Global Economics Monthly Review

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Key Issues

Global Economics – The Big Picture (p. 3)

- *The solid trend in economic activity is expected to continue in the short-run.*
- *There are several rising risks to our growth outlook, including: the hurricanes' economic impact and; the rising level of geo-political risk due to the escalation of tensions between North Korea and the US over the past few weeks. Other risks include the ongoing political occurrences in Europe.*
- *Inflation remains low and is a central concern for policy makers.*
- *Some central banks are expected to gradually normalize its policies.*

Global Economic Forecast Table (p. 4)

United States (p. 5)

- *Leading indicators and business surveys prior to the hurricanes, pointed to healthy investment growth in the short-run.*
- *There will be temporary negative effects of Hurricanes Harvey and Irma on economic activity.*
- *The debt ceiling risk was increased, but will need to be re-addressed before mid-December.*
- *The hurricanes' effects may support some temporary rise in inflation.*
- *The probability for a rate hike by the end of 2017 has decreased due to the hurricanes' effects. Changes in the composition of the twelve members of the FOMC at the Fed may have some effect on future monetary policy.*
- *Longer duration government bond yields declined in the past month, due to the rise in geo-political risks.*

Euro Area (p. 9)

- *The latest positive business surveys might translate to further growth in domestic demand.*
- *Economic reforms in France are expected to support further business sentiment and investments.*
- *Inflation probably increased temporarily more than expected in August, but is expected to be drawn downwards as the euro appreciates.*
- *Monetary policy and forward guidance has not changed, as the 2017 GDP growth estimate is revised upward and 2018-2019 inflation outlook is revised downward.*
- *Changes to the QE program may well be announced in October.*
- *Government bond yields are expected to rise modestly by the end of the year.*

<u>Global Economics – The Big Picture</u>

The global economy continues to grow at a healthy pace. The trend is expected to continue in the short-run: Based on official monthly data and business surveys from July and August, the global economy continues to expand at a healthy pace in the third quarter. This comes after an acceleration in global growth in the second quarter led by several major economies, including the US, Japan, the eurozone, the UK, China, and more. The global manufacturing PMI increased to its 75-month high in August, led particularly by the developed economies, as production rose strongly in continuation of the trend in the past months. Leading indicators such as new orders, new exports, and the improvement in the employment situation suggest that the global economy may continue to expand at a solid pace also in the short-run. Based on the relatively positive economic developments, we decided last month to slightly revise upward our 2017 global growth estimate by 0.1 percentage points to 3.4%, following 3.2% growth in 2016, and to keep our 2018 estimate unchanged at 3.5%.

Some rising risks to our growth outlook, including, among other things, the hurricane's economic impact: Recently, the risks to our growth forecasts have somewhat increased due to a few developments. First, we cannot rule out a slight downward revision to our 2017 US GDP growth forecast due to the economic effects of the hurricanes on 3Q17 data, due to significant damage and shutdowns, including in the energy, chemicals and agriculture sector. Some of the drag might be offset in the 4Q17 and in early 2018. Hence, we see the effects of hurricanes as transitory, and this will not change the medium-term trajectory of US economic activity (see the US economy chapter).

The second factor is the rising level of geo-political risk due to the escalation of tensions between North Korea and the US over the past few weeks: This comes following the latest missile tests and North Korea's nuclear program. The effects in scenarios of further escalation, or in a worst case of a military conflict, might be substantially negative. The direct effects could include damages to the South Korean and Japanese economies (at least), which constitute 1.9% and 6.6% of global GDP, respectively. This would disrupt production of major export products and global supply chains. There would also be indirect effects, such as heightened volatility and negative reactions in the financial markets, which will hurt business and consumer sentiments, and may weigh on overall demand.

Other risks include the political developments in Europe, surrounding in particular the Brexit negotiations between the UK and the EU, the election results in Germany (read more in the chapter on the euro area economy), and the popularity of the Eurosceptic parties in Italy, which will hold general elections in May 2018.

Inflation remains low and is a central concern for policy makers: Recently released data on inflation suggested that core inflation barely changed in July in the major economies, and stayed below, and in some cases substantially below, the major central banks' inflation targets. The relatively low rate of inflation will continue to affect central bankers' decisions, mainly those who feel prepared to normalize their monetary policy due to the improvement in economic activity and growing concerns about the side effects of their monetary accommodation on financial stability.

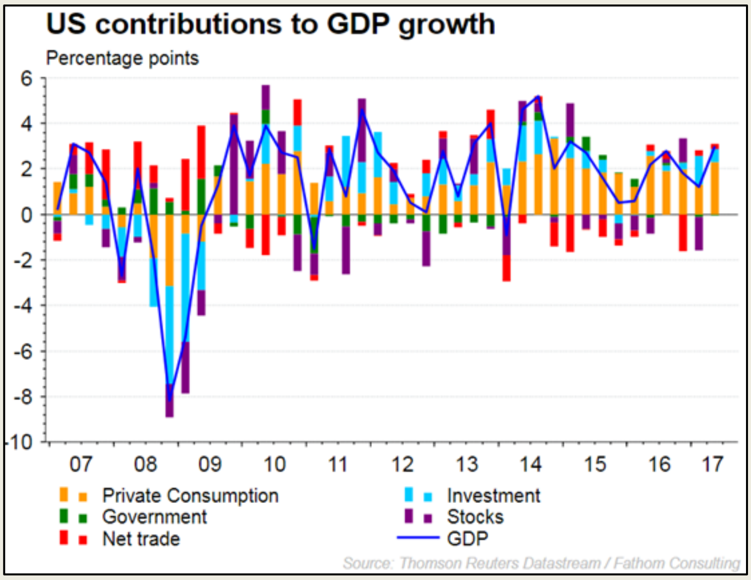
We still expect some central banks to take small and gradual steps towards policy normalization, mainly through the scaling down of unconventional monetary tools, before starting actual interest rate normalization. As we estimated in the past, the normalization process in the US is expected be slightly faster than in other major developed economies. There is also a possibility that the BoE will surprise the markets and raise the interest rate sometime next year due to the further depreciation in the exchange rate of the GBP, which results in relatively high inflation.

Leumi Global Economic Forecast, As of September 2017

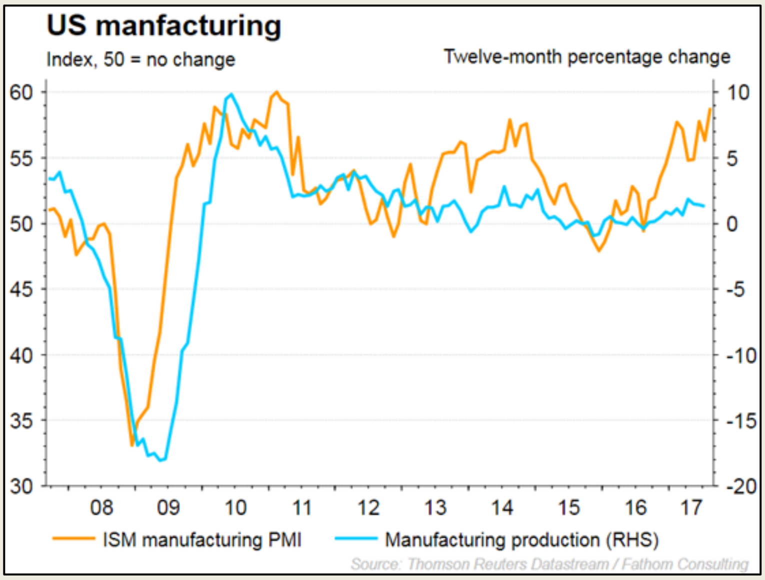
	2015	**2016**	**2017F**	**2018F**
GDP – Real Growth Rate				
World	*3.3%*	*3.2%*	*3.4%*	*3.5%*
USA	*2.9%*	*1.5%*	*2.1%*	*2.3%*
UK	*2.2%*	*1.8%*	*1.6%*	*1.4%*
Japan	*1.3%*	*1.0%*	*1.4%*	*1.0%*
Eurozone	*2.0%*	*1.7%*	*2.0*	*1.7%*
South East Asia (ex. Japan)	*4.5%*	*4.5%*	*5.8%*	*5.8%*
China	*6.9%*	*6.7%*	*6.7%*	*6.3%*
India	*7.9%*	*7.1%*	*7.1%*	*7.3%*
Latin America	*0.1%*	*-0.8%*	*1.1%*	*2.3%*
Israel	*2.5%*	*4.0%*	*2.9%*	*4.0%*
Trade Volume, Growth (%)				
Global	*2.5%*	*2.1%*	*4.0%*	*3.9%*
CPI, Annual Average (%)				
USA	*0.1%*	*1.3%*	*2.0%*	*2.1%*
UK	*0.1%*	*0.7%*	*2.7%*	*2.6%*
Japan	*0.5%*	*1.0%*	*0.5%*	*0.8%*
Eurozone	*0.8%*	*-0.1%*	*1.5%*	*1.4%*
Israel	*-0.6%*	*-0.5%*	*0.1%*	*0.6%*
Interest rates, Year End				
US Fed	*0.25-0.50%*	*0.50-0.75%*	*1.00-1.50%*	*1.50-2.00%*
Bank of England	*0.50%*	*0.25%*	*0.25%*	*0.25-0.50%*
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%*	*0.50%*

United States

Upward revision to GDP growth supported by private consumption and business investment: Recently released economic data were mixed and may point to some moderation in third quarter growth compared to the upwardly revised strong second quarter growth of 3.0% (the preliminary estimate was 2.6%). The upward revision in the second quarter was largely due to stronger consumption and investment growth. Data on real personal spending, construction spending, industrial production, and trade attest to moderate growth in July. In addition, the August labor market reports, pre-hurricanes, surprised to the downside and were relatively weak as average hourly earnings growth and employment growth were relatively low.



Leading indicators and business surveys point to further healthy investment growth in the short-run, but there will be temporary negative effects of the hurricanes on economic activity: Although headline durable goods dropped in July, the decline was entirely due to a drop in orders in the volatile aircraft category. Motor vehicle orders also dropped, partly due to seasonal reasons (summer shutdown), and declining demand. More importantly, excluding the volatile transportation component, new orders and shipments of durable goods increased relatively strongly. Also new orders and shipments of capital goods, excluding aircrafts, increased strongly, suggesting strength in demand for business equipment. Moreover, economic surveys for the month of August, pre-hurricanes, including purchasing managers' indices and



consumer confidence indices, attest to positive sentiment that may translate into further solid demand.

It should be noted that Hurricane Harvey disrupted economic activity in the second half of August, mainly in Texas and Louisiana, and Hurricane Irma, as we write, is sowing destruction in the state of Florida, and it on its way to other states, including Alabama, Georgia, South Carolina and Tennessee. These natural disasters likely caused a significant drag on third quarter GDP growth. The damages that the storm caused so far are quite substantial in the energy sector in the Gulf Coast region, which included disruptions to oil, natural gas, and chemical production in Texas, and the damages to the agricultural sector caused by Irma.

We expect the hurricanes to have negatively affect the regions' employment situation, private consumption, and industrial production, mainly in the energy sector as some oil and gas production were shut down completely due to Hurricane Harvey, and the agricultural sector due to Hurricane Irma. We estimate that the impact will be relatively short-lived and the negative effects will start to be reversed in the following months, supported by the rebuilding of infrastructure and capital stocks, and a "correction" in household' demand.

Inventories have been damaged and a massive cleanup, repair and re-stocking process should start, having most of its impact on 4Q17 and 2018 data. Accordingly, we do not expect a significant impact in terms of the overall annual GDP growth; however, we might marginally reduce our 2017 GDP growth estimate after we receive more data about the economic damage.

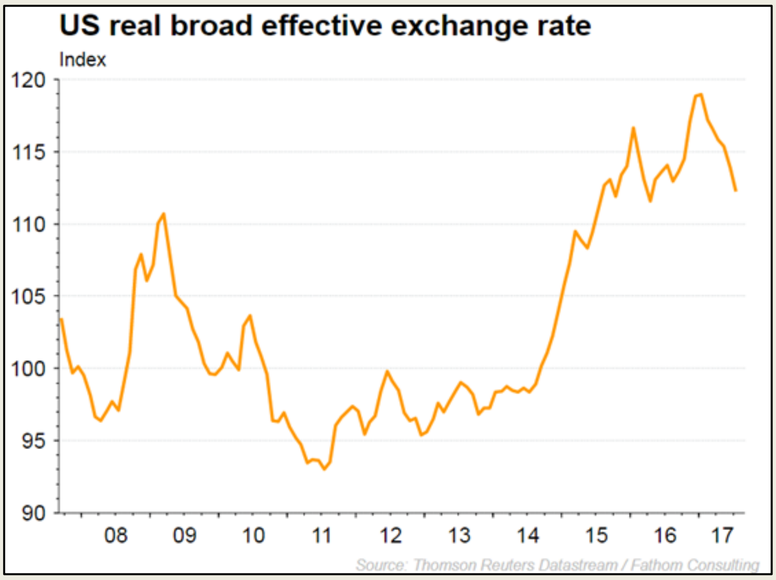
The debt ceiling risk was delayed to mid-December: President Trump's administration and the congressional Democrats' leaders agreed a deal to extend the debt ceiling period that includes funding the government until December 15th. This as a result of the emergency state due to Hurricane Harvey damaging results and the looming damages from Irma. That said, it should be noted that the extension does not resolve the underlying problem, it is just delaying the risk of not approving the debt ceiling by three months.

After the debt ceiling is eventually raised, smoothly or not, the issues of tax reform and infrastructure investments will be back on the table, but we do not expect a substantial deficit creating fiscal stimulus plan. Absent progress on policy issues, such as fiscal policy reforms, healthcare, deregulation, and international trade, economic growth will not accelerate substantially also in 2018 and will remain at slightly above 2%.

The potential for a further significant decline in inflation is limited. The hurricanes' effects may support some rise in inflation: July PCE and CPI inflation data barely changed, remaining below the Federal Reserve's 2% inflation target (which refers to

PCE data). As is already known, the recent moderation in inflation has been, to some extent, due to competitive pressures, and transitory oversupply forces in specific sectors. The weakness in prices was concentrated in several components, mainly energy prices, wireless prices, vehicle prices, airline fares, hotel prices, and apparel.

Looking forward, we estimate that the probability for a further significant moderation is limited, mainly due to the decrease in slack in the labor market, a healthy demand environment, increases in commodity prices in the recent period of time, and the depreciation in the USD.



Moreover, we estimate that the consequences of the hurricanes support a rise in prices in some components, including: energy prices due to the effects of hurricane Harvey in the Gulf Coast; and heightened probability to an ongoing increase in agricultural and food prices flowing Irma. This as a result of the expected damages of the storms in the South-East region, which is one of the most important in terms of production and exports of agricultural and food products. Moreover, inflation is expected to recover further after the base effects mentioned above will drop out of the annual inflation calculation in the second quarter of 2018.

The probability for a rate hike by the end of the year has decreased due to the hurricanes effects: Based on the minutes from July's meeting, some of the FOMC participants remain concerned about the inflation outlook, and suggested that the risk to the inflation outlook could be tilted to the downside, and therefore the Fed could "afford to be patient" with regard to its tightening monetary policy cycle. That said, the majority of the participants still thought the Phillips curve relationship between labor market slack and inflation was "valid", and other members stressed the tightness in the labor market and the easing in financial conditions, mainly the depreciation of the USD and the longer-durations bond yields.

Based on the Fed's projections and view on the labor market and economic activity, the Fed may hike the interest rate in the December meeting. That said, we estimate that the probability for a rate hike in December has decreased due to the damaging effects of the hurricanes and the uncertainty regarding the debt ceiling.

Regarding 2018, we currently expect two rate hikes, which is below the FOMC's projections (three hikes), and above investors' expectations who expect a single hike until the end of next year (low probability for a second hike), reflecting a relatively large gap between the policy makers' projections and market expectations. Moreover, the minutes from the last monetary meeting revealed that several officials wanted to announce a start date for balance sheet normalization already in the July meeting. The announcement about the balance sheet reduction may happen in the upcoming September meeting, and may actually start in the October or December meetings.

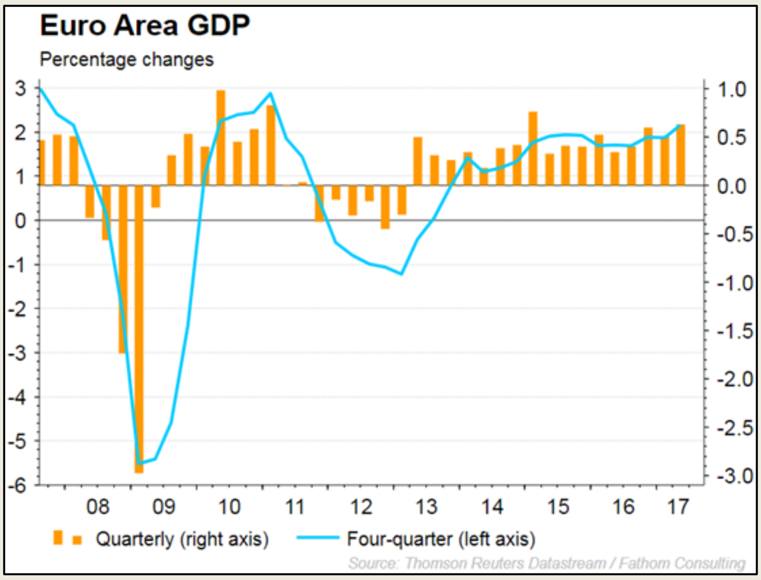
***Vice Chairman Fischer's resignation and other future shifting in Fed's FOMC may have some effect on future monetary policy*:** Federal Reserve's Vice Chairman, Stanley Fischer submitted his resignation as Vice Chairman and as a member of the Board of Governors effective "on or around" October 13th, due to "personal reasons". This, after three years as a Board member. Fischer was considered a hawkish member. This, due to his views that included concerns of long-term effect of prolonged low interest rates on the economy, and that the Fed should continue normalize rates and not pause due to the recent rising concerns over the moderation in inflation environment. Monetary policy in the short-medium term will depend on the new members that will join the FOMC in the near future and whether or not the Federal Reserve Chairman Janet Yellen will serve another four-year term beginning in February 2018.

Longer duration government bond yields declined in the past month, due to the rise in geo-political risks: Lately, interest rate expectations dropped, and this was reflected along the yield curve for Treasuries. We believe that the drop was a result of the rising degree of uncertainty regarding geo-political risks and US economic policy, along with the mixed data and views on the inflation environment. The yield-to-maturity of the 2-year Treasury bond decreased 1.26% (as of September 8th). Simultaneously, the 10-year yield decreased to 2.05%, and has been on a downward trend since March.

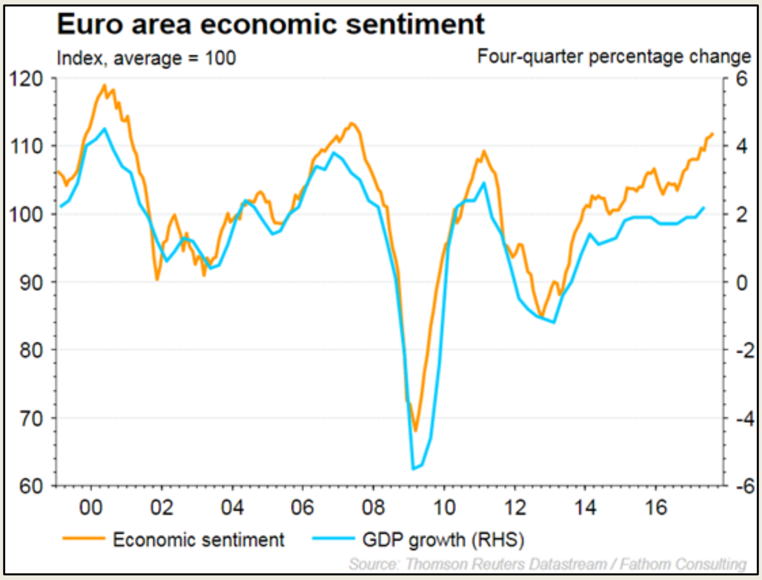
The current differential between the yields-to-maturity of the 10-year and the 2-year bonds has somewhat compressed to 79bps, which is relatively low and reflects a further reduction in the gap, as we estimated during the past two years. Based on the central scenarios within our macro-economic forecasts, we expect the interest rate trajectory over the short- and medium–terms, together with the balance sheet normalization, will support a very modest rise in yields across the entire yield curve over the upcoming months, while the potential for a further decrease in the yields' differential is limited. We expect the yield-to-maturity of the 2-year Treasury bond to rise to 1.3%-1.6% by the end of 2017 (fourth quarter average). The yield of the 10-year bond is expected to reach 2.1%-2.5% by the final quarter of 2017.

Euro Area

Investment growth is expected to remain solid in the short-run:



Recently released economic data and surveys suggest that economic activity continued to grow at a healthy pace in the third quarter, after expanding 0.6% quarter-on-quarter in the second quarter. Based on the second estimate of eurozone Q2 GDP, the annual growth rate was 2.2%, compared to 1.9% in the previous quarter.



Moreover, the latest business surveys attest to positive sentiment in the business sector, which might translate to further growth in investment. The business surveys also suggest that economic activity has continued to grow at a sustained pace over the third quarter and is expected to continue the trend in the fourth quarter.

August's Purchasing Managers' Index and the European Commission's sentiment indicators pointed to strong growth of the euro area private sector, with the rate of expansion remaining at multi-year highs. This is mainly due to strong performance in the manufacturing sector, with both output and new orders rising at sharper rates in August. The latter was boosted by the fastest rise in exports in six-and-a-half years. It should be noted that the risk to exports growth has risen recently due to the continued appreciation in the exchange rate of the euro. If the recent strength of the euro will continue, then exports growth may moderate in the short-run to some extent.

France's economic sentiment has improved significantly. Economic reforms are expected to support further business sentiment and investments: France's annual GDP growth rose in the second quarter to 1.9% - the highest since 3Q11. Based on the monthly data and recent business surveys, the strength is expected to continue in the second half of the year. In August, France's economic sentiment indicator rose to its 76-month high, driven by an improvement in business sentiment in both the industrial and services sectors. The improvement in sentiment was driven by, among other things, optimism arising from pro-business reforms, mainly in the labor market, introduced by the president, Emmanuel Macron.

Currently, the French labor market is characterized by, among other things, labor skills that do not meet employers' needs and demands, thus leading to higher labor-unit costs and lower efficiency. As a result of this mismatch and other structural problems in the French labor market, job creation is relatively low, and the unemployment rate is relatively high at 9.8%.

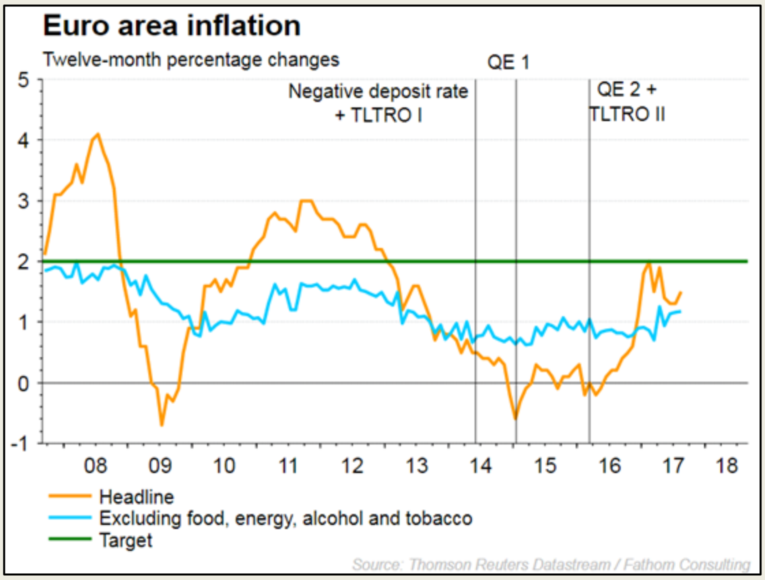
Macron's government unveiled its labor reforms on August 31st. One of the goals of the government is to reduce the unemployment rate to 7% by 2022. Some of the reforms' components include: providing companies with lower hiring and firing costs; reducing the risk of expensive legal disputes with employees; providing employers the flexibility needed to set working conditions, including wages and working hours; and slashing red tape. Regarding the latter, it will exempt companies with over 50 employees from the need to comply with many requirements, such as nominations of workers' representatives, setting up work councils, and health and safety committees.

While businesses applauded these proposed reforms, they have also drawn criticism from trade unions. We estimate these reforms will very slowly increase the incentive of employers to hire new workers and eventually improve the situation in the French labor market, which may support domestic demand in the short-medium term.

The political risk attributed to Germany's election is not significant: Although receding recently, the political risk in the eurozone has remained an important factor. This is mainly due to the political uncertainty in Italy, as the popularity of the Eurosceptic parties remains relatively high. Another political risk in the region is the upcoming general election in Germany. According to the polls, Angela Merkel's party is expected to win in the September 24th general election. However, an unexpected election outcome or a weaker coalition may cause an increase in volatility in financial markets and weigh on economic sentiment.

Overall, based on the economic surveys and other leading indicators, such as new orders and employment data, we expect further growth in the second half of the year. Due to the recent data and improved outlook, we upgraded our eurozone GDP growth estimate for 2017 to 2.0% from 1.9%.

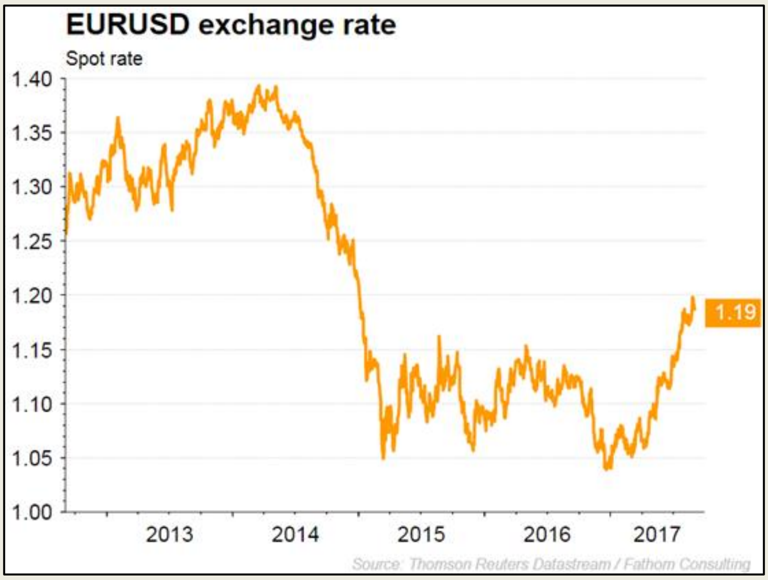
Inflation probably increased more than expected in August, but is expected to remain low in the short-run, as the euro appreciates: According to flash estimates, August inflation in the eurozone increased from 1.3% to 1.5%, which was slightly more than expected (1.4%). The rise was due to a sharper-than-anticipated increase in energy inflation. Core inflation (excluding food and energy) was unchanged at its highest rate since the beginning of 2013 - 1.2%.



As we mentioned previously, some of the recent rise in inflation is a result of some seasonal factors, such as tourism components, and is likely to subside in the coming months, and may weigh on core inflation in the short-run. Moreover, a further appreciation in the exchange rate of the euro may weigh on import price and CPI inflation. Another factor that is expected to weigh on inflation, at least in the short-run, is the continuing spare capacity in the economy, which is being reflected in low wage growth.

Caution in Jackson Hole, stressing the importance of openness: At his speech at Jackson Hole on August 25th, the president of the ECB, Mario Draghi, did not deliver new information or any hints regarding upcoming monetary policy decisions, as we had expected. Rather, he preferred to focus on the theme of the symposium “to foster a dynamic global economy.” In his speech, Draghi focused on, among other things, the importance of boosting productivity growth in order to increase potential output growth that has slowed from around 2% before the financial crisis to 1% today in OECD countries. Draghi also talked about the economic policies that governments should take, emphasizing economic openness for global trade, and warned about the risk of implementing protectionism and of excessively easing financial regulation, echoing some of the words of the chair of the US Federal Reserve, Janet Yellen, in her speech at Jackson Hole.

Monetary policy and forward guidance has not changed as 2017 GDP growth revised upward and 2018-2019 inflation outlook revised downward. Changes to the QE program might be announced in October: At its monetary meeting on September 7th the ECB kept its monetary policy and forward guidance unchanged, as expected. As it did in the past meetings, the ECB repeated its stance that interest rates will remain unchanged for an extended period of time "and well past the horizon of our net asset purchases." Furthermore, the ECB confirmed its net asset purchases program, which is intended to run until the end of December 2017, "or beyond, if necessary".



Moreover, and as expected, the ECB revised up its 2017 growth outlook from 1.9% to 2.2%, supported by improved outlook to domestic demand indicators and downward revisions to unemployment rates. In tandem the ECB left the 2018-2019 growth forecasts unchanged. Regarding inflation environment, the central bank reduced slightly its 2018-2019 both headline and core inflation outlook, partly due to assumptions that the euro effective exchange rate will increase more than previously assumed. At the opening remarks of the press conference, President Draghi stated that the recent volatility in the exchange rate requires monitoring for its medium-term implications for the price stability outlook. These remarks and the changes inflation projection demonstrates the importance of exchange rate developments on the inflation outlook and hence on the future monetary policy decisions.

Macroeconomic Projections for the Euro Area
Annual percentage change, unless otherwise indicated

	September 2017				June 2017			
	2016	2017	2018	2019	2016	2017	2018	2019
Real GDP	1.8	2.2	1.8	1.7	1.7	1.9	1.8	1.7
Headline inflation (HICP)	0.2	1.5	1.2	1.5	0.2	1.5	1.3	1.6
HICP excluding energy and food	0.9	1.1	1.3	1.5	0.9	1.1	1.4	1.7
USD/EUR exchange rate	1.11	1.13	1.18	1.18	1.11	1.08	1.09	1.09
Euro nominal effective exchange rate, annual percentage change	3.8	2.3	2.6	0.0	3.7	-0.4	0.3	0.0

Following the improvement in growth and despite the small downward revision to the inflation outlook, the ECB confirmed that "*this autumn we will decide on the* *calibration of our policy instruments beyond the end of the year*". President Draghi expected that "*the bulk of the decisions would be taken in October*". The ECB may announce in October an extension of its present QE program at a reduced pace of purchases, effective in this year or the next. The ECB might reduce the pace further in 2018. With regard to interest rates, we continue to estimate that an initial interest rate hike may not occur before the end of 2018 - conditional on an improvement in the inflation outlook.

Government bond yields are expected to rise modestly by the end of the year: Government bond yields dropped recently due to an increase in geo-political risks (North Korea), and the eurozone inflation outlook that remained low. We do not rule out a rise in yields in the short-run, supported by the improvement in macroeconomic conditions and the decrease in political risk in the euro area. However, we estimate that the potential for a significant rise in yields is limited due to the low inflation environment and the continuing spare capacity in the economy.

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