Global Macroeconomic Monthly Review

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Key Issues

Global Economic Forecast Table (p. 3)

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

- *Financial conditions have tightened since the beginning of October, although they receded a bit in the past two weeks. Further heightened volatility in the financial markets may hurt economic sentiment and weigh on global demand in the short-run.*
- *Trade talks between the US and China continue. It is in the best interest of both sides – probably the US more than China – to reach an agreement. That said, until the parties reach an agreement, uncertainty will continue to weigh on business confidence and trade growth.*
- *Economic growth moderated in the fourth quarter last year, after slowing in the preceding quarter.*
- *Economic growth is expected to moderate gradually further in 2019.*
- *Risks to our 2019 growth outlook are tilted to the downside.*
- *Base effects and the recent decline in oil and other commodity prices may weigh on headline inflation in the short-run. Further tightening in the global labor market and wage growth may limit downward pressures on core inflation.*
- *Due to an increase in the risk environment and economic uncertainty, the extent of monetary policy normalization may be more limited, and some major central banks may even pause their normalization processes.*
- *The recent decrease in US interest rate expectations may limit the widening trend in yield differentials between the US and other advanced economies in the short-run, before they start narrowing probably sometime in 2019-2020.*

United States (p. 7)

- *So far, the growth environment looks healthy, but various headwinds are expected to begin taking a toll in the short-run.*
- *Risks to our growth estimate are tilted to the downside.*
- *Headline inflation is expected to fall further in the short-run.*
- *Continuing tightening financial conditions may support a more dovish tone by the Fed down the road.*

Euro Area (p. 11)

- *Economic activity remains soft, and leading indicators point to further moderation in annual growth.*
- *We revised downward our 2018-2019 growth estimates.*
- *Headline inflation is expected to moderate in the coming months.*
- *The ECB may wait longer before tightening its policy if the current growth and inflation trends will continue.*

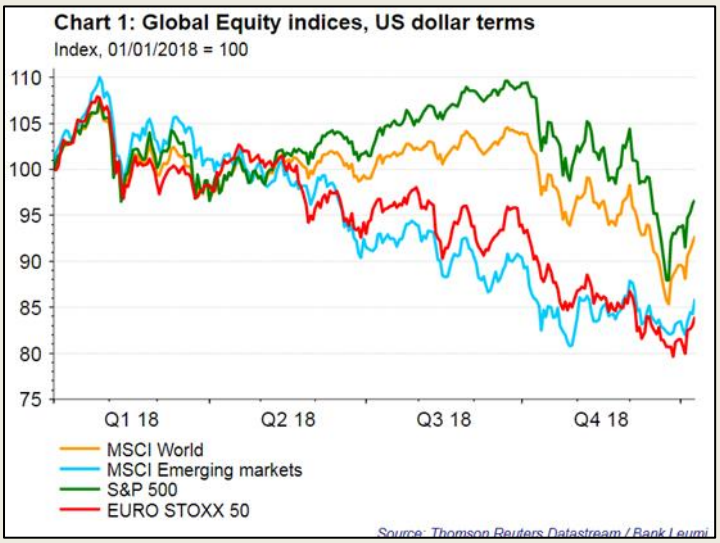
Leumi Global Economic Forecast, As of January 2019

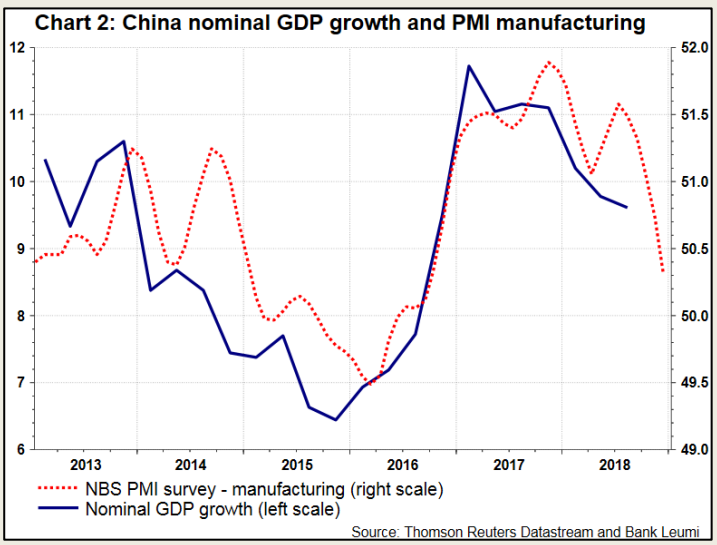
	2016	2017	2018F	2019F	2020F
GDP – Real Growth Rate					
World	*3.2%*	*3.7%*	*3.6%*	*3.5%*	*3.4%*
USA	*1.6%*	*2.3%*	*2.9%*	*2.3%*	*1.3%*
UK	*1.8%*	*1.6%*	*1.3%*	*1.5%*	*1.5%*
Japan	*0.9%*	*1.7%*	*1.1%*	*1.4%*	*0.5%*
Eurozone	*1.7%*	*2.5%*	*1.9%*	*1.7%*	*1.6%*
South East Asia (ex. Japan)	*4.5%*	*5.2%*	*5.0%*	*4.7%*	*4.4%*
China	*6.7%*	*6.9%*	*6.6%*	*6.3%*	*6.1%*
India	*7.1%*	*6.7%*	*7.6%*	*7.7%*	*7.5%*
Latin America	*-0.7%*	*1.2%*	*1.1%*	*2.0%*	*2.2%*
Israel	*4.0%*	*3.5%*	*3.2%*	*3.2%*	*3.8%*
Trade Volume, Growth (%)					
Global	*2.3%*	*5.3%*	*4.0%*	*3.3%*	*2.7%*
CPI, Annual Average (%)					
USA	*1.3%*	*2.1%*	*2.6%*	*2.4%*	*1.6%*
UK	*0.7%*	*2.7%*	*2.5%*	*2.1%*	*2.1%*
Japan	*1.0%*	*0.5%*	*1.1%*	*1.9%*	*2.3%*
Eurozone	*-0.1%*	*1.5%*	*1.8%*	*1.9%*	*1.7%*
Israel	*-0.5%*	*0.4%*	*0.9%*	*0.9%*	*0.5%*
Interest rates, Year End					
US Fed	*0.50-0.75%*	*1.25-1.50%*	*2.25-2.50%*	*2.50-3.00%*	*2.00-2.75%*
Bank of England	*0.25%*	*0.50%*	*0.75%*	*1.00-1.25%*	*1.25-1.75%*
Bank of Japan-Policy Rate	*-0.10%*	*-0.10%*	*0.00%*	*-0.10%*	*0.00%*
ECB-Main Refi	*0.00%*	*0.00%*	*0.00%*	*0.10-0.30%*	*0.20-0.50%*
Israel	*0.10%*	*0.10%*	*0.25%*	*0.25-0.75%*	*0.50-1.50%*

The Big Picture – The Global Economy

Global outlook – economic activity (1/2): further heightened volatility in the financial markets may hurt economic sentiment and weigh on global demand. Economic growth is expected to moderate in 2019. Risks to our growth outlook are tilted to the downside.

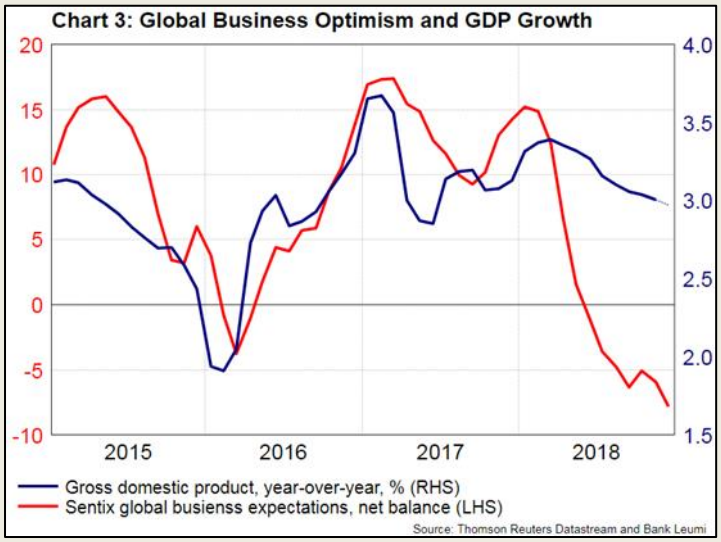
- Volatility in the equity markets has remained high since the publication of our previous monthly report. The S&P 500 and Dow Jones indices recorded their worst December performance since 1931. The negative sentiment in the equity markets was globally broad-based (chart 1). US government bond yields fell significantly, and credit spreads have widened. Since December 24th, volatility in the financial markets has somewhat receded from its periodical high levels, and the equity markets have recovered. However, further stress in the financial markets may weigh on business sentiment and consumer confidence, and hence, it may weigh on domestic demand and ease the pace of monetary normalization processes around the globe.
- Based on recent monthly economic data, global GDP growth slowed, albeit slightly, in the fourth quarter, in tandem with the trend since the beginning of last year. On the national level, the US is expected to register an economic slowdown in the fourth quarter compared to the preceding quarter mainly due to base effects. In addition, it should be noted that manufacturing output moderated during the last quarter, probably on the back of the stronger dollar and a softer global economy. The recent decrease in oil and other commodity prices may weigh as well on manufacturing activity in the short-run at least.
- Economic activity in China also moderated in the fourth quarter as credit growth continues to moderate. Business surveys, which are good leading indicators for future output, suggest that China's economic activity may moderate further downward in the short-run at least (chart 2). We estimate an economic slowdown in 2019, which poses some risk to the growth outlook for China's largest exporting partners. One of the major risks to our global growth outlook remains the uncertainty regarding the changes in US trade policies with its trading partners, and mainly the prospects of the trade war with China. During January 7-9 delegations of both countries met and discussed their future business relationships. Officials said that details will be released soon. It seems the countries are progressing toward an agreement, but the uncertainty may continue to weigh on market and business sentiment in the short-run at least.

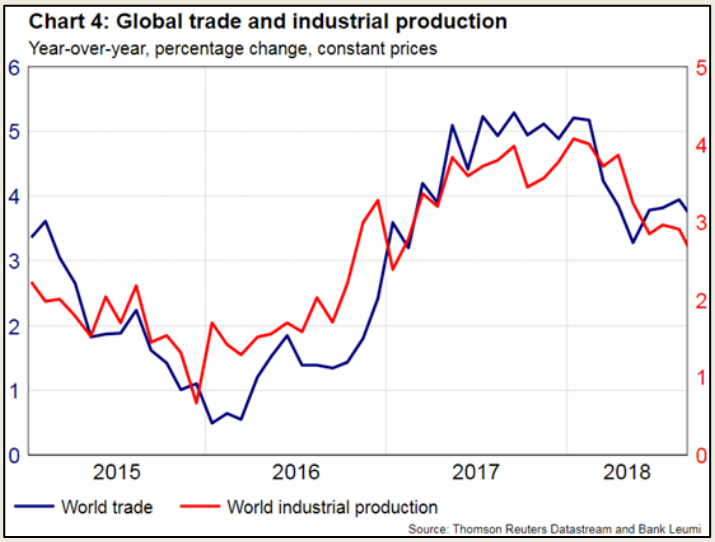




Global outlook – economic activity (2/2) - continued.

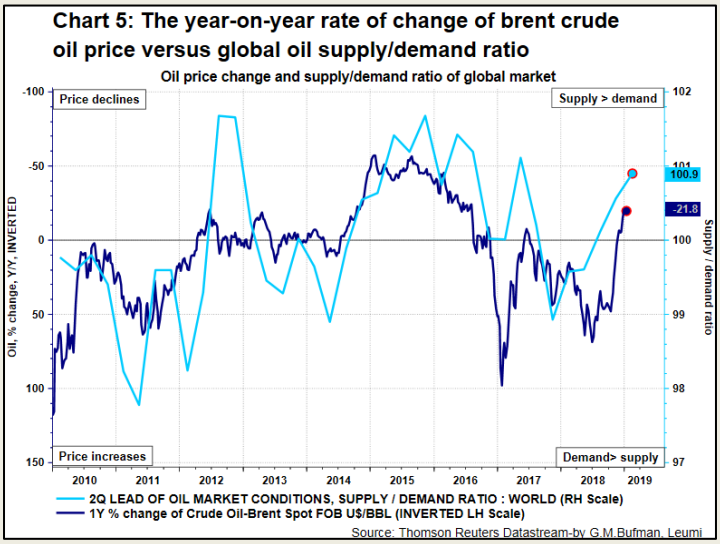
- Euro area GDP economic growth likely remained soft also in the fourth quarter on the back of the protests in France, weakening confidence in Italy's business sector due to economic uncertainty, continuing moderation in external demand, and disruptions in automobile production, which took a toll mainly in Germany (read more in the euro area section). In contrast, GDP growth in Japan apparently accelerated in the last quarter after contracting sharply in the preceding quarter on the back of different natural disasters during the third quarter.
- Based on recent business surveys, economic activity moderated further in December. According to PMI data, the rate of output expansion slowed to a 27-month low. This mainly reflected the ongoing weakness in new export orders and backlogs. The future output component has remained positive, but to a lesser extent. The Sentix global business expectations index dropped further downward. The weakness in the leading indicators may point to a further slowdown in global economic activity in the short-run (chart 3).
- Based on the latest data published by the CPB Netherlands Bureau, global trade rose in October supported by the advanced economies. It seems that annual growth in global trade has stabilized recently (based on 3-month average annual growth) at a pace of slightly less than four percent (chart 4). Still, business surveys continue to point to further moderation in global trade. Industrial production growth continues to moderate, but to a lesser extent compared to the first half of 2018.
- We expect the global economy to slow gradually and moderately in the medium-term, mainly due to an expected slowdown in the US in 2019-2020, and also due to a continuing slowdown in the EU economy and in China. Growth in emerging economies, excluding China, is expected to remain stable, and even improve in some of the major economies, including India, Brazil, and Russia. Overall, we expect global growth to ease slightly, from 3.6% in 2018 to 3.5% in 2019 and 3.4% in 2020, with some increasing divergence in the medium-term between the advanced and emerging economies, as growth in the advanced economies is expected to moderate while growth in EM economies is expected to remain constant, or to even somewhat accelerate. Risks to our outlook are still tilted to the downside (trade war, China, monetary and financial conditions tightening, etc.), and hence we do not rule out downward revisions to our growth outlook.

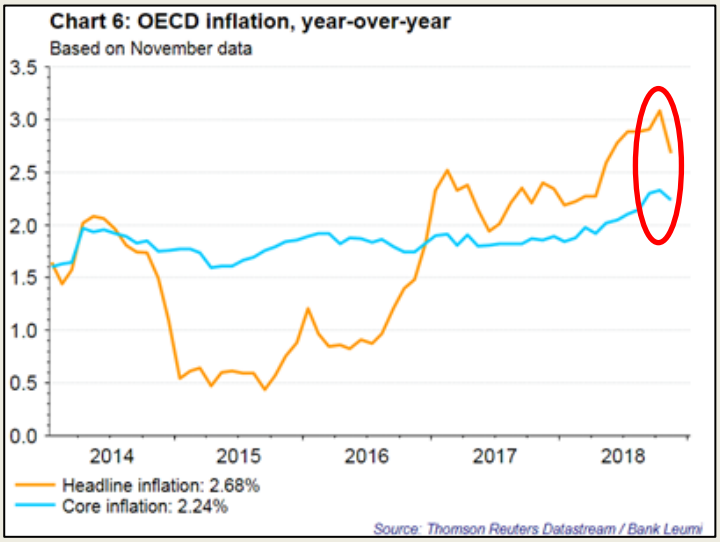




Global inflation and monetary policy outlook: the decline in oil and other commodity prices supports further moderation in headline inflation. Central banks may delay or halt their normalization processes.

- The average annual headline inflation rate in OECD economies moderated in November (2.7%) after it reached more than a seven-year high in October (3.1%). The decrease in November inflation was mainly due to the decline in energy prices since the beginning of October. In fact, it should be noted that oil prices rose slightly in the past few days after reaching an 18-month low on December 25th. The recent fall in oil prices was supported mainly by supply factors as global supply growth outpaced demand for oil recently. The global excess-supply was driven mainly by oil production expansion in some major producers including the US and other non-OPEC economies, including Russia (chart 5). Looking forward, we expect headline inflation to moderate in the short-run in some OECD economies, mainly due to base effects and the recent significant decline in oil and other commodity prices.
- The OECD average core inflation rate also moderated, albeit slightly, by 0.1 percentage point to 2.2% in November compared to 2.3% in the previous month (chart 6). Looking forward, core inflation may also moderate, but to a lesser extent, compared to the headline measure, as unemployment rates continue to fall and wage growth has been accelerating in some major economies, including the US, UK, EA, and more.
- In our opinion, the continuing slowdown in economic activity, the expected drop in inflation in the coming months, and the heightened risk environment, will continue to support a more dovish stance among central bankers as we have seen recently, mainly by the Federal Reserve and ECB officials. Recent communication from the Fed's chairman, Jerome Powell, which was interpreted by the financial markets as dovish, may limit the potential of a significant further widening of the rate differentials between the US and other major economies in the coming months. The recent changes in expectations may also limit the differentials in government bond yields between US Treasuries and other government bonds.

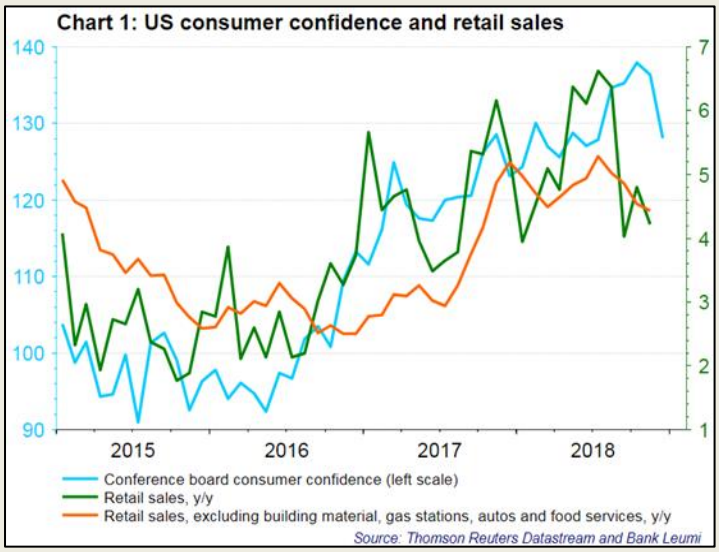


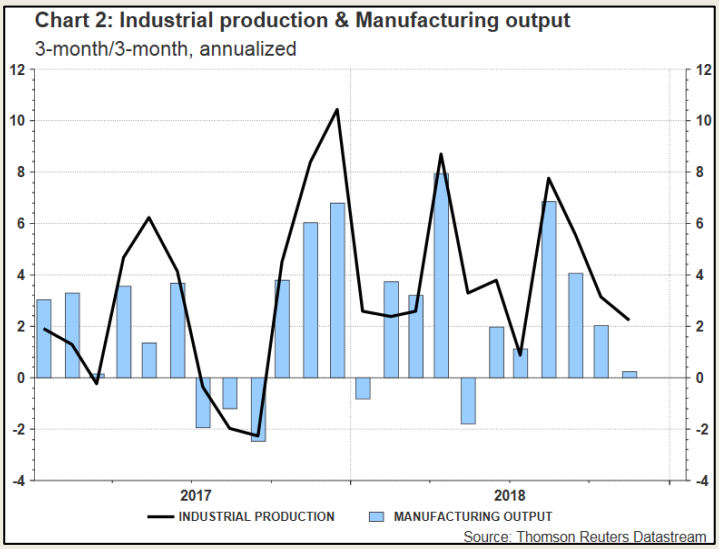


United States

US growth outlook (1/2): so far the growth environment looks healthy, but various headwinds are expected to begin taking a toll in the short-run. Risks to our growth estimate are tilted to the downside.

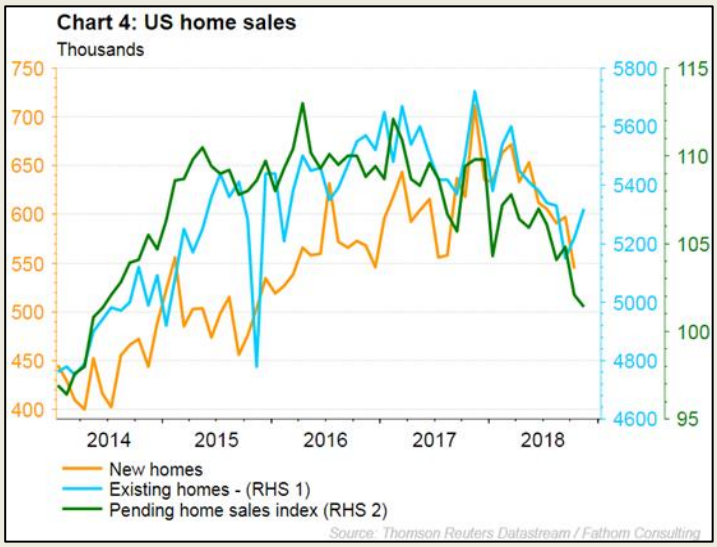
- Based on the latest data, economic activity continues to grow solidly. Retail sales (chart 1) increased as expected at the headline level in November, and were better than expected for core sales (the strongest monthly rise in the past 12 months). With significant upward revisions to October data, retail sales data point to healthy growth in US consumer spending. We expect private consumption growth to remain healthy in the short-run supported by solid employment, relatively high consumer confidence, and low gasoline prices. However, household demand growth is expected to slow this year as the positive impact of tax cuts fades. Also, rising household borrowing costs may weigh on spending on items that are sensitive to interest rates, mainly durable goods, led by vehicles and housing. It should be noted that if the recent volatility in the financial markets will continue, then it may hurt consumer confidence, and thus private spending as well.
- Industrial production rose in November supported by a surge in mining and utilities output. On a year-over-year basis, industrial production growth has somewhat accelerated, continuing to grow at a healthy pace. However, manufacturing output moderated, after contracting in October. Also, the 3-month over 3-month data add to other signs that may point to softness ahead. (chart 2). Risks to growth in industrial production stem from, among other things: the strength in the US dollar and weaker external demand, which may weigh on exports; higher interest rates; and the recent fall in oil prices, which may weigh on drilling activity.
- In addition, durable goods new orders growth slowed further in November (chart 3 – see next page), which may attest to further moderation in equipment investment growth. Recent surveys were positive regarding new orders, but the rise in borrowing costs in tandem with the increase in uncertainty may weigh further on equipment investment in the short-run at least.





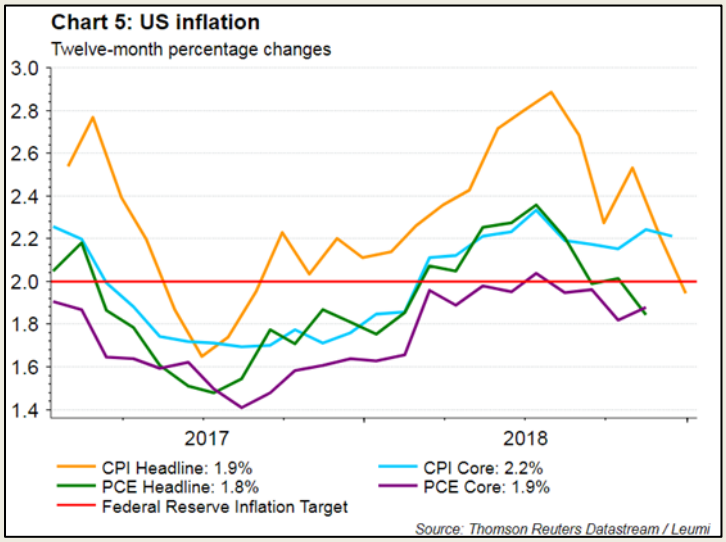
US growth outlook (2/2) – continued.

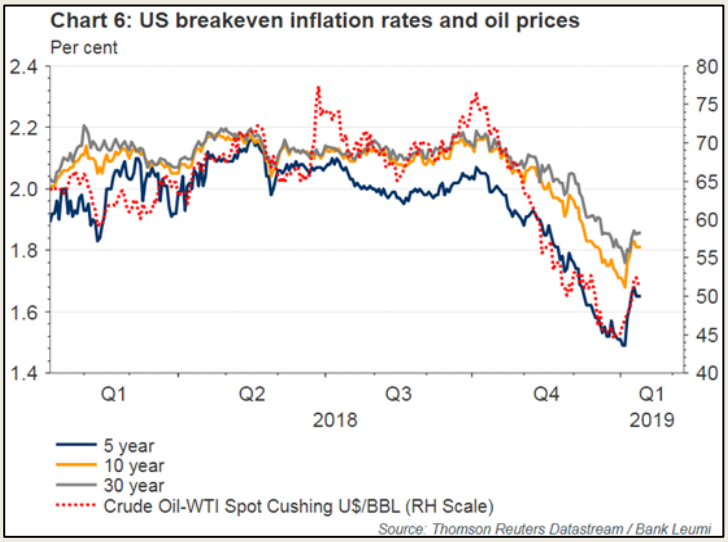
- The PMI indices, which serve as leading indicators, continue to point to some moderation in the short-run. The composite Markit PMI has continued its downward trend recently, while the December ISM indices, both manufacturing and non-manufacturing, dropped significantly on the back of the increase in economic uncertainty, which will have some toll on domestic demand.
- All in all, economic data continue to point to further solid growth in the current period. However, there are some headwinds and warning signs that point to a possible moderation in economic growth in the short-run, including: the recent heightened volatility in the financial markets, which may weigh on business and consumer confidence in short-run at least; the fading effects of fiscal stimulus; higher borrowing costs; USD strength; weak external demand; a slowdown in housing (see chart 4); and a moderation in drilling activity, as oil prices decline.
- Our GDP forecasts have not changed significantly since our December report. GDP growth likely accelerated in 2018 to 2.9%, from 2.3% in 2017, and is expected to moderate to 2.3% in the current year. On the back of the recently released economic leading indicators data, and the other risks mentioned above, risks to our 2019 growth outlook are currently tilted to the downside. We expect further moderation in 2020, as growth may dip below 2%.



US inflation and monetary policy outlook (1/2): headline inflation is expected to fall further in the short-run. Continuing tightening financial conditions may support a more dovish tone by the Fed down the road.

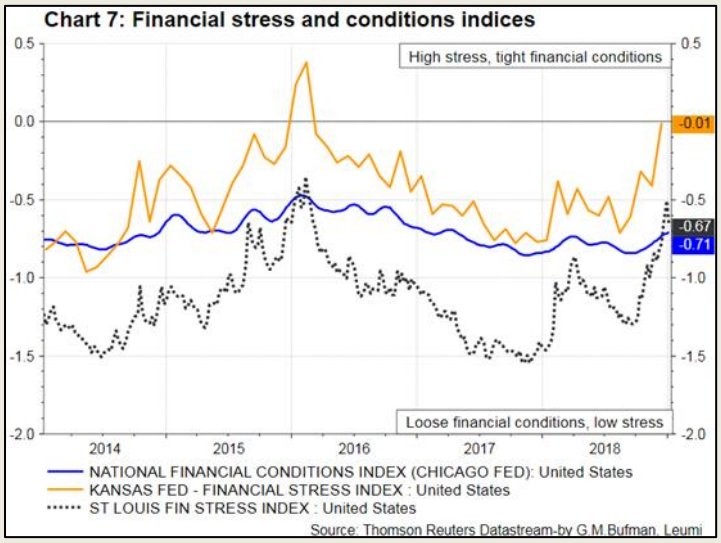
- The CPI headline inflation measure decreased further in December to 1.9% from 2.2% in the preceding month, due to the decrease in the energy component. The core CPI inflation figure remained firmer, above the Fed's target, at 2.2% (chart 5).
- The recent fall in oil prices, the US dollar appreciation, and base effects are expected to push inflation downward in the short-run. Inflation is expected to fall to around 1.5%, and perhaps even lower, in the first half of 2019 and remain low for most of the year, before recovering in the fourth quarter of the year.
- Core inflation is expected to moderate as well in the coming months, but to a lesser extent compared to the headline measure, as underlying fundamentals (labor market, wage growth, and domestic demand) are expected to remain solid, keeping the core rate close to the Fed's projected target.
- As a result of the fall in oil and other commodity prices, inflation expectations have fallen strongly since the beginning of October (chart 6). Recently, oil prices have recovered from their 18-month low. A further rise in oil prices may support a further recovery in inflation expectations as well.
- As a result of the tightening conditions in the financial markets, the recent dovish comments made by Fed officials, and changing expectations toward growth and inflation, interest rate expectations fell strongly recently. Currently, market based interest rate expectations are not pricing in any rate hikes in 2019, and there is an increasing probability for a rate cut by the end of the year or the beginning of next year.

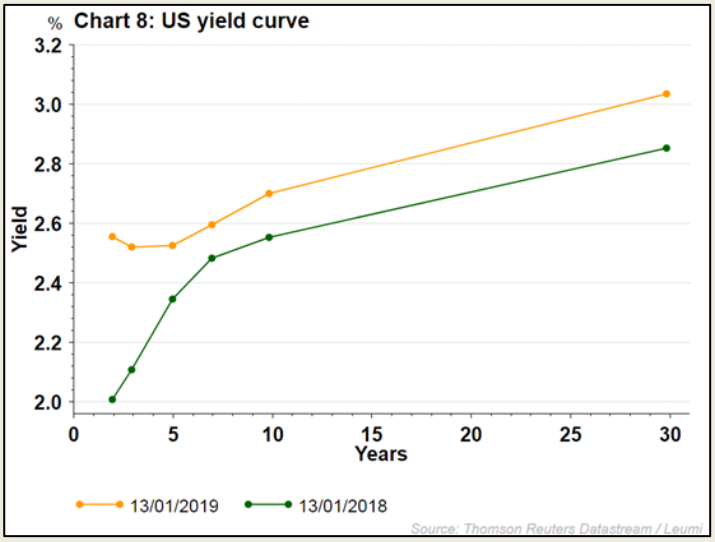




US inflation and monetary policy outlook (2/2) – continued.

- At its meeting on December 18-19 the Fed hiked the interest rate to between 2.25%-2.50% while the IOER was raised by 20bp to 2.40%, as expected. In tandem, the Fed revised downward its median interest rate projections for 2019 and for the longer-run by 20bp, and currently it projects the median rate rising to 2.9% by the end of the year and rising further to 3.1% in 2020, suggesting wide gaps between market expectations and the Fed's projections.
- In addition, it should be noted that recent communications made by Federal Reserve's officials (including by the Fed's Chairman Powell and the Vice Chairman Clarida), and the latest monetary meeting minutes emphasized that the FOMC will be patient before further tightening its policy stance. This mainly due to the tightening in financial conditions as implied in the financial stress indices (chart 7).
- The recent tightening in financial conditions has led us to revise downward our rates forecasts in the short-run to a single hike this year. The recent tightening is similar to the trend in 2015-2016, when the Fed was forced to halt the rate hike cycle, which had started in December 2015, for approximately a year. A further increase of financial stress could lead to a cancellation of the single rate hike. On the other hand, a significant loosening in the financial conditions may cause us to revise upwards our interest rates estimate.
- As a result of the changes in interest rate expectations and perceptions toward the future trend of growth, in tandem with the heightened risk environment, government bond yields continued to fall in December, at both ends of the curve. The yield curve remained relatively flat, mainly between the short end of the curve up until the medium-term bonds (chart 8).
- Our 2019 yield curve forecast (annual averages) was revised slightly downward at both ends of the curve, but mainly at the short-end, due to our downward rates revision. Based on our models, we expect the yield-to-maturity on 10-year bonds to average 3.1% in 2019 versus 3.2% in our previous 2019 estimate. We expect the yield-to-maturity on 2-year Treasuries to rise to an average of 2.7% in 2019 versus 3.1% in our previous estimate.

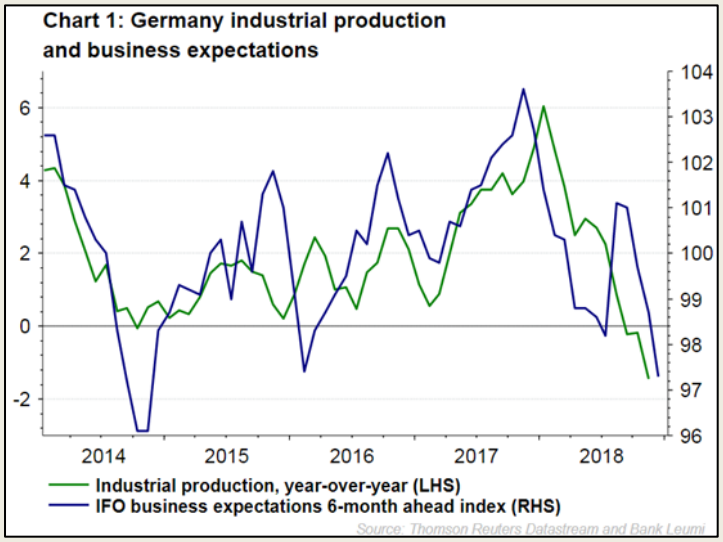


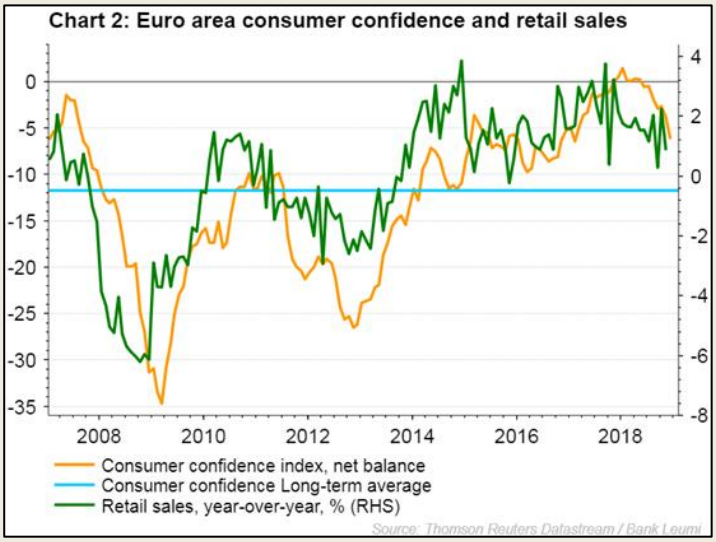


Euro Area

EA growth outlook (1/2): economic activity remained soft, and leading indicators point to further moderation in annual growth. We revised downward our growth estimates.

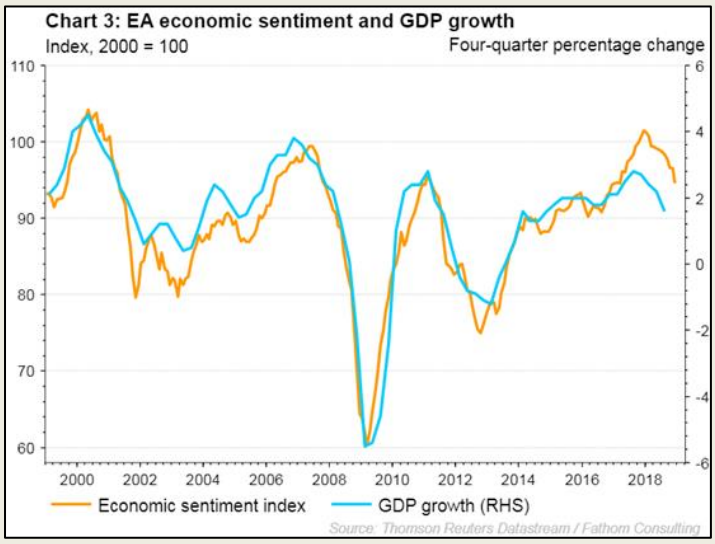
- The latest released data suggest that economic activity in the euro area (EA) continued to grow softly at the end of the fourth quarter after the slowdown in the third quarter. November industrial production fell in Germany for the third consecutive month (chart 1), and it was weak in both France (attributed mainly to the "yellow vests" protests) and Italy, which suffers from low confidence in the business sector due to heightened political risks.
- It should be noted that political risk in Italy faded somewhat recently after the government approved the 2019 budget with a lower deficit target. That said, Italy's macroeconomic environment is expected to remain very challenging in the short-run at least, as: economic growth may be weaker than currently expected; concerns may arise due to the challenging funding outlook on the back of the expected increase in the budget deficit; and possible snap elections may be called.
- EA retail sales look somewhat better than industrial production (chart 2), but household demand has continued to moderate recently. Based on consumer confidence data, we expect to see a moderation in private spending in the short-run at least. That said, the potential for a further significant deterioration in the growth rate is limited, as unemployment continues to fall, wages continue to grow, interest rates remain low, and oil prices decline. All these support higher purchasing power.

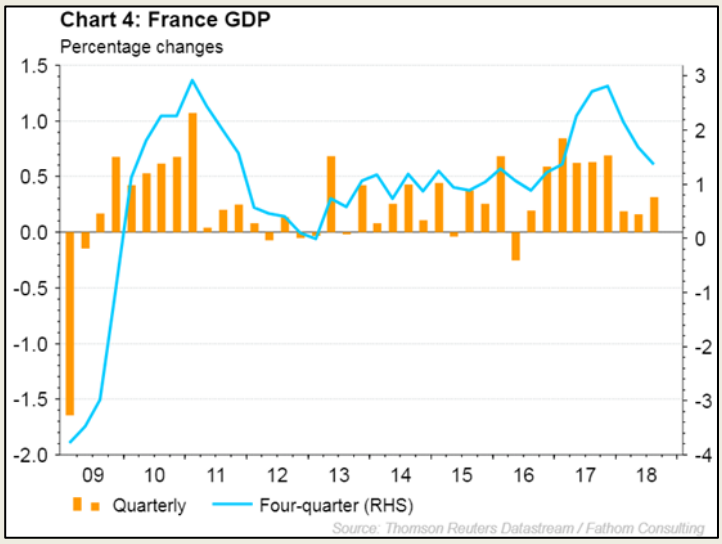




EA growth outlook (2/2) – continued.

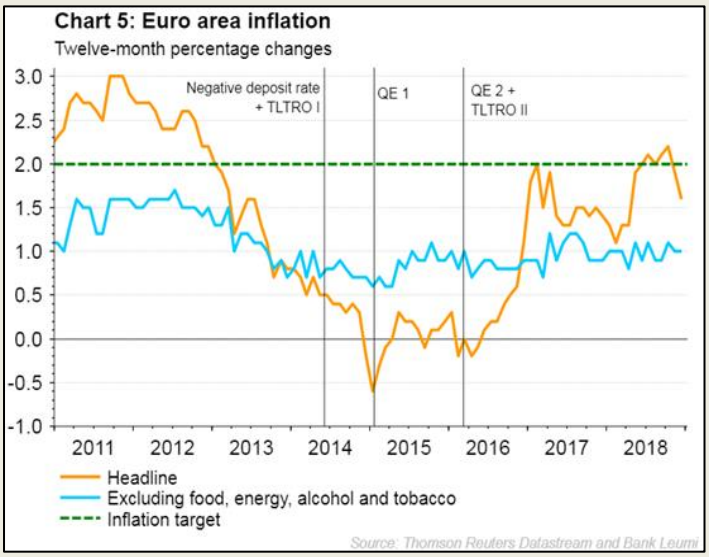
- Business surveys, such as the Markit PMI and European Commission's ESI, attest to further weakness in December (chart 3), while leading indicators point to a soft growth environment in the beginning of the year. The composite PMI fell in December to its lowest level in over four years. The ESI results were consistent with the message that came from the Composite PMI, as the indicator fell to its two-year low.
- The slowdown in growth in part reflected lower activity in France on the back of the protests that led to the first fall in economic output in 2.5 years. We expect further slowdown in economic activity in France in the short-run at least (chart 4). That said, growth also weakened elsewhere, led by Germany and Italy. Importantly, expectations pertaining to output fell to the lowest level in over four years, suggesting that companies are not anticipating any revival in demand in the short-run. The softening in business sentiment may weigh on GDP growth, which continues to trend downward.
- Based on leading indicators, we do not rule out an additional low quarterly growth rate figure in the fourth quarter, with further moderation in growth (on a y/y basis) in the short-run, slowing toward the potential growth rate. On the back of the recent activity data, we revised downward our 2018 outlook estimate to 1.9% from 2.1%. In addition, due to the recently released leading indicators and the risks to our outlook, we also revised slightly downward our 2019 growth estimate to 1.7% from 1.8% in the previous estimate. In our opinion, risks are currently tilted to the downside. The main risks to the short-medium term growth outlook include concerns regarding changes in US-EU trade policy, uncertainty regarding Brexit, the continuing slowdown in China, and other political and fiscal risks in Europe.

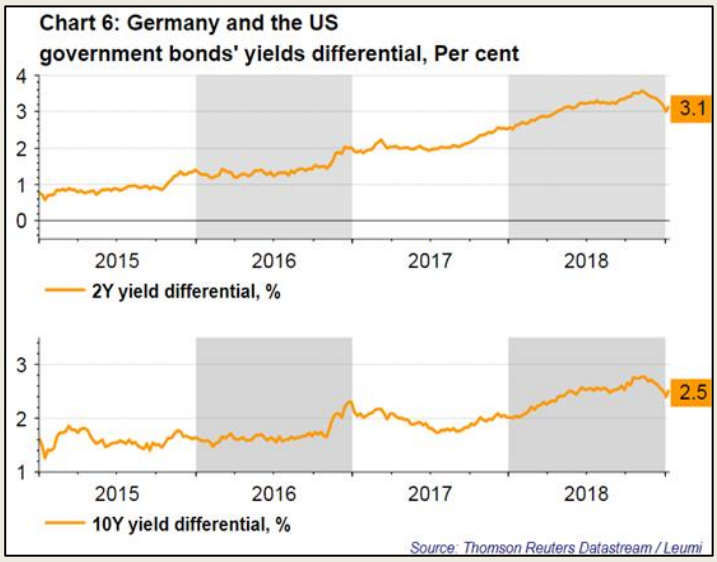




EA inflation and monetary outlook: headline inflation is expected to moderate in the coming months. The ECB may wait longer before tightening its policy if the current growth and inflation trends will continue.

- Headline inflation fell to 1.6% in December from 1.9% in November, driven by a significant drop in energy inflation (chart 5). The headline measure is expected to moderate further during 2019, reaching a trough in the second or third quarter (below 1.5%). On the other hand, core inflation is expected to show more durability to the easing in oil and other input prices, and be supported by services inflation during 2019.
- Overall, the latest economic data paint a picture of weaker growth and falling inflation. We still do not entirely rule out a rate hike next September in line with the ECB current forward guidance, but if the recent softness in economic activity and inflation data will continue, then the ECB may revise its forward guidance to a more dovish stance and wait longer before tightening its policy. We also do not rule out that the ECB will announce another TLTRO program in 2019.
- Changing expectations toward the US Fed funds rate may limit the potential for a further widening in government bond yield spreads (chart 6), and limit the downward pressure on the euro exchange rate. We expect heightened volatility in the financial markets down the road due to the existing risks, including trade protectionism, further possible downward changes to the EA growth outlook, and political risks in the bloc. Based on the current macro environment, we do not rule out some steepening of the EA yield curve in the short-medium term.





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