Global Macroeconomic Monthly Review

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Key Issues

Global Economic Forecast Table (p. 3)

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

- *Growth in economic activity was soft in the fourth quarter, after slowing in the previous quarter.*
- *There has been some positive progress in the relations between the US and China after the governments' recent agreement to a "ceasefire" for 90 days in their trade war while the parties negotiate trade and other economic issues. It is a positive development, but uncertainty will continue to weigh on business confidence and trade growth.*
- *Political risks in Europe, including the Brexit negotiations and Italy's fiscal issues, will continue to weigh on domestic demand on the continent, with effects to be felt mainly by the UK and its major trading partners.*
- *Economic uncertainty may support further heightened volatility in the financial markets and may weigh on confidence and growth in the short-run. We expect further moderation in economic growth rates over the short-medium term.*
- *Base effects and the recent decline in oil prices may weigh, at least temporarily, on headline and break-even 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 normalizations 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.*

United States (p. 8)

- *Economic growth is expected to moderate in 2019-2020 as the effects of fiscal stimulus subside over time, and as financial conditions tighten and the US dollar appreciates.*
- *Headline inflation is expected to moderate in the upcoming months due to base effects, the decline in oil prices, and the relatively strong US dollar.*
- *The Fed's communication has changed significantly over the last few weeks toward a more dovish stance, pushing down interest rate expectations and government bond yields.*

Euro Area (p. 12)

- *A low growth environment may persist at least in the short-run, as political uncertainty is expected to weigh on domestic demand.*
- *The ECB revised downward its growth and inflation outlook and took a more dovish stance regarding its forward guidance.*

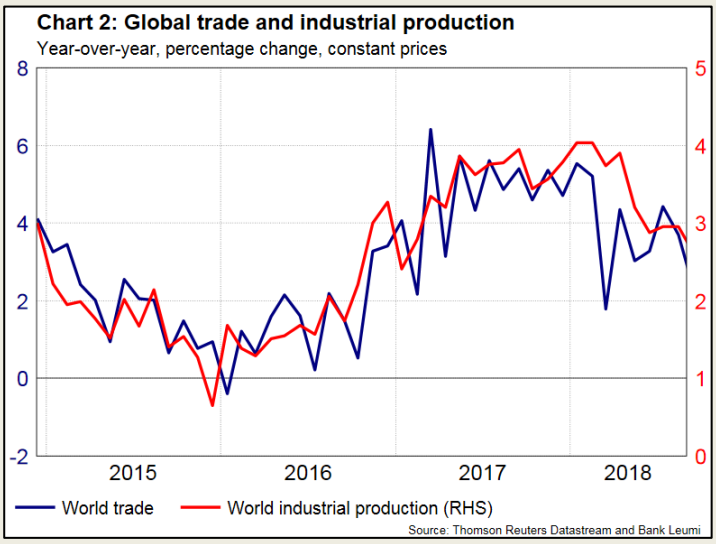
Leumi Global Economic Forecast, As of December 2018

	2015	2016	2017	2018F	2019F
GDP – Real Growth Rate					
World	*3.3%*	*3.2%*	*3.7%*	*3.6%*	*3.5%*
USA	*2.9%*	*1.6%*	*2.3%*	*2.9%*	*2.3%*
UK	*2.2%*	*1.8%*	*1.6%*	*1.3%*	*1.5%*
Japan	*1.4%*	*0.9%*	*1.7%*	*1.1%*	*1.4%*
Eurozone	*2.0%*	*1.7%*	*2.5%*	*1.9%*	*1.7%*
South East Asia (ex. Japan)	*4.5%*	*4.5%*	*5.2%*	*5.0%*	*4.7%*
China	*6.9%*	*6.7%*	*6.9%*	*6.6%*	*6.3%*
India	*7.9%*	*7.1%*	*6.7%*	*7.6%*	*7.7%*
Latin America	*0.1%*	*-0.7%*	*1.2%*	*1.1%*	*2.0%*
Israel	*2.5%*	*4.0%*	*3.5%*	*3.2%*	*3.3%*
Trade Volume, Growth (%)					
Global	*2.5%*	*2.3%*	*5.3%*	*4.0%*	*3.3%*
CPI, Annual Average (%)					
USA	*0.1%*	*1.3%*	*2.1%*	*2.6%*	*2.4%*
UK	*0.1%*	*0.7%*	*2.7%*	*2.5%*	*2.1%*
Japan	*0.5%*	*1.0%*	*0.5%*	*1.1%*	*1.9%*
Eurozone	*0.8%*	*-0.1%*	*1.5%*	*1.8%*	*1.9%*
Israel	*-0.6%*	*-0.5%*	*0.4%*	*1.0%*	*0.8%*
Interest rates, Year End					
US Fed	*0.25-0.50%*	*0.50-0.75%*	*1.25-1.50%*	*2.00-2.50%*	*2.50-3.00%*
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%*	*0.25%*	*0.50-0.75%*

The Big Picture – The Global Economy

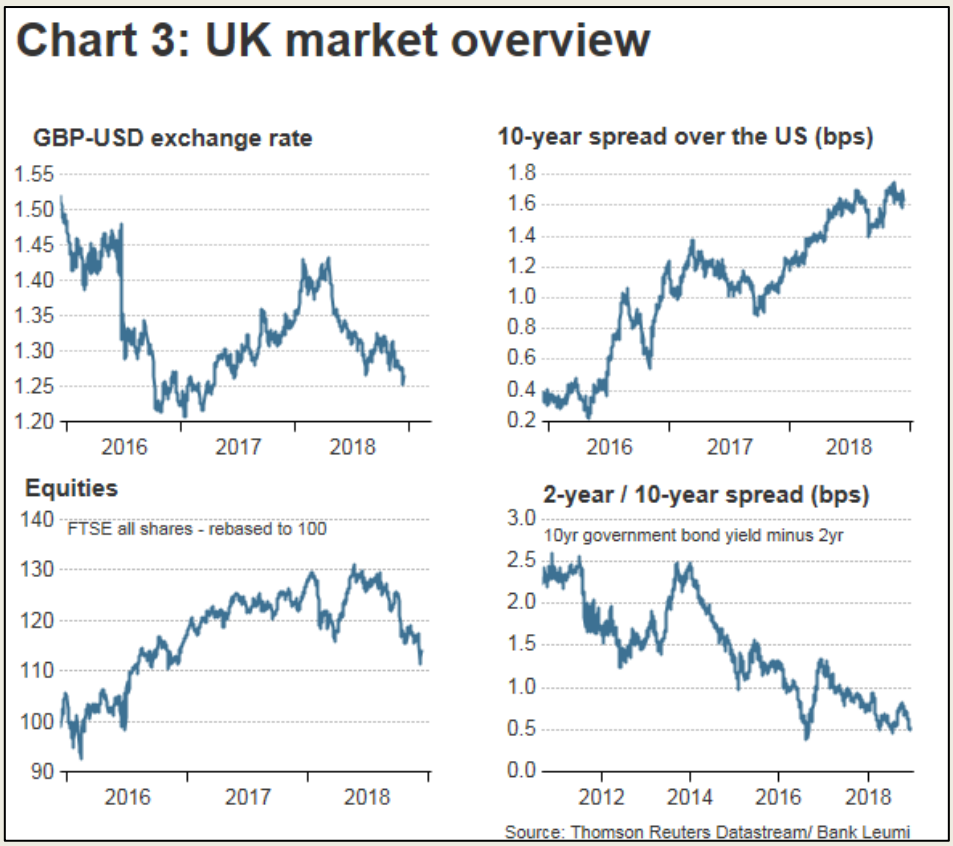
Global outlook – economic activity (1/3): global economic activity continues to grow but at a slower pace, led by lackluster growth in some of the developed economies. The recent heightened volatility in the financial markets, due to changing expectations regarding growth and the risk environment, may weigh on business and consumer confidence.

- Based on recently released monthly economic data, global economic activity has continued to grow in the fourth quarter, but at a slower rate (chart 1), after GDP growth slowed in the third quarter (see the November issue). This comes in continuation of the trend since the beginning of the year, which is also reflected in trade and industrial production growth (chart 2). The recent moderation in economic activity reflects the current heightened risk environment, which weighs on business and consumer sentiment in the major economies.
- One of the major risks over the recent period has been the uncertainty regarding the changes in US trade policies with its trading partners, and mainly the prospects of the trade war with China. Recently, there has been some progress on this front, as the US and China agreed to a "ceasefire" in their trade war at the recent G-20 summit. Based on the White House statement, both parties agreed they will attempt to reach an agreement over trade and other economic issues (intellectual property rights, forced technology transfers, cyber theft, etc.) within the next 90 days (approximately by the end of February 2019). If at the end of this period the parties are unable to reach an agreement, the 10% tariffs currently levied on US$200 billion worth of Chinese imports will be raised to 25%.
- We see the current development in US-China relations in a positive light. The progress achieved may decrease some of the stress experienced in the financial markets recently, and suggests that both countries are seeking to reach a deal by making concessions to each other. The future rhetoric, the official and unofficial communications, and changing expectations may weigh on market and business sentiment in the beginning of 2019, this until the economies will reach a trade agreement. In general, trade policy issues (mainly with China and the euro area) will continue to pose a risk to global growth and financial markets.



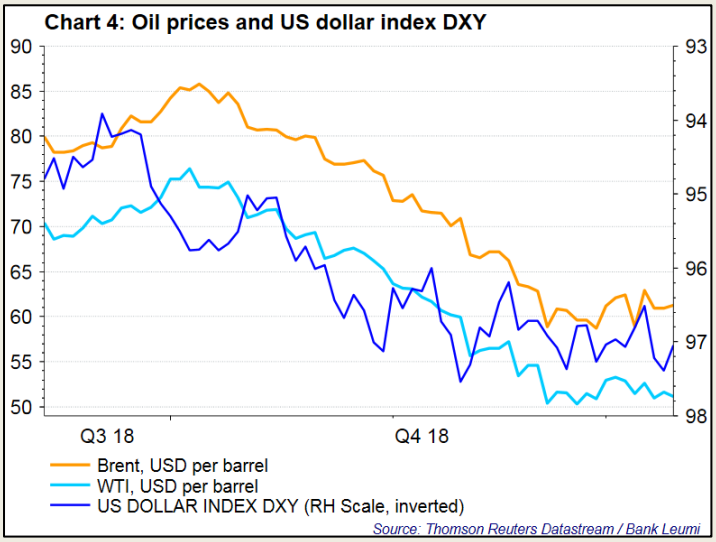
Global outlook – economic activity (2/3).

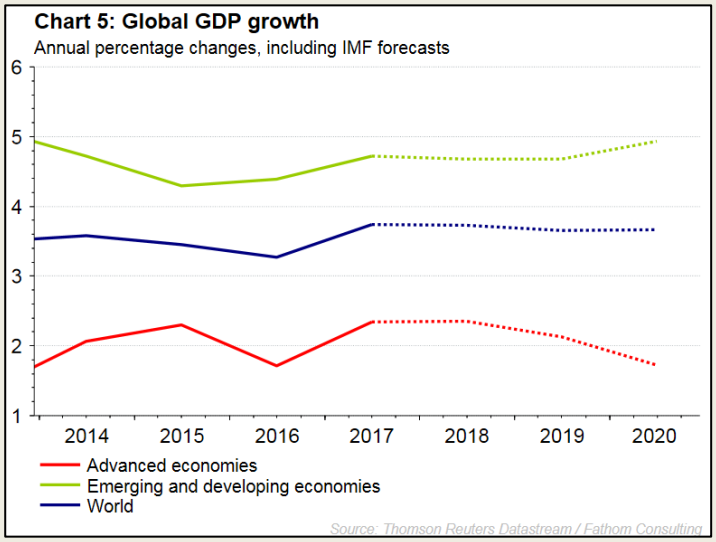
- Another major political risk that may have consequences on international trade policy and growth is Brexit. On December 10, the prime minister of the UK, Theresa May, decided to postpone the Brexit vote due to the low chance of actually passing the Withdrawal Agreement (WA) in Parliament. As a result, volatility in the financial markets increased and the GBP depreciated substantially (see chart 3). In the short-run, the prime minister is expected to renegotiate controversial issues within the WA with the EU leaders, mainly the Irish border backstop consequences, the trade agreement, and other issues concerning the future economic and governance relationship and more. Currently, heightened uncertainty clouds the economy as all options are on the table, including: Brexit with a deal; Brexit without a deal; and a no-Brexit scenario. The probabilities of Brexit without a deal or a cancellation of Brexit have increased recently. Most likely, in a scenario involving no deal, the UK economy may suffer more compared to the other scenarios, and might even enter a temporary recession. The effect of a no-deal scenario on the EU is expected to be relatively small, while only some economies may be somewhat worse off due to substantial trade relations with the UK, including Ireland, the Netherlands, and Belgium.
- Additional risks to the global economy include: the consequences of faster than expected monetary tightening in the US on the financial markets and the real economy; currency and financial stability risks in emerging markets that are characterized by weak fundamentals; and the debt problem in China. Furthermore, there are additional political and geo-political risks that may weigh on financial market sentiment and business confidence in the short-run, including Italy's economic policy against the backdrop of its weak fiscal profile, the Russia-Ukraine conflict, Middle East conflicts, etc.



Global outlook – economic activity (3/3).

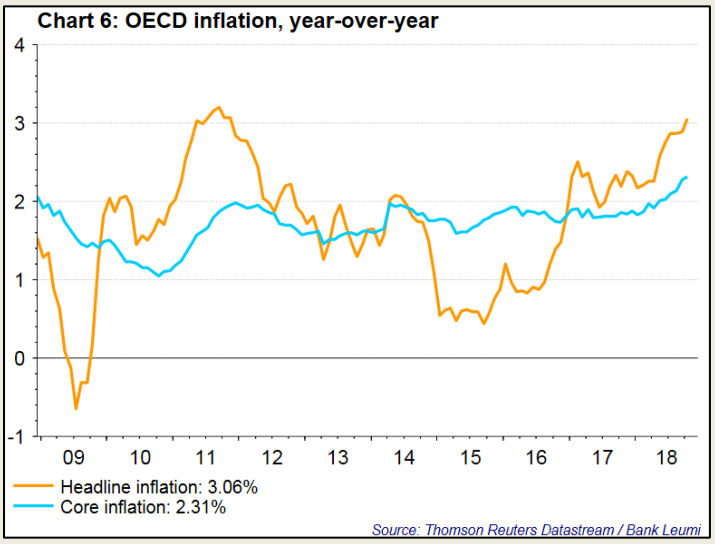
- Recently released business surveys suggest that global economic activity grew slightly faster in October and November after reaching a two-year low in September. Forward indicators continue to raise some potential headwinds as business expectations and new exports orders have remained weak.
- Oil prices declined substantially recently as crude oil prices fell approximately 30% from their four-year high in the beginning of October (chart 4). The decrease in oil prices may weigh in the short-run on oil-producing economies. On the other hand, the current low prices may support private spending, at least temporarily, and have a net positive impact (all other factors remain constant) on global growth.
- Looking forward, 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 (unless the decline in oil price will persist and affect significantly output).
- Overall, we expect global growth to ease slightly, from 3.6% this year 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. Our estimates are slightly lower relative to the IMF's latest estimates (chart 5). In our opinion, due to the heightened risk environment, we do not rule out downward revisions to our growth outlook.

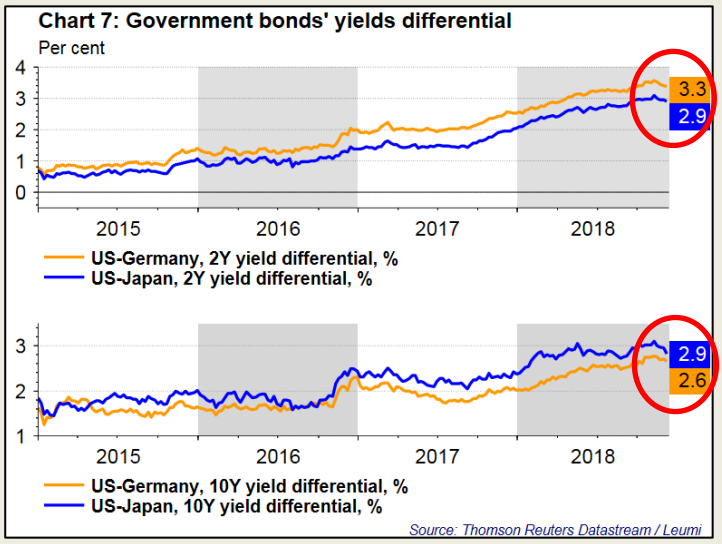




Global inflation and monetary policy outlook: headline inflation is expected to decrease in the major developed economies, driven by base effects and oil prices. Monetary policy normalization is expected to continue, but likely to a lesser extent relative to previous estimates.

- The average headline annual inflation rate in OECD economies rose further in October to 3.1% from 2.9% y/y in September, in continuation of the upward trend since the beginning of the year (chart 6). Looking forward, we expect headline inflation to somewhat moderate in the short-run in some of the OECD economies, including the US, EA, and Japan, mainly due to base effects and the recent significant decline in oil prices.
- The OECD average core inflation rate remained unchanged at its 10-year high (2.3% y/y) in October. Core inflation may also moderate, but to a lesser extent, compared to the headline measure, as unemployment rates continue to fall, and rising labor costs might be rolled over to consumer prices in the short-medium term.
- In our opinion, the continuing slowdown in economic activity, the expected drop in inflation in the upcoming months, and the heightened risk environment, will support a less hawkish stance among central bankers. In addition, we expect further widening of the rate differentials between the US and other major economies in the upcoming months, but the potential of the extent of widening may be smaller than previously estimated by the financial institutions and market participants. The recent changes in expectations may limit the differentials in government bond yields between US treasuries and other government bonds (chart 7), and may also affect the strength of the US dollar, which correlates with interest rates spreads.

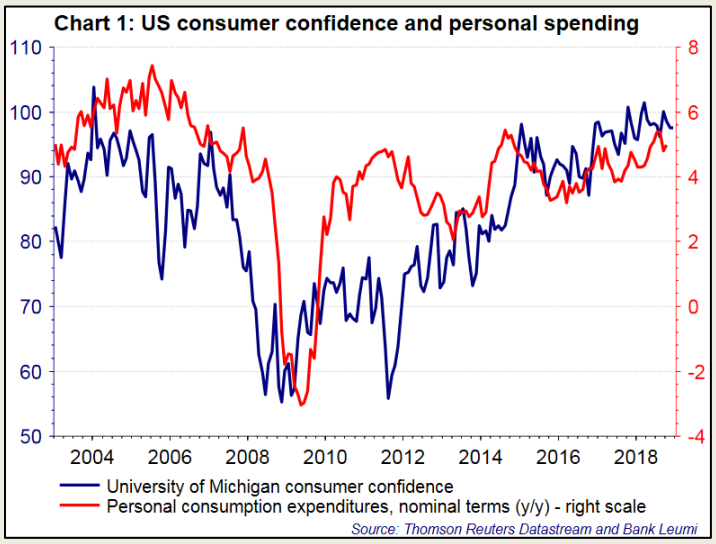


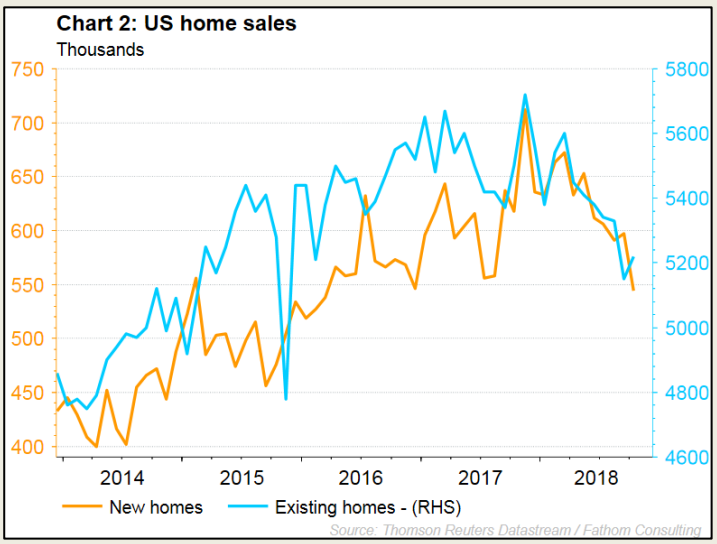


United States

US growth outlook (1/2): the economic activity growth rate which has been above potential for almost eight years, is expected to moderate in 2019.

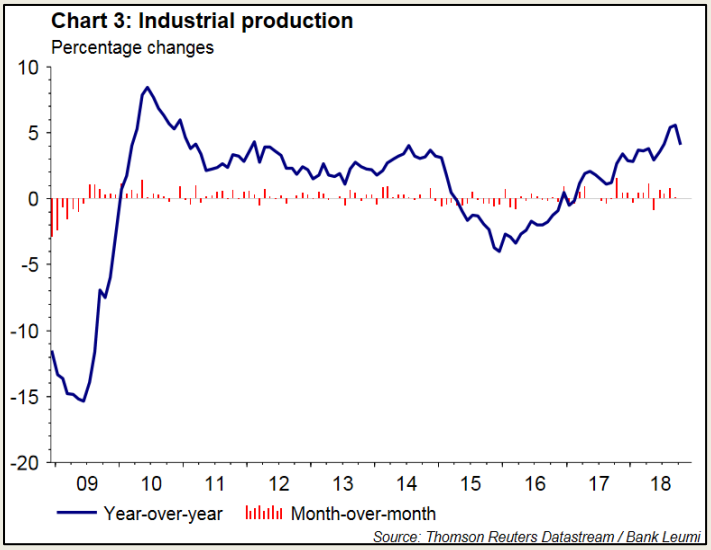
- Based on the latest estimate of national accounts data, GDP growth somewhat slowed in the third quarter to 3.5% (q/q annualized) from a high rate of 4.2% in the second quarter. Growth continues to be driven by public and personal spending, with investment growth slowing.
- Personal income and spending rose at a strong pace in October. Meanwhile, consumer confidence edged lower but remains solid. Our view on consumer spending remains positive against the backdrop of the positive trends in the labor market, healthy wage growth, and relatively high consumer confidence (chart 1). The recent decrease in oil prices is expected to support private spending in the short-run. In all, personal consumption may slightly moderate in the fourth quarter compared to the previous quarter, but remain at a healthy pace of growth. Looking forward to 2019, we expect private consumption to slow next 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 different types of durable goods, including vehicles and housing.
- Home sales and mortgage applications have continued to trend down (chart 2) in tandem with the trend since the early part of the year, as higher mortgage interest rates and decreasing affordability have weighed on housing demand, while a shortage in professional workers weighs to some extent on supply. The moderation in housing sales recently caused some downward pressure on housing prices growth. We do not rule out a further moderation in price growth, but low inventory levels (in a long-term perspective, and despite the recent rise) will likely limit any significant downward pressure on prices.
- It should be noted that the residential construction sector has been affected negatively by a recent increase in input prices and wages, thereby squeezing profit margins. Softening demand, in tandem with labor shortages in the housing sector, is expected to continue to weigh on housing starts and residential investment in the short-medium term.

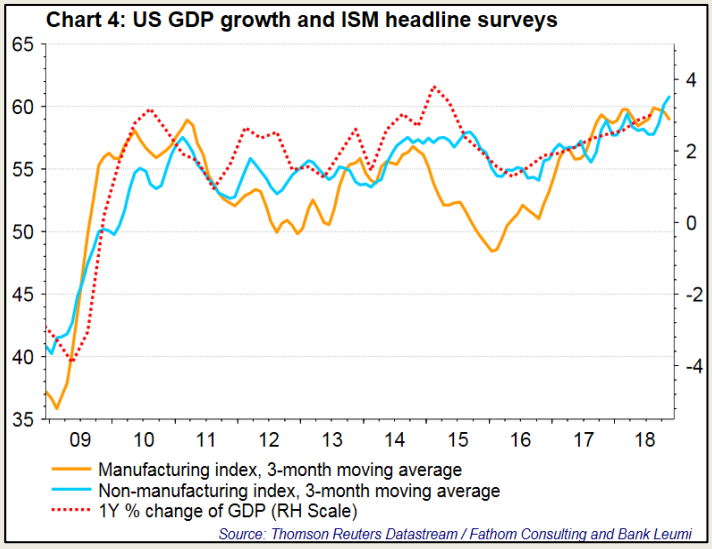




US growth outlook (2/2).

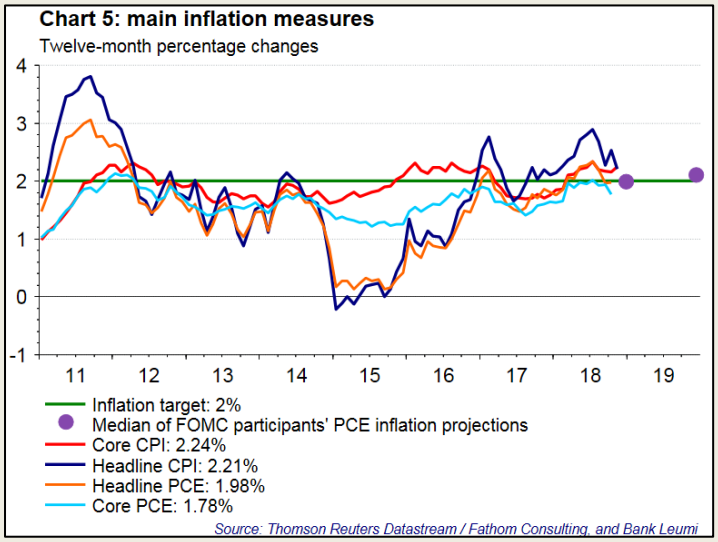
- Industrial production (IP) rose in November supported by a surge in mining and utilities output. On a year-over-year basis, IP growth has somewhat accelerated, continuing to grow at a healthy pace (chart 3). Risks to growth in industrial production stem from, among other things: the strength in the 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.
- October-November business surveys (such as the ISM, Markit PMI, and regional Fed surveys) provided some mixed signals (chart 4). While most surveys that have high correlations with economic growth suggest the US economy will continue to grow solidly in the fourth quarter, they also provided some warning signs, which may point to some moderation in the short-run, as growth of hiring has subsided recently, and new orders growth moderated too.
- Looking forward, we expect US growth to remain solid, with the economy growing above its potential growth level. However, we estimate economic activity will moderate in 2019 due to several factors, including: the fading effects of the current expansionary fiscal policy; higher interest rates; US dollar appreciation; rising uncertainty regarding US trade and foreign policy; and some political risks that may stem from policy uncertainty after the midterm elections and ongoing investigations of the president.
- Our GDP forecasts have not changed since our November report. GDP growth has likely accelerated this year to 2.9%, from 2.3% in 2017, and is expected to moderate to 2.2% in 2019. We expect further moderation in 2020, as growth may dip below 2%.

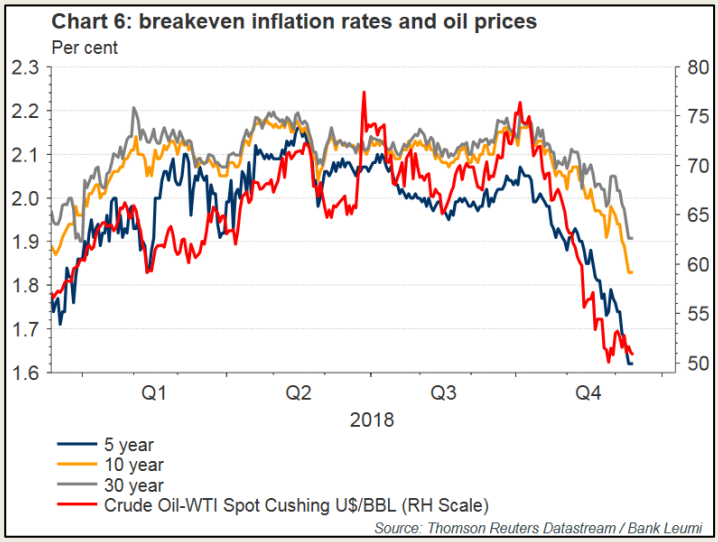




US inflation and monetary policy outlook (1/2): The Fed's dovish stance placed substantial downward pressure on interest rate expectations.

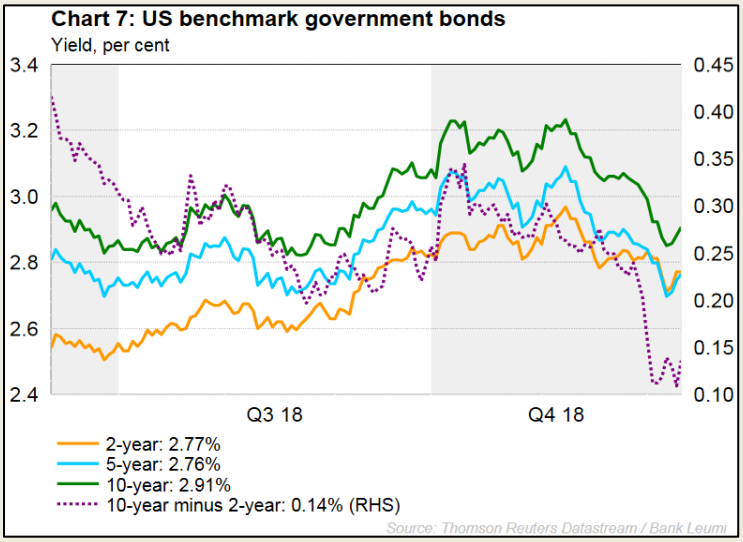
- The annual pace of headline CPI accelerated to 2.5% from 2.3%, supported by energy prices, while core CPI eased somewhat to 2.1% from 2.2%. Annual core PCE inflation also slightly moderated to 1.8% (seven-month low) from 1.9% - below the Fed's target (chart 5).
- The recent fall in oil prices, the 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 beginning of 2019 and remain low for most of the year.
- Core inflation is expected to moderate as well, but to a lesser extent compared to the headline measure, as underlying improving fundamentals (labor market, wage growth, and domestic demand) are expected to remain solid, keeping the core rate close to the Fed's projected target.
- The recent fall in breakeven inflation expectations and the heightened risk environment recently placed additional downward pressure on interest rate expectations, widening the gaps between the Fed's projections and the market's expectations. Currently, the futures markets are pricing in only less than two rate hikes between now and the end of 2019, compared to three hikes a month ago.
- Based on the Fed's recent communication, and in accordance with recently released data, the Fed is expected to raise the interest rate in the December meeting, as reflected in market-derived interest rate expectations. However, with respect to the interest rate path, recent Fed communications took a dovish shift, as both the Federal Reserve chairman, Jarome Powell, and the vice chairman, Richard Clarida, said the interest rate is "just below" or "much closer" to the neutral rate, softening the previous hawkish stance.

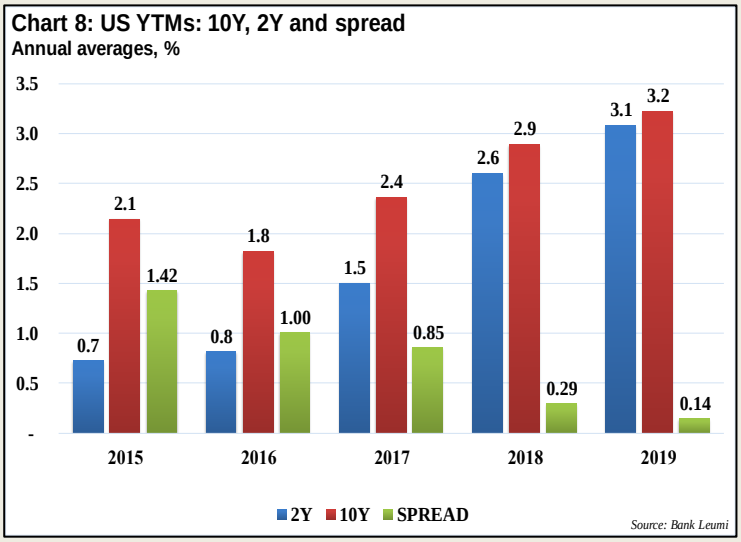




US inflation and monetary policy outlook (2/2).

- We expect an additional rate hike in the December 19th meeting, and currently we estimate the probability for two hikes in 2019 is greater than three hikes. If the growth environment will start to clearly moderate during 2019, then we do not rule out the possibility that the Fed will pause the tightening process already in the second half of 2019, and start cutting rates gradually in 2020, in contrast to the FOMC projections that point to an additional one or two hikes in 2020.
- The yield curve flattened further recently, mainly due to a transitory drop in yields at the longer end of the curve compared to the short-end, and the curve is currently around its lows since June 2007 (chart 7). The recent drop in yields is mainly attributed to the fall in inflation expectations. The recent trend of the curve reflects a change in market expectations and perceptions toward the future trend of growth and a lower path of rate hikes than previously expected.
- Our 2019 yield curve forecast (annual averages) was revised slightly downward at both ends of the curve (chart 8). Based on our models, we expect the yield-to-maturity on 10-year bonds to average 3.2% in 2019, compared to an average of 2.9% in 2018. We expect the yield-to-maturity on 2-year Treasuries to rise to an average of 3.1% in 2019 as well, from 2.6% this year, reflecting a flattening of the yield curve in 2019 on an average basis compared to 2018. A very modest and temporary 10-2 years curve inversion is expected in 2020.

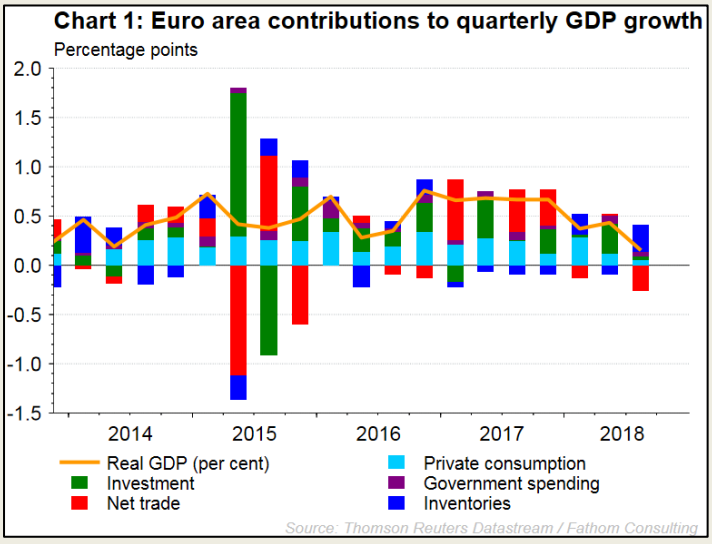


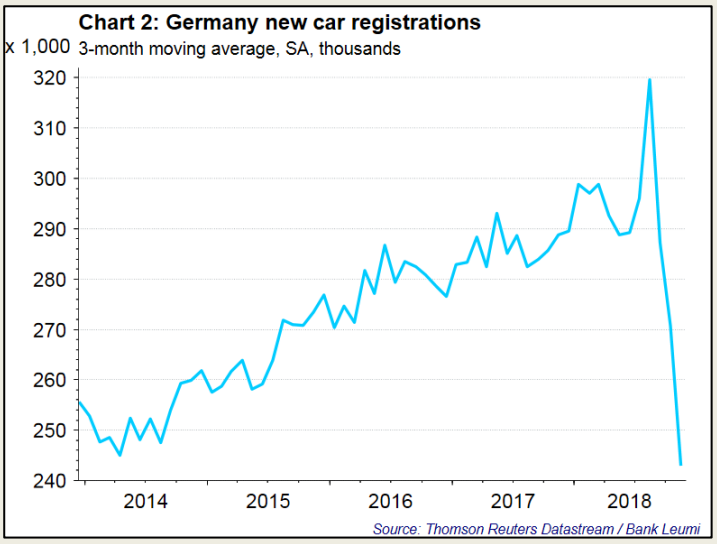


Euro Area

EA growth outlook (1/2): based on recent data and leading indicators, we expect another quarter of soft growth, after the slowdown in Q3 that was led by Germany and Italy.

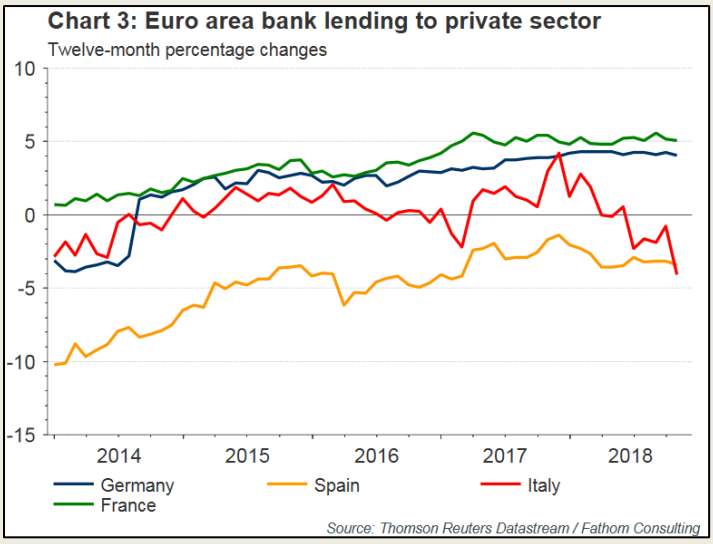
- The latest estimate of Q3 GDP confirmed that quarterly growth slowed to 0.2% from 0.4% in Q2. The weakness in the previous quarter was affected by, among other things, weak external demand, a moderation in domestic demand as business and consumer confidence indices have deteriorated recently (see chart 1), and some temporary factors, including the disruption in car production ahead of a new emissions testing procedure that started in September.
- This disruption has been hitting the vehicles-producing economies, but it seems that Germany's economy was hit the most (chart 2), contracting last quarter by 0.2% q/q – the first fall in GDP since the first quarter of 2015. We expect some "correction" in Germany's GDP growth in the current quarter. Looking forward, we expect Germany's 2019 economic growth to slightly moderate to a pace of around 1.6%-1.8%, compared to an estimated rate of around 1.8%.
- Also, Italy presented weak GDP data in the previous quarter, and based on the second Q3 GDP estimate, the economy contracted by 0.1%, mainly due to declines in private consumption and investment. Overall, the Italian economy has weakened recently due to the deterioration in business and consumer sentiment against the backdrop of heightened political risk and economic policy uncertainty. Based on leading indicators and business surveys, growth is expected to remain slow in the short-run at least. Italy's composite PMI was unchanged at 49.3 in November, thus signaling a second consecutive month of fall in output, increasing the chances that Italy's GDP will fall also in the fourth quarter of the year, registering a technical recession.

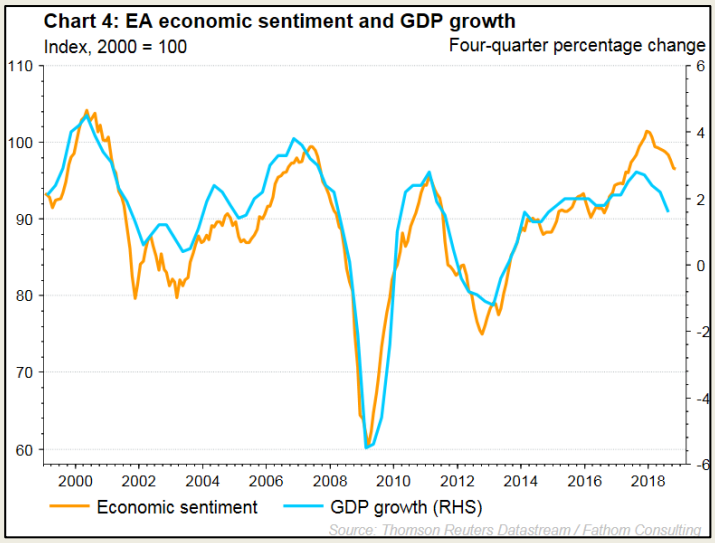




EA growth outlook (2/2).

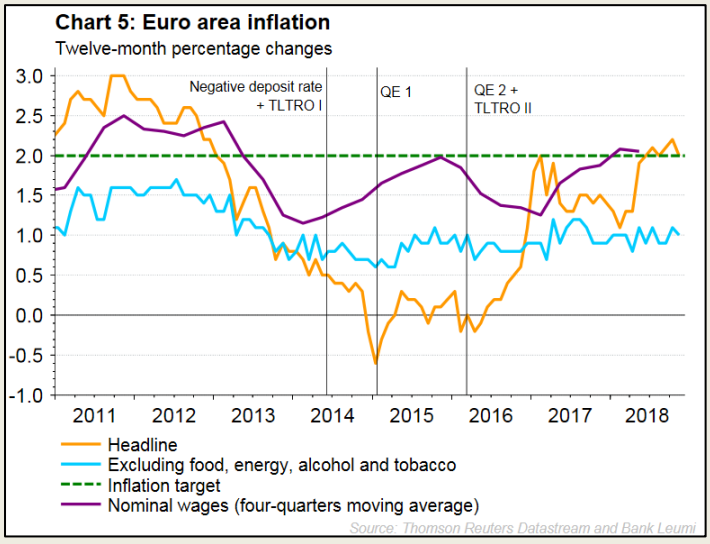
- The political risk in Italy is expected to remain high due to internal tensions between the two ruling parties, the 5-Stars party and Lega, and also due to tension between the Italian government and the European Commission over fiscal issues. Last week, Italy's Prime Minister, Mr. Conte announced that the government has agreed to lower its budget deficit forecast for next year from 2.4% of GDP to 2.04%. The recent political and fiscal developments have driven bond yields down to their lowest levels since the end of September. That said, continuing uncertainty with regard to the final budget and actual macroeconomic developments in 2019 will continue to pose risk to government bonds yields.
- Recently released lending data disappointed somewhat (chart 3). Annual household loan growth remained almost unchanged and close to its 2018 average (YTD), but the annual growth of loans to corporations moderated. On the national level, Italy's lending declined further and at an accelerated pace.
- Based on recent business surveys, which have a long-run positive correlation with GDP growth, EA economic activity continued to slow in the fourth quarter (chart 4). The PMI composite index registered its lowest level since September 2016 and business optimism is running at its lowest since late 2014. Italy remained the weakest performing economy, but Germany's activity also slowed. In contrast, firmer growth was registered in Ireland, France, and Spain. We expect a continuing divergence in the growth environment on the national level among the EA's major economies, as Italy's growth is expected to moderate more substantially this year and probably also in 2019, widening the growth gap with Germany, France, and Spain.
- Based on leading indicators, we do not rule out an additional low quarterly growth rate in the fourth quarter and further moderation in growth (on a y/y basis) in the short-run, at least toward the potential growth level. GDP growth is expected to moderate to 2.1% this year from 2.6% in 2017, and moderate further in 2019 to around 1.8%. The main risks to the short-medium term growth outlook are concerns regarding changes in US-EU trade policy, uncertainty regarding Brexit, and other political risks in Europe, including Italy's political and fiscal risks.

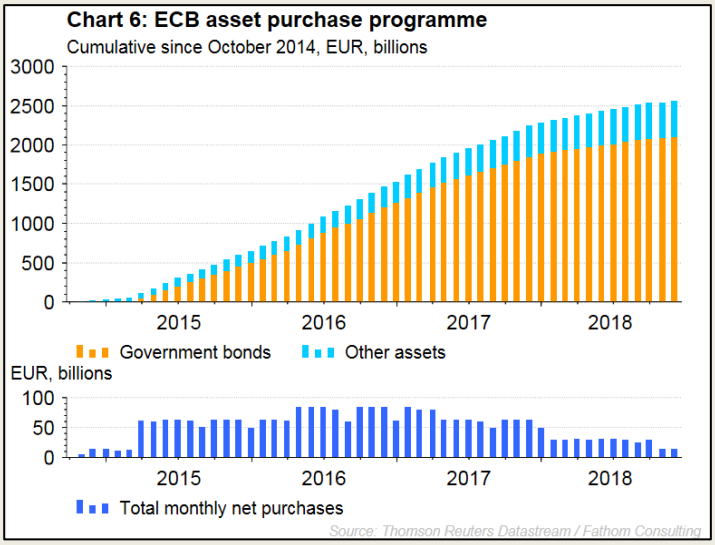




EA inflation and monetary outlook: the ECB revised downward its macroeconomic projections, and somewhat changed its stance to the dovish side.

- Flash headline annual inflation declined in November to 2.0% from 2.2% (chart 5), partly driven by weak energy and unprocessed food inflation, in tandem with a fall in some volatile core inflation components. Headline inflation is expected to moderate in the upcoming months due to base effects and the recent falls in oil prices.
- Core inflation fell to 1.0% from 1.1%, in line with its average over the past two years. The latest labor market data, which include a continuing fall in the unemployment rate and some moderate acceleration in wage growth, may support some recovery in core inflation over the short-medium term.
- At its meeting on December 13th, the ECB revised slightly downward its macroeconomic projections for 2018-2019 GDP growth and for 2018-2020 core inflation. Furthermore, the ECB's president, Mr. Draghi, also acknowledged that risks to the growth outlook were tilting to the downside. In addition, we believe that it provided a dovish stance regarding its future policy. As expected, the central bank confirmed it is ending its asset purchases (chart 6). However, the ECB enhanced the forward guidance to imply a longer period of re-investment "past the date when its starts raising the key ECB interest rates". We do not entirely rule out a rate hike next September in line with the ECB current forward guidance, although 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 with a later date for a rate hike. We also do not rule out another, substantial, 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, 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 substantial political risks in the bloc. Based on the current macro environment, we do not rule out some steepening of the EA yield curve in short-medium term.





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