Global Economics Monthly Review

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Key Issues

Global Economics – The Big Picture (p. 3)

- *Recent data suggest global economic growth accelerated in the second quarter.*
- *Positive trends in global trade, led by emerging markets.*
- *Global growth is expected to accelerate in 2017-2018.*
- *The risks to our outlook have decreased as the political risks in Europe have diminished recently.*
- *There has been a deceleration in the inflation environment.*
- *A more hawkish tone is expected, and maybe some monetary adjustments.*

Global Economic Forecast Table (p. 5)

United States (p. 6)

- *Second quarter data point to a rebound in growth after the transitory weakness in the first quarter.*
- *A further deceleration in the inflation environment.*
- *Gaps between the Fed's interest rate projections and market expectations.*
- *The rise in European government bond yields supported a recent rise along the US yield curve.*

Euro Area (p. 11)

- *Growth was relatively strong in the second quarter.*
- *Inflation remained low in June. Core inflation is expected to rise slowly.*
- *The ECB may make subtle adjustment to its monetary policy.*
- *The ECB's recent comments pushed the effective exchange rate of the euro upwards, as well as government bond yields.*

United Kingdom (p. 14)

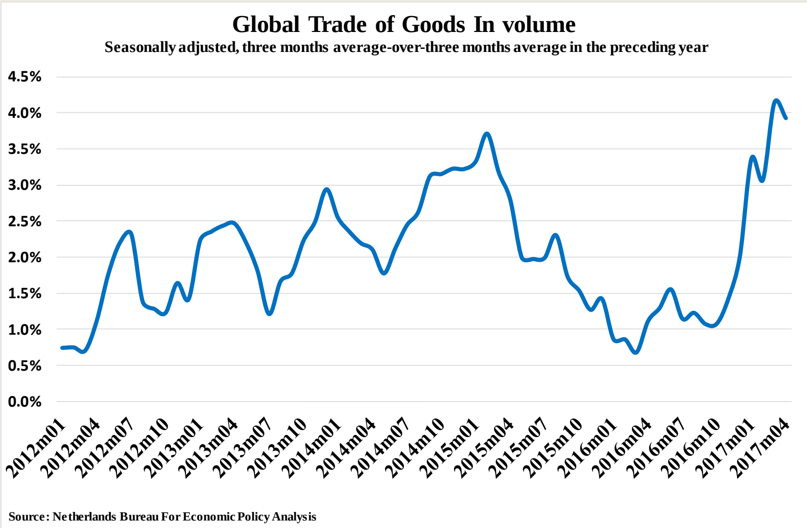
- *Modest acceleration in economic growth in the second quarter.*
- *Unpredictably, the BoE became more hawkish due to the rise in inflation.*

Global Economics – The Big Picture

It appears global economic growth accelerated in the second quarter: Recently released data point to some acceleration in global growth in the second quarter. The US economy is expected to rebound after it experienced slow economic growth in the first quarter. The eurozone economy is expected to maintain its relatively solid pace of growth, as some soft data items point to a slight acceleration in second quarter GDP growth compared to the first quarter.

Economic data from other major advanced economies also point to a pick-up in activity. Both the manufacturing PMI and the Bank of Japan's quarterly Tankan survey suggest that activity in Japan has accelerated, while the average reading for the UK manufacturing PMI in the second quarter was at its highest in three years. In contrast, it seems that China slowed in the second quarter from the relatively solid first quarter growth.

A positive trend in global trade, led by emerging markets: Based on the Netherlands CPB Bureau, global trade volumes fell in April, reversing the rise in the previous month. However, looking through the volatile monthly data, the growth of world trade volumes has picked up markedly since late last year, as growth has picked up in almost all the world's major advanced economies. Export volumes from emerging economies have been rising faster than those from advanced economies during the past six months.



The improvement in global trade is expected to continue at least in the short-run. One of the main risks to global trade is trade protectionism measures that might be taken by the US administration against some of its trading partners. That said, it should be noted that the threats made by the president of the US, Donald Trump, during his presidential campaign have failed to materialize so far, and we estimate it will be difficult for him to fulfill his trade agenda.

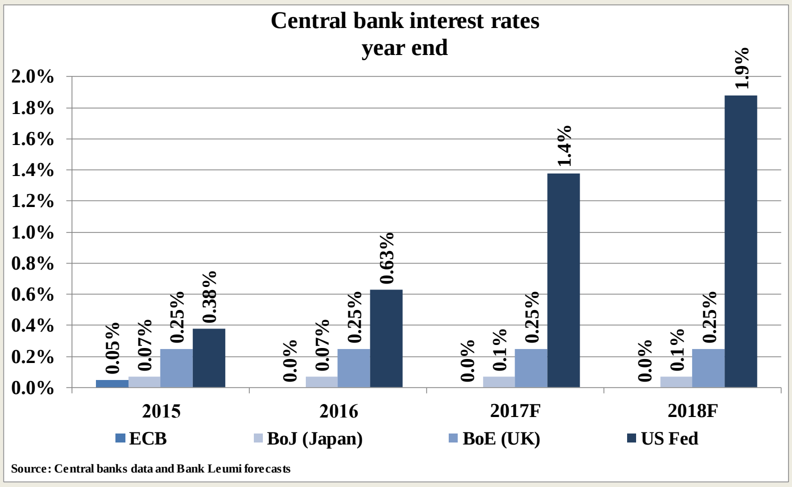
Global growth is expected to accelerate in 2017-2018. The risks to our outlook have decreased as the political risks in Europe have diminished recently: Based on leading indicators such as new orders, employment data, and economic sentiment indices, the economic recovery is expected to continue at least in the short-run. The improvement in the advanced economies is expected to support further improvement in export-oriented emerging markets. We maintain our global GDP growth forecast for 2017 at 3.3%, compared to 3.1% in 2016.

Global growth is expected to accelerate further, albeit insignificantly, in 2018. The risks to our economic outlook became more balanced recently, as the political risks in Europe have diminished recently. The French president, Emmanuel Macron, and his new centrist movement won a large majority in the French parliament, while in Italy the second round of local elections showed a victory for the center-right parties over the center-left parties. Moreover, it seems that the euro-sceptic 5-star party has been losing power in the polls recently.

Deceleration in the inflation outlook: Inflation has softened in the past few months as the oil price recovery effects faded, and as commodity prices decreased recently. The recent decline in commodity prices pushed inflation expectations downward. Moreover, muted wage growth continues to weigh on core inflation in tandem with other factors. In contrast, inflation in the UK continued to rise, driven mainly by the rise in imported prices as a result of the depreciation in the effective exchange rate of the pound and its pass-through to inflation.

Despite the recent moderation in the inflation outlook, some central banks, such as the US Federal Reserve, believe that the continuous improvement in the labor markets, especially the decline in the unemployment rate, will drive inflation upward. In contrast, the European Central Bank (ECB) and Bank of Japan (BOJ) sound more cautious on inflation. We expect a slow and gradual rise in inflation over 2017 and 2018.

More hawkish tone expected and maybe some monetary adjustments: Overall, the past month was characterized by a hawkish atmosphere among central banks around the world. The US Fed raised the interest rate, while interest rate projections did not change, and the central bank released an operational detailed statement for decreasing its balance sheet. The ECB changed it forward guidance and claimed that it



may make some adjustments to its monetary policy. The Bank of England (BoE) surprised, as three out of its eight members voted to increase interest rates compared to only one member in the previous meeting. The BOJ upgraded its economic assessment.

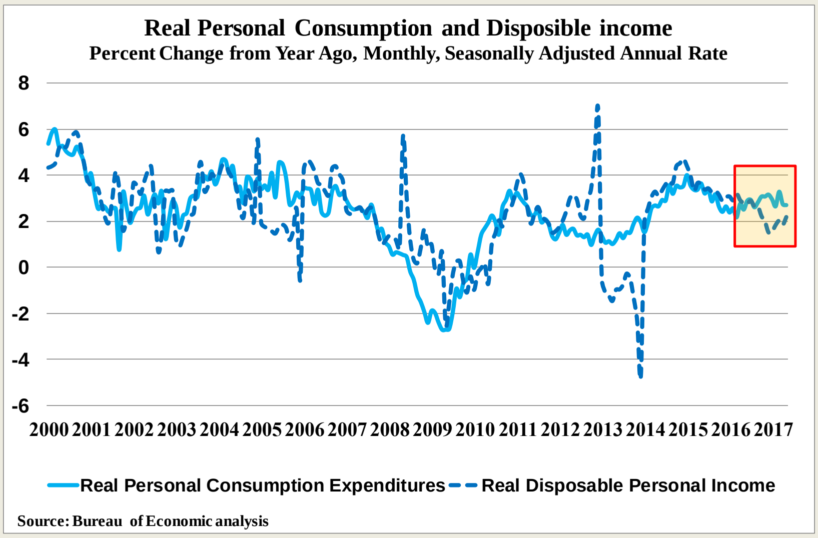
Looking forward, we expect that the continuing improvement in economic activity, in tandem with a return to normal and sustainable inflation levels, may continue to affect central bankers' rhetoric toward the hawkish side. We believe that some of the central banks will take small steps towards policy normalization (mainly through the scaling down of unconventional monetary tools) before starting actual interest rate normalization. Monetary policy in the US will be an exception among the major developed economies, as the tightening process is expected to continue at a moderate and gradual pace.

Leumi Global Economic Forecast, As of July 2017

	2015	2016	2017F	2018F
GDP – Real Growth Rate				
World	*3.3%*	*3.1%*	*3.3%*	*3.5%*
USA	*2.6%*	*1.6%*	*2.2%*	*2.3%*
UK	*2.2%*	*1.8%*	*1.6%*	*1.4%*
Japan	*1.3%*	*1.0%*	*1.3%*	*1.0%*
Eurozone	*2.0%*	*1.7%*	*1.8%*	*1.6%*
South East Asia (ex. Japan)	*4.5%*	*4.5%*	*5.9%*	*5.8%*
China	*6.9%*	*6.7%*	*6.6%*	*6.3%*
India	*7.9%*	*7.2%*	*7.1%*	*7.5%*
Latin America	*0.1%*	*-0.6%*	*1.3%*	*2.4%*
Israel	*2.5%*	*4.0%*	*3.2%*	*3.9%*
Trade Volume, Growth (%)				
Global	*2.5%*	*1.9%*	*3.8%*	*3.9%*
CPI, Annual Average (%)				
USA	*0.1%*	*1.3%*	*2.3%*	*2.2%*
UK	*0.1%*	*0.7%*	*2.7%*	*2.7%*
Japan	*0.5%*	*1.0%*	*0.6%*	*0.8%*
Eurozone	*0.8%*	*-0.1%*	*1.6%*	*1.5%*
Israel	*-0.6%*	*-0.5%*	*0.4%*	*1.0%*
Interest rates, Year End				
US Fed	*0.25-0.50%*	*0.50-0.75%*	*1.25-1.50%*	*2.00-2.25%*
Bank of England	*0.50%*	*0.25%*	*0.0-0.25%*	*0.0-0.25%*
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

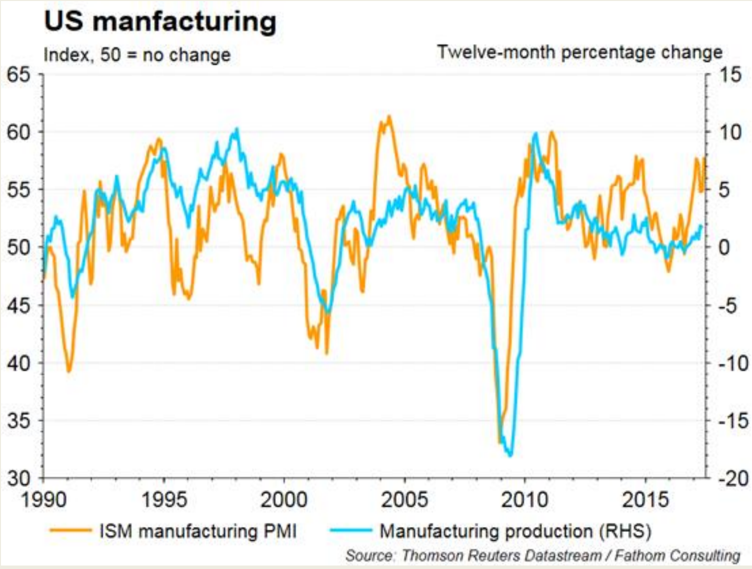
Second quarter data point to a rebound in growth after the transitory weakness in the first quarter: According to the third estimate released by the US Bureau of Economic Analysis (BEA) on the national accounts data for the first quarter, GDP growth was revised upward to 1.4% annualized, compared to 0.7% in the advance estimate. This change was mainly based on an upward revision to private consumption. Economic data for April-June were mixed, but point to an acceleration in economic growth in the second quarter from the low point in the first quarter.



On the household front, nominal personal spending rose modestly in May, as expected, but on a year-on-year basis, it rose at a better pace of 2.7%. The encouraging news came from the income side of the report, showing a solid rise in disposable income. We expect personal consumption to keep rising, but its contribution to GDP growth may somewhat decrease in the short- and medium-terms due to, among other things: uncertainty regarding the future of healthcare costs; a moderation in employment growth; rising household debt; and a gradual, moderate rise in interest rates.

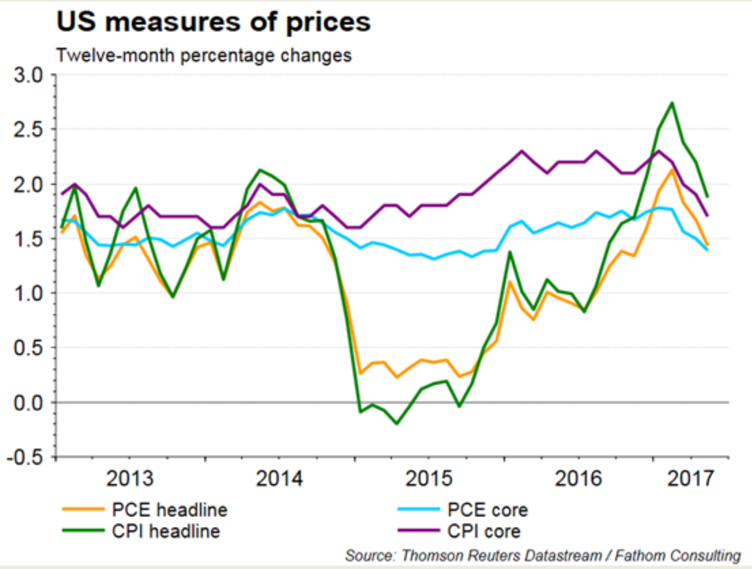
The trade deficit narrowed in May as export growth outpaced that of imports. It should be noted that in the past year exports have been growing relatively solidly, supported by the upturn in global growth and the depreciation in the effective exchange rate of the US dollar, which is expected to lead to solid export growth at least through 2017. The risk to this view involves a unilateral change to US trade policy vis-à-vis its trading partners, but this risk has diminished recently. Industrial production stagnated in May after a solid rise in April. Based on the average data from April-May, industrial production growth accelerated in the second quarter compared to the first quarter, driven by, among other things, mining production.

Other manufacturing indices, such as the ISM, the US Philadelphia Fed Manufacturing Index, and the Empire State Manufacturing Survey, point to an improvement in manufacturing output in the second quarter, as well as in the months ahead. The relatively healthy domestic demand, in tandem with the improvement in external demand, are expected to somewhat support manufacturing and investment. On the other hand, the uncertainty regarding economic policy and the recent drop in commodity prices may limit the potential recovery in the sector.



All in all, the recently released monthly data and surveys suggest that economic growth has somewhat accelerated in the second quarter, following the transitory weakness in the first-quarter. Based on the Bloomberg Consensus, GDP growth is expected to rebound to around 3% in Q2. For the full year, we expect 2017 growth of 2.2%, from 1.6% in 2016, driven mainly by domestic demand. As we mentioned in our previous economic report, one of the main risks to our forecast involves uncertainty regarding the economic policy that will actually be implemented by the Trump administration. For more information and views please see our June and previous global economics editions.

Further deceleration in the inflation outlook: PCE inflation fell further in May. Headline PCE inflation declined to 1.4% year-on-year from 1.7%, and core PCE inflation fell also to 1.4%, from 1.5%. Food prices remained flat on the month, while energy prices fell a sharp 3.0% month-on-month. It should be noted that some of the factors that caused the deceleration in core inflation recently include:



wireless services prices, used car prices, apparels, and some moderation in accommodation prices.

The recent moderation in inflation has been, to some extent, due to competitive pressures, transitory oversupply forces in specific sectors, and muted wage growth. Looking forward, we do not expect significant inflationary pressures in the short-run. It should be noted that recent economic developments forced financial institutions to revise downward their 2017 inflation forecasts. All in all, we expect the main inflation indicators to be close to, or above, the Fed's inflation target of 2% in the short-run, supported by healthy domestic demand and the depreciation of the USD.

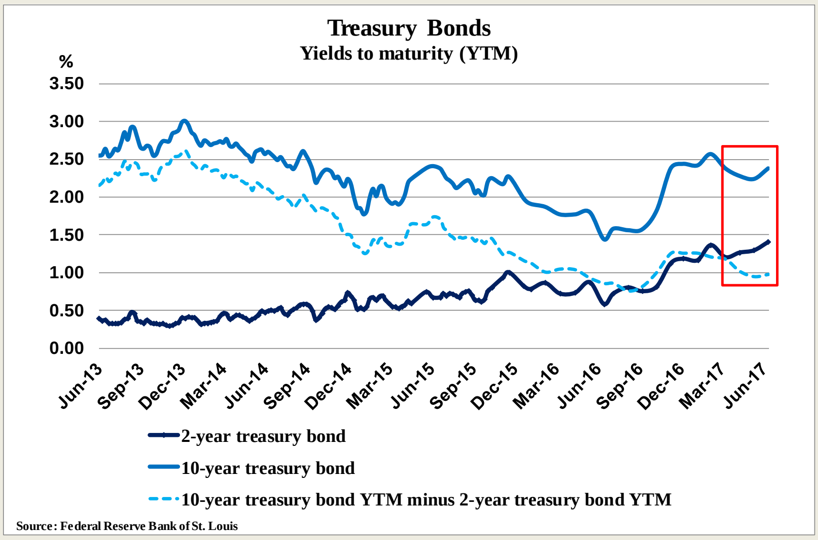
Gaps between Fed's interest rate projections and market expectations: At its last meeting on June 14th the Fed raised the interest rate by an additional 25bps, and it stands now at between 1.00% and 1.25%. With regard to the future path, the median interest rate projections remain unchanged at 1.4% for year end 2017 and 2.1% for year-end 2018, implying one more rate hike this year and an additional three hikes next year.

The recent weak growth in core consumer prices in the past few months caused a downward revision to 2017 inflation forecasts. The Fed estimates that the weakness is transitory; hence, despite pulling down its median forecast for core PCE inflation for this year from 1.9% to 1.7%, it still expects a rebound to the 2% target next year. Simultaneously, it added in the accompanying statement that it is “monitoring inflation developments closely".

In addition, the median forecast for GDP growth was almost unchanged, even though the unemployment rate was revised downward in 2017-2019, this probably due to the remaining slack in the labor market (low participation rate, low productivity, etc.). In addition, as widely expected, the Fed updated its policy normalization principles, and plans to reduce securities holdings. Initial cap sizes on maximum monthly principal reduction will be US$6bn for Treasuries and US$4bn for mortgage-backed securities, and these will be increased every three months until the monthly cap is US$30bn for Treasuries and US$20bn for mortgage-backed securities.

Looking forward, based on the Fed’s projections and its latest press conference, it seems the Fed is determined to increase the interest rate one more time this year, probably in December, and four times in total by the end of next year. Our central scenario also estimates four hikes by the end of 2018. In contrast, investors expect only two hikes by the end of next year, reflecting a relatively large gap between the policy makers' projections or intentions and market expectations. It should be noted that market expectations have increased recently due to the hawkish communication of the Fed's officials and some hawkish statements of central bankers around the world. In our opinion, the risks to our estimates have increased due to the recent fall in core inflation and uncertainty regarding fiscal policy.

Europeans' central bankers' hawkish messages and Fed's projections supported a recent rise along the US yield curve: The short-end of the yield curve increased further in the past month as the Fed has not changed its interest rate projections for the short- and medium-terms. In the past month, the yield-to-maturity of the 2-year Treasury bond rose further by more than 10bps to 1.4% (as of July 6th). In tandem, the 10-year yield rose by almost 20bps since June 27th after trending around its eight-month low. The rebound was driven, to some extent, by the rise in European government bond yields (see eurozone chapter).

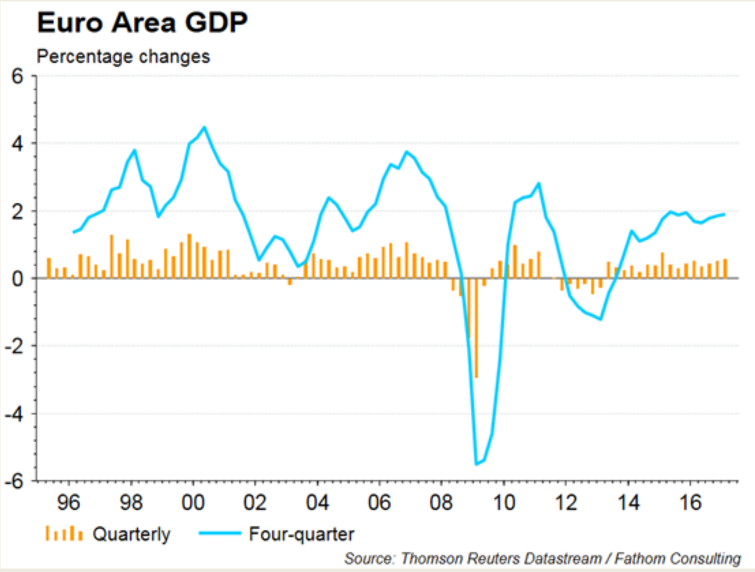


The current differential between the 10-year and the 2-year bonds is still relatively low at 93bps. The yield curve has been flattening since mid-December 2016 when the differential between the 2-year yield and the 10-year counterpart was above 130bps. The flattening in the past few months reflects the change in investors' perceptions and uncertainty with regard to the ability of the Trump administration to implement its economic policy agenda, and as a result the downward revisions to GDP growth, inflation, and interest rate expectations.

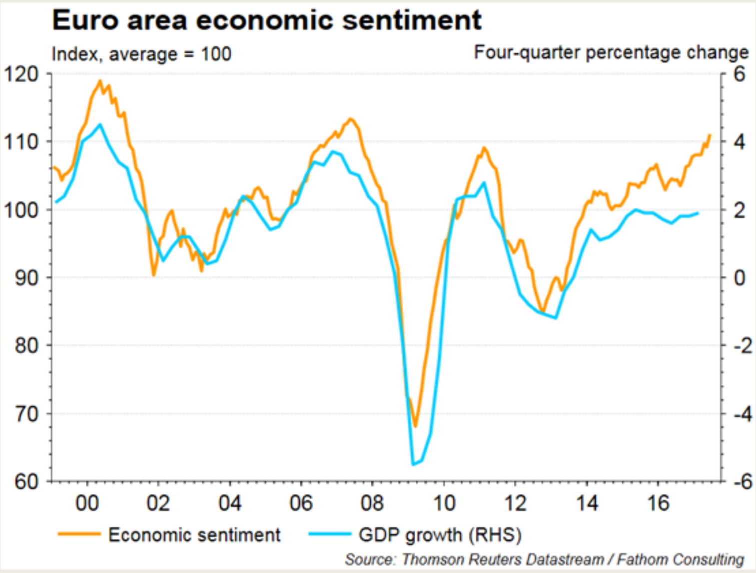
Based on the central scenarios within our macro-economic forecasts, we expect yields to rise across the entire yield curve over the upcoming months, albeit moderately. We expect the yield-to-maturity of the 2-year Treasury bond to rise to 1.4%-1.6% by the end of 2017 (fourth quarter average). The yield of the 10-year bond is expected to reach 2.3%-2.5% by the final quarter of 2017.

Euro Area

The growth outlook is expected to be relatively strong in the second quarter: Euro area final Q1-17 GDP growth was revised up to 0.6% q/q compared to 0.5% in the previous reading. As in the previous first quarter's reading, domestic demand was the main contributor to growth, as net trade contribution was muted. Recently released hard data and business surveys point to a further positive trend in the second quarter.

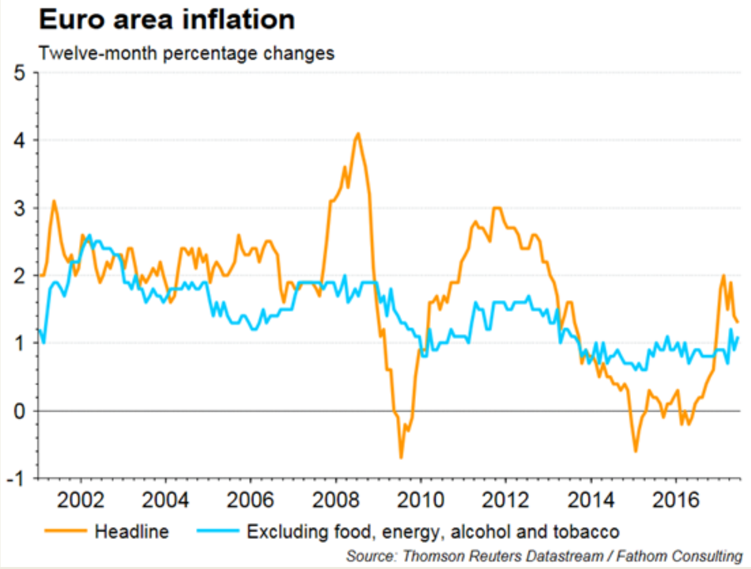


While industrial production figures were slightly soft, consumer spending data point to an acceleration in growth in Q2. The improving growth environment is also reflected in the credit market, as lending to both households and non-financial corporations continues to grow at a solid pace. Based on past standards, the Economic Sentiment Indicator points to some acceleration in Q2 (2.5% year-on-year from 1.9% in Q1) but it may overstate growth as it did in the past quarters. The PMI survey points to quarterly GDP growth matching Q1's 0.6%. This rate would still lift up the annual growth rate, but to a more moderate rate of 2.1%.



All in all, the improvement in euro area economic activity has continued in the beginning of the second quarter. One of the main risks that may weigh on activity is the political risk, which receded after the results of the French presidential election and parliamentary elections and the decrease in the probability for a snap election in Italy.

Looking forward, we cannot rule out an additional upward revision to our 2017 growth forecast (1.8%).



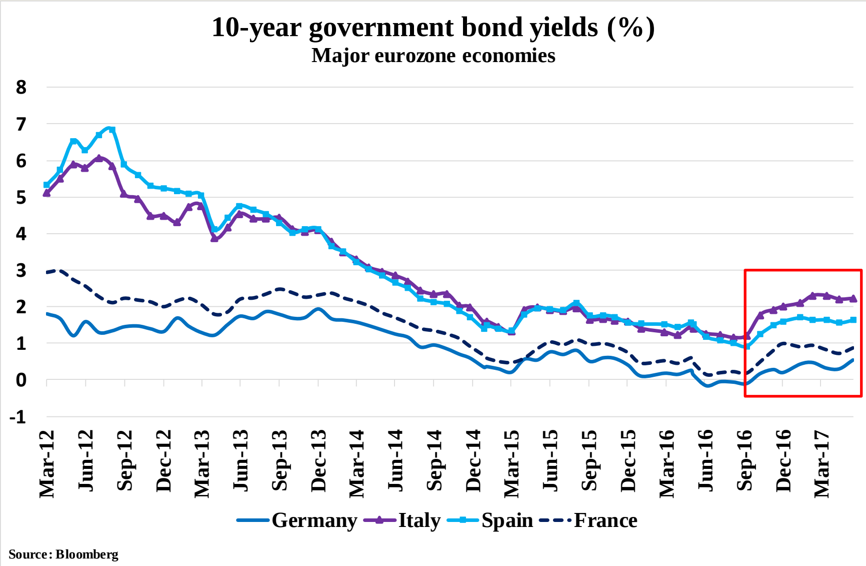
Inflation remained low in June. Core inflation is expected to rise slowly: According to flash estimates, eurozone inflation fell from 1.4% to 1.3% in June, while the consensus expected a slightly sharper fall to 1.2%. The decline in inflation was mainly due to the fall in energy prices. Meanwhile, core inflation increased from 0.9% to 1.1%. Despite the encouraging increase, core inflation is still well below the ECB's near-2% medium-term target for the headline rate, and there is still a variation in core data among the eurozone countries. Looking forward, core inflation is expected to rise as unemployment falls modestly and inflation expectations somewhat increased. However, the rise in core inflation is expected to be very moderate due to the continuing spare capacity and output gap in some of the major eurozone countries, including Italy and France.

The ECB may make subtle adjustments to its monetary policy. Monetary conditions have tightened recently: In its last meeting on June 8th, the ECB left its policy unchanged as expected, with all three key interest rates on hold and asset purchases of €60bn per month set to run until the end of this year "or beyond, if necessary". The significant change in the ECB's communication was that interest rates are now expected "to remain at present levels for an extended period", rather than "at present levels or lower" previously. The change was expected. The change reflected the Governing Council's view that the risk of deflation has "definitely gone" and that risks to growth are now "broadly balanced", rather than being to the downside.

The ECB highlighted the recent improvement in the growth environment, as reflected also in business sentiment surveys. The positive tone was also reflected in the growth outlook, which was revised upward from 1.8% to 1.9% this year and by 0.1 percentage points to 1.8% and 1.7% in 2018 and 2019, respectively. In contrast, the ECB revised downward its inflation forecasts to 1.5% for this year, 1.3% for 2018 and 1.6% for 2019 (previously 1.7%, 1.6% and 1.7%, respectively).

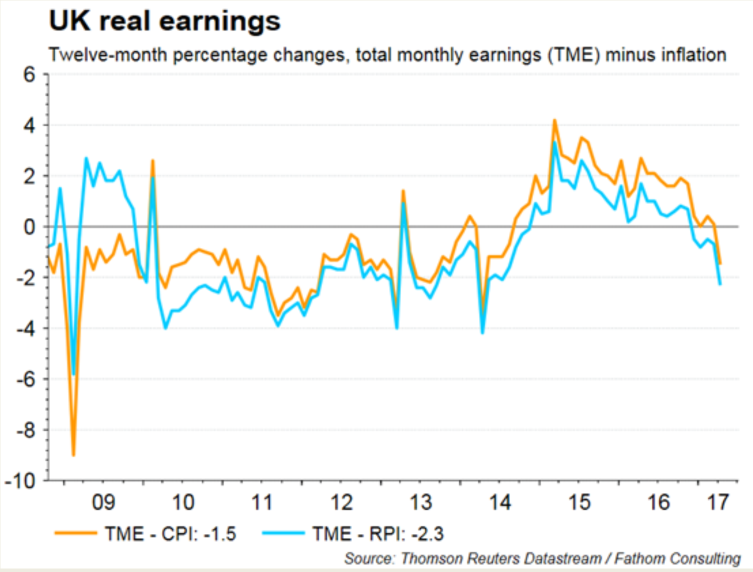
Recently, the ECB's president, Mario Draghi, said "as the economy continues to recover, a constant policy stance will become more accommodative, and the central bank can accompany the recovery by adjusting the parameters of its policy instrument". This statement is in line with our views. We expect the ECB to taper further, moderately and gradually, its QE purchases, most likely by the end of the year or in the beginning of next year. Furthermore, we do not expect the ECB to increase the interest rate in the short-run, nor do we expect any hikes as long as the inflation outlook remains low. It should be noted that the ECB has repeatedly said it will not hike the interest rate until "well beyond the horizon of net asset purchases".

It should be noted that as a result of the comments by Mario Draghi, the eurozone's monetary conditions have tightened since the last week of June as government bond yields rose, in tandem with the moderately increasing trend in the past few month, and the effective exchange rate of the euro has appreciated. At this point, we do not estimate that the current tightening will derail the current improvement in economic activity.



United Kingdom

Modest acceleration in economic growth in the second quarter: National accounts data confirm that the pace of growth of the UK's economy slowed sharply in the first quarter of the year, with growth of 0.2% q/q following 0.7% in the previous quarter. The composition of growth in the first quarter was also discouraging, as household consumption growth moderated to a very low rate of 0.4%, and this after the savings ratio fell to 1.7%, which is the lowest rate since records began in 1960.



Domestic demand may suffer from headwinds in the short-run due to the rise in inflation against the backdrop of the fall in the effective exchange rate of the pound. The rise in inflation erodes households' real earnings and purchasing power and weighs on consumption, in tandem with the slowdown in employment growth. In addition, the political uncertainty against the backdrop of the Brexit process may continue to weigh on investment sentiment during the current year and next year. That said, the softening in domestic demand is expected to weigh on import growth, while the depreciation of the pound in tandem with the global recovery are expected to support export growth.

These developments are expected to give some support to overall economic growth in the UK. Business surveys currently point to some acceleration in GDP growth in the second quarter. We maintain our estimates and expect growth to moderate to 1.6% in 2017 from 1.8% in 2016, with further moderation to 1.4% in 2018.

The BoE became more hawkish due to the rise in inflation: At its last monetary meeting on June 15th, the BoE left monetary policy unchanged, as expected. However, there was a significant surprise as three out of eight members voted to increase interest rates 25bps, while the consensus had expected that only one member would maintain their call for a rate hike. The more hawkish position of the MPC reflects the fact that inflation has accelerated faster than was expected in the past few months. Inflation is now forecast to exceed 3% "by the autumn" this year, while the strength of employment has continued to erode slack in the labor market.

In contrast, weak growth in wages and the slowdown in the housing market were cited as factors justifying leaving rates on hold. Another factor that probably affected the

MPC members’ decisions is the increase in the degree of uncertainty regarding the negotiations surrounding Brexit, and the recent weakness in domestic demand. Based on a survey by Consensus Economics, inflation estimates were revised slightly upward and growth forecasts were revised downward. As a result of the interest rate decision and following the release of the minutes, market interest rate expectations shifted sharply and now imply that rates will begin rising by the end of 2019, approximately one year earlier than priced the day before the monetary meeting. We expect BoE monetary policy to remain unchanged at least until the end of 2018. The BoE’s outlook on the economy and shift in policy stance might be affected in the foreseeable future by the developments and consequences of the Brexit negotiations.

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