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 growth likely accelerated in the second quarter after experiencing a slowdown in the first quarter. Looking ahead, economic activity is expected to remain solid, but risks to our growth outlook have increased, due to, among other things, rising protectionism in trade policy that may escalate in the short-medium term.*
- *Expectations for a further increase in US interest rates may pose an ongoing risk to some emerging economies – especially those with weak fundamentals.*
- *Global inflation is expected to increase slightly in the coming months, supported by an improving demand environment, a rise in commodity prices, and base effects in both advanced and emerging economies.*
- *We expect further gradual monetary tightening in the short-medium term, in some economies.*

United States (p. 6)

- *Economic growth is expected to accelerate in the second quarter and remain solid, supported by fiscal stimulus and an improving labor market.*
- *However, risks to our growth outlook have increased recently, due to possible direct and indirect effects of the US trade protectionism policy.*
- *Inflation is expected to be above the Fed's target in 2018-2019. The upside risk to our inflation estimates has increased due to the impact of possible additional tariffs.*
- *A further hawkish tone by the Fed. We expect an additional rate hike in 2018, while the probability for two hikes has decreased recently.*
- *The yield curve may flatten further in the short-run if the risk environment will intensify.*

Euro Area (p. 9)

- *The growth environment likely slowed in the first half of the year compared to H2-2017.*
- *The growth outlook may moderate in the current year after the economy grew significantly above its potential growth rate in 2017. Rising political risks may weigh on growth as well.*
- *Core inflation is expected to rise over the coming months, supported by solid domestic demand, wage growth, and base effects.*
- *The ECB is expected to end its asset purchases in December but may keep interest rates on hold at least through the summer of 2019.*

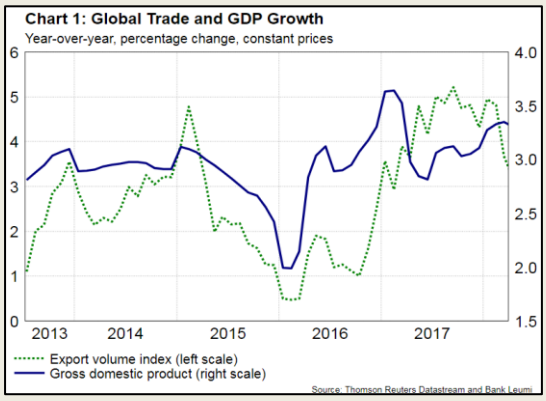
Leumi Global Economic Forecast, As of July 2018

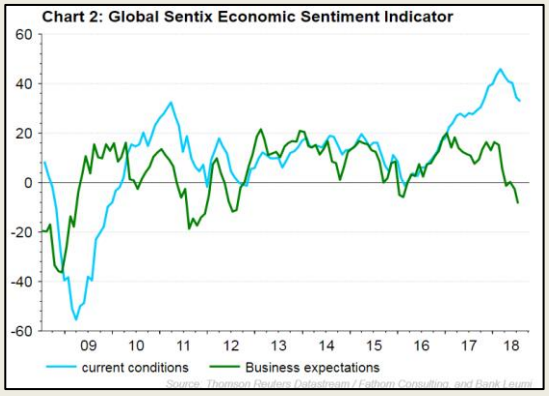
	2015	2016	2017E	2018F	2019F
GDP – Real Growth Rate					
World	*3.3%*	*3.2%*	*3.7%*	*3.8%*	*3.8%*
USA	*2.9%*	*1.6%*	*2.3%*	*2.7%*	*2.5%*
UK	*2.2%*	*1.8%*	*1.6%*	*1.3%*	*1.5%*
Japan	*1.4%*	*0.9%*	*1.7%*	*1.6%*	*1.7%*
Eurozone	*2.0%*	*1.7%*	*2.5%*	*2.2%*	*1.9%*
South East Asia (ex. Japan)	*4.5%*	*4.5%*	*5.2%*	*5.1%*	*4.9%*
China	*6.9%*	*6.7%*	*6.9%*	*6.7%*	*6.4%*
India	*7.9%*	*7.1%*	*6.7%*	*7.3%*	*7.7%*
Latin America	*0.1%*	*-0.7%*	*1.2%*	*1.7%*	*2.5%*
Israel	*2.5%*	*4.0%*	*3.3%*	*3.7%*	*3.4%*
Trade Volume, Growth (%)					
Global	*2.5%*	*2.3%*	*4.6%*	*4.0%*	*3.8%*
CPI, Annual Average (%)					
USA	*0.1%*	*1.3%*	*2.1%*	*2.4%*	*2.4%*
UK	*0.1%*	*0.7%*	*2.7%*	*2.5%*	*2.1%*
Japan	*0.5%*	*1.0%*	*0.5%*	*1.3%*	*1.6%*
Eurozone	*0.8%*	*-0.1%*	*1.5%*	*1.4%*	*1.5%*
Israel	*-0.6%*	*-0.5%*	*0.2%*	*0.8%*	*0.8%*
Interest Rates, Year End					
US Fed	*0.25-0.50%*	*0.50-0.75%*	*1.25-1.50%*	*2.00-2.50%*	*2.75-3.00%*
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%*

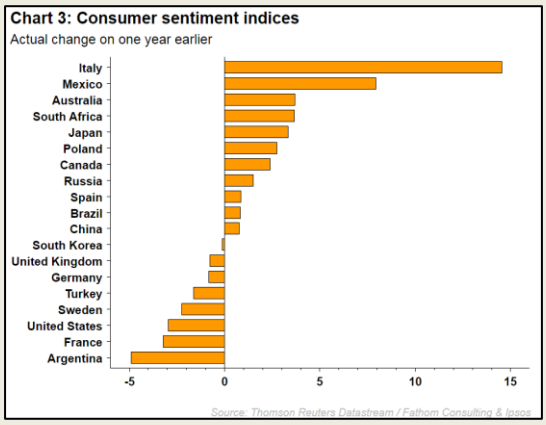
The Big Picture – The Global Economy

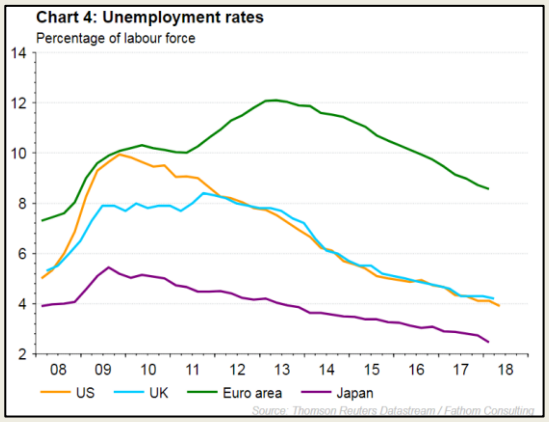
Global growth outlook: risks to our growth outlook are on the rise. Deterioration in sentiment may weigh on both financial markets and the real economy.

- Based on leading indicators, it seems global activity improved in June, mainly supported by the services sectors. In fact, the latest data attest to a continuing divergence in the performances of the manufacturing and services sectors, as the manufacturing sector continues to slow. Global trade moderated in the past few months (chart 1). Forward-looking indicators, such as export orders, have weakened considerably since the start of 2018, suggesting that trade growth is expected to remain soft in the short-run at least. The weakness in export orders is a result of concerns regarding a trade war rather than unease over global demand.
- In addition, based on various surveys (including Sentix, PMI, IFO, and EC) business optimism and expectations regarding growth have deteriorated recently (chart 2). The recent fall in confidence is likely due to, among other things, the rise in risks of protectionism and the increase in financial markets' volatility, mainly in emerging markets. Meanwhile, consumer confidence has remained high but deteriorated recently in some economies, including the US and France (chart 3) despite the continuing improvement in the labor market (chart 4).
- The latest steps taken by the US, the recent rhetoric and comments by Mr. Trump, and possible additional responses by some US trading partners, may hurt trade to a limited extent. However, if the situation will escalate then the damage to trade, production, and growth will be greater, leading to downward revisions to global growth estimates and upward revisions to inflation.



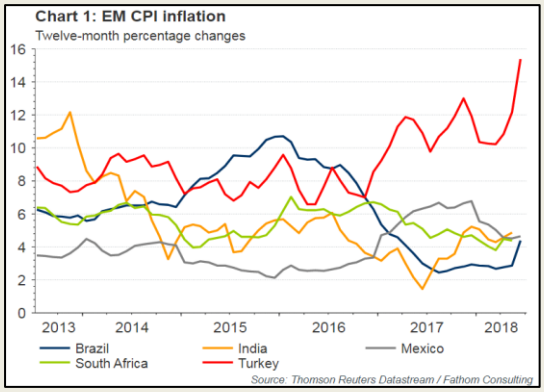


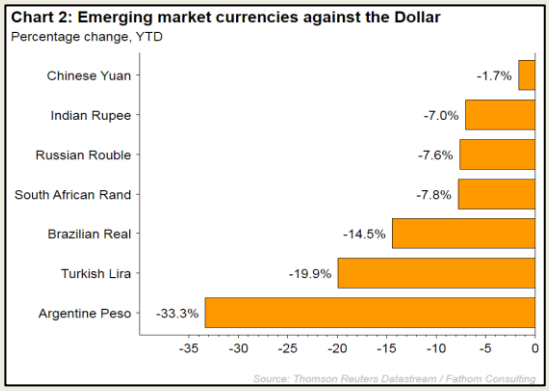


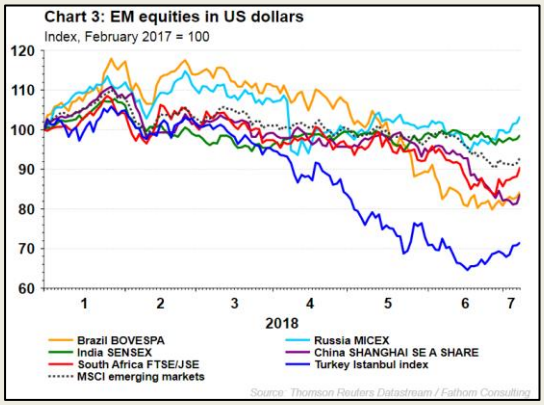


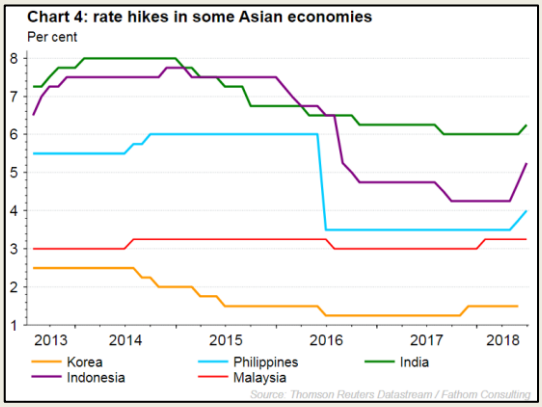
Global growth outlook (continued): risks to our growth outlook are on the rise. Deterioration in sentiment may weigh on financial markets and the real economy.

- Another major risk to our growth outlook is the risk of stagflation, mainly in emerging economies that are characterized by fragile fundamentals, including weak external accounts. Other parameters that may signal high levels of vulnerability include high government budget deficits and debts with a high external component. Some of the "fundamentally weak" economies have witnessed, or are expected to witness, a rise in inflation (chart 1), as a result of currency depreciation (chart 2), which may push real yields downward, causing an increase in financial outflows. Recently it seems that twin deficit economies have been more vulnerable and have experienced heightened volatility in their financial markets (chart 3) in tandem with depreciations in their exchange rates, causing some central banks to raise their interest rates (chart 4), which may weigh on economic growth.
- Political risks around the world may also weigh on sentiment in the short-run. In Europe, even though the German coalition parties reached an agreement regarding the policy of migration, we expect more disagreements down the road. In Italy, the political parties 5SM and NL established a coalition government, but political risk still exists, as the probability for a snap election is relatively high. In addition, we expect political disagreements between the new Italian anti-establishment coalition and the EU. The mid-term elections in the US may also have an effect on the volatility in the financial markets and economic policy in the US. All in all, global economic growth likely accelerated in the second quarter, after it moderated in Q1. Based on national data, is seems the rebound will be driven by the US economy. However, risks have increased recently, and if they materialize and hurt the real economy, we may revise downward our 2018 growth forecast.





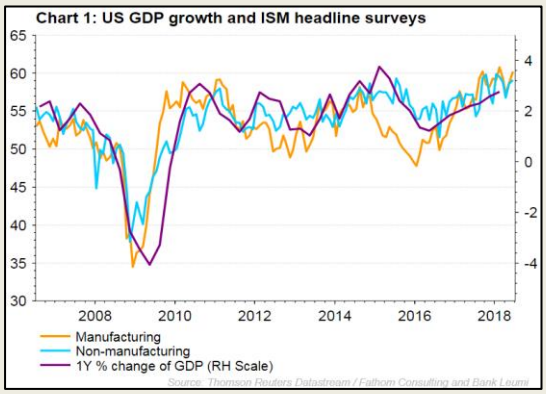


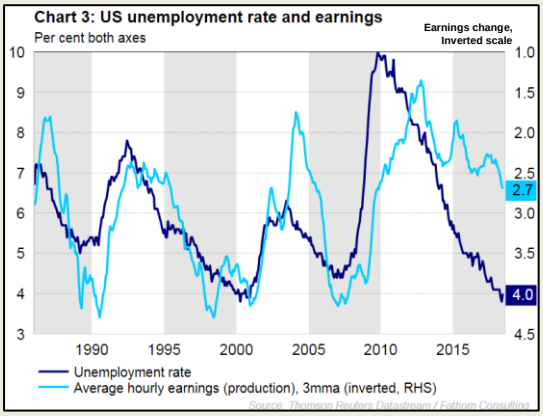


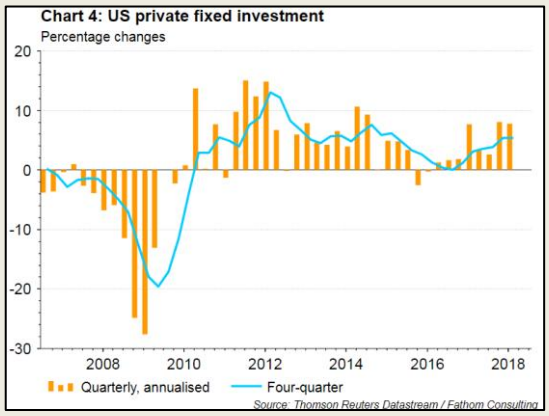
United States

US growth outlook: risks to our growth estimates are tilted to the downside.

- Based on recently released data, US GDP growth (chart 1) apparently rebounded in the second quarter of the year, after slowing in Q1 to 2.0% q/q, annualized. Financial institutions estimate that economic activity grew considerably more than 3% in Q2-2018. Second quarter growth was driven mainly by personal consumption, as retail sales improved significantly in the past few months (chart 2). The improvement in retail sales was supported by the strength of the labor market (chart 3), the tax cuts, and a wealth effect, which keeps consumer confidence at an elevated level. The recent rise in inflation, led by energy prices, in tandem with higher Fed interest rates, may weigh on household spending in the short-medium term. Fixed asset investment is also expected to contribute positively to overall growth in the short-term (chart 4). This will be supported by several factors, including: an improvement in structures investment as drilling rigs continue to increase, supported by the rise in oil prices; a further rise in residential investment as home prices continue to increase due to the rise in demand and low level of inventory; and the tax reform.
- We expect 2018 GDP growth to accelerate to 2.7% from 2.3% in 2017. However, the downside risks to our growth estimates have increased recently, mainly due to the heightened tensions in trade relationships between the US and its trading partners, which may hurt US exporters, squeeze corporate profits and consumer purchasing power, and affect general economic and investor sentiments, which may weigh on domestic demand in the short-medium term. Due to the rising risks, we do not rule out downward revisions to our 2018-2019 growth outlook for the US.

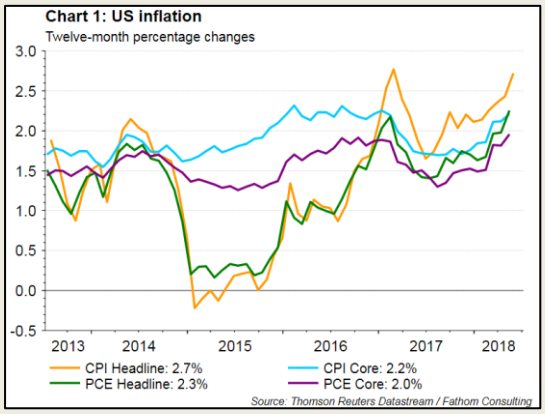


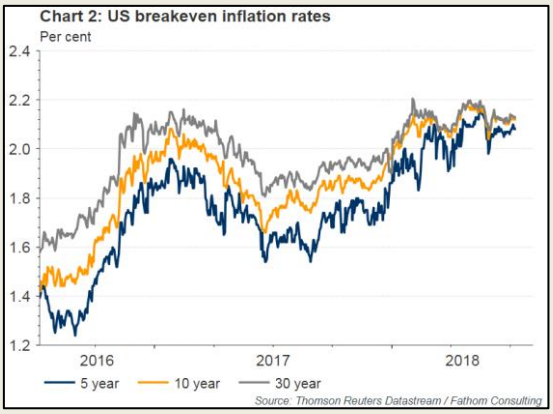


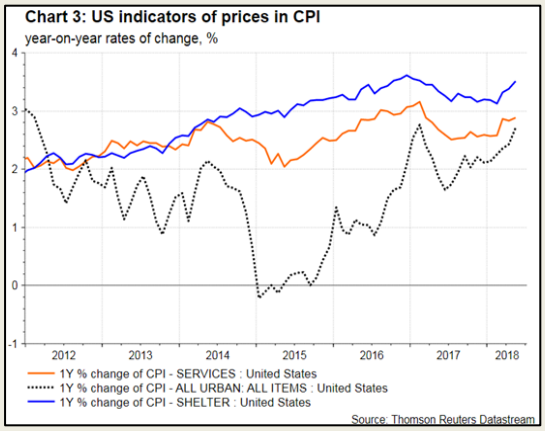


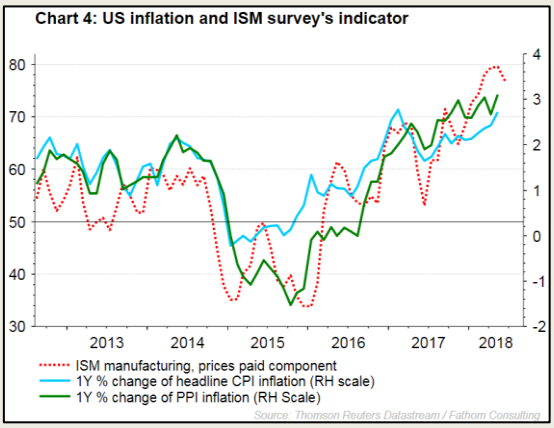
US inflation outlook: inflation continues to rise. We do not rule out some moderation by the end of the year.

- All main inflation indicators reached or crossed the Fed's inflation target in May (chart 1). Breakeven inflation measures have also been trending recently above the target (chart 2). The headline PCE and CPI measures were driven recently by energy prices.
- Core PCE inflation rose to 2.0% y/y in May from 1.8%, while the core CPI measures increased to 2.2% from 2.1%. These core measures were supported by base effects and services inflation, as the shelter component provided substantial support (chart 3).
- Other measures, such as import and producer prices, also rose further in the past few months. The headline PPI rate of change is at its highest level since January 2011. Leading inflation indicators, such as the ISM prices paid component, point to a further uptick in producer prices in the coming months (chart 4).
- Inflation is expected to remain above the Fed's inflation target in the short-medium term, supported by rising commodity prices and solid domestic demand, which is expected to be driven partly by fiscal policy, leading to increased resource utilization. All other things being equal, the tariffs imposed by the US government may also support inflation in the short-run. Looking forward, inflation is expected to somewhat moderate by the end of the year as the upside impact of base-effects will fade, and also as a result of the latest appreciation of the USD. On average, we expect CPI inflation to be around 2.4% in the current year, compared to 2.1% in 2017.



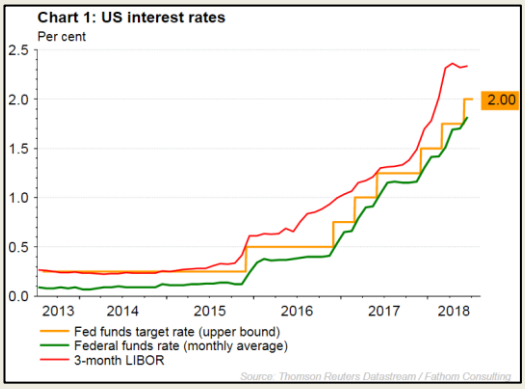


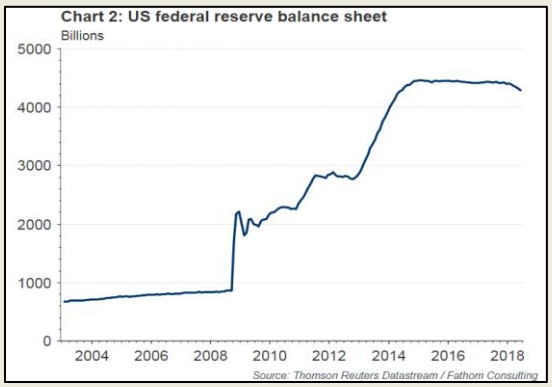


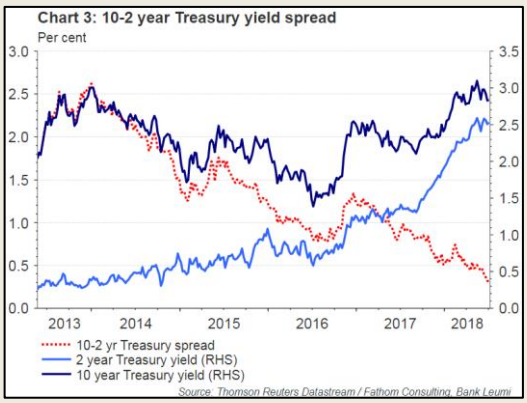


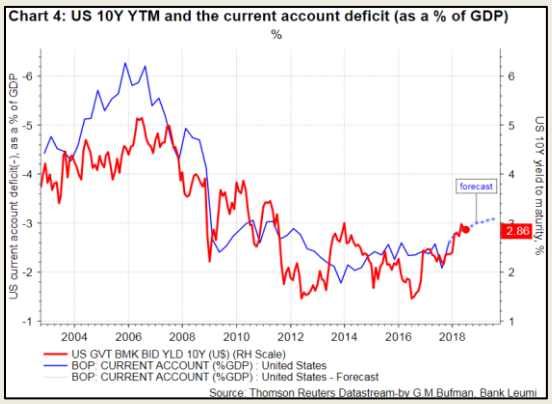
Monetary policy and financial indicators: the rise in risks may lead to just a single additional hike later this year. A net rise in Treasury issuance and inflation data may cause some upward pressure by the end of the year.

- On June 13th the FOMC increased the benchmark overnight interest rate to 1.75%-2.00%, as expected (chart 1), and at the same time raised its 2018 and 2019 rate projections. The FOMC currently expects two additional hikes in 2018, three hikes in 2019, and a single additional hike in 2020. Overall, the Fed ultimately expects the interest rate to reach close to 3.5%, which is around 1.5% in real terms. The Fed is expected to raise the interest rate at least one more time this year in tandem with its balance sheet normalization program (chart 2). In our opinion, the likelihood for two hikes has decreased recently, due to the increase in risks to the growth outlook. If trade tensions between the US and its trading partners will escalate further, then we will not rule out a more moderate and gradual path of rate hikes compared to the Fed's current projection, similar to the current pricing in market-implied interest rate expectations.
- Recently, the longer-end of the yield curve has moderated due to the increase in risks, and the curve has flattened further as the spread between the 10-year and the 2-year Treasury yields has narrowed to 30bp – the lowest since September 2007 (chart 2). Risks to our US growth outlook continue to weigh on the longer-end of the curve. However, there are factors that may limit to some extent a significant drop in yields, including an expected rise in Treasury bond issuance in the short-run against the backdrop of the tax reform and fiscal spending plans, which may lead to an increase in US twin deficits (chart 3), in tandem with the current solid growth data and above-target inflation. Based on our models, we expect the yield-to-maturity on 10-year bonds to rise toward 3.3% on average in 2019 compared to an average of 2.8% in the current year (chart 4). We expect the yield-to-maturity on 2-year bonds to rise to an average of 2.9% in 2019, from 2.5% this year.





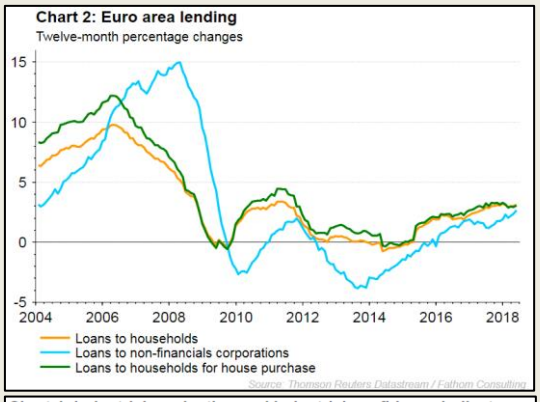


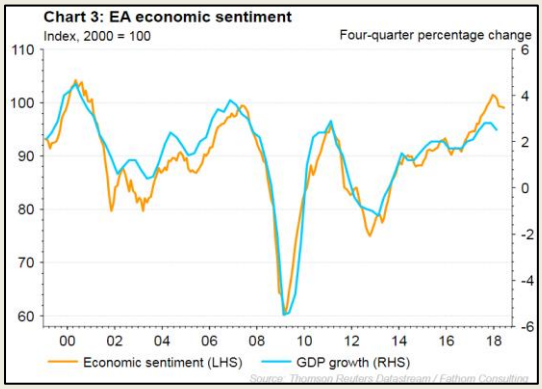


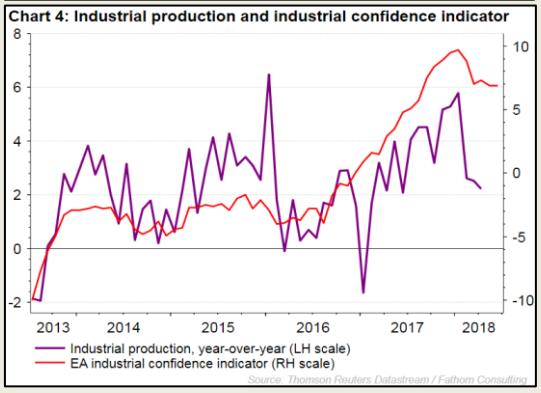
Euro Area

EA growth outlook: economic growth moderated in the first half of the year. Deterioration in business sentiment may weigh on growth in the short-run.

- Based on recently released monthly data it seems that second quarter growth remained close to the first quarter growth rate of 0.4%. On average, growth in the first half of the year apparently moderated compared to H2-2017. According to the monthly data, we assume the recent softness occurred due to some slowdown in domestic demand.
- Retail sales data in April-May were soft, most likely due to, among other things, the recent rise in prices, the rising volatility in the financial markets, and some recent decrease in consumer confidence (chart 1). Our outlook for private spending remains positive as the unemployment rate continues to decrease, albeit moderately, reaching in May 8.4% - the lowest since January 2009. In addition, credit flow to the private sector continues to improve, supported also by household demand. It should be noted that the recent rise in credit growth was driven by non-financial corporations (chart 2). Based on recent sentiment surveys (PMI, EC), it seems economic activity stabilized in June, mainly supported by the services sector, after moderating since the beginning of the year (chart 3). The manufacturing sector looks more vulnerable to the recent increase in political risks (chart 4). Industrial production moderated significantly, and based on the PMI survey, companies cited trade worries and political uncertainty as their biggest concerns. Sentiment for the year ahead in the manufacturing sector has sunk to its lowest since 2015.
- We expect some moderation in 2018 growth, to 2.2% from 2.5% in the previous year, but it seems that risks have increased recently and we do not rule out a downward revision to our growth outlook. Based on the latest Consensus Economics survey, financial institutions revised downward their EA 2018 growth outlook in the past few months.

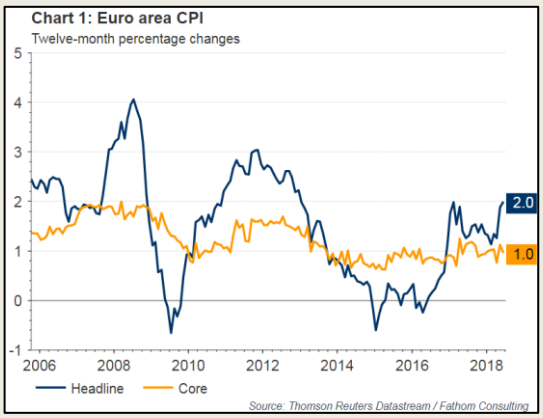


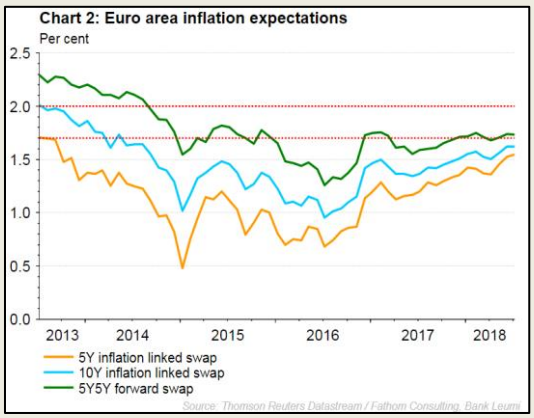


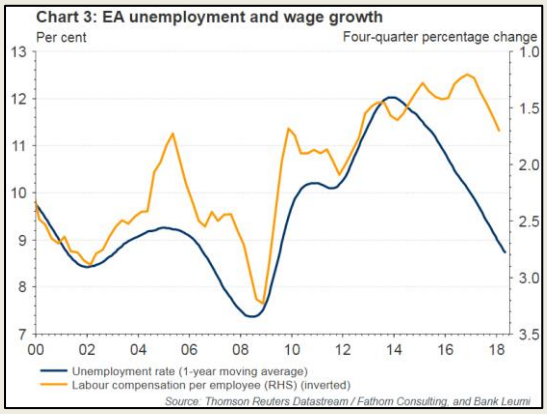


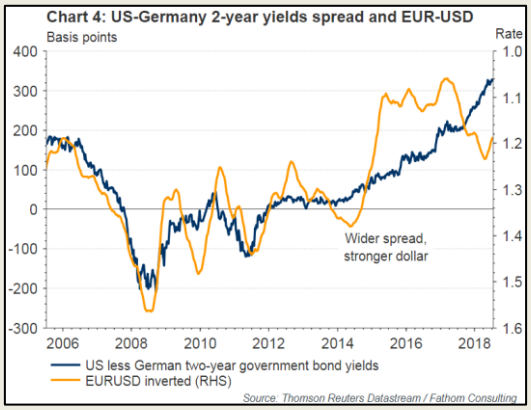
EA inflation outlook: headline inflation to remain close to the ECB's target in the short-run. Core inflation set to rise modestly.

- The preliminary headline index of EA consumer prices (HICP) rose to 2.0% y/y in June (chart 1), from 1.9% in May and 1.3% in April. The significant recent rise was supported by energy and food prices. Core inflation, which excludes the volatile energy and food price components, moderated to 1.0% from 1.1%, close to its average in the past few years.
- In addition, market-derived inflation expectations rose recently due to the recent increase in commodity prices (chart 2). The longer-duration expectations are currently at or within the range of ECB's inflation target, which is "below, but close to 2% over the medium-term".
- Inflation may be slightly higher this year compared to 2017, supported by an improvement in the labor market, which may prompt further moderate wage growth (chart 3). In turn, any wage growth should support a moderate and gradual pick-up in core inflation.
- The recent depreciation in the exchange rate of the euro may provide some support as well to inflation in the short-run. It should be noted that a further increase in US-EA government bond spreads may lead to further depreciation in the exchange rate of the euro (chart 4).



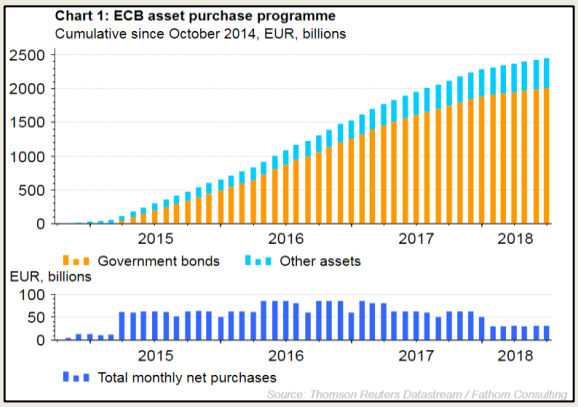


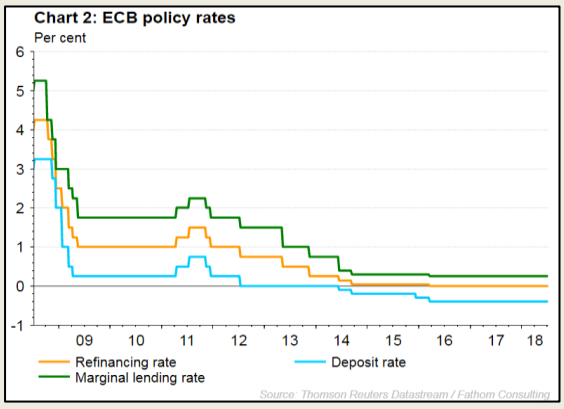


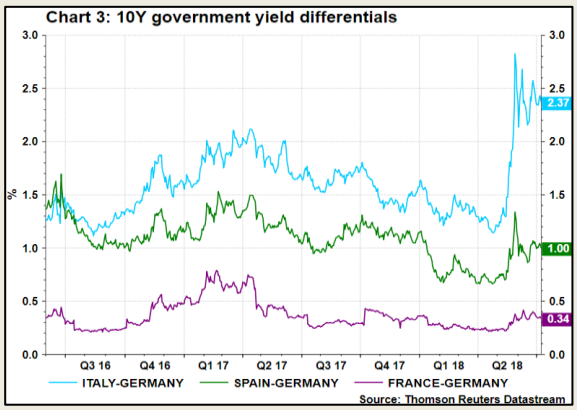


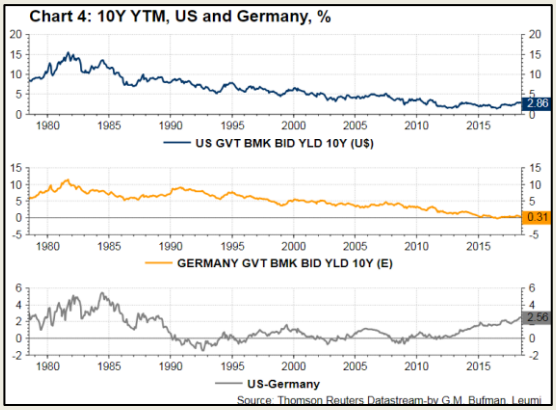
Monetary policy outlook and financial indicators: tapering is expected to continue throughout late 2018. The interest rate is expected to start rising modestly next summer.

- At its monetary meeting on June 14th, the ECB left its monetary policy unchanged, as expected. The main development in the meeting was the change in the ECB's forward guidance. The ECB announced it will continue to reduce its net asset purchases, and it is expected to end the purchases by the end of the year, subject to incoming data (chart 1). The ECB provided some forward guidance regarding the interest rate path, after stating it may keep interest rates on hold at least through the summer of 2019 (chart 2), which is longer than the market expected before the meeting. Based on market expectations, the deposit rate is expected to begin rising modestly, starting from September 2019. The ECB's forward guidance was apparently affected by the rising political risks as well as by changes in its projections, as its 2018 growth outlook was somewhat revised downward.
- Looking forward, we expect a complete discontinuation of QE purchases by the end of the year. This may support a recovery in government bond yields over the short-medium term. However, we expect the recovery in yields to be moderate and volatile, due to political risks and further possible downward changes to the EA growth outlook. The political disorder in Italy's politics caused an increase in volatility in the financial markets recently. Moreover, the yield spread between 10-year Italian and German bonds widened recently (chart 3). Other peripheral countries also experienced wider bond spreads. This was mainly due to rising yields in the peripheral countries, but also in part because yields in Germany fell alongside those in the US, due to the divergence in the Fed's and the ECB's policies, which pushed the yield differential to almost a 30-year high (chart 4).









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BANK LEUMI LE-ISRAEL, CAPITAL MARKETS DIVISION
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/