Global Economics Monthly Review

May 8th, 2018

Arie Tal, Research Economist

The Finance Division, Economics Department

Please see disclaimer on the last page of this report

Key Issues

Global Economic Forecast Table (p. 3)

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

- *Global growth is expected to accelerate in the coming quarters, but risks to this estimate are on the rise.*
- *Expectations for a further increase in US rates may pose an ongoing risk to some emerging economies – especially those with weak fundamentals.*
- *Inflation in the advanced economies rose in the past few months, while inflationary pressures in some emerging economies have eased.*
- *Global inflation is expected to slightly increase in the coming months, supported by the rise in commodity prices and base effects in the advanced economies.*
- *We expect further gradual monetary tightening in some of the advanced economies in the short-medium term.*

United States (p. 6)

- *Expected temporary slowdown in the first quarter. Economic activity is expected to grow strongly in the coming quarters, supported by improvement in the labor market and the fiscal stimulus.*
- *Inflation is expected to rise in the next few months, supported by base effects.*
- *A further hawkish tone by the Fed.*
- *We expect two additional hikes in 2018, while the upside risk to our estimate has recently increased.*
- *Upward pressure mainly on the short-end of the yield curve, but R* (the desired real interest of the central bank) has pushed up also the longer-end of the curve.*

Euro Area (p. 8)

- *Weakness in the beginning of the year, following strong year-end activity. Temporary factors weighed on demand, while supply constraints also played a role in the slowdown.*
- *The growth outlook may moderate in the current year after the economy grew above its potential growth rate in 2017.*
- *Inflation is expected to rise over the coming months, albeit just slightly, after dropping in April.*
- *We expect additional subtle changes in the ECB's forward guidance in upcoming meetings, with some further tapering steps in 2018 as the ECB's balance sheet is at an all-time high.*
- *The interest rate is expected to remain unchanged in 2018, with gradual, moderate rate hikes likely to resume in 2019.*

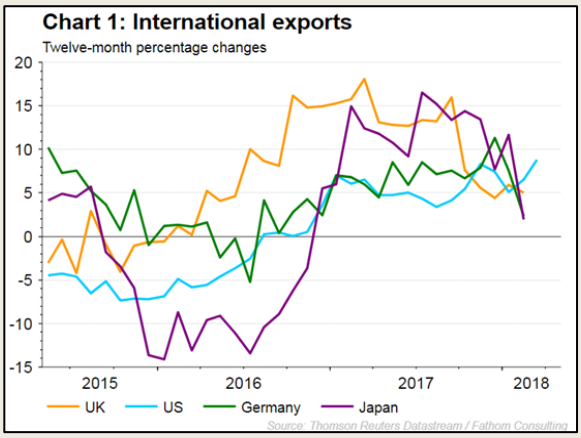
Leumi Global Economic Forecast, As of May 2018

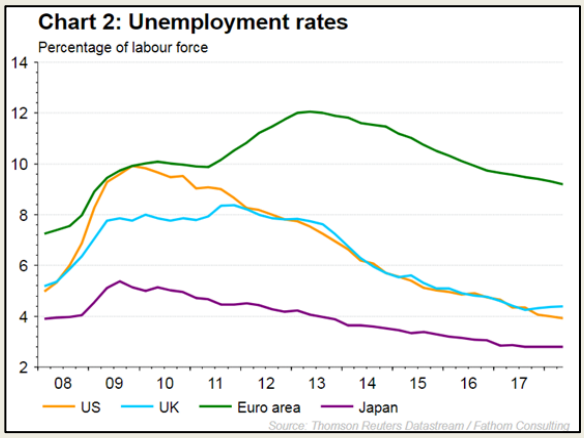
	2015	2016	2017E	2018F	2019F
GDP – Real Growth Rate					
World	*3.3%*	*3.2%*	*3.7%*	*3.8%*	*3.9%*
USA	*2.9%*	*1.6%*	*2.3%*	*2.6%*	*2.5%*
UK	*2.2%*	*1.8%*	*1.6%*	*1.5%*	*1.5%*
Japan	*1.4%*	*0.9%*	*1.7%*	*1.6%*	*1.7%*
Eurozone	*2.0%*	*1.7%*	*2.5%*	*2.2%*	*1.8%*
South East Asia (ex. Japan)	*4.5%*	*4.5%*	*5.2%*	*5.0%*	*4.9%*
China	*6.9%*	*6.7%*	*6.9%*	*6.4%*	*6.3%*
India	*7.9%*	*7.1%*	*6.7%*	*7.6%*	*7.9%*
Latin America	*0.1%*	*-0.7%*	*1.2%*	*2.0%*	*2.4%*
Israel	*2.5%*	*4.0%*	*3.3%*	*3.4%*	*3.5%*
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%*	*2.5%*
UK	*0.1%*	*0.7%*	*2.7%*	*2.6%*	*2.2%*
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%*	*0.7%*
Interest rates, Year End					
US Fed	*0.25-0.50%*	*0.50-0.75%*	*1.25-1.50%*	*2.00-2.25%*	*2.75-3.00%*
Bank of England	*0.50%*	*0.25%*	*0.50%*	*0.75%*	*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%*

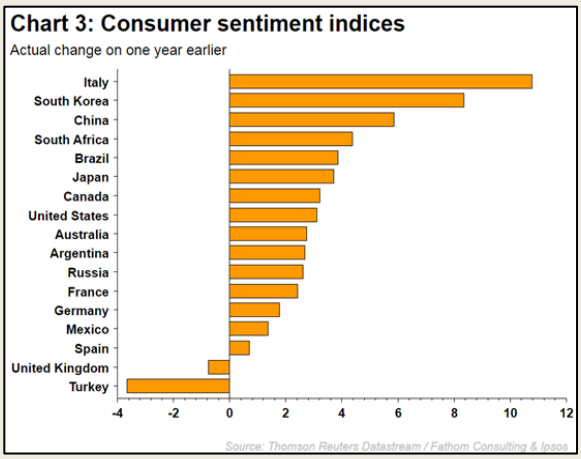
The Big Picture – The Global Economy

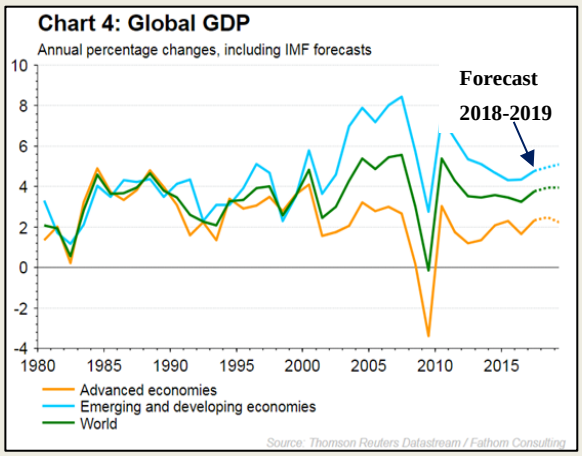
Global growth outlook: global growth is expected to accelerate, but risks are on the rise

- Economic growth moderated slightly in the first quarter of the year. Based on recently released data, economic slowdowns were registered in the US, EA, UK, Japan, and China. The slowdowns were expected, and occurred due to, among other things, base effects after solid growth at the end of 2017, and seasonal factors. In tandem, global trade growth also moderated recently (chart 1). Based on leading indicators, global growth is expected to somewhat accelerate in the coming quarters, driven by healthy improvement in the labor market (chart 2), positive business and consumer sentiments (chart 3), supportive credit conditions, and the stimulus fiscal policy in the US.
- Recently, we revised our global growth estimate further upward, expecting some acceleration in global growth in 2018, driven by the expected acceleration in the US, some EA economies, and commodity-exporting economies. Based on newly released IMF estimates, 2018 GDP growth is expected to slightly accelerate to 3.9% from 3.8% in 2017, driven by both advanced and emerging economies. The growth environment is expected to remain stable in 2019 (chart 4).
- Despite the expected improvement in growth, the IMF estimates that global risks are rising, with the main risks being a possible sharp tightening of financial conditions and a potential shift toward protectionist policies. Moreover, geopolitical strains remain also a major risk to macroeconomic estimates against the backdrop of the tension in the Middle East and uncertainty regarding the Iranian nuclear deal. In addition, despite the encouraging initial talks between the Korean leaders, it is still too early to draw conclusions regarding the risks in that region.



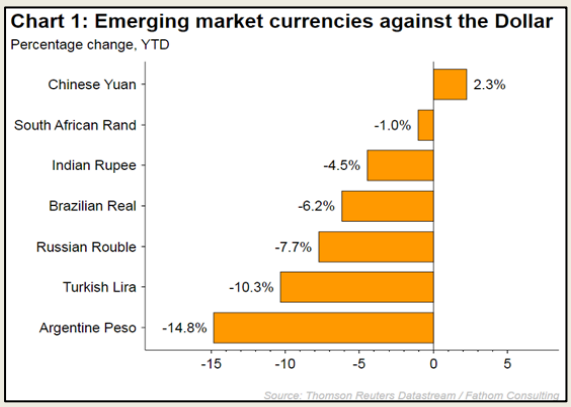


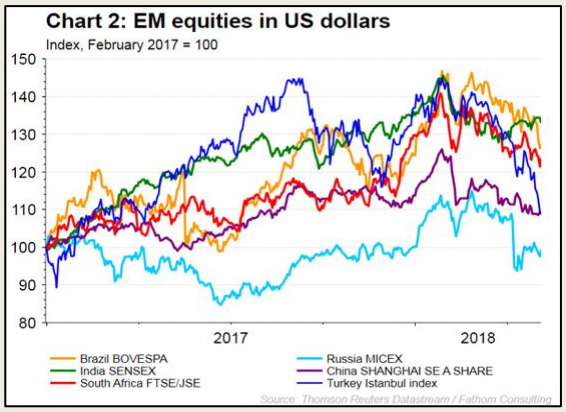


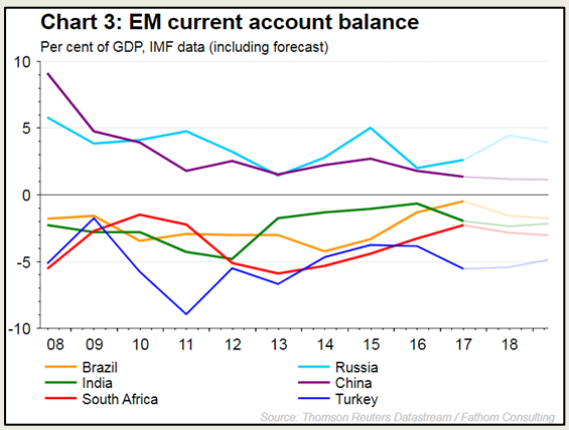


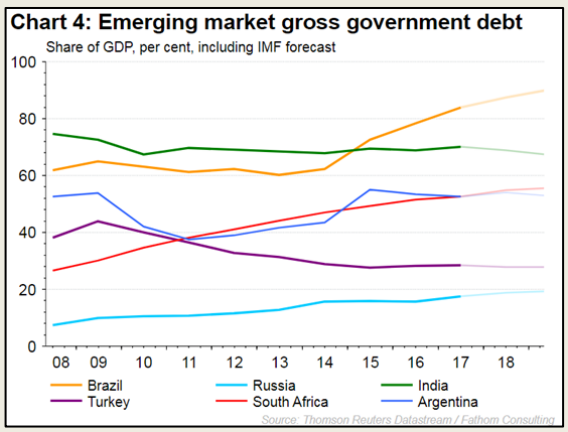
Expectations for a further increase in US rates may pose a risk to some emerging economies

- As interest rate expectations have increased in the US relative to other economies, the USD has appreciated against both advanced economies and emerging economies' currencies over the past month. Some of the EM economies were more vulnerable to the recent changes in rate-differentials expectations, and suffered significant depreciations, including Argentina and Turkey (chart 1). These countries are characterized by relatively weak economic fundamentals. Other economies that are facing relatively high political risks, such as Russia and Brazil, have also experienced a significant depreciation of their currency lately. As a result of the depreciations and capital flows, some EM equity markets dropped significantly in the past few months (chart 2) and inflation ticked upwards.
- The vulnerable economies are those that are characterized by fragile fundamentals, including relatively weak external accounts, particularly large current account (CA) deficits within their balance of payments (chart 3). Economies with large CA deficits include Turkey, South Africa and Argentina. Other parameters that may signal high levels of vulnerability include high government budget deficits and high government debt with a high external component (chart 4). Brazil, Argentina, South Africa, and India are characterized by weak fiscal profiles.
- Further currency weakness in the fundamentally weak EM economies may support further capital outflows, thereby weakening the financial position of these economies, increasing volatility in their financial markets, and decreasing economic sentiment, which may weigh on demand in the real economy. In addition, a depreciation coupled with an increase in commodity prices may support a further rise in inflation, which may lead central banks to tighten monetary policy. This process may weigh on the degree of recovery in some of the emerging markets.



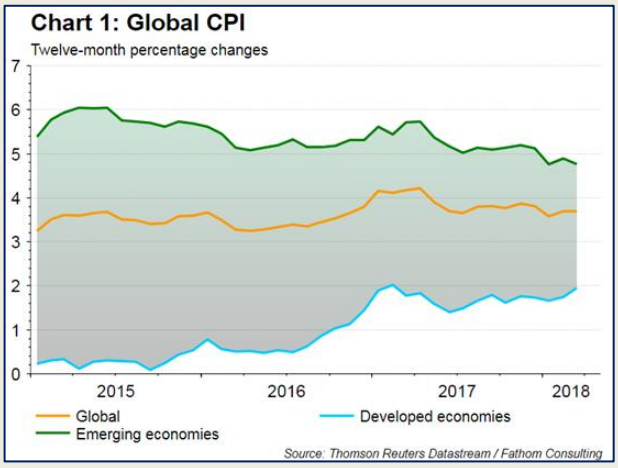


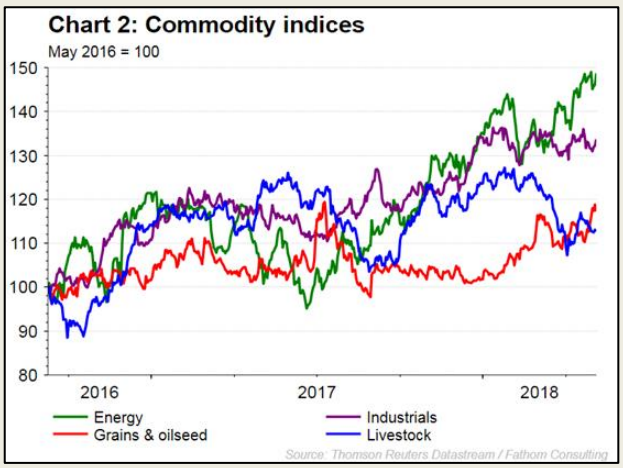


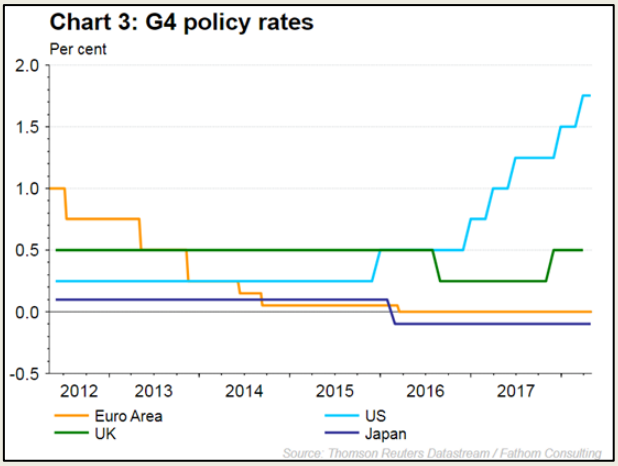


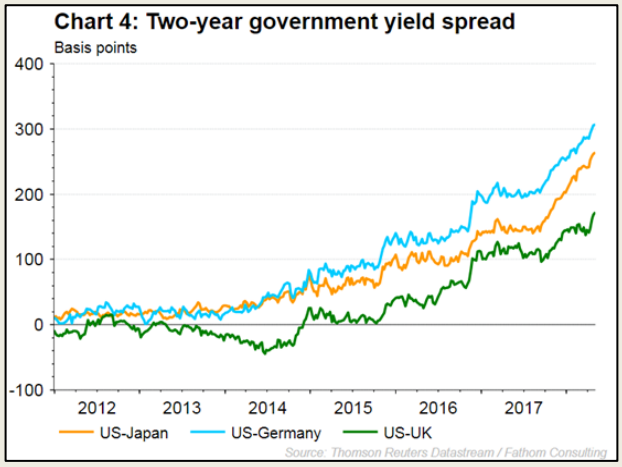
Global inflation and monetary policy: rate differentials are expected to widen

- Global inflation remained relatively stable over the past few months (chart 1), as the rise in advanced economies' headline inflation rates, supported by the US, was offset by easing inflationary pressures in some emerging economies, mainly in Latin America, Europe, and Africa.
- Global inflation is expected to slightly increase in the coming months, supported by the advanced economies and estimations that the moderation in the inflation environment in EM economies is expected to cease. This is due to several factors, including: base effects, mainly in the US, and to some extent in the EA; solid demand in tandem with further improvement in overall employment, which supports wage growth; and the rise in commodity prices (chart 2).
- Commodity prices rose over the past month, despite the appreciation in the US dollar. It appears rising tensions in the Middle East and US sanctions on Russia supported an increase in oil and aluminum prices, respectively, in April. In addition, easing concerns from a significant trade war probably also supported commodity prices recently.
- Due to the positive prospects regarding economic activity and a recovery in inflation, we expect further gradual monetary tightening in some of the advanced economies in the short-medium term. The interest rate in the US is expected to rise faster than in other major economies around the world (chart 3). This may support a further increase in short-term government bond yield spreads in the upcoming months (chart 4), unless interest rate expectations will change.





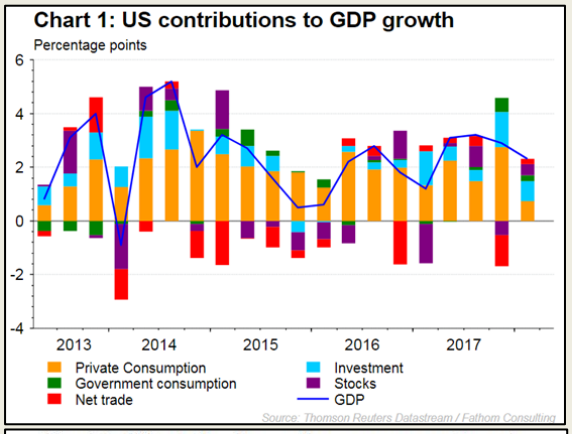


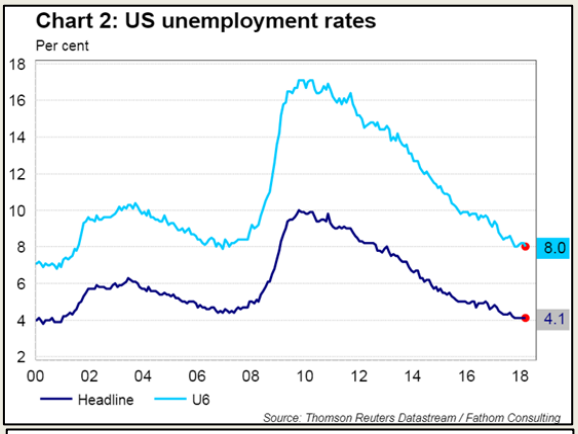


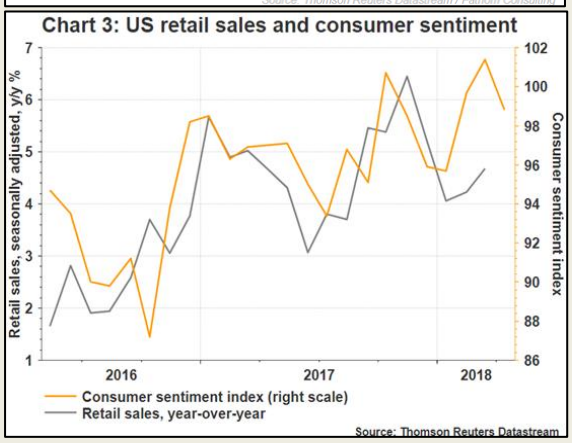
United States

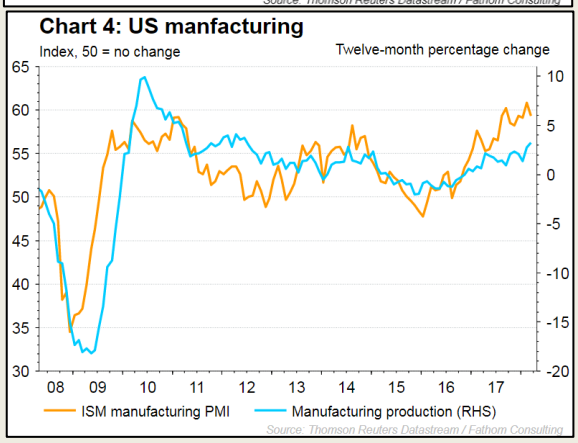
US growth outlook: temporary slowdown in the first quarter

- US GDP growth slowed in the first quarter of the year to 2.3% q/q (annualized) from 2.9% in the previous quarter (chart 1), but the results were better than previously forecast. On a y/y basis growth accelerated in the first quarter, for the seventh quarter in a row, from 2.6% to 2.9%, which is the highest figure since Q2-2015, reflecting the improvement in economic activity.
- The moderation compared to last quarter was due to a sharp slowdown in private consumption, caused by, among other things, a drop in spending on motor vehicles following the post-hurricane increase at the end of last year. We expect an improvement in consumer demand in upcoming quarters, supported by favorable conditions in the labor market (chart 2), an increase in disposable income as a result of the tax cuts, and improving consumer sentiment (chart 3).
- Gross private domestic investment accelerated, supported by a positive contribution from the volatile component of non-farm private inventories. Business investment growth slowed only slightly as acceleration in structures growth offset the fall in equipment growth. Residential investment was unchanged. Demand in the housing market, low inventory, and rising prices are expected to support positive growth in residential investment. We expect business investment activity to improve during the remainder of the year, supported by the tax reform and positive business sentiment (chart 4).
- The April PMI surveys registered the second strongest monthly expansion since last October, with manufacturing leading the expansion. After a relatively slow start to the year, growth is expected to accelerate, and we expect some expansion in the current year as a whole.



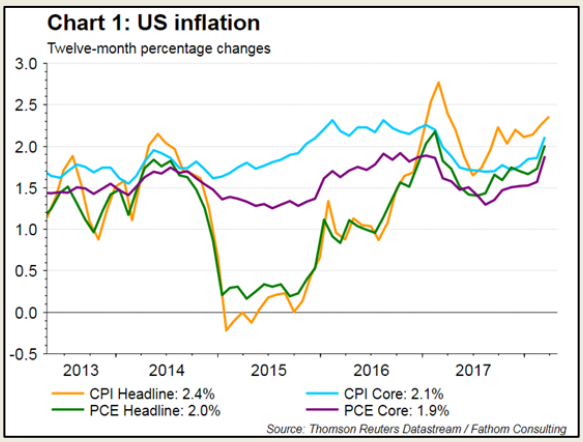


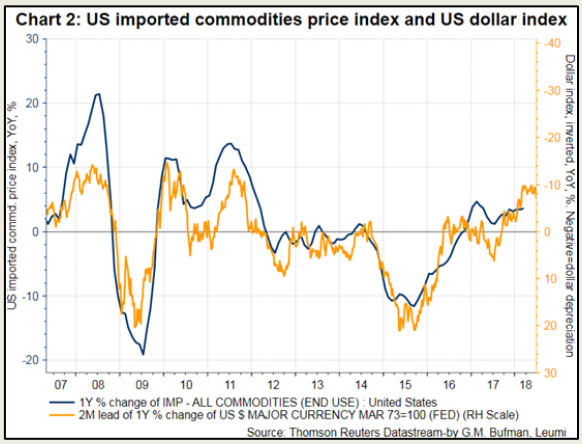


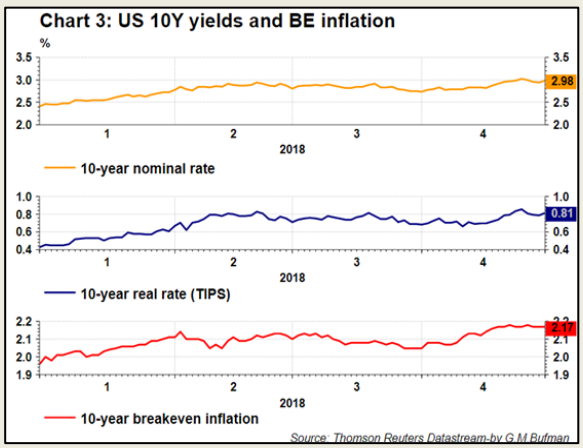


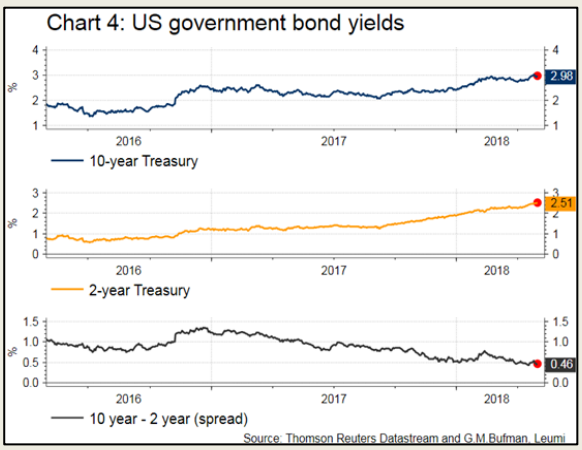
US inflation outlook and monetary policy: two or three additional hikes this year?

- Core PCE inflation rose to 1.9% y/y from 1.6% while the core CPI measures increased to 2.1% from 1.8% (chart 1). Part of the rise is attributed to the rise in services prices and base effects. Inflation is expected to rise further in the short-run, and peaking around mid-year. This will be supported by additional upward base effects, rising commodity prices, solid domestic demand, and the lagging effect of the depreciation in the effective exchange rate of the USD, which is feeding through to import prices (chart 2). On average, we expect CPI inflation to be around 2.4% in the current year, compared to 2.1% in 2017.
- On May 2nd, the FOMC kept its monetary policy unchanged as expected, and the accompanying statement suggests the Fed's outlook has not changed since the March meeting. We expect two additional hikes this year, similar to market-derived expectations: one in June, and the next in September or December. We do not rule out an additional third hike if growth data and the inflation environment will surprise to the upside in the short-run. Recent Fed communications supported a further rise in government bond yields. In the minutes from the March meeting it was noted that it would be appropriate at some point to set the federal funds rate "above its longer-run normal value for a time".
- The ongoing increase in the 10-year YTM reflects an increase in real interest rates (r*), and to a smaller degree, the recent rise of breakeven expected inflation (chart 3). Based on our models, we expect the 10-year YTM to average 2.9%-3.3% in Q4-2018, while we expect the 2-year YTM to rise to 2.6%-2.8%. This may lead to a further, albeit modest, additional flattening of the 2-10 year yield curve (chart 4).





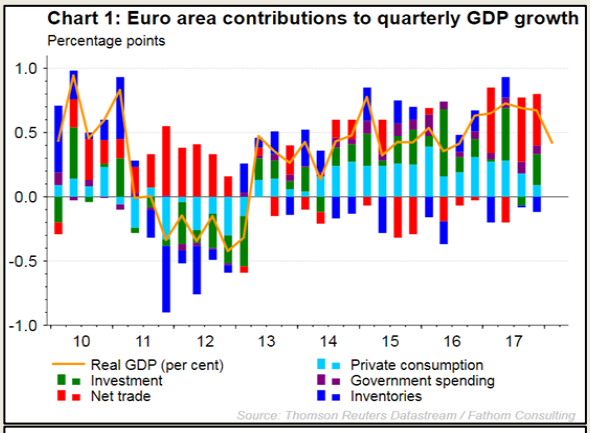


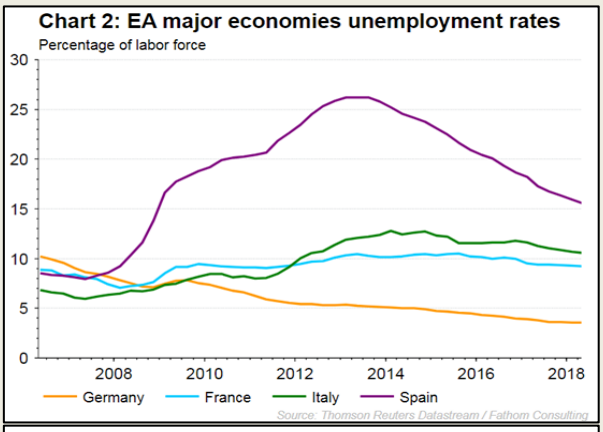


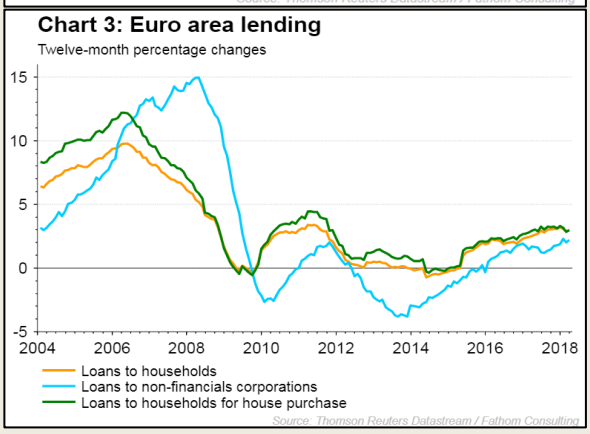
Euro Area

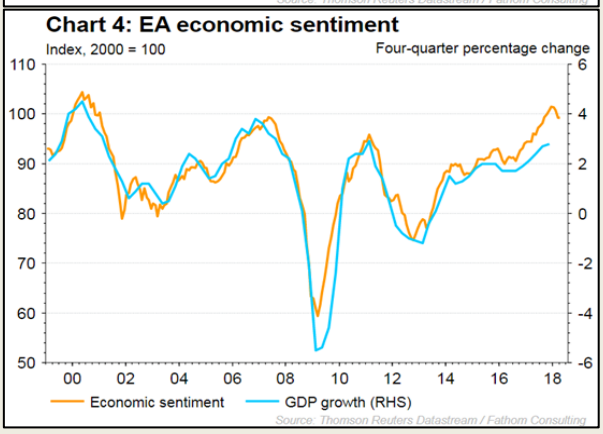
EA growth outlook: weakness in the beginning of the year after strong year-end activity

- Based on the initial estimate, EA Q1 GDP growth moderated to 0.4% q/q from 0.7% in Q4 (chart 1), as expected. Eurostat has not yet released the expenditure breakdown, but based on national data that have already been published, including GDP data of some of the major economies, such as France and Spain, we can infer that both domestic demand and net trade were weaker in the first quarter compared to the previous figure. On a year-over-year basis, growth moderated to a solid 2.5% from 2.8%. Moreover, recently released monthly official data, including retail sales and industrial production, were relatively soft and pointed to a slow start in the beginning of the year. Still, our outlook for private spending remains positive as the unemployment rate remained unchanged at 8.5% in April - the lowest since January 2009 (chart 2). In addition, credit flow to the private sector continues to improve gradually, mainly to non-financial corporations (chart 3). This is consistent with the view that investment activity is expected to remain solid in the short-run.
- Based on the PMI and the European Commission's sentiment surveys, eurozone economic growth remained unchanged in April, after growth moderated since the peak at the end of last year. Despite the moderation, eurozone business activity continued to increase at a solid pace in April (chart 4). It should be noted that the moderation in the beginning of the year is probably partly due to weaker demand growth, caused by temporary factors such as adverse weather and the timing of the Easter holiday, and due to supply constraints such as labor and equipment shortages. Although we expect some moderation in 2018 to 2.2% from 2.5% in the previous year, the growth outlook is expected to remain relatively solid, driven by healthy domestic demand, with some positive contribution from net-trade.



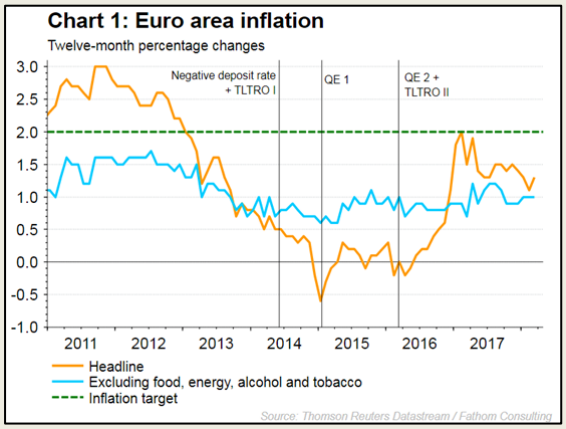


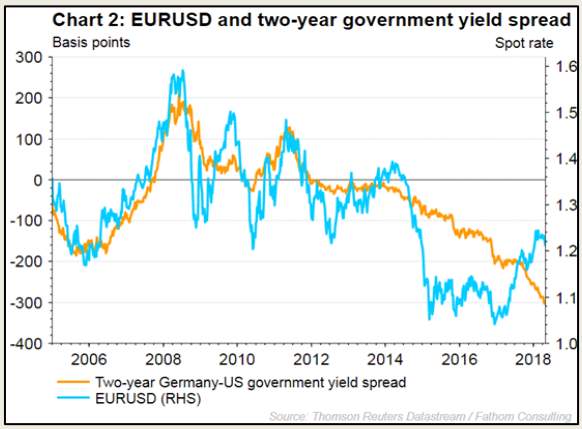


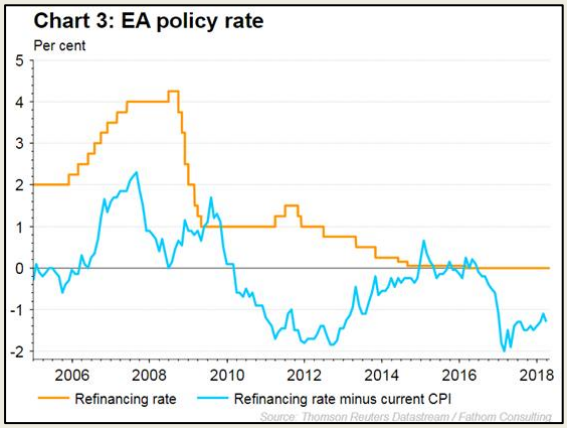


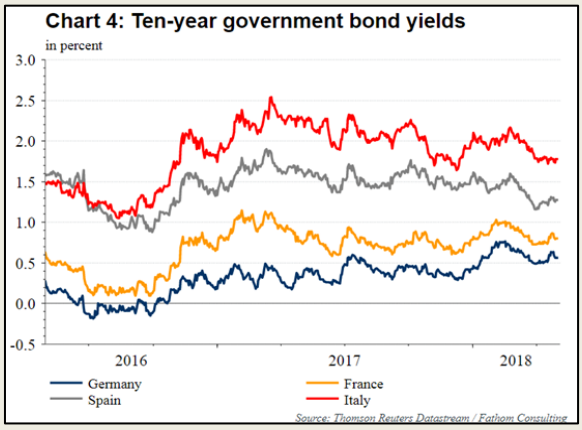
EA inflation outlook and monetary policy: a continuing low inflation environment may add to the ECB's cautiousness toward policy normalization

- The harmonized indices of consumer prices (HICP) measure moderated in April to 1.2% from 1.3%, and core inflation dropped strongly to 0.7% from 1.0%, reflecting soft services inflation (chart 1). The fall in inflation reflects partly Easter timing effects, and may prove to be temporary. Inflation may be slightly higher this year compared to 2017, supported by solid domestic demand, moderate wage growth, and the rise in commodity prices. The appreciation in the exchange rate of the euro since 2016 may limit the rise in inflation. That said, it should be noted that a further increase in US-EA government bond spreads may halt the appreciation in the exchange rate of the euro (chart 2). Market-derived inflation expectations rose recently due to the recent increase in commodity prices.
- At its recent monetary meeting on April 26th, the ECB left its monetary policy unchanged, as expected, leaving the real rate in negative territory (chart 3). Based on the meeting statement and press conference, it appears the ECB considered the latest soft economic data, stating "the underlying strength of the euro area economy continues to support our confidence that inflation will converge toward the inflation aim…"
- Looking forward, we expect some changes in the ECB's forward guidance in upcoming meetings, with some further tapering steps in 2018. A complete discontinuation of QE purchases will probably occur by the end of the year, which may support a further moderate recovery in government bond yields (chart 4). That said, interest rates are expected to remain unchanged in 2018, with gradual, moderate rate hikes likely to resume in 2019. Based on market expectations, the deposit rate is expected to start rising modestly in 2019, sometime after the end of the assets purchases process.









Disclaimer Notice

- Any statements, data, and information in the Economic Outlook which appears to be factual in nature are based on sources, including published sources, which Bank Leumi UK believes to be reliable but has not independently verified. Bank Leumi (UK) plc does not make any guarantee, representation, or warranty as to the accuracy or completeness of such statements. This material is based on public information as of the specified date, and may be stale thereafter. We have no obligation to tell you when information herein may change. Consequently, Bank Leumi (UK) plc is not responsible for its contents nor any losses, expenditure or damages which may be incurred as a result of relying on such contents. We reiterate that no representation, warranty or undertaking, express or implied is given to the accuracy or completeness of the information contained in this presentation, and Bank Leumi (UK) plc does not accept any liability for losses which might arise from an attendee making use of the information.
- **Bank Leumi (UK) plc is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.**

BANK LEUMI LE-ISRAEL, THE FINANCE 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/