Global Macroeconomic Monthly Review

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Key Issues

Global Economic Forecast Table (p. 3)

The Big Picture – The Global Economy (p. 4)

- *World economic growth appears to have slowed in the third quarter. Risks to global growth are on the rise.*
- *Positive developments achieved in US trade policy vis-à-vis some of its trading partners. Protectionism actions between the US and China are expected to continue.*
- *Monetary tightening poses risks to some EM economies.*
- *Inflationary pressures may increase temporarily, supporting an increasingly hawkish tone among central banks, primarily in emerging economies.*
- *Monetary policy normalization is expected to continue, both in major advanced economies, as well as in emerging economies.*
- *Interest rate differentials between the US and other advanced economies may widen further in the short-run.*

United States (p. 6)

- *Further strength in domestic demand in the short-run, boosted by fiscal stimulus.*
- *Risks to the medium-term growth outlook have risen due to an eventual waning of fiscal stimulus over time, along with tighter financial conditions and USD appreciation.*
- *Inflation is expected to remain above the Fed's target in the short-run.*
- *The Fed is expected to hike the interest rate in December. The tightening cycle is expected to continue in 2019, but we do not rule out the possibility that the Fed will temporarily pause the rate hike cycle in 2019, and cut rates gradually later on in 2020.*
- *US Treasury yields have increased over the last few weeks and the yield curve has steepened. Looking forward, rates are expected to increase further in 2019, while the slope is estimated to somewhat flatten.*

Euro Area (p. 12)

- *EA economic growth is expected to remain stable in Q3. Increasing economic uncertainty may weigh on business confidence in the short-run.*
- *Core inflation declined in September, and currently is noticeably low. We expect the core measure to rise modestly over the short-medium term.*
- *No change in the ECB's tone despite the moderation in economic growth.*
- *Long-term government bond yields are expected to rise gradually in the short-run in tandem with the ECB's tapering actions and along with a narrowing of current account surpluses.*

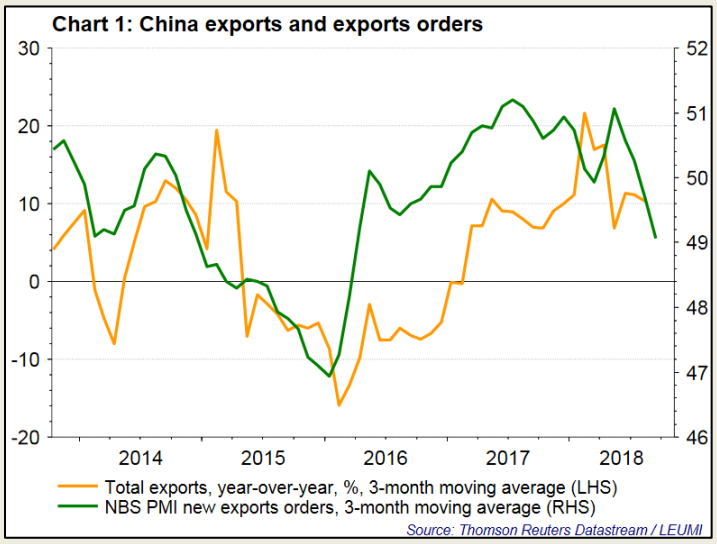
Leumi Global Economic Forecast, As of October 2018

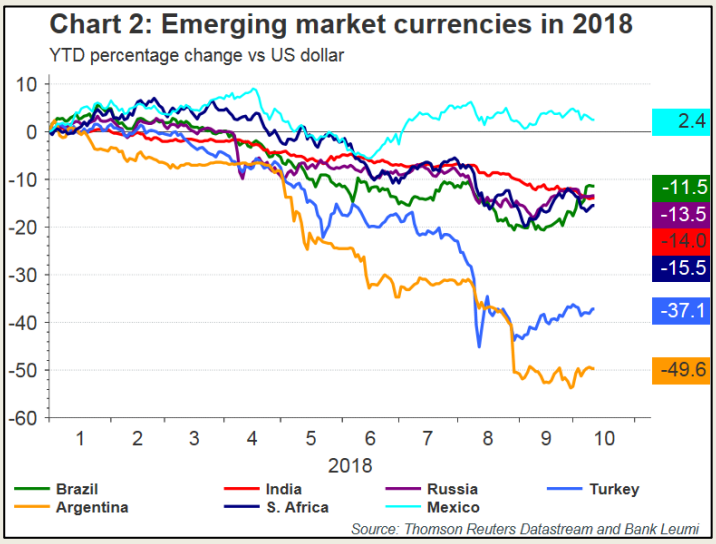
	2015	2016	2017	2018F	2019F
GDP – Real Growth Rate					
World	*3.3%*	*3.2%*	*3.7%*	*3.7%*	*3.6%*
USA	*2.9%*	*1.6%*	*2.3%*	*2.8%*	*2.2%*
UK	*2.2%*	*1.8%*	*1.6%*	*1.3%*	*1.5%*
Japan	*1.4%*	*0.9%*	*1.7%*	*1.3%*	*1.4%*
Eurozone	*2.0%*	*1.7%*	*2.6%*	*2.1%*	*1.8%*
South East Asia (ex. Japan)	*4.5%*	*4.5%*	*5.2%*	*5.1%*	*4.8%*
China	*6.9%*	*6.7%*	*6.9%*	*6.6%*	*6.2%*
India	*7.9%*	*7.1%*	*6.7%*	*7.4%*	*7.6%*
Latin America	*0.1%*	*-0.7%*	*1.2%*	*1.1%*	*2.0%*
Israel	*2.5%*	*4.0%*	*3.5%*	*3.2%*	*3.3%*
Trade Volume, Growth (%)					
Global	*2.5%*	*2.3%*	*5.3%*	*4.0%*	*3.7%*
CPI, Annual Average (%)					
USA	*0.1%*	*1.3%*	*2.1%*	*2.5%*	*2.4%*
UK	*0.1%*	*0.7%*	*2.7%*	*2.4%*	*2.1%*
Japan	*0.5%*	*1.0%*	*0.5%*	*0.9%*	*1.4%*
Eurozone	*0.8%*	*-0.1%*	*1.5%*	*1.6%*	*1.7%*
Israel	*-0.6%*	*-0.5%*	*0.2%*	*1.0%*	*0.5%*
Interest rates, Year End					
US Fed	*0.25-0.50%*	*0.50-0.75%*	*1.25-1.50%*	*2.00-2.50%*	*2.75-3.25%*
Bank of England	*0.50%*	*0.25%*	*0.50%*	*0.75%*	*1.00-1.25%*
Bank of Japan-Policy Rate	*0.00%*	*-0.10%*	*-0.10%*	*0.00%*	*0.00%*
ECB-Main Refi	*0.05%*	*0.00%*	*0.00%*	*0.00%*	*0.10-0.30%*
Israel	*0.10%*	*0.10%*	*0.10%*	*0.10*	*0.50-0.75%*

The Big Picture – The Global Economy

Global outlook – economic activity: the world economy appears to have slowed in the third quarter; the risks to global growth are on the rise (1/2).

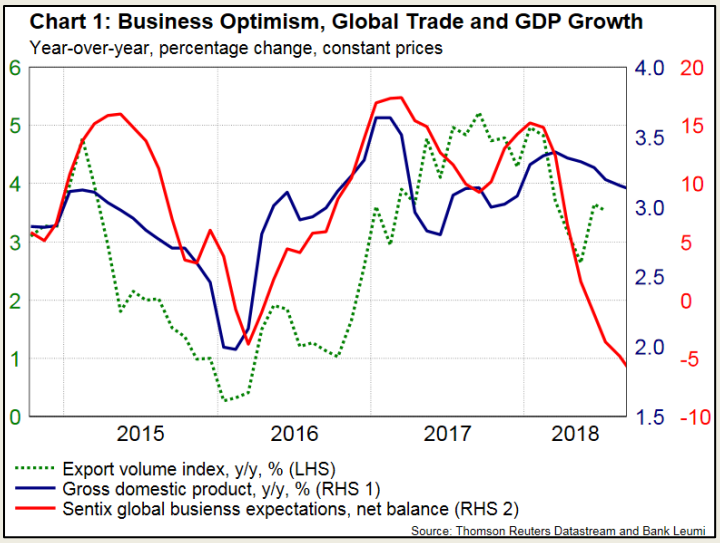
- Recently released economic data attest to some slowdown in global growth in the third quarter as exports and manufacturing activity probably moderated. This is partly due to increasing concerns over trade wars between the US and its trading partners, mainly with the largest exporter in the world, China.
- Chinese exports are facing risks of a further moderation in growth in the short-run (chart 1), particularly as new US tariffs on USD200bn of Chinese goods took effect recently. We do not rule out further protectionism actions by the two economies.
- In contrast, risks of trade wars between the US and other trading partners have receded recently, after the US reached trade deals with Canada and Mexico (the USMCA agreement, which will likely replace NAFTA), and signed a new trade agreement with South Korea. The recent trade agreements between the US and some of its major trade partners may suggest that the Trump administration may be willing to compromise in order to reach additional trade agreements with its other trading partners, including the EU and Japan.
- In addition to the potential trade war risks, political and geopolitical risks in several economies (Italy, UK-EU, Brazil, the Middle East region, etc.) and tightening financial conditions, mainly in some major emerging economies, also weighed to some extent on demand and production in the past few months.
- Financial risks in some emerging markets have remained high against the backdrop of the depreciations in EM currencies since the beginning of the year (chart 2), mainly in economies characterized by large external and/or fiscal imbalances, and high political risks, including economies such as Argentina, Turkey, and South Africa. The risk in certain EM economies is expected to remain relatively high in the short-run, leading to relatively heightened volatility in the financial markets, and posing a risk on economic sentiment and activity in the short-run.

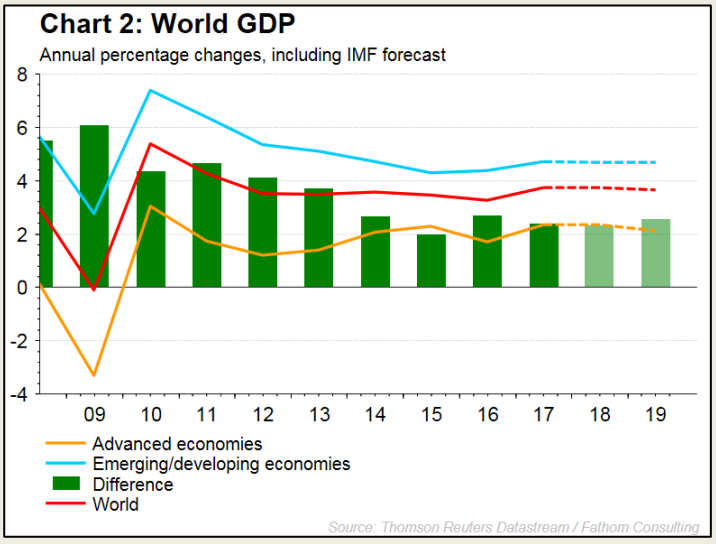




Global outlook – economic activity: the world economy appears to have slowed in the third quarter; the risks to global growth are on the rise (2/2).

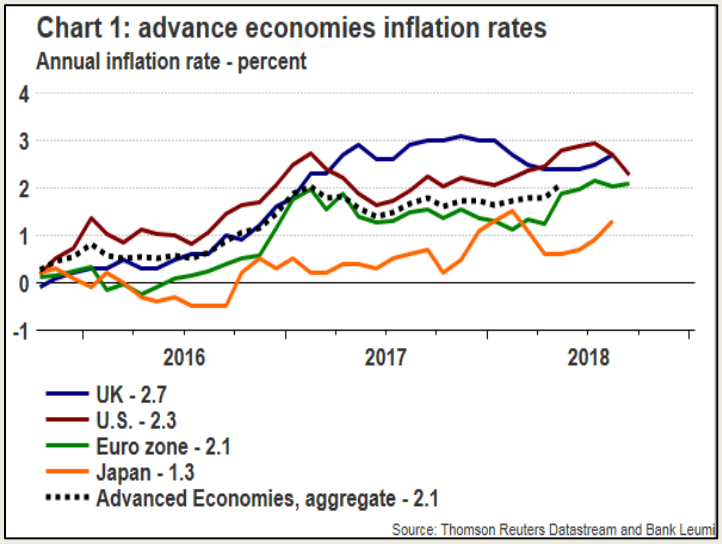
- Recently released business surveys also attest to some softer conditions in activity. The J.P. Morgan Global Composite Output index fell further in September, driven by a slowdown in worldwide manufacturing production, which rose at the slowest pace since September 2016. The trend in international trade data was especially weak, driven by lower new export orders and output. Based on Sentix data, business expectations fell as well in September, which may point to some slowdown in business investment in the short-run (chart 1).
- Based on national hard and soft data, there is still a high degree of variance in the development of activity between the US, which continues to grow solidly, supported by expansionary fiscal policy, and some of the other major economies, including the euro zone, the UK, China, and Japan, all of which are characterized by a softer growth environment.
- As a result of the slowdown in some economies in recent months, in tandem with an increase in economic risks, the IMF revised downward its 2018-2019 global growth outlook, to its current annual growth expectation of 3.7% in both years, similar to the growth rate registered in 2017 (chart 2). The main differences between the IMF's and Leumi's projections stem from our view that the slowdown during 2020 in the pace of economic growth in the major advanced economies, the US and the EA, will be somewhat sharper compared to the IMF's estimates. However, the IMF's expectations for a slowdown in growth, through 2023, are similar in magnitude to those that we foresee for 2020. In parallel, the IMF also noted that downside risks to global growth have risen in the past six months and the potential for any upside surprise to the growth outlook has receded recently.

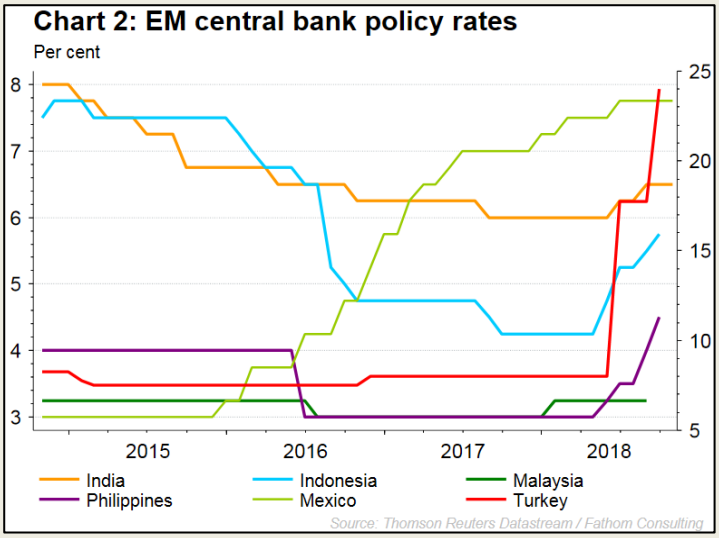




Global outlook – inflation and monetary conditions: inflationary pressures may increase temporarily, supporting a more hawkish tone among central banks, mainly in emerging economies. Rate differentials between the US and other advanced economies may widen further.

- Headline inflation has increased in the past few month (chart 1), driven partly by the continuing increase in oil prices. In the past year, oil prices increased approximately 46%. Further increases in oil prices, which may be driven by supply concerns (sanctions on Iran by the US, supply bottlenecks for US producers, OPEC willingness to keep supply unchanged, etc.) may pose an upside risk to the inflation outlook in the short-run.
- In addition, higher oil prices may intensify the effect of the exchange rates' depreciation on inflationary pressures, mainly in emerging markets, especially if second-round effects will emerge. Core inflation will be affected as well. Net importers of oil, such as Turkey, South Africa, and India, are currently exposed to more inflationary risks, while net exporters of oil, such as Russia, which recently boosted oil output, are expected to benefit from the increase in oil prices.
- The increase in EM inflationary pressures may lead to a more hawkish stance among some central banks, and may support higher government bond yields.
- Over the past month there have been additional monetary tightening actions by some advanced economies and several EM central banks. The US increased the interest rate last month as expected, and Norway increased its interest rate, for the first time since 2011, by 25bp to 0.75%. We expect additional gradual normalization processes in the advanced economies in the short-medium term. However, interest rate differentials between the US and other major advanced economies, including the euro area and Japan, are expected to widen further.
- Regarding the EM economies, we expect to see a more hawkish stance in the short-run and monetary policy tightening in order to try to stabilize their currencies. Such steps may provide some confidence to investors, and curb accelerating inflation risks in some of the economies.

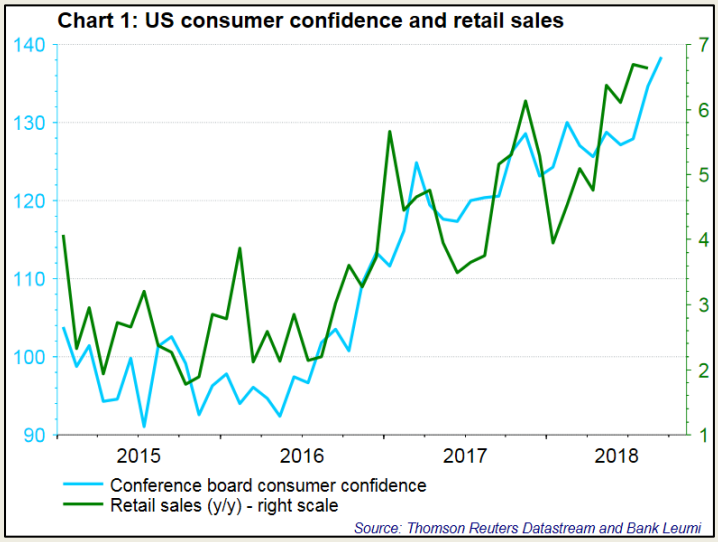


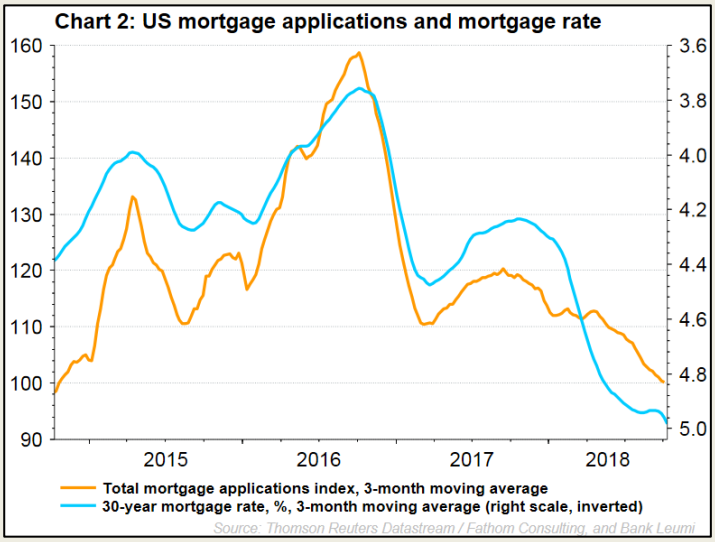


United States

US growth outlook (1/2): further strength in domestic demand in the short-run, boosted by fiscal stimulus. Risks to the short-medium term growth outlook have risen due to waning fiscal stimulus, tightening monetary conditions, and USD appreciation.

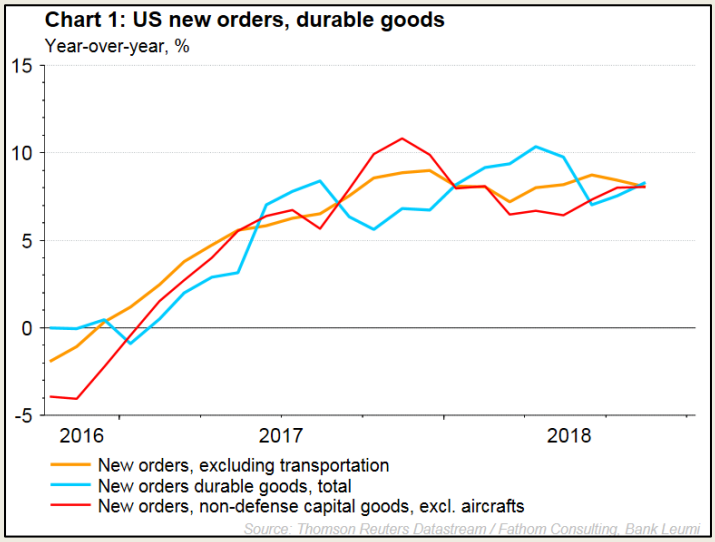
- US economic activity continues to rise strongly, supported by domestic demand. Based on core retail sales and personal consumption official data, Q3 household spending has remained solid, supported by positive developments in the labor market.
- The latest employment data were mixed; however, looking at the broader picture, the labor market data remain relatively strong. The weaker than expected gain in September employment (partly due to the impact of hurricane Florence) was offset by upward revisions to the data of previous months. In addition, the unemployment rate fell to 3.7%, which is the lowest since 1969. The broader measure of unemployment, the U-6, rose slightly, but is still at its lowest since 2002. The strength in the labor market, in tandem with the acceleration in wage growth and positive wealth effect, are expected to support household demand in the short-run.
- However, rising headline inflation and interest rates may erode household purchasing power and somewhat weigh on spending growth in the short-medium term. It should be noted that the increase in mortgage interest rates in the past year (the 30-year rate is at 4.9% - the highest since May 2011), in tandem with a decrease in housing affordability, caused a decrease in demand for mortgages and homes in the past year (chart 2). Softening demand, in tandem with labor shortages in the housing sector, is expected to continue to weigh on housing starts and residential investment in the short-medium term.

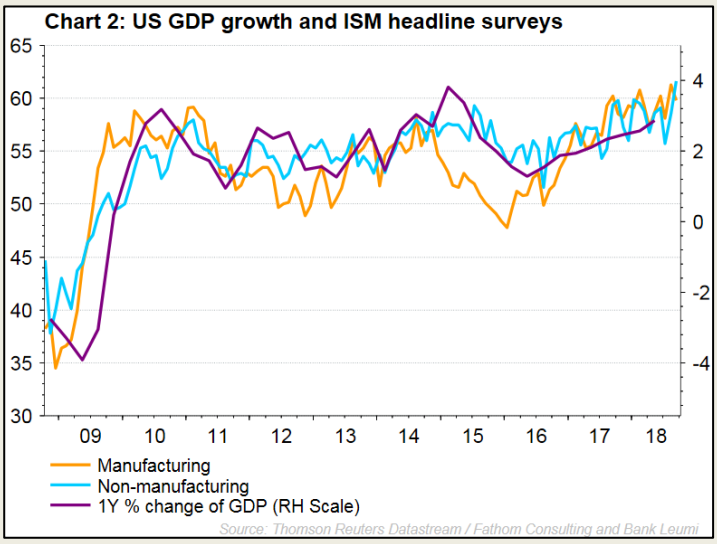




US growth outlook (2/2): further strength in domestic demand in the short-run, boosted by fiscal stimulus. Risks to the short-medium term growth outlook have risen due to waning fiscal stimulus, tightening monetary conditions, and USD appreciation.

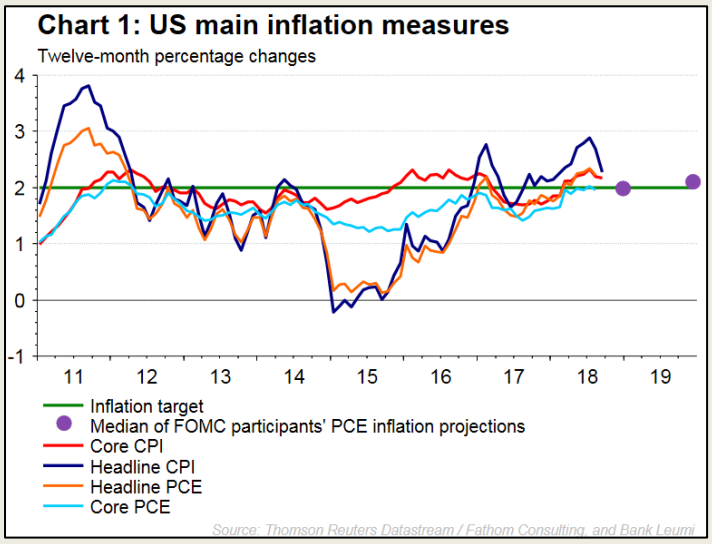
- Other investment indicators, such as capital goods imports, point to a further strengthening in equipment investment. Also, an increase in orders points to a further improvement in investment in the short-run at least (chart 1). Investment in mining may rise as oil prices increased significantly, supporting the economic feasibility of increasing production.
- In contrast, net trade is expected to be a drag on GDP growth in the third quarter, mainly due to base effects after it contributed significantly in the first half of the year. We also expect the appreciation in the US dollar, in tandem with tariffs on US goods exports, will put some downward pressure on exports in the short-medium term.
- Recently released business surveys also attest to strength in the economy. A weighted average of the ISM manufacturing and non-manufacturing indices is now at its highest level on record (chart 2). Based on the positive correlation between the ISMs and GDP growth (and other hard and soft data), we expect US economic activity to continue to expand at a solid rate close to 3% on a year-over-year basis in the coming quarters, before moderating during 2019-2020.
- We expect 2018 GDP growth to accelerate to 2.8% from 2.3% in 2017, and moderate to 2.2% in 2019. The moderation next year is expected to be driven by several factors, including: the fading effects of the current expansionary fiscal policy; higher interest rates; USD appreciation; rising uncertainty regarding US trade and foreign policy; and some political risks that may stem from policy uncertainty after the mid-term elections and ongoing investigations of the president. We expect further moderation in 2020, as growth may dip below 2%.

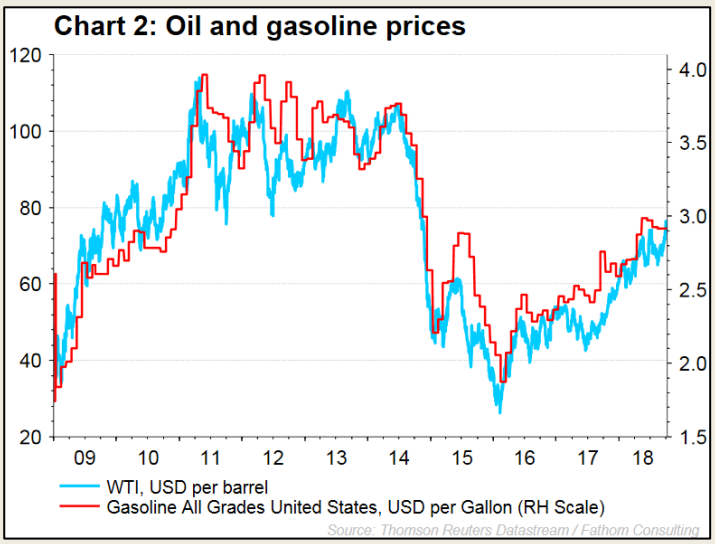




US inflation outlook: the rise in oil prices poses some upside risk to our headline inflation outlook. Inflation is expected to remain above the Fed's target in the short-run.

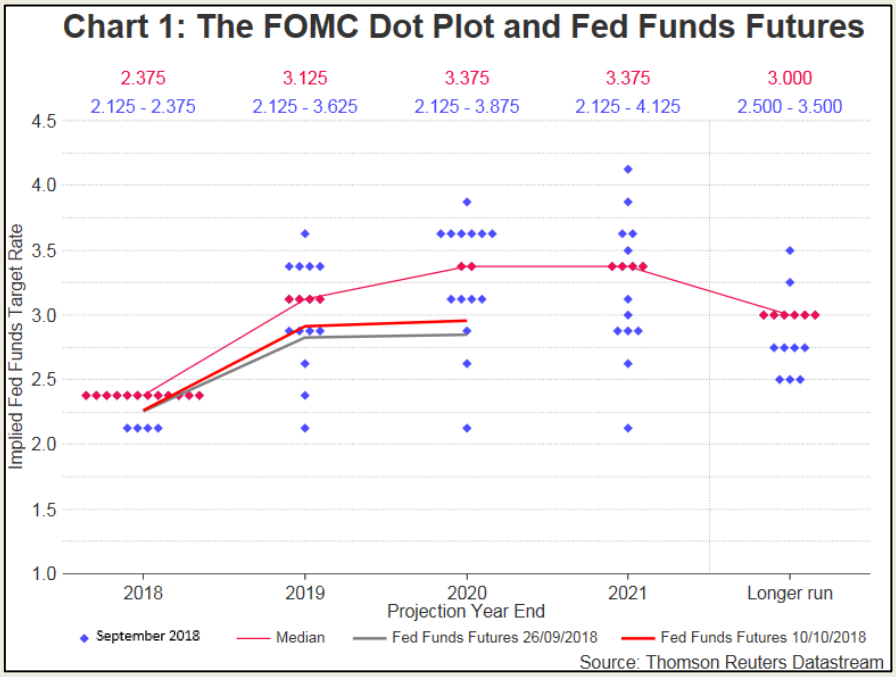
- Headline CPI inflation moderated in September, for the second month in a row, as expected, due to base effects. However, the headline measures have remained above the FOMC inflation target.
- The continuing rise in oil prices is expected to support gasoline prices, which are already at their almost four-year high, in the short-run. Further increases in oil prices pose an upside risk, at least temporarily, to the inflation outlook. In contrast, downside risks to the inflation outlook may stem from the continuing appreciation in the USD.
- New tariffs imposed by the US on Chinese imported goods so far have not significantly affected consumer prices. However, we do not rule out inflationary effects if the US will impose additional significant tariffs in the future, as was threatened by the president.
- Both core and headline inflation are expected to remain above the FOMC target in the short-run at least, supported by a further tightening labor market, which may support wage growth. On average, we expect CPI inflation to be around 2.5% in the current year, compared to 2.1% in 2017, and to remain above the Fed's target also in 2019.





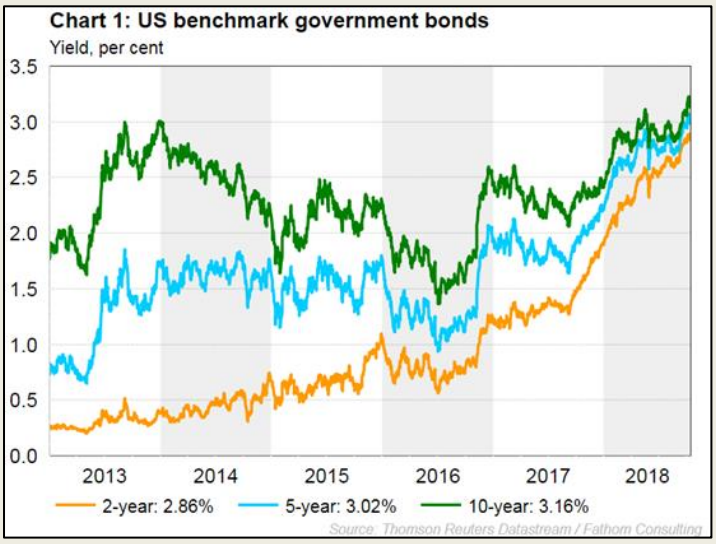
Monetary policy and financial indicators outlook: is the Fed overly optimistic on the macro environment? We do not rule out that the Fed will pause the rate hike cycle in 2019, and will start cutting rates gradually during 2020 (1/2).

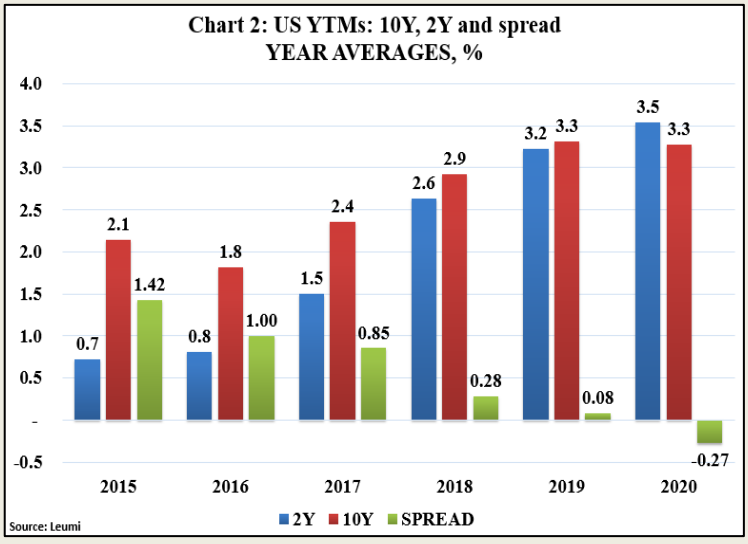
- At its last monetary meeting on September 25-26th, the FOMC hiked the interest rate by 25bp to 2.00-2.25%, in line with expectations. The committee's statement was generally positive on the growth outlook, noting "economic activity has been rising at a strong rate". In addition, the FOMC upgraded its 2018-2019 growth projections to 3.1% and 2.5%, from 2.8% and 2.4%, respectively.
- At the press conference following the statement's publication, the chairman of the Fed, Jerome Powell, said that he sees only limited implications from the trade war on economic activity. With respect to inflation, the Fed's chair said that he does not see a significant upside risk to inflation, and that it is expected to remain near the Fed's 2% target over the medium-term.
- The FOMC also somewhat upgraded its estimate of the long-run funds rate to 3%, from 2.875%, while the estimates on other funds rates remained unchanged, as the Fed expects the interest rate to rise to 2.4% in 2018, 3.1% in 2019, and 3.4% in 2020 (chart 1).
- The improvement in the committee's assessment of the economy supports the view that the Fed will raise the interest rate in the short-run, most likely in the December meeting, as reflected in market-derived interest rate expectations. Looking ahead, we expect the Fed to continue hiking the interest rate in 2019, providing upward pressure to short-term yields. However, due to the increase in risks, the level of uncertainty regarding the number of hikes next year is relatively high. Based on market-derived interest rate expectations, the Fed is expected to hike the interest rate twice, by 50bp overall, fewer than projected by the FOMC – three hikes.



Monetary policy and financial indicators outlook: is the Fed overly optimistic on the macro environment? We do not rule out that the Fed will pause the rate hike cycle in 2019, and will start cutting rates gradually during 2020 (2/2).

- If the growth environment will start to clearly moderate during 2019, then we do not rule out the possibility that the Fed will pause the tightening process already in the second half of 2019, and start cutting rates gradually in 2020, in contrast to the FOMC projections that point to an additional one or two hikes in 2020.
- Recently, the yield curve rose strongly, mainly due to an increase in the issue of new Treasury securities, solid economic activity, strengthening employment data, rising inflation expectations, and the upbeat assessment of the Federal Reserve (chart 1). The longer-end of the curve rose stronger than the short-end, leading to some steepening, after the yield curve had reached an 11-year low in the end of August.
- Based on our models, we expect the yield-to-maturity on 10-year bonds to rise toward an average of 3.3% in 2019 compared to an average of 2.9% in the current year. We expect the yield-to-maturity on 2-year bonds to rise to an average of 3.2% in 2019, from 2.6% this year, reflecting some flattening of the yield curve in 2019 on an average basis compared to 2018. A very modest and transitory 10-2 curve inversion is expected in 2020 (chart 2).

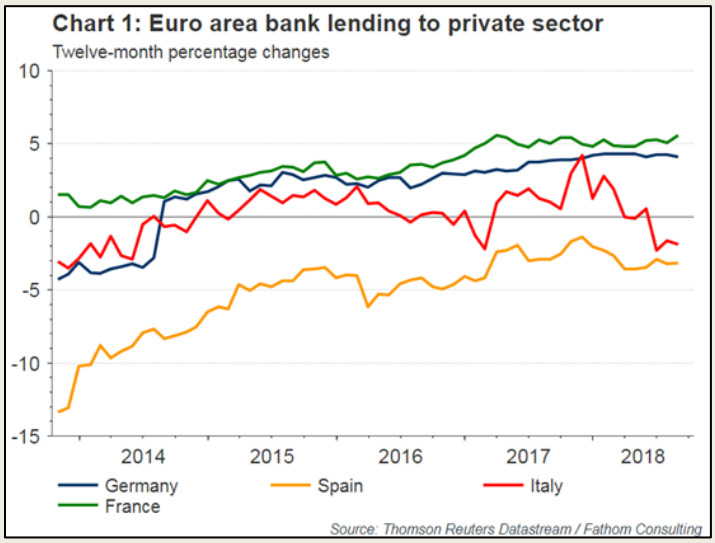


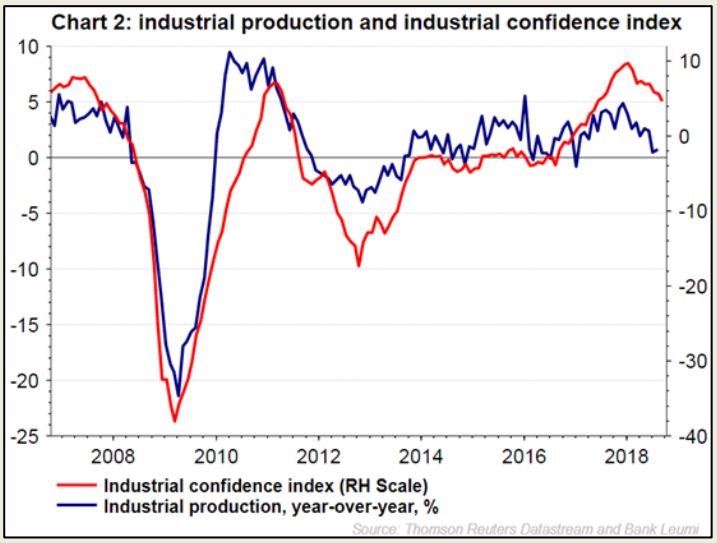


Euro Area

EA growth outlook: political risks may weigh on growth in the short-medium term (1/2).

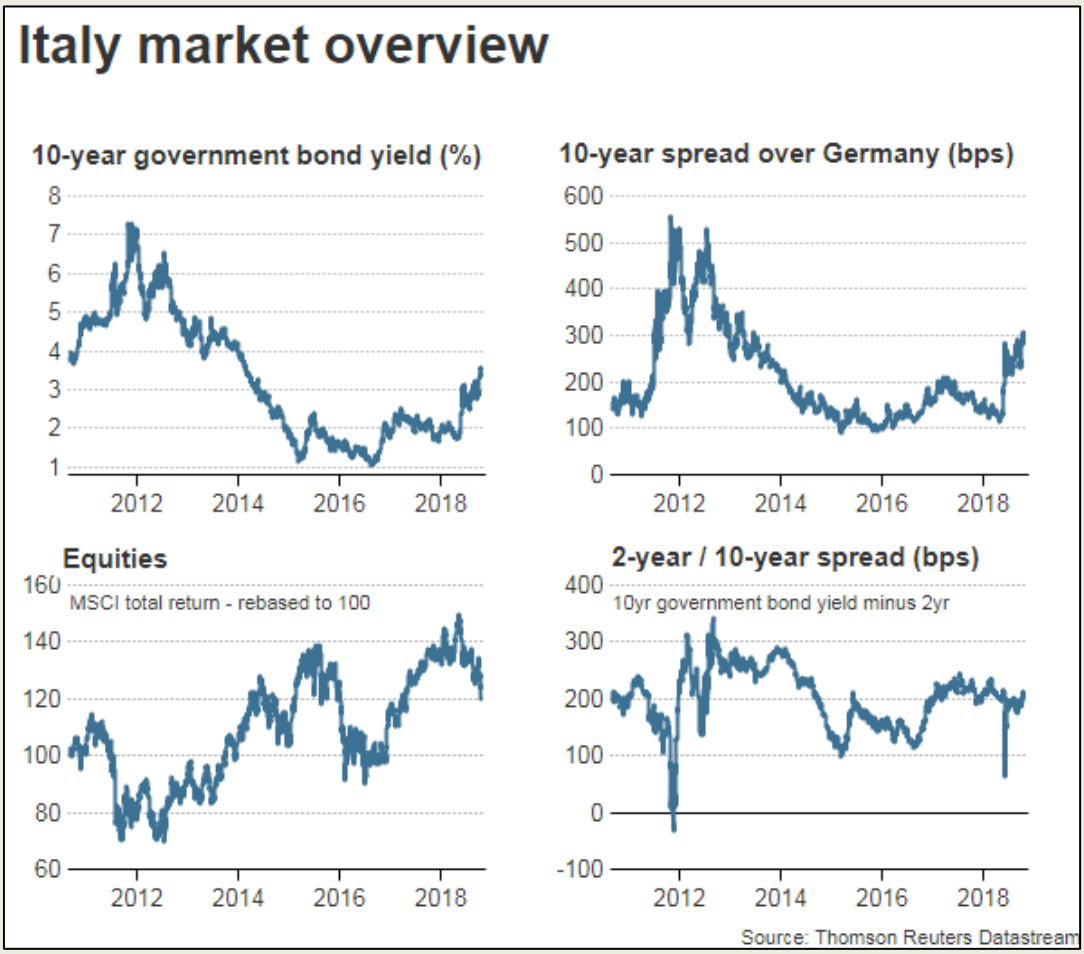
- Based on the latest economic data it seems that economic growth stabilized in the third quarter on a quarterly basis, after having moderated in the first half of the year.
- Lending to the private sector increased further in August, with substantial divergence between the major EA economies (chart 1), as lending in Germany and France continues to grow solidly while lending in Italy dropped significantly in the past year. Meanwhile, lending growth in Spain continues to be negative, despite the improvement in economic activity. Italy is expected to remain a drag on EA economic growth at least in the short-run.
- "Other" hard economic data point to some softness recently. Industrial production has continued to slow over the past few months, in tandem with some moderation in exports growth (chart 2). The moderation in IP and exports growth was probably affected to some extent by the continuing appreciation in the effective exchange rate of the euro and some deterioration in business confidence, caused by rising political uncertainty (Brexit, EU-US tensions, Italy, etc.).
- In addition, retail sales moderated in tandem with some decrease in consumer confidence. Looking forward, we expect a moderate improvement in household demand in the short-run, supported by a further decline in unemployment and a moderate, gradual improvement in wage growth, which is on an upward trajectory.
- Despite falling in September, both the European Commission economic sentiment and the Markit PMI data are consistent with steady economic growth in the third quarter.





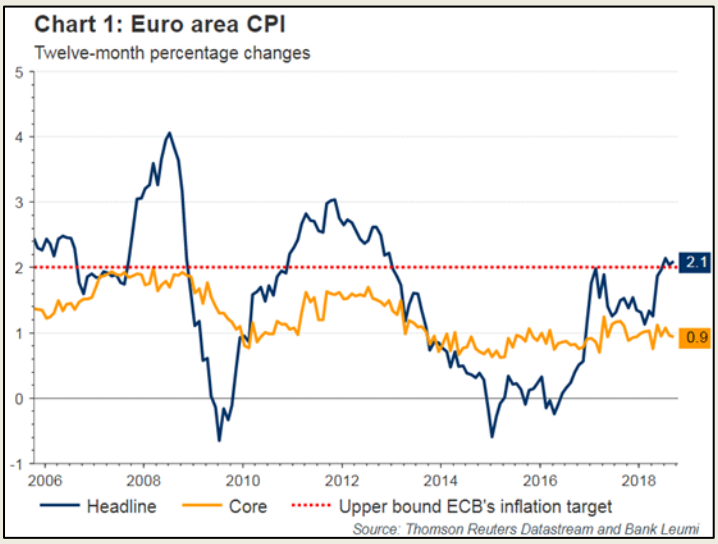
EA growth outlook: political risks may weigh on growth in the short-medium term (2/2).

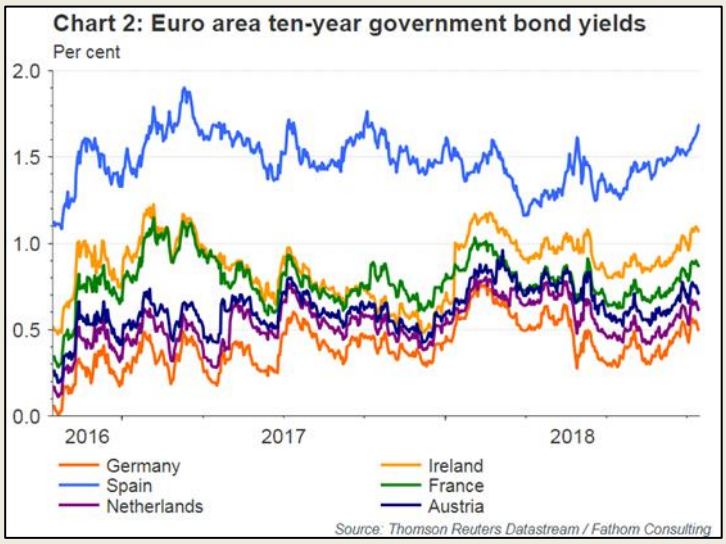
- The main risks to the short-medium term growth outlook are concerns from changes in US-EU trade policy, uncertainty regarding Brexit, and other political risks in Europe including Italy's political and fiscal risks.
- Government bonds yields in Italy rose strongly over the past few weeks, due to continuing fiscal concerns as the deficit is estimated to widen to 2.4% of GDP in 2019 from an expected 1.8% in 2018, before it declines in 2020 and 2021 to 2.1% and 1.8%, respectively. This comes against the backdrop of what appears to be overly optimistic GDP growth assumptions. Under the IMF GDP estimates, the budget deficit is expected to rise more than currently estimated by the Italian government, posing an increase in Italy's fiscal profile risk, and supporting continuing heightened volatility in Italy's financial markets (see chart). The uncertainty may continue to weigh on market sentiment and result in capital outflows from Italy.
- Overall, economic growth in the EA moderated since the beginning of the year, as expected, compared to the significantly above-potential growth in 2017. The moderation in growth was affected mainly by base effects and some softening in external demand. Still, economic activity continues to grow at a reasonably healthy pace, despite the moderation in economic activity since the beginning of the year. GDP growth is expected to moderate to 2.1% this year from 2.6% in 2017, and moderate further into 2019 to around 1.8%.



EA inflation and monetary outlook: core inflation remained low but the ECB is expected to stick, for now, to its plan.

- Flash headline inflation for September rose slightly to 2.1% year-on-year from 2.0% (chart 1), likely supported by food and energy prices. In contrast, core inflation declined, from 1.0% to just 0.9%, near the one-year average. We expect core inflation to increase over the short-medium term, supported by a further rise in wage growth driven by a continuing decline in the unemployment rate.
- Headline inflation is expected to moderate in the short-run to some extent, due to base effects. The recent rise in oil prices, if it will continue, may pose a temporary upside risk to inflation.
- The statement following the ECB's latest monetary meeting was almost identical to the previous statement in July, despite the recent softening in economic activity and the central bank's downward revisions to its 2019 growth and core inflation forecasts. The president of the ECB, Mario Draghi, stressed that trade tensions were the biggest risk, while the possibility of financial market "volatility" related to interest rate hikes by other central banks was also a concern.
- We expect QE to conclude by the end of the year with a possible rate hike in the summer of 2019, followed by a modest normalization process. The expected process of gradual, moderate rate hikes limits the potential for a significant increase in short-term government bond yields.
- The ECB's continuing reduction in the level of accommodation may support a recovery in longer-term government bond yields over the short-medium term (chart 2). However, we expect the recovery in yields to be moderate and volatile due to the existing risks, including trade protectionism, further possible downward changes to the EA growth outlook, and the existing political risks in the bloc, mainly in Italy.





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