Global Macroeconomic Monthly Review

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Arie Tal, Research Economist

Capital Markets Division, Economics Department

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Key Issues

Global Economic Forecast Table (p. 3)

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

- *Global economic growth may somewhat moderate in the third quarter after accelerating in the previous quarter.*
- *Growth continues to be driven mainly by an improvement in domestic demand, while trade activity data point to further softening, partly due to growing uncertainty regarding US trade policy. NAFTA negotiations are progressing, while Trump's hawkish tone against China and the WTO continues.*
- *Risk levels in some major emerging economies continue to increase, most significantly in Argentina and Turkey. Due to the current macroeconomic developments, emerging markets government bond yields have increased recently.*
- *Global inflation is expected to increase slightly in the coming months, due to, among other things, temporary factors.*
- *Monetary policy normalization is expected to continue, both in major advanced economies, as well as in emerging economies.*

United States (p. 6)

- *US economic growth may moderate in Q3, mainly due to base effects. We expect further moderation in 2019, and to a greater extent in 2020 after the effects of US fiscal policy will fade, and due to the constraints of full employment and tighter monetary conditions.*
- *Inflation is expected to remain above the Fed's target in the short-run.*
- *The Fed is expected to hike the interest rate in September, and the probability for an additional hike in December is relatively high. The tightening cycle is expected to continue in 2019, but we do not rule out the possibility that the Fed will pause the rate hike cycle in 2019, and start cutting rates gradually in 2020.*
- *The yield curve has flattened since the beginning of August, reaching an 11-year low. A modest 10-2 inversion is expected in 2020.*

Euro Area (p. 9)

- *EA economic growth is expected to remain stable in Q3. Increasing uncertainty (trade war, Italy's risks, Brexit's implications, and more) may weigh on business confidence in the short-run.*
- *Inflation slightly moderated in August and is expected to remain close to the ECB's inflation target in the short-run, before moderating toward the end of the year. Core inflation, which is noticeably low, is set to rise modestly.*
- *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.*

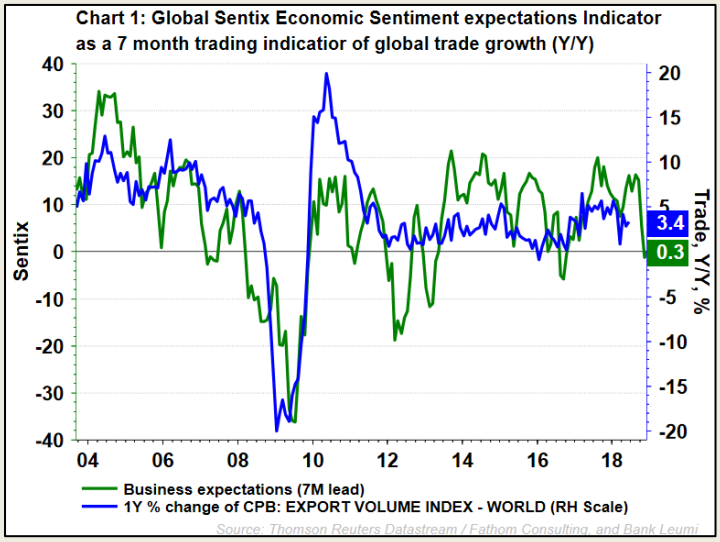
Leumi Global Economic Forecast, As of September 2018

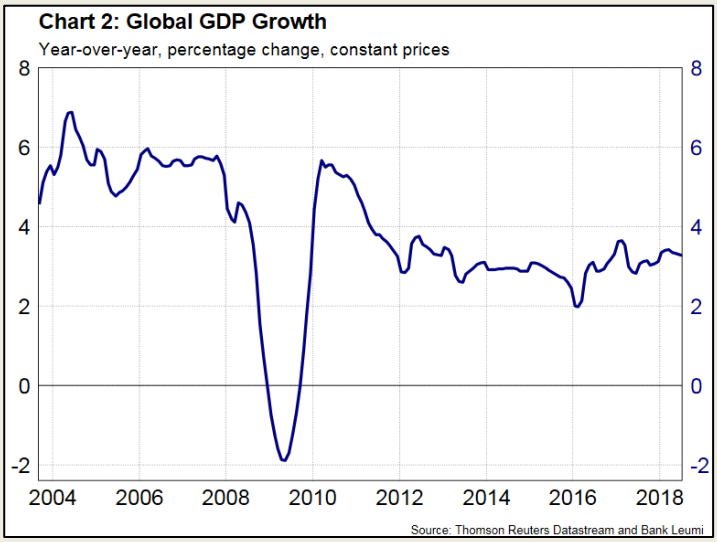
	2015	2016	2017	2018F	2019F
GDP – Real Growth Rate					
World	*3.3%*	*3.2%*	*3.7%*	*3.8%*	*3.7%*
USA	*2.9%*	*1.6%*	*2.3%*	*2.8%*	*2.2%*
UK	*2.2%*	*1.8%*	*1.6%*	*1.3%*	*1.5%*
Japan	*1.4%*	*0.9%*	*1.7%*	*1.4%*	*1.6%*
Eurozone	*2.0%*	*1.7%*	*2.6%*	*2.1%*	*1.8%*
South East Asia (ex. Japan)	*4.5%*	*4.5%*	*5.2%*	*5.1%*	*4.9%*
China	*6.9%*	*6.7%*	*6.9%*	*6.6%*	*6.2%*
India	*7.9%*	*7.1%*	*6.7%*	*7.3%*	*7.6%*
Latin America	*0.1%*	*-0.7%*	*1.2%*	*1.5%*	*2.2%*
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%*	*1.0%*	*1.5%*
Eurozone	*0.8%*	*-0.1%*	*1.5%*	*1.6%*	*1.7%*
Israel	*-0.6%*	*-0.5%*	*0.2%*	*0.8%*	*0.7%*
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%*	*0.10-0.25%*	*0.50-1.00%*

The Big Picture – The Global Economy

Global outlook: growing uncertainty may weigh on global growth in the short-medium term.

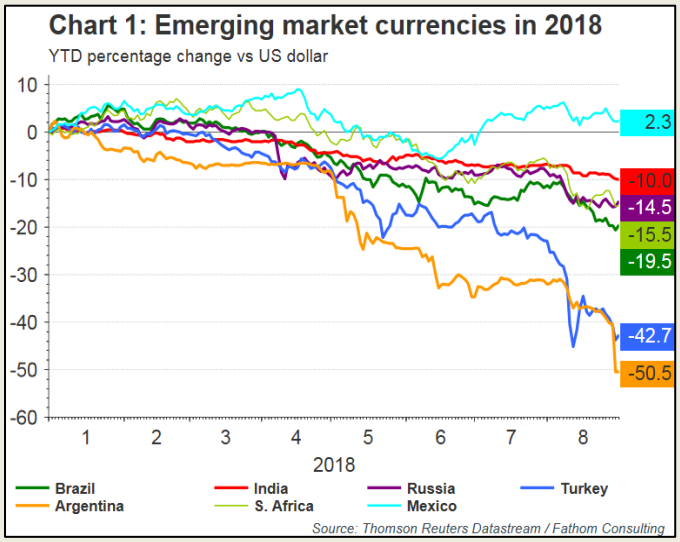
- Recently released data on economic activity attest to continuing growth. However, leading indicators, such as new orders, PMI, and other sentiment indices, point to some moderation in growth rates in the short-run. We expect economic growth to somewhat slow in the third quarter, due to base effects, after accelerating in the previous quarter in some major economies, including the US, UK, Japan, India, China, and some of the eurozone economies, including Germany and the Netherlands.
- Growth continues to be driven mainly by improvement in domestic demand, while data on trade activity point to further softening, partly due to growing uncertainty regarding US trade policy. Based on data published by the CPB Netherlands Bureau, global trade significantly moderated in the second quarter compared to the previous one, in tandem with a deterioration in business expectations (chart 1).
- The uncertainty regarding US trade policy may weigh both directly on the global economy through softening investment and production intentions, and also indirectly, through deterioration in sentiment in the financial markets (chart 2).
- Recently, there have been some additional developments and news about US trade policy. Recently, a preliminary deal between the US and Mexico has been reached on how to renew NAFTA, with the two countries agreeing on key issues concerning the automobile sector, intellectual property rights, labor, and more. The next step would be to re-engage Canada to reform a new NAFTA deal. In addition, the US is expected to announce soon whether it will impose additional tariffs on a further US$200bn of imports from China, and consider tariffs on an additional US$267bn of Chinese goods if China will retaliate. On top of all that, the president of the US, Donald Trump, remarked recently that he was prepared to pull the US out of the WTO. The uncertainty regarding trade policy may continue to weigh on economic sentiment.

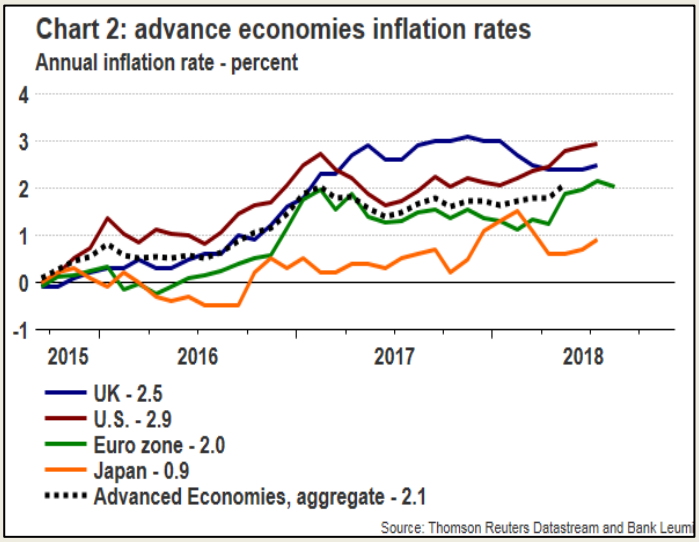




Global outlook (2/2): Risks in some major EM countries are on the rise, particularly in Argentina and Turkey. EM currency weakness may support further inflationary pressures and rate hikes.

- Financial risks in some emerging markets remain high as depreciations in EM currencies have continued recently (chart 1), partly due to rising interest rate differentials with the US. The heightened vulnerability is mainly evident in economies characterized by external or fiscal imbalances, and high political risks. Argentina and Turkey remain in the spotlight and continue to battle over investor confidence. Lately, Argentina asked the IMF to speed up the payments of its approved loan, and the central bank increased the policy rate by 15 percentage points to 60% (the highest in the world). 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.
- Despite the expected moderation in Q3, global growth is expected to slightly accelerate this year, supported by easing or expansionary fiscal policies in advanced economies, easing lending standards by the financial system, and improving labor markets. We revised slightly downward our 2019 growth estimate to 3.7% from 3.8% due to downward revisions to the US economy. There are still downside risks to our growth outlook that stem from concerns over escalating trade wars and tighter financial conditions in emerging markets. Hence, we do not rule out additional downward revisions to our 2018-2019 global growth outlook.
- Inflation in advanced economies has increased recently, particularly in the developed economies (chart 2). Also, some of the major emerging economies experienced a rise in inflation due to increases in import prices as a result of depreciations in their exchange rates and rising commodity prices. These developments support hawkish bias communication and actions among some central banks, in tandem with rising government bond yields.
- A solid global growth outlook and higher inflation are expected to support advanced economies' central banks to normalize policy further in the short-run, led by the US Federal Reserve, which is expected to continue to normalize its policy faster, in the next few months at least, compared to other central banks.

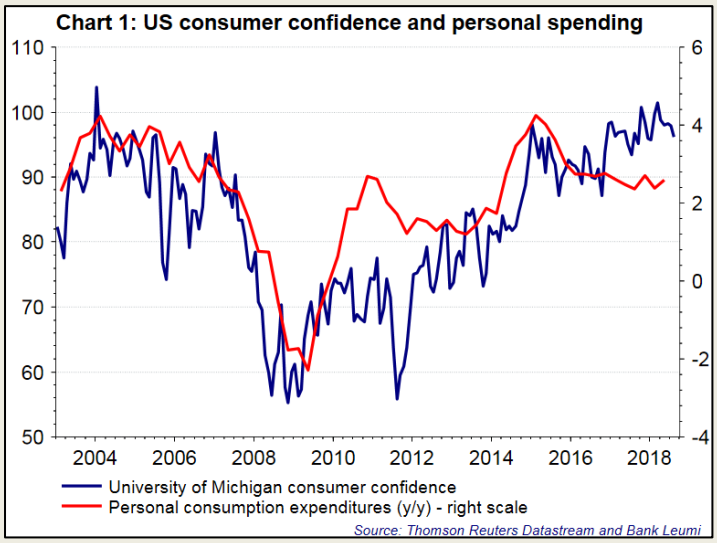


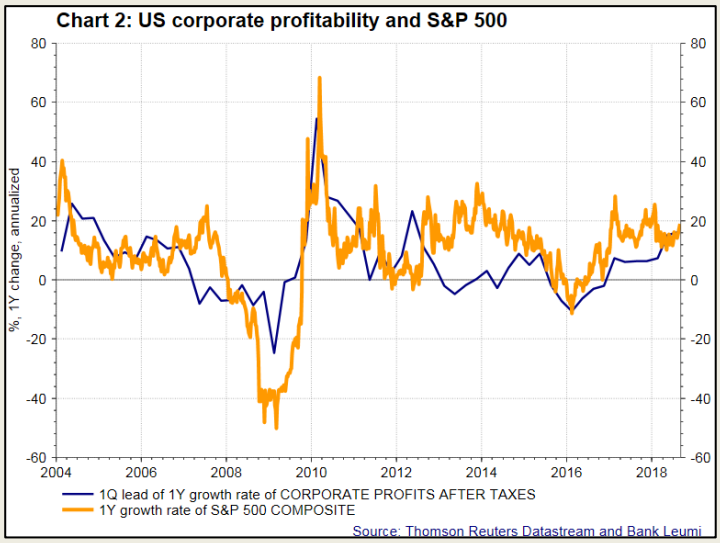


United States

US growth outlook (1/2): strong domestic demand, supported by fiscal stimulus, continues to maintain solid economic growth. Risks to our growth outlook are on the rise.

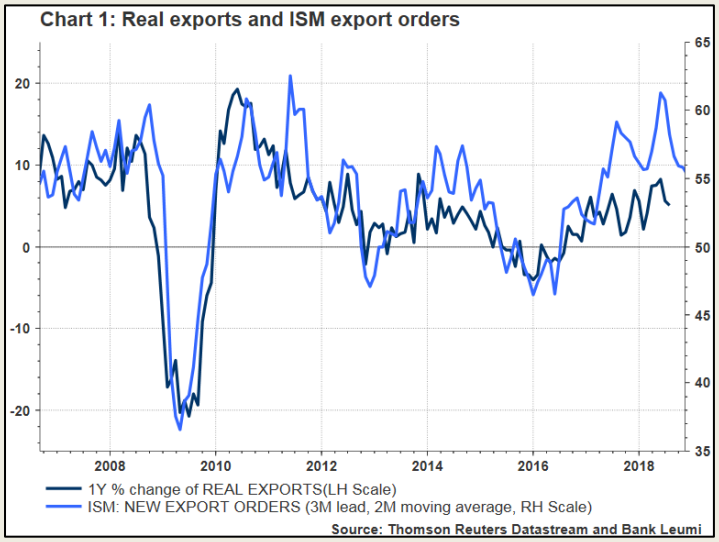
- The US economy has continued to grow firmly in the third quarter of the year, following the upwardly revised 4.2% quarter-on-quarter annualized growth rate in the second quarter. Private spending and retail sales have remained relatively solid, supported by the positive developments in the labor market as the unemployment rate remained near an 18-year low and wage growth accelerated further. Wealth effects and high consumer confidence are expected to support a further rise in household demand (chart 1). However, rising inflation and tariffs on imported products may erode household purchasing power and somewhat offset spending growth to some extent in the short-medium term.
- Recently, industrial production growth accelerated further, supported by manufacturing activity, mainly in the auto sector. We expect industrial production to remain firm, supported by solid domestic demand, expansionary fiscal policy, the positive trend in oil prices, and an improvement in business confidence in tandem with the increase in corporate profits.
- Corporate profits after tax increased significantly in the second quarter, supported by the reduction in corporate tax rates. The improvement in corporate profits is in general supportive for equity markets. However, expectations for an economic growth deceleration in 2019-2020 and growing uncertainty (chart 2) pose a risk to equity markets.
- Housing market data have disappointed lately on both the demand and the supply sides. Housing starts disappointed to some extent in June-July, and both new and existing home sales decreased in the past few months. As a result of these developments, growth in housing prices has moderated recently. The slowdown in activity is a reflection of a decrease in housing affordability as housing prices grow faster than income, and as mortgage interest rates are near a 4 1/2 year high. A further decrease in affordability may weigh on housing demand and investment.

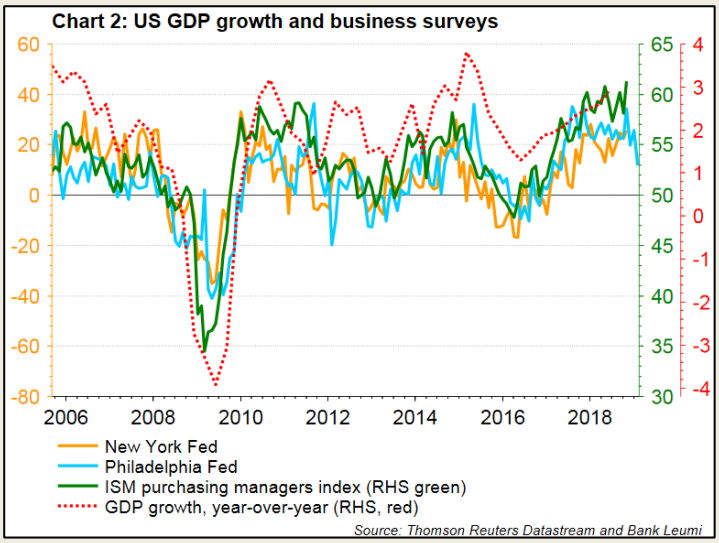




US growth outlook (2/2): growth is expected to moderate in 2019-2020. Due to growing risks, we revised downward our 2019 growth estimate.

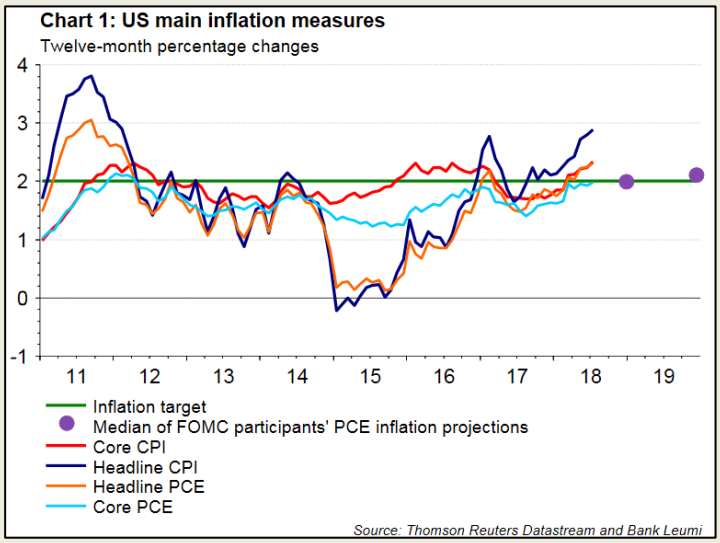
- Net trade is also expected to be a drag on GDP growth in the third quarter, mainly due to base effects after it contributed significantly in the previous quarter. Based on advanced readings, the goods trade deficit widened in July, driven by an increase in imports and a fall in exports. The decrease in exports was affected by a fall in soybean exports, after it increased significantly in the second quarter before China's tariffs went into effect. We also expect the appreciation in the US dollar, in tandem with tariffs on imported goods from the US, will put some downward pressure on exports in the short-run. Leading indicators point to a further slowdown in the short-run in exports.
- Based on business surveys, it seems economic activity has somewhat moderated in the third quarter of the year. Both manufacturing and services Markit PMIs moderated in July-August compared to the readings registered in the second quarter. The ISM indices sent mixed messages. Overall, the business surveys point to solid growth in the short-run, but momentum may somewhat moderate (chart 2).
- We expect 2018 GDP growth to accelerate to 2.8% from 2.3% in 2017. With regard to 2019, we revised downward our growth estimate to 2.2% from 2.5% due to rising uncertainty regarding US trade and foreign policy, ongoing investigations on the president, fading effects of the current expansionary fiscal policy, and FOMC normalization of monetary policy. We expect further moderation in 2020, as growth may dip below 2%. The constraints of full employment are likely to become evident in the weak growth rate expected for 2020.

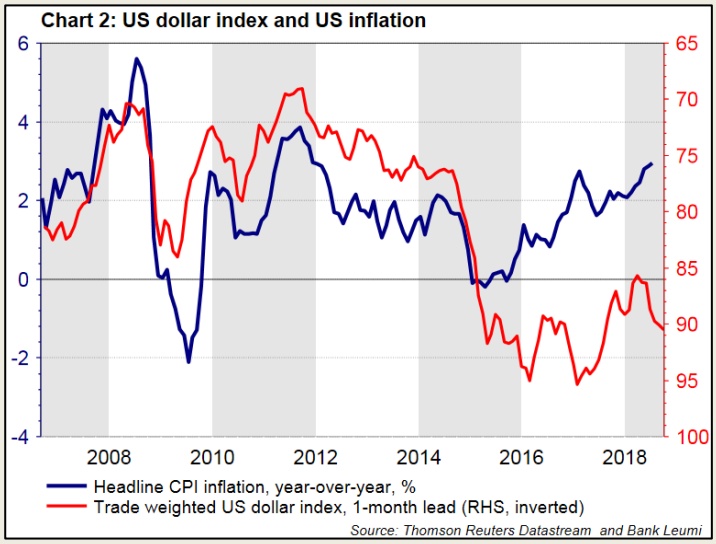




US inflation outlook: inflation is expected to remain above the Fed's target in the short-run.

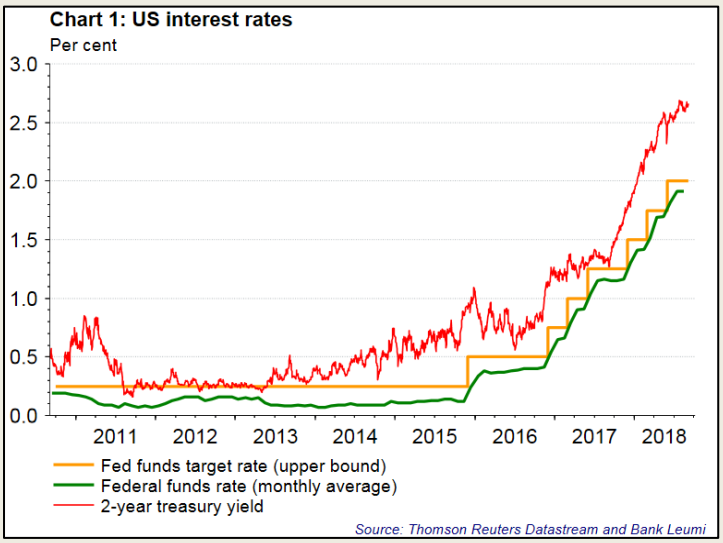
- The major inflation measures, CPI and PCE, both at the headline and core levels, rose further in July, and also accelerated further on a year-on-year basis (chart 1). The four major measures are currently at or above the FOMC inflation target. The recent rise in core inflation largely reflected a gain in the housing component, vehicle prices, and airfares. It should be noted that headline inflation may slightly drop in the upcoming months due to base effects stemming from the rise in energy prices.
- Import prices rose strongly by 4.8% on a year-over-year basis, supported mainly by imported petroleum prices (almost 44% year-on-year). The rise in import prices may be rolled over to consumer prices to some extent in the short-run.
- So far there has been little evidence that the tariffs imposed by the US on Chinese imported goods in June affected consumer prices. However, we do not rule out inflationary effects if the US will impose significant tariffs in the future, as was threatened by the president.
- In addition, the appreciation in the USD may temporarily limit, to some extent, the rise in inflation in the short-medium term (chart 2).
- Headline inflation is expected to still remain above the FOMC target in the short-run at least, supported by a further tightening labor market, which may support wage growth. This will be accompanied by solid domestic demand, which is expected to be driven partly by fiscal policy expansion. On average, we expect CPI inflation to be around 2.4% in the current year, compared to 2.1% in 2017.

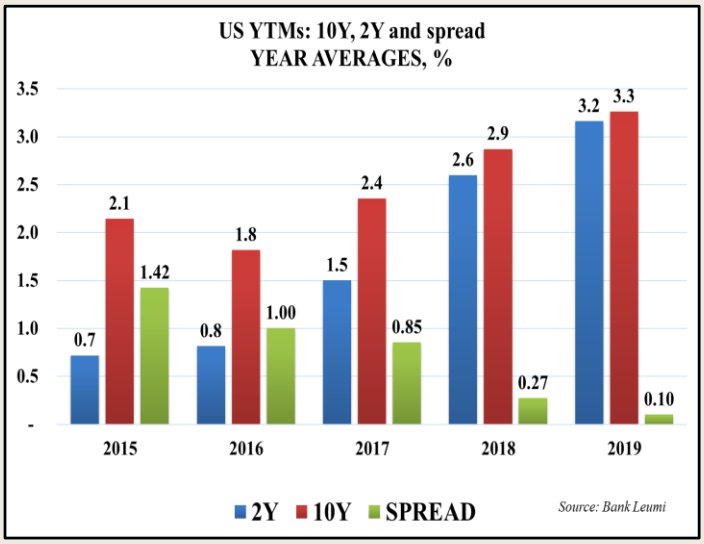




Monetary policy and financial indicators outlook: the tightening cycle is expected to continue in 2019, but we do not rule out the possibility that the Fed will pause the rate hike cycle in 2019, and will start cutting rates gradually in 2020.

- The latest Fed chair speech at Jackson Hole did not signal any change in policy, concluding that further rate hikes "will likely be appropriate." However, it should be noted that the Fed chairman, Jerome Powell, mentioned the increase in uncertainty caused by concerns about protectionism, and emphasized that if the economic outlook changed markedly, the Fed is ready to change direction too, saying he is "confident" the FOMC would do "whatever it takes" if a new crisis will threaten.
- Based on the current macroeconomic developments and market-implied probability, the Fed is expected to raise the interest rate in September, and the likelihood for an additional hike remains relatively high. Looking ahead, we expect the Fed to continue hiking the interest rate in 2019, providing upward pressure to the short-term yields (chart 1). 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 only once, much lower than projected by the FOMC – three hikes.
- We do not rule out the possibility that the Fed will pause the tightening policy already in the second half of 2019, and start cutting rates gradually in 2020, in contrast to the FOMC projections that point to additional hikes in 2020. It should be noted that the tendency for the Fed to overshoot during a rate increase cycle has been observed frequently in the past.
- The 10-year Treasury yield rose lately mainly due to an increase in treasuries' issuance, while the short-end of the curve increased as well on solid activity and employment data. The yield curve has flattened further recently to an 11-year low. 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 additional flattening of the yield curve in 2019 on an average basis compared to 2018. A modest and temporary 10-2 curve inversion is expected in 2020.

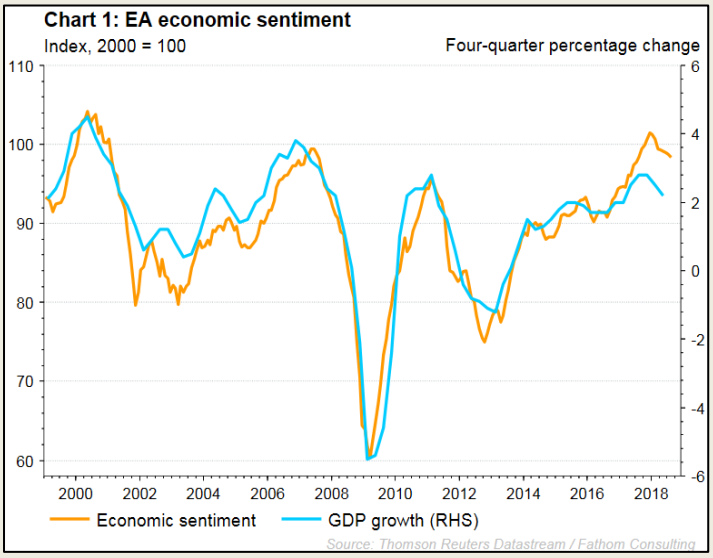


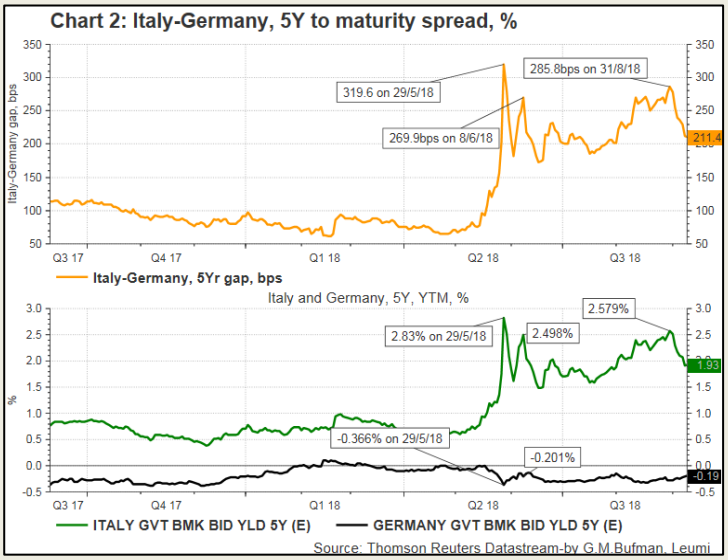


Euro Area

EA growth outlook: economic growth is expected to remain stable in Q3. Increasing uncertainty may weigh on business confidence in the short-run.

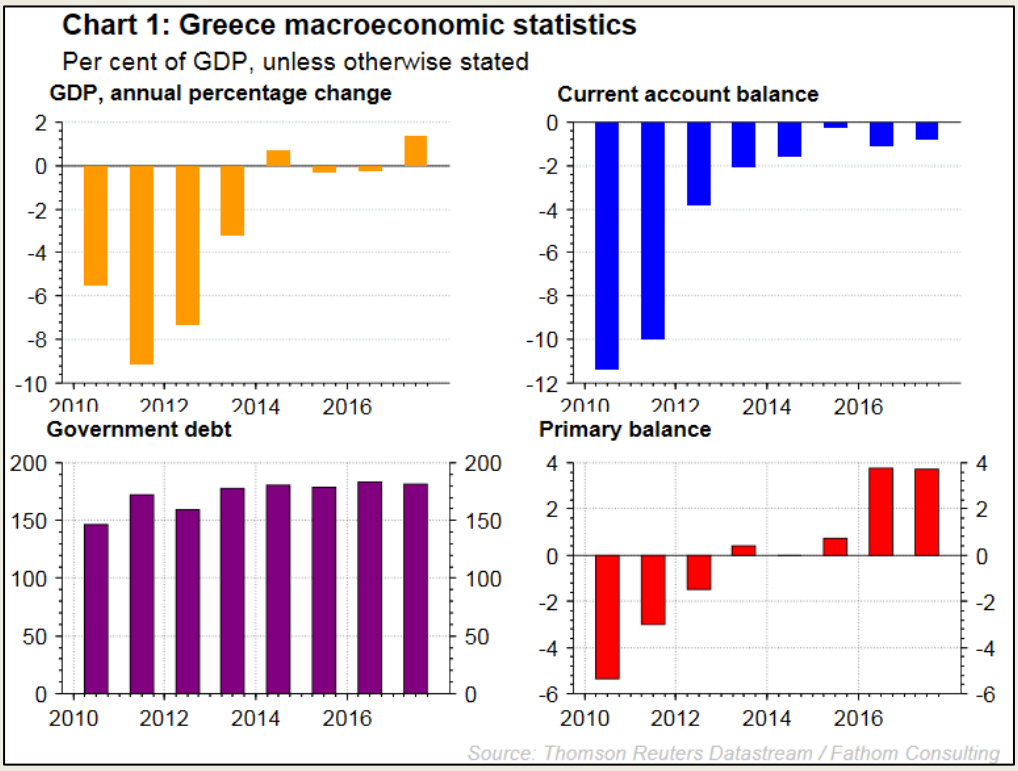
- Recently released data attest to a stabilization in economic growth in the third quarter after the GDP rose 0.4% q/q in the second quarter of the year. The volume of retail sales declined in July (due to oil and food sales) and moderated in annual growth. Looking forward, we expect moderate improvement in household demand in the short-run, supported by the further decline in unemployment and a moderation in headline inflation in the upcoming months. It should be noted that forward-looking aspects of the consumer confidence survey remain positive, with consumers' only concern on employment prospects. In addition, loans to the private sector continue to grow, led by non-financial corporations. However, we do not rule out the possibility that the growing economic uncertainty will weigh on demand to credit and overall domestic demand.
- July-August business surveys sent mixed messages as the European Commission's (EC) confidence index in the industry and services sectors fell slightly, but confidence in retail trade rose to 4-month high, and confidence in construction rose to 3-month high. The PMI composite rose in August, supported by the services sector. Based on past standards, both the PMI and EC attest to ongoing growth in the short-run (chart 1).
- Growing uncertainty in the euro area, mainly due to the US-EU trade tensions, uncertainty regarding Brexit's implications, and Italy's political and fiscal risks, may weigh on business confidence and hurt investment in the short-run. Italy's government bond yields rose since mid-July, and the Germany-Italy government bond spread has widened (chart 2), on concerns of a worsening in Italy's fiscal profile, as the 2019 budget season approaches. More recently, the spread has somewhat decreased following efforts by Italy's leadership to assuage investors' concerns. The uncertainty may continue to weigh on market sentiment and result in capital outflows from Italy.





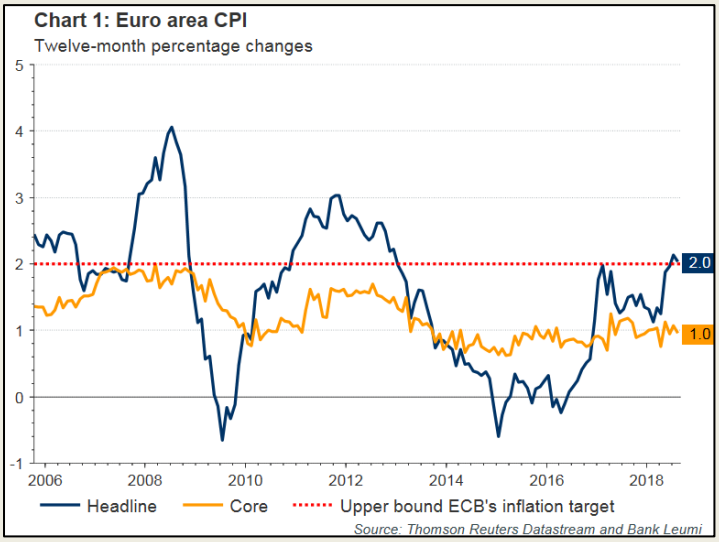
EA growth outlook: EA economic growth is expected to remain stable in Q3. Increasing uncertainty may weigh on business confidence in the short-run.

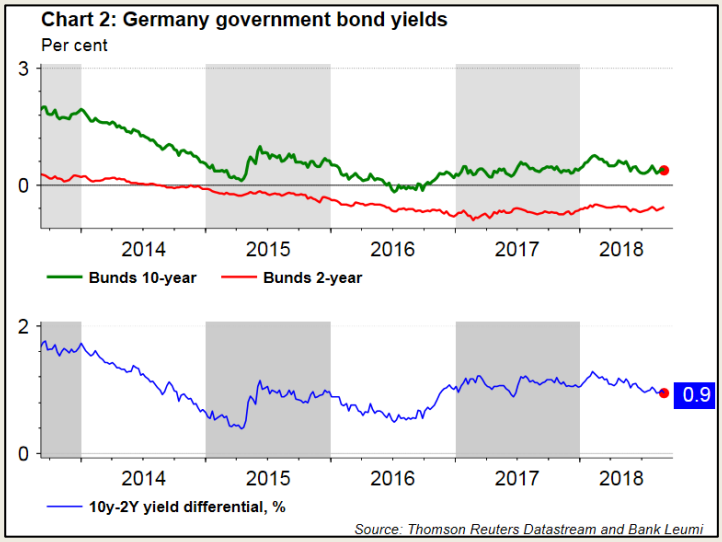
- In contrast to the developments in Italy, Greece's outlook became somewhat brighter in the past year. Last month, Greece completed its third term of bailout due to a continuing improvement in its macroeconomic condition, ending eight years of international bailouts. Presently, the economy is characterized by a moderate recovery in economic activity, in tandem with processes of improvement in the fiscal profile and its external accounts (chart 1). Despite the improvement, it should be noted that Greece's risk outlook remains high, mainly due to a high level of external debt and weakness in the banking system. Due to the improvement in Greece's economic fundamentals, the government bond yield spread between Greece and Germany has decreased over recent years, but it is still relatively high compared to other EA economies due to the existing risks.
- All in all, the growth outlook in the euro area 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 (high growth rate last year) and some decline in business expectations due to the rising uncertainty. Still, economic activity continues to grow at a reasonably healthy pace and above the potential growth rate, which is around 1.5%.
- Due to the moderation in GDP growth in the first half of the year compared to the second half of 2017, and against the backdrop of the recent monthly data, we revised slightly downward our 2018 growth estimate to 2.1% compared to 2.2%. This compares to a growth rate of 2.6% in 2017. Also, based on the Consensus Economics survey in the past few months, financial institutions revised downward their EA 2018 growth outlook in the past few months.



EA inflation and monetary outlook: the ECB is expected to stick to its plan, according to its forward guidance, for now.

- Flash headline inflation for August moderated slightly to 2.0% year-on-year from 2.1% (chart 1). The decline in the eurozone's headline rate was partly driven by energy related inflation. The core rate also declined, from 1.1% to just 1.0% - in line with its average over the past two years. Currently, there are still few signs that core inflation may move to an upward trend in the short-run. However, a further decline in unemployment may support some growth in wages, which may support core inflation in the medium-term.
- With regard to headline inflation, we expect some moderation toward the end of the year after the positive contribution of the temporary factors and base effects will start to fade. In contrast, the depreciation in the exchange rate of the euro since April may offset, to some extent, the forces that support the rise in inflation in the short-run.
- As growth remains relatively solid, while core inflation is noticeably below the ECB's inflation target (below, but close, to 2%), the ECB provided forward guidance for the months ahead. For now, we expect the ECB to stick to its plan. Hence, we expect a complete discontinuation of QE purchases by the end of the year, and the interest rate may start rising "through the summer" in 2019.
- The expected gradual and moderate rate hike limits the potential for a significant increase in the short-term government bond yield. 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. 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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The Economics Sector, P.O. Box 2, Tel Aviv 61000
Ph: 972-76-885-8737, Fax: 972-77-895-8737, e-mail: Gilbu@bll.co.il
http://english.leumi.co.il/Home/