2011, 2.2% in 2012 and 1.7% in 2013. No growth jump-start. Millions of jobs were created, due more to natural economic forces and the passage of time we would guess, rather than to government intervention and stimulus, 1.571 million nonfarm payroll jobs created in 2011, 2.243 million more in 2012, and 2.206 million new jobs in 2013. In economics, someone got a Nobel Prize for

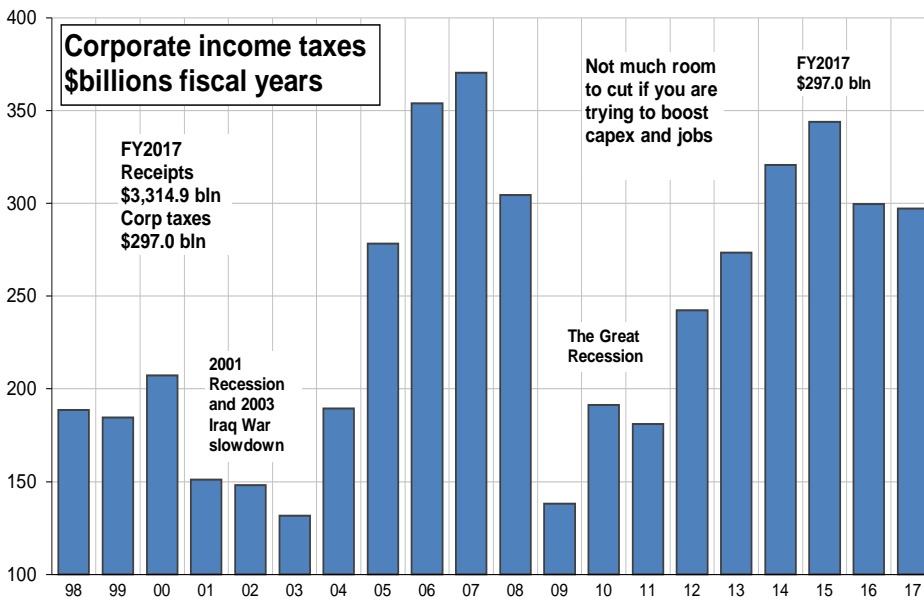
Federal Government Spending (\$bln)				Fiscal	Fiscal
Where to cut?	4 Qtrs FY17	4 Qtrs FY16	Year	Year	
	<u>Q4 16-Q3 17</u>	<u>Q4 15-Q3 16</u>	<u>Changes</u>	<u>% chg</u>	
TOTAL BUDGET OUTLAYS	3,980.605	3,852.420	128.185	3.3	
Legislative	4.499	4.344	0.155	3.6	
Judicial	7.566	7.497	0.069	0.9	
Agriculture	127.563	138.162	-10.599	-7.7	
Food Stamps	70.148	73.081	-2.933	-4.0	
Child Nutrition	22.471	21.978	0.493	2.2	
Commerce	10.304	9.162	1.142	12.5	
Defense	568.905	565.364	3.541	0.6	
Military Personnel	144.706	147.905	-3.199	-2.2	
Operation Maintenance	245.186	243.200	1.986	0.8	
Procurement	104.126	102.651	1.475	1.4	
Research Development	68.126	64.873	3.253	5.0	
Military Construction	6.673	6.677	-0.004	-0.1	
Education	111.702	76.981	34.721	45.1	
Office of Federal Student Aid	84.986	42.796	42.190	98.6	
Energy	25.796	25.852	-0.056	-0.2	
Health Human Services	1116.764	1102.965	13.799	1.3	
Medicare	708.299	698.024	10.275	1.5	
Medicaid States Grants	374.681	368.280	6.401	1.7	
Homeland Security	50.502	45.195	5.307	11.7	
Housing Urban Development	55.474	26.393	29.081	110.2	
Interior	12.141	12.584	-0.443	-3.5	
Justice	30.977	29.523	1.454	4.9	
Labor	40.120	41.371	-1.251	-3.0	
State Unemployment Benefits	30.388	32.178	-1.790	-5.6	
State	27.061	29.448	-2.387	-8.1	
Transportation	79.440	78.419	1.021	1.3	
FAA	15.866	15.560	0.306	2.0	
Federal Highway Admin.	44.167	114.055	-69.888	-61.3	
Treasury	546.434	526.116	20.318	3.9	
TARP	4.146	4.961	-0.815	-16.4	
IRS	139.539	133.126	6.413	4.8	
Earned Income Credit	59.749	60.580	-0.831	-1.4	
Child Tax Credit	19.408	20.188	-0.780	-3.9	
Interest on Public Debt	456.955	429.963	26.992	6.3	
Veterans Affairs	176.050	174.018	2.032	1.2	
Corps of Engineers	6.453	6.388	0.065	1.0	
Other Defense Civil Programs	58.695	64.505	-5.810	-9.0	
Environmental Protection	8.088	8.729	-0.641	-7.3	
Exec. Office of President	0.411	0.395	0.016	4.1	
International Assistance	18.922	16.241	2.681	16.5	
NASA	18.698	18.829	-0.131	-0.7	
National Science Foundation	7.215	6.904	0.311	4.5	
Personnel Management	95.461	91.316	4.145	4.5	
Small Business Admin.	0.439	-0.444	0.883	----	
Social Security Admin.	1000.812	976.783	24.029	2.5	
Retirement Benefits	791.098	762.126	28.972	3.8	
Federal Disability Payments	142.957	143.130	-0.173	-0.1	
Other Independent Agencies	11.660	11.482	0.178	1.6	

saying that people will save any windfall gained from temporary tax cuts instead of spending it to help make the economy grow. Personal saving as a percent of disposable personal income indeed moved up from 5.6% in 2010 to 6.0% in 2011 and 7.6% in 2012 before dropping back to 5.0% in 2013.

Stay tuned. Story developing. Seems like the tax cuts are meant more philosophically to reduce the size of the Federal government, return the monies to the people, rather than to jumpstart growth and create jobs, jobs, jobs. But it's early yet with virtually no details available. Hard to assess.

[Mnuchin/Mulvaney statement on FY2017 Federal budget results](#)

Corporate tax collection looks pretty low already at just under \$300 billion annually



Growth in spending outpaced growth in tax receipts for the second year in a row as a result of historically subpar economic growth. Rising deficits show that smart spending restraint and pursuing policies that promote economic growth, like tax reform and reductions in regulatory burden, are critically necessary to promote long-term fiscal sustainability.

“Today’s budget results underscore the importance of achieving robust and sustained economic growth. Through a combination of tax reform and regulatory relief, this country can return to higher levels of GDP growth, helping to erase our fiscal deficit,” said Secretary Mnuchin. “The Administration’s pro-growth policies will create better, higher-paying jobs, make American businesses competitive again, and bring back cash from offshore to invest here at home. This will help place the nation on a path to improved fiscal health and create prosperity for generations to come.”

“These numbers should serve as a smoke alarm for Washington, a reminder that we need to grow our economy again and get our fiscal house in order. We can do that through smart spending restraint, tax reform, and cutting red tape,” said Director Mulvaney.

MARKETS OUTLOOK

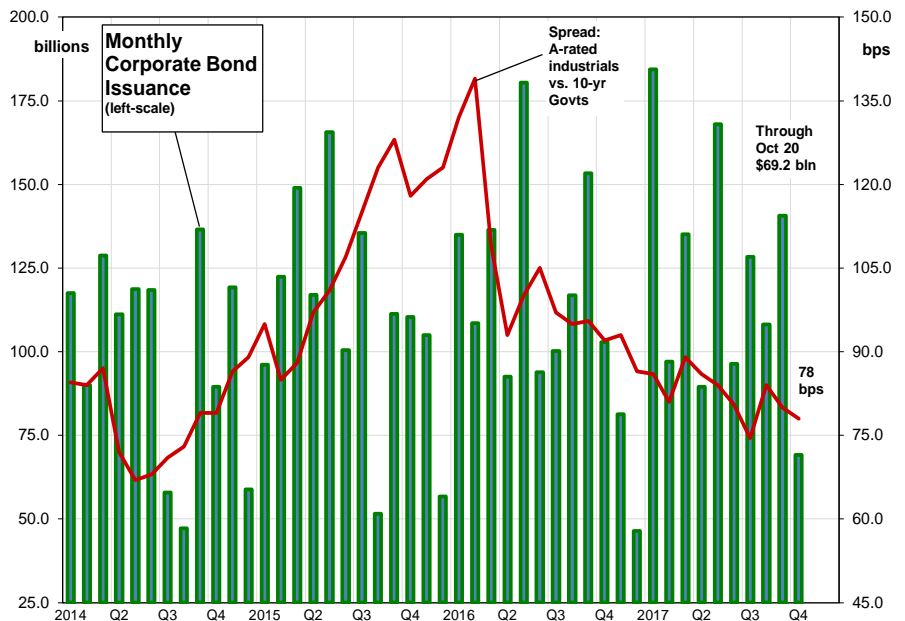
	29-Sep 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019	Q2 2019	Q3 2019	Q4 2019	Q1 2020	Q1 2020
30-Yr Treasury	2.86	3.10	3.20	3.40	3.60	3.70	3.80	4.00	4.10	4.10	4.10	4.20
10-Yr Note	2.33	2.50	2.70	3.00	3.20	3.40	3.50	3.70	3.80	3.90	3.90	4.00
5-Yr Note	1.94	2.10	2.40	2.70	3.00	3.20	3.30	3.50	3.60	3.70	3.70	3.90
2-Yr Note	1.48	1.60	1.85	2.10	2.40	2.60	2.85	3.10	3.35	3.35	3.60	3.85
3-month Libor	1.33	1.65	1.90	2.20	2.45	2.70	2.95	3.20	3.45	3.35	3.70	3.95
Fed Funds Rate	1.25	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	85	90	85	90	80	80	65	60	45	55	30	15

10-year Treasury yields closed higher at 2.38% this week versus 2.27% last Friday. Stock market gains helped and odds of a December Fed rate hike rose to 80%. 10-yr yields were 2.35% by Wednesday on the 160 point rally in the Dow industrials, also following UK bond yields higher earlier on the better wage data there. Friday saw higher yields on the Senate vote on the budget resolution late Thursday night.



CORPORATE BONDS: KIA MOTORS, PACIFIC MUTUAL, TARGET

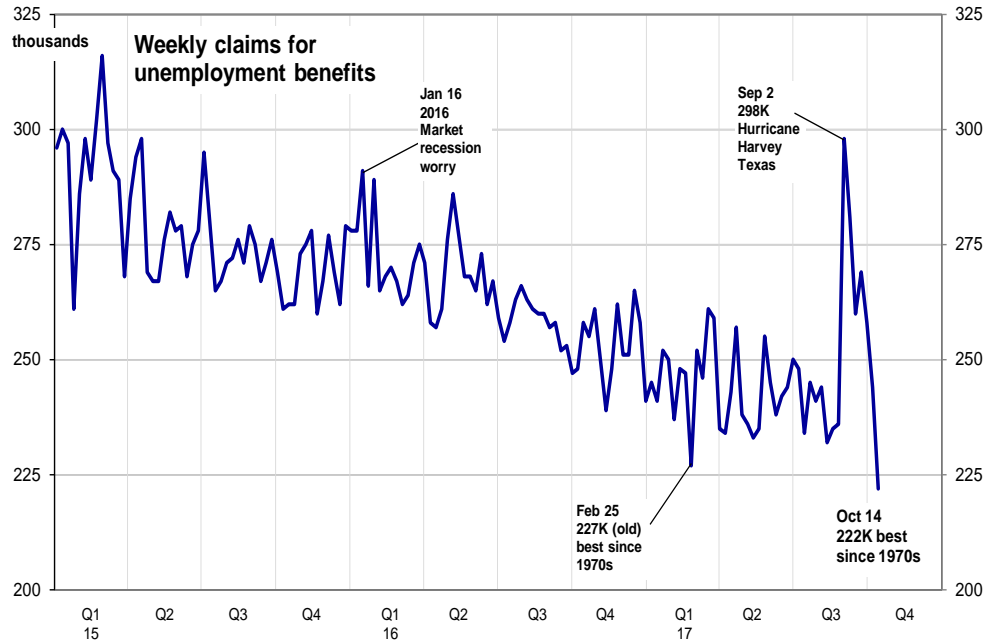
Corporate offerings were \$20.4 billion in the October 20 week versus \$33.0 billion in the October 13 week. On Wednesday, UnitedHealth Group sold \$4.0 billion 3s/5s/10s/30s/FRN. It priced \$950 million 2.95% 10-yrs (m-w +10bp) at 70 bps (A3/A+). The health care management company will use the proceeds to repay commercial paper and other debt. Corporate bonds (10-yr Industrials rated A2) were 78 bps above 10-yr Treasuries this week versus 79 bps last Friday.



OTHER ECONOMIC NEWS THIS WEEK

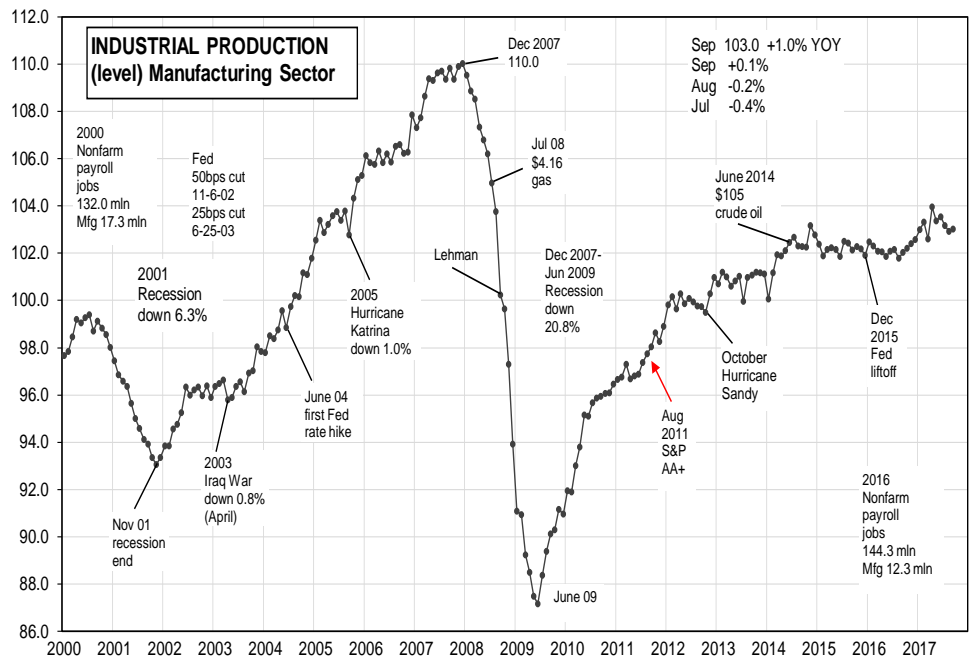
Unemployment claims at new 2017 low following hurricanes

Unemployment claims fell 22K to 222K in the October 14 week. Hurricane Harvey hit Texas in the September 2 week, and Hurricane Irma hit Florida in the September 16 week, but now claims have fallen surprisingly to the lowest level since the 1970s. This signals the labor market has moved beyond full employment.



Industrial production trend remains murky after hurricanes

Manufacturing industrial production rose 0.1% in September after falling the prior two months. The peak was in April this year where many industries saw greater output even if motor vehicles were a big part of that increase. Auto production is down sharply from April.



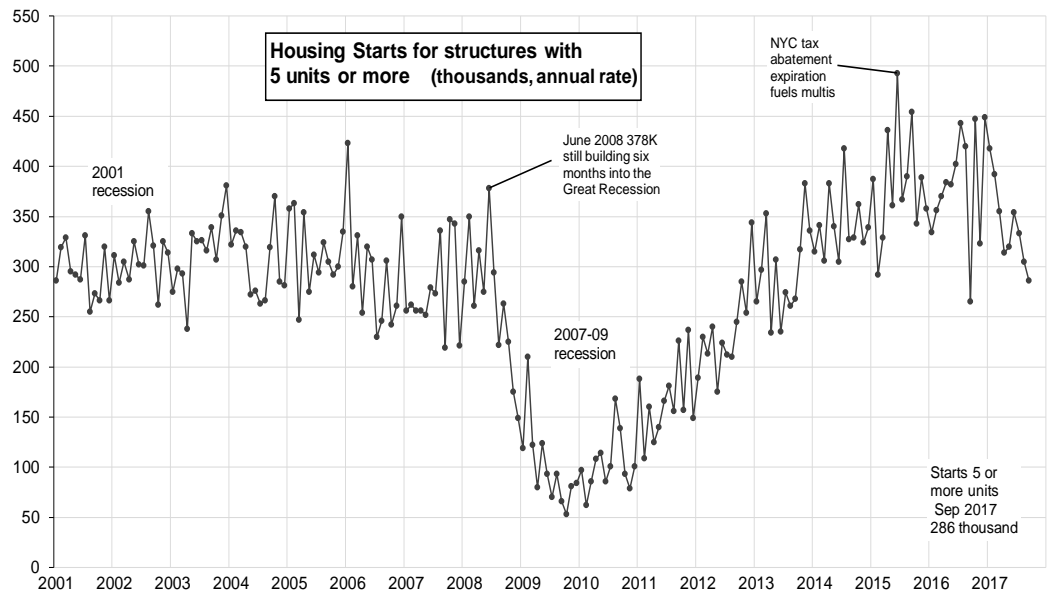
Industrial Production September 2017	
% YOY	Weight
<u>1.6 Total Index</u>	<u>100.0</u>
1.0 Manufacturing	76.5
9.8 Mining	12.9
-4.1 Utilities	10.6
Manufacturing payroll jobs 12.4 million +117K YOY 10.0% of Private Payroll Jobs	

Another eco stat sunk by the storm

Breaking economy news. Housing starts fall 4.7% to 1.127 million in September and permits are down 4.5% to 1.215 million. While the construction of multifamily dwellings is way off this month and this year from the earlier construction boom in apartments, single family home construction is better than the headlines suggest with every area of the country seeing a surge of construction except for the storm battered South.

Net, net, residential housing construction is down but not out for this record-long recovery in home building in this economic cycle. It stands to reason that the recovery would be a long one from the severity of the deep downturn in construction seen during the housing bubble bust a decade ago.

But today's report is really a tale of two housing markets. Multifamily construction had recovered already from the housing bubble dip in building during the recession. It was single-family home building that failed to return to anywhere near their housing bubble peaks. It is possible that



homebuilders like everyone else are struggling to guess at what millennials want, and there does seem to be a tendency for the new generation to want homes with less square-footage and overall maintenance perhaps.

For whatever reason, the silver lining in today's construction report is that momentum is building in single family construction that has been the weak link in overall investment spending that helps make the economy run. In today's report, September single family home construction is at new highs this year in the West and in the Northeast, and rebounded strongly this month in the Midwest. Single family home construction tumbled in the South by 15.3% to 403 thousand which was to be expected after Hurricanes Harvey and Irma.

The housing market is down not out and the positive elements in today's report suggest the Fed will keep to its schedule of gradual rate hikes later this year and next. The economy continues to defy expectations come whatever storm is thrown its way and it is time for the Fed to stop playing offense and instead return monetary policy back to normal. The economy is better than you think. Bet on it.

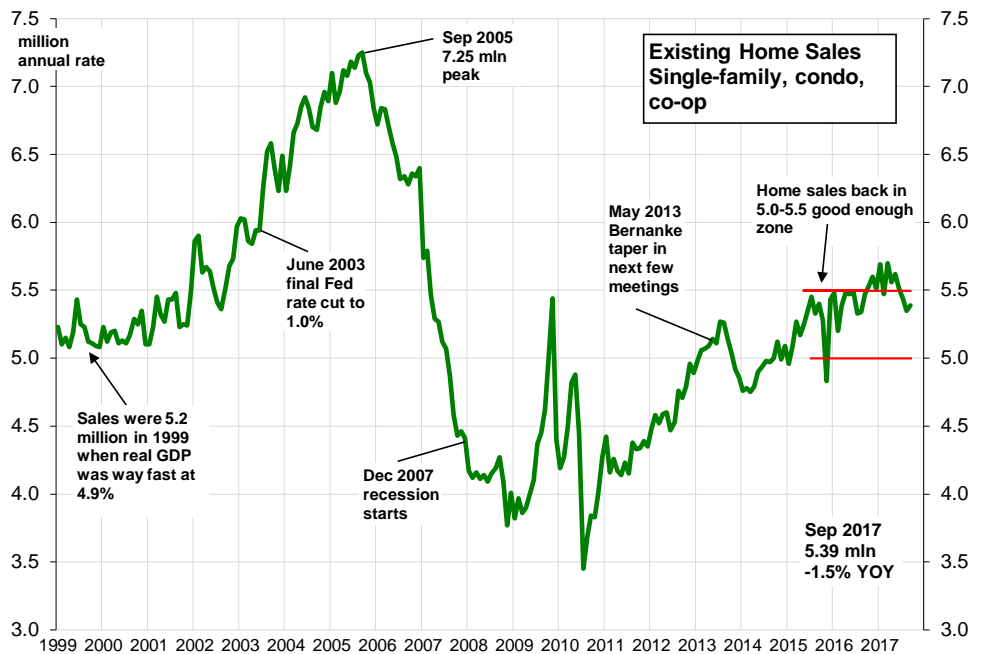
September existing home sales still calm before the storms

Breaking economy news. Existing home sales from the National Association of Realtors rose 0.7% to a 5.39 million annual rate of turnover in September. We guess this is a good rate of sales activity in a country with 326 million people. This September data and the results could weaken further in the months ahead as many existing home sales are recorded at the time the sales contract is closed, and therefore September data represents activity that could have occurred in July and August.

Sales were slightly better or unchanged in the Northeast, Midwest and West, while the biggest market down South declined slightly from 2.15 million in August to 2.13 million in September, 0.9%, hardly hurricane-sized declines... yet.

Realtors continue to complain that sales are held down by the lack of supply, and certainly California talks about housing shortages constantly in the local media. About 40% of sales nationwide are for homes from \$100 to \$250 thousand, and these are in short supply.

Net, net, the turnover of the existing home stock is sufficient to generate enough consumer spending to keep the economy growing at a 2% pace in the coming year as homebuyers redecorate and purchase appliances and furniture to fill their new homes. Maybe put a new car in the driveway, music to Detroit's ears, unless they want more SUV sales. The Federal Reserve can continue to remove its stimulative



policies left over from the recession with confidence knowing that the economy is strong enough to withstand a gradual pace of rate hikes. Even with the Fed lifting rates 100 bps the next year according to their forecasts, no private forecaster sees mortgage rates lifting higher than 5.25%. And 5.25% is not high enough to send homebuyers to the sidelines from the increase in borrowing costs.

The press release from the realtors did mention the potential negative effects of removing the deduction for state & local taxes or altering the mortgage interest deduction and what this could do to residential housing sales. They advise not to do it.

The economy remains stronger than you think for now assuming Congress does not make too many dramatic changes to the tax code, altering the way Americans have paid their taxes for decades.

Consumers don't like change, and the bigger the change, the worse it can be. We will still wonder why tax cuts are necessary at this stage of the business cycle as every other Administration has not provided fiscal stimulus unless the economy was either in recession or perhaps still struggling immediately after the recession. Stay tuned. Story developing. The economy is great again already. Bet on it.

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 2017 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 guarantee 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.mufgamerica.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.