# Global Economics Monthly Review

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# Key Issues

## Global Economics – The Big Picture (p. 3)

- *An acceleration in second quarter growth has been led by the advanced economies.*
- *"Soft" data point to further growth in the beginning of the third quarter.*
- *We have slightly revised upward our 2017 global growth outlook.*
- *Inflation environment moderated recently, but the potential for further significant decreases in inflation is limited.*
- *Mixed messages from central bankers.*

## Global Economic Forecast Table (p. 4)

## United States (p. 5)

- *GDP growth accelerated in the second quarter, supported by domestic demand.*
- *Base effects are expected to keep core inflation below the Fed's target in the short-run.*
- *Balance sheet normalization may start soon.*
- *Unlike the market's view, we expect one more rate hike this year and additional two hikes in 2018.*
- *The rate hike trajectory and balance sheet normalization may support a rise, albeit modest, in government bond yields.*

## Euro Area (p. 8)

- *Both domestic and external demand support economic growth in the euro area.*
- *Economic growth is expected to remain solid in the third quarter.*
- *Inflation is expected to remain low in the short-run, at least, as wage growth remains muted and the euro appreciates.*
- *ECB: "reassess the monetary policy parameters sometime until the autumn".*
- *The potential for a significant rise in government bonds yields is limited.*

# Global Economics – The Big Picture

**Acceleration in second quarter growth led mainly by the advanced economies:** Based on preliminary national accounts reports from the major economies, we believe global growth accelerated in the second quarter of the year. According to the available GDP data, the acceleration in global growth was led by the advanced economies, supported by domestic demand in the US economy (see US chapter), a slight expansion in the eurozone (see the eurozone chapter), and growth in the UK economy. Other data from the second quarter of the year point to expansion in economic activity in Japan, Australia, and Switzerland.

With respect to the major emerging economies (EM), China showed some resilience in the second quarter of the year, as GDP growth increased 6.9% year-on-year, the same growth rate as in the previous quarter, and slightly higher than the average over the past six quarters. This may suggest that China's economic activity has been stabilizing recently. Looking forward, growth in China may moderate in the second half of the year as the Chinese government is expected to continue to lead regulatory steps and reforms in order to reduce the financial risks in the private and financial sectors.

**The third quarter started on a positive note. We have slightly revised our growth outlook upwards:** Although the global composite PMI decreased in July due to a slight fall in the services PMI, the current index's level is on a consistent and steady growth path. Although output increased at a slightly reduced pace, accelerated growth of new orders, work backlogs, and employment suggests that the current pace of economic expansion will be sustained during the coming months. Moreover, surveys suggest that the developed economies had (on average) a steadying influence over the global economy in July.

Output across these nations rose at a robust rate that was broadly unchanged from those registered during the first half of the year, while economic growth in emerging economies moderated. Based on second quarter GDP data and leading indicators such as new orders, employment data, and economic sentiment indices, we decided to slightly revise upward our 2017 growth estimate by 0.1 percentage point to 3.4%, following 3.0% growth in 2016, and keep our 2018 estimate unchanged.

**The inflation environment fell recently, but the potential for further decreases is limited:** Headline inflation has decreased in the past few months in advanced economies, mainly due to a decrease in energy prices since the beginning of the year. The recent rise in oil and other commodity prices may support headline inflation in the upcoming months. Core inflation has been more stable in the developed world as a whole, but it also moderated due to both temporary and structural changes (read more in the US and eurozone chapters). Moreover, muted wage growth may continue to weigh on core inflation in the short-run at least. Despite the recent moderation in the

inflation outlook, some central banks, such as the US Federal Reserve, believe that the continuing improvement in the labor markets, especially the decline in the unemployment rate, will drive inflation upward in the medium-term. We expect a slow and gradual rise in inflation over 2017 and 2018.

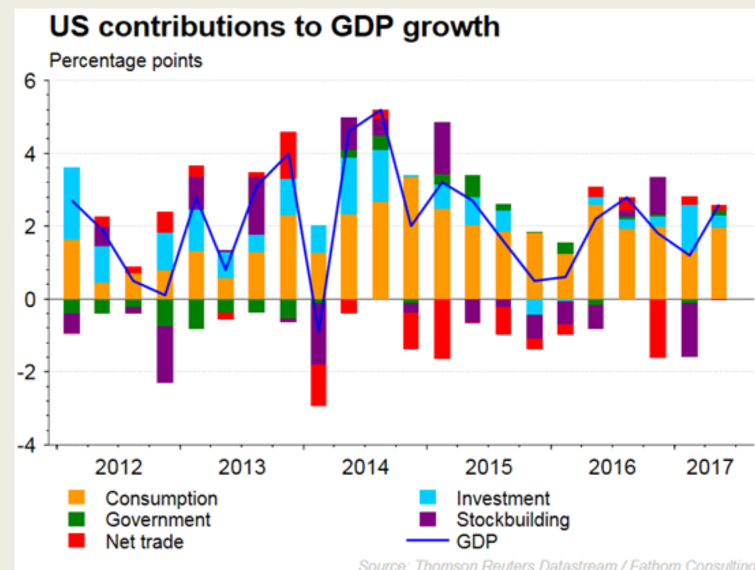
**Mixed messages from central bankers**: With regard to monetary policy, we expect the ongoing improvement in economic activity to continue to influence central bankers' rhetoric toward the hawkish side, although they will be cautious. However, due to spare capacity, the slow process of returning to inflation targets, and risks to growth, the global monetary normalization process is expected to be very slow and gradual. Some central banks are expected to take small steps towards policy normalization, mainly through the scaling down of unconventional monetary tools, before starting actual interest rate normalization. The normalization process in the US will probably be slightly faster than in other major developed economies.

***Leumi Global Economic Forecast, As of August 2017***

| | 2015 | 2016 | 2017F | 2018F |
|---|---|---|---|---|
| **GDP – Real Growth Rate** | | | | |
| *World* | *3.3%* | *3.0%* | *3.4%* | *3.5%* |
| *USA* | *2.9%* | *1.5%* | *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%* | *1.9%* | *1.7%* |
| *South East Asia (ex. Japan)* | *4.5%* | *4.5%* | *5.7%* | *5.8%* |
| *China* | *6.9%* | *6.7%* | *6.6%* | *6.3%* |
| *India* | *7.9%* | *7.1%* | *7.1%* | *7.3%* |
| *Latin America* | *0.1%* | *-0.8%* | *1.2%* | *2.3%* |
| *Israel* | *2.5%* | *4.0%* | *3.2%* | *3.8%* |
| **Trade Volume, Growth (%)** | | | | |
| *Global* | *2.5%* | *2.1%* | *3.8%* | *3.9%* |
| **CPI, Annual Average (%)** | | | | |
| *USA* | *0.1%* | *1.3%* | *2.1%* | *2.1%* |
| *UK* | *0.1%* | *0.7%* | *2.7%* | *2.7%* |
| *Japan* | *0.5%* | *1.0%* | *0.5%* | *0.8%* |
| *Eurozone* | *0.8%* | *-0.1%* | *1.5%* | *1.5%* |
| *Israel* | *-0.6%* | *-0.5%* | *0.1%* | *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%* | *0.25%* | *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

**GDP growth accelerated in the second quarter, supported by domestic demand:** According to the advance estimate released by the US Bureau of Economic Analysis (BEA) on the national accounts data, US GDP increased at an annual rate of 2.6% in the second quarter of 2017. This figure is close to the consensus estimations and follows a modest 1.2% increase in the first quarter (revised downward from the previous estimate). On a year-over-year basis, the US economy grew 2.1%, which is the highest rate since Q3-2015. The rebound in activity was driven by domestic demand, mainly personal consumption expenditure, with consumption of both durables and nondurables rising strongly. Non-residential investment grew solidly as well, driven by investment in equipment, while government expenditure also contributed positively after decreasing in the first quarter.




In addition, net trade also contributed to Q2 growth, for the second quarter in a row, as exports continued to grow solidly, supported by the positive effects from further improvement in global growth demand and the weaker US dollar. On the other hand, residential investment dropped in the second quarter after increasing substantially in the previous two quarters. Moreover, private inventories stabilized in the second quarter after declining 1.5 percentage points in the first quarter.

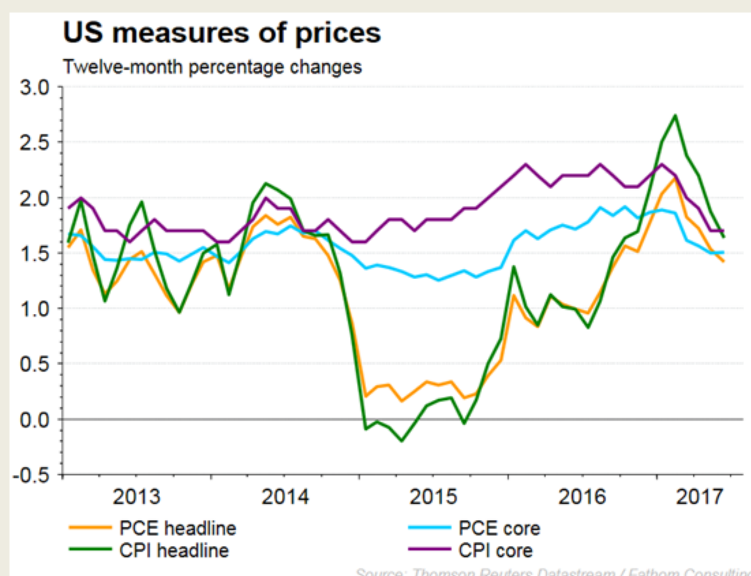
The national accounts figures confirm that the slow growth in the first quarter was temporary and resulted from, among other things, technical factors and residual seasonality. Furthermore, the results also confirm that the US economy continues to be driven by private consumption, while business investment has recovered recently, supported by a sustained period of positive business optimism as domestic and external demand continue to improve.

**Leading indicators point to further growth around 2% in the H2-2017:** The positive trend in residential investment is expected to continue, supported by the improvement in the financial situation of households (the decrease in the second quarter was probably temporary) and an ongoing increase in the homeownership rate. It should be noted that final sales of private domestic purchases, which are used as a gauge for

"core" domestic demand, somewhat moderated in the second quarter (2.7% quarter-on-quarter annualized versus 3.1% in the first quarter), but are still slightly above the two-year average. We expect the strength in domestic demand to continue in the second half of the year at least. Furthermore, the increase in external demand, with an increase in global trade volumes, in tandem with the improvement in the competitiveness of US goods and services, are also expected to remain supportive of net trade for the rest of the year. Recently released business surveys and leading indicators (for example new orders, employment data, consumer confidence, and ISM manufacturing) suggest that the US economy is expected to continue growing at a rate of around two percent (in real terms) in the second half of the year.

One of the main risks to our growth outlook involves uncertainty regarding the economic policy that will ultimately be implemented by the Trump administration. Absent progress on policy issues, such as fiscal policy reforms, healthcare, deregulation, and international trade, suggests that economic growth may be constrained to a pace of not much more than 2% in the short-run. We maintain our 2017 GDP growth estimate unchanged at 2.2%, similar to consensus, up from 1.5% in 2016.

**Base effects are expected to keep core inflation below the Fed's target in the short-run:** June inflation data were mixed. Headline and core PCE inflation data were in line with consensus estimations while the CPI's data surprised slightly to the downside. Recent months were characterized by a moderation in the inflation environment, which was concentrated in just a few components, including energy prices, wireless prices, vehicle prices, airline fares, hotel prices, and apparel.




At her testimony to Congress, the Federal Reserve's chair, Janet Yellen, commented that "*the recent lower readings on inflation are partly the result of a few unusual reductions in certain categories of prices,*" and that the FOMC continues to expect that inflation will rise to 2 percent *"…(as) ongoing job gains should continue to support the growth of incomes*". The recent moderation in inflation has been, to some extent, due to competitive pressures, transitory oversupply forces in specific sectors, and muted real wage growth. Some of these factors may weigh on inflation in the short-run, but the probability for a significant moderation is limited. It should be noted that recent

developments forced financial institutions to revise downward their 2017 inflation forecasts. All in all, we estimate PCE inflation will be relatively low through early next year due to the negative base effects from the transitory factors mentioned above.

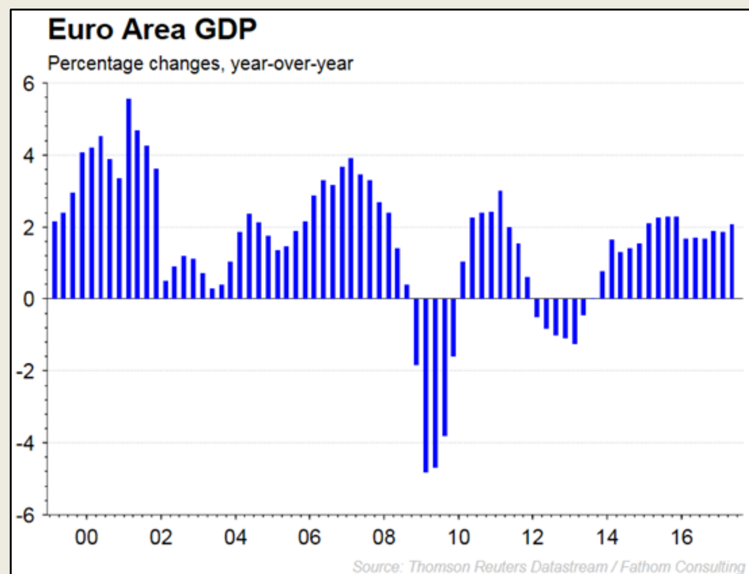
**Balance sheet normalization may start soon. Unlike the market, we expect one more rate hike this year:** The statement from the last monetary meeting on July 26th revealed that the Fed expects to begin implementing its balance sheet normalization *"relatively soon"*. We expect that the normalization process will start this year. Moreover, despite the slightly dovish tone with respect to inflation, we still expect that the Federal Reserve will raise the interest rate one more time this year.

If inflation will moderate unexpectedly and the FOMC's inflation forecasts for 2017 and 2018 will be revised substantially downward, then there could be a delay in the Fed's tightening cycle. Most FOMC members have concerns over the inflation outlook, and seem to prefer a more cautious approach as long as uncertainty exists. Regarding 2018, we expect two to three rate hikes, depending on several factors: how the economy evolves, the changes in US economic policies, shifts in economic uncertainty, and the volatility in the financial markets, which is close to the all-time low. In contrast, investors expect a single hike by the end of next year (low probability for a second hike), reflecting a relatively large gap between the policy makers' projections (four hikes until the end of 2018) and market expectations.

**The rate hike trajectory and balance sheet normalization may support some rise in government bond yields:** 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 economic policy, especially the healthcare and tax reforms, along with the mixed data on activity and inflation. The yield-to-maturity of the 2-year Treasury bond decreased 6bps to 1.36% (as of August 3rd). Simultaneously, the 10-year yield decreased 9bps in the last month to 1.26%, after rebounding during the month of June.

The current differential between the yields-to-maturity of the 10-year and the 2-year bonds has somewhat compressed to 90bps, which is relatively low. This may be a reflection of investors' perceptions and uncertainty with regard to the ability of the Trump administration to implement its economic policy agenda, and the decrease in interest rate expectations. 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 modest rise in yields across the entire yield curve over the upcoming months. 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




***Both domestic and external demand support economic growth in the euro area:*** The preliminary flash estimate of euro area GDP shows that GDP growth accelerated in the second quarter of the year to 0.6% quarter-on-quarter from the downward revised GDP figure for Q1 (cut 0.1 percentage point to 0.5% quarter-on-quarter). On a year-on-year basis, euro area economic activity growth accelerated from 1.9% to 2.1%, similar to the US growth rate. However, on a per-capita basis, the euro area economy continues to expand at a greater pace than the US economy.

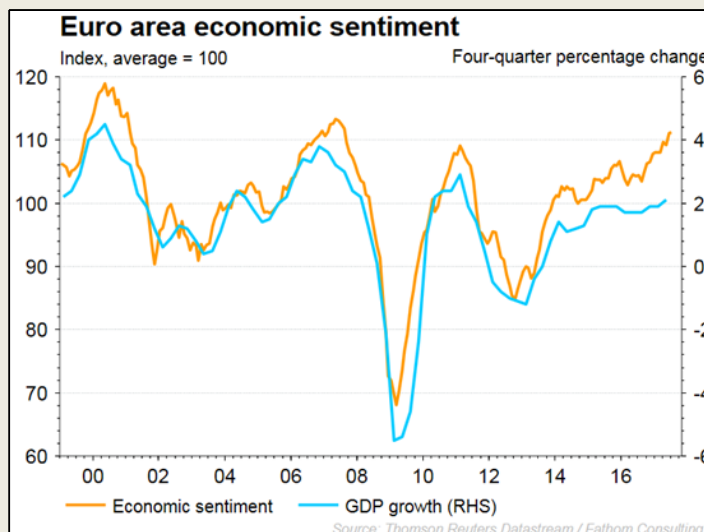
Among the major countries within the euro area that have already published their national accounts data, the results are relatively positive. Quarterly growth in Spain and Austria edged up, and France grew by a relatively healthy rate of 0.5% quarter-on-quarter for the third quarter in a row. In contrast, Belgium's GDP growth moderated in the second quarter. The flash estimate on German GDP will be published on August 15th, but monthly economic data suggest that second quarter economic growth will be robust.

Italy is expected to release its national accounts report on August 16th, and monthly data suggest the country will probably show a modest recovery. Based on national data, it seems that both domestic demand and foreign trade growth supported Europe's economic growth. According to French national accounts data and other major countries' monthly trade data, it seems that net exports have had a positive contribution as well to second quarter economic growth.

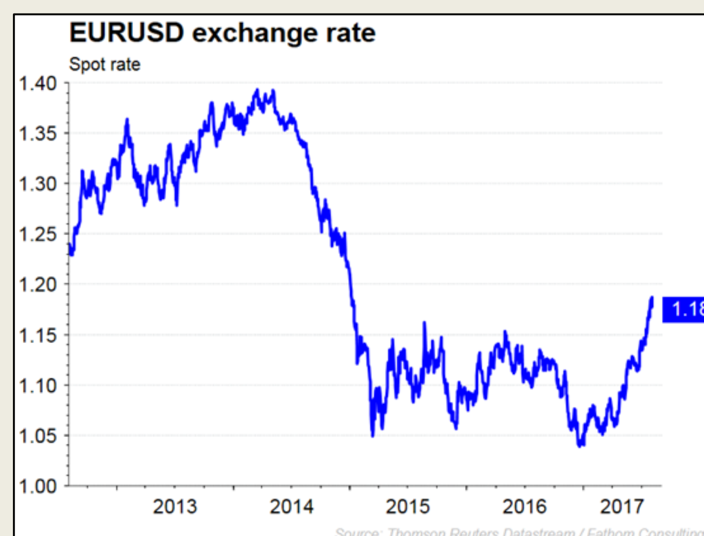
***Economic growth is expected to remain solid in the third quarter:*** Recently released business and consumer surveys are mixed, but they all point to further solid economic growth in the beginning of the third quarter of the year. Based on a survey by the European Commission, eurozone economic activity rose strongly in July as the ESI (Economic Sentiment Indicator) reached its highest level since August 2007. Moreover, although the PMI (Purchasing Managers' Index) moderated slightly in July, it still

points to solid growth of around 0.6% quarter-on-quarter, similar to the growth rate in the second quarter.

Overall, based on the economic surveys and other leading indicators, such as new orders and employment data, we expect further growth in the third quarter of the year. However, growth within the euro area countries is still unequal, and the growth outlook varies from country to country. Some of the countries that still suffer from economic weakness, in tandem with relatively high financial risks, include Italy and Greece. Political risk, which has receded recently, remains an important factor. Due to the recent data and improved outlook, we recently upgraded our eurozone GDP growth estimate for 2017 to 1.9% from 1.8%.




**Inflation is expected to remain low in the short-run, at least as wage growth remains muted and the euro appreciates:** According to flash estimates, eurozone inflation remained unchanged at 1.3% in July. Meanwhile, core inflation increased for the second month in a row and it stands now at 1.2%. Some of the rise is a result of the recovery in services inflation since last March that was driven by seasonal factors (tourism components) and is likely to subside in the coming months, and may weigh on core inflation in the short-run. Moreover, despite the recent 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, 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 continuing spare capacity, which is being reflected in low wage growth after a multi-year moderation and negative output gap in some of the major eurozone countries,

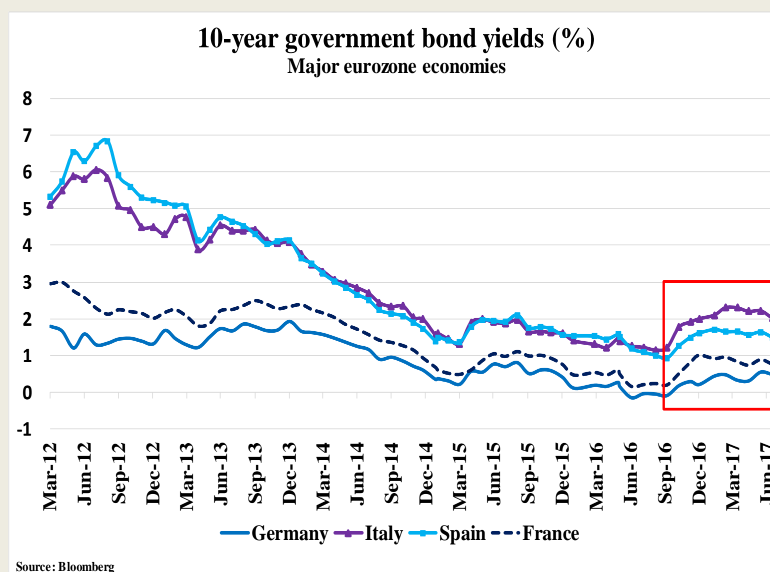


including Italy and France. In addition, the further appreciation in the exchange rate of the euro may also weigh on import price and CPI inflation.

**ECB: "reassess the monetary policy parameters sometime until the autumn":** At its monetary meeting on July 20th the ECB kept its monetary policy unchanged. The ECB repeated that the interest rates will "remain at their present levels for an extended period of time, and well past the horizon of our net asset purchases". Furthermore, the ECB confirmed their net asset purchases program, which is intended to run until the end of December 2017, "or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim." One of the main messages in the last monetary meeting was that the ECB will reassess the monetary policy parameters by the autumn (September/October). This is mainly due to the further improvement in economic activity. In the press conference that followed the monetary meeting, the ECB's president, Mario Draghi, said that "after a long time, we are finally experiencing a robust recovery, where we only have to wait for wages and prices to move towards our objective".

With respect to inflation, the ECB appears confident it will achieve the inflation targets, being aware that "keeping the current stimulus in place is needed as the recovery is conditional on significant monetary stimulus". Based on the ECB's forward guidance, we continue to estimate that the first hike may not occur before the end of 2018 - conditional on an improvement in the inflation outlook. This will be in tandem with further moderate and gradual tapering of its QE purchases, most likely by the end of the current year or in the beginning of next year.

Despite the hawkish comments, eurozone government bond yields dropped, in contrast to the trend in the past few months, as geo-political risks have increased recently (sanctions on Russia and North Korea), and the eurozone inflation outlook 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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