Global Economics Monthly Review

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Global Economics – The Big Picture

Further growth in the fourth quarter being led by manufacturing activity: Based on recently released economic data for the major advanced and emerging economies, global economic activity continues to rise in the fourth quarter. Although the US economic growth rate is expected to moderate in the current quarter (Q417) after a strong run in the previous one (Q317), GDP is still expected to rise by more than 2% quarter-over-quarter in annualized real terms.

Based on business surveys, euro area economic growth is expected to accelerate further in the fourth quarter, recording the best annual growth since 2007. It should be noted that the Eastern and Central European economies continue to grow rapidly, supported by both domestic and external demand from the major European countries. The UK economy is expected to maintain its moderate growth trend, supported mainly by its manufacturing activity. Japan's growth may somewhat moderate, but should remain on a positive path. Economic activity in China has been characterized recently by mixed data, among other things, due to the challenges of the corporate deleveraging process led by the government.

The global manufacturing PMI increased further in November to its highest level in six and a half years, implying that global industrial production, which has been expanding at a solid pace this year, may even accelerate further. The services sector output also has grown strongly in the fourth quarter, similar to the pace since the beginning of the year. Based on the available official data and the current business surveys, we believe that the global economic activity growth rate accelerated to 3.7% in 2017, following 3.2% growth in 2016. Moreover, we expect the global growth rate to moderate slightly in 2018 to 3.6%.

The global economy is on a path of long and very gradual monetary normalization. Some of the major central banks, like the Bank of England, the Bank of Canada, and the Bank of Korea, joined the US Federal Reserve (the Fed) and tightened their policies lately, yet monetary policies and financial conditions around the world are still very accommodative. A stimulative and expansionary US tax reform could lead US monetary tightening beyond what is currently expected by markets and this may have global implications later on.

We expect the tightening cycle to continue in some of the major developed economies, but the process is expected to be moderate and gradual. The federal funds rate in the US is expected to rise faster than in other major economies in the world. The Fed is expected to raise the interest rate in the upcoming meeting on December 13th for the fifth time in this current tightening cycle, while in October it started the balance sheet normalization process.

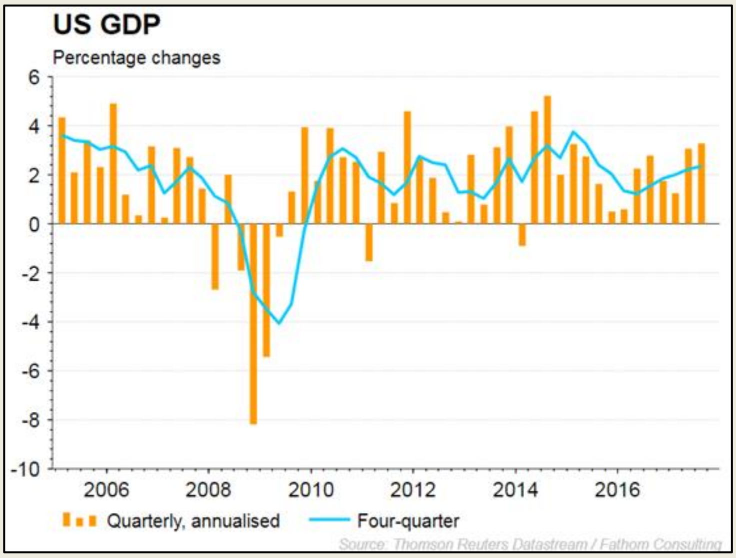
In the "emerging world", some of the central banks that were challenged by stability issues up until recently continue to loosen their monetary policies from a tight stance. The central bank of Brazil cut the SELIC rate to 7.0%, and the Russian central bank cut the interest rate to 8.25% and it is expected to cut the interest rate further in the short-run.

Leumi Global Economic Forecast, As of December 2017

	2015	**2016**	**2017F**	**2018F**
GDP – Real Growth Rate				
World	*3.3%*	*3.2%*	*3.7%*	*3.6%*
USA	*2.9%*	*1.6%*	*2.2%*	*2.2%*
UK	*2.2%*	*1.8%*	*1.6%*	*1.4%*
Japan	*1.3%*	*1.0%*	*1.6%*	*1.3%*
Eurozone	*2.0%*	*1.7%*	*2.3%*	*1.9%*
South East Asia (ex. Japan)	*4.5%*	*4.5%*	*4.9%*	*4.7%*
China	*6.9%*	*6.7%*	*6.8%*	*5.8%*
India	*7.9%*	*7.1%*	*6.7%*	*7.7%*
Latin America	*0.1%*	*-0.7%*	*1.2%*	*2.2%*
Israel	*2.5%*	*4.0%*	*2.9%*	*4.0%*
Trade Volume, Growth (%)				
Global	*2.5%*	*2.3%*	*4.6%*	*3.5%*
CPI, Annual Average (%)				
USA	*0.1%*	*1.3%*	*2.1%*	*2.2%*
UK	*0.1%*	*0.7%*	*2.7%*	*2.6%*
Japan	*0.5%*	*1.0%*	*0.5%*	*0.6%*
Eurozone	*0.8%*	*-0.1%*	*1.5%*	*1.3%*
Israel	*-0.6%*	*-0.5%*	*0.3%*	*0.6%*
Interest rates, Year End				
US Fed	*0.25-0.50%*	*0.50-0.75%*	*1.25-1.50%*	*1.75-2.00%*
Bank of England	*0.50%*	*0.25%*	*0.50%*	*0.50-0.75%*
Bank of Japan-Policy Rate	*0.00%*	*-0.10%*	*-0.10%*	*-0.10%*
ECB-Main Refi	*0.05%*	*0.00%*	*0.00%*	*0.00%*
Israel	*0.10%*	*0.10%*	*0.10%*	*0.25%*

United States

Economic activity remains solid in the fourth quarter despite some moderation: Recently released economic data suggest that the economy continues to grow at a healthy pace, albeit more moderately compared to the previous quarter. The second estimate of third quarter GDP by the Bureau of Economic Analysis indicates that the US economy grew faster than previously estimated as growth was revised upwards to 3.3% quarter-over-quarter (annualized) from 3.0%. The upward revision was the result of a larger positive contribution from business investment and a much smaller drag from public sector spending. On a year-over-year basis, the US economy grew 2.3% in the third quarter, which is the highest rate since Q3-2015.



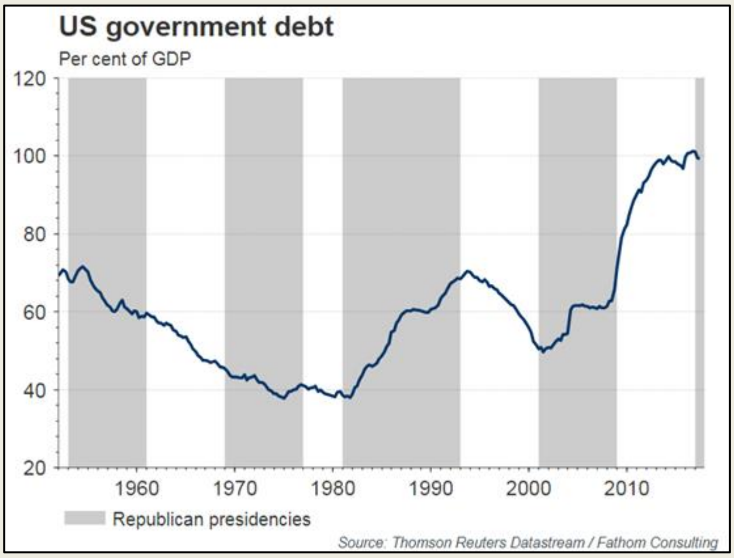
Newly released incoming data for the fourth quarter attest to some moderation in economic growth compared to the previous quarter. This comes as the positive effects from the bounce in activity in September (mainly in private spending), following the initial economic impact of the hurricanes, have faded. Also, net trade is expected to be a small drag on GDP growth after the trade deficit widened relatively significantly in October on strong imports, reflecting the strength in domestic demand. Looking forward, we expect external demand, which is now supported by a further recovery in global economic activity, to support GDP growth in the short-run at least.

Approval of the currently proposed tax reform, may bring a slight upward revision to our GDP growth outlook: We currently maintain our 2017 GDP growth estimate unchanged at 2.2%, similar to consensus, up from 1.6% in 2016, and expect this growth rate to be maintained next year (2018). However, and as we wrote in previous reviews, one of the main risks to our growth outlook involves uncertainty regarding the economic policy that will finally be implemented by the Trump administration. On December 2nd, the US Senate approved its proposal for tax reform, entitled the "Tax Cuts and Jobs Act", meaning that now both the Senate and the House of Representatives passed their tax reform proposals. It is now up to the joint committee of both chambers to reconcile the differences between the two proposals.

One of the key differences that needs to be resolved is the timing of the corporate tax cut. As in the House approved plan, the Senate proposal also includes a decrease of the corporate tax rate from 35% to 20%. However, the Senate proposal reduces the corporate tax rate only in 2019 in order to reduce the cost of the plan for budgetary purposes, while the House proposal calls for an immediate cut. For reconciliation purposes, the final figure might be somewhat higher than 20% (the president, Donald Trump, noted through the media that the final figure could be also 22%) in order to start the plan immediately. The proposed tax plan also includes: allowing businesses to fully write-off the cost of new investments for at least five years; reducing the number of marginal tax brackets for individuals from seven to three; and more. Part of the plan will be financed by taxing US firms on repatriation of profits earned abroad, and by an expected increase in economic activity following the implementation of the plan.

We expect the plan will temporarily boost economic growth, mainly through fixed asset investment, and to some extent also through private consumption. The boost to economic activity may slowly start to take place by mid-2018, depending on the timing of the implementation of the plan. Hence, we may revise our growth outlook soon. As of now, the US economy is expected to grow 2.2% both in 2017 and 2018. Significant positive effects on US economic activity, and to some extent on inflation, may also bring an upward revision to our interest rate forecast.

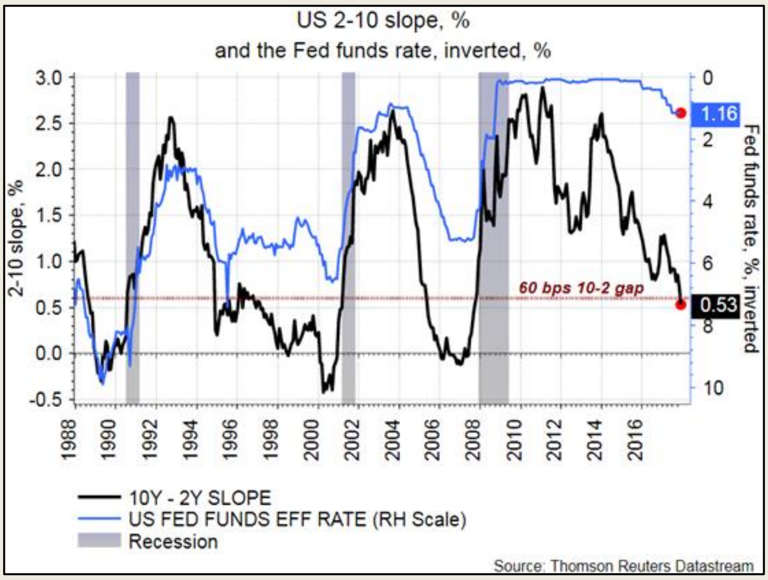
The major macro downside of the plan is the significant increase in the budget deficit, which is not low to begin with. A greater than expected increase in the US budget deficit and the government's debt ratio may increase fiscal risks and may have some upward effect on US credit default swap premiums and government bond yields. Consequently, we cannot rule out some negative effect on the US sovereign credit rating outlook in the medium term.



No major changes in the inflation outlook. The Fed is on track to raise the interest rate in the December meeting: PCE inflation remained moderate in October and below the Fed's target, as the headline PCE moderated slightly to 1.6% from 1.7% in the previous month and the core measure remained unchanged at 1.4%. PCE inflation is likely to remain below the Fed's 2% target in the upcoming months, but is expected to start recovering in the second quarter of 2018 as the negative base effects will drop out of the annual calculation. A major factor that may support a gradual re-inflation is the continuing improvement in the labor market, in tandem with the shortage of skilled workers in some industries and the impact of the "Tax Cuts and Jobs Act", which may support wage growth.

The further improvement in economic activity, in tandem with the substantially loose financial conditions, as reflected in the Fed's financial stress and monetary conditions indices, support further policy tightening. Based on market-derived interest rate expectations, there is an almost unanimous market expectation for a rate hike in December. Regarding 2018, we expect two rate hikes (to 1.75-2.00% by YE2018), which is below the FOMC's projections (three hikes to 2.00-2.25%) and slightly above market expectations. Note that the market has been adjusting its outlook and there has been an ongoing increase in interest rate expectations in the past few weeks.

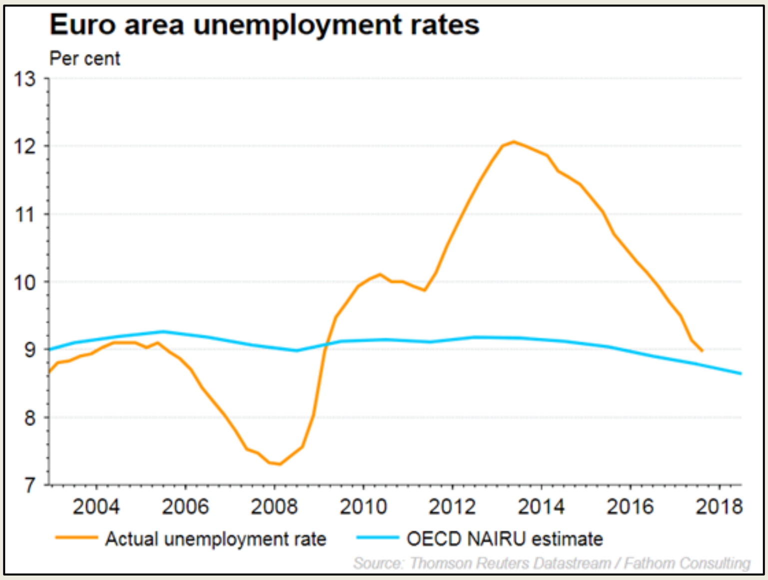
Further flattening of the yield curve as part of the tightening cycle of the Fed: The further improvement in economic activity, in tandem with expectations that the expansionary fiscal policy proposed by both chambers of Congress will be approved in the near term, supported a further rise in the short portion of the yield curve, while the longer section of the curve remained relatively stable. The yield-to-maturity of the 2-year Treasury bond increased 23bps to 1.83% in the past month (as of December 5th). Simultaneously, the 10-year yield remained unchanged at 2.38%. The current differential between the yields-to-maturity of the 10-year and the 2-year bonds has compressed to 55bps (the 2-10 slope), the lowest since October 2007.



Based on the central scenarios within our macro-economic forecasts, we expect the interest rate trajectory over the short- and medium–terms, together with the balance sheet normalization, to support a modest rise in yields, mainly in the short-term portion of the curve, which may lead to a further, albeit very modest, flattening. There are a few factors that could lead to a modest increase of the slope and limit the potential for further flattening. These factors include: the expected increase in the budget deficit and government bond flotation in the next few years if the current proposed fiscal plans will be approved; and an increase in fixed asset investment based on the tax incentives to do so, which would lead to an increase in demand for medium- and long-term financing by the private sector.

Euro Area

Economic activity shows further strength in the fourth quarter. The positive trend is expected to continue in the short-run: Recently released economic data were mixed. October retail sales fell more than expected, due to, among other things, a sharp fall in clothing sales as a result of unseasonably warm weather. However, November sales might "correct" upwards and the short-run private spending outlook appears positive. This is mainly due to the ongoing improvement in the labor market as the unemployment rate continues to trend downwards, reaching in October its lowest level since January 2009, and continues to close the gap from the NAIRU (non-accelerating inflation rate of unemployment) level, suggesting that spare capacity in the labor market is closing. This situation may support wage growth in short-medium term.

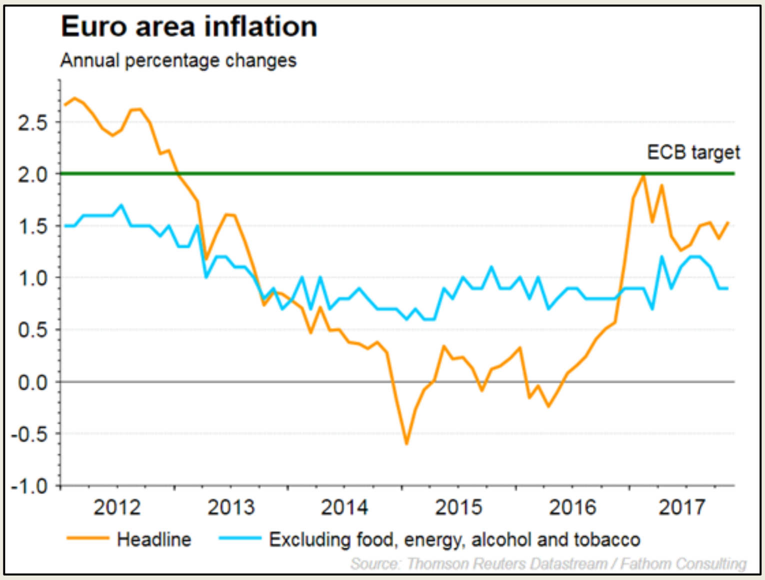


Another factor that may support private spending, in the short-run at least, is the further increase in the consumer confidence index, which has recently reached a 16-year high. Moreover, lending activity continued to expand in October as lending to non-financial corporations grew solidly by 2.9% year-over-year from 2.4% in the previous month. The solid corporate lending growth in recent months may attest to a continuing appetite for investments in the business sector.

Furthermore, recent business surveys point to further solid economic growth in the fourth quarter of the year and in the short-run at least. Based on a survey by the European Commission, eurozone economic activity rose strongly in November as the ESI (Economic Sentiment Indicator) reached its highest level since October 2000. Moreover, the November PMI (Purchasing Managers' Index) rose solidly as well, pointing to some acceleration in fourth quarter GDP growth after expanding by 0.6% quarter-over-quarter in the previous quarter.

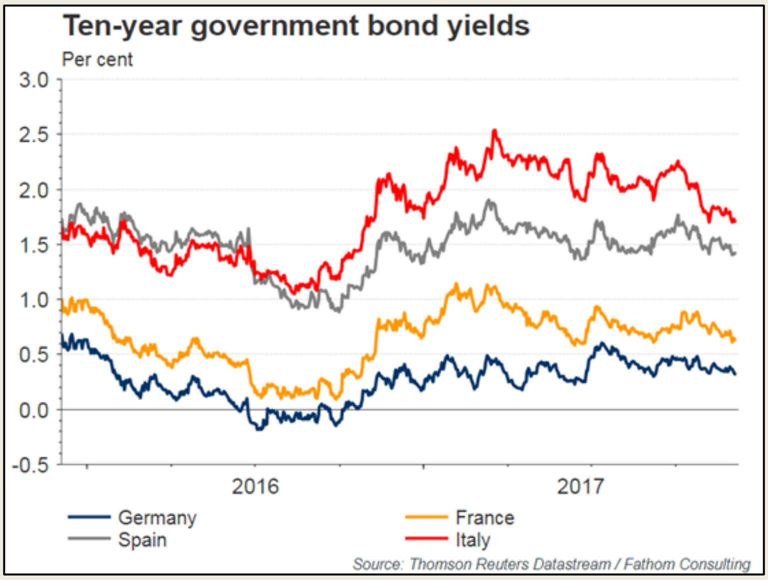
Overall, we expect GDP to grow 2.3% this year from 1.7% in 2016. Next year, growth is expected to somewhat moderate as some of the region's economies have grown at a pace that exceeds their potential and may converge toward their real potential output, which is burdened by relatively low productivity growth. Moreover, the contribution of net exports to growth may also be low or even negative in 2018 due to the appreciation of the effective exchange rate of the euro, and as imports are expected to grow solidly due to the improvement in domestic demand. Furthermore, it should be noted that the degree of political risk (social unrest in Catalonia, uncertainty regarding the coalition in Germany, and above all the elections in Italy, which will likely be held in the second quarter of 2018) remains an important factor and may weigh on growth in the short-medium term.

Core inflation remains low, but is expected to rise moderately in the short-run: According to November flash estimates, eurozone inflation rose slightly from 1.4% year-over-year to 1.5%, supported by a rise in energy prices. Meanwhile, core inflation remained unchanged below the consensus forecast at 0.9%, well below the ECB's near-2% medium-term target for the headline rate. Looking forward, inflation is expected to rise modestly in the short-medium term as domestic demand is on the rise. However, the rise in core inflation is expected to be very moderate due to the existence of spare capacity in the economy. It should be noted that the spare capacity is declining and is expected to decrease further as economic activity continues to improve.



The ECB policy rates will be hiked only well after the end of the QE program: With regard to monetary policy, the ECB's asset purchase program is expected to run until at least September 2018, as the monthly asset purchases are expected to sum to €30bn a month starting from next month. The ECB did not mention a definitive end-time for its asset purchase program, but it may be not much longer after September next year. It should be noted that even after the asset purchase program will end, the ECB's monetary policy will still be very accommodative. We continue to expect that the first hike may occur not before 2019 - conditional mainly on an improvement in the inflation outlook and on a continuation in the trends of positive economic activity.

Government bond yields fell further in the past month on weak inflation data and rising political uncertainty: Eurozone government bond yields dropped further in November, for the second month in a row, partly due to low inflation figures, and expectations that interest rates will stay unchanged for a long time, while in other economies, mainly the US, rates are expected to continue to rise. In addition, bond yields were also affected by the "risk-off" sentiment in financial markets, caused by, among other things, the political uncertainty in Europe with regard to the elections in Catalonia on December 21st and the difficult process of coalition formation in Germany. The rise in the degree of political uncertainty,



pertaining to the US tax reform and the federal investigations, probably weighed on investors' sentiment and as a result contributed to the decline of European government bond yields. Due to the solid improvement in Europe's economic activity, we believe that there is limited room for a further fall in core European country yields.

Looking ahead, we expect European government bond yields to rise next year, albeit moderately and gradually, in tandem with the expected moderate rise in US Treasury yields. As we stated in the past, we believe that the potential for a significant rise in yields next year will be limited due to the below target inflation outlook and the continuing spare capacity in the economy.

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